GROOM LAW GROUP

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The Regulatory Impact Analysis – DOL's Fiduciary Advice Definition Proposal

On April 14, 2015, the U.S. Department of Labor ("DOL") made available its long-awaited 2015 Proposed Regulation on the definition of "fiduciary" under section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The package of materials proposed by the DOL included:

- A regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "2015 Proposed Regulation");
- Two new prohibited transaction class exemptions; and
- Amendments to several existing prohibited transaction class exemptions.

This client alert prepared by Groom Law Group provides a summary of the regulatory impact analysis accompanying the 2015 Proposed Regulation. For information regarding the 2015 Proposed Regulation or the proposed revisions to existing class exemptions, introduction of new class exemptions, please see our client alerts covering those subjects.

I. Executive Summary

Executive Orders 13563 and 12866 require federal agencies to provide the public and the Office of Management and Budget ("OMB") with a careful and transparent analysis of the anticipated consequences of economically significant regulatory actions, a "regulatory impact analysis" ("RIA"). According to the Office of Information and Regulatory Affairs ("OIRA"), the OMB office that plays a key role in coordinating the review of Federal regulations, "the purpose of the RIA is to inform agency decisions in advance of regulatory actions and to ensure that regulatory choices are made after appropriate consideration of the likely consequences." That is, to (1) establish whether Federal regulation is necessary and justified to achieve a social goal and (2) design any such regulation in the most efficient, least burdensome, and most cost-effective manner.

A RIA will generally include three basic elements: (1) a statement of the need for the regulatory action; (2) a clear identification of a range of regulatory approaches; and, (3) an estimate of the costs and benefits of the proposed regulatory action and its alternatives, and should be based on the best available scientific, technical, and economic information.

II. Overview of the 2015 Proposed Regulation's Regulatory Impact Analysis

Following the publication of the DOL's 2010 Proposed Regulation on fiduciary advice many commenters described that rule's meager RIA as insufficient in that it failed to: (1) demonstrate the need for the regulatory action; (2) adequately identify the other regulatory approaches DOL had considered; and, (3) adequately quantify the potential benefit to plan and IRA investors, and therefore, was unable to support the imposition of the significant costs associated with the 2010 Proposed Regulation. DOL clearly took these comments seriously. The 2015 Proposed Regulation contains an eighteen page summary of DOL's RIA and multiple links to a nearly 250 page RIA written specifically for the rule.

1) A statement of the need for the regulatory action--

DOL contends that the current rule, which substantially narrowed the broad statutory language conferring fiduciary status on all persons rendering investment advice for a fee to a plan or an IRA, has been overtaken by subsequent and dramatic changes in the design, operation, and marketing of employer–sponsored retirement plans with a resulting increase in the need for expert financial advice. Additionally, DOL states that "IRAs' important role in retirement security, which warrants special protections against conflicts in advice, underscores the need for the new proposal to ensure the broad application of these protections" and that these consumer protections should go beyond those applicable to other retail investment accounts. The RIA goes on to state that "the IRA advice marketplace exhibits characteristics that economic theory suggests would lead to market failures and harmful to advice recipients" and that "such harm exists in the IRA marketplace even in spite of existing regulations." See, Sections 3.2 and 4.2 of the RIA.

2) A clear identification of a range of regulatory approaches--

Section 7 of the RIA discusses the regulatory alternatives that the DOL considered before settling on the 2015 Proposed Regulation. Although it appears that DOL considered a number of alternatives, some appearing more credible than others, DOL concluded that that none would protect plan and IRA investors as effectively as the 2015 Proposed Regulation.

These alternatives include: (1) excluding IRAs in whole or part from the rule; (2) not issuing the PTEs; (3) adopting the statutory definition of fiduciary advice; (4) relying heavily on disclosure as an adequate consumer protection; (5) deferring this rulemaking until the SEC takes related actions; (6) treating certain ESOP valuations as fiduciary advice; (7) conditioning the PTEs on disclosure alone; (8) issuing a streamlined, "low-fee" PTE; (9) issuing a prescriptive PTE in lieu of the proposed "best interest contract" exemption; (10) prohibiting mandatory binding arbitration; (11) adjusting the date by which affected advisers must comply; and, (12) delaying the 2015 Proposed Regulation's compliance date. *See* Table 7.11-1 of the RIA for summaries the DOL's analysis of the qualitative and, in some cases, quantitative assessments of these alternatives.

3) An estimate of the costs and benefits of the proposed regulatory action and its alternatives--

DOL's Fact Sheet on the 2015 Proposed Regulation and President Barack Obama's February 23, 2015 speech discussed a White House Council of Economic Advisers analysis that found that conflicts of interest result in annual losses of about 1 percentage point for retirement account investors—or about $17 billion per year in total. But, the RIA only "quantifies" gains of between $40 billion and $44 billion over 10 years and between $88 billion and $100 billion over 20 years. These gains appear to come solely from an increase in the rate of reduction of the amount of front-end loads paid by IRA investors. Although DOL contends that "these estimates account for only a fraction of potential conflicts, associated losses, and affected retirement assets," it does not appear that DOL was able to quantify those additional gains.

The RIA states,

> "There is a lack of comprehensive data on the potential harmful effects of conflicts of interest in the ERISA plan and IRA marketplaces. Industry sources have indicated to [the] Department that the data necessary to fully address this question would be prohibitively expensive to compile or obtain. The Department invites interested parties to provide data or analysis that might shed additional light on this question.
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> In the absence of comprehensive data that would allow for an estimate of the total investor gains the rule, the Department has assessed the gains to investors attributable to the rule by specifically quantifying benefits in an area of the IRA market, namely front-end load mutual funds, where the conflicts are well measured. This segment of the IRA assets currently amounts to approximately 13 percent of overall IRA assets. Narrowly focusing only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve, the underperformance attributable to these practices alone amounts to more than $80 billion over 10 years and almost $200 billion over 20 years." Section 3.3.1 of the RIA.

The Department estimates that the compliance cost associated with the proposal will total between $2.4 billion and $5.7 billion over 10 years. These costs are (1) significantly frontloaded and (2) do not include any costs associated with compliance with the new or revised PTEs. Additionally, these costs are not evenly distributed among service providers; new fiduciary advisers (i.e., those made fiduciaries by the 2015 Proposed Regulation) and broker-dealers, will likely bear most of these costs. DOL also assumes that small ERISA plans would bear some costs in preparing the seller's carve-out representations.

Importantly, DOL admits that, while it does not believe it will be widespread, some service providers may find that the increased costs associated with being a fiduciary will cause them to discontinue offering services to the plan and IRA market. DOL contends that the exit of these service providers will not result in "a diminution of the amount or quality of advice available to small or other retirement savers."