TESTIMONY OF PHYLLIS C. BORZI
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EMPLOYEE BENEFITS SECURITY ADMINISTRATION
BEFORE THE
HOUSE COMMITTEE ON EDUCATION AND THE WORKFORCE
SUBCOMMITTEE ON HEALTH, EMPLOYMENT, LABOR, AND PENSIONS
UNITED STATES HOUSE OF REPRESENTATIVES

Introductory Remarks

Good morning Chairman Roe, Ranking Member Andrews, and Members of the Subcommittee. Thank you for inviting me to discuss the Department of Labor's proposed amendment to its fiduciary regulation and activities we have undertaken to date in connection with this initiative. I am Phyllis C. Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA). EBSA is committed to pursuing policies that encourage retirement savings and promote retirement security for American workers.

A key part of EBSA's job is establishing policies that safeguard the money that workers and employers set aside for workers' retirement. There are about 48,000 private-sector defined benefit plans that hold approximately $2.6 trillion in assets.[1] In addition, there are nearly 670,000 private-sector 401(k) and other defined contribution account plans that hold about $3.9 trillion in assets.[2] Individual Retirement Accounts (IRAs) hold an additional $4.7 trillion.[3] In fact, nearly 50 million households own some type of IRA. That number represents more than 40 percent of the households in the United States.[4] Americans' retirement security depends in large measure on the sound investment of

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[1] For estimates of the number of plans, see U.S. Department of Labor, Private Pension Plan Bulletin Abstract of 2008 Form 5500 Annual Reports (Dec. 2010), *at* *http://www.dol.gov/ebsa/PDF/2008pensionplanbulletin.pdf*. For asset estimates, EBSA projected ERISA covered pension assets based on the 2008 Form 5500 filings with the US Department of Labor (available at *http://www.dol.gov/ebsa/publications/form5500dataresearch.html*), and the Federal Reserve Board's Flow of Funds Accounts Z1 Release (available at *http://www.federalreserve.gov/releases/z1/Current/*).
[2] Ibid.
[3] Federal Reserve Board, *Flow of Funds Accounts of the United States*, June 2011, *at* *http://www.federalreserve.gov/releases/z1/Current/*.
[4] Peter Brady et al., *The U.S. Retirement Market, Third Quarter 2010*, Investment Company Institute, Jan. 2011, *at http://www.ici.org/pdf/ppr_11_retire_q3_10.pdf*.

this money. While some investment decisions are made by large professional money managers, today most are made by individual workers who must manage their own 401(k) accounts and IRAs. To guide their decisions, workers often rely on advice from trusted experts.

The Employee Retirement Income Security Act of 1974 (ERISA) expressly provides that a person paid to provide investment advice with respect to assets of a private-sector employee benefit plan is a plan fiduciary. The Internal Revenue Code (the "tax code") has the same provision regarding investment advisers to IRAs. ERISA and the tax code prohibit both employee benefit plan and IRA fiduciaries from engaging in a variety of transactions, including self-dealing – when a fiduciary puts his or her own financial interests first – unless the relevant transaction is authorized by an "exemption" contained in law or issued administratively by the Department of Labor. In the case of an employee benefit plan, but not an IRA, under ERISA a fiduciary also owes a duty of prudence and exclusive loyalty to plan participants, and is personally liable for any losses that result from a breach of such duty. This has been the law since ERISA was enacted in 1974.

The law on its face is simple enough: advisers should put their clients' interests first. But as always the devil is in the details – in this case, in the question of what constitutes paid investment advice. The Department's current initiative will amend a flawed 35-year-old rule under which advice about investments is not considered to be "investment advice" merely because, for example, the advice was only given once, or because the adviser disavows any understanding that the advice would serve as a primary basis for the investment decision.

Investors such as pension fund managers and workers contemplating investing through an IRA should be able to trust their advisers and rely on the impartiality of their investment advice. That is the promise written into law in 1974. The Department's initiative sets out to fulfill this promise for America's current and future retirees. The impact of investment advice depends on its quality. Prudent, disinterested advice can reduce investment errors, steering investors away from higher than necessary expenses

and toward broad diversification and asset allocations consistent with the investors' tolerance for risk and return. Accordingly, it is imperative that good, impartial investment advice be accessible and affordable to plan sponsors and especially to the workers who need it most.

The Department's October 2010 proposed amendment to its fiduciary rule represented its approach to accomplishing these goals. The proposal has prompted a large volume of comments and a vigorous debate. The Department is committed to developing and issuing a clear and effective rule that takes full and proper account of all stakeholder views, and that ensures that investment advisers can never profit from hidden or inappropriate conflicts of interest.

The Law

In enacting ERISA in 1974, Congress established a number of provisions governing investment advice to private-sector employee benefit plans and IRAs. Under ERISA and the tax code, any person paid directly or indirectly to provide investment advice to a plan or IRA is a fiduciary.

Prohibited transactions – Substantially identical provisions in ERISA and the tax code prohibit fiduciaries from engaging in a variety of transactions, including those that result in self-dealing, unless they fall within the terms of an exemption from the general prohibition. The relevant ERISA provisions apply to private-sector employee benefit plans, and the related tax code provisions apply to both plans and IRAs. In either case, fiduciaries who engage in prohibited transactions are subject to excise taxes. ERISA and the tax code each provide the same statutory exemptions from the general prohibition against self-dealing. The Secretary of Labor is authorized to issue additional exemptions.

What is an exemption? From the fiduciary's point of view, an exemption is permissive: it allows the fiduciary to engage in certain transactions that would otherwise be prohibited. From a worker's point of view, an exemption should be protective, because it establishes rules of the road that fiduciaries must follow when they self-deal so that transactions are in workers' interest. In other words, if an investment adviser is

compensated for steering a worker's retirement savings toward a particular financial product, the adviser must first satisfy conditions established by Congress or the Department to protect the worker's interests and rights.

Section 102 of the Reorganization Plan No. 4 of 1978 generally transferred to the Department of Labor the Treasury Department's authority to interpret the tax code's prohibited transaction provisions and to issue related exemptions, thus consolidating interpretive and rulemaking authority for these substantially identical ERISA and tax code provisions in one place – the Department of Labor. At the same time, the IRS's general responsibility for enforcing the tax laws extends to excise taxes imposed on fiduciaries who engage in prohibited transactions. Thus, the Department shares with the IRS responsibility for combating self-dealing by fiduciary investment advisers to plans and IRAs.

Fiduciary duties – ERISA additionally subjects fiduciaries who advise private-sector employee benefit plans to certain duties, including a duty of undivided loyalty to the interests of plan participants and a duty to act prudently when giving advice. Fiduciaries face personal liability for any losses arising from breaches of such duties. ERISA authorizes both participants and the Department to sue fiduciaries to recover such losses. These ERISA provisions, however, generally do not extend to fiduciaries who advise IRAs.

Problems with the Existing Regulation

In 1975, the Department issued a five-part regulatory test defining "investment advice" that gave a very narrow meaning to this term. The regulation significantly narrowed the plain language of the statute as enacted, so that today much of what plainly is advice about investments is not treated as such under ERISA and the person paid to render that advice is not treated as a fiduciary. Under the regulation, a person is a fiduciary under ERISA and/or the tax code with respect to their advice only if they: (1) make recommendations on investing in, purchasing or selling securities or other property, or give advice as to their value; (2) on a regular basis; (3) pursuant to a mutual

understanding that the advice; (4) will serve as a primary basis for investment decisions; and (5) will be individualized to the particular needs of the plan.

An investment adviser is not treated as a fiduciary unless each of the five elements of this test is satisfied for each instance of advice. For example, if a plan hires an investment professional on a one-time basis for advice on a large complex investment, the adviser has no fiduciary obligation to the plan under ERISA, because the advice is not given on a "regular basis" as the regulation requires. Similarly, individualized, paid advice to a worker nearing retirement on the purchase of an annuity is not provided on a regular basis. Thus, the adviser is not a fiduciary even though the advice may concern the investment of a worker's entire IRA or 401(k) account balance.

In a different example, consider an IRA holder who consults regularly with a paid adviser, and regularly buys and sells securities pursuant to that person's advice. The IRA holder may rely on the advice as a primary or even the sole basis for investment decisions, but if the adviser cannot be shown to have *agreed or understood* that the advice would be a primary basis for the investment decisions – then the adviser avoids fiduciary status and is free to self-deal. This example is particularly important. Today many service providers (such as brokers) attempt to avoid fiduciary status simply by including disclaimers in their written agreements with IRA holders explaining that they are not acting as registered investment advisers and that their advice will not constitute a primary basis for the IRA holders' decisions.[5] An authoritative study by RAND for the SEC demonstrated that consumers often do not read such agreements and do not understand the difference between brokers and registered advisers or the services they provide.[6]

The narrowness of the existing regulation opened the door to serious problems, and changes in the market since the regulation was issued in 1975 have allowed these

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[5] The Department does not necessarily agree that the inclusion of such language in an agreement ensures that a broker is not a fiduciary under the existing regulation.

[6] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice, commissioned by the U.S. Securities and Exchange Commission, 2008, *at* *http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf*.

problems to proliferate and intensify. The variety and complexity of financial products have increased, widening the information gap between advisers and their clients and increasing the need for expert advice. Consolidation in the financial industry and innovations in products and compensation practices have multiplied opportunities for self-dealing and made fee arrangements less transparent to consumers and regulators. At the same time, the burden of managing retirement savings has shifted dramatically from large private pension fund managers to individual 401(k) plan participants and IRA holders, many with low levels of financial literacy. These trends could not have been foreseen when the existing regulation was issued in 1975.

In 1975, private-sector defined benefit pensions - mostly large, professionally managed funds - covered over 27 million active participants and held assets totaling almost $186 billion. This compared with just 11 million active participants in individual-account-based defined contribution plans with assets of just $74 billion.[7] Moreover, the great majority of defined contribution plans at that time were professionally managed, not participant directed. In 1975, 401(k) plans did not yet exist and IRAs had just been authorized as part of ERISA's enactment the prior year. In glaring contrast, by 2008 defined benefit plans covered just 19 million active participants, while individual-account-based defined contribution plans covered over 67 million active participants - including 60 million in 401(k)-type plans.[8] Ninety-five percent of 401(k) participants were responsible for directing the investment of all or part of their own account, up from 86 percent as recently as 1999.[9] Also, in 2010, almost 50 million households owned IRAs.[10] In dollar terms, by 2010, defined benefit plans, with $2.6 trillion in assets, had been eclipsed by defined contribution plans which held $3.9 trillion. IRAs held the most: $4.7 trillion, with most of this attributable to rollovers from plans.[11]

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[7] U.S. Department of Labor, *Private Pension Plan Bulletin Historical Tables and Graphs, (*Dec. 2010)*, at* *http://www.dol.gov/ebsa/pdf/historicaltables.pdf*.

[8] U.S. Department of Labor, *Private Pension Plan Bulletin Abstract of 2008 Form 5500 Annual Reports,* (Dec. 2010), at *http://www.dol.gov/ebsa/PDF/2008pensionplanbulletin.PDF*.

[9] U.S. Department of Labor, *Private Pension Plan Bulletin Abstract of 1999 Form 5500 Annual Reports,* Number 12, Summer 2004 (Apr. 2008), *at* *http://www.dol.gov/ebsa/PDF/1999pensionplanbulletin.PDF*.

[10] Peter Brady et al., *The U.S. Retirement Market, Third Quarter 2010*, Investment Company Institute, Jan. 2011, *at* *http://www.ici.org/pdf/ppr_11_retire_q3_10.pdf*.

[11] Federal Reserve Board, *Flow of Funds Accounts of the United States*, June 2011, *at* *http://www.federalreserve.gov/releases/z1/Current/;* Peter Brady, Sarah Holden, and Erin Shon, "*The U.S.*

The narrowness of the regulation has harmed some plans, participants, and IRA holders. Research has linked adviser conflicts with underperformance. SEC reviews of certain financial sales practices may also reflect these influences. Finally, EBSA's own enforcement experience has demonstrated specific negative effects of conflicted investment advice.

One academic study found that investors purchasing funds through brokers generally get lower returns, even before paying the brokers' fees, than those who buy them directly, and do no better at asset allocation. The study's authors say this might be evidence of harmful conflicts of interest, but might also be evidence that investors are buying something "intangible" from their brokers.[12] Another study finds that advisers' compensation structures matter – those with conflicts give poorer advice.[13] Other research, relevant to valuation advice, finds that accountants value property higher when working for sellers than for buyers.[14] Still other research finds that disclosure of conflicts fails to protect consumers. A conflicted adviser may feel morally licensed by disclosure to pursue his self interest, and he may exaggerate his advice to compensate for the possibility that a consumer will discount it. The consumer may be reluctant to question the advice, not wanting to imply that the adviser is being dishonest or come between the adviser and his pay.[15]

It is worth noting that none of this research evidence necessarily demonstrates abuse. On the contrary, it seems to suggest that conflicts may color advice in some instances from honest advisers without their even realizing it. But whether deliberate or inadvertent, the

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Retirement Market, 2009," Investment Company Institute, Research Fundamentals, Vol. 19, No. 3, May 2010, *at* http://www.ici.org/pdf/fm-v19n3.pdf.

[12] Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, The Review of Financial Studies, 22, no. 10, Oct. 2009.

[13] Ralph, Bluethgen et al., *High Quality Investment Advice Wanted!* , SSRN Working Paper Series, Feb. 2008, *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102445&http://scholar.google.com/scholar?cluster=10674815933415125485&hl=en&as_sdt=0,9.

[14] Don Moore et al., *Conflict of Interest and the Unconscious Intrusion of Bias, Judgment and Decision Making*, Vol. 5, No. 1, Feb. 2010.

[15] George Loewenstein et al., *Pitfalls and Potential of Disclosing Conflicts of Interest*, American Economic Review, forthcoming May 2011.

result where conflicts exist is often the same: adviser conflicts are a threat to retirement security. Academic research suggests this, and experience bears it out.

For additional evidence, consider the underperformance of IRAs relative to plans. Some gap might be expected, as the comparison is between retail and institutional customers. But the size of the gap is troubling. Unlike plan participants, IRA holders do not have the benefit of a plan fiduciary, usually their employer, to represent their interests in dealing with advisers. EBSA estimates that from 1998 to 2007, the average annual returns for IRAs were 4.5 percent, compared with 5.4 percent for 401(k)s.[16] Further, in a recent report, the Government Accountability Office stated that IRA holders often pay fees that can be two to three times higher than the fees paid by employee benefit plan participants for in-plan investments. [17]

A 2007 SEC report provides more evidence. The report examines "free lunch" sales seminars that market financial products to retirees. The SEC conducted 110 examinations of financial services firms providing "free lunch" seminars. Of these, only five found no problems or deficiencies. More than half found that materials used might have been misleading or exaggerated. Twenty-five found that unsuitable recommendations were made. Seminar attendees often may not have known that presenters had a financial stake in the products they recommended, the SEC said.[18]

Finally, consider the evidence provided by EBSA's enforcement experience. Too often advisers who put their own interests first escape fiduciary status through a loophole in the existing regulation. For example, consider the following case: A financial services firm often recommended mutual funds that paid it revenue sharing. Even though some of its consulting agreements with plans acknowledged the firm's status as an ERISA fiduciary, it denied being a fiduciary for any ERISA clients. Consequently, the Department had to

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[16] EBSA's estimation approach was inspired by similar findings in an article using older data, *see* Alicia H. Munnell et al., "Investment Returns: Defined Benefit vs. 401(k) Plans," Center for Retirement Research at Boston College, Issue Brief No. 52, Sep. 2006, p. 6.

[17] GAO, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest,* Report to the Ranking Member, Committee on Education and the Workforce, House of Representatives, GAO-11-119 (Jan. 2011).

[18] Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars*, Sep. 2007, *at* http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

interview dozens of the clients in order to determine whether the firm's advice met the current regulation's five-part test. In many cases, the advice did not meet the “regular basis” requirement because the firm's representatives had infrequent contact with plans after the selections of mutual funds. Due to the ambiguous nature of the evidence on the firm's fiduciary status under the existing rule, DOL could not pursue enforcement against it.

Another example involves improper appraisals in connection with employee stock ownership plans (ESOPs). Since the early 2000s, EBSA began to identify issues involving ESOPs, encompassing a variety of different violations of ERISA and affecting over 500,000 participants. In many instances, the most important investment advice to a plan concerns how much to pay for an asset. In the case of ESOPs, in particular, the key decision is typically not whether to buy stock – the plan was established precisely to buy and hold employer stock – but rather what price to pay for the stock. The Department has uncovered abuses reflecting flawed valuation methodologies, internally inconsistent valuation reports, the use of unreliable and outdated financial data, and the apparent manipulation of numbers and methodologies to promote a higher stock price for the selling shareholders. Under ERISA, a loss remedy is only available from plan fiduciaries. As a result, under the current regulatory structure, neither the Secretary nor plan participants can hold the appraiser directly accountable for disloyal or imprudent advice about the purchase price, no matter how critical that advice was to the transaction. The sole recourse available to the Secretary and plan participants is against the trustee who relied on the advice, rather than against the professional financial expert who rendered the valuation opinion that formed the necessary basis for the transaction.

Consequently, the Department believes there is a need to re-examine the types of advisory relationships that should give rise to fiduciary status on the part of those providing investment advice services. The 1975 regulation contains technicalities and loopholes that allow advisers to easily dodge fiduciary status. Plan fiduciaries, participants, and IRA holders are entitled to receive impartial investment advice when they hire an adviser.

Overview of Proposed Regulation

On October 22, 2010, the Department published a proposed regulation defining when a person is considered to be a "fiduciary" by reason of giving investment advice for a fee with respect to assets of an employee benefit plan or IRA. The proposal amends the current 1975 regulation that may inappropriately limit the circumstances that give rise to fiduciary status on the part of the investment adviser.[19] The proposed rule takes into account significant changes in both the financial industry and the expectations of plan fiduciaries, participants and IRA holders who receive investment advice. In particular, it is designed to protect participants from conflicts of interest and self-dealing by correcting some of the current rule's more problematic limitations and providing a clearer understanding of when persons providing such advice are subject to ERISA's fiduciary standards, and to protect IRA holders from self-dealing by investment advisers.

The proposed regulation would modify the 1975 regulation by: (1) replacing the five-part test with a broader definition more in keeping with the statutory language; and (2) providing clear exceptions for conduct that should not result in fiduciary status. Under the proposal, the following types of advice and recommendations may result in fiduciary status: (1) appraisals or fairness opinions concerning the value of securities or other property; (2) recommendations as to the advisability of investing in, purchasing, holding or selling securities or other property; or (3) recommendations as to the management of securities or other property.

To be a fiduciary, a person engaging in one of these activities must receive a fee and also meet at least one of the following four conditions. The person must: (1) represent to a plan, participant or beneficiary that the individual is acting as an ERISA fiduciary; (2) already be an ERISA fiduciary to the plan by virtue of having any control over the management or disposition of plan assets, or by having discretionary authority over the administration of the plan; (3) be an investment adviser under the Investment Advisers

[19] The proposed regulation would also supersede the conclusion set forth in Advisory Opinion 76-65A (June 7, 1976), where the Department held that the valuation of closely-held employer securities that an ESOP would rely on in purchasing the securities would not constitute investment advice under the regulation.

Act of 1940; or (4) provide the advice pursuant to an agreement or understanding that the advice may be considered in connection with investment or management decisions with respect to plan assets and will be individualized to the needs of the plan.

At the same time, the proposed regulation recognizes that activities by certain persons should not result in fiduciary status. Specifically, these are: (1) persons who do not represent themselves to be ERISA fiduciaries, and who make it clear to the plan that they are acting for a purchaser/seller on the opposite side of the transaction from the plan rather than providing impartial advice; (2) persons who provide general financial/investment information, such as recommendations on asset allocation to 401(k) participants under existing Departmental guidance on investment education; (3) persons who market investment option platforms to 401(k) plan fiduciaries on a non-individualized basis and disclose in writing that they are not providing impartial advice; and (4) appraisers who provide investment values to plans to use only for reporting their assets to the DOL and IRS.

Concerns Raised about the Proposed Regulation and the Department's Preliminary Responses

The proposed regulation has prompted a large volume of comments and a vigorous debate. The Department is working hard to hear and consider every stakeholder concern.

The October proposal itself drew more than 200 written comments, many raising important and complex issues that require serious attention. The Department followed up by holding two days of hearings on March 1 and 2, providing an additional forum for 36 witnesses and prompting more than 60 additional, post-hearing written comments. We also have met individually with many groups that sought additional opportunities to explain their views. Altogether, the Department has heard from many representatives of the financial services industry, as well as from plan sponsors, advocates for small investors, service providers, academics who study the roles of financial intermediaries and the effects of conflicts between consumers and expert advisers, and interested Members of Congress. The Department is devoting a major effort to appropriately

resolve the concerns raised by stakeholders. Let me offer examples of how we are thinking about some of the major ones.

Coordination with Other Federal Agencies – We have received many comments emphasizing the importance of harmonizing the Department's proposed rulemaking with certain Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) rulemaking activities under the Dodd-Frank Act, including activities related to SEC standards of care for providing investment advice and CFTC business conduct standards for swap dealers. There are concerns that inconsistent standards could negatively impact retirement savings by increasing costs and foreclosing investment options. Likewise, concerns have been raised about the adequacy of coordination between the Department and other relevant agencies, including the SEC, Treasury Department, and Internal Revenue Service, with respect to oversight of IRA products and services.

The Department, Treasury Department, Internal Revenue Service, SEC, and the CFTC are actively consulting with each other and coordinating our efforts. Our shared goal is to harmonize our separate initiatives. We are also committed to ensuring that the regulated community has clear and sensible pathways to compliance. We are confident that these goals will be achieved.

The SEC is currently considering staff recommendations to establish uniform fiduciary duties under the securities laws for advisers and brokers. While the Department and the SEC are committed to ensuring that any future fiduciary requirements applicable to investment advisers and broker-dealers under the applicable laws are properly harmonized, the Department is also committed to upholding the separate federal protections that Congress established in 1974 for plans, plan participants, and IRAs under ERISA and the tax code.

The Department also plans to harmonize its fiduciary regulation with the CFTC's and SEC's proposed business conduct standards for swap dealers. The Department does not seek to impose ERISA fiduciary obligations on persons who are merely counterparties to plans in arm's length commercial transactions. Parties to such transactions routinely

make representations to their counterparties about the value and benefits of proposed deals, without purporting to be impartial investment advisers or giving their counterparties a reasonable expectation of a relationship of trust. Accordingly, the Department's proposed regulation provides that a counterparty will not be treated as a fiduciary if it can demonstrate that the recipient of advice knows or should know that the counterparty is providing recommendations in its capacity as a purchaser or seller.

Costs and Unintended Consequences for IRAs – Many comments also raised concerns about the proposed regulation's impact on IRAs and questioned whether the Department had adequately considered possible negative impacts. Similar concerns were voiced by other stakeholders, especially those providing advice in connection with brokerage services. Some stakeholders have provided their own estimates of high costs and other major negative impacts.

The stated concerns can be summarized as follows:

- Today a large proportion of IRAs, especially smaller accounts, are brokerage accounts. Brokers often advise the IRA holders, and are compensated for that advice by means of commissions paid for trades and often by third parties, as with revenue sharing and 12b-1 mutual fund fees. Though the brokers give advice, they typically contend that they are not fiduciaries under the Department's existing rule because they disclaim any understanding that their advice might constitute a primary basis for the IRA holders' investment decisions.[20]

- The proposed rule would make brokers fiduciaries because IRA holders will at least "consider" their advice. As fiduciaries, the brokers could not accept commissions or revenue sharing payments. To do so would constitute fiduciary self-dealing, a prohibited transaction, and would trigger a requirement to return the commissions or payments to their sources and to pay an excise tax.

[20] As noted above, the Department does not necessarily agree that the inclusion of such language in an IRA agreement ensures that a broker is not a fiduciary under the existing regulation.

- Brokers therefore would be forced to restructure their compensation as "wrap fees" expressed as a percentage of assets in the account. Receipt of wrap fees in turn would force the advisers to register and conduct their business as registered investment advisors (RIAs) under the Investment Advisers Act of 1940. IRAs would have to be converted from brokerage accounts to either advisory accounts (which cost more and deliver more service than most IRA holders want) or internet-based discount brokerage accounts (which offer no personalized advice), or be closed. Advisory accounts require high minimum balances so small accounts would lose all access to advice and many would be closed.

- The result will be dramatically higher fees and widespread distributions from small accounts, both of which will undermine retirement security.

- There will be no benefits to offset these costs and other negative impacts. There is no evidence that the quality of advice currently is diminished by the conflicts that are present, so there is no reason that the proposed regulation will improve advice.

- IRAs should not be treated like plans. They are retail accounts and should be treated like other retail accounts. IRA holders do not require as much protection as plan participants because they have unlimited choice of vendors and products and are therefore empowered to secure quality services.

The Department will continue to carefully study these arguments. We have, however, the following observations on some of the comments.

- We did not propose to force brokers to eliminate commission-based fee arrangements, restructure all of their compensation as wrap fees, or convert all brokerage IRAs to advisory accounts. Exemptions already on the books authorize brokers who provide fiduciary advice to be compensated by commission for trading the types of securities and funds that make up the large majority of IRA assets today. We will attempt to provide this clarification in a more formal manner as we proceed in this process.

- The Department is considering providing interpretive guidance to make this clear, as well as issuing additional exemptions. Such additional exemptions might cover, for example, revenue sharing arrangements that are beneficial to plan participants and IRA holders, and/or so-called "principal" transactions, wherein a fiduciary adviser, rather than acting as an agent, itself buys an asset from or sells an asset to an advised IRA. Such exemptions would carry appropriate conditions to protect plan participants' and IRA holders' interests.

- The Department believes there is strong evidence that unmitigated conflicts cause substantial harm, and therefore is confident that the proposed fiduciary regulation would combat such conflicts and thus deliver significant benefits to plan participants and IRA holders. As noted above, this evidence is found in academic research, IRA underperformance, SEC examinations, and EBSA's own enforcement experience. While no single piece of evidence by itself directly demonstrates or provides a basis for quantifying the negative impact of conflicts on plans and IRAs, taken together the available evidence appears to indicate that the negative impacts are present and often times large. Plans, plan participants, and IRA holders will benefit from advice that is impartial and puts their interests first.

- The tax code itself treats IRAs differently from other retail accounts, bestowing favorable tax treatment, and prohibiting self-dealing by persons providing investment advice for a fee. In these respects, and in terms of societal purpose, IRAs are more like plans than like other retail accounts. Most IRA assets today are attributable to rollovers from plans.[21] The statutory definition of fiduciary investment advice is the same for IRAs and plans. The proposed regulation therefore sensibly set forth a single consistent definition, addressing practical differences between the two by tailoring exemptions accordingly. As for the level of protection that is appropriate, while IRA holders have more choice, they may

[21] Peter Brady, Sarah Holden, and Erin Shon, *The U.S. Retirement Market, 2009*, Investment Company Institute, Research Fundamentals, Vol. 19, No. 3, May 2010, *at* http://www.ici.org/pdf/fm-v19n3.pdf.

nonetheless require more protection. Unlike plan participants, IRA holders do not have the benefit of a plan fiduciary, usually their employer, to represent their interests in dealing with advisers. They cannot sue fiduciary advisers under ERISA for losses arising from fiduciary breaches, nor can the Department sue on their behalf. Compared to those with plan accounts, IRA holders have larger account balances and are more likely to be elderly. For all of these reasons, combating conflicts among advisers to IRAs is at least as important as combating those among advisers to plans.

- The Department believes that the assessment of economic impacts it provided with the proposed rule provided an economic basis for the proposal. I agree, however, that a fuller analysis is called for at this point, and we are undertaking such an analysis now. The expanded analysis will be informed by all relevant stakeholder input, as well as by our consultations with other federal agencies, and will be provided along with any final regulation pursuant to applicable requirements.

Appraisals and valuations – Another issue raised by stakeholders relates to whether the valuation of employer securities should constitute “investment advice” as the proposed regulation would require. Although the current regulation includes advice as to the value of securities within the term "investment advice," a 1976 advisory opinion issued by the Department took the position that advice to an ESOP on the value of employer securities would not be so treated. A number of witnesses at our hearing on this proposed rule testified that the proposal would cause many qualified appraisers to discontinue ESOP valuations and would significantly increase costs of appraisals for small businesses that sponsor ESOPs. It is the Department’s opinion that, in many instances, the most important investment advice to a plan concerns how much to pay for an asset. In the case of closely-held companies, ESOP trustees typically rely on professional appraisers and advisers to value the stock, often with little or no negotiation over price. Unfortunately, in our investigations and enforcement actions, the Department has seen many instances of improper ESOP appraisals—often involving most or all of a plan’s assets—resulting in millions of dollars in losses. Accordingly, we believe that employers and participants

will benefit from being able to rely on professional impartial advice that adheres to the fundamental fiduciary duties of prudence and loyalty. However, we will continue to work with stakeholders to structure a rule that adheres to these duties but does not cause unnecessary harm or cost to small businesses.

Distinguishing Education from Advice – A number of witnesses expressed confusion over how the proposed regulation will impact participant investor education. There were concerns about what will be considered financial literacy and education and what will be considered investment advice under the proposed regulation. In particular, there were concerns that the proposal appears to significantly reduce what constitutes financial education and raises the question as to whether Interpretive Bulletin 96-1 (IB 96-1) is still in effect. The Department believes education is important for plans and plan participants. Under the proposed regulation, employers who provide general financial/investment information, such as a recommendation on asset allocation to 401(k) participants under IB 96-1, would not be considered fiduciaries under the new regulation. The Department also has general education resources available to plans and plan participants.

Next Steps

Our current approach to the fiduciary regulation consists of multiple steps.

First, we are working to better understand how specific compensation arrangements would be affected by the proposed rule and whether clarifications of existing prohibited transactions exemptions would be appropriate. We have already begun to issue subregulatory guidance describing some of these clarifications and will continue to do so as necessary as we complete our analysis.

Next, as we further develop our thinking in this rulemaking, we are paying special attention to the two primary exceptions to fiduciary status under the proposed rule: (1) clarifying the difference between investment *education* that does not give rise to fiduciary status and fiduciary investment advice; and (2) clarifying the scope of the so-called "sellers' exception" under which sales activity is not fiduciary advice. In both cases, we

will make sure to analyze and address the comments and concerns that were raised during our extensive public comment period.

Finally, we are exploring a range of appropriate regulatory options for moving forward, taking into consideration public comments submitted for the record, EBSA's economic analysis, and relevant academic research. In so doing, we are aiming to address conflicted investment advice while not unnecessarily disrupting existing compensation practices or business models.

Conclusion

Thank you for the opportunity to testify at this important hearing. The Department remains committed to protecting the security and growth of retirement benefits for America's workers, retirees, and their families.