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Re: Proposed Conflict of Interest Rule [RIN-1210-AB32]

The Pension Rights Center ("the Center") submits the following comments on the Department of Labor's proposed regulations on conflicts of interest and the definition of investment advice. The Center is a nonprofit consumer organization that has been working since 1976 to protect and promote the retirement security of American workers, retirees, and their families. The Center believes that the Department of Labor has produced an elegant and workable regulatory structure that protects retirement investors while also accommodating the reasonable and legitimate concerns of the financial industry. As we make clear in these comments, the regulations still have room for improvement to strengthen protections for consumers.

The proposed regulations would replace current ones, adopted in 1975, that tightly circumscribed the circumstances under which a person or entity becomes a fiduciary when providing investment advice to a plan or participant for a fee. The result of the original regulations is that ERISA failed to regulate much of the investment advice industry, allowing many financial advisers to provide workers and retirees with advice tainted by the conflicting interests of advisors or the firms for which they work. Too often this has meant that advisors focus on the fees generated by the advice, rather than on whether the advice is in the best interests of the saver.

In 2010, the Department of Labor recognized that these regulations were inadequate for protecting participants in the retirement savings systems as it has evolved since 1975, so it proposed a new rule on this subject. However, after reviewing comments from a broad array of stakeholders and a multi-day hearing, the DOL withdrew the proposed rule for further study,

The proposed regulations on which this letter comments is the result of several years of thoughtful consideration of comments on the withdrawn proposal; of serious study of the underlying economics of conflicted investment advice; of active coordination and consultation with other governmental agencies and the legislative branch; and of engagement with the investment industry, academics, and organizations concerned with consumer protection and retirement security. With all of this input and study, the Department has now produced more nuanced regulations that should improve the quality of investment advice for the tens of millions of participants in our tax-subsidized retirement savings system, while maximizing industry flexibility to pursue legitimate business goals and to continue using historical compensation models for people who provide investment advice.

The Center disputes industry criticism that the rule is “unworkable.” It appears that the Department of Labor has taken into account industry concerns in developing new principles-based prohibited transaction exemptions and in the careful structure and language of the proposed rule itself. The agency has threaded the regulatory needle to weave together a carefully-crafted proposal that should satisfy the majority of stakeholders.

The 1975 regulation on investment advice was not compelled by the statute. In our view, it was not faithful to the language and purpose of ERISA, and it improperly narrowed the definition of fiduciary. In addition, as the Department suggests in the preamble to the proposed rule, economic and legal developments in the fields of investments and employee benefit plans have rendered the 1975 position anachronistic and, at times, at cross-purposes with the statute. The new proposed regulations are much-needed and will mitigate structural conflicts that compromised the integrity of investment advice and resulted in unnecessarily high fees. Over time, the new rule should materially improve the retirement security of American workers.

These comments are divided into five sections: the first section provides background on ERISA and the 1975 regulations; the second section discusses why revision of the regulations is warranted, including a review of the Department’s impact analysis; the third section comments on particular provisions of the proposed rule and also suggests some modifications of those rules; the fourth section considers exemptions from the prohibited transaction rules; and the fifth section responds to the Department’s query on alternative proposed “best interest” proposals.

I. Background

When Congress passed ERISA in 1974, it included rules governing the conduct of fiduciaries. Senator Harrison Williams, Chair of the Senate Labor Committee and a key co-sponsor of ERISA in the Senate, explained the need for these rules when he presented the ERISA Conference Committee resolution reconciling the House and Senate versions of pension reform legislation: “Despite the value of full reporting and disclosure, it has become clear that such provisions are not in themselves sufficient to safeguard employee benefit plan assets from such abuses as self-dealing, imprudent investing, and misappropriation of plan funds.”[1]

In other words, fiduciary standards were essential for the protection of participants in employee benefit plans. Congress crafted rules applying fiduciary standards not only to plan trustees, but to a range of individuals and entities whose actions affect the security and use of plan funds and the benefits of participants. These rules of conduct applied to “fiduciaries,” which Congress defined as any person who fits one of the following categories:

(1) exercises any discretionary authority or discretionary control respecting management of a plan;[2]

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[1] Comments of Senator Harrison Williams, Legislative History of the Employee Retirement Income Security Act of 1974, Vol. III, at 4741(Aug 22, 1974)(comments concerning the Committee of Conference on H.R. 2).

[2] ERISA § 3(21)(A)(i).

(2) exercises any authority or control respecting management or disposition of a plan's assets;[3]

(3) renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of a plan, or has any authority or responsibility to do so;[4] or

(4) has any discretionary authority or discretionary responsibility in the administration of a plan.[5]

The 1975 regulations addressed the third aspect of the definition – a person who renders investment advice for a fee. The regulations narrowed the statutory language (which broadly provided that a person is a fiduciary if he/she renders investment advice "for a fee or other compensation, direct or indirect, with respect to any moneys or other property of" a plan) to two narrow circumstances: first, if a person has discretionary authority or control with respect to purchasing or selling securities or other property for a plan;[6] and second, if a person renders investment advice to a plan on a *regular* basis, pursuant to an agreement or understanding that the advice will be a *primary* basis for the plan's investment decisions, and that the advice is *individualized* to the particular needs of the plan.[7]

This rule is often described as a five-part test, with a person found to be a fiduciary only if all five parts of the test are met. A person who provided investment advice could thus easily avoid being characterized as a person "who renders advice under the statute" fiduciary responsibility simply by indicating that he did not intend his recommendations to be the primary basis for an investment decision or by not providing advice on a regular basis.

The regulations also provided, in effect, a definition of the type of advice that concerned plan investments: advice concerning the value of securities or property, or advice concerning the advisability of investing in, purchasing, or selling securities or other property.

A year after the 1975 regulations were promulgated, the Department held that a consultant who provided an evaluation of employer securities for an ESOP was not a fiduciary under the regulatory definition, because the valuation would not "involve an opinion as to the relative merits of purchasing the particular employer securities in question as opposed to other securities," and would thus not serve as a "primary basis" for plan investment decisions nor "constitute advice as to the value of securities."

The 2010 proposed regulations offered a simpler and more easily understood, enforceable, and administrable test that bore increased fidelity to the statutory language and was designed in part to address developments over the intervening 35 years in the areas of retirement plans and investments. The new test would have provided that a person renders investment advice for a fee

[3] ERISA § 3(21)(A)(i)

[4] ERISA § 3(21)(A)(ii)

[5] ERISA § 3(21)(A)(i

[6] We note that a person who has such authority would be an investment adviser even without the "investment advice for a fee" component of the statutory definition, since the person would be exercising discretionary control of a plan asset.

[7] C.F.R. § 2510.3-21(c)(1)(ii)(B).

under ERISA if the person gives certain types of advice to a plan, plan fiduciary, or plan participant or beneficiary, and also falls within certain categories of persons.

The Pension Rights Center was generally supportive of the 2010 regulations, although we criticized some provisions of the regulation, especially a seller's exemption, which we argued should be restricted in scope to fiduciaries of large plans. The regulations also asked for comments on whether advice on plan distributions should be characterized as investment advice, a position that the Center and other consumer groups generally supported.

Some segments of the investment industry criticized the proposed regulation, arguing that it would prohibit certain common compensation arrangements, which might result in retirement savers with small account balances losing access to investment advice.

They also argued that the proposed 2010 regulation could create fiduciary status in unintended situations -- for example, when employees of a plan sponsor help the plan sponsor review investment and potential investment options for the sponsor's 401(k) plan. There were also comments that argued that individuals who valued property for plans, particularly employer stock and employee real property, were already adequately regulated by state law and industry standards and that enveloping them in fiduciary status would add costs to plans without adding commensurate value for plan participants.

Over the next several years, the Department considered these and other comments and also conducted a thorough analysis of the benefits and costs of a new rule. On April 14, 2015, after concluding that the rule's benefits vastly exceeded its costs, it proposed a new carefully-crafted rule.

The new rule reflects many of the comments on the withdrawn rule. For example, it generally limits the seller exemption to sales presentations to certain fiduciaries of larger plans, who would have the sophistication to evaluate the merits of particular investments and to make their own informed judgments about the merits of particular investments. The rule also specifies that advice on plan distributions is investment advice. The rule further adds new principles on the distinction between investment education and investment advice to prevent attempts to camouflage investment advice as investment education.

The proposed rule also includes changes prompted by concerns raised by industry. The new rule, for example, has an expanded list of carve-outs, and is accompanied by new prohibited transaction exemptions and amendments to existing prohibited transactions -- most significantly an exemption for investment advisers and financial institutions who enter into a contract with a retirement saver and agree to act in the client's best interest and to mitigate and control conflicts.

The Best Interest Contract exemption permits financial firms considerable flexibility with respect to how they compensate investment advisers and institutions, including the use of indirect compensation, such as revenue sharing and 12b-1 fees. One of the new fiduciary carve-put provides that appraisers are not fiduciaries when they render appraisals, fairness opinions, or statements of value to an ESOP. The preamble to the regulations indicates that the Department is separately considering issues related to ESOPs.

II. Revision of the 1975 Regulations is Warranted

a. The 1975 Regulations Improperly Narrowed the Meaning of Investment Advice under the Statute

The centerpiece of Title I of ERISA is its definition of fiduciary and the rules that govern a fiduciary's conduct. In particular, fiduciaries are required to act in the exclusive interest of plan participants and their beneficiaries and to exercise prudence in the exercise of their plan responsibilities. Title I of ERISA also prohibits a fiduciary from causing a plan to engage in a prohibited transaction with a party in interest, and the Internal Revenue Code imposes a significant tax on the amount involved in a prohibited transaction. An important effect of the rules governing fiduciary behavior is to limit self-dealing and other conflicts of interest of fiduciaries, which Congress determined was critical to the goals it enacted ERISA to advance. Who is a fiduciary is critical to the statutory scheme.

Section 3(21)(A) of ERISA defines the term fiduciary and plainly states 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 such plan, or has any authority or responsibility to do so." The 1975 regulations narrowed the scope of this language by limiting it to investment advice that was "regular," rather than one-time or episodic; advice that was rendered pursuant to an agreement or understanding that it would be a "primary basis" for investment; and advice that is "individualized" to the particular needs of the plan.

These limitations are not consistent with the plain meaning of the term "investment advice," and, given the remedial character of ERISA, can be said to have impeded rather than to advance the congressional goals of limiting self-dealing and of assuring prudent investment of plan assets. The regulatory definition is also inconsistent with judicial language indicating that Congress generally intended the term fiduciary to be "broadly" construed.[8]

b. Speculation on the Reasons for the 1975 Regulatory Constriction on the Statutory Language

The preamble to the 1975 regulations did not provide a clear explanation for why the Department narrowed the statutory meaning of investment advice. If there was any additional explanatory material, it no longer exists. It is possible that the Department wished to reassure banks and other financial institutions that the new statute did not create new legal uncertainty when they did routine work for plans. Moreover, 1975 predated the line of Supreme Court decisions that held that relief against non-fiduciaries was limited to traditional equitable remedies, so the question of who was a fiduciary would have appeared to be less consequential than it does today.

Moreover, as we discuss further below, the retirement plan world was different in 1975 from what it is today. Forty years ago, defined benefit plans held most retirement assets, covered the majority of plan participants, and almost always paid benefits in annuity form. And in 1975, defined contribution plans were typically invested in pooled, professionally managed portfolios

[8] *See*, e.g., *LoPresti v. Terwilliger*, 126 F.3d 34, 40 (2nd Cir. 1997).

rather than in assets selected by individual participants. Thus, even in the defined contribution employer plans of yore, participants were generally shielded by plan fiduciaries and their advisors from individual responsibility for investments. At the time, Individual Retirement Accounts were still curiosities and comprised a small portion of total national retirement savings. And Congress had not yet added section 401(k) to the Internal Revenue Code.

The Department of Labor would have had to display nearly perfect clairvoyance to predict that the intervening 40 years would make the individual participant the fulcrum for investment and retirement distribution strategies and a significant consumer of investment advice. It did not and thus did not foresee the regulations' negative future effects.

And two other points are relevant here: first, the Department of Labor employees who wrote the 1975 regulations had only limited experience in fiduciary regulation, having been transferred to the Pension Welfare Benefits Administration from the Fair Labor Standards Administration after the enactment of ERISA. Second, consumer-oriented and labor organizations apparently did not comment on the regulations, so there was little counterpoint to industry support for the rule.

As a result, in 1975, the Department may well have perceived that the rule would reassure the financial industry about the impacts of the new statute while imposing few if any costs on the ability of American workers to build financial security for retirement. The view about costs, as we now know, was a wildly inaccurate perspective with destructive consequences. The regulations were not only inconsistent with the statute but have, as the Department of Labor's regulatory impact study now clearly demonstrates, diminished the financial security of millions of Americans.

c. The Evolution of the American Retirement System Since 1975

There have been significant changes in the retirement plan and investment landscape that have undermined whatever arguable justification there might have been in 1975 for the regulations' cramped scope. As the preamble to the new rules note, there has been a seismic shift in the retirement plan world from defined benefit plans—in which investment advice was generally rendered to sophisticated plan fiduciaries—to self-directed defined contribution plans—in which investment advice is issued to individual participants, who often lack significant investment experience and knowledge. Mutual funds, and sellers and brokers for mutual funds, who played a relatively small role in retirement plans when ERISA was enacted, have become dominant players in the new economic order. The variety and complexity of investment products has also increased markedly over the last four decades.

There have also been significant and unanticipated legal developments since the 1975 regulations were promulgated. As we noted, the Supreme Court in 1993 ruled that a participant generally is entitled to legal relief under ERISA only against a defendant who is a fiduciary whose breach of duty caused monetary loss to a plan. Legal relief is not available against a non-fiduciary even when a non-fiduciary knowingly and for personal profit assisted a fiduciary in the commission of such a breach. A participant can sue a person other than a fiduciary only for traditional forms of equitable relief. The DOL, which filed amicus briefs arguing against these positions, could not have known in 1975 that the combination of its narrowly drawn regulation, the limitation on available remedies, and ERISA preemption would effectively create an ineffectively regulated playing field for so many actors who have a direct and substantial impact on plan investment performance.

Another important change is simply the growth of assets held by qualified retirement plans. In 1975, defined benefit plans and defined contribution plans held $300 billion in assets. In 2015, these plans held about $8.6 trillion dollars of assets. Individual Retirement Accounts account for another $7.4 trillion, and insurance annuities an additional $2.9 trillion.[9] Clearly, retirement plans are today a critical market for virtually all serious capital market participants. It is, simply, where the money is.

Thus, in today's new order, the people and institutions who help individual participants and small 401(k) plans navigate the complex geography of investing for retirement are essential to helping Americans prepare financially for retirement. Where in 1975 they may have stood on the periphery of the statutory scheme, today they stand in its epicenter. To exempt them from the statute's prohibitions against conflicts and self-dealing undermines Congress' goals in enacting ERISA and in encouraging plans with generous tax subsidies.

d. The Negative Costs of the 1975 Regulations Have Been Substantial

Because of the 1975 regulations' artificial constriction of the meaning of investment advice, many individuals and institutions that provide investment advice have been effectively immunized from meaningful ERISA regulation. While they have been subjected to regulation under other regimes, those other regimes do not always impose a best-interest standard or prohibit conflicts of interest. As a result, many vendors of investment recommendations have operated under conflicts of interest.

Conflicts of interest can incentivize investment advisors to recommend investments that maximize fees to the advisor, when the client is better served by investments that generate lower fees. Conflicts of interest can also lead advisors to recommend that retirement savers take distributions from plans in which fees are low and roll over the distribution into Individual Retirement Accounts, where fees are typically higher and legal protections reduced. Similarly, investment advisors have financial incentive to encourage pension plan participants to take lump-sum payments in lieu of a plan annuity, foregoing the substantial benefits of an annuity.

Moreover, exotic, complex investments often pay higher fees to those who recommend and sell them, even though such investments may be expensive and present risks that make such investments suboptimal for many retirement savers. Actively managed funds designed to maximize income generate higher fees for brokers who recommend and sell them, but such funds often invest in riskier assets than other funds and thus may not be optimal for older investors who should not bear such risk. Yet the Center has seen cases in which octogenarians have been advised to invest a majority of their assets in volatile funds or in other high-risk securities. Relying significantly on independent research, the Department documented substantial gains to retirement investors from the proposed rule, perhaps as high as $1 trillion over a 20-year period.

[9] Federal Reserve Board of Governors, Flow of Fund Accounts of the United States, Table L.226, pg. 127, June 11, 2015.

Even if a fraction of these gains were realized for participants, the revised rule's benefits would dwarf the compliance and other costs associated with it.

We anticipate several arguments being raised against the regulatory analysis. First, we believe that some commentators will argue that the research relied upon by the analysis is inconclusive and that the potential benefits are speculative, because there is no way to determine whether most investment advisors in fact act on conflicts of interest. But the notion that a class of actors—in this case investment advisors—are immune from conflicts of interest, is a counterintuitive assertion with virtually no empirical support. While there are certainly some investment advisors that successfully resist yielding to conflicts of interest and/or are subject to business models and compensation structures that control them, many advisors who receive higher compensation for selling certain products than others will act, consciously or not, to maximize their own compensation at a significant cost to their clients. Moreover, advisors who do not act on such conflicts should not incur substantial costs from complying with the proposed rules.

Some have also argued that the rules will result in investment firms deciding to withdraw from offering advice to investors with small account balances and from providing assistance to smaller plans. But such predictions are speculative, based on selective and questionable assumptions and/or manipulated "survey" data. One study commissioned by a "coalition" of unidentified businesses concludes that 30 percent of small-plan employers will drop their plan if the new regulations take effect. However that survey suggested to respondents that they will be unable to obtain assistance from financial firms if the proposed rule is adopted before it asked if they will continue to sponsor their plans.

Moreover, the "best interest contract" exemption from the prohibited transaction rules will permit firms to continue to compensate advisors with various forms of commission and indirect payments. In addition, our market economy is remarkably resilient and has a genius for creating innovative mechanisms to serve markets. The proposed rule will not reduce the demand for investment advice, and innovative firms will continue to find efficient ways to service and profit from that demand. We have confidence that financial advisors can provide investors with good advice at least as efficiently as it can provide conflicted advice.

We also note that some opponents of the new rule display a chameleon-like assessment of the sophistication of the average investor. On the one hand, they argue that investors are sophisticated enough to evaluate the impact of conflicts of interest of their advisors, but on the other hand implying that the same investors may be unwilling to pay for investment advice unless the cost of that advice is hidden from them.

e. The Current Regulations Create Legal Uncertainty

The 1975 regulations incorporate inherently vague concepts into the definition of investment advice, which impede enforcement efforts under the statute. The regulations do not define what is meant by providing advice on a "regular basis," what is meant by advice that will be "a primary basis" for the plan's investment decisions, nor what is meant by advice that is "individualized to the plan's" needs. These must be determined on a case-by-case basis. The inherent ambiguity and subjectivity of these concepts creates uncertainty in the law and strains

Departmental, judicial, and private resources in litigation of issues not related to the core concept of investment advice.

The problems of the regulatory definition are illustrated in judicial decisions. *In Farm King Supply, Inc. Integrated Profit Sharing Plan and Trust v. Edward D. Jones & Company*, 884 F.2d 288 (7th Cir. 1989), a plan followed a brokerage firm's conflicted investment advice and suffered a loss, but the court held that the brokerage firm was not a fiduciary because "there was no mutual understanding that Jones' advice would be a *primary basis* for Plan investments." In another case, *Bhatia v. Dischino*, 2010 WL 1236406 (N.D. Tex. March 30, 2010), the trial court held that an actuarial consulting firm was not a fiduciary under the regulations, because the plaintiffs did not plead adequate facts to show that the firm "rendered advice on a regular basis as part of a mutual agreement that such advice serve as the primary basis of investment decisions."

The Department has explained that developing proof of the elements of the regulations, even where proof exists, has slowed and impeded enforcement of ERISA for the Department of Labor. The lack of support in the statute for the conditions in the regulation and the difficulties for enforcement are reasons enough for the regulation. But the Center would like to point out that Congress intended that ERISA would be enforceable by ordinary participants and beneficiaries who, unlike the Department of Labor, do not have subpoena power and have no ready access to the documents and testimony that would demonstrate fiduciary status under the detailed existing regulation. This has always been a severe impediment to enforcement of fiduciary responsibility by private plaintiffs, but it has been greatly exacerbated in recent years because the Supreme Court has adopted a "plausibility" standard for the evaluation of complaints on a motion to dismiss.

As a consequence, complaints alleging fiduciary status may be dismissed if they fail to allege factual support for some element of the regulation, and factual support will typically be unavailable or limited without discovery. See e.g. *Glen Ridge Surgicenter, LLC v. Horizon Blue Cross Blue Shield of New Jersey, Inc.*, No. 08-6160 (JAG), 2009 WL 3233427, at *6 (D.N.J. Sept. 30, 2009) ("[P]roof of [defendant]'s fiduciary status is an element of the fiduciary duty claim, and 'a formulaic recitation [in the complaint] of the elements of a cause of action will not do.'" (quoting *Bell Atl. Corp*. v. *Twombly,* 550 U.S. 544 (2007)); see also *Braden v. Walmart Stores, Inc.*, 588 F.3d 585, 598 (8th Cir. 2009) (discussing the problem that participants are often without access to information that would allow them to plead factual support for each element of a claim).

III. Comments on Proposed Regulations

The Center strongly supports the Department's proposed rule generally and has the following specific comments.

a. Distribution Advice and Management of Securities

The Department of Labor's current position is that advice on whether to take a distribution from a plan does not in itself result in fiduciary status for the person rendering such advice. Section 2410.3-21(a)(1) of the proposed rule would reverse this position by providing that ". . . a recommendation to take a distribution of benefits" is investment advice. See also Section 2410.3-21(a)(2) ("a recommendation as to the management of securities or other property to be rollover over or otherwise distributed from the plan or IRA" is investment advice). We believe that this aspect of the rule is critical to the retirement security of millions of Americans and that such advice should meet the dictionary meaning of investment advice.

We note that the decision on whether to take a lump-sum distribution from a plan can have profound effects on someone's future financial security in retirement. In some cases, the decision to move assets from a defined contribution plan to an individual retirement account by rollover or direct transfer can result in the retirement saver paying higher fees for similar investment assets and can also result in loss of access to plan investment options that may not be available in an IRA. The effects of such a decision can be especially profound in a pension plan, where a participant loses the benefits of having benefits paid as an annuity or, in the case of a married participant, a joint-and-survivor annuity.

While there are certainly situations in which a distribution of benefits from a plan, defined benefit or defined contribution, is warranted, in many situations -- if not the great majority of situations -- such a decision will have significant costs to the participant taking the distribution. The person providing advice to take a distribution, however, typically has strong financial incentive to recommend taking the distribution. In a draft paper, which we attach as an appendix to these comments, the authors provide an example of how conflicts of interest can lead to poor advice in the context of rollovers.

We thus strongly support this proposed change to current law.

b. Circumstances Under Which a Person Renders Investment Advice

The proposed rule provides that a person who provides investment advice is a fiduciary if the person either represents or acknowledges fiduciary status or if the advice is rendered "pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA." Proposed Rule Section 22510.3-21(a)(2)(ii).

We are concerned that the reference to an agreement, arrangement, or understanding may be interpreted as required bilateral or shared understanding by both the retirement investor and the advisor that advice is being directed toward the advice recipient. We believe that a person or entity may provide investment advice even in the absence of such a bilateral or shared understanding. More specifically, we believe that a person offers investment advice if, under the totality of circumstances, it appears that a person is offering advice to another person regarding an investment or management decision related to assets of a plan or IRA, regardless of whether there is a bilateral, common, or shared understanding that advice is being provided.

c. Sales Carve-out

The 2010 proposed regulations provided that a person shall not be considered to be a fiduciary investment adviser if such person can demonstrate "that the recipient of the advice knows or, under the circumstances, should have known, that the person is providing the advice or making the recommendations in its capacity as a purchaser or seller of a security or other property, or as an agent of, appraiser for, such a purchaser or seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice." We believe that this accommodation is appropriate when a "sales" presentation is provided to a sophisticated plan fiduciary, but not when it is given to individual participants or their beneficiaries.

In our experience, most plan participants will not be able to discern whether advice is impartial or conflicted. In addition, even if there is disclosure, in a one-to-one meeting, whether in person or by phone, an unsophisticated investor will often regard the adviser as acting in his interest. This is particularly true if the participant does not have access to other advisers. Indeed, an adviser's success may depend on a client's belief that the adviser is interested primarily in the customer's welfare, despite a declaration of self-interest. There is the further fact that most participants will not be knowledgeable about the types of fees and benefits that can accrue to the purchaser or seller of securities.

The new proposed rule eliminates the sales exception for individual participants. The sales exception remains as part of a carve-out for counterparty transactions, but this carve-out is appropriately limited to sophisticated plan fiduciaries. Eliminating the sales exception for individuals is a critically important revision to the proposed rule and we urge the Department to retain it in the final rule.

d. Investment Education Carve-out

The proposed rule, like the 2010 proposed rule before it, provides that a person does not become a fiduciary when that person only provides investment education. The 2010 proposed rule referred to previous guidance distinguishing investment education from investment advice. See DOL IB 96-1. That guidance permitted investment education to include references to investment products (as illustrations) sold by the provider of the education. Research has shown that such references can have powerful anchoring effects, and this can be expected to influence recipients favorably to the products referenced. In effect, such educational activities comprise a sophisticated sales presentation and should be regarded as such. Thus, we believe the proposed regulations, which do not allow investment education to refer to specific products, are far more protective by creating a stronger line between investment education and invest advice, and this distinction is critical and should be retained in the final rule.

e. Applicability of Proposed Rule to IRAs

As a general comment, we laud the clarity with which the proposal states that the proposed rules will apply equally to IRAs as well as ERISA plans. IRA assets now constitute about one third of all private retirement savings. While plan participants continue to earn their private retirements benefits almost entirely in employer plans, the investment of those savings after termination of employment, including the distribution of those benefits throughout their retirement years, is increasingly being made from IRAs to which they have rolled the lump sum benefit they earned under their traditional pension plan or their 401(k)-type plan. After such a rollover, there is no ERISA protection or employer support, and this has led to some high-fee abuses The argument that the Department should not be regulating IRAs ignores that Reorganization Act No. 4 of 1978 expressly granted the Department of Labor regulatory authority to define the term "fiduciary" for purposes of both the Internal Revenue Code and ERISA.

f. Carve-out for ESOP Advisors

The proposed rule generally provides that an appraisal, fairness opinion, or similar opinion is investment advice and a person who provides it generally a fiduciary. Prop. Rule Section 2510-21(a)(1)(ii). The rule, however, includes a carve-out for persons who provide such investment advice to an ESOP. The Labor Department indicates that it is separately studying issues relating to ESOPs and presumably the issue of whether appraisers of employer securities.

The carve-out, even if only temporary, is unfortunate, since proper valuation of stock in an ESOP maintained by a closely-held corporation is critical to the fairness of such ESOPs. Whether incorrect valuations are frequent or infrequent is a contested issue, but when it happens participants in plans suffer and should have recourse if the appraiser acted improperly. There is no reason to grant ESOPs a special agency exemption from an essential part of ERISA's fiduciary structure.

In any event, there is no clear evidence that ERISA fiduciary liability would result in significantly higher costs to plans, especially given the procedural and substantive obstacles that private parties and the Department of Labor face in ERISA fiduciary litigation. We would urge the Department to either remove the carve-out or provide that the carve-out will sunset within a reasonable period of time.

g. Carve-Out for Platform Providers

The proposed rule includes a carve-out for providers of investment platforms, so that they do not become fiduciaries when a person "merely markets and makes available to an employee benefit plan… a platform or similar mechanism from which a plan fiduciary may select of monitor investment alternatives, including qualified investment alternatives." Yet marketers of investment platforms can limit the investment options from which a fiduciary may choose and may be influenced by the payments they will receive from the vendors of the investment products available on the platform. We thus believe the broad carve-out may permit conflicts that should be controlled. We suggest eliminating this carve-out and substituting a prohibited transaction exemption that requires disclosure and mitigation of conflicts.

IV. Comments on Prohibited Transaction Exemptions

The proposed rule was accompanied by a package of new prohibited transaction exemptions and amendments to existing exemptions. The package is meticulously constructed, and the heart of it -- the Best Interest Contract exemption -- succeeds in mitigating the impact of conflicts while preserving substantial flexibility for financial institutions to market their products and compensate those persons who recommend and sell them. Notwithstanding the Department's success in creating the package, there is room for improvement at the margins and we provide some comments to this end. We also respond to the Department's request for comments on whether it should adopt a streamlined exemption for low fee, quality investment vehicles.

a. The Best Interest Contract Exemption Should Be Amended to Clarify that It Applies to Rollover Advice Provided by Either a Third-Party Call Center or Advisors Not Affiliated with the Plan.

Some comments on the proposed Best Interest Contract exemption suggest that it is not applicable to advice concerning plan distributions. While we read the exemption to clearly cover such advice, the Department should make the language more specific to clarify that it applies to distribution and rollover advice, which as detailed earlier, is critical to protecting workers and retirees. The Department should also consider whether special contract formation rules might be appropriate when advice is being provided through persons at a call center, although any such rules should be tailored to ensure that the participant fully understands the nature of the contract at the point of initial communication with the call center and that the execution of the written contract occurs within a reasonably short period following the initial communication.

b. The Exemption Should Not Endorse Arbitration When Fiduciary Advice is Rendered to a Plan or to a Participant or Beneficiary in a Plan.

The proposed Best Interest Contract exemption requires the contract to provide for resolution of disputes and explicitly sanctions binding arbitration for individual claims. In our view, this undercuts ERISA's private enforcement scheme and the express Congressional purpose of "providing ready access to federal courts." ERISA Section 1(b), 29 U.S.C. 1001(b).

The exemption should be amended to bar mandatory arbitration clauses in disputes involving a plan fiduciary and a plan participant or beneficiary. Such clauses should be limited to disputes regarding investment and management decisions related to an existing Individual Retirement Account, where there are no existing federal remedies other than the imposition of the Section 4975 tax on amounts involved in prohibited transactions. The exemption should also prohibit contractually modifying the ERISA statute of limitations for claims against fiduciaries and should similarly prohibit contractual restrictions of other ERISA jurisdictional, remedial, or substantive provisions.

c. Thoughts on the Appropriateness of a Streamlined Exemption for Certain Investment Options.

The Department of Labor has asked for comments on whether it should provide a streamlined version of the Best Interest Contract exemption for advisors offering high-quality, low-fee investment products. In our view, there would be several difficult conceptual problems to negotiate in order to create such an exemption. Such difficulties include defining the concepts of low-fee and high-quality for investment products.

We are also concerned that such designation may itself become the equivalent of a consumer seal of approval, which may result in investors focusing only on such products and perhaps not developing appropriate investment strategies. Such designation might also have profound consequence in future product development, stifling innovation. Nevertheless, the notion of a streamlined exemption is intriguing and is worth exploration but perhaps not on the same time track as this proposed rule.

V. Alternative "Best Interest" Standards

SIFMA and others have offered alternative proposals that they characterize as based on a "best interest" standard that they argue would not impose unnecessary burdens on the industry nor result in unintended consequences. These proposals, however, are at best an uneasy, uncertain, and inadequate compromise between suitability-type and true best-interest standards. The proposals tolerate disclosure as a remedy to conflicts of interest – which we know does not work; and the factors that would be used to measure compliance are sufficiently numerous that the overall effect is one of vagueness and subjectivity and not dissimilar from the standards now used to measure compliance with a suitability standard.

In short, the proposals require identification of conflicts rather than meaningful mitigation of conflicts. While they reflect a minor shift in emphasis, at their heart the proposals wrap a suitability standard in more attractive packing. Such proposals are not suited toward ensuring that the tens of millions of retirement savers are given advice unfiltered through the myriad conflicts that distort its quality in the current world.

They are a last-ditch effort by the industry to defeat a well-crafted rule that was developed over years with the input of all stakeholders. They are no substitute for the rule.

Conclusion

Our nation depends on employee plans and individual retirement plans to help Americans build financial security for their retirement. At the individual level, the success of this enterprise means comfort and dignity in retirement; at the aggregate level, it serves and implements vital societal goals.

It is for these reasons that Congress subsidizes the retirement system with generous tax subsidies, and it is for these reasons that Congress enacted ERISA to ensure that the system serves and protects the interests of plan participants.

Some have argued that our securities laws can adequately protect the interests of retirement savers and, by implication, that the more protective ERISA regime was neither needed nor intended by its Congressional authors. This is simply wrong and misguided. Securities law is intended to ensure honesty in markets and to check fraud and sharp practices. It is based on disclosure and honest behavior.

ERISA, on the other hand, was designed to ensure that Americans can build adequate financial security for that period in their life when they no longer participate in the workforce and to ensure that their reasonable expectations are protected. It is for these reasons that ERISA is organized around a fiduciary standard—the highest standard of behavior in law—to eliminate rather than merely to disclose conflicts of interest. As Harrison Williams, one of ERISA's two principal sponsors in the Senate, observed about the statute's fiduciary anatomy, "…despite the value of full reporting and disclosure, it has become clear that such provisions are not in themselves sufficient to safeguard employee benefit plan assets from such abuses as self-dealing, imprudent investing, and misappropriation of plan funds."[10]

The Department has worked mightily to construct a regulatory regime consistent with this purpose. It has modified its 2010 proposal to reflect legitimate industry concerns. It has consulted and coordinated with the Securities Exchange Commission and others to ensure that its rules do not undermine the SEC's own mission nor create unnecessary burdens for business. The Department deserves high praise for its efforts to date, and we encourage it now to complete its work -- so essential to the protection of the American worker -- with due expedition.

Respectfully Submitted,

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[10] Comments of Senator Harrison Williams, supra, note 1.

Financial Illiteracy Meets Conflicted Advice:

The Case of Thrift Savings Plan Rollovers

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Abstract

Bad financial decision-making can be due to a combination of lack of financial literacy and conflicted advice from advisers who know that many people are insensitive to differences in fees. The paper examines rollovers from the Thrift Savings Plan (TSP) for federal government workers. It focuses on the TSP because it has the lowest fees of any plan in the United States, charging less than 3 basis points. By analyzing issues related to TSP rollovers, this paper sheds light on the broader topic of rollovers to IRAs and the yet broader topics of the quality of financial advice that people receive and how that is affected by the fiduciary standard. The two leading models of choice—the traditional price theory model with rational decision makers and behavioral economics with its emphasis on inertia both predict that rollovers from the TSP would generally not occur. We argue that these rollovers can be explained by a model of financially illiterate consumers facing conflicted advice, which is a type of agency problem model. While the fiduciary standard is considered to be the highest standard for conduct under the law, the paper is to our knowledge the first paper to test the effect of a fiduciary standard on the quality of advice. It undertakes a small survey to find out what advice participants receive concerning TSP rollovers and to test the hypothesis that having a fiduciary duty does not affect the quality of advice provided. Because of the extremely low fees the TSP charges, the strategy of assessing advice concerning rollovers from the TSP provides a strong test of the hypothesis that the standard used by many financial advisers for quality of advice is low. Participants in a very low fee plan are being advised to roll over to high fee products. While we find a statistically significant difference between the advice provided by advisers with a suitability standard and the SEC fiduciary standard, even advisers with that fiduciary standard often appear to be insensitive to large differences in fees, focusing instead on the benefits of their advice. They provide self-interested analysis that justifies their self-interested advice. Thus, the SEC fiduciary standard does not appear to be adequate by itself, without robust enforcement, to overcome the problem arising from the advisers' conflict of interest, combined with the information asymmetry between advisers and clients.

“One of the best things you can do as an investor is to keep the costs that you can control as low as possible.” Wes Moss (2014)

Because many people lack financial literacy, they seek financial advice. Information asymmetry is inherent in that situation. The information asymmetry creates the potential for an agency problem, where the agent or adviser may not act in the best interest of the client. The financial adviser has a financial incentive to take advantage of his informational advantage because he has a conflict of interest. Because of the way the adviser is compensated, the advice that yields the adviser the most income is not the best advice for the client. This financial incentive results in clients not receiving the best advice. As a result, government has stepped in to regulate financial advice in order to protect the interests of clients. This regulation sometimes involves imposing a fiduciary standard, requiring that the advice be the best advice for the client.[ii] Because of the large amount of money at stake for financial advisers, they have attempted to influence the regulators, sometimes referred to when it is successful as regulatory capture.

This paper applies the framework just described to analyze the market for financial advice. It does so by focusing on pension rollovers to Individual Retirement Accounts (IRAs). In the market for financial advice, people with low levels of financial literacy (demand side) encounter advisers with conflicts of interest (supply side). In 2013, 38.3 percent of families reported obtaining information about investing from bankers, brokers and other sellers of financial services, and 31.3 percent of families reported obtaining information from lawyers, accounts and other financial advisers (Bricker et al. 2014).

Individual Retirement Accounts (IRAs) are the largest type of pension plan in the United States, having overtaken 401(k) plans. Rollovers are the primary source of funding for IRAs, with relatively few people contributing to IRAs (Investment Company Institute 2015b). Thus, the topic of rollovers is one of the most important topics in pension policy, involving issues that determine the fundamental structure of the way retirement savings is provided. Because of the importance of the rollover decision, many people seek financial advice. One survey finds that 61 percent of the people with rollover IRAs received advice from a financial adviser in connection to the rollover (Investment Company Institute 2015b).

In a rollover, the person receives a check from the pension plan of a former employer, then deposits the check with the IRA. In a transfer, the pension plan sends the check directly to the IRA. We follow common practice and refer to both as rollovers.

We argue that if participants are receiving bad advice where it is least likely, which is a plan with extremely low fees, it is likely that bad advice is occurring in less extreme situations. Similarly, if the financial regulators fail to take action in this situation, it is likely that they will fail to take action in less extreme situations that would still warrant action.

We focus on advice concerning rollovers from the Thrift Savings Plan because it has the lowest fees of any plan in the United States. The Thrift Savings Plan (TSP) is a 401(k)-type defined contribution plan for federal government workers, the military, and Members of Congress. The

TSP is the largest pension fund in the United States (Towers Watson 2014) and the largest defined contribution plan in the world (White 2011). It has more participants than the social security systems of more than 90 countries (World Bank 2014). It charges extremely low fees—less than three basis points for each of its funds. With fees of 3 basis points, someone investing $100,000 would pay $30 in fees annually. By comparison, the same person having the money managed by an adviser charging one percent per year would pay $1,000 to the adviser, on top of the fees for the investments, and someone with a high fee adviser charging two percent per year would be paying $2,000, and probably with the costs of the investments thus paying more than 70 times as much in fees. Yet, as documented in this paper, advisers charging as much as two percent a year are advising clients to rollover their TSP accounts so that the adviser can manage it.

We focus on the TSP because it charges extremely low fees, making a rollover to an IRA generally a bad decision. In 2014, the fees charged to participants in the Thrift Savings Plan were 2.9 basis points (TSP 2014b), compared to 83 basis points as the participant-weighted average for a survey of 401(k) plans (Deloitte 2011), 58 basis points for an asset-weighted average of 401(k) plans and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs (Investment Company Institute 2015b). IRAs have on average higher fees than do 401(k) plans, reflecting that retail fees for IRAs tend to be higher than institutional fees for 401(k) plans. While it is possible to find investments with very low fees, on average fees were roughly 25 times higher in IRAs than for the TSP, with the difference being substantially larger if the person who rolled over also started using a financial adviser, where fees are often 100 basis points or more.

This paper analyzes financial advice as a reason why rollovers are occurring. By focusing on advice, we do not claim that that is the only reason for rollovers or that it is the most important reason for all the rollovers that have occurred. Nonetheless, based on a survey of TSP participants who made a withdrawal, in 2013, an estimated 16,400 participants (about one-third of those making withdrawals) made a withdrawal of all or part of their TSP account because they were advised by their financial adviser to do so (AonHewitt 2014). In this paper, we make a preliminary attempt to assess the extent to which participants who receive advice from financial advisers are receiving bad advice.

After providing introductory material further describing the TSP, the paper discusses a few situations where it has been argued that a rollover from a TSP may be advantageous. Next, based on a survey we conducted, it assesses advice that clients receive concerning rolling over their TSP accounts to IRAs. The paper addresses the issue of whether having a fiduciary duty makes a difference in the advice received. To our knowledge, our paper is the first to empirically study whether having a fiduciary duty makes a difference in the quality of advice received.

INTRODUCTION

The market for TSP rollovers is complex, involving the activities of five parties: (1) TSP participants, (2) the TSP, (3) IRA providers, (4) advisers and (5) regulators. In this paper, we focus on the behavior of participants and advisers, commenting briefly on regulators and describing the characteristics of the TSP and IRAs but not focusing on the activities of the TSP and of IRA providers.

Previous Literature

Relevant to this paper on the quality of advice is a small but growing literature on the quality of advice that people receive as a factor leading to poor outcomes. This literature is a subset of a larger literature on the agency problem, where agents may have a conflict of interest and not act in the best interests of their clients. Mullainathan et al. (2012) in an audit study find that people with low-fee, well-diversified portfolios are advised to invest in higher-fee, less diversified portfolios. Dvorak (2015) compares the 401(k) plan investment options in the plans of financial advisory firms with the plans of the companies they advise. He finds that the investment options that are in the advisee firms' plans but not in the adviser firms' plans tend to have high fees, with the advisers not putting the high fee funds in their own plans. Christoffersen et al. (2013) find that brokers tend to sell higher-cost funds that give them higher compensation. The Council of Economic Advisers (2015) surveys the literature on financial advice and conflicts of interest, but fail to recognize that the issues relating to pension rollovers differ from those relating to advice as to investments for an established client. Concerning the low end of the quality of advice people receive, the SEC has issued an Investor Alert concerning fraudulent advice that some participants in Self-Directed IRAs have received (SEC 2011).

Three approaches have been taken in law to deal with conflicts of interest: prohibition, disclosure and the fiduciary standard. A fourth approach in public policy is financial literacy and financial education campaigns. The law and economics literature discusses the role of a fiduciary standard as one way of dealing with the agency problem where the agent has a conflict of interest and superior knowledge, and it is difficult for the client to assess the output of the agent (Sitkoff 2011). With the fiduciary standard, the agent is supposed to act solely in the best interest of the client. Agency problems are common because in a modern economy people must rely on experts to assist them. In our paper, the monitoring problem is due to asymmetric information, with the advisers having superior knowledge to the clients. Clients have a lack of financial sophistication and are unable to evaluate the quality of the advice they receive. For this reason, they play a weak role in the enforcement of regulations protecting them. We test for whether having a fiduciary standard affects the quality of advice. Thus, our paper relates to the effect of a fiduciary standard in dealing with the agency problem.

Rollovers from the Thrift Savings Plan, and indeed from most 401(k) plans (Turner and Klein 2014), are surprising from an economics perspective. The two main choice models in economics –traditional price theory, based on rational decision-makers, and behavioral economics, with its emphasis on inertia—cannot explain rollovers from the TSP.

From the perspective of traditional price theory, most rational decision-makers presumably would not roll over from the Thrift Savings Plan to an IRA because of the large difference in fees. In addition, pension participants have fiduciary protections in the TSP, but lose those protections when they transfer their assets to an IRA. Loss of fiduciary protections can be particularly important at advanced older ages when the risk of cognitive impairment is greater (Barlyn 2010). IRAs are not protected from judgments in civil law suits (TIAA-CREF 2013), and thus are subject to greater risk than is the TSP. The weakness of this model may be due to participants not knowing how much they are paying in fees, which is due at least in part to the lack of salience of these fees. A 2013 survey of civilian TSP participants who were separated but had not started taking benefits indicated that 18 percent expected to rollover from the TSP because of lower fees elsewhere (AonHewitt 2013), suggesting that they did not know the fees that TSP charges. That survey found that 42 percent of participants rated the TSP as about the same (37 percent) or below (5 percent) other plans. In addition, generally, people tend to think that their financial adviser is providing advice in their best interest, with roughly three out of four indicating that in a survey, while most advisers have a suitability standard for the advice they provide (Schoeff 2015).

From the perspective of behavioral economics, rollovers are surprising because some studies have documented the tendency for pension participants to exhibit inertia (Madrian and Shea 2001, Choi et al. 2002; see, however, Muller and Turner 2013). Inertia would cause TSP participants to not roll over because that is the "path of least resistance." Rollovers would seem to be even more unlikely when considering that many participants presumably would be overwhelmed by the large number of options as to IRA providers and then as to investment choices. However, the force of inertia may be less for workers at the point of job change or retirement, when the worker's attention is focused on choices related to the change in employment, than for workers who are continuing in the same job.

We propose the decision-making model of financial illiteracy with conflicted advice, which is an aspect of agency theory. This model dominates the traditional economics model and the behavioral economics model in the problem we analyze in that it predicts that TSP rollovers will occur, while the other two models predict the opposite for most participants. The effects of inertia and differences in fees are offset by conflicted advice. The client is not able to judge the quality of the advice and trusts the expertise and motivations of the adviser. We thus argue that the explanation for rollovers from the TSP, at least to some extent, is bad financial advice, both generalized advice provided through widespread advertising to rollover your "old" 401(k) plan, and advice provided to individuals.

Why do price theory and behavioral economics fail to explain TSP rollovers? We present evidence in this paper suggesting that in financial markets people often do not know what the prices are. We also suggest that the force of inertia may be less at job change than while working at a job and that inertia has been overcome at that point by advice.

THE MARKET FOR RETIREMENT SAVINGS VEHICLES AND THE DERIVED DEMAND FOR FINANCIAL ADVICE

Participants in the TSP face the choice of whether to continue in the TSP at job change or to transfer their TSP account to an IRA. Thus, they presumably consider the relative merits of the two forms of retirement savings. In addition, because they tend to lack financial literacy, they may seek the assistance of a financial adviser.

The TSP

The TSP is administered by the Federal Retirement Thrift Investment Board--an independent board whose members are nominated by the President and confirmed by the Senate. The TSP provides the same type of savings and tax benefits that are offered by 401(k) plans. Participants can make either Roth or traditional contributions. Its 4.6 million participants make it the largest defined contribution plan in the United States. The Thrift Savings Plan as of May 2014 had assets of $412 billion (Long 2014b) and in early 2015 was up to $440 billion (Money Management Intelligence 2015). The participation rate of 88.6 percent for employees in the Federal Employees Retirement System (FERS) (Thrift Savings Plan 2013) is higher than is typical for 401(k) plans, which tends to be less than 70 percent (U.S. Department of Labor 2014).

Participants in the TSP pay extremely low fees. The fees for all the TSP funds were 2.9 basis points or less in 2013 and 2014 (Thrift Savings Plan 2014b). The fees in 2013 were less than one-twentieth the average cost of a stock index fund (Zweig 2013), and one-thirtieth the average cost of target date funds (Vanguard 2014). Its fees are low primarily because of its large size and in part because some administrative costs are borne directly by the Federal government (Boccia 2014). The advantage of these low fees can be passed on to a surviving spouse, who can maintain an account in the TSP.

While 401(k) participants tend not to know how much they are paying in fees (Turner and Korczyk 2004), TSP participants may particularly be uninformed about their plan fees because all the funds charge essentially the same fee, making the level of fees irrelevant in the choice of funds.

Inertia Has Been Overcome

Inertia, which plays a key role in pension policy based on behavioral economics and choice architecture, has been overcome in the case of TSP rollovers. The default is to remain in the TSP. A survey in 2008 indicated that relatively few TSP participants (14.0 percent) planned to rollover their TSP to an IRA when they left government service (Watson Wyatt 2009). The intention to roll over was more prevalent among participants with small account balances at the time of the survey, with 15.7 percent of those with account balances of between $5,000 and $25,000 indicating that they planned to rollover to an IRA, versus 12.7 percent for those with account balances of $100,000 or more. One-fifth (22.5 percent) of participants planned to not take withdrawals until required to at age 70 ½. That percentage rises with age, and among those already retired, 40.7 percent planned to not take a withdrawal until age 70 ½.

Five years later, in 2013, 47,836 TSP participants requested transfers. Of those who separated from service in 2012, by the end of 2013, 45 percent had withdrawn all their funds (Long 2014b). The total amount rolled over to IRAs or other plans in 2013 was roughly $7.2 billion. Thus, the average rollover was about $150,000, which is slightly lower than the median account balance for someone with more than 20 years of tenure, which in 2011 was $155,119 and somewhat lower than the average account balance for that group, which was $185,741 (Thrift Savings Plan 2012). These figures compare to a median account balance for families with retirement accounts in 2013 of $59,000 (Bricker et al. 2014). In the age group where the family head was 55 to 64, the median value of assets in retirement accounts for households with a retirement account was $105,000 (Bricker et al. 2012). Thus, the rollovers are considerably larger than typical 401(k) account balances for those near retirement, which may make them a desirable target for financial advisers. In 2012, transfers of the full account balance to an IRA or another plan accounted for 65 percent of the money withdrawn from the TSP (Long 2014c).[iii]

A beneficial aspect of maintaining a TSP account rather than rolling it over is that participants can roll in money from plans from previous or subsequent employers or IRAs. The ability to roll in from subsequent employers is rarely if ever found in 401(k) plans. In 2014, $1 billion was rolled into the TSP (Steyer 2015). The roll ins suggest that the traditional, rational economic analysis still applies for some participants, who are financially astute and realize that the low fees in the TSP make it a desirable place to hold retirement savings.

Among those responding to a survey conducted by the Federal Retirement Thrift Investment Board, the primary reason for withdrawing money (rollovers and withdrawals) was a life event or major expenditure (36 percent), wanting greater withdrawal flexibility in benefits options (27 percent), wanting other investment options (23 percent), and wanting a managed account, wanting investment advice, receiving advice from a financial adviser, or other factors such as account consolidation or required minimum distributions (20 percent) (Long 2014b). Workers age 59 ½ and older can take a one-time partial or full withdrawal from the TSP while still working for the Federal government. A survey found that 23 percent of persons taking an in-service withdrawal were doing so because a financial adviser recommended that they do so (Long 2014b). Reacting to the situation that participants are being advised to roll over from the TSP the TSP has undertaken a policy of active retention, meaning that it is attempting to encourage participants to remain in the plan.

Are IRAs a Good Alternative?

In terms of fees, two types of rollovers to IRAs can be identified. In one type, the participant is advised by an adviser to rollover and the adviser manages the account for a fee, which is added to the fees charged by the underlying investments. In the second type, the participant is not charged an ongoing advisory fee, but only pays the investment fees. Advisory fees generally are at least one percent of assets, but in one rollover we encountered involving a major financial adviser in the Washington, DC area fees are two percent.

As indicated earlier, in 2013, $7.2 billion was rolled over from the TSP to other pension plans and IRAs (Long 2014b). If the other pension plans had the average fee of 74 basis points, which is the asset-weighted average of fees for equity mutual funds held in IRAS (Investment Company Institute 2015b), the participants would lose in aggregate about $50 million due to higher fees in the first year, with annual losses continuing for the life of the account. That would be a loss of more than $1,000 per participant per year. Because that amount would compound over time due to the loss of investment income due to the smaller asset base, it can be used as the basis of a present value calculation, yielding a rough estimated present value loss of $20,000 for a person making the average rollover. That estimate is an understatement because it does not include fees for financial advice. However, it is also a rough approximation, depending on the age at which the person retires, how long the person lives, when the person starts drawing down their assets and how rapidly, and the rate of return on their assets.

When Would a Rollover Make Sense?

While generally, advice to rollover from the TSP is bad advice because of the substantially higher fees the individual will pay in IRAs and to advisers, in a few circumstances, the higher fees may be outweighed by the benefits of a rollover. We discuss the primary reasons given by financial advisers for rolling over the TSP.

First, for people preferring investment options not in the TSP, or a high tolerance for risk, a rollover may be desirable. These options would include high-risk investments, actively managed mutual funds, real estate, and international bonds. However, individuals having the financial sophistication and risk tolerance to want these investments probably have sufficient assets outside of the TSP to use to make those investments. They could make these investments through their IRA, assuming they had one, and would not need to rollover to do so. Many TSP participants have exposure to the real estate market through owning their home.

Second, as indicated by the Federal Retirement Thrift Investment Board survey, some people find the TSP withdrawal options too inflexible. The TSP works well for people who want to receive regular monthly payments, but it does not work well for people who want to make an occasional withdrawal. Because most TSP members also receive a defined benefit plan monthly benefit, some may prefer to use the TSP for irregular withdrawals for special needs, but it cannot be used that way. Retirees can only take one partial withdrawal. People wanting to have extra money for special purposes could do a partial rollover to an IRA. After that, they must withdraw the full amount remaining, either as an annuity, a lump sum payment, or a series of payments, which can be tied to life expectancy. They can use a combination of those options that are available for full withdrawal. For the partial withdrawal, workers cannot choose which fund the withdrawal comes from, with the withdrawal being made on a pro rata basis from all funds in which they are invested. Allowing more than one partial withdrawal, and allowing workers to specify the fund from which it is taken, would be a step toward greater flexibility. The inflexibility in withdrawal options appears to be one reason why workers rollover their TSP accounts. However, because of its low fees, participants should first spend down their non-pension savings and their higher fee pension savings before making withdrawals from the TSP.

Third, people with small TSP account balances may roll over to an IRA rather than to maintain a separate small account. However, a superior strategy would be to maintain a small TSP account and later roll over higher-fee pension assets into that account. This type of rollover can be done by former and current federal employees who maintain a TSP account.

Our conclusion is that rarely is a complete rollover from the TSP good advice. Generally, the cost of a rollover in terms of higher fees outweighs the advantages of a rollover in the circumstances where there are advantages.

SUPPLY OF ADVICE

This section discusses issues relating to advice concerning rollovers.

Conflicts of Interest, Advice and the Compensation Model

Conflicts of interest arise from the ways advisers are compensated. Conflicted advice arises whenever the adviser earns higher fees from advising a strategy that is not in the best interest of the client. Generally, advisers earn higher fees by doing what is in the best interest of their companies or themselves. However, the analysis of conflicts of interest relating to investment advice, as has been done by the Council of Economic Advisers (2015), does not directly apply to conflicts of interest in the case of pension rollovers. In the case of investment advice, advisers charging by the hour or based on assets under management do not have an incentive to provide bad advice, In the case of rollovers, however, advisers charging by the hour or based on assets under management will generally make more money if their clients decide to roll over their assets. When an adviser has a client who is considering a rollover, the adviser generally will receive higher fees over time from that client by advising a rollover because that advice will lead to the need for continuing advice on managing the person’s investments.

An Assessment of Advice Concerning Rollovers from the TSP

Since the TSP does not provide individualized advice, participants may turn to the financial services industry for advice. Advice can be categorized in two dimensions—it can be self-interested versus neutral advice, and it can be generalized versus individualized advice. With self-interested advice, the adviser has a conflict of interest in that his compensation may be higher if he provides advice that is not in the best interest of the client. With neutral advice, the adviser's compensation does not depend on what he advises. With generalized advice, the advice is provided through advertising and through information on websites. With individualized advice, the advice is provided by a financial services professional to an individual. Different regulatory standards apply to generalized versus individualized advice, and arguably different regulatory reforms are needed concerning the current standards.

A Survey Concerning Individualized Advice. In 2013, the Government Accountability Office (2013) conducted a survey of thirty call-in centers to assess what advice people were receiving concerning rollovers from 401(k) plans to IRAs. It found that frequently people were being encouraged to roll over to an IRA by financial advisers who had obtained little information concerning the situation of the person, including information on the fees being charged by the plan they were in. Because of its extremely low fees, advice concerning rollovers from the TSP provides a stronger test of the quality of advice people are receiving than does the GAO survey.

Empirical Analysis

Studying advice received by TSP participants provides at least two advantages over studying advice to pension participants in 401(k) plans. First, we know the TSP participants are paying less than 3 basis points for their investments. Second, we know that any investment they are advised to roll over to will have higher fees, with the fees generally being substantially higher.

To obtain information on the advice that TSP participants receive from different types of financial advisers, we selected thirty advisers through a telephone survey and an email survey. With these surveys, we test two hypotheses. First, we test the hypothesis that participants in an extremely low fee plan are being advised to rollover to higher fee arrangements. Second, we test the hypothesis that having a fiduciary duty makes no difference in the quality of advice that advisers provide. To our knowledge, this is the first study to test that hypothesis, a weakness of previous studies according to the Investment Company Institute (2015a).

For most people, the best advice concerning rollovers would be to roll over IRAs and other pension accounts into the TSP. However, many advisers may not be aware that that is an option. The next best advice would be to leave the money with the TSP. The worst advice would be to roll over from the TSP to an IRA.

Telephone Survey. In the telephone survey, we contacted firms providing IRAs to see what advice one of the authors would receive concerning his own TSP account as a former federal government employee. We obtained contact information in two ways. We obtained telephone numbers from websites encouraging rollovers to IRAs. We also obtained telephone numbers for financial services firms from the Washington, DC telephone book. This survey is a convenience sample survey, and is not meant to be statistically representative of any universe of advisers. In most cases, we believe that the person providing advice was a person subject to a “suitability” standard, rather than a registered investment advisor subject to a fiduciary standard requiring that services be in the best interests of the customer.

We contacted seven mutual fund companies, seven banks and one insurance company seeking advice (a total of fifteen service providers) (Table 1).[iv] It was clear that many of the advisers were aware that the TSP charges extremely low fees, but it was also clear that some of the advisers did not know that. The advice generally ignored fees as an issue. The advice we received generally focused on TSP participants having a small number of investment options, while IRA participants had a large number of options. Ten companies indicated that the client should rollover the TSP to an IRA. We can state unequivocally that this was bad advice because we know the details of the person receiving it.

Four declined to provide advice, but instead to differing degrees tried to sell the idea that a rollover would be desirable. One adviser asked about the risk tolerance of the client and then advised that a client with moderate to high risk tolerance should roll over to obtain a greater range of funds, while a client with low risk tolerance should stay in the G Fund. One adviser said that we would receive $600 as an incentive to rollover plus 300 free stock exchange trades through their brokerage service. None of them advised rolling into the TSP.

From some of the advisers, we received false information that made a rollover seem to be desirable. One adviser said that we could reduce fees by rolling over. The insurance company indicated that we could obtain lower priced annuities outside of the Thrift Savings Plan. One company said we had no control of our investments in the Thrift Savings Plan. Two advisers praised actively managed funds, which are not an option with the Thrift Savings Plan.

Table 1. Telephone survey results for advisers with a suitability standard

Outcome	Number of Firms
Advised not to roll over	1
Declined to advise but suggested a rollover would be a good idea	4
Recommended a rollover	10
Total	15

Source: Author’s calculations

Advisers who worked for companies that took a more aggressive stance on their websites concerning IRA rollovers also tended to take a more aggressive stance in advising those rollovers in our phone conversations. We do not know how the people we contacted on the telephone were compensated, but it was clear that they viewed it as their job to encourage us to rollover from the TSP. While most of the companies we contacted advised rollovers, some companies that had more balanced presentations on their websites declined to provide advice, but instead focused on what they considered to be the advantages of rolling over. One adviser indicated that for rollovers, the company would make available mutual funds it managed that were currently closed to new investors as an incentive to rollover. One adviser suggested investing in a small cap fund when he learned that our portfolio did not include that. The lowest fee small cap fund that mutual fund company offers has an expense ratio of 91 basis points, compared to 2.9 basis points for the TSP small cap fund (the S Fund). Thus, fees would be more than 30 times higher. One adviser stated that we would have thousands of investment options if we rolled over.[v]

Information received in the mail from one mutual fund company we contacted indicated that an advantage of their IRA was that their investment advisers are noncommissioned, implying presumably that their advice would not be affected by a conflict of interest. An adviser from that company subsequently advised rolling over the TSP account to an IRA at their company.

All the fifteen advisers we contacted worked for companies that sold financial products. In total, two-thirds of the companies advised rollovers, one advised against rollovers for participants who were highly risk averse, and four companies declined to provide advice but indicated that their companies offered a good alternative. They generally ignored the issue of fees and made little effort to find out information about their client.

Email Survey. To test the hypothesis that having a fiduciary standard makes no difference in the quality of advice clients receive, we obtained a list of such advisers from the website for the National Association of Personal Financial Advisors (NAPFA 2015). That website provides email addresses, and we contacted the advisers in this survey by email.[vi] All members of NAPFA have a NAPFA fiduciary duty concerning the advice they provide their clients, but we believe that all of the ones we contacted were also subject to the SEC fiduciary standard. In addition, members of NAPFA can only receive compensation as fees from their clients. They cannot receive compensation from investment management companies whose products they purchase for their clients. The fees can be on an hourly basis, as a percentage of assets under management (AUM) or as a combination of those two approaches. Thus, this survey allows us to test for the effect of having a fiduciary duty concerning the advice provided. Our null hypothesis is that having a fiduciary standard has no effect on advice.

In the email survey, because we were dealing with financial advisers in one-person or small firms, for ethical reasons we wanted to make it clear that we were not actual clients but that we were doing a survey. The email survey may have two biases. First, by providing their answers in writing, the advisers may have felt more cautious about providing "bad" advice, or even any definite advice. Second, because we indicated it was a survey, the may have been less aggressive in seeking rollovers because they knew they were not dealing with actual potential clients, so that no money was at stake. Both effects may bias the results away from recommending rollovers.

Because we did not specify a fixed set of response options, the responses we received were varied, as indicated in Table 2. Among these advisers, the issue of fees was more commonly discussed. Four advisers recognized the extremely low fees charged by the TSP and recommended against rolling over. One of these advisers recommended rolling other pension accounts into the TSP. The majority of advisers argued that in some circumstances a rollover might be advisable. Because it is our conclusion that in most circumstances it would not be advisable, the effect of having a fiduciary standard is weaker than we expected. It appears that having a conflict of interest still affects the quality of advice. For those advisers, we do not know whether they would recommend a rollover to most of their clients, but that is a possibility, given the responses. Nonetheless, when comparing these responses with those in the earlier survey, the null hypothesis is rejected—the two sets of responses are statistically different at the 2.5 percent level according to a chi square test.

One reason why some advisers may recommend a rollover from the TSP is that they have misperceptions concerning the TSP. For example, one adviser told us that the TSP does not have investments in corporate bonds, which it does, and that a comparable Vanguard fund had lower fees, which it does not.

Table 2. Email survey results of fee-only advisers with a fiduciary standard

Outcome	Number of Firms
Advised not to roll over because of low fees	4
Advised not to roll over during accumulation phase, but would recommend rollover during the distribution phase	2
Would recommend partial rollover in some circumstances for greater diversification	3
Would recommend rollover in some circumstances, depending on the individual situation	4
Recommended a rollover for greater diversification	2
Total	15

Source: authors' calculations

This survey suggests that having a fiduciary duty does affect the advice advisers provide. However, the survey suggests that advisers with a fiduciary duty often use the argument that a rollover would provide the opportunity for greater diversification, which is true, without the adviser considering the extra cost in fees that a rollover would entail. This finding suggests that in addition to a fiduciary standard, education of advisers may be needed as to what a fiduciary standard implies, particularly with respect to the cost of alternative investment approaches. Greater enforcement may also be needed.

Further Reasons Why an Adviser May Advise a Rollover

We have already identified two general categories of reasons why an adviser might advise a rollover from the TSP. First, under limited circumstances, a rollover may be good advice. Second, the adviser may be acting based on a conflict of interest. In addition to those sets of reasons, based on our surveys, we now add two other categories.

First, we encountered advisers who are not familiar with the TSP or have incorrect information about it which makes it seem to be less favorable than it is.

Second, advisers may have valid reasons for recommending a rollover, but they fail to balance those reasons against the cost of the rollover in terms of higher fees. Thus, their analysis is flawed by not taking into account costs. In effect, they are telling a half-truth because they are not divulging all the relevant information, and in particular they are ignoring fees. They are not alone in this last respect. NASDAQ (2010) lists five common errors in making rollovers to IRAs, but it does not include considering differences in fees. Similarly, the SEC (2015) provides information on the availability of rollovers, but it does not mention that the person should consider the level of fees in the new plan versus the old plan. FINRA (2013) provides the following advice: “An IRA often enables an investor to select from a broader range of investment options than a plan. The importance of this factor will depend in part on how satisfied the investor is with the options available in the plan under consideration. For example, an investor who is satisfied by the low-cost institutional funds available in some plans may not regard an IRA’s broader array of investments as an important factor.” This advice does not indicate that the extra diversification should be weighed against the extra cost.

Counter Arguments

This section responds to two counter arguments—first, that the TSP offers too few options and second, that higher fees can be paying for other services, such as peace of mind and having a person to interact with.

Does the TSP Offer Too Few Options? One of the main criticisms of the TSP by advisers advocating rollovers from it is that it offers too few funds. A survey of TSP active participants found that 36 percent would roll over once they left federal employment to access more or better investment options (Long 2014). Thus, addressing this issue is key in evaluating the advice that TSP participants receive. Hewitt (2013) addresses the question of whether a non-U.S. bond fund and other categories of investments not currently included in the TSP funds should be added. For some categories, such as value and growth stocks, and real estate, it concludes that the TSP funds already provide access to investments in those areas. For the non-U.S. bond fund, it concludes that a small improvement in the efficient frontier (risk-return tradeoff) would be obtained for participants, particularly those with low-risk portfolios.

The TSP stock funds do not cover emerging markets, Canada, and international small capitalization stocks, and its other investment options do not international bonds. Copeland (2013) finds that in aggregate, IRA participants invest 13.8 percent of their assets in the category “other,” which refers to investments not in stocks, bonds, or target date funds. This finding suggests that IRA participants do hold a wider range of investments, since the TSP does not have any investments in that category. The TSP does not offer actively managed funds.

Adding new funds would improve the opportunity for diversification, but because the TSP already offers wide diversification in international and domestic stocks and domestic bonds, the benefits of increased diversification are likely to be relatively small. Investment advisers encouraging rollovers for this reason apparently do not weigh the relatively small benefits against the costs in increased fees. Advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits. They provide self-interested analysis that justifies their self-interested advice.

In addition to traditional arguments relating to the advantage of having more choice versus the added costs, behavioral economics also provides analysis. The paradox of choice refers to the negative effects of having too many choices. For some pension participants, having too many options may make investment decisions more difficult, which would cause the limited options in the TSP to be an advantage. Several studies have documented problems people have generally in making decisions when facing a large number of options (Iyengar and Lepper 2000, Carosa 2011). Despite the concept from traditional economics that more options are always better, recent research has documented that for psychological reasons of mental overload, above a minimum level, fewer choices are better for many people when the remaining choices allow a sufficient range of choice. A further study found that too many investment options in 401(k) plans lowered participation rates (Iyengar, Huberman and Jiang 2004). The idea that having unlimited choice is a good feature is thus not supported by behavioral research.

Another aspect of too much choice, in the context of IRAs, is that there may be a tradeoff between quantity of choice and quality of choice, with a larger number of choices including more options that are of poor quality, having high fees, poor rates of return and being poorly diversified because of their limited scope (Goldreich and Halaburda 2011).

In the TSP, where the choices have been preselected by financial experts, the average quality of choice is better than for IRA participants who face a much larger range of choice, with limited or no elimination of poorly performing investment options. Because the TSP has a preselected choice of investments, it may be easier for participants to make good investment choices in that setting than with an IRA, particularly for participants who are not financially sophisticated.

Are Higher Fees Justified by Other Services? The response to this argument is basically the same as for the preceding argument. The fees may be paying for other services besides asset management. The question is, does the marginal value of the other services justify the substantially higher cost incurred by rolling over?

CONCLUSIONS

We argue that a logical place to look for bad advice concerning pension rollovers is participants in a really low-fee plan. The same words spoken to participants in a high-fee plan advocating a rollover may be good advice, while they would be bad advice to someone in a really low-fee plan. While a lower-cost investment option is not always the best choice, when the cost difference is large, the cost of not taking that option needs to be considered.

Because of the low fees the Thrift Savings Plan charges and the quality of the investment options it provides, the advice provided by financial advisers concerning rollovers from the TSP permits a particularly strong test of the hypothesis that the standard used by many financial advisers concerning the advice they provide is low. The Thrift Savings Plan provides participants uniquely low fees, many times lower than fees generally available in IRAs.

Because of its very low fees, for most people it would be bad advice to rollover from the TSP. For this reason, the advice does not even meet the suitability standard, much less the standard that it is in the best interest of the client. On average, workers taking this advice appear to be paying more than $20,000 extra in present value of fees compared to if they had stayed in the TSP. In some cases, the fees are more than 70 times larger. We thus provide evidence of insensitivity by some pension participants to large differences in fees. We argue that this is the outcome of financial illiteracy meeting conflicted advice.

Advisers with a conflict of interest need a justification for advising a rollover, which for the TSP often is the possibility of greater diversification. However, it appears that when conflicted advisers find a justification, they do not weigh the added costs against the benefits. Our surveys suggest that a fiduciary standard does have some effect on advice, but it does not guarantee good advice. It appears that advisers with a conflict of interest concerning rollovers may engage in a partial analysis that justifies their position, focusing on the benefits of a rollover, while not fully considering the costs.

In sum, we provide evidence on the following points. First, traditional economics (rationality) and behavioral economics (inertia) cannot explain TSP rollovers. We argue that a new decision-making model is needed. The model we present is financial illiteracy with conflicted advice, which is in the class of models relating to agency problems. Second, pension participant inertia has been overcome by advice, and for other reasons. Pension participant inertia appears to depend on the context, being less at the point of job change than while working for the employer. This concept relates to research on "fresh starts," indicating that people are more likely to make changes following the New Year or a birthday (Benartzi et al. 2015).

Third, because of the financial illiteracy of many people and the conflicts of interest of advisers, the market for financial advice may result in bad outcomes for clients. Fourth, some people are insensitive to large differences in fees. While not everyone rolling over from the TSP does so because of financial advice, those rolling over for other reasons appear often to not be taking into account the cost of doing so in terms of higher fees. The insensitivity to fees may be due in part to lack of knowledge of the fees the person is paying and lack of knowledge relating to the effect of apparently small differences in fees. Fifth, some people are not aware when they are receiving bad advice. Bad advice has been followed by pension participants, presumably due to financial illiteracy. Sixth, bad advice can be very costly, with a present value cost of roughly $20,000 for a person making the average TSP rollover.

Seventh, the analysis of conflicts of interest for pension rollovers differs from the standard analysis of conflicts of interest concerning investment advice. When advising concerning rollovers, advisers generally have a conflict of interest, even if they charge by the hour or by assets under management, because the rollover will lead to the need for further advice in the future. Eighth, in our survey of advice, we find that among advisers with a suitability standard, fees were rarely mentioned. Ninth, advisers with a conflict of interest need a justification for advising a rollover, but it appears that when they find one, they do not fully explore its merits. It appears that even advisers with a fiduciary duty often do not weigh the costs of higher fees against the benefits of a rollover, that being, for example, the benefits of marginally greater diversification. They are telling a half-truth because they do not fully divulge the relevant information.

Tenth, existing regulatory standards, as they currently are enforced, are not adequate to protect pension participants from seriously bad advice. Eleventh, a fiduciary standard, in particular the SEC standard, for advisers does make a difference, but it does not completely solve the problem that arises from the financial incentives inherent in their conflicts of interest. Just making an adviser a fiduciary is not sufficient to overcome self-interest and assure good advice for clients.

They may use self-interested analysis to support self-interested advice, with the end result being harm to pension participants.

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[i] We have received valuable comments from Brigitte Madrian, David Laibson and other participants in a session at the 2015 American Economic Association meetings; from Natalya Shnitser and Peter Weidenbeck and other participants at the Fourth Annual ERISA Scholars Conference, from Ike Brannon and other participants at the Savings & Retirement Forum, from Anna Maria l Lusardi and other participants in the Global Financial Literacy Excellence Center Seminar on Financial Literacy, and from Stewart Kaplan, Daniel Kasprzyk, Anna Rappaport and Steve Vernon.

[ii] Unless otherwise indicated, we are referring to the SEC fiduciary standard. Different organizations have different fiduciary standards, as discussed later in the paper. The SEC standards are not as stringent as standards found in ERISA and the IRC. In particular, the SEC generally permits self-dealing transactions that would largely be prohibited under ERISA and the IRC, as long as the Registered Investment Adviser (RIA) fully discloses the conflict to the client.

[iii] Some of the transfers may have been for the purpose of making a withdrawal, while avoiding the 20 percent withholding tax. We have no information on the importance of that strategy.

[iv] We presented the following scenario. "I am a retired Federal employee. I am trying to decide whether I should keep my Thrift Savings Plan account or I should roll it over to an IRA. What would you advise?"

[v] One adviser told us that he had recently advised his mother-in-law to roll over her TSP account to an IRA.

[vi] We sent the following email text: "I am an economist investigating advice that fee only financial advisers provide concerning TSP rollovers to IRAs. Would you generally advise a retired federal government employee to roll over their TSP account to an IRA? Thanks for your help."