Statement of Bradford P. Campbell, Esq.
ERISA Attorney and Former U.S. Assistant Secretary of Labor
For Employee Benefits

Before

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Committee on Ways and Means
Subcommittee on Oversight

Hearing on the Department of Labor's Proposed Fiduciary Rule

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Introduction:

Chairman Roskam and Ranking Member Lewis, thank you for the opportunity to testify today regarding the U.S. Department of Labor's (the "Department") proposed regulatory package redefining fiduciary investment advice and proposing new and amended prohibited transaction class exemptions (the "Proposal").[1] I commend the Committee for holding this hearing, as Congressional oversight on the remarkably broad scope of the Department's regulatory activity is necessary to ensure that any final regulation resulting from this process protects, rather than disrupts, Americans' efforts to save for retirement.

I share the goals motivating the Department to take up this regulatory initiative, even though I believe the resulting Proposal is fundamentally flawed, exceeds the Department's regulatory authority, and must be significantly revised. As the former U.S. Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration ("EBSA"), the agency that is promulgating this rule, I understand the enforcement concerns that led the Department to review the 1975 regulation. The current regulation does contain conditions that are worthy of review, such as the requirement that advice be provided on a "regular basis" in order to be fiduciary advice.[2]

I also believe that investment advice provided to retirement plan fiduciaries, to plan participants, and to IRA owners should be in their "best interest"—that is, the advisor should put the needs of the retirement investor ahead of the advisor's own interests. Unfortunately, as I'll explain in more detail below, the Proposal does not achieve these goals—in fact, it likely will harm the very retirement investors it is intended to help.

The Proposal Would Increase the Cost and Reduce the Availability of Advice to Small Plans and to Small-Account IRA Owners:

I am particularly concerned about the effect the Proposal likely would have on reducing choice, restricting access, and increasing costs facing small retirement plans and individuals with small account balances. These groups are most in need of access to

[1] 80 Fed. Reg. 21,927-22,042 (Apr. 20, 2015).

[2] *See*, 29 CFR 2510.3-21(c)(1)(ii)(B)

professional investment advice, but are least likely to be served due to the increased compliance costs and increased legal liability risks unnecessarily created by the Proposal.

The Small Business Administration's ("SBA") Office of Advocacy expressed similar concerns in its formal comment letter to the Department in which it questioned the Department's economic analysis and criticized the Department for not sufficiently taking into account the effects of the Proposal on small businesses. The conclusion from focus groups held by the SBA was that "the proposed rule would likely increase the [advisers'] costs and burdens associated with serving smaller plans…[and] could limit financial advisers' ability to offer savings and investment advice to clients…ultimately lead[ing] advisors to stop providing retirement services to small businesses."[3]

- The Cost of No Advice

The Department itself estimated in 2011 that plan participants and IRA owners already lose more than $100 billion per year due to the lack of access to investment advice, due in part to the very rules that this Proposal would apply even more broadly.[4] Instead of tackling that very real problem by expanding access to investment advice, the Proposal goes in the opposite direction, further restricting access to advice.

- Conflating Sales with Advice

One of the essential flaws of the Proposal reducing access is that it redefines sales activity as fiduciary investment advice. The effect of this is to reduce the sources and methods of providing investment information to retirement investors. For example, an agent for a specific company would be effectively prohibited from discussing the company's investments because they are proprietary products, and she is not impartially recommending her competitors' products. This restriction would apply regardless of how well the investment might have served the retirement investor's "best interest" (unless there is an applicable exemption). Despite this, it is clear the Department recognizes that sales activity is valuable, as it permits such activity for large plans with more than 100 participants or more than $100 million in assets, but it denies the right to receive sales information to small plans, participants and IRA owners.

The Department's rationale that large plan fiduciaries are sophisticated investors who can distinguish between sales activity and impartial advice makes little sense on its face—there is no clear basis to believe that plan size is a proxy for financial sophistication, and no basis to treat every IRA owner as if she is incapable of making informed choices. With clear disclosure that the information being provided is not fiduciary advice but is sales activity

[3] Comment letter from the Small Business Administration's Office of Advocacy, July 17, 2015, at 5-6.

[4] *See,* The Preamble to the final regulation implementing the Pension Protection Act investment advice provisions, 76 FR 66,151-66,153 (October 25, 2011) ("Unfortunately, there is evidence that many participants of these retirement accounts often make costly investment errors due to flawed information or reasoning…Financial losses (including foregone earnings) from such mistakes likely amounted to more than $114 billion in 2010…Such mistakes and consequent losses historically can be attributed at least in part to provisions of the Employee Retirement Income Security Act of 1974 that effectively preclude a variety of arrangements whereby financial professionals might otherwise provide retirement plan participants with expert investment advice.) [Emphasis added].

for which the seller receives compensation, there is no reason to so narrowly restrict permissible activity by so broadly defining fiduciary advice.

A well-crafted proposal would focus on the specific conduct the Department has found to be abusive through its enforcement efforts, rather than attempting to change the entire regulatory structure governing retirement advice, resulting in significant unintended consequences and practical barriers to investment information. These unintended consequences and technical problems raise significant risks that a final rule will not function properly, causing disruption to necessary services to plans, plan participants, and IRAs.

Unless the Regulatory Package Is Reproposed to Permit an Additional Round of Public Comment There Will Be Serious Technical and Practical Problems:

The Department developed the Proposal behind closed doors, despite a limited knowledge of the IRA marketplace and the role of other financial regulators. The result is a Proposal that does not work in practice. Instead of learning from that experience, the Department intends again to draft the final regulation behind closed doors.

- One Round of Comments is Not Enough for a Rule of This Scope

While I appreciate that the Department received extensive comments, and heard four days of testimony during administrative hearings on the Proposal, the comments and testimony served to highlight that this unusually broad and aggressive rule has an unusually large number of technical and policy problems. A rule this complex cannot be fixed with only one round of comments and review. No matter how well-intentioned and hard-working the Department may be, retreating again behind closed doors to rewrite a final rule will result in serious technical flaws at the very minimum.

Based on my experience in promulgating regulations at the Department, including many of the regulations implementing the Pension Protection Act of 2006, the Department is unlikely to promulgate a well-crafted final rule that properly addresses the Proposal's practical problems without submitting a revised rule for public comment. While a reproposed rule would add a short amount of additional time to the process, it is necessary, in my view, to avoid promulgating a final rule that simply does not work in important respects.

The Proposal's Overly Broad Scope Will Result in Serious Unintended Consequences Harming Retirement Investors and Ongoing Conflicts with Federal and State Financial Regulators:

As the former head of EBSA, I am very familiar with the Department's responsibility under the Employee Retirement Income Security Act of 1974 ("ERISA") to regulate private-sector, employer-provided benefit plans. However, in this Proposal, the Department is attempting to position itself broadly as the primary regulator of compensation and conduct for all types of financial advisors—registered investment advisors, insurance agents, bank officials, registered representatives of broker dealers, consultants, etc.—not only to ERISA-covered employee benefit plans, but also to Individual Retirement Accounts ("IRA"), and to rollovers and other distributions from ERISA plans and IRAs. This is a significant departure from the Department's traditional view of its authority, particularly with respect to IRAs.

In my opinion, the controversy surrounding the Proposal and the comments and testimony identifying a large number of significant technical problems are a direct result of the Department's unfamiliarity with the IRA marketplace and with the role of other regulators in governing financial advice provided to IRAs. The Department is trying to force a square peg into a round hole by asserting that the ERISA standards can and should apply to IRAs.

- Lack of Coordination with Other Regulators Would Lead to Conflicting but Simultaneously Applicable Advisor Requirements

It is difficult to overstate how broad the Proposal's effects would be. ERISA plans and IRAs collectively hold approximately $16 trillion in assets on behalf of tens of millions of Americans.[5] The Proposal would impose new restrictions and compliance obligations on advisors to these plans and IRAs that apply in addition to the extensive State and Federal regulatory regimes already in place. The result is predictable—the Proposal and the existing regulations do not mesh. It is very clear that the Department did not coordinate its Proposal sufficiently with other financial regulators. The Financial Industry Regulatory Authority ("FINRA") offered 21 pages of formal comments to the Department identifying various problems, including direct conflicts with securities law and regulation, created by the Proposal.[6]

Another example is the likely effect of the Proposal on the types of fee arrangements used in IRAs and plans. While the Proposal does not directly prohibit commission or transaction-based fees, the fee-leveling requirements associated with the new fiduciary status of advisors will put considerable pressure to transition many IRAs to fee-based accounts. This is a likely outcome due to the administrative complexity of levelizing commissions and transaction-based compensation. However, this will clearly increase costs for some workplace plans and IRAs that benefit from transaction-based pricing. The U.S. Securities and Exchange Commission ("SEC") has a targeted enforcement program directly addressing this so-called "reverse churning" in which fee-based accounts are used to make investors pay more for services than they would have paid in transaction-based accounts. The inappropriate use of fee-based accounts is an SEC examination priority for 2015.[7] It is not clear how advisors pushed towards fee-based accounts by the Proposal would comply with the SEC standards.

Congress Did Not Intend IRAs to Be Treated As ERISA Plans:

The reality is that the Department is attempting to do something through the prohibited transaction rules (and the Best Interest Contract Exemption) that Congress explicitly chose not to do. Congress devised through ERISA a very specific and protective fiduciary standard for employee benefit plans rooted in trust law in response to the unique history of abuses in pension plans. Despite their simultaneous creation in 1974, Congress expressly chose not apply the ERISA fiduciary standard to IRAs. Instead, the standard of care for

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[5] *See,* "The U.S. Retirement Market, First Quarter 2015," the Investment Company Institute, June 24, 2015, available at https://www.ici.org/research/stats/retirement/ret_15_q1.

[6] *See,* Comment letter from Financial Industry Regulatory Authority ("FINRA"), July 17, 2015.

[7] *See* "Examination Priorities for 2015--National Exam Program, Office of Compliance Inspections and Examinations," available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

advice to IRAs is determined by the conduct requirements of financial regulators governing each type of advisor. While the prohibited transaction rules apply to IRAs, the ERISA fiduciary standard of conduct does not.

In my opinion, Congress' choice recognizes the essential difference between employee benefit plans and IRAs—in an employee benefit plan, the fiduciary makes decisions for me, and in an IRA I make them for myself. The tax advantages of an IRA as compared to a taxable investment account don't change the nature of the relationship between the account owner and the advisor.

Despite the Rhetoric, the Department's Proposal Is Not a "Best Interest" Standard—It Actually Could Prevent Advice That Is in Your Best Interest:

If the effect of the proposed rule was simply to ensure that advisors to retirement plans and IRA owners must give advice that is in retirement savers' "best interest," this Proposal would not be controversial. What the Department actually has proposed is something very different than a "best interest" standard. The reason is that the Proposal ultimately rests on an even broader application of the prohibited transaction rules in ERISA and the Code.

The prohibited transaction rules are not a proxy for the quality of advice—in fact, their application is effectively unrelated to the content of the advice. Instead, they broadly prohibit compensation arrangements based on cost differences or affiliated relationships. As discussed above, the prohibited transaction rules would prevent an agent from advising on her company's investment products unless specifically permitted to do so by an exemption. In another example, a plan's investment advisor would not be able to advise a plan participant on a rollover, simply because of the structural reality that a typical IRA has to charge a higher investment advice fee than a typical institutionally-priced 401(k). The reality is that different investment products and services have different costs and prices for reasons unrelated to any conflict—the Proposal does not take into account those realities and simply prohibits the advice, unless an exemption applies.

Unfortunately, the new exemption proposed by the Department to address these issues simply does not work as proposed, and its requirements exceed the Department's regulatory authority.

The Best Interest Contract Exemption Does Not Work as Proposed, Would Encourage Unnecessary Litigation, and Exceeds the Department's Regulatory Authority

The Best Interest Contract Exemption (the "BIC Exemption") is the key to the Proposal. In order to permit advice that would otherwise be prohibited by the broad fiduciary rule and the prohibited transaction rules (such as in the rollover advice example above), the advisor and the participant or IRA owner would sign a contract enforceable in state court. The contract could not restrict the ability to bring class action lawsuits, would require a long list of warranties and representations by the advisor and its financial institution, and would require very specific disclosures regarding fees and expenses. The advisor would also have to agree to a standard of conduct that is a slightly reworded version of the ERISA fiduciary standard.

As Proposed, the BIC Exemption would not be feasible for many advisors—the disclosure provision would require gathering and disclosing information to which some advisors

would not have access (or only at great expense), and it is not clearly written to apply to many important transactions. For example, it would not apply to managed accounts, so a participant wanting to rollover from a 401(k) plan to a managed account in an IRA may not be able to find an advisor who could assist him.

The BIC Exemption essentially outsources enforcement of advice arrangement to private lawsuits. The class action requirement, combined with the subjective nature of many of the warranties and representations required to be in the contract, likely would result in excessive and unnecessary litigation. The lack of clear, objective criteria in the exemption and contract terms result in compliance uncertainty and greater risk of litigation.

- BIC Exemption Exceeds Regulatory Authority

It is my belief that the BIC Exemption exceeds the Department's legal authority to regulate in four areas.

First, by providing a new cause of action in state court, the BIC Exemption is attempting to create an alternative remedy to ERISA's exclusive remedies available to plan participants. The Department has no authority to create alternative remedies directly by regulation—it cannot, in my view, do as a condition of an exemption what it lacks the authority to do directly in a regulation.

Second, the contract creates a fiduciary conduct standard for advisors to IRAs. The Department has no authority to establish a standard of conduct for advisors to IRAs—it cannot, in my view, do so as a condition in an exemption.

Third, the requirement that the contract cannot limit access to class action litigation in state court impermissibly limits the right of private parties to agree to binding arbitration of disputes. The Federal Arbitration Act ("FAA") has been held to require a clear Congressional statement of intent to override the FAA's protection of arbitration clauses,[8] and ERISA does not have such a provision.

Finally, the IRS, not the Department, has the sole enforcement authority over prohibited transaction violations under Sec. 4975 of the Code under Sec. 105 of Reorganization Plan No. 4 of 1978. This Executive Order provides the Department the interpretive authority over prohibited transaction, but not enforcement authority. Thus, the exemption cannot delegate enforcement authority to state courts.

State-Run Private Sector Retirement Plans and Related Fast-Tracked DOL Regulation Suggest a Need for Congressional Oversight

Though never appearing on a semi-annual regulatory agenda, the Department wrote and submitted to the Office of Management and Budget on September 1st a proposed rule that apparently will facilitate various state efforts to provide a state-run retirement savings plan to private sector workers. This is a significant policy development, as it would be a Federal endorsement of a role for states in private sector retirement plans.

[8] *See*, *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665, 669 (2012).

While we don't know the details of the proposed regulation under review, I believe Congress should review these actions. Given this Committee's longstanding jurisdiction over the tax treatment of retirement plans, and the intentional decision by Congress to preempt the states in regulating private sector retirement plans, Congress has an interest in seeing how the Department is encouraging states in these matters.

Personally, I am curious what types of plans states would be establishing, how they will determine appropriate fees and investments, and whether any retirement promises made to participating private sector workers would be funded.

Conclusion:

Thank you Mr. Chairman and Mr. Lewis for your commitment to the retirement security of America's workers. I appreciate the opportunity to discuss these issues with the Committee, and I would be happy to answer any questions you may have.

Thank you.