

MERCATUS CENTER

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Public Interest Comment on *Investment Advice – Participants and Beneficiaries*¹

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The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the Employee Benefits Security Administration’s (EBSA) proposed rule² does not represent the views of any particular affected party or special interest group, but is designed to assist the Department of Labor as it seeks to expand the amount of investment advice available to investors while protecting them from advisors’ potential conflicts of interest.

I. Introduction

Investment advisors face a potential conflict of interest when their compensation varies based on the investments their clients choose. An advisor may have incentives to steer investors toward investments that generate higher fees for the advisor but are not necessarily the best choice for the investor.

Federal law recognizes this conflict and provides special protections for participants and beneficiaries of defined-benefit retirement plans (such as 401ks) and Individual Retirement Accounts (IRAs). The Employee Retirement Income Security Act (ERISA) prohibits fiduciaries that offer these plans from giving investment advice to plan participants or beneficiaries that would result in the payment of additional fees to the fiduciary or an affiliate.

Such prohibitions are not costless for investors. As the department’s 2008 Regulatory Impact Analysis notes, “These provisions effectively preclude participants from obtaining

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² Department of Labor, Employee Benefits Security Administration, “Investment Advice—Participants and Beneficiaries,” Proposed Rule, 75 Fed. Reg. 9360 (March 2, 2010).

advice under arrangements that are widely used by other investors.”³ They may protect investors from advisors’ conflicts of interest, but they also diminish the amount of advice available to investors.

In 2006, Congress sought to expand the amount of investment advice available to plan participants and beneficiaries by enacting a statutory exemption to ERISA’s prohibition. On January 21, 2009, the Labor Department issued a final rule implementing this statutory exemption. The exemption permits fiduciaries to offer certain types of investment advice if (1) neither the fiduciary nor the person providing the advice receives any type of fee or other compensation that varies based on the investment selected, or (2) the advice is generated by a computer model meeting certain requirements. In either case, certain auditing, disclosure, and recordkeeping policies must also be followed.

The January 2009 final rule also included a “class exemption” that permitted fiduciaries to provide individualized investment advice even in some situations where the fiduciary or the person giving the advice could receive fees that vary based on the investor’s choice of investments. The class exemption included several provisions intended to prevent conflicts of interest that might motivate the advisor to recommend inferior investments. During 2009, the department extended the implementation date of the regulations several times and sought additional comments on the legal and policy issues. This new proposed rule essentially implements the statutory exemption from the January 2009 final rule but declines to implement the class exemption.

The department should not deprive investors of the class exemption’s potential benefits without a clear theory and evidence indicating that the proposed safeguards are insufficient to protect investors from advisors’ conflicts of interest. Unfortunately, neither the department’s previous notices regarding the class exemption, nor the comment letters cited in the most recent notice, contain evidence-based analysis demonstrating whether the safeguards in the proposed exemption are sufficient or insufficient to protect investors. Therefore, the department’s decision to nix the class exemption is premature. Before making a final decision, the department should conduct rigorous, evidence-based analysis to assess whether the class exemption would create incentives for advisors to cheat investors, and if so, whether the safeguards would prevent advisors from acting on those incentives.

II. Assessing the class exemption

The class exemption would go beyond the statutory exemption by permitting fiduciaries to offer investment advice under two circumstances:

³ Department of Labor, Employee Benefits Security Administration, “Investment Advice—Participants and Beneficiaries,” Proposed Rule, 73 Fed. Reg. 49896 (Aug. 22, 2008) at 49905.

- (1) Fee-leveling: The individual offering the advice receives no fee or other form of compensation that varies based on the investments chosen. This requirement applies only to the individual advisor, not to the fiduciary or its affiliates.
- (2) Computer modeling: Even if the individual offering advice receives compensation that varies based on the investments chosen, he or she can offer advice after the investor has received investment recommendations generated by a computer model, or other specified investment education materials if computer modeling is not feasible.

1. Fee-leveling

It is difficult to imagine how an advisor whose compensation is unaffected by the investments the investor selects would have much of an incentive to offer biased investment advice. The department's definition of relevant compensation is quite broad; it includes "salary, bonuses, awards, promotions, or other things of value ... received, directly or indirectly by any employee, agent, or registered representative that provides investment advice on behalf of a fiduciary advisor..."⁴ Discussion in the January 2009 final rule indicates just how broadly the concept applies. In response to commenters who asked if bonus programs based on the overall profitability of a fiduciary advisor would violate the fee-leveling requirement, the department stated:

[A]most every form of remuneration that takes into account the investments selected by participants and beneficiaries would likely violate the fee-leveling requirement of the final rule. On the other hand, it is conceivable that a compensation or bonus arrangement that is based on the overall profitability of an organization may be permissible *to the extent that it can be established that the individual account plan and IRA investment advice and investment option components were excluded from, or constituted a negligible portion of, the calculation of the organization's profitability.*⁵ [emphasis added]

The fiduciary employing the individual advisor, or its affiliates, might wish the advisor would offer biased advice that favors the mutual funds or other investments they sell. But if the fiduciary or affiliate cannot offer the individual advisor any type of compensation for steering business their way, the advisor has no clear incentive to do so.

The class exemption did permit fiduciaries and their affiliates to receive compensation that varies based on the investments chosen by plan participants. A rigorous analysis of the potential for investor harm would start by articulating a logical theory, consistent with human behavior, that explains why an investment advisor would steer investors into

⁴ Investment Advice Proposed Rule, *supra* note 3, at 49897.

⁵ Department of Labor, Employee Benefits Security Administration, "Investment Advice—Participants and Beneficiaries," Final Rule, 74 Fed. Reg. 3822 (Jan. 21), at 3823.

suboptimal investments offered by the fiduciary or its affiliates, when he or she receives no compensation for doing so. The analysis would then investigate actual evidence that demonstrates whether, or to what extent, investment advisors under fee-leveling arrangements actually do recommend investments that increase profits of the fiduciary or its affiliates but are not the best choice for the investor.

2. Computer modeling

The class exemption outlines some conditions under which individual advisors could offer advice even if their compensation varies based on the investments selected. The investor must first receive advice from a computer model that meets specified requirements or receive specified investment education materials if computer modeling is not possible. Computer models must be based on “generally accepted investment theories,” cannot be biased in favor of investment offered by the fiduciary advisor or affiliate, and must explicitly state all facts and assumptions. Several additional requirements apply:

- The investment advice arrangement must be authorized by the plan fiduciary or IRA beneficiary.
- The advisor must disclose potential conflicts of interest to the investor.
- The investment advice must be based on “generally accepted investment theories,” must take into account investment management fees and expenses, and must take into account certain information furnished by the plan participant, such as age, time horizon, risk tolerance, other investments, and related factors.
- The advisor must explain to the investor the basis for the advice, why the advice recommends options with higher fees (if applicable), and how the advice deviates from or relates to the advice from the computer model or educational materials furnished before the advice was given.
- The fiduciary must maintain written policies and procedures designed to ensure compliance with the conditions attached to the exemption.
- The fiduciary must arrange for an independent compliance audit at least annually. IRA beneficiaries must receive the auditor’s report, and the auditor must report and noncompliance to the Department of Labor.
- The fiduciary must maintain records necessary to evaluate its compliance for six years.

- The advisor must document the basis of any advice given, and the fiduciary must keep this information as part of the records retained for six years.⁶

Allowing an individual whose compensation varies based on the investments chosen to offer advice has the potential to create conflicts of interest, since the advisor could receive greater compensation by steering the investor into investments that pay higher fees to the advisor but produce worse performance for the investor. The attached conditions seek to mitigate the conflict of interest by ensuring that investors are informed about the possibility, giving investors access to unbiased advice from computer models or other educational materials before they receive personalized advice, circumscribing the nature of the advice that can be given, and requiring a compliance audit and retention of records. In short, they rely on disclosure, consumer education, and compliance audits to counter the advisor's incentive to bias his or her advice.

An additional factor comes into play with IRAs. Because these are *individual* accounts established by individuals, investors can easily shop among a wide variety of fiduciaries who offer IRAs. Investors can track the performance of their IRAs and compare their results with those achieved by friends and relatives who may have IRAs with different fiduciary advisors. Indeed, fiduciaries vying for new business eagerly furnish information on past performance so that investors can compare their own IRA's performance with what they might have achieved with another fiduciary. As the department's 2008 Regulatory Impact Analysis acknowledges in a footnote, "IRA beneficiaries' vulnerability to risks attendant to conflicts of interest may be mitigated by their ability to make rational and well informed purchases in a vibrant, competitive markets for investment advice and other financial products and services, in which some vendors will offer unconflicted advice."⁷ In other words, competition can play a powerful role in disciplining advisors' conflicts of interest.

Competition at the level of the individual investor is perhaps less robust for defined-contribution plans. Except in the case of government or large, private employers that offer a choice of multiple plan providers, an individual dissatisfied with an account's performance would have to convince an employer to switch its plan to a different fiduciary. This might be a practical remedy if most employees are dissatisfied with a fiduciary which has a consistent pattern of giving biased investment advice to most plan participants, but it would not be a very effective constraint on the provision of biased advice to a few individual clients by a few individual advisors.

Whether competition or the regulatory requirements in the class exemption are sufficient to protect investors from advisors' potential conflicts of interest is an open question. The department's decision on this aspect of the class exemption should be based on research that identifies whether disclosure, education, and compliance requirements—or competition—effectively protect investors. One huge "laboratory" for such research is

⁶ Investment Advice Final Rule, *supra* note 5, at 3850–52.

⁷ Investment Advice Proposed Rule, *supra* note 3, at 49910.

the universe of investment accounts not covered by ERISA's restrictions, such as ordinary mutual fund and brokerage accounts. In the absence of such research, the decision to withdraw the class exemption is premature.

III. The Absence of Analysis

Unfortunately, the department conducted no rigorous analysis of the issues we discuss above before it decided to withdraw the class exemption. None of the Regulatory Impact Analyses prepared for the statutory exemption and the class exemption determined definitively whether these exemptions would create or mitigate conflicts of interest. These analyses did a reasonable job of demonstrating the very large benefits to investors of more widespread investment advice, and they estimated the effects of the department's decisions on the benefits and costs of investment advice. But the original 2008 analysis, the final 2009 analysis, and the revised 2010 analysis largely took the department's decisions about exemptions as given, then proceeded to calculate benefits and costs.

The 2008 analysis does cite several studies that reach conflicting conclusions on whether investment advisors have conflicts of interests that harm investors. The analysis notes that the conditions attached to the class exemption are intended to guard against self-dealing, then warns in a footnote, "The department has no basis to estimate how much risk might remain."⁸ It explicitly assumes that investors who receive advice make fewer errors than other investors, and "The remaining errors reflect possible flaws in some advice..."⁹ "Flaws" might include biased advice motivated by conflicts of interest.

The 2009 final regulatory analysis states that "the RIA assumed that advice arrangements operating pursuant to the proposals would be as effective as arrangements operating without the need for exemptive relief, notwithstanding the conflicts that are attendant to the former."¹⁰ But this is just an assumption, not a proven fact. It is the critical issue that should be addressed with evidence-based analysis before the department can determine whether the class exemption would help or harm plan participants.

The department's March 2, 2010 notice, which proposes to implement the statutory exemption without the class exemption, contains no new analysis of conflicts of interest. It merely states that some comments received in response to its February 4, 2009 notice claimed that the class exemption would create conflicts of interest and contains insufficient safeguards to mitigate them.¹¹ The comments themselves contain arguments to this effect, but they present no evidence demonstrating that the class exemption will, in fact, create conflicts of interest that are unmitigated by the proposed safeguards. The comments below are representative of assertions not backed by evidence-based analysis:

⁸ Investment Advice Proposed Rule, *supra* note 3, at 49910.

⁹ Investment Advice Proposed Rule, *supra* note 3, at 49910.

¹⁰ Investment Advice Final Rule, *supra* note 5, at 3839.

¹¹ Investment Advice Proposed Rule, *supra* note 2, at 9363.

It's hard to believe that you are even considering allowing representatives of mutual fund companies to provide investment advice to 401K participants. They cannot be unbiased if they get a paycheck from a fund company. You will save yourselves a lot of problems going forward if you just insist on fee-only independent advisers. If you get a commission on a product, your opinion is tainted by definition.¹²

Vendor personnel have vested interests in promoting their own funds, asset allocation products and services. Blatant financial conflicts of interest may be muted, understated or undisclosed. No amount of industry regulation will be able to eliminate the many different types of "conflicts of interest" that these arrangements contain and no rules or governing body will be able to assure compliance with any potential stop gap measures designed to "police" vendor personnel from promoting their own interests through "deemed object/independent" advice arrangements. The only truly independent and objective investment advice arrangement comes from highly trained, licensed investment professionals who have no financial or moral "conflicts of interest."¹³

In an effort to provide easier access to investment advice legislators penned into law inherent conflicts of interest in that advice. Fee-only, independent, third party advisors were providing 401(k) investment advice on a discretionary basis long before the PPA. Because their compensation was never driven by the investments they were recommending, they never ran afoul of ERISA.¹⁴

While conflicts of interest have been at the heart of many financial scandals, retirement accounts have been better-protected thanks to the prohibition against conflicts of interest that is part of ERISA. The new rules would shift emphasis from avoiding conflicts to managing and disclosing them. The class exemption is bad policy introduced at the worst possible time. It contributes to a perception that regulators favor the interests of financial services companies over those of investors.¹⁵

ERISA's long-standing requirements for fiduciaries to act in the sole interests of the plan participants preserves the distinction between

¹² Comments of Joe Lyons, EBSA Docket 08-11 (Feb. 9, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-02190905.pdf>.

¹³ Comments of Stace Hilbrant, Managing Director, Investment Advisor Representative, Accredited Investment Fiduciary, 401(k) Advisors, LLC, EBSA Docket 08-11 (Feb. 10, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-02190906.pdf>.

¹⁴ Comments of David Kudla, Chief Executive Officer, Mainstay Capital Management, LLC, EBSA Docket 08-11 (Feb. 16, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-02190908.pdf>.

¹⁵ Comments of Blaine F. Aikin, CEO, Fiduciary360, EBSA Docket 08-11 (Feb. 26, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-03060901.pdf>.

fiduciary relations and ordinary commercial transactions—a distinction which should be maintained.¹⁶

The final regulation excludes affiliates of the fiduciary adviser from the fee-leveling requirement while the class exemption limits it to the particular employee, agent or registered representative providing the investment advice. These provisions, both restricting the scope of the statutory exemption, raise significant questions of law and policy ...¹⁷

Without stronger participant protections, the published Class Exemption and regulation will lead us down a road of conflict of interest problems that ERISA has long sought to prevent.¹⁸

The class exemptions do not counter the opportunity for self-dealing with effective controls and should be withdrawn... a. Limited audits based upon self-imposed policies and procedures cannot provide adequate protection against self-dealing investment advisers... b. The disclosure requirements do not protect participants from conflicts of interest... c. There is no single structure to monitor compliance and protect participants from self-dealing investment advisers... d. Participant investment advice is available from independent providers, or through the statutory exemption...¹⁹

We searched the comments for references to any empirical studies that demonstrated whether the class exemption would create conflicts of interest or mitigate them if they occur. One comment cites several law review articles, including one by SEC Commissioner Troy Paredes, which suggest that information disclosure alone is insufficient to protect investors, because investors do not read and process all of the information.²⁰ Indeed, excessively detailed disclosure may lead to “information overload.” Yet even Paredes’ article calls for more empirical research on the topic and suggests that a better disclosure regime might involve *less* disclosure, with greater

¹⁶Comments of Diahann Lassus, Chair; Ellen Turf, CEO, and Susan MacMichael John, Chair, Industry Issues Committee, National Association of Personal Financial Advisors, EBSA Docket 08-11 (Mar. 6, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-03090901.pdf>.

¹⁷Comments of Thea Lee, Policy Director, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), EBSA Docket 08-11 (Mar. 6, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-03090902.pdf>.

¹⁸Comments of David Certner, Legislative Counsel and Legislative Policy Director, American Association of Retired Persons (AARP), EBSA Docket 08-11 (Mar. 6, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-03090904.pdf>.

¹⁹Comments of Cynthia Milstead, Senior ERISA Counsel, Hewitt Associates, LLC, EBSA Docket 08-11 (Mar. 6, 2009), available at <http://www.dol.gov/ebsa/pdf/cmt-03090905.pdf>.

²⁰Comments of Diahann Lassus et. al, *supra* note 16, at 4-5.

sensitivity about the ways investors process information.²¹ This line of research implies that the disclosures the department requires should be crafted with an understanding of how investors will actually use the information and that the department should be cautious about relying upon disclosure alone to mitigate conflicts of interest. But these sound insights hardly prove that the class exemption will create unresolvable conflicts of interest.

The only study using data cited was a working paper by Nicolaj Siggelkow that found mutual fund providers maximize profits by shifting expenses to fund investors when they can.²² Nothing in this paper addresses investment advice offered by mutual fund companies. Thus, the comments the department cited as the only justification for withdrawing the class exemption provide some assertions but very little evidence about its likely effects.

IV. Conclusion

The class exemption offers two different scenarios under which investment advisors could offer individualized advice to participants and beneficiaries in defined-contribution plans and IRAs. Under the fee-leveling requirement, it is difficult to imagine how an individual advisor would have direct incentives to offer tainted investment advice. Under the computer modeling requirement, allowing an advisor whose compensation varies based on the investments chosen to offer advice poses greater potential danger to investors, since individuals offering advice under that option could receive compensation that could reward them for giving biased advice. However, this provision also includes greater safeguards intended to keep advisors honest.

Perhaps both aspects of the class exemption would give investors access to quality advice while controlling any potential conflicts of interest. Perhaps neither would. Or perhaps only the fee-leveling requirement would. These are the central issues to consider, but the record contains insufficient evidence to determine which of these possibilities is more likely true.

To best protect investor interests, the department's decision on the class exemption should rely on evidence-based research that offers a clear theory of investor harm and evaluates whether that harm would in fact be likely to occur. Neither the prior Regulatory Impact Analyses nor the comments cited in the department's most recent notice provide any definitive analysis on this issue. Therefore, the department should conduct this research before making a final decision on the class exemption.

²¹ Troy Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation," Washington University in St. Louis School of Law Faculty Working Paper 03-02-02 (June 1, 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=413180 at 47-53.

²²Nicolaj Siggelkow, "Caught Between Two Principals," undated paper, Wharton School, <http://knowledge.wharton.upenn.edu/papers/1280.pdf>.

Appendix RSP Checklist

Element	Agency Approach	RSP Comments
1. Has the agency identified a significant market failure?	<p>The department identifies a large body of research demonstrating that individuals would benefit if investment advice were more widely available.</p> <p>Grade: A</p>	<p>This is not a market failure, but the systemic problem is that ERISA creates barriers that discourage fiduciaries from offering advice.</p>
2. Has the agency identified an appropriate federal role?	<p>Since the source of the problem is ERISA, altering ERISA regulations is the appropriate solution.</p> <p>Grade: A</p>	
3. Has the agency examined alternative approaches?	<p>Three main alternatives are considered: no change, statutory exemption only, or adopt both the statutory exemption and the class exemption. Some additional tweaks on the statutory exemption are also considered.</p> <p>Grade: B+</p>	<p>Examination of alternatives outside this “box” might shed light on the central issue of whether proposed restrictions are sufficient to protect investors from advisor conflicts of interest.</p>
4. Does the agency attempt to maximize net benefits?	<p>In both 2009 and 2010, the department chose the alternative that maximized net benefits to investors as calculated in the RIA. However, the RIA did not explicitly determine whether safeguards are sufficient, so it is not really clear if the chosen alternative really maximized net benefits to investors.</p> <p>Grade: C</p>	<p>It is unclear whether the department was really making decisions based on net benefits to investors, or sacrificing net benefits to achieve other objectives.</p>

Element	Agency Approach	RSP Comments
5. Does the proposal have a strong scientific or technical basis?	<p>RIAs calculate benefits and costs but do not offer definitive analysis of whether regulatory safeguards are adequate to control conflicts of interest.</p> <p>Grade: C</p>	<p>This is the critical issue that must be settled before decisions whether the proposed class exemption will help or harm investors.</p>
6. Are distributional effects clearly understood?	<p>The analysis largely focuses on total benefits and costs, rather than incidence.</p> <p>Grade: C</p>	
7. Are individual choices and property impacts understood?	<p>The potential for participant/beneficiary choice in a competitive market to discipline advisor self-dealing is considered only in a footnote.</p> <p>Grade: C</p>	<p>Consumers' role as active choosers is important in many markets and should have been analyzed thoroughly. This should have received much more attention—especially since some of the proposed requirements involve information disclosure to investors, which presumably empowers them to evaluate the quality of advice they receive and shop around.</p>