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Before the Senate Subcommittee on Employment and Workplace Safety

Of the Senate Committee on Health, Education, Labor and Pensions

July 21, 2015

Mr. Chairman and Members of the Committee, thank you for inviting me to testify today about the Department of Labor's proposed new rules governing retirement savings investment advice.

My testimony is based on a study of the proposal with Hal Singer, a Principal at Economists, Inc, and a Senior Fellow at the Progressive Policy Institute.[2]

We reach two central conclusions in our report:

--First, contrary to what the Labor Department claims, the benefits of the rule do not outweigh its costs. In fact, during a future market downturn, we estimate the rule could cost investors as much as $80 billion. In part, this is because the benefits are overstated, based on a misreading of the academic research the Department cites. Even more important, the Department did not take proper account of the benefits to investors of brokers and advisers paid on a commission basis, and how investors would either lose those benefits or end up paying more for investment advice than they do now.

--Second, the notion that all retirement investment advisers should be held to a best interest of client standard is not controversial. It's the way the Department proposes to implement it, which because of its costs and risks, will lead to many clients going without an adviser, or if they are able to retain one, only at substantially higher costs, as I outline below. Meanwhile, the Department failed to adopt a simple straightforward fix to the problems of insufficient disclosure on which the proposal is based – namely, simpler and better disclosure. The one study it cites for not taking this obvious step is theoretical and has no empirical grounding in the real world of investing.

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[1] This testimony draws on a recent report, supported by the Capital Group, I have co-authored with Hal Singer: "Good Intentions Gone Wrong: The Yet-To-Be Recognized Costs of the Department of Labor's Fiduciary Rule." The views expressed here are my own and do necessarily represent those of the Brookings Institution or the Capital Group, their officers, directors, trustees, or employees.

[2] The study was supported by the Capital Group, one of the largest mutual fund asset managers in the United States. Dr. Singer and I are solely responsible for the analysis and conclusions in the study.

To understand how we come to these conclusions, it is important to understand the essence of what the Department is proposing, as well as the February 2015 study of retirement advice by the Council of Economic Advisors which has been widely cited by supporters of DOL's proposal.[3]

Both Labor and CEA believe that the way that many individual brokers and advisers serving those with modest retirement portfolios – or small savers – are compensated generates "conflicted advice," which can only be eliminated if commissions were prohibited. DOL's regulatory analysis claims that a ten-year phase out of brokerage commissions on mutual funds IRAs would enable investors to earn about $4 billion more annually from their investments.

Before I critique these claims, let's begin with a fundamental fact. It costs money to serve any client seeking retirement investment advice, and the mutual fund IRA market to which the Department devotes most of its attention has developed two basic ways those costs, plus some profit, are recovered:

(1) through an up-front sales charge which the Department notes has been falling over time, but is now a bit less than 2% of the amount invested, coupled with a low annual "12b-1" charge, typically ¼% of the total invested; or
(2) a higher annual "wrap fee", which typically is 1% or more of the assets invested.

As it is now, many small savers pay brokers and advisers on a commission basis (method 1), while those with larger portfolios often pay a wrap fee, assuming they want any investment advice at all.

If the DOL ends up effectively banning method (1), brokers and advisers have two choices: they can quit serving small savers or they can tell them: "we will continue to serve you, but only with a wrap fee." Those brokers who choose and small savers who accept the second option will end up paying more in the medium to long run than they do now for investment advice. This should be obvious since even a 1% annual fee on all amounts invested after three years (3%) will exceed the average up-front brokers' sales charge plus two years of the annual ¼% 12b-1 fee (2.75%).[4]

Small investors who lose their broker because of the rule – perhaps 7 million or more -- also will lose.[5] This is because advisers now provide two very important kinds of advice to

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[3] CEA, *The Effects of Conflicted Investment Advice on Retirement Savings*, (Feb. 2015), *available at* www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

[4] In our report, we refer to an estimate by Oliver Wyman that an investor's costs associated with a forced transition to the wrap-fee model would increase by approximately 75 to 195 percent, depending on the size of the investor's assets.

[5] The Department's Regulatory Analysis breezily dismisses this estimate by claiming that brokers still can receive commissions under an exemption, presumably the new Best Investment Contract Exemption (BICE). But we show in our study, the BICE has numerous restrictions that make it

investors which also are not factored into DOL's analysis: encouraging clients to avoid trying to "time the market," one of the worst decisions a long-term investor can make, and also helping clients rebalance their portfolios over time.

There is a belief in some quarters that "robo-advice" delivered online can replace human advice from brokers and advisers who find it uneconomic to serve the small saver segment of the market if DOL's rule goes forward. While robo-advisors can help savers identify asset allocations and products to consider, it's a dangerous fallacy to believe that an email or text message during a market rout is an adequate substitute for a human being on the other end of a telephone. As famed Princeton professor Burton Malkiel has written: "We know that investors generally move money to and out of the stock market at the exactly the wrong times."[6]

More investors, especially small savers, are likely to make that mistake if they no longer have a human broker to serve them when they are most needed, which is a likely outcome if the DOL is implemented. In our study, we estimate that the cost of depriving clients of human advice during a future market correction -- just one of the many costs not considered by DOL -- could be as much as $80 billion, or twice the benefits the administration claims for the rule over the entire next decade. Put differently, if investors holding only one in seven dollars invested in mutual fund IRA accounts now are persuaded by their brokers or advisors to hold on through the next major stock market correction and rebound, the gains from doing so would totally offset the ten-year benefits DOL claims for its rule.

As if all this weren't enough, we show in our study that DOL actually overstates the benefits of its rule, and CEA likewise overstates the costs of conflicted advice, by selectively and inappropriately drawing from the academic literature. In addition, we show the weaknesses in DOL's studies purporting to rebut our study's analyses that brokers help clients avoid market timing or help them rebalance their portfolios.

The bottom line from a careful analysis of DOL's proposal is that rather than generating benefits for investors, it would produce net *harm* of $1-3 billion annually, depending on how many brokers are induced by the proposed rule to no longer serve the IRA mutual fund market. These dollar cost estimates are conservative.

Fortunately, there is an easy and obvious way to avoid this adverse outcome. If the problem is insufficient disclosures of how brokers are paid, then why not require better, simpler disclosure? Our report gives a one sentence example, and also points to one chart that the Department itself proposes as an Appendix to its proposed BIC exemption as a possible solution.

The Department's only basis for rejecting this idea is one academic paper reporting results from a lab experiment – not from the real investing world -- in which more disclosure didn't work well. But these very same authors elsewhere endorse disclosure as an appropriate

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unattractive, and thus not likely to be taken up by many, if not most, brokerage and advisory firms.

[6].Burton G. Malkiel, *Janet Yellen Is No Stock Market Sage*, WALL STREET JOURNAL, June 2, 2015, at A13 (emphasis added), *available at* http://www.wsj.com/articles/janet-yellen-is-no-stock-market-sage-1433199503.

remedy for information failure under certain conditions, which Hal and I note in our report are present in the investment advice market.

Even if the study the Department cites were based on real world empirical data – which it is not – using a single study is an extremely thin reed on which to adopt a rule that would fundamentally change the internal compensation systems of many, if not most, brokerage and advisory firms, while imposing massive new paperwork and contracting requirements for millions of clients, all under an impractical eight-month deadline. On top of this, do policy makers in a presidential election year want to face potentially millions of small savers when they receive notices they are being dropped by their longtime advisors or forced to pay much more via fee-based accounts in order to keep them?

Doesn't make it far more sense at least to *try* better disclosure before risking any of this? I trust the question answers itself.

Thank you.