TESTIMONY OF

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of

THE COMMITTEE FOR THE FIDUCIARY STANDARD

before the

DEPARTMENT OF LABOR

for the

HEARING ON DEFINITION OF THE TERM "FIDUCIARY";
CONFLICT OF INTEREST RULE –
RETIREMENT INVESTMENT ADVICE
AND RELATED PROPOSED
PROHIBITED TRANSACTION EXEMPTIONS

AUGUST 12, 2015

I am Kathleen M. McBride, an Accredited Investment Fiduciary Analyst® and a CEFEX Certification Analyst with the Centre for Fiduciary Excellence – CEFEX. I serve as Chair for The Committee for the Fiduciary Standard, an all-volunteer group of investment professionals and fiduciary experts, formed to advocate that all investment and financial advice be rendered as fiduciary advice and meet the requirements of the Committee's five core fiduciary principles. The Committee's work is pro bono.

We are challenging the status quo to ensure that all Americans can achieve a dignified, secure, retirement. I testify in support of this DOL Rulemaking. It is long overdue.

Thank you for the opportunity to testify here today, and for proposing a strong fiduciary rule that will eliminate many conflicts of interest that harm America's retirement investors. Americans who work and sacrifice to save and invest for their retirement should not have their nest egg diminished by Wall Street and insurance companies that place their own interests before the retirement investors they have the privilege of serving. Their short term greed ensures only one thing: that America's retirees will not have the spending power in retirement that they would have with advice that is in THEIR best interest.

We applaud DOL for prohibiting a seller's exemption for retail investors – including IRA owners. DOL has proposed a rule in which the North Star of fiduciary obligation is paramount, including in any exemptions.
Now we will finally close the unintended loopholes that enabled systematic taking of assets from America's retirement investors, for decades.

DOL has used its rulemaking authority to include IRA investors under this proposal, including advice on whether it is in their best interest -- or not -- to roll retirement plan assets from 401(k)-type plans into IRAs. This has been an area of particular, egregious harm, a wild west of abusive strategies by some industry entities to grab enormous amounts of retirement money from hard-working retirement investors, just as they will need this money the most.

When retirement investors are making the decision whether or not to roll retirement savings over to an IRA, they are at their most vulnerable. This fact is not lost on the non-fiduciary sales reps of banks, broker-dealers, insurance companies, and mutual fund companies. It is the subject of enormous planning, strategy and training at firms that seek to "capture" retirement investors' assets, along with unreasonably high commissions and fees.

And it is here that retirement investors are often caught off guard. As one behavioral economist (who as done much research on the effects of disclosures in adviser and investor behavior) points out;

"It is very hard to say "No" to the representative sitting at your kitchen table, even if you know that what they are telling you to do is NOT in your best interest."

An Example of Harm: Pension Rollover Solicitations

David Franklin (not his real name to protect his privacy), had just celebrated his 65th birthday. After college he joined the Navy, retiring as a lieutenant after his tour of duty. He entered the private sector. Over his successful career he accumulated a combination of traditional, defined benefit pension plans and 401(k)-type plans. Mr. Franklin worked hard to accumulate a retirement nest egg. He was a beneficiary of a two multibillion-dollar pension plans, which send retirees a monthly check, for life.

Shortly after his birthday, Mr. Franklin got a phone call from an "adviser" claiming to work with one of the traditional pension plans. He wanted to discuss Mr. Franklin's retirement situation. This "adviser" began by asking whether Mr. Franklin was confident he'd have enough to live on for the rest of his life.

This "adviser" insinuated that the (Fortune 40 and Fortune 15) companies with the traditional pension plans might go out of business, taking Mr. Franklin's monthly payment with them. What would Mr. Franklin do then?

This "adviser" strongly urged Mr. Franklin to take the lump sum payouts from his two pensions -- six-figures -- and put his money into a "guaranteed" annuity in an IRA at his major mutual fund company. Sure, it would pay Mr. Franklin ***several hundred dollars less every month*** than the pension plan would, "**but it would be guaranteed**."
He hounded Mr. Franklin until Mr. Franklin did, in fact, rollover one of his pension plans into an IRA at that major mutual fund company, ready for that annuity. And then Mr. Franklin called a friend. It is too late for Mr. Franklin

to reverse his lump sum pension payout so he now has to find a way to replace the retirement income his pension would have provided -- for life.

While Mr. Franklin will not be taking any more “advice” from that “adviser,” damage has already been done.

This happens every day, to thousands of America’s retirement investors.
This is the model Wall St and Insurance special interests want to protect.

And Now, A Few Words About “Best Interest”

There are currently two very different interpretations of “Best Interest” being discussed, as various parties assert their views on this DOL rulemaking.

One is DOL’s meaning, as stated on page 36 of the preamble to the proposal:

“As proposed, the best interest standard is intended to mirror the duties of prudence and loyalty, as applied in the context of fiduciary investment advice under sections 404(a)(1)(A) and (B) of ERISA. Thus, the “best interest” standard is rooted in the longstanding trust-law duties of prudence and loyalty adopted in section 404 of ERISA and in the cases interpreting those standards.”

This definition must be indelible, untouchable, and undiluted. The North Star of Fiduciary Obligation that goes hand in hand with the privilege of serving retirement investors.

Lobby groups are floating the other version of “Best Interest”:

Special interests lobbyists have stated they want a revamped “Best Interests” proposal from DOL. But, if you read or listen carefully, when they discuss “Best Interest,” it’s **NOT** about Best Interest of the investor! They want a Best Interest proposal that **is in the “Best Interest” of the broker-dealers and insurance companies**. One that’s in the Best Interest of the Special Interests!

To put it another way, they want to preserve the status quo that allows them to continue to systematically exploit unintended loopholes in 40-year old ERISA regulation, and bleed retirement investors for every dollar they can grab.

We Know the Fiduciary Model Works: RIAs Already Act as Fiduciaries -- In their Clients’ Best Interest

Registered Investment Advisers are already serving plans and retirement investors as fiduciaries, across all account sizes. **DOL’s proposal is workable. It’s doable, and, by the way, it’s profitable.**

RIAs Are Advising Millions of Investors - They now advise or manage $67 Trillion through more than 11,000 (11,473) RIA firms. They employ 750,000 individuals, and serve 30 million clients. [1]

So much for the special interests' scare tactic, the claim that nobody will get any advice if DOL’s fiduciary rulemaking goes through.

PS, The argument that nobody will get advice, if the DOL rulemaking proceeds is really very funny. In fact it is many things -- But it is not true. Brokers and insurance reps do not provide actual advice, especially on-going advice. They sell a security, one-time -- often under the guise of advice -- and reap an upfront commission and an ongoing annual fee – for doing nothing. Their firm may get a back door payment from an unwitting investor, too, for as long as the investor owns the security. But that’s not advice. It is, however, the way broker-dealers and insurance companies deal with retirement investors. It’s not advice. It’s not a service. And updated DOL ERISA rules that prohibit those practices are *LONG OVERDUE*.

[1] Evolution Revolution – A Profile of the Investment Adviser Profession
https://www.investmentadviser.org/eweb/docs/Publications_News/EVREV/evolution_revolution_2015.pdf

Let's Debunk Some of the Myths About the Fiduciary Standard for Retirement Advice

Myth #1 It Costs More to Get Advice From A Fiduciary

Opponents to the DOL proposal claim the fiduciary standard would raise costs to investors, and reduce access to advice and investment products.

That's not true, according to the latest fi360 Fiduciary Standard survey. It measures financial intermediaries' attitudes toward the fiduciary standard. It includes RIA/IARs, brokers, dually registered broker / adviser reps, and insurance reps.[2]

The survey asked, ***"Do you believe it costs more to work with fiduciary advisors than brokers, when all costs to the investor (not only the advisor's compensation) are considered?"***

Nearly 91% of respondents say no -- it does not cost more to work with a fiduciary adviser than with a broker.

Many of the comments from survey respondents indicate that, **instead of a higher cost for the investor to work with a fiduciary adviser, *<u>it actually costs investors less to work with a fiduciary</u>*.** There is much academic research that supports this finding.[3] [4] [5]

Myth #2 It Would Cost Us Too Much to Provide Fiduciary Advice; We'd Have to Pass Those Costs Along to Investors

The survey asked: ***"Do you believe a fiduciary standard of care would price some investors out of the market for investment advice?"***

Survey respondents say, **no it would not**. Eight out of ten, **83%, say no, the fiduciary standard would not price some investors out of the market for advice.**

Myth #3 If We Are "Forced" to Provide Advice That's in the Investor's Best Interest, We Will Abandon Retirement Investors

Opponents of the fiduciary standard claim products and services would be reduced for investors, if brokers were required to act as fiduciaries. What they *really* mean is, if they had to act as fiduciaries, they couldn't sell the high risk, high commission products they sell now, because those would not be in the investor's best interest. And remember, brokers and insurance reps don't provide advice now, certainly not to smaller investors.

The survey asks: ***"Do you believe a fiduciary duty for brokers who provide advice would reduce product and service availability for investors?"***

A majority of 78% says no, fiduciary duty for brokers who provide advice <u>would not reduce product or service availability for investors</u>.[6]

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[2] There have been four surveys, 2011, 2012, 2013 and 2015. http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf

[3] Ayres, Ian and Curtis, Quinn, "Beyond Diversification: The Pervasive Problem of Excessive Fees and 'Dominated Funds' in 401(k) Plans" (February 21, 2014). Yale Law & Economics Research Paper # 493. Available at SSRN: http://ssrn.com/abstract=2399531 or http://dx.doi.org/10.2139/ssrn.2399531

[4] "Broker Incentives and Mutual Find Market Segmentation," Diane Del Guercio, Jonathan Reuter, and Paula A. Tkac, National Bureau of Economic Research, http://www.nber.org/papers/w16312

[5] "It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans," Veronika K. Pool, Clemens Sialm, Irina Stefanescu, NBER Working Paper No. 18764 February 2013 http://www.nber.org/papers/w18764

[6] Report on the 2015 fi360 Fiduciary Standard Survey from fi360 and FiduciaryPath, "Seeking Trusted Advice for Individual Investors." http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf

Many survey participants added comments -- some said that extending a fiduciary duty to brokers may “filter out products that may be suitable, but are not in clients’ best interests. That’s a good thing.” We agree.

In addition, academic research shows that in states where there already is a fiduciary requirement for brokers, there has been no change in the number of brokers providing advisory services to investors -- even though they have to act in the best interest of their client.[7]

To recap:

- Nearly 91% say no, it does not cost more to work with a fiduciary advisor than a broker.
- 83% say no, a fiduciary standard would not price investors out of the market for advice.
- 78% say no, fiduciary duty for brokers would not reduce investor access to products or services for investors.

The opposition’s myths are just not plausible. Those myths are -- Busted.

Thank you for the opportunity to comment on the DOL’s thoughtful and substantive proposal. **We believe an undiluted ERISA fiduciary standard should apply when anyone has the *privilege* of advising retirement investors.**

Members of The Committee for the Fiduciary Standard applaud the courage and tenacity of the White House and Department of Labor in proposing the Conflict of Interest Rule. **We especially commend your steadfastness in the face of ferocious, but baseless, opposition.**

Thank you.

[7] Finke, Michael S. and Langdon, Thomas Patrick, The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice (March 9, 2012). Available at SSRN: http://ssrn.com/abstract=2019090 or http://dx.doi.org/10.2139/ssrn.2019090

Disclosures and Investor and Adviser Behavior: It's Not What You Would Expect

We applaud the DOL for requiring transparency and disclosure of cost and performance projections and comparisons to like investments.

We also are heartened to see that it is not an option to "disclose and waive" investor's best interest requirements, or "disclose and harm" – that the best interests of the retirement investor are the North Star, and not negotiable.

Transparency is Necessary But Disclosures Are "Ineffective" and Often, Worse

While transparency is crucial, disclosures of costs (and other information) to the investor have many unexpected and perverse effects on the investor, and on many well-meaning advisors, and certainly on salespeople, according to current academic research.

Disclosures are necessary, but not sufficient to fulfill fiduciary duty. Transparency is essential. The adviser needs to avoid the conflicts in the first place, and manage unavoidable conflicts in the investor's best interest – not disclose, proceed, and harm.

The effects of disclosures are surprising and quite unsettling. **Regulators may not be aware of the effects even good disclosures have on even well-meaning advisers and investors**, according to Prof. Dalian Cain, Yale School of Management, in "The Dirt on Coming Clean: The Perverse Effects of Disclosing Conflicts of Interest." [8]

According to Dr. Cain's research:

"*Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse."*

Transparency is Necessary But Disclosures Are "Ineffective" and Often, "Worse"

Some of the most recent work on disclosures and their effects on even well-meaning advisers, and investors receiving advice after being disclosed to, indicates that the effects are extremely perverse, according to Dr. Cain. Dr. Cain's research is compelling and it underscores the fact that disclosure is not enough to mitigate conflicts of interest or fulfill fiduciary duty to investors.

A 2013 research paper, "The Burden of Disclosure: Increased Compliance with Distrusted Advice," by Sunita Sah, George Loewenstein, and Dr. Cain, continues work they have led for years.[9] Their research indicates:

"Professionals are often influenced by conflicts of interest when they have a personal, often material, interest in giving biased advice. Although disclosure (informing advisees about the conflict of interest) is often proposed as a solution to problems caused by such conflicts, prior research has found both positive and negative effects of disclosure. ***We present four experiments that reveal a previously unrecognized perverse effect of disclosure:*** *While disclosure can decrease advisees' trust in the advice,* ***it simultaneously increases pressure to comply with that***

[8] Cain, Daylian M., George Loewenstein, and Don A. Moore. "The dirt on coming clean: Perverse effects of disclosing conflicts of interest." *The Journal of Legal Studies* 34.1 (2005): 1-25.

[9] "The Burden of Disclosure: Increased Compliance with Distrusted Advice," Sah, Sunita and Loewenstein, George and Cain, Daylian M., The Burden of Disclosure: Increased Compliance with Distrusted Advice (December 7, 2011). Sah, S., Loewenstein, G., & Cain, D. (2013). The Burden of Disclosure: Increased Compliance with Distrusted Advice. Journal of Personality and Social Psychology, Vol 104(2), 289-304. doi: 10.1037/a0030527. SSRN: http://ssrn.com/abstract=1615025 or http://dx.doi.org/10.2139/ssrn.1615025

same advice. *We demonstrate that the increased pressure results from advice recipients feeling obliged to help satisfy their advisors' personal interests when those interests have been disclosed.* ***Hence, disclosure can burden those it is ostensibly intended to protect.***

Dr. Cain notes that there are some requirements that may help mitigate these perverse effects:
"The increased pressure to comply is reduced if (1) the disclosure is provided by an external source rather than from the advisor, (2) the disclosure is not common knowledge between the advisor and advisee, (3) a cooling-off period is introduced, or, (4) the advisee can make the decision in private."

One More Thought on Disclosures

Few put it better than writer James Surowiecki, writing in *The New Yorker*: "Transparency is well and good, but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them."[10]

Annuities Awareness: What Annuities Owners Do and Don't Understand About Their Annuities.

Findings of a recent survey of annuity counselors in a large RIA firm indicate that most investors are **not aware of the total fees they pay** on the annuities, or many other contract provisions. They're unaware that the return percentages quoted include the return of their own principal that they put into the annuity, that those return percentages often include a "come hither" starting rate which changes as soon as six months in, and they're not aware that their principal is being returned to them, that there is no principal left at the end, unlike in a mutual fund or most other investments.

The Annuity counselors work with annuity owners to determine whether it is in their best interest to remain in an annuity or not. This firm has spoken with 5,000 annuity owners regarding 10,000 annuity contracts. The annuity counselors call the annuity-issuing insurance company, with the annuity owners, to uncover the facts about the annuities contracts. These are the counselors' conclusions from these three-party discussions with thousands of annuity owners.

Variable Annuities
How many annuity owners are unaware of the total fees they are paying annually for their VA?

- 62% of the annuity counselors say **annuities owners are "almost always" unaware of the total fees they are paying for their VA.**
- Another 31% of the annuities counselors say 75**% or more VA owners are unaware of the total fees they pay**.

That means **more than 9 out of 10 counselors, 93%, say more than three-quarters of VA investors are unaware of the total fees they pay -- with nearly a two-thirds majority of VA investors almost always unaware of the total fees they pay.**

How many annuity owners have a VA in their qualified retirement account?

The counselors found that **at least 50% of annuity owners have a VA in their qualified account. (That's a very expensive retirement investment, and it's not appropriate location of that asset -- there is no need for the annuity's tax deferral in an IRA.)**

- Nearly a quarter, 23%, of the counselors said **more than 75% of the VA owners they talked with had a VA in their qualified retirement account**

- Almost half the counselors, 46%, say **more than half, but less than three-quarters of the annuity owners had a VA in their qualified retirement account**.

[10] "The Talking Cure," *The New Yorker*, 12/9/2002, http://www.newyorker.com/magazine/2002/12/09/the-talking-cure

- The rest of the counselors, 31%, **said 50% of annuity owners had a VA in their qualified account.**

How many annuity owners do not understand that death benefits are taxable (as opposed to life insurance which is not)?

- More than 92% of the counselors said **more than half of annuity owners do not understand that the death benefits are taxable (**unlike regular life insurance)
- 31% said annuities owners are **almost always, unaware that annuity death benefits are taxable**
- 38% of the counselors found **75% or more annuity owners were unaware that the death benefit is taxable**

There is much more to come from this research and we will be reporting on that soon.

The Sales Relationship versus The Relationship of Trust

No retirement investor would knowingly harm herself or himself. When harm is caused to a retirement investor it is typically because they have been scared and/or deceived into buying a high commission, high fee annuity or other high cost investment product. They are harmed because a salesperson, measured by how much commission and fee revenue they "produce," has used deceptive, misleading or fraudulent sales tactics that are coldly calculated to scare the investor into thinking they will run out of money in retirement.

This sales deception, masquerading as "advice," begins with advertising that brands banks, brokerage firms, and insurance companies as "trusted advisers," invited to family weddings and retirement dinners. "We are," they say, "on your side." "We put members first." "We are advocates for our customers, put them at the center of everything we do." But when harm comes to light, they disavow any fiduciary duty to the retirement investor.

Deceptive, Misleading, Fraudulent Sales Tactics, Advertising, Titles

The titles issue is especially deceptive: a recent survey of investment advisers, brokers, dual registrants and insurance reps, asked, "Do you believe the titles "advisor," "consultant," and "planner" imply that a fiduciary relationship exists?" 72% of survey participants say these titles imply a fiduciary relationship with clients.[11]

Public Policy and Retirement in America
What Happens When Retirement Investors Are $2 Trillion Poorer at Retirement?

We note that the DOL has been very conservative in its estimates of the current harm to retirement investors. One estimated shortfall to retirement investors, of $1 Trillion dollars, (just in one segment, mutual funds, in one retirement vehicle, IRAs) is unworkable and unacceptable. Especially when this shortfall is caused by a deliberate and systemic looting of retirement investors' nest eggs by less progressive Wall Street banks, brokers, insurance companies, and mutual fund companies who pretend to be trusted advisers, but are arranging their businesses to extract the highest dollar amounts from investors via kickbacks, hidden commissions and fees and deceptive sales tactics in the guise of "advice." Of course, they don't think of it as looting America's retirement savers – they think of it as "business as usual."

DOL notes that just 1% in extra fees can leave a retirement investor with 27% less in their nest egg. Well-respected economic and investment leaders note that 200 basis points, (2%) of excess fees per year, is typical and can take 50% out of a retirement investor's nest egg. (David Swensen of Yale, and Burton Malkiel of Princeton). When you add in other types of investment alternatives in IRAs, such as annuities, where the costs to investors are much higher, 4% to 10% annually, and another 7% to 10%, in penalties or even 20% in surrender fees, the actual

[11] Report on the 2015 fi360 Fiduciary Standard Survey from fi360 and FiduciaryPath, "Seeking Trusted Advice for Individual Investors." http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf

retirement investor shortfall is likely to be much higher than the DOL's conservative $1 Trillion -- closer to $2 Trillion over the next 20 to 40 years.

Less progressive banks, broker-dealers, insurance companies, mutual fund companies are sharing, in the short term, retirement investors' savings that should remain in their accounts, compounding and growing. It should be growing in investors' nest eggs. And then, retirees can spend it in the American economy over the next two to four decades – $1 Trillion to $2 Trillion dollars.

One has to ask: **If private companies are allowed to continue extracting such a toll in unreasonably high commissions and fees from retirement investors**, **and retirement investors would be missing $1 to $2 Trillion from their retirement nest eggs, how will these retirement investors get by in retirement? Who will make up this shortfall?** Taxpayers? This could mean that the federal government would need to engineer a bailout plan bigger than what we have seen over the past eight years -- all because corporations have taken out so much -- for themselves -- from retirement investor's nest eggs. Corporate greed resulting in a federal bailout paid for by American taxpayers.

Let's correct this now, before retirement investors lose any more of their nest eggs to Wall Street and Insurance companies.

This is the choice we face here, and why it is so **vital that all who have the privilege of advising retirement investors must do so in the <u>Investor's Best Interest</u>.**

So many Americans have little idea why this rulemaking is so important – yet they do know something is not right. They cannot always articulate it. DOL articulates it in this rulemaking. And this is why this DOL rulemaking must proceed, and quickly.

So that all Americans saving and investing for a dignified and financially secure retirement can attain that worthwhile goal.

Thank you.

Respectfully submitted,

Kathleen M. McBride, AIFA®

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About The Committee for the Fiduciary Standard

The Committee was formed in June 2009 by an all-volunteer group of investment professionals and fiduciary experts, just as policymakers and industry leaders were reviewing the repercussions of the financial crisis, to advocate that all investment and financial advice be rendered as fiduciary advice and meet the requirements of the five core fiduciary principles. The Committee's work is pro bono.

The Committee's goal is to advocate for the authentic fiduciary standard. The Committee seeks to help inform and nurture a public discussion on the fiduciary standard. Its objective is to ensure that any financial reform regarding the fiduciary standard, 1) meets the requirements of the authentic fiduciary standard, as presently established in the Investment Advisers Act of 1940, or ERISA, and 2) covers all professionals who provide investment and financial advice or who hold themselves out as providing financial or investment advice, without exceptions and without exemptions. www.TheFiduciaryStandard.org

The Committee for the Fiduciary Standard's Five Core Fiduciary Principles:

• Put the client's best interests first;
• Act with prudence, that is, with the skill, care, diligence and good judgment of a professional;
• Do not mislead clients--provide conspicuous, full and fair disclosure of all important facts;
• Avoid conflicts of interest;
• Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.