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SUMMARY AND ANALYSIS OF CEA REPORT ON RE-PROPOSED FIDUCIARY RULE: 'THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS'

The U.S. Department of Labor (DOL) recently submitted to the Office of Management and Budget (OMB), a revised version of the "conflict of interest" rule expanding the definition of the term "fiduciary." This is a revised version of the regulation that was proposed in 2010 and subsequently withdrawn for reconsideration. After OMB review, the rule will be published in proposed form, with a formal comment period, before it is finalized. The text of the proposal will not be made public until it is published.

The White House did, however, release **a new report** from the Council of Economic Advisors (CEA), outlining its analysis of the effects of conflicted investment advice on retirement savings. This report outlines the economic justification for the forthcoming regulation by estimating that losses of $17 billion per year to retirement savings result from what the report calls "conflicted" investment advice.

BACKGROUND

It is important to understand the procedural context of this rulemaking as we consider the CEA's report.

The policy and principles governing the development of federal regulations is set forth in Executive Order 12866 issued by President Clinton in 1993. These are reiterated in Executive Order 13563 issued by President Obama in January 2011. The Executive Orders establish several underlying principles that must guide regulatory decision making including that *"Each agency shall assess both the costs and benefits of the intended regulation and, recognizing that some costs or benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs"* In undertaking this analysis *"each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as*

possible." It is very important to note that this justification of the *need* for regulation is distinct from the cost-benefit analysis of feasible alternatives that explain the ultimate choices made in crafting the regulation that is also required under the two Executive Orders.

The standards for this regulatory analysis are set forth in OMB Circular A-4. This reiterates the principle that *"Before recommending Federal regulatory action, an agency must demonstrate that the proposed action is necessary."* It requires that an economic rationale indicating a *"market failure or other social purpose"* be identified and all quantifiable and unquantifiable costs and benefits be evaluated in the analysis.

The CEA report is presumably indicative of what DOL will use to support its forthcoming proposal. The following summary includes our initial observations regarding the extent to which the analysis fulfills the requirement for justification of the need for regulation.

SUMMARY OF ANALYSIS AND OBSERVATIONS

The report describes the rapid shift from defined benefit pensions to individual account retirement plans over the past few decades, making individuals increasingly responsible for investment decisions with respect to their plan assets. The report also describes the "explosion" of investment options and notes that individuals providing investment advice regarding the assets in these accounts are subject to varying standards depending on whether the individual providing advice is a Broker Dealer or Registered Investment Adviser (RIA). The report does *not* discuss the existing definition of a fiduciary under DOL regulations or its application to employer sponsored plans that are the primary focus of the forthcoming regulatory proposal, instead focusing entirely on Individual Retirement Accounts (IRAs).

As detailed in the report, the current regulatory framework imposes a fiduciary duty of loyalty and care on RIAs, while Broker Dealers are subject to a less stringent suitability standard. The CEA notes that persons providing advice may be compensated through commissions (or other types of payments that vary with the behavior of the account owner) or fees associated with the value of the investment. It further notes that commissions and other related fee arrangements may provide an incentive to direct investment decisions to products providing higher payment to the advice giver. The report deems any arrangement with such an incentive to be "conflicted" investment advice. It presumes that in all circumstances the combination of a different standard of duty and potential incentives of varying fee arrangements creates an inherent conflict of interest and suggesting that this uniformly results in negative outcomes. The report states that this type of advice is prevalent in decisions to roll over account balances from a 401(k)-type plan to an IRA and in the investment of IRAs in mutual funds, which is estimated to account for $3.5 trillion of the $7 trillion in total IRA assets.

Based on the findings of several academic studies, using a sample of transactions in the retail mutual fund market and applying these findings to the universe of IRA investments in mutual funds, the report estimates that "conflicted" advice costs IRA owners $17 billion per year. It does this by estimating that there is a 1 percent per year lower return on what is estimated to be half of the current IRA assets that have been rolled over from ERISA plans ($1.7 trillion) that are presumed to have been invested through broker-dealers who are assumed to have provided "conflicted" advice. Each of the elements of this estimate warrant some further scrutiny.

The analysis primarily references four academic studies to derive and justify the estimate of the 1 percent loss in returns. The first three of these studies compare the returns of mutual fund investments that are sold directly to investors with those sold through intermediaries such as brokers[1]. These studies conclude that funds sold through intermediaries have higher fees (which the report presumes involve an inherent conflict of interest) and experience about a 1 percent per year lower performance compared to those that are directly sold.

There are a variety of issues related to the applicability of these studies to IRAs (and more generally retirement savings) that are not addressed in the report. Both papers attempt to address the inability of the sample of data to consider likely potentially different characteristics of the resulting investment that might explain differences in observed returns by measuring performance on a risk-adjusted basis. They do this, however, by using measures that are not fully applicable to the evaluation of investments that do not constitute the entire investment portfolio of an individual, as is typically the case for a rollover IRA. Neither study specifically evaluates IRAs or retirement savings or is able to consider the role of the investment in individuals' overall portfolios or other characteristics of the investors. The studies on which the 1 percent assumption are based do not consider actual data that is available on IRA investments in mutual funds that indicate that IRA investors own funds that have fees that are considerably less than the average for all mutual fund investors. Moreover, no adjustment for this difference is incorporated into the cost estimate.

The third study cited in the body of the reports seeks to explain the application of findings not specific to IRAs to the investment of retirement savings[2]. This study evaluates changes in investment returns when participants in a qualified retirement

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[1] Bergstressor, Daniel, John Chalmers and Peter Tufano. 2009 "Assessing the Cost and Benefits of Brokers in the Mutual Fund Industry" The Review of Financial Studies 22(10): 4129-4156 ; Del Guerico, Diane and Jonathan Reuter. 2014. "Mutual Fund Performance and the Incentive to Generate Alpha". The Journal of Finance 69: 1673-1704 and Christoffersen, Susan E. K., Richard Evans and Daniel K. Musto. 2013 "What Do Consumers' Fund Flows maximize? Evidence from Their Brokers Incentives." Journal of Finance 68(1)201-235

[2] Chalmers, John and Jonathan Reuter. 2014. "What is the Impact of Financial Advisors and Choice on Retirement Portfolio and Outcomes" National Bureau of Economic Research Working Paper w18158

plan lose access to a brokerage account and primarily move to default choices (specifically target date funds, in the case studied). The report interprets this outcome as evidence that, in the absence of commissions and the potential for conflicts of interest, plan participants can be expected to improve the cost effectiveness and quality of investment choices. It does not consider alternative explanations for the outcomes observed such as lower negotiated fees for default investment alternatives or the more conservative portfolio in target date funds that may be appropriate for older participants who otherwise exhibit the well documented inertia in investment behavior until motivated by a change in plan design.

The report goes on to assert that the evidence of lower performance of 1 percent per year derived from the first two studies, is corroborated by a fourth study that finds a relationship between the level of costs and the degree of "underperformance." This study, which is primarily focused on distinguishing between the outcomes of "captive" and "unaffiliated" brokers rather than the nature of advice, has the same limitations as the first two studies with respect to its specific applicability to IRAs and does not specifically risk-adjust the observed returns.

Without commenting on the applicability of the findings from mutual fund investors to the circumstances of IRA investors, the report extrapolates the findings to the full universe of IRA holdings to estimate the magnitude of the losses that result from presumed "conflicted" investment advice. It does this by applying the 1 percent lower performance estimate to all of the IRA assets estimated to be held in mutual funds and annuities that have some type of "load" or commission associated with them. It assumes that the distribution of IRA mutual fund investments among commission based products is the same as the "share of load funds among non-institutional mutual fund assets." The report also assumes that "conflicted" advice occurs with respect to all IRA assets invested either in load mutual funds or annuities, for a total of about $1.7 trillion in potentially affected IRA assets.[3] Applying the 1 percent per year loss estimate derived from the studies to this total yields the estimated annual loss of $17 billion that is highlighted throughout both the report as well as President Obama's remarks in announcing DOL's regulatory initiative.

The report concludes with a brief discussion of alternative explanations for the differences in investment performance in relation to the fee structure on which the estimates of the costs of conflicted advice are based. First, it considers the potential need to compensate brokers for the value of investment advice that is provided, and rejects this possibility because the studies attempt to exclude fees paid solely for advice on portfolio management. The report also acknowledges that there may be intangible benefits associated with the manner in which investment advice is provided (and

[3] The report considers this a middle-range estimate of affected IRA assets, with a low range of $1.05 trillion (IRAs invested in load mutual funds) and a high range of $3.26 trillion (the total estimated advised IRA assets).

therefore the structure or magnitude of fees), but disregards this on the basis of other evidence showing that households are unaware of fee arrangements or may not understand the nature of the fees or their potential to engender conflicts of interests.

While the report acknowledges that there are potentially a wide range of characteristics among the different types of investors that are not accounted for in the study, the report associates these only with possible differences in the willingness to pay different types of fees rather than differing investment strategies and products, such as a movement to more conservative, and therefore lower yielding, investments. The report notes the potential that negative behavioral biases may be associated with higher fees and lower returns, but does not conclude that there is a need to adjust the findings for this possibility due to studies that find that payments to advisers result in deviations from "best practices" rather than improvements in strategy.

The CEA's report correctly identifies the importance of how fees are paid in the investment of retirement savings and the potential conflicts of interest that may arise from some arrangements. It provides some evidence that there can be differential outcomes associated with the way in which fees are structured in the overall mutual fund market. In the apparent absence of analysis that is specific to retirement savings vehicles, the report utilizes studies evaluating mutual fund investments that suggest that broker sold mutual funds experience significantly lower returns than those which are direct sold, construing this difference to be entirely a consequence of perceived conflicts of interest. The analysis uses this indirect evidence to construct an estimate of $17 billion per year in losses accruing to IRA investors by assuming that those who have purchased a mutual fund involving a sales commission will experience a 1 percent lower rate of return.

CONCLUSION

Tanalysis does not attempt to adjust for the many unobserved characteristics of investors that might explain differences in value received for fees or investment returns such as varying strategies arising from differing individual circumstances or the value of advice on overall portfolio strategy or appropriate levels of retirement savings that may be associated with brokerage commissions. Despite available evidence that indicates that IRA mutual fund investment involve lower fees than other investments in mutual funds it applies the 1 percent fee differential derived from studies of the broader universe of mutual funds to the full universe of estimated IRA mutual fund holdings. It offers little direct evidence of the applicability of these findings to the particular circumstances of retirement plan and IRA investments that the announced DOL regulations will address. Rather, it focuses on one element of this much larger market.

There is very little guidance or precedent regarding the standard for demonstrating the economic justification for regulations of this type or the threshold for indications of

a "market failure" that are referenced in the policies and guidelines applicable to the federal regulatory process. If the CEA report is indicative of the justification that will accompany the forthcoming regulations, what is certain is that there will be significant opportunity for discussion and commentary regarding whether all of the quantifiable and unquantifiable costs and benefits have been evaluated to fulfill this threshold requirement for regulatory action.