

# **Concerns Regarding the Regulatory Impact Analysis of the 2010 EBSA Fiduciary NPRM**

This report comprises a summary of the concerns that we raised at our meeting with Assistant Secretary Borzi in September 2011. The specific context of these comments is the proposed rule which was published on October 22, 2010, and which has subsequently been withdrawn.

The proposed rule published by EBSA on October 22, 2010 would have imposed fiduciary responsibilities and liabilities on individuals or companies who provide services such as investment advice to employer sponsored benefit plans. The proposed rule would have broadened the class of covered fiduciaries compared to the status quo as presently interpreted.

A thorough analysis of the cost of that proposal or of any future proposal that broadens the membership of the class of persons defined as fiduciaries should carefully and accurately identify the total number of persons who currently provide any advice or other services not currently covered by the fiduciary designation and who would become covered under a proposed redefinition. In the economic analysis of the proposed redefinition, EBSA failed to fully identify all affected advice (or other service) providers, and the that contributed to a significant under- estimate of the cost impact of the proposed rule. Other factors, discussed below, made additional contributions to the overall underestimate of regulatory cost.

EBSA derived its estimate of compliance cost for the proposed rule from its estimate that 5,300 providers of services to covered plans would have been impacted by the proposed rule. EBSA estimated annualized costs of \$1.9 million to \$2.1 million (depending on the use of 3% or 7% present value discount rate) for affected service providers to conduct compliance review and to implement changes in operating procedures necessary to comply with the fiduciary status requirement. The EBSA "annualized cost" estimate reflects an estimated first year cost of \$10.1 million for legal review by 5,300 affected service providers and an estimated \$845,000 per year subsequent cost for compliance review by newly entering service providers. EBSA assumed 8% of 5,300 service providers would be new each year. EBSA assumed that the average service provider would require 16 hours of labor at a cost of \$119 per hour to accomplished the necessary compliance review. EBSA also qualitatively noted, but did not attempt to quantify, "higher costs of doing business for services providers..." (75 FR 204, p. 65270).

EBSA estimated the number of distinct service providers based on an analysis of 2007 filings of Form 5500, Schedule C, on which plan administrators of plans with 100 or more participants identify service providers who received \$5,000 or more in reportable compensation directly or indirectly in connection with services rendered to the plan. EBSA limited its analysis to service providers reported under service codes corresponding to real estate brokerage, stocks, bonds, or commodities brokerage, general consulting, insurance agents and brokers, valuation services and investment advisory services. The sample data examined by EBSA included a small but undisclosed number of smaller firms that also filed Schedule C in 2007. EBSA claimed that most

small plans filing Schedule C reported the same set of investment and valuation service providers as the larger firms, and that, therefore, the number of identified providers of advisory services would not be increased by consideration of all small plans including non-filers of schedule C. EBSA implicitly assumed that the subset of small plans that do file schedule C is a representative sample of the larger subset of small plans that do not file schedule C. EBSA provided no credible statistical evidence to justify such a critical assumption. Without evidence to support this assumption, the claim that the number of affected providers of advisory services is limited to 5,500 is unfounded.

Small plans that do not file Schedule C are only one element of the sources of error in EBSA's estimate of the number of affected service providers. By focusing only on service providers listed on Form 5500, Schedule C, EBSA has overlooked the impact on plan services and service providers falling into the following classes covered by the proposed rule:

1. Services provided to large (100+ participants) plans which file Form 5500 for which compensation is less than \$5,000 per year;
2. Services provided to smaller plans that file Form 5500 (these total about 500,000 per year ; and
3. Services provided to plans or individuals exempt from filing any version of Form 5500, such as qualified One Participant Plans, Simplified Employee Pension (SEP) plans; Brokerage IRAs, and Savings Incentive Match Plans.

In each case EBSA's economic impact analysis should have acknowledged the numbers of plans and participants potentially affected and should have estimated the impacts of higher administrative costs resulting from transition to the fiduciary fee-based advisory approach or the loss of value of advisory services to plans or individuals whose small account balances will not qualify for fee-based services.

Within the limited context of EBSA's analysis of compliance review costs for service providers, there is no empirical basis for the assumption that the average service provider would be able to conduct an adequate compliance review of its entire business "book" in 16 person hours. Neither is the \$119 per hour labor cost based on empirical evidence. At the very least EBSA should have conducted interviews of potentially affected service providers to determine this key parameter. With the decision to withdraw the proposed rule and to reconsider the regulatory alternatives and the economic impact of each alternative, EBSA has the opportunity to correct this serious flaw in its previous analysis and to conduct field surveys and research to identify correctly the full number of affected plans and service providers and to identify the full costs to both service providers, to retirement plans and to retirement savers of the transition of current service providers from non-fiduciary to fiduciary status. Questions to ask service providers in surveys or through other research include

1. How many covered plan clients does the provider serve?
2. What services are provided?
3. How many separate service transactions per client occur annually?
4. How are services compensated?
5. Are records kept to document the existence and extent of investment advice or valuations provided?

6. What is the total money under management related to provider services to covered plans?
7. What is the service provider's total revenue from all covered plans?
8. What is revenue from covered plans as a proportion of total revenue from all services?
9. Does the service provider also offer a fee-based investment advisory services arrangement?

It is recommended that EBSA include in its survey/research plan a field investigation component that includes in-depth interviews or focus groups including plan administrators and service providers to ensure that the agency has the benefit of a thorough and accurate understanding of the operating procedures, structure and organization of the affected institutions and industries.

EBSA's analysis mischaracterized the economic impact of its proposed rule as affecting only the service providers who will be required to adopt fiduciary status. The ultimate economic impact of the proposed rule will also fall on covered plans and on the employees who are the plan participants. Even if plan participants benefit from an expanded scope of fiduciary responsibilities, expansion of scope may also impose costs to participants that will at least partially offset any benefits.

The effect of imposing the proposed new fiduciary responsibilities on service providers will require changes in the way in which their services are provided and will generally increase the costs of the services that they provide. These increased costs will be reflected in higher service fees charged to plans for the affected services. The resulting higher plan administration costs will directly impact plan participants in terms of lower returns on investment or smaller employer contributions to participant's retirement savings plans as a result of the higher plan administration costs. In addition to the direct costs of higher service fees, plans and participants may also be adversely affected by the reduction in services available as some service providers withdraw from the market or restrict the range of services offered in response to the requirements of the regulation. These considerations have significant implications for the research that EBSA should conduct in order to compile data to consider adequately the costs of alternative future regulatory proposals.

To examine the economic impact of the any proposed regulation to redefine fiduciary status, EBSA should conduct empirical research to examine how the proposal will change the structure and size of the market for investment advisory services. An adequate examination of how a proposal may change the structure, operation and size of the market for investment advisory services, must, obviously, begin with a thorough and accurate baseline characterization of the structure, operations and size of the market as it exists prior to regulatory revision. Questions that EBSA's research plan should address include:

1. How will the business model for sales of financial securities be changed? This will entail an analysis to describe and characterize the current range of practices and an examination of what practices will be required to change to comply with the proposed new definition of fiduciary.

2. What training or certification requirements for employees of service providers will be required or will change from existing practice?
3. What will be the impact of the proposal on employment in the financial services industry?
4. Beyond initial compliance review, what new records, record systems and procedures will service providers need to put into place to ensure compliance with fiduciary responsibilities?
5. What annual audits, analyses, or legal review processes will service providers need to conduct?
6. What insurance/bonding costs will service providers face?
7. What will be the effect of the proposed rule on the likelihood and outcome of litigation brought by plan administrators or participants?
8. What will be the effect of increased litigation (even if unsuccessfully prosecuted) be on the administrative costs of plans and on participant's return on investment?
9. What will be the effect of the proposed rule and resulting higher plan administrative costs on the propensity to employers to offer covered benefits?

A thorough economic analysis, fully compliant with Executive Orders 12688 and 13563 should include, for each regulatory alternative considered (including the alternative of maintaining the status quo), a weighing of the costs of each alternative against its expected benefits. For the proposed (now withdrawn) rule EBSA claimed as a benefit the discouragement of "harmful conflicts of interest, improve service value, and enhance the Department's ability to redress abuses..." (ibid.) EBSA also noted as a benefit the ability of plans to obtain recoupment of losses when they claim to have been harmed by fiduciary failure to act in their best interests. However, no attempt was made to estimate benefits in monetary terms. Executive Orders and current OMB guidance emphasize the need for agencies to monetize benefits explicitly unless there is clear reason that monetization is impractical. EBSA did not credibly show any practical obstacles to monetization of benefits. Since supposed benefits of fiduciary responsibility are inherently monetary – in terms of return on dollar invested on behalf of plan participants – it should be a relatively simple matter to conduct experiments or to collect field data from enforcement activities to demonstrate the effects of different fiduciary status situations on investment returns. In particular, EBSA should be able to document the likelihood and extent of employee benefit losses that currently occur because of the lack of fiduciary obligations related to investment advisory services.

Questions that EBSA should to investigate in the context of estimating benefits for any future proposed rule include:

1. What is the total number of service transactions per year that would be affected by the proposed rule?
2. What is the incidence (probability) per service transaction of conflicts of interest that would be eliminated by compliance with the proposed rule?
3. What is the average dollar amount of the adverse impact resulting from such conflicts of interest?

The product of (1) x (2) x (3) above may provide an initial estimate of the expected value of the annual benefits from the proposed rule. It should be possible for EBSA to

monetize and compare both the costs and benefits of the proposed rule to determine whether or not benefits exceed expected costs.

Finally, any proposed regulatory approach should include within its terms provision for collection of data and specification of regulatory performance measures that will facilitate subsequent review, evaluation and assessment of the effectiveness of the regulatory program, so that the need for future adjustments can be determined. This objective is aligned with the intent of Executive Order 13563. In this case the primary regulatory performance measure should focus on whether or not the regulation achieves the objective of improving the long-term return on investment enjoyed by retirement savers. Any positive or negative impact the per capita level of retirement savings contributions should also be assessed. The costs of regulatory compliance, also, should be tracked and compared to the values forecast during the rulemaking decision process.

