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STATEMENT OF NORMAN P. STEIN

ON BEHALF OF THE PENSION RIGHTS CENTER

ON

"REDEFINING 'FIDUCIARY': ASSESSING THE IMPACT OF

THE LABOR DEPARTMENT'S PROPOSAL ON WORKERS AND RETIREES"

BEFORE THE

SUBCOMMITTEE ON HEALTH, EMPLOYMENT, LABOR, AND PENSIONS

COMMITTEE ON EDUCATION AND THE WORKFORCE

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Thank you, Chairman Roe and Mr. Andrews, and members of the subcommittee, for inviting me here to speak with you this morning on the Department of Labor's proposed regulation on the definition of fiduciary. I am testifying this morning on behalf of the Pension Rights Center. The Center is a nonprofit consumer organization that has been working since 1976 to protect and promote the retirement security of American workers, retirees, and their families.

The proposed regulations that are the subject of today's hearing describe when a person who renders investment advice to a plan or plan participant is considered a fiduciary under Title I of ERISA and under the Internal Revenue Code. These regulations would replace 1975 regulations, which reflect an improper agency constriction of the relevant statutory language and congressional intent. In addition, as the Department suggests in its preamble to the proposed regulations, economic and legal developments in the fields of investments and employee benefit plans have increased the original regulations' harmful impacts.

One of the principal congressional goals in enacting ERISA was to ensure that those individuals who provided investment advice with respect to retirement plan assets would be fiduciaries, subject to ERISA's prohibitions against fiduciaries entering into certain conflict-tainted transactions. ERISA was clear and unequivocal on this issue: the term fiduciary is defined to include any person "who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property" of a plan.

The Department of Labor's 1975 regulation narrowed this definition, providing that investment advisers would not be considered fiduciaries, unless their advice was provided "on a regular basis" and "pursuant to an agreement, arrangement or understanding that such services will serve as a primary basis for investment decisions with respect to plan assets." There is nothing in the legislative history that supported these extra-statutory limitations on the definition of fiduciary. Moreover, the terms "regular basis," "mutual agreement, arrangement or understanding," and "a primary basis" are subjective and ambiguous and have created confusion.

In the context of the times, however, the regulation's inconsistency with the statute did not create serious problems. The retirement world was then dominated by defined benefit pension plans, and the regulations permitting today's 401(k) plan were almost six years away. Investment professionals were primarily advising sophisticated fiduciaries, who were more capable of synthesizing market information and better able to identify and evaluate potential conflicts of interest than today's typical participant in a self-directed 401(k) plan.

Today, the world is different: most people saving for retirement are in 401(k) plans and individual retirement accounts (most of which hold rollover money from employer plans), and these account holders have to make their own investment decisions despite their lack of investment experience or knowledge. They are thus highly dependent on the advice offered to them by the multi-billion-dollar investment industry, but unfortunately the advice they receive is sometimes subject to serious conflicts of interest. Indeed, today some investment advisers receive payments from the vendors of the products they recommend.

ERISA would prohibit some such payments if the investment advisers are ERISA fiduciaries, but a significant part of the advice industry claims that the 1975 regulation shields them from fiduciary status and allows them to accept all third-party payments, so long as they include fine print indicating that investment services rendered are not provided under "an agreement, arrangement or understanding that the advice will be a primary basis for investment decisions" or are not provided on a "regular" basis. The Government Accountability Office has shown that such conflicts can have significant costs to participants in 401(k) plans.

I can tell a story from my own experience to illustrate the impact of such conflicts. In 1987, while I was a visiting professor at the University of Texas, a friendly and confident man knocked at my door. He had gotten my name from a colleague on the faculty, and he wondered whether he could talk with me about investing in a flexible premium fixed annuity. During the conversation he learned, among other things, that I would be at Texas for only that semester and thus the contributions I made during the semester would be my only contributions to the product he advised me to purchase. I am not certain now exactly everything he told me then, but he was a polished salesman and I ended up following his recommendation.

During the year I contributed $1,165.19 in salary reductions to this annuity product. Today, 24 years later, the value of this investment contract is $1,506.89, which provided me, for those who are interested, an annual yield of just a smidgen over 1 percent. And because of inflation, my investment today, in 1987 dollars, is worth only $229.73. I would have done better putting my money in an insured, passbook savings account at my credit union.

The reason that this investment performed so poorly for me is that the actual earnings under the plan were themselves very low, and the fees, relative to the earning, were very high. The salesperson should have known that this was a terrible investment choice for a person still in his 30s. He either knew no more than I did about investments or, more likely, was motivated by the amount of fees he would earn by selling me that particular and inappropriate product rather than another product. My real problem was that he was an investment salesman posing as my investment adviser.

If he had been a fiduciary and had been free of conflicts, I would have received better advice. And if all investment advisers were fiduciaries, millions of Americans—some even less sophisticated than I was in 1987—would receive a better quality of advice.

Some segments of the investment community have argued that the proposed regulations would make it impossible for broker-dealers to give advice or sell products to participants in 401(k) plans and individual retirement accounts. The proposed regulation, however, would not prohibit broker-dealers from giving investment advice, and indeed many broker-dealers today give investment advice by complying with statutory and regulatory exemptions to the prohibited transaction rules.

The argument that broker-dealers would be excluded from giving investment advice apparently is based on the notion that the only permissible form of compensation paid to an investment adviser would be on a fee basis. This is not correct: the Department of Labor has a prohibited transaction exemption that permits fiduciaries to receive commission-based compensation for the sale of mutual funds, insurance and annuity contracts and has signaled its willingness and intent to issue additional exemptions. In addition, the statute itself includes a prohibited transaction exemption for investment advice if fees are leveled or if the investment advice is determined through objective computer programs. And broker-dealers are also free to provide investment education rather than investment advice.

But it is true that under the new regulations broker-dealers will not be able to use certain business models in which their objectivity is compromised by serious conflicts of interest. Will these people abandon the retirement savings market? Perhaps some will, but we are confident, given the size and importance of that market, that most will adapt. And in our view, those who are unwilling to eschew serious conflicts have no business advising retirement-plan participants.

Finally, we think public policy would be better served if those are currently trying to kill these proposed regulations instead devoted their efforts to working with the Department of Labor to help craft exemptions from the prohibited transaction rules that will accommodate a wide variety of reasonable compensation structures for those who sell, directly or indirectly, their services to participants in 401(k) and individual retirement plans. That would be good for participants and good for the industry.

(Attached to this testimony are comments of the Pension Rights Center and the National Employment Lawyers Association on the regulations, which were submitted to the Department of Labor on February 3, 2011.)