

2016

## The Pension Mis-selling Scandal, the SEC, And The Fiduciary Standard

John A. Turner

Follow this and additional works at: <https://opencommons.uconn.edu/cilj>



Part of the [Insurance Law Commons](#)

---

### Recommended Citation

Turner, John A., "The Pension Mis-selling Scandal, the SEC, And The Fiduciary Standard" (2016).  
*Connecticut Insurance Law Journal*. 4.  
<https://opencommons.uconn.edu/cilj/4>

## **THE PENSION MIS-SELLING SCANDAL, THE SEC, AND THE FIDUCIARY STANDARD**

JOHN A. TURNER\*

\*\*\*

A growing literature has documented the low quality of financial advice that many people receive because of conflicts of interest that many financial advisers have. The Council of Economic Advisers has found that bad advice from financial advisers concerning rollovers from 401(k) plans to IRAs costs U.S. workers \$17 billion a year. When a similar situation occurred in the United Kingdom, the situation was termed the “pension mis-selling scandal.” British financial market regulators levied billions of pounds in fines on financial service providers to compensate pension participants for the bad advice they had received. This paper argues that a pension mis-selling scandal is occurring in the United States. Despite the fiduciary duty of financial advisers, and the task of the SEC to enforce that fiduciary responsibility, the SEC has taken no action to protect pension participants relating to advice to roll funds over from low-fee 401(k) plans to IRAs, which generally charge higher fees. Even in the case of advice to roll funds over from the extremely low-fee Thrift Savings Plan for federal government workers (which charges less than 3 basis points), the SEC has taken no action. This paper compares the pension mis-selling scandal in the United Kingdom to the situation in the United States concerning pension rollovers to IRAs. The paper then compares the regulatory response of financial market regulators in the United Kingdom to that of the SEC. The main findings of this paper are the apparent view of the SEC that fees in the context of pension rollovers are not an important issue, and the related finding that there has been a lack of action by the SEC concerning pension mis-selling in the United States. These findings are both consistent with the hypothesis of regulatory capture of the SEC. Because the fiduciary standard of the SEC is weak, extending it to broker-dealers will have limited effect.

\*\*\*

---

\*I received helpful comments from participants at the Fifth Annual National Benefits and Social Insurance Conference at the University of Connecticut, from participants at a seminar of the Savings and Retirement Foundation in Washington, DC, and from Benjamin Jones.

*“The mission of the U.S. Securities and Exchange Commission is to protect investors. . . .”<sup>1</sup>*

## I. INTRODUCTION

The Securities and Exchange Commission (SEC) has the job of protecting U.S. investors in financial markets.<sup>2</sup> One way it does that is to regulate the services provided by Registered Investment Advisers (RIAs). RIAs have a fiduciary duty to provide advice that is in the best interest of their clients.<sup>3</sup> However, one problem clients encounter is called “hat switching.”<sup>4</sup> With “hat switching,” an adviser sometimes acts as an RIA with a fiduciary duty, and sometimes acts as a broker-dealer, with a suitability duty, which is a lower standard. Broker-dealers are regulated by the Financial Industry Regulatory Authority (FINRA). Under the suitability standard, advice, rather than being in the best interest of the client, must merely be suitable for the client, given the client’s age, income and assets, risk preferences, and other factors.<sup>5</sup> For this and other reasons, it may be difficult for clients to determine what standard of regulatory protection, if any, applies to the advice they are receiving.<sup>6</sup> The SEC has been considering extending its fiduciary standard to broker-dealers.<sup>7</sup>

RIAs advise some workers relating to their pensions, which for many people are their primary or only form of financial market investment. While only 13.8 percent of households directly held stocks in 2013, 49.2 percent of households held retirement accounts, primarily Individual

---

<sup>1</sup> U.S. SEC. AND EXCH. COMM’N, *What We Do* (2016), <https://www.sec.gov/about/whatwedo.shtml>.

<sup>2</sup> *Id.*

<sup>3</sup> Peter Lazaroff, *The Difference Between Fiduciary and Suitability Standards*, FORBES (Apr. 6, 2016), <http://www.forbes.com/sites/peterlazaroff/2016/04/06/the-difference-between-fiduciary-and-suitability-standards/#4d42e9a735bf>.

<sup>4</sup> John A. Turner & Dana M. Muir, *The Market for Financial Advisors* 13-45 (Olivia S. Mitchell & Kent Smetters, eds., 2013).

<sup>5</sup> Lazaroff, *supra* note 3.

<sup>6</sup> Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisors and Broker-Dealers*, RAND INST. FOR CIV. JUST. (2008) [https://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf).

<sup>7</sup> John Manganaro, *Optimizing Your Practice to Capture Rollovers, Plan Adviser* (Mar. 28, 2014) [http://www.planadviser.com/Optimizing\\_Your\\_Practice\\_to\\_Capture\\_Rollovers.aspx](http://www.planadviser.com/Optimizing_Your_Practice_to_Capture_Rollovers.aspx).

Retirement Accounts (IRAs) and 401(k) plans.<sup>8</sup> When employees with a 401(k) plan, or with a similar type of defined contribution plan, terminate employment, they generally have the options of leaving the money in the retirement fund of the former employer, cashing out the account, transferring the money to the plan or another employer, or transferring the money to an Individual Retirement Account (IRA).<sup>9</sup>

Because many people lack financial sophistication, when they change jobs or retire they seek the advice of investment advisers about how to invest the assets in their employer-sponsored retirement accounts.<sup>10</sup> Because of the way the adviser is compensated, the advice that yields the adviser the most income is not always the best advice for the client. According to one adviser, "...you come to believe what is in your interest to believe; your objectivity and professional judgment is always at risk of being compromised if you put yourself in a conflicted situation where your interests are not 100% aligned with your client's."<sup>11</sup>

Financial advisers who earn fees based on the amount of assets they manage may advise rolling over pension assets into an IRA because that will yield greater income for the adviser. The situation of financially illiterate clients interacting with advisers who have a conflict of interest generally creates the potential for an agency problem, in which the agent or adviser may not act in the best interest of the client.<sup>12</sup>

---

<sup>8</sup> Jesse Bricker et al., *Changes in U.S. Family Finances from 2010-2013: Evidence from the Survey of Consumer Finances*, 100 FED. RES. BULL. 4 (Sept. 2014), <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>.

<sup>9</sup> U.S. DEP'T OF LAB., EMP. BENEFITS SEC. ADMIN. PRIV. PENSION PLAN BULL., ABSTRACT OF 2013 FORM 5500 ANN. REP. (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

<sup>10</sup> Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 25 J. OF ECON. LITERATURE 1, 5-44 (Mar. 2014), <http://www.aeaweb.org/articles.php?doi=10.1257/jel.52.1.5>; David M. Abbey & Brian Reid, INV. CO. INST., *The Role of IRAs in U.S. Households' Saving for Retirement 2014*, [http://www.ici.org/pdf/15\\_ici\\_omb\\_data.pdf](http://www.ici.org/pdf/15_ici_omb_data.pdf).

<sup>11</sup> Christopher Carosa, *Exclusive Interview: Clark Blackman II Says SEC Fiduciary Fix 'Not Tough Stuff'; Proposed DOL Fiduciary Rule a "Band-Aid"*, FIDUCIARYNEWS (Dec. 15, 2015), <http://www.fiduciarynews.com/2015/12/exclusive-interview-clark-blackman-ii-says-sec-fiduciary-fix-not-tough-stuff-proposed-dol-fiduciary-rule-a-band-aid/>.

<sup>12</sup> John A. Turner, Bruce W. Klein, & Norman P. Stein, *Financial Illiteracy Meets Conflicted Advice: The Case of Thrift Savings Plan Rollovers*, 3 J. RETIREMENT 47 (2016).

In advising a client on whether to roll funds over to an IRA, an RIA has a conflict of interest, even if the adviser charges by the hour, rather than by assets under management. If the adviser advises the client to stay with the 401(k) plan, the adviser will receive a one-time fee for that advice. But if the adviser advises the client to roll funds over to an IRA that he or she manages, the adviser will receive a continuing stream of advisory fees, which can be as much as two percent of assets under management,<sup>13</sup> though more generally they are around one percent.<sup>14</sup> Thus, the adviser's incentive to advise a client to roll over his or her 401(k) plan to an IRA can be substantial. Employees often wrongly assume that they are receiving objective advice, that they have fiduciary protection concerning the advice they receive, and that the adviser has their best interests at heart. One survey found that 42 percent of investors thought that broker-dealers have a fiduciary duty to their clients, which is incorrect.<sup>15</sup>

This paper raises an issue that when it occurred in the United Kingdom was called the "pension mis-selling scandal."<sup>16</sup> It presents the case that pension mis-selling has occurred in the United States as well. The paper applies the economic theory of agency to analyze the regulation of the market for financial advice by the SEC. It does so by focusing on pension rollovers to IRAs. It compares the role of the SEC in protecting pension participants in the United States when they receive bad advice from financial advisers to the actions taken by British financial market regulators following the pensions mis-selling scandal in the United Kingdom.

The paper is structured as follows. First, it discusses the literature relating to financial advice and regulatory protections. Second, it documents that pension rollovers play a key role in the U.S. retirement income system, causing IRAs to have more assets than either 401(k) plans or defined benefit plans. Third, it presents evidence that these rollovers are often not in the best interest of workers, in part because of the higher fees attached to IRAs, but also because of the loss of fiduciary protections. Fourth, it discusses an extreme example of bad advice, which relates to rollovers from the Thrift

---

<sup>13</sup> *Id.*

<sup>14</sup> *Intro: Average Financial Advisor Fees in 2016: Full Details on Advisory & Investment Management Fees (Comparison)*, ADVISORYHQ (2016), <http://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors/#Percentage-AUM>.

<sup>15</sup> Hung et al. *supra* note 6, at 10.

<sup>16</sup> Sue Ward, *Personal Pensions in the UK, the Mis-Selling Scandal and the Lessons to be Learnt* 139-146 (Gerard Hughes & Jim Steward eds., 2000).

Savings Plan for federal government workers, a plan that charges extremely low fees of less than 3 basis points. Fifth, it compares the lack of action by the SEC with the regulatory response of the U.K. financial markets regulators. It also presents evidence that the SEC has not considered fees charged for rollovers to be an important issue, despite a Council of Economic Advisers study indicating that bad advice about making pension rollovers is costing U.S. pension participants \$17 billion a year. Last, the paper draws conclusions concerning the protection the SEC provides to U.S. pension investors.

## II. LITERATURE

Three approaches have been taken in law to deal with conflicts of interest: (1) prohibition, (2) disclosure, and (3) the fiduciary standard. With prohibition, conflicts of interest are not allowed. With disclosure, conflicts of interest are allowed, but the adviser must disclose these conflicts of interest. With the fiduciary standard, conflicts of interest may be allowed, but the adviser is prohibited from acting on them.<sup>17</sup>

The law and economics literature discusses the role of a fiduciary standard as one way of dealing with the “agency problem”: a problem in which the agent has a conflict of interest and superior knowledge, and it is difficult for the client to assess the advice of the agent.<sup>18</sup> Because of low levels of financial literacy among pension participants, financial advisers (the agents) have superior knowledge over pension plan participants. To deal with the potential for bad advice, with the fiduciary standard, the agent is supposed to act solely in the best interest of the client. However, clients have a lack of financial sophistication and thus are unable to evaluate the quality of the advice they receive. For this reason, they play a weak role in helping regulators enforce the financial market regulations that supposedly protect them.

A fourth approach in public policy for dealing with conflicts of interest is to provide financial education that leads to financial literacy. Presumably, financially literate investors will be less susceptible to bad advice.

People who are not financially literate often are not able to evaluate the quality of advice they receive. The Australian financial markets regulator did a study that rated the quality of financial advice that people received. Out

---

<sup>17</sup> Turner & Muir, *supra* note 4.

<sup>18</sup> Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1041-55 (2011).

of 64 cases reviewed, it found that only two people received what it considered to be high-quality financial advice. The majority (37 people) received adequate advice, while a significant minority (25 people) received poor quality advice—i.e., advice that was inappropriate for their situation.<sup>19</sup> Yet in the Australian study, most people who received poor advice thought that they had received good advice.<sup>20</sup> This phenomenon makes it difficult for regulators to counteract poor quality advice.

Turner, Klein, and Stein document that some advisers with a fiduciary duty are advising participants in the Thrift Savings Plan for federal government workers to roll their funds over to higher-fee IRAs.<sup>21</sup> The Thrift Savings Plan charges the lowest fees of any 401(k)-type plan in the United States, less than three basis points per year.

This paper documents that the SEC has not taken a role in protecting American pension participants concerning pension mis-selling, whereas the British financial regulators have stepped in and done so. The literature relating to the pension mis-selling scandal in the United Kingdom is discussed later.

One possible explanation for the inaction of the SEC is “regulatory capture.” Regulatory capture refers to the regulated industry so influencing the regulator that the regulator does a poor job in protecting the public. Woodward and Etzioni discuss the issue of the regulatory capture of the SEC.<sup>22</sup> Gadinis presents evidence as to the weak enforcement of cases by the SEC against large banks and brokerage firms.<sup>23</sup> The article demonstrates a

---

<sup>19</sup> Peter Kell, *The Future of Financial Advice Post FOFA* (2012), [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Future-of-advice-post-FoFA.pdf/\\$file/Future-of-advice-post-FoFA.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Future-of-advice-post-FoFA.pdf/$file/Future-of-advice-post-FoFA.pdf).

<sup>20</sup> *Id.*

<sup>21</sup> Turner, Klein & Stein, *supra* note 12 at 47.

<sup>22</sup> SUSAN E. WOODWARD, REGULATORY CAPTURE AT THE U.S. SECURITIES AND EXCHANGE COMMISSION in JAMES R. BARTH, R. DAN BRUNBAUGH, JR., & GLENN YAGO, EDS., *RESTRUCTURING REGULATION AND FINANCIAL INSTITUTIONS*, (The Milken Institute Series on Financial Innovations and Growth, Kluwer Academic Publishers 2000), <http://books.google.com/books?hl=en&lr=&id=mAHsmzdUbsIC&oi=fnd&pg=PA99&dq=regulatory+capture+of+the+SEC&ots=IL-K2zHvG3&sig=cRYeKtvws3yHw9EdiAWpsiPjkHk#v=onepage&q=regulatory%20capture%20of%20the%20SEC&f=false>; Amitai Etzioni, *The Capture Theory of Regulations – Revisited*, 46 *SOC'Y* 319 (2009), <http://www2.gwu.edu/~ccps/etzioni/documents/A400%20Society,%20Capture.pdf>.

<sup>23</sup> Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67(3) *BUSINESS LAWYER* 679 (2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1333717](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1333717).

systematic lack of action against individual violators in high-profile cases. As far as we are able to determine, the SEC has never filed a case concerning advice about pension rollovers, despite those rollovers sometimes involving large increases in fees.

The International Organisation of Pension Supervisors (IOPS 2015) argues that pension mis-selling is more likely to occur in countries with relatively little regulation on competition in financial markets. For the purposes of our paper, whether or not the inaction by the SEC is due to regulatory capture is a secondary issue. The main issue is the failure of the SEC to act to deal with pension mis-selling in the United States.

### III. PENSION MIS-SELLING IN THE UNITED STATES

The Council of Economic Advisers (CEA) has quantified the cost of pension mis-selling in the United States. It finds that conflicted advice costs participants in IRAs \$17 billion a year.<sup>24</sup> That amount comprises not only excess fees but also lower investment returns compared to what investors would have received in net rates of return had they not been advised to roll their funds over to an IRA. Thus, pension mis-selling is one reason for the shortfall of retirement savings in the United States. A large amount of this loss, and the underlying reason for why it is occurring, relates to the higher fees earned by the financial services industry.

Supporting the conclusions of the CEA, a recent study in 2015 by Munnell, Aubrey and Crawford finds that IRAs tend to receive net rates of return that are about 1 percentage point less than those of employer-provided defined contribution plans, such as 401(k) plans.<sup>25</sup> This result is largely due to a difference in fees, but it is also due to differences in asset allocation. A higher percentage of assets in IRAs is invested in money market funds, which would seem to be a poor investment choice for retirement savings.

The CEA estimate takes into account increased trading costs and increased administrative fees compared to a 401(k) plan, but it does not factor in that a person in an IRA is more likely to pay a financial adviser for

---

<sup>24</sup> EXEC. OFF. OF THE PRESIDENT, COUNCIL OF ECON. ADVISERS, *The Effects of Conflicted Investment Savings* (2015), [http://www.whitehouse.gov/sites/default/files/docs/cea\\_coi\\_report\\_final.pdf](http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf).

<sup>25</sup> Alicia H. Munnell, Jean-Pierre Aubrey & Caroline V. Crawford, *Investment Returns: Defined Benefit vs. Defined Contribution Plans*, CTR. FOR RET. RES. AT B.C., Issue Brief no. 15-21 (Dec. 2015), [http://crr.bc.edu/wp-content/uploads/2015/12/IB\\_15-21.pdf](http://crr.bc.edu/wp-content/uploads/2015/12/IB_15-21.pdf).



ongoing investment management services than a person in a 401(k) plan. Thus, in that respect, it understates the loss.

The bad advice, as well as being costly in the aggregate, is costly at the individual level. A person who receives advice from a financial adviser who has a conflict of interest in advising that person to roll over a 401(k) account to an IRA at retirement will lose, on average, an estimated 12 percent of his or her savings when those savings are drawn down over 30 years—not taking into account fees charged by investment advisers.<sup>26</sup>

Bad outcomes as a result of bad financial advice generally require a combination of three factors operating simultaneously. First, the pension participant has a low level of financial literacy—in particular, not understanding the importance of the difference in fees between different financial products. Second, the financial adviser has a conflict of interest in that the advice that yields him the most income is not the best advice for the pension participant. Third, the regulatory protections are weak or the enforcement of regulations is weak.

Even bad advice needs to be supported by some argument. One of the main arguments financial advisers make for rolling over a 401(k) pension account to an IRA is that the IRA holder has a much larger range of investment options.<sup>27</sup> However, a substantial literature demonstrates that the cognitive costs of greater choice can lead to worse savings and retirement investment choices.<sup>28</sup> The evidence presented by Munnell, Aubrey, and Crawford concerning IRA investments in money market funds supports the idea that the larger range of options does not necessarily have a positive effect.<sup>29</sup> In addition, Shen and Turner demonstrate that the small number of

---

<sup>26</sup> EXEC. OFF. OF THE PRESIDENT, COUNCIL OF ECON. ADVISERS, *supra* note 24.

<sup>27</sup> Turner, Klein & Stein, *supra* note 12.

<sup>28</sup> See Nava Ashraf, Dean Karlan & Wesley Yin, *Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines*, 121(2) Q.J. OF ECON. 635 (2016), <http://www.jstor.org/stable/pdf/25098802.pdf>; Brigitte C. Madrian & Dennis Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116(4) Q.J. OF ECON. 1149, 1180-1182 (2001), <http://www.jstor.org.ezproxy.lib.uconn.edu/stable/pdf/2696456.pdf>; Fabian Duarte & Justine Hastings, *Fettered Consumers and Sophisticated Firms: Evidence from Mexico's Privatized Social Security System*, Yale U. Dep't of Econ. (Oct. 2009) (unpublished manuscript), [http://www.nber.org/aging/rrc/papers\\_files/orrc09-04/orrc09-04.pdf](http://www.nber.org/aging/rrc/papers_files/orrc09-04/orrc09-04.pdf); Justine Hastings & Lydia Tejada-Ashton, *Financial Literacy, Information and Demand Elasticity: Survey and Experimental Evidence from Mexico* (NBER Working Paper No. 14538, 2008), <http://www.nber.org/papers/w14538.pdf>. (Choi et al. 2006, 2007)

<sup>29</sup> See Munnell, Aubrey & Crawford, *supra* note 25, at 6.

options in the Thrift Savings Plan for federal government workers, the military, and members of Congress (five basic options) permit a high degree of portfolio diversification.<sup>30</sup> Furthermore, section 404(c) of ERISA requires that 401(k) plans must provide a sufficient range of choices to pension participants to allow them to select an adequately diversified portfolio.<sup>31</sup>

IRAs are the largest type of pension plan in the United States, having overtaken 401(k) plans. Rollovers are the primary source of funding for IRAs, as relatively few people contribute to IRAs.<sup>32</sup> In a rollover, the person receives a check from the pension plan of a former employer, then deposits the check with the IRA. In a transfer, the pension plan sends the check directly to the IRA. We follow common practice and refer to both as rollovers.

Because of the importance of the rollover decision, many people seek financial advice. One survey finds that 61 percent of the people with rollover IRAs received advice from a financial adviser before making the rollover.<sup>33</sup> This compares to 38 percent of families who reported obtaining information about investing from bankers, brokers, or other sellers of financial services, and 31.3 percent of families who reported obtaining information from lawyers, accountants, or other financial advisers.<sup>34</sup> Thus, rollovers are a financial decision in which advice is particularly prevalent.

The frequency of rollovers is surprising because studies have documented the tendency for pension participants to exhibit inertia.<sup>35</sup> Inertia

---

<sup>30</sup> Sally Shen & John A. Turner, *Analyzing the Quality of Financial Advice: Do Conflicted Advisers Tell Half Truths?* (Pension Pol. Ctr., Working Paper May 2016), <http://www.busman.qmul.ac.uk/newsandevents/EventDocuments/BFWG%20Conference%20Papers%202016/177059.pdf>.

<sup>31</sup> Employee Retirement Security Act of 1974, Pub. L. No. 93-406, §404(c), 88 Stat. 829 (codified in part at 29 U.S.C. (2015)).

<sup>32</sup> David M. Abbey & Brian Reid, INV. CO. INST., *The Role of IRAs in U.S. Households' Saving for Retirement 2014*, [http://www.ici.org/pdf/15\\_ici\\_omb\\_data.pdf](http://www.ici.org/pdf/15_ici_omb_data.pdf).

<sup>33</sup> *Id.*

<sup>34</sup> Jesse Bricker et al., *Changes in U.S. Family Finances from 2010-2013: Evidence from the Survey of Consumer Finances*, FED. RES. BULL. 100(4) (Sept. 2014), <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>.

<sup>35</sup> John Manganaro, *Optimizing Your Practice to Capture Rollovers*, Plan Adviser, (March 28), [http://www.planadviser.com/Optimizing\\_Your\\_Practice\\_to\\_Capture\\_Rollovers.aspx](http://www.planadviser.com/Optimizing_Your_Practice_to_Capture_Rollovers.aspx); See also James J. Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance* 16, 67-113 (2002). But see Leslie A. Muller & John A. Turner, *The Persistence of Employee 401(k) Contributions Over a Major Stock Market Cycle: The Limited Power of Inertia* 3, 51-65 (2013).

would cause participants to leave their 401(k) accounts with their former employers because that is the “path of least resistance.” The rollover trend is inconsistent with participant inertia because it requires an action by participants. Most analysis in behavioral economics concerning retirement focuses on why people do not do something—they do not annuitize, some do not participate in 401(k) plans offering an employer match or, if they do participate, do not contribute sufficiently to receive the maximum matching contribution. However, the study of why clients make rollovers involves the opposite tendency—a question of why people are doing something.

Because of concerns that rollovers are being driven by faulty advice, the Department of Labor (DOL), the SEC, and FINRA have all considered regulatory action,<sup>36</sup> and in 2016 the DOL released major new regulations concerning financial advice received by pension participants.<sup>37</sup> The SEC indicated that it would make examining rollovers a priority for 2014, and would focus on investment advisers who encourage people to roll funds over to investments with higher fees.<sup>38</sup> However, two years later, the SEC still has taken no action.

#### A. FEES

From an economics perspective, fees are an important issue in pension rollovers—not just the fees of the investment products, but also the advisory fees of fiduciary advisers advising participants to roll over their funds to accounts the adviser would manage. In 20 years, a fee of 50 basis points (0.5 percent) reduces a portfolio with a 4 percent annual return by \$10,000 compared to a fee of 25 basis points, while the reduction is \$30,000 if the fee is 100 basis points.<sup>39</sup>

In comparing the fees of IRAs and 401(k) plans, the question is not whether an IRA can be constructed that provides lower fees than 401(k) plans. Rather, the question is whether the IRAs that people actually have

---

<sup>36</sup> See Manganaro, *supra* note 35.

<sup>37</sup> U.S. DEP'T OF LABOR, *Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year*, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest-pdf>.

<sup>38</sup> Fred Reish et al., *FINRA's Reminder About Rollovers: News to Many*, RET. INCOME TEAM NEWSLETTER, [http://files.drinkerbiddle.com/files/ftpupload/MemosandNewsletters/Retirement-Income-Team-Newsletter\\_Article-2.pdf](http://files.drinkerbiddle.com/files/ftpupload/MemosandNewsletters/Retirement-Income-Team-Newsletter_Article-2.pdf).

<sup>39</sup> U.S. SEC. AND EXCH. COMM'N, *How Fees and Expenses Affect Your Investment Portfolio*, [https://www.sec.gov/investor/alerts/ib\\_fees\\_expenses.pdf](https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf).

generally charge lower fees than the 401(k) plans they formerly had. In aggregate, fees are lower in 401(k) plans than in IRAs. In 2014, fees were 58 basis points for an asset-weighted average of 401(k) plans and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs.<sup>40</sup>

Some workers changing jobs or retiring may be able to reduce the fees they pay by moving from a 401(k) plan to an IRA. Such a worker may be in a 401(k) plan with no low-fee options. For example, the 401(k) plan for the nonprofit firm Demos in 2012 did not offer any investment options with an expense ratio of less than 70 basis points.<sup>41</sup> A worker may also face higher fees if he has several small accounts than if he rolls over those accounts into a single account, such as an IRA or a subsequent employer's 401(k) plan. For example, some accounts charge fixed fees for small account balances.

Thus, a rollover may be good advice in some circumstances, but it generally is not.<sup>42</sup> Most 401(k) participants are in large plans, but a minority are in small plans. In 2013, 9.8 million participants were in plans with less than 100 participants, while 54.7 million participants were in plans with 100 or more participants.<sup>43</sup> Fees tend to be higher in smaller 401(k) plans than in larger ones. A study of 401(k) fees has found that, because of economies of scale, plans with more total assets and with more assets per participant tend to have lower fees.<sup>44</sup> Thus, on the basis of fees, a rollover to an IRA is more likely to be beneficial if it comes from a 401(k) plan that has a small number of employees and that has relatively small account balances.

---

<sup>40</sup> Abbey & Reid, *supra* note 31.

<sup>41</sup> ROBERT HILTONSMITH, *THE RETIREMENT SAVINGS DRAIN: THE HIDDEN & EXCESSIVE COSTS OF 401(K)S* 5 (2012).

<sup>42</sup> Nancy Anderson, *7 Reasons Not To Rollover Your Orphan 401(K) To An IRA*, FORBES (2012), <http://www.forbes.com/sites/financialfinesse/2012/07/10/are-your-401k-investments-worth-their-cost/>; *See also* John A. Turner and Bruce W. Klein, *Retirement Savings Flows and Financial Advice: Should You Roll Over Your 401(k) Plan?*, *Benefits Quarterly* 30: Fourth Quarter (2014), 42-54. The fees in these two studies are not directly comparable. The fees in the 401(k) plan study are plan averages, while the mutual fund fees are weighted by assets. Thus, the mutual funds study is overweighted for large accounts, compared to a participant based statistic, while the plan statistics are over weighted for small plans, compared to a participant based statistic.

<sup>43</sup> U.S. DEP'T OF LAB., EMP. BENEFITS SECURITY ADMIN., *PRIV. PENSION PLAN BULLETIN, ABSTRACT OF 2013 FORM 550 ANNUAL REPORTS* (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

<sup>44</sup> INV. CO. INST. AND DELOITTE, *DEFINED CONTRIBUTION/ 401(K) FEE STUDY* (2009), [http://www.ici.org/pdf/rpt\\_09\\_dc\\_401k\\_fee\\_study.pdf](http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf).

Fees vary considerably across 401(k) plans. One study found that 10 percent of the 130 plans in the study had an “all-in” fee, which includes administrative fees, of 0.37 percent of assets or less, while 10 percent had an “all-in” fee of 1.71 percent or more, with an average of 0.72 percent.<sup>45</sup> In an update of that study, 10 percent of the 525 plans surveyed had an “all-in” fee of 0.28 percent of assets, while 10 percent had an “all-in” fee of 1.38 percent of assets.<sup>46</sup> These statistics compare to an average fee for equity mutual funds for retail investors of 0.79 percent (79 basis points) and 0.62 percent (62 basis points) in bond funds.<sup>47</sup>

Some 401(k) plans offer very low fee options that are not available to participants in IRAs. In particular, some plans provide options that are institutionally priced rather than retail priced. Institutional pricing is the reduced pricing that sponsors of defined benefit plans have, which is sometimes extended for some investment options to participants in the 401(k) plan of the employer. For example, an institutionally priced equity index fund that a plan sponsor’s defined benefit plan uses could charge fees as low as 6 basis points to 401(k) plan participants of that plan sponsor. In some 401(k) plans, the plan sponsor pays the administrative fees, whereas in an IRA those fees are the individual’s responsibility. According to the consulting firm AonHewitt, “[w]ithin the defined contribution system, plan participants not only generally have access to high-quality investment options at reasonable prices (through lower-cost institutional fund products such as collective trusts and separate account vehicles), but also benefit from fiduciary protections. Workers cannot obtain these benefits individually in the retail market.”<sup>48</sup> The “retail market” refers to the IRA market and the market for private savings. Institutional shares account for 43 percent of the equity mutual funds held in 401(k) plans.<sup>49</sup>

The financial incentives for financial firms to advise their clients to make rollovers are substantial. Even firms that manage clients’ 401(k) investments often advise their clients to roll those funds over to an IRA when

---

<sup>45</sup> *Id.* at 6.

<sup>46</sup> DELOITTE CONSULTING, INSIDE THE STRUCTURE OF THE DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE “ALL-IN” FEE (2011), [http://www.ici.org/pdf/rpt\\_11\\_dc\\_401k\\_fee\\_study.pdf](http://www.ici.org/pdf/rpt_11_dc_401k_fee_study.pdf).

<sup>47</sup> INV. CO. INST., TRENDS IN THE EXPENSES AND FEES OF MUTUAL FUNDS, 2011 (2012), <http://www.ici.org/pdf/per18-02.pdf>.

<sup>48</sup> AON HEWITT, LEAKAGE OF PARTICIPANTS’ DC ASSETS: HOW LOANS, WITHDRAWALS, AND CASHOUTS ARE ERODING RETIREMENT INCOME (2011), [http://www.aon.com/attachments/thought-leadership/survey\\_asset\\_leakage.pdf](http://www.aon.com/attachments/thought-leadership/survey_asset_leakage.pdf).

<sup>49</sup> INV. CO. INST., *supra* note 47, at 17.

they retire or leave their employers because the firms can make more money managing IRAs. Not only do financial advisers encourage rollovers, but so do record keepers for 401(k) plans that also provide mutual funds. These record keepers advise participants who no longer work for the employer sponsoring the plan to roll their funds over to an IRA, which the record keepers would then manage.<sup>50</sup>

The fees for IRA participants may also include fees for financial advice because many people are not financially sophisticated and feel as if they need assistance in managing their accounts, especially when faced with the large number of options available to IRA participants. One large provider of financial advice charges fees of 1.5 percent for advisory services for account balances up to \$500,000 on top of the investment fees the mutual funds in the account charge.<sup>51</sup>

As an example of bad advice, National Public Radio (“NPR”) documented the case of a woman who was advised to roll over her 401(k) plan to an IRA. The adviser told her that the rollover would not result in her paying any extra fees. When NPR analyzed her financial documents relating to the rollover, it found that the adviser had invested her money into mutual funds that charge load fees of 5.75 percent, causing her to lose nearly 6 percent of her retirement savings.<sup>52</sup>

#### IV. THRIFT SAVINGS PLAN (TSP) ROLLOVERS TO IRAS

Financial advisers are advising clients to roll funds over from good, low-fee defined contribution plans to higher-fee IRAs. The case of the Thrift Savings Plan is a particularly dramatic example. The TSP is a 401(k)-type defined contribution plan for federal government workers, the military, and members of Congress. The TSP is the largest pension fund, in terms of assets,

---

<sup>50</sup> John A. Turner & Kathy K. Perry, *Protecting Pension Participants: Communications Concerning Pension Rollovers From Record Keepers* (2016).

<sup>51</sup> U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-30, 401(K) PLANS LABOR AND IRS COULD IMPROVE THE ROLLOVER PROCESS FOR PARTICIPANTS 36 (2013).

<sup>52</sup> Chris Arnold, *When Fees Attack: Rolling Over A 401(k) Can Trigger Big-Time Charges*, KUNC (Nov. 20, 2015), <http://www.kunc.org/post/when-fees-attack-rolling-over-401k-can-trigger-big-time-charges#stream/0> (Noting a “load” fee is a sales charge or commission charged to an investor for buying or redeeming shares in a mutual fund. The fee may be a one-time charge or an annual charge).

in the United States.<sup>53</sup> Its assets are more than 10 times as large as the largest private-sector defined contribution plan, which is sponsored by IBM.<sup>54</sup>

The TSP charges extremely low fees—the lowest fees of any plan in the United States. In 2015, the fees for all the TSP funds, including the international stock fund and the target date funds, were 2.9 basis points or less.<sup>55</sup> The fees in 2013 were less than one-twentieth the average cost of a stock index fund and less than one-thirtieth the average cost of target date funds.<sup>56</sup> In 2014, the TSP fees compared to 83 basis points as the participant-weighted average for a survey of 401(k) plans, 58 basis points for the asset-weighted average of 401(k) plans, and 74 basis points for the asset-weighted average of equity mutual funds held in IRAs.<sup>57</sup> A survey by Morningstar, an investment research firm based in Chicago, finds that the asset-weighted average of all mutual funds, excluding money market funds and funds of funds (FOFs), such as target date funds, was 64 basis points in 2014.<sup>58</sup> For passively managed funds it was 20 basis points, and for actively managed funds it was 79 basis points.<sup>59</sup> That study finds that over time, investors on average have moved to lower-fee funds, which is the reverse of what happens when TSP participants roll over their accounts to an IRA.<sup>60</sup> The TSP's fees are low primarily because of its large size, but in part because some administrative costs are borne directly by the federal government, and in part because, as an employer-sponsored plan, it does not engage in advertising.<sup>61</sup>

---

<sup>53</sup>*The world's 300 largest pension funds – year end 2013*, WILLIS TOWERS WATSON (September 2014), <http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2014/09/The-worlds-300-largest-pension-funds-year-end-2013>.

<sup>54</sup>*The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 21 ICI RESEARCH PERSPECTIVE 1 (2015).

<sup>55</sup>*Fund Comparison Matrix*, THRIFT SAVINGS PLAN (2016), <https://www.tsp.gov/InvestmentFunds/FundsOverview/comparisonMatrix.html>.

<sup>56</sup>*Vanguard Target Retirement Funds*, VANGUARD (2014), <https://investor.vanguard.com/mutual-funds/target-retirement/#/>.

<sup>57</sup>DELOITTE, INSIDE THE STRUCTURE OF DEFINED CONTRIBUTION/401(K) PLAN FEES: A STUDY ASSESSING THE MECHANICS OF THE 'ALL-IN' FEE 28 (2011); See generally, *The Role of IRAs in U.S. Households' Saving Retirement, 2014*, 21 ICI RESEARCH PERSPECTIVE 1 (2015).

<sup>58</sup>MICHAEL RAWSON & BEN JOHNSON, 2015 FEE STUDY: INVESTORS ARE DRIVING EXPENSES RATIOS DOWN 1 (2015).

<sup>59</sup>*Id.*

<sup>60</sup>*Id.*

<sup>61</sup>Boccia Romina, *Q&A: Should All Americans Join the Same Retirement Plan as Congress?*, THE DAILY SIGNAL (May 15, 2014) <http://dailysignal.com/2014/05/15/qa-americans-join-retirement-plan-members-congress/>.

Despite the TSP's extremely low fees, some participants are being advised to roll their TSP funds over to managed investment accounts in IRAs, sometimes resulting in as much as a seventy-fold increase in fees (from 3 basis points to 230 basis points). A survey of TSP participants who made a withdrawal in 2013 found that an estimated 16,400 participants (about one-third of those making withdrawals) withdrew all or part of their TSP account because they were advised by their financial adviser to do so.<sup>62</sup> A telephone survey study that asked financial advisers for advice concerning TSP rollovers found that advisers generally advised the callers to make a rollover, despite the very low fees in the TSP. That advice on average cost participants approximately \$20,000 in present value of increased fees.<sup>63</sup>

#### V. UNITED KINGDOM—THE PENSION MIS-SELLING SCANDAL<sup>64</sup>

The United Kingdom also has had experience with people being advised to roll over from good, employer-provided pension plans to higher-fee individual account pension plans. That episode is known in the U.K. as the “pension mis-selling scandal.”<sup>65</sup> The “pension mis-selling scandal” is the term used in the United Kingdom to refer to the situation in which many people were advised to switch their pension plans from employer-provided defined benefit pension plans to individual account pensions in instances where those changes were in the financial interest of the adviser, but with little effort made to determine whether the advice was suitable for the client.

In 1988, a regulatory change expanded eligibility for personal pensions from just the self-employed to all employees. This change presented financial service providers with an opportunity. As part of a deregulation of financial products, individuals were permitted to choose personal pensions instead of participating in the earnings-related part of social security (SERPS—the State Earnings-Related Pension Scheme) or in employer-provided plans that had been used for “contracting out” of that part of social security.

---

<sup>62</sup> AON HEWITT, *supra* note 48.

<sup>63</sup> Turner, Klein & Stein, *supra* note 12.

<sup>64</sup> In the U.K., it is spelled “mis-selling”. See Dana Muir, *Regulation and Personal Pensions*, in PERSONAL CHOICE IN THE PROVISION OF RETIREMENT INCOME: MEETING THE NEEDS OF OLDER PEOPLE? (Gerard Hughes & Jim Stewart eds., 2009).

<sup>65</sup> Ward, *supra* note 16.



Firms responded by rewarding new, untrained sales forces with sales incentives to capture market share. These incentives were awarded for making direct sales of financial products to consumers who were unfamiliar with those financial products. Insurance salesmen targeted groups like nurses and steelworkers who were in good defined benefit plans but who were nonetheless encouraged to roll those plan funds over to personal pensions that provided lower benefits.<sup>66</sup> These factors created an environment in which aggressive sales practices thrived.<sup>67</sup>

The mis-selling of personal pensions from 1988 to 1994 resulted in the regulatory review of sales of pension products to almost 2 million customers and in extensive regulatory change. During that six-year period, people had been encouraged by financial services companies and advisers, and through a large advertising campaign by financial services companies, to switch their pension arrangements from employer-sponsored defined benefit plans to individual account plans, only to end up receiving lower benefits as a result.<sup>68</sup>

Due to reports of advisers not complying with regulatory standards in the sale of personal pensions, in 1992 the government regulator, the Securities and Investments Board (SIB), reviewed a sample of the records associated with personal pension sales and found that only 9 percent substantially complied with regulatory rules.<sup>69</sup> The SIB later became part of a new agency called the Financial Services Authority (FSA), which has since been replaced by the Financial Conduct Authority. The SIB commissioned a study of industry practices that found “widespread regulatory compliance failure”.<sup>70</sup>

The British media were highly critical of the insurance companies involved in the mis-selling scandal. The BBC reported that Prudential (U.K.), which it cited as one of the worst offenders in the mis-selling scandal, had set aside £1.1 billion to pay for claims related to the scandal. This implicit admission of guilt followed an earlier statement by the company’s CEO in 1994 expressing “total reassurance” that Prudential was not guilty of

---

<sup>66</sup> *Id.*

<sup>67</sup> Richard Nobles & Julia Black, *The Privatization Process: Pensions Mis-selling – The Lessons for Regulating Privatised Social Security*, 64 BROOK. L. REV. 933 (1998); TREASURY SELECT COMMITTEE, NINTH REPORT, 1997-98, H.C. 712-I (UK).

<sup>68</sup> *Pension Mis-selling*, PENSIONS ADVISORY SERV. (2009), <http://tools.pensionsadvisoryservice.org.uk/common-areas-of-concern/pension-mis-selling>.

<sup>69</sup> Nobles & Black, *supra* note 67.

<sup>70</sup> Marina Milner & Keith Syrett, *Personal Pensions and the Financial Services Authority: New Chapter or Same Old Story?*, 51(2) N. Ir. Legal Q. 141 (2000).

pension mis-selling. In 2002, the BBC reported that more than one million customers would receive compensation for being victims of pension mis-selling and the total cost would be at least £11.8 billion, with the financial market regulator taking disciplinary action against 346 firms.<sup>71</sup>

The concern with mis-selling focused on the sale of personal pensions, by both insurance companies and independent financial advisers, to employees who then opted out of an employer-provided pension plan. Two factors caused employer-provided pension plans to be better arrangements than personal pensions for most individuals. First, employers typically contributed to plans they sponsored but did not contribute to personal pensions. Second, the benefits formula of an employer-provided plan typically was more generous than the investment growth in a personal pension.<sup>72</sup>

Nobles and Black attribute pensions mis-selling in the U.K. to failures both by regulators and by the firms involved in mis-selling.<sup>73</sup> They argue that until the 1992 SIB audit, regulators failed to focus their efforts on personal pensions as a product line. Instead the regulators suffered from a lack of expertise with personal pensions, which represented a new line of financial products.<sup>74</sup> The regulators established review processes that tended to focus at the firm level and on the activities of the internal firm monitors. In a government inquiry into the cause of mis-selling, the FSA indicated that the multiple regulators experienced coordination problems in determining the responsibilities of the different regulators.<sup>75</sup>

In 2006, the FSA took further action to deal with investment product mis-selling, with those new rules coming fully into force in 2012. Despite the existence of a best-interest or fiduciary standard—meaning the adviser must act in the best interest of the client—continued problems with investment mis-selling were observed, leading to the implementation of the new rules. Previously, financial advisers receiving commissions for making recommendations concerning pensions to clients had an obligation to make recommendations in the best interest of the client, but it had become clear that, because of commissions that caused a conflict of interest for the advisers, this approach was not working. These regulatory changes improved the transparency of fees and eliminated the practice of mutual funds and

---

<sup>71</sup> *Pensions Scandal Costs £11.8 Billion*, BBC (June 27, 2002), <http://news.bbc.co.uk/2/hi/business/2070271.stm>.

<sup>72</sup> TREASURY SELECT COMMITTEE, *supra* note 67.

<sup>73</sup> Nobles & Black, *supra* note 67.

<sup>74</sup> *Id.*

<sup>75</sup> TREASURY SELECT COMMITTEE, *supra* note 67.

other financial intermediaries paying commissions to advisers that recommend their products.<sup>76</sup>

These rules in the United Kingdom thus differ from the approach taken in the U.S. Department of Labor regulations of 2016, discussed later, which do not prohibit advisers from receiving commissions, so long as they act in the best interest of their clients.<sup>77</sup> The United Kingdom previously had taken the approach used by the U.S. Department of Labor but found that the incentives embedded in that approach were sufficiently strong—and presumably the enforcement sufficiently weak—to cause that approach to not provide adequate protection for pension participants.

The new U.K. rules require advisers to receive their income solely by charging their clients fees for their services. This approach reduces conflicts of interest that advisers have with respect to the choice of financial products to sell. It has the further advantage of making the compensation advisers receive more transparent. This reform was enacted because the receipt of commissions has been viewed as a root cause of the pension mis-selling scandal in the United Kingdom.

The U.K. pension mis-selling scandal was much more visible to participants and plan sponsors than the scandal in the United States, where, despite the CEA's report, so far is largely invisible. In the United Kingdom, the scandal involved a switch from defined benefit plans with clearly determinable benefits to defined contribution plans that were required to provide benefits as annuities. Initial concern about the situation was expressed by plan sponsors, with that concern leading to a study by the financial regulator, which ultimately documented mis-selling.<sup>78</sup>

The SIB, the U.K. financial markets regulator at the time, issued guidance to participants, stating that “it is nearly always best for you” to stay with your employer's plan rather than rolling those funds over into an individual account plan.<sup>79</sup> While such advice would probably also apply in the United States, the U.S. regulators have not given that advice.

---

<sup>76</sup> Fin. Conduct Auth., *Post-implementation review of the Retail Distribution Review* (2014).

<sup>77</sup> See U.S. DEP'T. OF LABOR, EMP. BENEFITS SEC. ADMIN., *Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year*, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest> (2016).

<sup>78</sup> Ward, *supra* note 16.

<sup>79</sup> SEC. AND INV. BD. (UK), *Pension Opt Outs, A Factsheet for People Thinking of Opting Out of an Employer's Scheme* (1994).

The situation in the United States involves a switch from defined contribution plans to IRAs, in which the comparison with the former plan's benefits is difficult for participants to make because it is not as clear what they would have received had they stayed in the former plan. Perhaps as a consequence, there appear to be no complaints by people about bad advice they have received encouraging a rollover to an IRA. If participants were aware of the importance of fees in determining financial outcomes, the comparison would not be so difficult, but with the low level of financial literacy of many people, many participants do not understand the importance of fees.

A lesson from the experience of the United Kingdom is that the financial service industry may take advantage of unsophisticated pension participants in selling them expensive pensions when more suitable, lower-fee pensions are available to them. Pension participants need regulatory protection.

## VI. THE SEC

This section considers the regulatory oversight provided by the Securities and Exchange Commission (SEC) related to fees charged in connection to pension rollovers, reasons why that oversight appears to be weak, and the views of the SEC concerning the level of fees charged by advisers as a fiduciary or regulatory issue.

### A. THE SEC AND THE FIDUCIARY STANDARD

As a result of the conflict of interest of financial advisers, government has stepped in through the SEC to regulate financial advice in order to protect the interests of investors. This regulation involves imposing a fiduciary standard, which requires that the advice be the best advice for the client.<sup>80</sup> However, over time broker-dealers have increasingly provided advice, but the SEC has not required that they register as RIAs.<sup>81</sup>

---

<sup>80</sup> Unless otherwise indicated, we are referring to the SEC fiduciary standard. Different organizations have different fiduciary standards, as discussed later in the paper. The SEC standards are not as stringent as standards found in ERISA and the IRC. In particular, the SEC generally permits self-dealing transactions that would largely be prohibited under ERISA and the IRC, as long as the Registered Investment Adviser (RIA) fully discloses the conflict to the client.

<sup>81</sup> Michael Kitces, *Is the SEC Failing to Enforce the 'Solely Incidental' Advice Exemption for Broker-Dealers Under the Investment Advisers Act of 1940?*, NERD'S EYE VIEW AT KITCES.COM (Jan. 12, 2015), <https://www.kitces.com/blog/is-the-sec->

In 2008, the SEC first considered updating its fiduciary standard. Christopher Cox, chairman of the SEC at the time, has stated that updating the standard “is harder than perhaps it ought to be.” He noted, “There are enormous interests at stake here.” The 2016 chairwoman of the SEC, Mary Shapiro, has stated that the SEC has had “hundreds of meetings” and that a task force is working on a proposed rule, but that its efforts only resulted in a study.<sup>82</sup>

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the SEC to undertake a study of the adequacy of consumer protections regarding financial advice. The study is to assess whether there should be a uniform standard of conduct for broker-dealers and RIAs. In 2011, the SEC staff released that report, *Study on Investment Advisers and Broker-Dealers*.<sup>83</sup> The report recommended extending the fiduciary standard that applies to investment advisers to include broker-dealers. However, the SEC has not acted on those recommendations, even though more than five years have passed since the report was released. In March 2015, the SEC indicated that it would move toward a uniform standard for broker-dealers and RIAs, but it has provided no indication of the time frame in which it would do that.<sup>84</sup>

The Consumer Federation of America has noted that despite years of entreaties from consumer advocates, the SEC has done nothing to protect investors in this area. It has failed to propose, let alone finalize, new rules.<sup>85</sup> While rule-making in this area is not required by the Dodd-Frank Act, rule-

---

failing-to-enforce-the-solely-incidental-advice-exemption-for-broker-dealers-under-the-investment-advisers-act-of-1940/.

<sup>82</sup> Hazel Bradford, *Former SEC Chairmen Call on Agency to Adopt Fiduciary Rule*, PENSIONS & INVESTMENTS (Oct. 6, 2015), [http://www.pionline.com/article/20151006/ONLINE/151009909/former-sec-chairmen-call-for-agency-to-adopt-fiduciary-rule?newsletter=defined-contribution-digest&issue=20151006&utm\\_campaign=P%26I+Defined+Contribution+Digest&utm\\_medium=email&utm\\_source=Newsletters](http://www.pionline.com/article/20151006/ONLINE/151009909/former-sec-chairmen-call-for-agency-to-adopt-fiduciary-rule?newsletter=defined-contribution-digest&issue=20151006&utm_campaign=P%26I+Defined+Contribution+Digest&utm_medium=email&utm_source=Newsletters).

<sup>83</sup> U.S. SEC. AND EXCH. COMM’N, *Study on Investment Advisers and Broker-Dealers* (2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>84</sup> *Examining the SEC’s Agenda, Operations and FY 2016 Budget Request: Hearing before H. Comm. on Fin. Serv.*, 114th CONG. 1 (2015) (statement of Mary Jo White, Chair of the SEC).

<sup>85</sup> *Preserving Retirement Security and Investment Choices for all Americans: Joint Hearing Before the Capital Mkts. and Gov’t Sponsored Enters. Subcomm. and the Oversight and Investigations Subcomm. of the H. Fin. Servs. Comm.*, 114th Cong. (2015) [hereinafter *Hearing*] (written testimony of Barbara Roper, Director, Investor Protection Consumer Federation of America).

making in other areas is required, and as of December 31, 2015, the SEC had failed to meet Dodd-Frank deadlines on 22 percent of its required rules.<sup>86</sup>

The SEC has been criticized in other contexts for its deference to the industry it regulates. For example, it has been criticized for its handling of the bankruptcies of Enron in 2001 and of Lehman Brothers in 2008, and for its handling of the Bernie Madoff Ponzi scheme (which cost investors \$50 billion) in 2009.<sup>87</sup>

The SEC regulates RIAs, holding them to a fiduciary standard. The literature on the regulation of RIAs often focuses on the problem called “hat switching,” where an adviser will sometimes act as a broker-dealer, with a suitability standard, and sometimes act as a RIA, with a fiduciary standard for conduct.<sup>88</sup> While the “hat switching” problem is a serious problem, it is not the main problem with respect to advice concerning pension rollovers. The main problem is the lack of action by the SEC.

#### B. THE SEC, THE FIDUCIARY STANDARD, AND FEES

The SEC appears to consider fees charged by advisers to not be an important issue in the context of pension rollovers. On its website, the SEC provides information as to the options a person has when changing jobs. It provides information on the option of rollovers from a 401(k) plan to an IRA, but it does not mention that the person should consider the level of fees in the new plan versus the old plan.

It also fails to mention that the person generally has the option of leaving the money in the 401(k) plan of his or her former employer, thus biasing the person’s decision toward the other options, including a rollover to an IRA. It further biases the decision by noting that for the rollover to an IRA, but not for other options, your money “can continue to grow over time, giving you more income to live on in retirement.”

We sought to obtain further information from the SEC concerning its views on the importance of fees in the rollover decision. To assess the SEC’s views on the fiduciary standard and the importance of fees, we asked the SEC through its online contact portal the following question: “If a

---

<sup>86</sup> DAVIS POLK REGULATORY, DODD-FRANK PROGRESS REPORT: FOURTH QUARTER (2015), [http://prod.davispolk.com/sites/default/files/Q4\\_2015\\_Dodd-Frank\\_Progress\\_Report.pdf](http://prod.davispolk.com/sites/default/files/Q4_2015_Dodd-Frank_Progress_Report.pdf).

<sup>87</sup> Quentin Fottrell, *10 Things the SEC Won’t Tell You*, MARKETWATCH, (Nov. 29, 2012), <http://www.marketwatch.com/story/10-things-the-sec-wont-tell-you-1320000352729>.

<sup>88</sup> See e.g., Turner & Muir, *supra* note 4.

Registered Investment Adviser advises a client to roll over his or her 401(k) account to an IRA that the adviser would manage, are the management fees charged by the adviser taken into account when analyzing whether this advice meets the fiduciary standard?" The SEC declined to provide an answer to the question, replying that it does not answer hypothetical questions.

We then presented an actual situation where someone was advised to roll funds over from the TSP by an adviser that charges a management fee of 200 basis points, which raised the fees paid by that individual by more than 70 times. The SEC again declined to provide an answer, saying that it does not comment on specific cases and that we should consult with an attorney. In addition, we filed a complaint with the SEC concerning that particular case, but the SEC never responded to the complaint.

It appears that the SEC does not take into account the fees charged by advisers when considering whether the advice of the adviser meets the fiduciary standard, as long as the adviser has clearly disclosed the fees. That approach considerably weakens the protection provided by the fiduciary standard. An adviser can thus provide advice that is clearly not in the best interest of the client if fees are taken into account, so long as the adviser discloses the fees.

Thus, merely by disclosing the fees, an adviser can satisfy the fiduciary requirement of acting in the best interest of the client. To give a specific example, an adviser can advise rolling over assets from the TSP, which charges fees of less than 3 basis points, to a plan managed by the adviser that charges 200 basis points for the management fee, and that advice can meet the standard of being in the best interest of the client if the adviser discloses the fees.

The SEC thus places considerable reliance on the disclosures of financial advisers. Surveys of investors, however, indicate that most investors find the disclosures of financial advisers to be difficult to understand. Investors also feel that financial advisers do not spend sufficient time helping them understand the disclosures.<sup>89</sup>

The SEC has taken a weak position on other issues relating to fees. For example, in 2012, as required by the Dodd-Frank Act, the SEC released new rules to protect investors concerning income and asset thresholds at which advisers could charge performance-based fees.<sup>90</sup> However, it greatly

---

<sup>89</sup> Hung, *supra* note 6.

<sup>90</sup> U.S. SEC. AND EXCH. COMM'N, SEC TIGHTENS RULES ON ADVISORY PERFORMANCE FEE CHARGES (2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487308>.

weakened the effect of those rules by grandfathering in all persons affected by the old rules.

The SEC has announced that it intends to propose a new fiduciary rule that would extend its current fiduciary rule to broker-dealers, perhaps as early as April 2017.<sup>91</sup> While this would be a step in the right direction, its fiduciary standard is so weak that it would not provide much protection for pension participants or other investors.

### C. EXPLANATIONS FOR WEAK OVERSIGHT

The SEC's Office of Compliance Inspections and Examinations has enforcement authority. However, because of a decrease in the number of staff in that office owing to a reduction in congressionally approved funding, the number of examinations has declined, presumably resulting in a weakening of enforcement by the SEC.<sup>92</sup> Furthermore, the Consumer Federation of America points out that even when a fiduciary duty applies, the SEC has shown little inclination to enforce it.<sup>93</sup>

Because of the large amount of money at stake for financial advisers, they have attempted to influence the regulators. Such influence is sometimes referred to when it is successful as "regulatory capture" or "regulatory influence." One way the SEC may be influenced is through the "revolving door" of government. Former SEC employees must file post-government employment statements if they plan to represent a client before the Commission within two years of leaving the SEC. The Project on Government Oversight (POGO) filed a Freedom of Information Act (FOIA) request for all post-employment statements filed by former SEC employees between 2006 and 2010. It found that between 2006 and 2010, 219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the Commission.<sup>94</sup> The Dodd-Frank Act raised salaries at the SEC, and at other federal financial regulatory agencies, compared to those at other agencies in the federal government, in order to attract and retain qualified staff at the financial regulatory agencies. For

---

<sup>91</sup> Mark Schoeff Jr., *SEC plans to propose fiduciary rule next April*, PENSIONS & INVS., (May 19, 2016), [http://www.pionline.com/article/20160519/ONLINE/160519849/sec-plans-to-propose-fiduciary-rule-next-april?utm\\_campaign=saxo\\_rss&utm\\_medium=rss&utm\\_source=rss02\\_rss](http://www.pionline.com/article/20160519/ONLINE/160519849/sec-plans-to-propose-fiduciary-rule-next-april?utm_campaign=saxo_rss&utm_medium=rss&utm_source=rss02_rss).

<sup>92</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 83.

<sup>93</sup> *Hearing*, *supra* note 85.

<sup>94</sup> Michael Smallberg, *Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door Project*, POGO (May 13, 2011), <http://www.pogo.org/our-work/reports/2011/fo-fra-20110513.html>.



example, staff at the SEC in 2016 could earn up to \$237,700, depending on where they were working.<sup>95</sup> The previously mentioned study refers to the period before that change, but the effect of that change is not known at this time.

The SEC is a stand-alone regulatory entity, whereas the Employee Benefits Security Administration, which has responsibility for protecting pension participants, is part of a larger agency, the DOL. This difference in administrative structure may be part of the explanation for why the SEC is weaker than the Employee Benefits Security Administration with respect to independence from industry influence.<sup>96</sup>

#### D. THE FEC AND THE SEC

The Federal Elections Commission (FEC) may account for part of the explanation for the weak oversight provided by the SEC: it may be due to the election campaign contributions of the financial services industry to members of Congress, who then favor weak oversight by the SEC. Over the 2013–2014 election cycle, the financial services industry spent \$1.4 billion. More than 340 financial service companies and trade associations each spent more than \$500,000 during this period. Of the total spending, \$497 million was spent on contributions to federal candidates and \$908 million was spent on lobbying. The contributions to federal candidates were split unevenly between the two parties, with 63 percent going to Republicans and 37 percent going to Democrats. The financial sector's campaign contributions were more than twice that of any other business sector.<sup>97</sup> Thus, regulatory capture can occur both at the agency level and at the level of Congress through financing congressional election campaigns.

#### E. THE SEC AND COMPLAINTS

---

<sup>95</sup> U.S. Securities and Exchange Commission, *SEC Pay Structure* (2016), <https://www.sec.gov/jobs/sec-pay.shtml>.

<sup>96</sup> John A. Turner, Gerard Hughes & Michelle Maher, *An International Assessment of Regulatory Capture and Regulatory Outcomes: The Case of Pension Regulators in Ireland and the United States*, J. OF FIN. REG. AND COMPLIANCE (forthcoming 2017).

<sup>97</sup> AMERICANS FOR FINANCIAL REFORM, *Updated AFR Report: Financial Sector Lobbying and Campaign Spending Top \$1.4 Billion for 2014 Election Cycle—\$1.9 million a day* (March 18, 2015), <http://ourfinancialsecurity.org/2015/03/af-r-report-financial-sector-lobbying-and-campaign-spending-top-1-2-billion-for-2014-election-cycle-1-8-million-a-day/>.

A person receiving bad advice from a financial adviser concerning a rollover could file a complaint with the SEC. The SEC website, however, is not “user-friendly” to pension participants filing a complaint. The link on the SEC website to “Enforcement” would be the most obvious path to follow. But instead, a person must file a complaint under the link to “Education”—that’s if they persist sufficiently in searching through the links on the website to find that link; “Education” would seem to be one of the least likely places to file a complaint. Even after the person has found the right page, it is not set up for easily dealing with complaints concerning advice on pension rollover.

## VII. TWO ALTERNATIVE HYPOTHESES

This section briefly considers two alternatives to the hypothesis of regulatory capture as explanations for the weak oversight provided by the SEC. First, the SEC may not consider the issue of pension rollovers to be in its bailiwick, but rather, it may hold that issue to be the responsibility of the DOL. But contrary to that view, some members of Congress have argued that the SEC, not the DOL, should have jurisdiction in this issue.<sup>98</sup> In addition, opponents of the DOL fiduciary regulations have argued that point in court.<sup>99</sup> Second, the SEC may feel that if it were to bring cases in this area, it would not prevail in court. Presumably, if the SEC had that opinion it would favor stronger regulations, but it has not taken that position.

## VIII. DEPARTMENT OF LABOR REGULATIONS

In the absence of action by the SEC, the DOL in 2016 promulgated a fiduciary rule that provides some protection for private-sector pension participants.<sup>100</sup> The rule explicitly provides fiduciary protection to pension participants for advice from a financial adviser to roll funds over to an IRA.

---

<sup>98</sup> John J. Topoleski & Gary Shorter, *Department of Labor’s 2015 Proposed Fiduciary Rule: Background and Issues*, CONGRESSIONAL RESEARCH SERVICE 19 (2015) <https://www.fas.org/sgp/crs/misc/R44207.pdf>.

<sup>99</sup> Mark Schoeff Jr., *SEC Commissioner: DOL Fiduciary Rule Would Create a ‘Mess’*, INVESTMENTNEWS (2015), <http://www.investmentnews.com/article/20150804/FREE/150809978/sec-commissioner-dol-fiduciary-rule-would-create-a-mess>.

<sup>100</sup> U.S. DEP’T. OF LABOR, EMP. BENEFITS SEC. ADMIN, PRIVATE PENSION PLAN BULLETIN, ABSTRACT OF 2013 FORM 5500 ANNUAL REPORTS 1-2 (2015), <https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/2013pensionplanbulletin.pdf>.

The rule arguably would protect all pension participants, including government employees, when they are advised concerning a rollover to an IRA. Before the DOL promulgated this regulation, Republicans in Congress sought to block it by introducing a bill, the Retail Investor Protection Act, that would prohibit the DOL from finalizing its rule until 30 days after the SEC had finalized a rule.<sup>101</sup> The Republicans presumably made this move because they recognized the low probability that the SEC would act.

Despite its inaction, at least one of the SEC's five commissioners has criticized the attempt of the DOL to deal with pension mis-selling.<sup>102</sup> According to a report released by Republicans in the House of Representatives, the SEC opposes the DOL proposed regulation. The DOL has denied the substance of that report, while the SEC has refused to comment on it.<sup>103</sup>

The DOL has been criticized for regulating in an area outside of its expertise, and a lawsuit has been filed against the department arguing that rulemaking in this area should be done by the SEC.<sup>104</sup>

The regulations do not protect pension participants from generalized bad advice, such as advertisements that encourage participants to roll over your old 401(k) plan because "the future you envision for yourself matters

---

<sup>101</sup> *Preserving Retirement Security and Investment Choices for all Americans, Joint Hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee and the Oversight and Investigations Subcommittee and the Financial Services Committee*, U.S. HOUSE OF REPRESENTATIVES (Sept. 10, 2015) (Written testimony of Barbara Roper delivered to the Joint Hearing of Capital Markets and Government Sponsored Enterprises Subcommittee and the Oversight and Investigations Subcommittee), [http://www.consumerfed.org/pdfs/9-10-15%20CFA%20HFSC%20Hearing%20on%20DOL%20COI%20Rule%20and%20HR1090\\_Testimony.pdf](http://www.consumerfed.org/pdfs/9-10-15%20CFA%20HFSC%20Hearing%20on%20DOL%20COI%20Rule%20and%20HR1090_Testimony.pdf); John J. Topoleski & Gary Shorter, *Department of Labor's 2015 Proposed Fiduciary Rule: Background and Issues*, CONG. RES. SERV. (2015), <https://www.fas.org/sgp/crs/misc/R44207.pdf>.

<sup>102</sup> Schoeff, *supra* note 99.

<sup>103</sup> Suzanne Barlyn & Sarah N. Lynch, *U.S. Labor Dept., SEC clashed over retirement advice rule –report*, REUTERS (Feb. 24, 2016, 1:29 PM), <http://www.reuters.com/article/usa-brokers-fiduciary-idUSL2N1630ME>.

<sup>104</sup> Erika Reynoso & Alison Hawkins, *U.S. House Should Protect Americans' Access to Financial Advice*, FIN. SERVICES ROUNDTABLE (Oct. 27, 2015), <http://www.fsroundtable.org/u-s-house-should-protect-americans-access-to-financial-advice/>; Nevin E. Adams, *It's On! Litigation File Challenging DOL Fiduciary Regulation*, NAPA NET (June 6, 2016), <http://www.napa-net.org/news/managing-a-practice/regulatory-compliance/its-on-litigation-filed-challenging-dol-fiduciary-regulation/>.

to us.”<sup>105</sup> That advice generally results in pension participants paying higher fees and having fewer regulatory protections.<sup>106</sup>

## IX. CONCLUSION

The SEC has not taken any action concerning financial advice to roll over from low-fee 401(k) plans to higher fee IRAs. The lack of action by the SEC stands in stark contrast to the situation in the United Kingdom, where the type of advice people received to roll funds over to substantially higher-fee pensions is considered to be a scandal and was addressed more than a decade ago by the U.K. financial market regulators.

The SEC appears to not consider the fees charged by financial advisers to be an important issue. It does not include fees as an issue in its advice to people considering rollovers from 401(k) plans to IRAs. It has, to our knowledge, never brought a case against a financial adviser concerning fees relating to pension rollovers, even in the extreme case of rollovers from the TSP, which charges less than 3 basis points. The CEA has concluded that bad advice concerning pension rollovers is costing U.S. pension participants \$17 billion, but the SEC thus far has not considered this to be an issue that would warrant action on its part. The CEA study indicates that pension mis-selling, in which financial advisers have advised pension participants to switch from relatively low-fee 401(k) plans to higher-fee IRAs, has occurred on a widespread basis in the United States.

With more responsibility placed on individuals to invest their retirement assets when they leave an employer’s 401(k) plan, workers often rely on investment advisers but are often not well-served by them. In this paper, we compare the regulatory protections pension investors receive in the United Kingdom to those that have been provided by the SEC relating to advice concerning pension rollovers. Although the SEC holds RIAs to a fiduciary standard, and the literature on advice has expressed concern about the weakening of that protection because of the so-called “hat switching” problem, the more serious problem is that the SEC does not apply the fiduciary standard to advice provided by RIAs concerning pension rollovers. While the DOL has promulgated regulations in this area, those regulations

---

<sup>105</sup> *Have you settled for average with your old 401(k)?*, T. ROWE PRICE (2016) (on file with author).

<sup>106</sup> John A. Turner & Bruce W. Klein, *Retirement Savings Flows and Financial Advice: Should You Roll Over Your 401(k) Plan?*, INT’L SOC’Y OF CERTIFIED EMP. BENEFIT SPECIALISTS: BENEFITS QUARTERLY, (Fourth Quarter 2014).

in 2016 are being challenged in court, in part on the basis that this area should be the responsibility of the SEC.

While we have addressed one aspect of the issue of bad advice concerning pension rollovers, other issues also warrant addressing. For example, the advice contained in the mutual fund industry advertising campaign to “roll over your old 401(k)” is bad advice for many participants and does not come with disclaimers. That advice campaign is treated by the regulators as sales and marketing, rather than advice. Because most participants have encountered this advice many times, and presumably many roll their funds over based on that advice, the protections that this paper indicates are needed may still be weak in that there are no regulations on this type of generalized advice—generally bad advice that comes without disclaimers.