Research

Primer on DOL Fiduciary Standards: Impact & Outlook

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On February 23, President Obama announced that his administration was moving forward with new regulations on financial advisers, commonly known as fiduciary standards. The U.S. Department of Labor (DOL) first proposed such a rule in 2010 to protect consumers from professional advisers who financially benefit from recommending certain investments. Fiduciary standards legally bind an adviser to act in a client's best interest. This paper provides background on the regulation and its purpose, while also outlining the policy and market implications of DOL's rulemaking.

BACKGROUND

TABLE 1. TIMELINE OF ACTIONS, RULEMAKINGS, & RELATED EVENTS ON FIDUCIARY STANDARDS	
JULY 2010	DODD-FRANK ACT EFFECTIVE
OCTOBER 2010	NPRM: CONFLICT OF INTEREST RULE-INVESTMENT ADVICE FROM DOL/EBSA
JANUARY 2011	SEC RELEASES STUDY ON FIDUCIARY STANDARDS FOR BROKER-DEALERS & INVESTMENT ADVISERS
MARCH 2011	DOL/EBSA HOLDS PUBLIC HEARINGS ON CONFLICT OF INTEREST RULE-INVESTMENT ADVICE
SEPTEMBER 2011	DOL/EBSA WITHDRAWS NPRM ON CONFLICT OF INTEREST RULE-INVESTMENT ADVICE
MARCH 2013	RFI: DUTIES OF BROKERS, DEALERS, & INVESTMENT ADVISERS FROM SEC
JANUARY 2015	CEA MEMO ON FIDUCIARY STANDARD REPROPOSAL LEAKED
FEBRUARY 2015	WHITE HOUSE RELEASES FACT SHEET & CEA REPORT ON CONFLICTED ADVICE; REMARKS BY PRESIDENT OBAMA TO AARP
Note: Request for Information (RFI) & Notice of Proposed Rulemaking (NPRM)	

Section 913 of the Dodd-Frank Act directed the Securities and Exchange Commission (SEC) to study the existing regulatory framework governing broker-dealers and investment advisers and the impact of adding more stringent protections for investors.[1] It empowered the SEC to put in place those protections by issuing new rules on broker-dealers and investment advisers based on its findings.[2] Yet DOL moved forward with a notice of proposed rulemaking (NPRM) in October 2010, before the SEC was able to complete its study of the issue or promulgate related regulations.

DOL, with its original proposed rule, would have broadly redefined the circumstances under which a person is considered a fiduciary under the Employee Retirement Security Act of 1974 (ERISA). But following public comment[3] and bipartisan legislation passed in the House of Representatives[4], DOL ultimately withdrew its proposal in September 2011.

A reproposal of that rule has now been sent to the White House Office of Management and Budget (OMB) for standard review and a formal NPRM will be published in the coming months, according to DOL.[5] While the text of the regulation has not yet been released, market participants will be looking for material changes from the original. With the release of a memo and report by the President's Council of Economic Advisers (CEA) and a speech to the AARP, the Obama Administration has touted the DOL rulemaking as an effort to stop Wall Street firms from hurting middle class families and workers.[6] SEC Chair Mary Jo White also recently stated her personal desire for the SEC to move forward with its own rulemaking on fiduciary standards, setting up a potential for overlapping regulations.[7]

That potential for overlap between DOL and SEC rulemakings was one concern repeatedly cited by both lawmakers and industry stakeholders when DOL's original proposal was released and will likely reappear in response to the news that both agencies are moving forward on the issue. Table 2 outlines how the authority to issue regulations relating to fiduciary standards compares between the two government agencies.

TABLE 2. COMPARISON OF DOL & SEC REGULATORY AUTHORITY ON FIDUCIARY STANDARDS

	U.S. DEPARTMENT OF LABOR (DOL)	***SECURITIES & EXCHANGE COMMISSION (SEC)***
WHO:	Advisers for Retirement Account Investments	Broker-Dealers and Investment Advisers
WHAT:	DOL may redefine the circumstances under which a financial adviser would be considered "fiduciary," though those standards would be limited to advisers giving advice for retirement plan investments that fall under ERISA	SEC could impose a uniform fiduciary standard of care for all broker-dealers and investment advisers providing personalized investment advice
WHEN:	A reproposal of a withdrawn regulation is expected to be formally proposed in the coming months, followed by a period of pubic comment	The SEC Chair has stated a desire to move forward with a uniform fiduciary standard and SEC staff has been studying the issue, but there is no formal timeline for when a regulation may be proposed

HOW:	DOL can set standards for retirement plans under the Employee Retirement Income Security Act of 1974 (ERISA)	Section 913 of the Dodd-Frank Wall Street Reform & Consumer Protection Act gave SEC the authority to establish a uniform standard of care for broker-dealers and investment advisers

POTENTIAL IMPACTS ON LOW- AND MIDDLE-INCOME SAVERS

Advocates both favoring and opposing DOL's actions have cited the potential impacts on low- and middle-income savers to support their respective arguments. In particular, administration officials have emphasized how regulations could curtail the costs of conflicted advice on retirement savings as part of the president's "middle-class economics" agenda. Yet industry stakeholders and policymakers have expressed concern that such a singular focus on the cost of conflicted advice (a cost under dispute) ignores the merits of alternative proposals and the potential for far-reaching impacts on consumers, including the possibility of higher costs for savers seeking investment advice.

In its 2010 NPRM, DOL included an impact analysis associated with its rulemaking.[8] In its assessment, DOL estimated that the monetized costs of the rule would be $17.7 million on affected entities.[9] Yet many found this cost estimate narrowly focused (since it only factored in the costs for companies to review and implement the regulation) and fundamentally inadequate. For example, a comment letter from the American Bankers Association noted, "…In its regulatory analysis, the Department does not fully or realistically quantify the Proposal's burdens and costs."[10] In particular, DOL did not study any impact the proposal could have on the costs and availability of professional financial advice to consumers or comprehensively assess viable regulatory alternatives to their proposal. For its reproposal, DOL has assured the public, "The new proposal will include a robust economic analysis, which will detail the costs of conflicts of interest and the expected impact of the rule." [11]

Closer Look at CEA's Findings & Market Perspectives

In conjunction with the president's recent push forward with DOL's fiduciary standard reproposal, the CEA released a white paper that includes a review of academic research on the topic and its own estimate of the costs to consumers of conflicted advice, an estimate being widely cited by administration officials in support of DOL's rulemaking.[12] The report's authors use academic research to produce their own estimate of a simplified cost of conflicted advice, relying heavily on a paper by Christoffersen et al.[13]

The CEA's paper makes many assumptions but ultimately concludes that investments influenced by conflicted advice underperform by 100 basis points. They then apply that estimate of underperformance to the entire value of load mutual funds and annuities in IRA assets, approximately $1.66 trillion, and conclude that conflicted advice costs Americans approximately $17 billion annually. However, a recent paper by NERA Economic Consulting analyzed the CEA report and noted at least six major flaws with their analysis of the economic literature and cost estimate[14]:

1. The academic literature CEA cited does not simply provide for the conclusion that all IRA assets in load mutual funds and annuities underperform by 1 percent annually. Instead, CEA made many assumptions and extrapolations of more complex academic research to arrive at a simplistic aggregate cost on American savers; the reality is much more nuanced.
2. CEA did not justify or support with academic literature why annuities in IRAs were included along with load mutual funds as total assets when calculating their cost of conflicted advice.
3. No attempt was made to quantify or factor in the benefits provided by brokers, some intangible, such as

customer service, risk reduction, and encouragement to invest more that may outweigh fees.

4. The assumptions made by CEA rely more heavily on studies that look at the average performance of funds instead of the more realistic tracking of investor performance within a fund.
5. The paper does not explore the costs and benefits of an alternative system. For example, while it assumes that implementing DOL's proposal would not materially impact the cost of investment advice for American savers, that assessment is not supported with any kind of quantitative analysis.
6. Comparisons to similar initiatives abroad categorically ignore studies that have shown those actions increased brokers' fees and decreased access to investment advice for some consumers.

PRIMARY CONCERNS & CRITICISMS

Here are a few of the most commonly cited criticisms of DOL's rulemaking on fiduciary standards for retirement investment advisers:

DOL's fiduciary standard rulemaking will reduce access to retirement savings options and increase the costs of seeking investment advice for low- and middle-income Americans.

While the Obama Administration attempted to examine the cost of conflicted advice in its CEA report and memo, some argue that the imposition of DOL's fiduciary standards have their own costs and benefits, which DOL may not have fully explored despite widespread criticism of its original proposal. A new regulatory regime could increase costs on brokers' who may then elect to raise fees to cover compliance with new rules and/or drop low-balance clients who are no longer profitable. Additionally, as SEC Commissioner Daniel Gallagher remarked, "The White House memo is clearly premised on a belief that the status quo is deficient. But it ignores the main reason for the mitigation-based approach to conflicts and related disclosures: Investors benefit from choice; choice of products, and choice in advice providers."[15] A number of other policymakers, academics, and industry stakeholders have also expressed concern over how these unintended consequences may make DOL's proposal better politics than policy.[16][17][18]

DOL failed to consult SEC in drafting both the original proposal and re-proposal.

Concern that the DOL original rule would conflict and confuse the regulatory regime regarding investment advisers and broker-dealers prompted lawmakers and others to push for greater cooperation in any reproposal. Addressing those concerns, DOL Assistant Secretary for the Employee Benefits Security Administration Phyllis Borzi testified that DOL and SEC "are actively consulting with each other and coordinating our efforts."[19] Yet according to SEC Commissioner Gallager, "…despite public reports of close coordination between DOL and SEC staff, I believe this coordination has been nothing more than a 'check the box' exercise by DOL designed to legitimize the runaway train that is their fiduciary rulemaking."[20] Chairman John Kline (R-MN) and Subcommittee Chairman Phil Roe (R-TN) of the House Committee on Education and Workforce similarly agreed and have since requested documents and communications related to the DOL's consultation with the SEC to be furnished to the Committee.[21]

Professional financial advice is already highly regulated; the appropriate avenue for further regulatory changes is not through DOL.

Lawmakers and others have expressed concern about increased regulations on professional financial advice stemming from DOL instead of first allowing the SEC to finish its ongoing review of the current regulatory regime and rulemaking. A bipartisan bill passed the House of Representatives in October 2013 that would have

cemented the need for SEC to move before DOL, but was not taken up by the Senate.[22] That bill has been reintroduced to prevent DOL from moving forward with its current reproposal.[23] SEC Chair Mary Jo White's recent comments that she intends for the SEC to pursue a uniform fiduciary standard of care for broker-dealers and investment advisers may add further concern that regulators are pursuing two separate and costly rulemakings to tackle the same issue.[24] Professional financial advisers are additionally subject to disclosure, examination, and other reporting regulations from SEC and the Financial Industry Regulatory Authority (FINRA).

Evidence from similar regulatory initiatives abroad does not support adoption of DOL's rule.

Administration officials and the recent CEA report on conflicted advice reference the experiences of other countries who have enacted similar reforms on investment advisers without negative market impacts despite much of the literature expressing uncertainty about the full effects of regulatory changes and some negative impacts for low-balance investors.[25]

CONCLUSION

DOL's rulemaking on fiduciary standards may have serious impacts not only for financial advisers but also on American workers saving for their retirement. While perhaps well intentioned, policymakers and industry stakeholders have shown that moving forward with these rules could fundamentally impact the ability of low- and middle-income savers to affordably seek qualified investment advice for their retirement futures. In the coming months, DOL will release the text of its rulemaking. As the public, industry stakeholders, and policymakers assess that proposal, a thorough analysis of the proposal's costs and benefits and how it dovetails with ongoing efforts at SEC will be vital.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1824 (2010); http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf