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Comment Letter
Department of Labor, Employee Benefits Security Administration
RIN 1210-AC02
Retirement Security Rule: Definition of an Investment Advice Fiduciary
November 14, 2023

Dear Lisa M. Gomez,

I write to comment on your proposed regulation to extend and expand the existing fiduciary rules pertaining to retirement plans and accounts. Because you have not made a compelling case nor offered sufficient evidence for the necessity of these changes, and have not seriously considered the likely downsides of or alternatives to this expansion, the proposed regulation should be rescinded.

By way of background, I am currently a senior fellow at the American Enterprise Institute where I conduct research on retirement plans and behavior, as well as on insurance markets. Over a long career, I have done research and development on retirement plans, products, strategies and policies, as a federal government senior official, a benefits consulting firm analyst, financial services firm director, and founder of a fin-tech company. In short, I am a long-term student of, and participant in, the retirement marketplace.

Your central premise, repeated throughout the proposal, is that consistent and high "best interest" fiduciary standards from the Department of Labor are needed across all actors and aspects of retirement investing, even beyond the strict confines of plans and accounts. This is regardless of the costs, benefits, overlaps with other regulators, needs of investors, and likely loss of services to those with small accounts. Although you give a narrow accounting of the costs, you studiously do not give an estimate of the expected benefits, despite citing dozens of studies, surveys and statistics, which on closer examination are largely not relevant to the expansion you intend.

On the assumption that most retirement investors, including plan sponsors, are ignorant and naïve, you assert that disclosure measures would be insufficient: only the force of government—backed by the prospect of private legal actions—can offer the right level of protection. Yet despite the litany of studies cited, you offer no direct support to this essential claim nor define the optimal level of protection. Because many of these studies conflate commissions and loads with conflicted advice without considering the possibility that extra services and features are being provided, or difficult-to-serve markets are being reached, the interpretation you and they give is not necessarily warranted. Moreover, one of the studies cited did find that investors are generally aware of product differences; more

prosaically, it is common sense to say that most people know the essential differences between an annuity sold by insurance agent and a no-load mutual fund sold over the internet. For a market to perform efficiently, not all need be fully knowledgeable, just the marginal actor, and you have not shown that the market is failing. Besides, some of the studies you invoke show the opposite of your assertion: investors have long been moving toward lower-cost funds and products even without the intervention of new fiduciary standards.

You initially cite new NAIC rules favorably as part of a picture of general regulatory trends toward best interest standards, then criticize them as inadequate, and still say that you will continue to coordinate with the NAIC. Your stance on SEC standards is similar but more subtle. You repeatedly call out the new SEC standards with apparent approval, but given that they are largely made up of enhanced disclosure and you are dismissive of that approach, you are implicitly criticizing them also as inadequate, but say that you will coordinate with the SEC. You do not address the problems and costs that overlapping regulation from the NAIC, SEC, CFTC, FINRA and states on the same products, plans, and people will entail.

You cite studies and surveys that show that stricter fiduciary standards result in fewer products and services for small account holders. Indeed you do not evaluate a possible untoward result of what you apparently intend to happen in the marketplace – movement away from commissions and toward fee-based accounts – that total costs will increase for retirement investors over their lifetimes.

You and an accompanying Council of Economic Advisers analysis show particular animus toward fixed indexed annuities. Yet a study you cite shows that the imposition of stricter fiduciary standards has moved investors away from variable annuities, regulated by the SEC, toward fixed indexed annuities, regulated by the NAIC and the states. Moreover, during the retirement of the baby boom generation and the mass drawdown of 401(k) accounts and IRAs, there is a policy consensus that the use of income annuities should be encouraged. Yet this regulation does not consider whether the changes being made here would lead to or away from this goal, for example, whether the commissions currently being charged on the sales of immediate annuities or other similar products and strategies would be considered reasonable compensation or not.

You say that in distinction to the earlier 2016 regulation, in response to the vacatur of a 2018 Circuit Court decision, that this regulation is more narrowly drawn and careful not to mix provisions in ERISA's Title I, covering employer plans, and Title II, covering IRAs. Indeed, the heavy-handed contract obligation structure is removed, but replaced by more ambiguity and uncertainty. The only examples you give of what is left out of the extent of this regulation's ambit are car dealers and HR department personnel. Similarly there still seems to be a mixing of Titles I and II by imposing the loss of Prohibited Transaction Exemption protection, coming with the threat of legal class action, if excise taxes are not assessed and paid. I am not a legal expert but my intuition is that there is significant legal risk here for this regulation.

Finally, this regulation repeatedly cites a 2015 study by the then Council of Economic Advisers. As I and Hester Peirce, now a Commissioner at the SEC, demonstrated in an April 17, 2017 public interest comment sent to your Department in response to a Presidential memorandum on the fiduciary duty rule,

that study is a weak and exaggerated analysis of the academic studies and data on the performance of so-called conflicted advice funds. In case you have misplaced that comment, I reproduce the relevant sections in the Appendix below.

Sincerely,

Mark J. Warshawsky, Ph.D.

Appendix

II. The Economic Analysis Underlying the Fiduciary Rule is Flawed

In February 2015, the Obama administration's Council of Economic Advisers (CEA) issued a report, "The Effects of Conflicted Investment Advice on Retirement Savings," in support of the effort by the DOL to impose fiduciary standards on the giving of investment advice for IRAs and other tax-advantaged accounts. Soon thereafter, the DOL itself released a regulatory impact analysis (RIA) repeating many of the findings and inferences made by the CEA, in support of the proposed regulation, which was put in place in 2016. These reports were basically a review of academic studies, and—through some stretches of logic and extrapolation—the CEA claimed that about $17 billion each year was lost to investors because of conflicted advice. This advice, according to the CEA, causes wrong fund selections, excess trading, and other investment errors, and it is self-serving to financial advisers because it is generated by inappropriate forms of compensation paid to them, such as loads and commissions. Indeed, as noted above, the DOL fiduciary rule appears to be intended to lead to changing adviser compensation to be based on a percentage of assets under advisement.

The CEA estimate has been widely cited and is thought to be influential in the case made for the DOL fiduciary rule. Yet, review, analysis, and the introduction of new data reveal that the CEA report is quite weak and should not serve as the basis for such an extensive remaking of the structure of the financial services and retirement industries.

The CEA defines conflicted advice as occurring when payments to the adviser depend on actions taken by the investor—in particular, when they are encouraged through arrangements such as revenue sharing, front-end and back-end loads, and commissions that vary by type of product. It claims that, per se, these arrangements lead to lower returns to investors, by 100 basis points, applied to $1.7 trillion in supposedly affected fund assets in IRAs. Although the CEA cites several studies, it is mostly relying on two studies by Bergstresser et al. (2009) and Christoffersen et al. (2013).

Bergstresser et al. compares the performance of funds sold through intermediaries with that of funds sold directly to investors over the period 1996–2004. The CEA says that Bergstresser et al. finds that funds sold through intermediaries—who the CEA says are more likely to be conflicted—deliver lower returns, net of operating expenses and adjusted for risk through a complex factor model, on an asset-weighted basis, by 77 basis points for domestic equity funds and 90 basis points for bond funds. Yet, the same analysis finds that broker-sold international equity funds outperform directly sold funds by 183 basis points. It is unclear and concerning why intermediation would lead to different results in different investment classes. Moreover, when the calculations are done in a simpler manner that avoids estimation errors and is like how other studies of this nature are done—just controlling for benchmark category and not using a factor model—the underperformance is much smaller: 27 basis points for domestic equity, 34 for bonds, and −145 for foreign equity.

Christoffersen et al. examines only load funds over the period 1993–2009 and connects the magnitude of payments an intermediary receives for selling a particular mutual fund to inflows and underperformance.

Comparing flows for mutual funds with “outlier” (unusually high or low) payments to intermediaries, Christofferson et al. find that initial inflows are larger for funds with high payments. It finds funds with unusually high payments to intermediaries tend to generate unusually low returns, controlling for fund category—in particular, “the average 2.3% payment to unaffiliated brokers corresponds to a 1.13% reduction in annual performance.” Christofferson et al., however, does not find this effect for brokers affiliated with the mutual funds they are selling or for revenue sharing. Because the estimated effect is just for a segment of the market, is just for initial inflows (not net flows over time), and is not clearly asset weighted, it is not correct for the CEA to extrapolate from this study’s results to the entire $1.7 trillion IRA brokered funds market.

Moreover, it seems that the DOL’s RIA made a mistake in its use of the Christoffersen et al. study results by multiplying average positive loads on funds by the coefficient of an equation estimated on outlier load payments, which average to zero. The loss to investors therefore is likely to be quite small, based on the correct calculation.

There are several other fundamental problems of interpretative logic and extrapolation that apply to the use of these and similar studies cited by the CEA. First, the studies generally are based on data from an earlier time period, when fund markets were more segmented between broker-sold funds and funds sold without loads directly to investors, and other competing low-cost investment types, such as ETFs, were not common. More recently, an increasing proportion of funds with front-end loads also offer no-load share classes, so there is more awareness of sales costs and, therefore, more competition.

Also, according to National Economic Research Associates (2015), since 2000, expense ratios across all types of funds, by investment and management categories, have dropped significantly; the average front-end load that investors pay also has declined, while nearly all net new cash flow is going to no-load funds. According to the Investment Company Institute (ICI) (2015), based on sales-weighted return (net of expenses, adjusted for benchmark category) data from 2007 through 2013, investors in front-end load shares underperform investors in retail no-load shares by only 21 (one-year return basis) or 6 basis points (three-year return basis). Moreover, most of the studies used by the CEA in arriving at a 100 basis point average underperformance are not asset weighted.

Second, the estimated effects in these studies are “reduced form,” and not “structural.” To evaluate the impact of a change in regulations on market prices and quantities, we need to know the equations for the demand function and the supply function separately (structural) in order to do an economic analysis of policy. But the studies cited by the CEA are reduced form, in that they do not separate out the independent and complete effect of conflicted advice on investment performance; there is no structural model containing the separate supply and demand equations determining price and quantity for advice of different kinds. Such a structural model would be made up of variables explaining fund construction, marketing, different market segments, different forms of adviser compensation, and so on. For example, perhaps the estimated underperformance of load funds is actually payment to the broker for the discovery of new, initially smaller, funds that will eventually have higher returns, or for the tailoring of portfolios to the specific risk preference and personal financial and tax conditions of investors. Admittedly, estimating a structural model is an ambitious project, often requiring instrumental variables

and other econometric techniques, yet it is possible to do so, as evidenced by their use in other areas of economic policy analysis, such as monetary, labor, and public finance.

As just stated, none of the studies are directly relevant to the policy question at hand—whether the imposition of a fiduciary standard of the specific type put forward by the DOL will improve investment performance. In fact, it is distinctly possible that the opposite is true—the new fiduciary standard will increase investment costs and thereby worsen performance if asset-based fees become widespread. This is the third problem of interpretation and extrapolation. In particular, consider the comparison done by the ICI (2015). The average asset-based fee that investors incur when they pay a financial adviser directly is currently 111 basis points. By contrast, IRA investors currently pay between 26 and 28 basis points per year in front-end loads and another 24 basis points for the average 12b-1 fee paid to the broker—about 50 basis points total. Although there are many assumptions in these calculations, including rebalancing frequency, and conditions will change in unknown directions after the regulation is in place, a conservative assessment based on current market conditions and practices implies a decidedly negative impact of the fiduciary standard rule on investment costs and net performance.

Fourth, alternative, less intrusive, forms of government intervention, such as enhanced disclosure, need to be considered and even tried before more massive interventions are imposed. Because of the structure of Social Security and the tax code, most IRA holders are in households with middle incomes and higher. These individuals are generally well educated or experienced, and they presumably would be in good positions to benefit from better disclosure of the cost and nature of the compensation paid to financial advisers involved with their IRAs.

Fifth, it is distinctly possible that for certain segments of the market—smaller accounts, more complex financial situations, and so on—advice from investment advisers will simply disappear. The rules applying to the best interest contract exemption in the regulation for conflicted advice and allowing the continued use of commissions are limiting, burdensome, and—perhaps more importantly—exceedingly vague. Therefore, this carve out represents a constraint, cost, and considerable risk to large brokerage firms in the current litigious class-action environment.

The likely consequence of the DOL regulation (and indeed perhaps its real intention) is that most investment advice will be compensated mainly on the basis of percentage of assets. Yet this causes small and difficult retirement investment accounts to be unprofitable to advisers, who will have an incentive to avoid such accounts. This indeed seems to be happening in late 2016 and early 2017, as some brokers reportedly are dropping small accounts entirely or shunting them to robo-advisers and other do-it-yourself forms of investments.

Similarly, because the finalized DOL rule classifies advice on rollovers from an employer-sponsored plan to an IRA as fiduciary advice, even level-fee investment advisers have to comply with a streamlined best-interest contract that requires acknowledging fiduciary status and documenting why the rollover is in the best interest of the client. The documentation must take into account the difference in fees and services between the employer-sponsored plan and the IRA. Because of the increased compliance procedures and potential difficulty in justifying a rollover, it is reasonable to believe that more assets will stay in

employer-sponsored plans like 401(k)s, particularly for small accounts.

Whether these induced changes will lead to better or worse investment and retirement savings outcomes for lower-income individuals is unknown, but the changes are clearly not what the market would have produced in the absence of the new regulation. Moreover, this approach of heavy government intervention picks winners and losers in the investment provider marketplace. It is welfare decreasing to those small account holders who prefer and even need personal advice and service and would have liked to consolidate all of their retirement accounts in one location.

III. Conclusion

The DOL should embrace the opportunity afforded it by the presidential memorandum to reconsider the fiduciary rule. The 2015 CEA report that DOL and others have used to justify the DOL fiduciary rule is a weak and exaggerated analysis of the academic studies and data on the performance of conflicted advice funds. Moreover, the rule itself will not necessarily have a positive impact on the retirement savings of Americans and is hugely disruptive to established financial and retirement industries. If there is evidence for significant confusion and misinformation about the compensation of financial advisers among investors, then the appropriate solution may be improved disclosure, rather than this massive government intervention. Any regulation in this area should be coordinated closely with the SEC, which has a broader understanding of and longer experience with regulating financial products and services.