Economic
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EPI comment on the examination of the fiduciary rule

Testimony • By Heidi Shierholz • April 17, 2017

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Attention: Fiduciary Rule Examination, RIN 1210-AB79

To the Department of Labor:

People tend to be shocked when they learn that unlike lawyers and doctors, all financial advisers are not required to act in their clients' best interest, and, instead, can legally do things like steer clients towards investments that provide the adviser with a commission but provide a lower return to the client. This kind of "conflicted" advice costs retirement savers $17 billion per year. The fiduciary rule closes this loophole, requiring that financial advisers provide retirement investment advice that is in the best interest of their clients. This is a common-sense protection for savers. People who have worked hard to save for retirement need and deserve to know that when they go to a financial adviser, they are receiving honest advice, not a sales pitch in disguise.

The rule has been delayed for 60 days in order to conduct an "examination" of its likely impact, as directed by President Trump in a Presidential Memorandum. Even the 60-day delay will negatively impact working people's retirement accounts, and not just during the period of the delay. In the proposal to delay the rule by 60 days, the Department noted that the losses that retirement savers experience from being steered towards higher-cost investment products during the delay "would not be recovered, and would continue to compound, as the accumulated losses would have reduced the asset base that is available later for reinvestment or spending." The Economic Policy Institute estimates that the 60-day delay will cost retirement savers' IRAs $3.7 billion over the next 30 years —and this estimate is an undercount because it

does not include other subjects of potential conflicted advice, like 401(k)s. Conflicted advice is fleecing retirement savers and they need the protections of the fiduciary rule.

In the Presidential Memorandum directing the Department to conduct an examination of the fiduciary rule, the Department was directed to prepare an updated economic analysis concerning the likely impact of the final rule.

In what follows, I make three main comments regarding this examination:

1. The fiduciary rule has already been thoroughly analyzed and vetted, resulting in a finding that the rule will "support consumer choice, and deliver substantial gains for retirement investors and economic benefits that more than justify its costs." The Department should look to the extensive Regulatory Impact Analysis of the final rule to answer the questions raised in the Presidential Memorandum.
2. What is needed to meaningfully further examine the impact of the rule is not additional predictions about its impact, but data based on the actual experience of implementation. The Department should implement the rule and conduct a detailed review of the implementation in three to five years to assess the implementation and determine at that time if any revisions are needed.
3. In the economic analysis of the fiduciary rule, the Department used a highly rigorous and conservative methodology in estimating costs and benefits of the rule – a methodology that has withstood judicial scrutiny on multiple occasions. If, as a result of the current examination, the Department does decide to publish for notice and comment a revised rule, it must either use the same methodology in estimating costs and benefits of the new rule, or justify any change in methodology. If there is a justified change in methodology, the Department must identify and document the effects the change in methodology have on any new estimates. This would be necessary in order for the public to have the opportunity to rigorously assess both the new estimation methodology and the economic impacts of the revised rule.

I will take these points in turn.

1. The fiduciary rule has already been thoroughly analyzed and vetted; the Department should look to the extensive Regulatory Impact Analysis of the final rule to answer the questions raised in the Presidential Memorandum.

The 382-page economic analysis concerning the likely impact of the final rule was the end-product of a lengthy (roughly six-year) and exhaustive process that incorporated, among other things, the feedback from four days of hearings, more than 100 stakeholder meetings, thousands of public comments, and a detailed review of the academic literature. On pages 6 and 7 of the economic analysis, this process is explained:

"As part of the 2015 Proposal, the Department conducted an in-depth economic assessment of current market conditions and the likely effects of reform and conducted and published a detailed regulatory impact analysis. That analysis examined a broad range of evidence, including public comments on the 2010 Proposal; a growing body of empirical, peer-reviewed, academic research into the effect of conflicts of interest in

advisory relationships; a recent study conducted by the White House Council of Economic Advisers; and some other countries' early experience with related reform efforts, among other sources. ..The Department took significant steps to give interested persons an opportunity to comment on the 2015 Proposal and to participate in the rulemaking process. The Department initially provided a 75-day comment period, ending on July 6, 2015. In response to stakeholder requests, the Department extended the comment period until July 21, 2015. The Department also held a four-day public hearing on the new regulatory package in Washington, D.C. on August 10-13, 2015, at which over 75 speakers testified. A significant portion of the hearing on August 11 was devoted expressly to testimony from stakeholders specifically regarding the Department's Regulatory Impact Analysis. The Department made the hearing transcript available on EBSA's website on September 8, 2015, and provided additional opportunity for interested persons to comment on the proposed regulation and PTEs and hearing transcript until September 24, 2015. In total, the Department received over 3,000 individual comment letters on the proposal. The Department also received over 300,000 submissions made as part of 30 separate petitions submitted on the proposal. The comments and petitions came from consumer groups, plan sponsors, financial services companies, academics, elected government officials, trade and industry associations, and others, both in support and in opposition to the rule. The Department also held numerous meetings with interested stakeholders at which the Regulatory Impact Analysis was discussed."

That exhaustive analysis finds that conflicted advice is widespread and causes serious harm to retirement investors, and that the fiduciary rule will "support consumer choice, and deliver substantial gains for retirement investors and economic benefits that more than justify its costs."

The Department can look to the economic analysis it has already done to answer the questions raised in the Presidential Memorandum. For example, the memorandum raised the question of whether the anticipated applicability of the final rule has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings products, information, or advice. This question was addressed in multiple places in the Department's analysis. For example, Section 2.10, which is titled "Reform Abroad," looks at the experiences of other countries in implementing similar standards. Among other examples, this section includes an investigation into the United Kingdom's Retail Distribution Review (RDR) — which aimed to reduce conflicts of interest in the UK — and concludes that "based on the available data from post-RDR reports since 2013, the Department believes that the RDR has not significantly reduced availability of advice, and any RDR-related advice gap is likely minor and temporary. Simple, affordable advice, which is mostly likely to benefit many small investors, was scarce before the RDR, but indications are the market is evolving to meet these needs under the RDR." Section 2.9.2.1 describes how the Best Interest Contract Exemption "will permit investment advice fiduciaries 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." Sections 2.9.1 and 4.3.1.2 explain how access to investment education will be protected. Section 8.4.4 and Appendix C, along with a Q&A on low- and middle-income "small" savers (https://www.dol.gov/ebsa/regs/QA-

SmallSavers.pdf), discuss how the rule will likely impact small savers, noting in the Q&A on small savers that "advisers will still be able to deliver advice to all savers and charge for the costs of the advice delivered – the only difference is that this advice must now be in savers' best interests."

The Department's economic analysis also explicitly dealt with the question of whether the anticipated applicability of the final rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees. Section 8.4.1, for example, reviews the financial industry's responses to the final rule and finds that it is likely that "those responses will add to the plan and IRA investor gains predicted by this analysis." In particular, that section concludes that "advisory firms' responses to the final rule and exemptions (and to related changes in consumer demand and competition) will impact the labor market for advisers. These dynamics may involve frictional costs and have distributional effects. For example, advisers may migrate from advisory firms where conflicts had been most deeply embedded to firms that are well situated to efficiently provide impartial advice compliant with the final rule and exemptions. 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 Department's analysis has also directly addressed the question in the President's Memorandum of whether the final rule is likely to cause an increase in litigation and an increase in prices for access to retirement services. In fact, there is an entire section (Section 5.4.1) in the Department's regulatory impact analysis entitled "Increased Insurance Premiums/Litigation." The section concludes that "(1) premiums for these affected advisers could be expected to increase by approximately 10 percent due to their new fiduciary status, (2) insurance is priced on a per-representative basis; and (3) the average insurance premium is approximately $3,000 per representative. Based on the foregoing, the estimated 10 percent premium increase would be approximately $300 per insured representative." These costs are already factored in to the Department's cost-benefit analysis.

2. What is needed to meaningfully further examine the impact of the rule is not additional predictions about its impact, but data based on the actual experience of implementation.

As described above, the Department has already undertaken an exhaustive analysis of the likely impact of the rule, addressing – among many other things –the questions outlined in the Presidential Memorandum. This comprehensive analysis resulted in the determination that the rule will "support consumer choice, and deliver substantial gains for retirement investors and economic benefits that more than justify its costs." It is not feasible to get a meaningfully more accurate assessment without letting the rule take effect and assessing the impact based on actual experiences and data. The Department should implement the rule in its current form and conduct a detailed review of the implementation in three to five years to assess the implementation and determine at that time if any revisions are needed. This would be in line with the retrospective reviews mandated by Section 6 of EO 13,563 on Improving Regulation and Regulatory Review: "to facilitate the periodic review of

existing significant regulations, agencies shall consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned." During a retrospective review, the Department could use actual experiences and data – not predictions and extrapolations, which is by necessity what is being used now – to assess the impact. One reason it is important to implement the rule and do a later review based on actual data is that there is a very strong incentive for the financial industry to provide a biased assessment of the projected adverse effects of the rule, due to the fact that it continues to profit from the status quo.

Implementing the rule in its current form and then doing a review in three to five years using real data from the real experience of implementation and revising the rule at that time if the review suggests ways it could be improved is the path forward that is justified by the available evidence.

3. If the Department decides to publish for notice and comment a revised rule, it must either use the same methodology in estimating costs and benefits of the new rule it used in the existing rule, or fully justify any change in methodology. If there is a justified change in methodology, the Department must identify and document the effects the change in methodology had on any new estimates.

In estimating the gains to retirement savers and the costs to industry of the fiduciary rule, the Department was extremely rigorous and conservative. The methodology has withstood judicial scrutiny on multiple occasions, for example, in issuing an opinion upholding the fiduciary rule, a federal judge wrote "The Court finds the DOL adequately weighed the monetary and non-monetary costs on the industry of complying with the rules, against the benefits to consumers. In doing so, the DOL conducted a reasonable cost-benefit analysis."

If the Department decides to publish for notice and comment a revised rule, it must either use the highly vetted and approved methodology it used in the current rule, or fully justify any change in the approach.

The Department based its core methodology for estimating gains to consumers as a result of the rule on a highly rigorous, peer-reviewed academic paper (Christoffersen, S.E.K., Evans, R. and Musto, D.K. (2013), What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives. The Journal of Finance, 68: 201–235). This paper, unlike other papers in the broader literature on this topic, employs an approach that directly identifies the impact of conflicts of interest on performance. If the Department decides to base future estimates on a less rigorous or less directly applicable foundation, it must justify that change.

Notably, the paper the Department based its estimates on only identifies the effects of conflicts in one area of the IRA market, namely front-end-load mutual funds, where the conflicts are well measured. Thus, the quantified gains to retirement savers in the Department's cost-benefit analysis actually quantify gains in only a small fraction of the universe of types of investments and types of losses that conflicted advice produces. On page 9 of the Regulatory Impact Analysis, the Department summarizes all that its approach

leaves out, underscoring how profoundly conservative the estimates of the gains to retirement savers as a result of the rule truly are:

“The estimate does not reflect expected losses from so-called timing errors, wherein investors invest and divest at inopportune times and underperform pure buy-and-hold strategies. Such errors can be especially costly. Good advice can help investors avoid such errors, for example, by reducing panic-selling during large and abrupt downturns. But conflicted advisers often profit when investors choose actively managed funds whose deviation from market results (i.e., positive and negative “alpha”) can magnify investors’ natural tendency to trade more and “chase returns,” an activity that tends to produce serious timing errors. There is some evidence that adviser conflicts do in fact magnify timing errors. The quantified losses also omit losses that adviser conflicts produce in connection with IRA investments other than mutual funds. Many other products, including various annuity products, among others, involve similar or larger adviser conflicts, and these conflicts are often equally or more opaque. Many of these same products exhibit similar or greater degrees of complexity, magnifying both investors’ need for good advice and their vulnerability to biased advice. As with mutual funds, advisers may steer investors to products that are inferior to, or costlier than, similar available products, or to excessively complex or costly product types when simpler, more affordable product types would be appropriate. Finally, the quantified losses reflect only those suffered by retail IRA investors and not those incurred by plan investors, when there is evidence that the latter suffer losses as well. Data limitations impede quantification of all of these losses, but there is ample qualitative and in some cases empirical evidence that they occur and are large both in instance and on aggregate.”

Again, if the Department decides to base future estimates on a less rigorous and conservative approach, it must justify and document that change so the public has the opportunity to fully assess the new methodology.

In estimating costs to industry in the RIA, the Department was also extremely and deliberately conservative, (note: I adopt the Department’s use of the word conservative in regard to cost estimates, where conservative is defined as “erring on the high side” when estimating costs). First, the Department relied on industry cost estimates. Industry estimates are likely biased upward due to the strong incentive on the part of industry to show that the rule is very costly (due to the fact that industry profits from the status quo). Further, at virtually every turn in determining how to apply those industry data, the Department made conservative choices. For example, the Department very conservatively assumes there is no overlap between firms servicing ERISA plans and IRA investors, which means the number of affected firms is overestimated, leading to an overestimate of costs. This is described on page 247 of the cost benefit analysis

“A survey found that 41 percent of RIAs advise ERISA plans or are pension consultants, while 22 percent advise retail individuals. To provide a conservative estimate, the Department assumes that there is no overlap and therefore 63 percent of firms advise either an ERISA plan or IRA investors and will be affected by the rule. While the amount of overlap is not known the true value of the overlap is likely to be nearly complete as the expertise to provide service to IRAs would be similar to that needed to service plans”

As another example, the Department assumed there is no overlap between registered investment advisers (RIAs) who receive commissions and those receiving performance-based fees, leading to an overestimate of the number of affected investment advisers, and therefore an overestimate of costs. This is described on page 234 of the cost benefit analysis:

"In order to determine what share of RIAs are likely to require the ongoing use of an exemption and that these costs should be applied to, the Department turned to a Rand study for the SEC which reported that 13 percent of RIAs surveyed reported receiving commissions while 8 percent reported specifically receiving performance-based fees. Taking a conservative approach that, all else equal, creates a tendency towards overestimation of costs, the Department assumes no overlap between these two groups and estimated that 21 percent of affected RIAs will have to incur the costs described above."

These are just two of many examples of conservative choices made in developing the cost estimates; the word "conservative" (or some form of it) was used, by my count, 19 separate times in the chapter on costs alone in the Regulatory Impact Analysis. If, as a result of the current examination, the Department does decide to publish for notice and comment a revised rule, it must either use the same conservative approach in estimating costs, or fully justify any change in methodology. If there is a justified change in methodology, the Department must identify and document the effects of the change in methodology on the new estimates so that they can be clearly distinguished from the effects of the proposed change in policy.

The following example illustrates why this clear documentation of any change in methodology is so crucial to the public's assessment of both the new methodology and the proposed policy. Consider the case where the Department publishes a proposed rule for public comment that is weaker than the current rule, and as a part of the economic impact analysis of the proposed rule, it estimates that costs to industry are smaller than estimates of the current rule. If the Department uses a different methodology that, for example, makes less conservative assumptions than those used in the current economic analysis, the public must be given the information to assess how much of the reduction in the estimate of costs is due to the effects of the new methodology and how much is due to the effects of the proposed change in policy. This would be necessary in order for the public to have the opportunity to rigorously assess both the new estimation methodology and the costs of the new proposed rule.

Sincerely,

Heidi Shierholz

Senior Economist and Director of Policy at the Economic Policy Institute in Washington, D.C.