

Impact of the DOL Fiduciary Rule on the Capital Markets

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Committee on Financial Services
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*I thank Meghan Milloy for her assistance in preparing this testimony. The views expressed here are my own and not those of the American Action Forum.

Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to appear today and share my views on the impact of the Department of Labor's (DOL's) fiduciary rule on capital markets. And thank you for your efforts to repeal the rule and to enact a rule that is more workable and effective for both consumers and the retirement advice market.

When the fiduciary rule was finalized in 2016, it was (and still is) the most expensive regulation that year, with \$31.5 billion in total costs and \$2 billion in annual burdens¹ on the companies—many of which are small businesses – and advisors it affects. Although the rule has not yet been fully implemented, research from the American Action Forum (AAF) has found that several major companies have already left part of the brokerage business or are drawing down their business and/or switching to a fee-based arrangement. From these companies alone, reported compliance costs have already topped \$100 million, affecting 92,000 investment advisors, \$190 billion in assets, and at least 2.3 million consumers.²

Advocates for DOL's fiduciary rule argue that it is necessary to prevent bad actors from prioritizing their own interests above those of their clients. They argue that without it, consumers will be short-changed in their retirement savings by being steered into investments that don't work for them. On its face, a fiduciary standard is widely supported throughout the industry. The only issue is the best way to implement a standard. The problem with DOL's fiduciary rule is not the requirement to act in a client's best interest, but the dissuasion of commission-based accounts and the imposition of the Best Interest Contract (BIC) Exemption, which exposes financial advisors to the risk of litigious clientele.

Despite its length and complexity, the fiduciary rule can be broken down into two basic paths of compliance for advisors: 1) Moving to a primarily fee-based model or 2) Entering into the BIC with clients. The consequences resulting from each of these options are explored in detail below.

1. Moving to a primarily fee-based model

Created by the Employee Retirement Income Security Act of 1974 (ERISA), individual retirement accounts (IRAs) have become an integral part of Americans' retirement saving strategies. Based on data from the Internal Revenue Service (IRS), by the end of 2014, 57.3 million Americans owned at least one IRA, all totaling nearly \$7.3 trillion in assets.

¹ See,

<http://regrodeo.com/?year%5b0%5d=2016®ulation=Definition%20of%20the%20Term%20%E2%80%9CFiduciary%E2%80%9D;%20Conflict%20of%20Interest%20Rule--2016--3150000000>

² <https://www.americanactionforum.org/insight/fiduciary-rule-already-taken-toll-100-million-costs-fewer-options/>

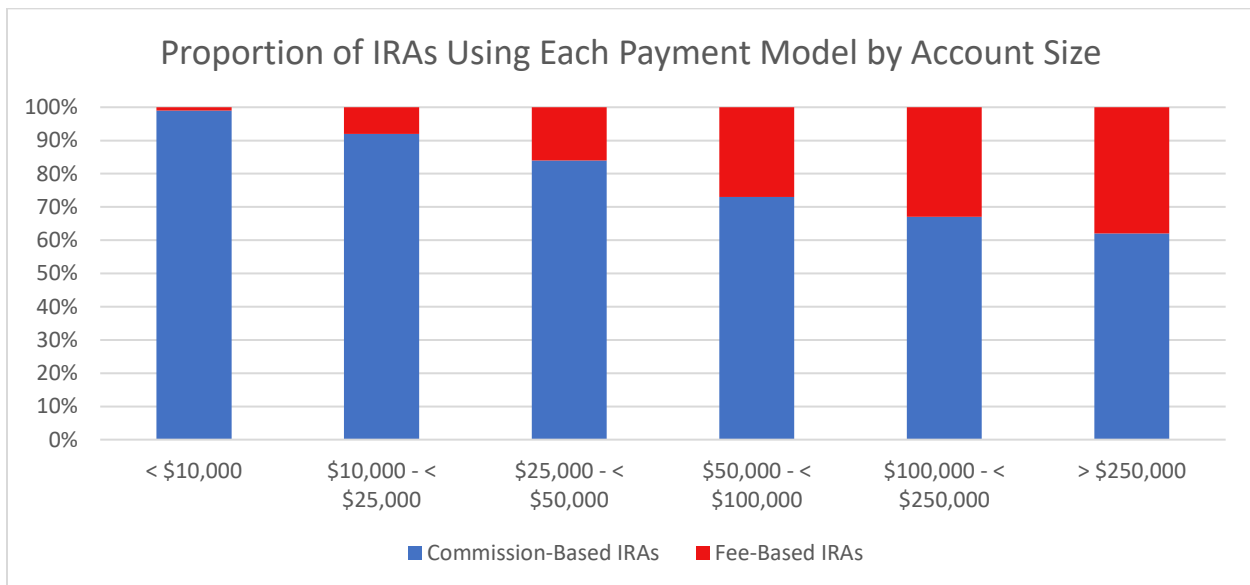
Table 1. Taxpayers with Individual Retirement Arrangement (IRA) Plans, by Filing Status and Gender, Tax Year 2014

(All figures are estimates based on samples--money amounts are in thousands of dollars)

Filing status and gender	Number of taxpayers			Taxpayers with IRA accounts reported on Form 5498 or Form 1099-R					
	Total	With pension coverage on Forms W-2 [1]	Eligible to make IRA contributions [2]	Roth conversions [3]		Withdrawals [4]		End-of-year fair market value of IRAs	
				Number of taxpayers	Amount	Number of taxpayers	Amount	Number of taxpayers	Amount
	(1)	(2)	(3)	(10)	(11)	(12)	(13)	(14)	(15)
All taxpayers	202,530,196	71,427,452	155,481,150	488,827	8,255,152	17,985,606	275,107,505	57,279,386	7,291,587,418
Men	98,259,891	36,501,418	79,643,021	272,918	5,326,927	8,939,710	167,122,701	28,146,406	4,483,874,245
Women	104,270,305	34,926,034	75,838,129	215,909	2,928,225	9,045,896	107,984,804	29,132,980	2,807,713,173
Taxpayers filing joint									
returns, total	110,797,852	41,879,949	77,554,816	367,962	6,285,405	11,600,461	185,056,156	40,120,901	5,495,436,967
Men	55,447,186	23,033,568	42,299,478	207,034	4,366,251	6,805,223	134,236,273	21,140,438	3,809,952,218
Women	55,350,666	18,846,381	35,255,338	160,928	1,919,154	4,795,238	50,819,883	18,980,463	1,685,484,749
Taxpayers filing non-joint									
returns, total	91,732,345	29,547,502	77,926,336	120,865	1,969,747	6,385,145	90,051,348	17,158,485	1,796,150,451
Men	42,812,705	13,467,850	37,343,544	65,884	960,676	2,134,487	32,886,428	7,005,968	673,922,027
Women	48,919,640	16,079,652	40,582,792	54,981	1,009,071	4,250,658	57,164,920	10,152,517	1,122,228,424

[1] Number of taxpayers with pension coverage is determined from Form W-2 box 13, which indicates participation in a retirement plan.
 [2] Those individuals qualifying under Federal Income Tax law to make deductible or non-deductible contributions to a traditional IRA and/or Roth IRA plan.
 [3] Owners of traditional IRAs were able to convert them to Roth IRAs as long as they met the income limitations for making Roth IRA contributions. Under certain circumstances, SEP or SIMPLE IRAs could also be converted to Roth IRAs; however, these amounts could not be identified separately for the purpose of these statistics.
 [4] Withdrawals are reported on Form 1099-R; does not include withdrawals for the purpose of rollovers to other IRA accounts if the transfer was made by the trustee; Roth IRA conversions are shown separately.
 For additional explanations, see Bryant, Victoria and Jon Gober, "Accumulation and Distribution of Individual Retirement Arrangements, 2010", SOI Bulletin, Fall 2013, Volume 33, Number 2.
 Note: Details may not add to total due to rounding.
 Source: Matched file of Forms 1040, 1099-R, and 5498 for Tax Year 2014.
 IRS, Statistics of Income Division, Individual Retirement Arrangements Study, September 2016.

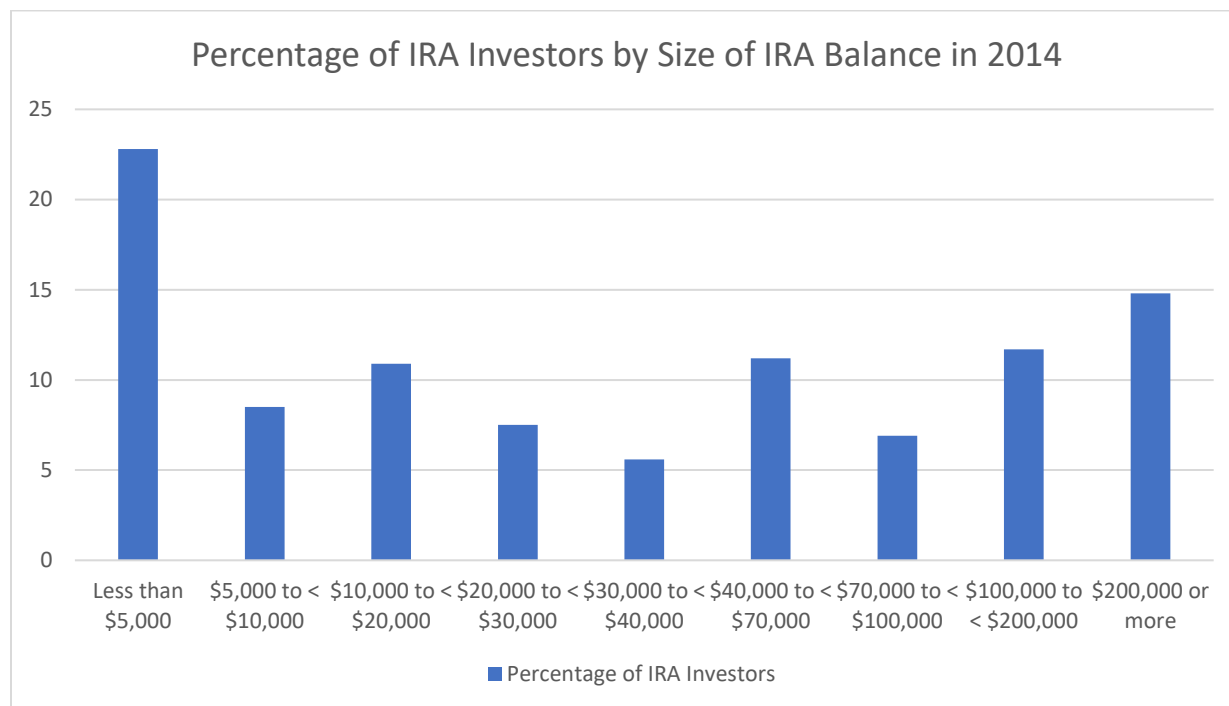
In 2011, a survey of 25.3 million IRA accounts³ found that a large majority of IRA investors opted for a commission-based instead of a fee-based arrangement, and that those investors with lower IRA account balances opted for a commission-based arrangement at higher rates than those with higher account balances as seen in the chart below.⁴



³ <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32/oliverwymanreport.pdf>

⁴ Source, Oliver Wyman Study, 2011

In a 2014 study, the Investment Company Institute (ICI) found that nearly 23 percent of the 57.3 million Americans with IRAs have balances less than \$5,000, over 42 percent have less than \$20,000, and almost 74 percent have less than \$100,000.⁵



All of this data is important in understanding the fiduciary rule’s effects on consumers. The fiduciary rule will force many investment advisors to move away from a commission-based model to a fee-based model in order to avoid any possibility of an apparent conflict of interest. In fact, some firms have already announced⁶ that they are doing away with their commission-based IRAs entirely. This presents two major problems for consumers. First, fee-based accounts are much more expensive for investors. As Morningstar explains⁷, fee-based accounts yield upwards of 50 percent more revenue for firms than commission-based accounts because “[f]ee-based accounts are already under a fiduciary standard of care that is defined by the Securities Exchange Commission (SEC). This SEC fiduciary standard requires increased monitoring, legal liability, and typically is accompanied with a higher service level than commission-based accounts, so clients are charged more.” By way of background, the reason DOL is involved in a developing a fiduciary standard is because of its oversight of ERISA and the retirement plans under it, which are the only ones covered by this rule.

One study found⁸ that advisors earn 0.54 percent on commission-based accounts versus 1.18 percent on fee-based accounts. With nearly \$7.3 trillion of assets in IRAs, that’s a difference

⁵ Source: ICI’s IRA Investor Database

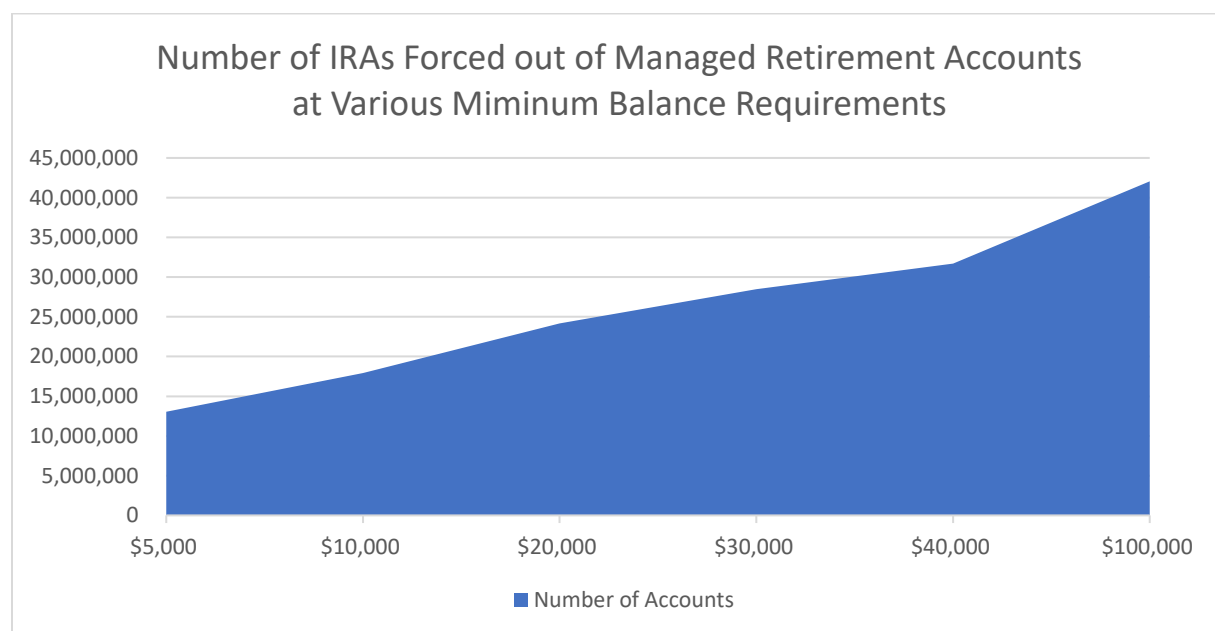
⁶ <https://www.ml.com/articles/delivering-a-higher-standard-of-care.html>

⁷ <http://ibd.morningstar.com/article/article.asp?id=733096&CN=brf295>, <http://ibd.morningstar.com/archive/archive.asp?inputs=days=14;frmtId=12,%20brf295>

⁸ http://www.pricematrix.com/cms/wp-content/uploads/PriceMatrix-Insights_Transitioning-To-Fee_English.pdf

between consumers paying a total of \$39.4 billion or \$86 billion in fees each year. This is an average of \$813 per IRA account holder – an unaffordable amount for many.

The second major problem is that because fee-based accounts mean increased monitoring, liability, and servicing, advisors will be forced to require higher minimum balances in order to remain financially viable. For example, Edward Jones will require⁹ investors to have \$100,000 in retirement assets to open a fee-based IRA, whereas other firms will require¹⁰ minimum balances of \$20,000 or \$30,000. Looking back at the third chart above, even with a minimum account balance requirement of \$20,000, over 42 percent of IRA holders will be forced out of managed retirement accounts and almost half of all IRA holders will be forced out if that minimum is increased to \$30,000. Even with a minimum balance requirement of just \$5,000, over 13 million accounts will fail to qualify for managed advice.



In 2013, the Retail Distribution Review initiative (RDR) was implemented in the United Kingdom. It's not an exact match of DOL's fiduciary rule, in that it explicitly forbids commission-based accounts, but it is a close-enough comparison to merit attention. Since the RDR was implemented, several studies¹¹ have looked at its effects on investment advisors and their clients. Without getting bogged down in the details because it is, in fact, an imperfect comparison, I would be remiss to ignore them completely.

The UK's Financial Conduct Authority (FCA) conducted a review in 2016 of the changes in the retirement advice market as a result of the RDR. One of the more telling findings is that “over

⁹ <http://time.com/money/4459130/edward-jones-bans-funds-etfs-in-iras/>

¹⁰ <https://www.merrilledge.com/pricing#tab3>

¹¹ See, http://www.cass.city.ac.uk/_data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf and <https://www.fca.org.uk/publication/corporate/famr-final-report.pdf> and <https://www.fsb.co.za/NewsLibrary/FSB%20Retail%20Distribution%20Review%20Status%20as%20at%20December%202016.pdf>, for example.

the last two years, the proportion of firms who ask for a minimum portfolio of more than £100,000 has more than doubled, from around 13 percent in 2013 to 32 percent in 2015. The FCA's recent survey of advisors also supports this, suggesting that 45 percent of firms very rarely advise customers on retirement income options if those customers have small funds (i.e. less than £30,000) to invest."

Another review of the RDR's impact on the UK's financial advice market conducted by the Cass Business School at the City, University of London found that the enhanced requirements on advisors would drive advisors out of the investment advice market completely. "Advisor numbers fell from 40,000 at the end of 2011 to 31,000 by the start of 2013: we find that the remaining financial advisors are unduly optimistic about their own business prospects in the RDR world." Further, they found that "the average advisor expects to garner around £1,500 from each of roughly 150 clients to sustain the £220,000 of gross revenue that they tell us they require to function as a business. With fees averaging approximately 1 percent of assets under advisory this means that the average client will need to have around £150,000 in investible assets on average."

In sum, the fiduciary rule will force many IRA investors into fee-based accounts which, at a minimum, will noticeably increase the amount they pay their advisor each year, and, at a maximum, will cut them out of the investment advice market completely. Considering that the IRAs with the lowest account balances will be hit the hardest, it's reasonable to conclude that the fiduciary rule will do the most harm to those low- to middle-income retirement savers it was intended to protect.

2. Entering into the BIC with clients

The second option presented to investment advisors by the fiduciary rule is to enter into the BIC with their clients. Like the rule itself, on its face, the BIC sounds good – a best interest contract between advisor and advisee. But in reality, the BIC will open the door to excessive litigation, especially class action lawsuits. Specifically, the BIC exemption purports to¹² "allow entities such as registered investment advisors, broker-dealers, banks and insurance companies...and their employees, agents and representatives...that are ERISA or Code fiduciaries by reason of the provision of investment advice, to receive compensation that may otherwise give rise to prohibited transactions as a result of their advice to plan participants and beneficiaries, IRA owners and certain plan fiduciaries..."

In other words, the BIC exemption allows advisors to provide investment advice that may seem conflicted as long as they enter into a contract with their client stating that it is in the client's best interest, and, if the client decides that it's not, the client can sue them for breach of contract. And while it does allow for the inclusion of mandatory arbitration clauses, the BICs cannot waive the client's ability to file or participate in a class action lawsuit.

¹² <https://www.federalregister.gov/documents/2016/07/11/2016-16355/best-interest-contract-exemption-correction>

In 2016 alone, consumers filed nearly 4000 arbitration cases¹³ with the Financial Industry Regulatory Authority (FINRA) alleging some wrongdoing by broker-dealers. However, yet only 158 cases were decided in favor of the consumer. This means many broker-dealers spent significant time and money defending themselves, and perhaps unnecessarily. One could expect BIC litigation to fall along the same lines, but with the added threat of class action lawsuits and, at times, their resulting settlements.

One study estimated the costs¹⁴ of class action lawsuits under the BIC using historical restitution data from wealth management firms, claims on implied errors and omissions insurance policies, DOL monetary estimates, and previous settlements on retirement plan class actions. It found that the long-term costs for class action lawsuits is between \$70 million and \$150 million each year – in addition to DOL’s estimate of \$1.5 billion in ongoing costs. The study also found that the near-term class action settlements could exceed the long-term estimates by a multiple “as firms try to figure out how to determine, demonstrate, and document best interest.” Some strategic litigation could force targeted investment advisors into some extremely costly settlements – not as a result of their malpractice, but as a result of gray area in the law of the fiduciary rule and the BIC. The same study estimated that near-term class action settlements could decrease the operating margins on commission-based IRAs by 24 to 36 percent.

In an effort to curb potential litigation costs, investment advisors may purchase liability insurance. DOL’s cost estimates¹⁵ identify the increase in premiums at approximately 10 percent, or \$300 per year, but independent studies estimate that number to be much higher. In an Oxford Economics study¹⁶, researchers found that the potential cost of litigation stemming from the fiduciary rule was the greatest concern to investment advisors, largely because it is the area of the greatest unknown. Due to that uncertainty, the study does not give an exact estimate of the increase in the cost of insurance, but it does say, “importantly, from an economic perspective, the full cost of all this may be far larger than the ultimate amount spent on litigation – although that could end up being quite large as well. The cost of the uncertainty caused by the proposed rule could be far greater, as firms waste resources and forgo opportunities because of the risk of litigation...DOL assumes that Error and Omission insurance costs for some representatives will increase by 10 percent. This appears to be a wild underestimation of the potential costs of litigation, and the uncertainty it fosters as a result of the proposed rule.”

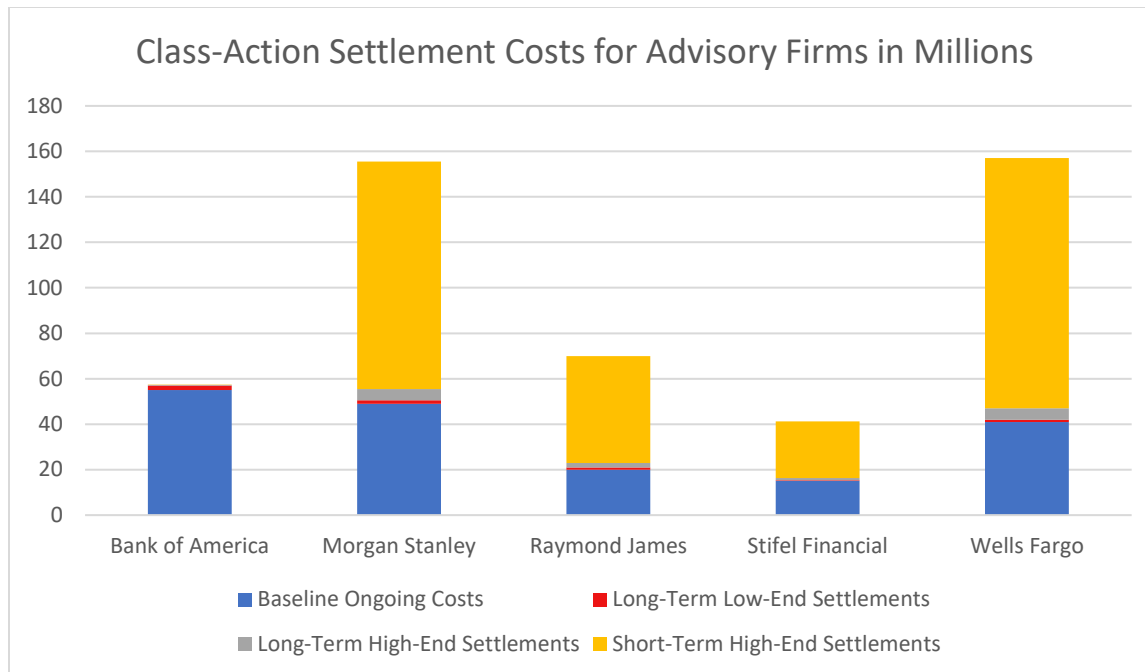
Morningstar estimates that, in the short-term, class action settlements could double the costs of the fiduciary rule for firms.

¹³ <https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>

¹⁴ <http://news.morningstar.com/articlenet/article.aspx?id=793268>

¹⁵ <https://www.federalregister.gov/documents/2016/04/08/2016-07924/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-10>

¹⁶ <https://d2rpg8wtqka5kg.cloudfront.net/311980/open20150818044300.pdf?Expires=1491316097&Signature=eM4yKMJvLWY2Js24XLrWtFXiTWfuyaz2dl2dH7opibHCvRfH0V7Tv5fZrJrH48C1CYoqWgUf3eyLa0d7NKytou20LlpKe4stR-hasRYiNCrj5F5spBLqW-PpKdu-WGZwb38TLkT-~YzE9-EtdqwTNkw11R1A7BVUyNkFAYsGmmVnOMYoXA0x~S86-6lyjPAHzo1HFetJV9CGNoC7FvZDnBGOVbMwtn6lQdQB9MIAYy7GrSDvg5K7-JMymZi1MzZR51vlcLcraAqtGuqkytFTqFKAjpbkspeEXnGuikBVp1cJ34geCQo9xWjbls9tjpnRJ5ekRjYMcs68SsgMNsVRg&Key-Pair-Id=APKAJVGCMR6FQV6VYIA>



Conclusion

At the end of the day, the fact remains that the fiduciary rule is the most expensive regulatory action of 2016 and the second most expensive non-environmental rule since 2005. Even DOL's own conservative compliance cost estimate is astronomical.

Based on the above data, the fiduciary rule has the potential to increase consumer costs by \$46.6 billion, or \$816 annually per account, in addition to the \$1500 in duplicative fees for retirement savers that have already paid a fee on their commission-based accounts that move the same investments into a fee-based account. Worse, based on a minimum balance requirement of \$30,000, the fiduciary rule could force 28 million Americans out of managed retirement accounts completely. Add that to \$150 million in annual litigation costs and operating margins reduced by 24 to 36 percent, which will ultimately be passed on to consumers, or will force firms out of the market, decreasing the supply of advice.

In short, the DOL's fiduciary rule will end up doing much more harm than good. Despite its good intentions, the costs it imposes – especially to low- and middle-income consumers – are far too high to justify implementing the rule as it is currently written.

Thank you, and I look forward to answering your questions.