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The Department of Labor's Fiduciary Rule for Dummies (But Not the Dummies They Think We Are)

Rule Blocks Investment Choices and Could Cost Middle Class Savers Billions

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This briefing paper explains the Department of Labor's (DOL) needlessly complex "fiduciary rule," now being reviewed at the Office of Management and Budget and soon to become a final rule. Given the language in the rule, DOL may well believe it was drafting a "fiduciary rule for dummies," because it expresses doubt that savers can make wise investment choices in their 401(k)s and individual retirement accounts. In the proposed fiduciary rule it issued last April, DOL proclaims that individuals cannot "prudently manage retirement assets on their own," and that they "generally cannot distinguish good advice, or even good investment results, from bad."[1]

Q: What is the justification for the fiduciary rule? Is it intended to improve disclosure for 401(k)s and IRAs?

A: In the Department of Labor's own words, no, because even with disclosure, DOL argues, savers are not smart enough to make what DOL considers the correct investment decisions for their retirement. "Disclosure alone has proven ineffective," states the rule. In fact, proclaims DOL, "recent research suggests that even if disclosure … could be made simple and clear, it would be ineffective—or even harmful."

The Department of Labor wants to mandate that a broad swath of financial professionals who service 401(k) plans and individual retirement accounts only serve the "best interest" of savers when providing investment guidance—with the definition of "best interest" to be decided by regulators. It does so by defining these professionals as "fiduciaries."

Q: Why is DOL even involved? Isn't the Securities and Exchange Commission (SEC) the agency charged with regulating investments?

A: DOL is bypassing the SEC to reshape the investment industry by massively, and probably illegally, stretching the very limited authority DOL has over some types of retirement plans from the Employee Retirement Income Security Act (ERISA) of 1974. ERISA gave DOL power over financial services professionals that have clear "fiduciary" relationships with retirees, such as those who manage a defined-benefit pension plan or provide regular investment advice for a fee. The new rule is broadening the definition of "fiduciary" (as explained below) in a way that directly conflicts with the definition of the

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term under both federal securities laws and common law precedent of state courts, in order to place more in the finance industry under DOL's jurisdiction.

Q: Who would be a "fiduciary" under the DOL rule?

A: A better question might be, "Who wouldn't be?" Most of the news coverage of the rule has focused on the fact that it would deem broker-dealers "fiduciaries," clashing with the SEC, which so far has declined to designate them as such. But the rule would go much further than that. Under the new rule, financial professionals who provide even one-time guidance or appraisal of investments could find themselves classified as "fiduciaries."

As Eugene Scalia, a partner at Gibson, Dunn & Crutcher who has successfully challenged many financial regulations in court, wrote in his comments to DOL on the proposed rule:

> The Department has proposed a definition of "fiduciary" so broad that it must be accompanied by seven carve-outs and six prohibited transaction exemptions to limit the scope of even a small portion of the vast new regulatory regime it would establish. A regulatory definition that cannot function or be harmonized with generations of practice unless it is re-worked through a dizzying array of carve-outs and exemptions is, axiomatically, a definition that does not faithfully interpret the words Congress wrote.[2]

For centuries, the standard definition of fiduciary has been someone in a clear position of trust.[3] In finance, this means someone whom the client has specifically entrusted to manage his or her assets and make investment decisions. While managers of defined benefit pensions and registered investment advisers have qualified as fiduciaries under various laws, broker-dealers have not, because they have been considered more akin to salespeople. While the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 gives the SEC the authority to deem broker-dealers as "fiduciaries," with the attendant duties that entails, it has not *required* the SEC to do so, and the SEC has not done so to date.

But the Labor Department, which was never given authority from Congress to broaden the term "fiduciary," is trying to do an end-run around the SEC via this rule. Under DOL's expanded definition, broker-dealers, insurance agents who recommend annuities, appraisers of a self-directed IRAs, and others who clearly are not entrusted to manage a portfolio—the classic definition of a fiduciary—may find themselves facing fiduciary liability and punishment under the new rule. In fact, according to some observers, the rule may even extend to television and radio hosts who give advice to individual callers.

In recent article in LifeHealthPro, a prominent online trade journal for insurance professionals and financial advisers, insurance agent Michael Markey calls for radio host Dave Ramsey to "be regulated and to be held accountable" by the government for the opinions he gives to listeners. Going through a litany of financial tips given by Ramsey to callers on which Markey holds differing views, such as on what type of life insurance to purchase, Markey hails the DOL rule as ushering in a new era in which "entertainers like Dave Ramsey can no longer evade the pursuit of regulatory oversight."[4]

The rule could ensnare financial broadcasters as fiduciaries, as Kent Mason, partner at the Washington, D.C. law firm Davis & Harman points out. "Under the proposed regulation, investment advice from a radio host to a caller regarding the caller's own investment issues would appear to be fiduciary advice if the advice addresses specific investments," Mason said in an email to CEI. It does not matter that Ramsey and other hosts are not compensated by listeners, he adds, as the DOL rule explicitly covers those who give investment advice and receive compensation "from any source."[5]

Mason agrees with Markey that the compensation Ramsey receives from radio stations that carry his show and from book sales are enough to define Ramsey as a "fiduciary" under the rule. Although the rule does contain an exemption for "recommendations made to the general public," both Mason and Markey agree it would not protect Ramsey and other radio and television presenters if they gave specific answers to callers or audience members.

Q: Will the fiduciary rule restrict choices and lead to government-favored investment decisions?

A: As noted, the DOL rule labels a vast number of financial professionals as "fiduciaries," and imposes on them a mandate to invest in savers' "best interest." Center-left economists Robert Litan and Hal Singer describe this "best interest" requirement as "a vague open-ended obligation with seemingly no bounds."[6] As a result, it will be almost inevitable that financial service providers will restrict choices of investment vehicles and strategies and look for a "safe harbor" of particular investments the government would bless.

This restriction in choices would have many adverse consequences. As CEI and the FreedomWorks Foundation noted in comments to DOL, many investors have self-directed IRAs with alternative assets from precious metals to peer-to-peer loans. We wrote:

> Venture capitalists and angel investors have also given crucial seed funding to startup businesses through their IRAs, and some of these firms went on to create thousands of jobs and changed the way we live. According to *Forbes*, venture capitalist Peter Thiel invested in Facebook in its early stages partially through his IRA.[7]

We further note that "whether inclusion of these alternative assets is a good investment strategy is a matter of opinion, but it should be a choice for the investor to make."

The DOL rule posited that index funds would be viewed as an investment choice that would comply with the "best interest" standard. But as we noted in the comments (co-authored by Chartered Financial Analyst Christopher Kuiper, then a CEI research associate):

> Index funds may in aggregate be cheaper, but their low expense ratios do not reflect the total cost. Active managers, for instance, can protect investors on the downside; pure passive and index investing cannot. Studies have confirmed active funds' underperformance on the way up during booms but outperformance on the way down during busts.[8]

Also of concern is an October 2015 Department of Labor interpretive bulletin that endorses so-called socially responsible investing for "fiduciary" pension plans currently governed under ERISA. DOL states:

> Fiduciaries … do not need to treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors.[9]

DOL's glowing description of such politically correct investments indicates it may encourage them as a way for newly minted "fiduciaries" to comply with the "best interest" mandate.

Q: What are the most far-reaching consequences of this rule?

A: A "guidance gap" created by the rule could cost middle-class savers $80 billion in lost savings, according to Litan and Singer.[10] Brokers would have to charge investors much more, because the DOL rule creates a presumption against brokers taking third-party commissions from mutual funds they sell to savers. As a result, investors who currently pay only a small commission on the execution of an order may have to pay a much larger fee based on a percentage of their assets. And since some portfolios are too small to justify the cost of even a management fee, brokers will simply stop servicing them.

For illustration, we can look to what happened in the United Kingdom after it banned third-party commissions in 2013. A June 2013 study by the Cass Business School at City University London found that brokers had largely stopped serving British savers with portfolios below £150,000 ($240,000), because the fees alone would not pay for servicing the accounts.[11] This study and other research estimates that this "guidance gap" will see 85 percent of British savers lose their brokers or get reduced services for their retirement accounts. Litan and Singer argue that similar effects will take place here, and estimate that savers could lose $80 billion over 10 years because of it.[12]

Q: What can Congress do to stop implementation of the fiduciary rule?

A: Members of Congress from both parties have expressed serious concerns about the rule. In September, 96 House Democrats, including avowed progressives like Rep. Gwen Moore (D-Wis.), wrote to DOL expressing concern about its effects on consumer choice and access to advice, and the potential for low-income savers to lose access to vital financial services.[13]

Congress has a variety of options to block or delay implementation of the DOL rule, including defunding, voting the measure down, and rewriting the law. These options are not mutually exclusive. One thing Congress must do when the final rule comes out—assuming it is not substantially different from the proposed rule, which it most likely will not be—is to exercise its prerogative under the Congressional Review Act (CRA) to vote down the rule with a resolution of disapproval.

Under the CRA, Congress has 60 legislative days after a final rule is released to disapprove of that rule. The votes take place in an expedited procedure with no filibuster allowed, so only a simple majority is required for passage. The resolutions are still subject to presidential veto, but even if the president vetoes it, and there are not enough votes for an override, the statement of disapproval by Congress is still important. It forces Members of Congress and the President to go on the record as supporting or opposing a given measure, thus providing important information for voters.

The resolution of disapproval stands as a statement that the president is going against Congressional intent. As Jeff Rosen of the law firm Kirkland & Ellis pointed out recently on the blog of the *Yale Journal of Regulation*, CRA votes "could be relevant to lawsuits" under the Administrative Procedure Act.[14] This would seem to be especially true in cases such as this, in which the regulation departs so much from the law on which it claims to be based. Thus, subsequent lawsuits challenging the rule will almost certainly point to lack of authority from Congress.

Notes

[1] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 *Federal Register* 21,928, 21,932 (Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510).
[2] Eugene Scalia is the son of the late Supreme Court Justice Antonin Scalia. Comments of Eugene Scalia to the Employee Benefits Security Administration of the U.S. Department of Labor, July 20, 2015, http://www.dol.gov/ebsa/pdf/1210-AB32-2-00547.pdf.
[3] Roget's Thesaurus deems the word "fiduciary" interchangeable with "guardian" and "trust." http://www.thesaurus.com/browse/fiduciary
[4] Michael Markey, "What If Dave Ramsey Were Held to a Fiduciary Standard," LifeHealthPro, October 22, 2015, http://www.lifehealthpro.com/2015/10/22/what-if-dave-ramsey-were-held-to-a-fiduciary-stand?slreturn=1455801277.
[5] Author interview with Kent Mason, November 16, 2015.
[6] Robert Litan and Hal Singer, "Good Intentions Gone Wrong: The Yet-to-Be- Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule," Report prepared by Economists Incorporated for the U.S. Department of Labor, July 2015, p. 6, http://www.dol.gov/ebsa/pdf/1210-AB32-2-00517.pdf.
[7] Comments of the Competitive Enterprise Institute and FreedomWorks Foundation to the Employee Benefits Security Administration of the U.S. Department of Labor, July 21, 2015, p. 4, http://www.dol.gov/ebsa/pdf/1210-AB32-2-00771.pdf.
[8] Ibid, p. 5.
[9] "Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors," Employee Benefits Security Administration of the U.S. Department of Labor, October 22, 2015, http://www.dol.gov/ebsa/newsroom/fsetis.html.
[10] Litan and Singer.
[11]Andrew Clare et al, "The Impact of the RDR on the UK Market for Financial Advice," Cass Business School, June 2013, http://www.cass.city.ac.uk/__data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf.
[12] Litan and Singer.
[13] Nick Thornton, "Over Half of House Democrats Call for Changes in DOL Fiduciary Rule," BenefitsPro, September 24, 2015, http://www.benefitspro.com/2015/09/24/over-half-of-house-democrats-call-for-changes-in-d?slreturn=1454941863.
[14] Jeff Rosen, "The Congressional Review Act Revisted," *Yale Journal of Regulation*, December 14, 2015, http://www.yalejreg.com/blog/the-congressional-review-act-revisited-by-jeff-rosen.