TESTIMONY OF RON A. RHOADES, JD, CFP®

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Re: U.S. Department of Labor / Employee Benefits Security Administration

Hearing on "Improving Investment Advice for Workers & Retirees"

September 3, 2020

Thank you for this opportunity. I am Professor Ron Rhoades of Western Kentucky University's Gordon Ford College of Business and its Department of Finance. These remarks are my own, and do not necessarily represent the views of any institution, organization, or firm with whom I am presently associated nor any cult nor gang I have been previously kicked out of.

In my experience as a university professor teaching courses in retirement planning, insurance, and investments, and as a registered investment adviser, and as an attorney to both businesses and private individuals, I have had the opportunity to review many 401(k) plans and their investment offerings. I offer the following observations.

Plan sponsors are business owners; as such they focus on their business operations. Plan sponsors, whether large or small, don't understand the scope of their fiduciary duties under ERISA, and they certainly don't understand the requirements of the prudent investor rule. Efforts to educate plan sponsors in the complexities of the prudent investor rule and the investment marketplace cannot overcome the vast information asymmetry which exists. The world of investment due diligence requires specialized skills, which these plan sponsors lack. As a result, American businesses are subject to liability should plan sponsors not be aided by fiduciaries – experts upon whom they can rely. Last year the settlements in these class action cases, including both for-profit businesses and non-profits such as private universities, totaled nearly half a billion dollars, and that does not include the tremendous costs incurred during litigation.

In class action suits, plaintiffs' attorneys are now moving on from the very largest ERISA-covered plans, to those maintained by mid-sized and smaller companies. When such lawsuits are filed, usually the broker-dealer or insurance company, and their representatives, who have provided investment recommendations, are easily dismissed from the litigation. Brokers essentially hide behind the suitability shield. Reg BI does not substantially change this lack of accountability.

I have represented many individuals who are participants in qualified retirement plans and IRAs. I have seen the harm done through the sale of high-cost investment products. The academic evidence on the impact of higher fees is conclusive. Higher-cost investments have lower returns, especially over the long term, all other things being equal. A mere 1% increase in fees over the course of a worker's lifetime results far less in a retiree's nest egg – 20% or more less.

The fact of the matter is … defined contribution plans possess economies of scale. This permits investments to be provided at very low cost to plan participants. Indeed, the prudent investor rule mandates that plan sponsors, as fiduciaries, not waste the assets of the plan sponsors on expensive products.

Moreover, the existence of commissions, as seen in Class A mutual funds, result in a substantial drag on investment returns. The impact is especially severe given the need for portfolio rebalancing in many accounts, applying Modern Portfolio Theory, as more commissions would be incurred in the rebalancing process. There exists no valid reason for 12b-1 fees, which provide no real benefits for fund shareholders. Together, commissions and 12b-1 fees often result in unreasonable compensation, a violation of fiduciary requirements.

I have served as a consultant to broker-dealer firms. For decades many such firms have communicated to me their prospects for huge profits resulting from the commissions earned on rollovers from ERISA-covered plans to IRA accounts. There is no question that investors need, and deserve, fiduciary investment advice at the critical period when they enter retirement and consider whether to undertake a rollover to an IRA, or whether to annuitize a part of their nest egg.

Reg BI does not, by the SEC's own admission, impose a fiduciary standard of loyalty. It is completely inappropriate for the Department of Labor to suggest that ERISA's requirement to act in the interest of the plan participants be interpreted under a non-fiduciary standard.

The Department suggests that consumers need more choice. This is but a red herring. Greater choice is <u>not</u> what Congress, in enacting ERISA, mandated. The strict fiduciary standard applied under ERISA intentionally limits choice. ERISA's prudent investor rule is designed to eliminate bad investment choices.

The Department seeks to adapt the fiduciary standard to the practices of the industry, by chipping away at the fiduciary standard. Yet the fiduciary standard, like this square piece sitting atop a round glass, is not susceptible to "particular exceptions," as the late Justice Benjamin Cardoza put it. Start chipping away at it, and very soon the fiduciary standard collapses, just as this brownie collapses into this jar. The result is just a mess, when the fiduciary standard is eroded.

Disclosure of a conflict of interest is not sufficient to meet the fiduciary standard set forth by ERISA and the requirements applicable to class exemptions. I can attest that plan participants don't read disclosures. Those few that do don't understand them. If disclosures were effective, there would be no need for the fiduciary standard under the law.

There is a single truth, that is irrefutable. No person can serve two masters. You cannot adhere to the fiduciary standard and also act as a seller of products. The duty of loyalty requires strict adherence to the protection of the interests of plan sponsors and plan participants. The two roles – product salesperson, and purchaser's representative – are simply incompatible.

The express language of ERISA requires a broad application of the fiduciary standard upon those who provide advice to plan sponsors and plan participants. The common law, which applies the fiduciary standard to those providing investment advice who are in a relationship of trust and confidence with their clients or customers, is utilized to inform rule-making under ERISA. Yet, this proposed rule fails to properly consider the common law application of fiduciary duties, and it does not explore the alternatives for the application of the fiduciary standard to those who provide investment advice and recommendations to ERISA-covered plans.

Having taught an advanced course in economics as applied to the capital markets, I can attest that substantial negative economic effects will result from this proposed rule. Tens of millions of Americans to have less in retirement, due to excessive intermediation. In turn, this will result in lesser accumulations of capital. In turn, this increases the cost of capital to businesses. It will also reduce the fuel necessary to drive new innovations forward via entrepreneurship. Over a long period of time, due to the compounding effect of the high fees and costs that would be permitted under this proposed rule, future U.S. economic growth will be substantially reduced.

The betrayals of trust by those who represent themselves as acting in the best interests of a plan sponsor or participant, but who fail to adhere to ERISA's strict fiduciary duty requirements, will further negatively affect the formation of new defined contribution plans, their maintenance, and the essential trust needed to foster our capital markets system.

This proposed rule is substantively flawed. The Department should look to Justice Douglas' majority opinion in the 1939 U.S. Supreme Court decision in *Pepper vs. Litton* to better understand the obligations which flow from the fiduciary duty of loyalty.[1]

Furthermore, the circumstances present over the past few months – with multiple rulemakings occurring at the same time regarding investment advice, disclosures, and standards of conduct. In addition, the effects of the pandemic have imposed greater time burdens upon investment practitioners, with the demand for financial advice in this recession soaring, with temporary tax laws and regulations increasing the need of advice, and with capital market valuations fluctuating widely. In addition, academics that may have desired to make comments have been and continue to be time-constrained, as we deal with training to improve the delivery of online classes, greater outreach to students who endure stress and anxiety, and assisting students who have contracted COVID 19 or who have been quarantined. This rush to a hearing only eight days following the publication in the Federal Register of the Notice of Hearing, with significant restrictions on who may testify and the topics permitted, is procedurally flawed as well.

This is a monumental rulemaking, with a huge impact upon the retirement security of individual Americans, the future burdens upon both federal and state and local governments to provide for the elderly, and substantial implications for the growth of the U.S. economy. The proposed rule only fosters poor investment choices, lack of accountability by those who recommend investments, and betrayals of trust.

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[1] Justice Douglas's majority opinion in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), in which he stated: "He who is in such a fiduciary position cannot serve himself first and his *cestuis* second … He cannot use his power for his personal advantage and to the detriment of [the *cestuis*], no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation … Otherwise, the fiduciary duties … would go for naught: exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart."

The Department should return to the drawing board and start over again to fashion a proposal that reflects the plain language of ERISA’s statutory language, and which protects both the American people and the American economy.

Thank you.