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Hearing on

The Administrative State: An Examination of Federal Rulemaking

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Introduction:

Chairman Johnson and Ranking Member Carper, thank you for the opportunity to testify regarding the need to reform the Federal regulatory process.

My testimony today reflects my personal views as a former Federal regulator and as a current ERISA attorney, and not those of any client, of my firm, or of my colleagues. I am not testifying on behalf of any client or any other party.

I commend the Committee for holding this important hearing not just on the alarming growth in Federal rules and regulations, but also on the manner in which Federal rule-making authority is being misused by some Federal agencies.

The sheer scope of Federal regulation is remarkable. What we eat, what we wear, what we drive, how we work, how we save, even the air we breathe—nearly every fundamental activity of our lives is now at least partially subject to Federal regulations. While there is a legitimate role for Federal regulation, it is fair to say that the current regulatory environment—and the practices of some Federal regulators—are in significant need of review and reform.

Current Regulatory Practices Overstep Intended Scope of Authority:

Regulatory authority delegated to the Executive Branch by Congress was not intended to make Federal regulators an ersatz legislative body, but to facilitate the practical implementation of laws passed by Congress. The Administrative Procedure Act and related laws, as well as the various Executive Orders and Office of Management and Budget guidance documents governing the regulatory process, are intended to ensure that such rules are promulgated in a manner consistent with the intent and direction of Congress in Federal law, and only after a thorough and fair consideration of the economic impact, costs and alternatives available to achieve these goals.

Unfortunately, the reality of the regulatory process is all too often quite different.

The ambition of some Federal regulators has eclipsed this limited delegation of authority, and we are increasingly seeing regulations that are, in effect, new Federal laws and policies created by unelected officials rather than Congress. These regulators are using the rulemaking process to make policy and legal judgments that are properly the responsibility of Congress—in fact, some regulators are promulgating rules that clearly conflict with the intent of Congress, but which they attempt to justify through aggressive and convoluted interpretations of their delegated authority, knowing that costly litigation or a literal "act of Congress" is the only real brake on their efforts.

Even more common, rather than using economic impact analysis to inform the development of the policy itself, carefully considering and choosing among alternatives as they are required to do, Federal agencies increasingly use the economic analysis as an after-the-fact paperwork exercise seeking to justify the predetermined policy position of the agency.

I believe the recently promulgated final rule by the U.S. Department of Labor governing investment advice related to $15 trillion in retirement savings is just such an example of a regulation that infringes on Congressional prerogatives, that is contrary to the intent of the legislation it claims to interpret, and that uses the economic analysis to justify its predetermined policy decision, rather than to inform the development of its policy and to consider alternatives.

Labor Department Fiduciary Rule Highlights Why Reform is Necessary:

As the former U.S. Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration, I have personal experience with the scope of the Labor Department's authority, and in exercising that authority to implement the laws passed by Congress. One of my primary duties during my tenure was to promulgate regulations implementing the Pension Protection Act of 2006.

In that law, Congress specifically delegated certain decisions to the agency, including the definition of a Qualified Default Investment Alternative ("QDIA"). This was a significant regulation, as it determined what investments commonly are selected for participants automatically enrolled in 401(k)-type plans, or who otherwise do not provide investment direction for their own accounts. Billions of dollars have been allocated to investment products and services that meet the definition we adopted in the final rule. However, we were exercising authority specifically delegated by Congress to make a particular decision based on extensive discussions with all of those affected by the rule, as well as a thorough public notice and comment rulemaking process. In my view, this is an example of the proper use of regulatory authority.

By contrast, the new fiduciary regulation—which likely is the most sweeping change to retirement savings and financial regulation since the 401(k)—is entirely the product of the Department's own initiative. The law did not change. If anything, Congressional direction

was for a fiduciary standard to be handled by the Securities and Exchange Commission ("SEC") through a provision of the Dodd-Frank Act.

- **Labor Department Final Rule is Legislation-by-Rulemaking**

Even more concerning, the Labor Department decisions, though described as necessitated by changing circumstances in the retirement marketplace, are contrary to the intent of Congress. Congress did not intend for the Labor Department to become a primary regulator of the conduct and compensation of financial advisors to Individual Retirement Accounts ("IRA"). Congress did not intend for the unique fiduciary standard of care applicable to employee benefit plans under the Employee Retirement Income Security Act of 1974 ("ERISA") to apply to IRAs.

In fact, Congress created ERISA plans and IRAs at the same time, and affirmatively chose <u>NOT</u> to apply the ERISA fiduciary standard to IRAs. The reason is clear—in an ERISA plan, a fiduciary makes many decisions for me, and thus a fiduciary standard rooted in trust law strictly governs those decisions over which I have no control. By contrast, in an IRA, I make my own decisions, so Congress treated IRAs much as it treated other types of investment vehicles, and relied on the extensive network of Federal and state financial regulators and laws already protecting investors. Congress created a new private right of action and legal remedies for ERISA plans, but did not create a special cause of action for IRAs. Rather than create an IRA-only cause of action, Congress let recourse against investment advisors be determined by the Federal and state regulation applicable to the type of advisor.

In other words, Congress made affirmative choices about the different roles of ERISA plans and IRAs, and while they share a common bond in the prohibited transaction rules, they were intended to be regulated quite differently otherwise.

Remarkably enough, these intentional Congressional decisions are exactly the flaws the Labor Department cited to justify its new set of judgements displacing Congressional intent. Regulation is needed, said the Labor Department, because there is no independent fiduciary protecting the IRA owner. The Best Interest Contract (BIC) Exemption right for an IRA owner to bring a class action in state court for breach of contract is needed, said the Labor Department, because there is no separate cause of action for IRAs. Underpinning all of this is the belief by the Labor Department that securities, insurance and other financial laws applicable to IRA advisors generally are inferior to ERISA, and that IRAs should be treated more like ERISA plans, largely because ERISA plan assets are frequently rolled over into IRAs.

To achieve this, the Labor Department took a legal two (or maybe three) step. First, it expanded the definition of what constitutes fiduciary investment advice under ERISA. Then, based on a 1978 reallocation of regulatory authority in the Carter Administration that gave the Labor Department interpretive authority over the prohibited transaction rules in both ERISA and the Tax Code, it applied that new fiduciary definition to the Tax Code prohibited transaction rules. These rules apply to IRAs. Thus, the final regulation turns an advisor to an IRA, whose compensation is entirely consistent with the securities

laws (let's assume the advisor is a registered representative of a broker dealer) into a person committing a prohibited transaction under the Tax Code. The BIC Exemption is now necessary for that registered representative to give advice or to help a participant with a rollover, because the advisor's compensation is causing a prohibited transaction that the BIC Exemption will exempt. The BIC Exemption requires the broker-dealer and the registered representative enter into a contract in which they agree to a fiduciary standard of care based on ERISA, and to be subject to a class action lawsuit in state court if they breach the contract.

In summary, by prohibiting the way certain financial advisors are commonly paid if they give advice regarding ERISA plans, IRAs, rollovers and distributions, and by then offering them a narrow way out through an exemption with conditions, the Labor Department foists onto advisors a standard of care and a legal liability Congress affirmatively chose not to impose.

Whether you think the Labor Department is right that IRAs should be subject to the ERISA standard of care is not the issue. The issue is that this matter is something Congress previously addressed, and changing it should be a Congressional decision, not legislation-by-rulemaking.

- **Labor Department Final Rule Is the Product of a Flawed Process**

Separate from concerns about the Labor Department's authority to issue the regulation given Congressional intent, there are a large number of concerns regarding how the Department promulgated the regulation, and regarding the content of its economic analysis.

In an unusual step, the Office of Advocacy at the Small Business Administration and the Financial Industry Regulatory Authority ("FINRA") both offered formal comments on the public record after the proposed regulation was released. FINRA offered 21 pages of comments identifying various problems, including direct conflicts with securities law and regulation, created by the Proposal.[1] While some of these were addressed in the final rule, not all of them were.

The Small Business Administration's ("SBA") Office of Advocacy expressed concerns in its formal comment letter to the Department, questioning the Department's economic analysis and criticizing the Department for not sufficiently taking into account the effects of the Proposal on small businesses. The conclusion from focus groups held by the SBA was that "the proposed rule would likely increase the [advisers'] costs and burdens associated with serving smaller plans…[and] could limit financial advisers' ability to offer savings and investment advice to clients…ultimately lead[ing] advisors to stop providing retirement services to small businesses."[2]

[1] *See,* Comment letter from Financial Industry Regulatory Authority ("FINRA"), July 17, 2015.

[2] Comment letter from the Small Business Administration's Office of Advocacy, July 17, 2015, at 5-6.

Even more significantly, this Committee issued a report detailing the findings of its inquiries with the SEC and other Federal agencies regarding their interaction with DOL. I won't repeat in detail here the findings of the Committee's own report, but it contained remarkable information showing that:

- Treasury Department officials questioned the rule's IRA provisions, and viewed them as contrary to Congressional intent;
- The SEC staff raised many issues that the Labor Department ignored in the proposed regulation; and
- Despite requirements to consider the costs and benefits of alternative approaches, Labor Department staff objected on the grounds that it would be difficult and delay the project.

The Labor Department also persists in using unrealistic assumptions about the costs of implementing the final rule. To highlight just one example, let me address their estimates for the cost of legal advice. The final rule estimates that the average hourly rate of legal advice to assist in compliance with the rule would be about $134. As an ERISA attorney in private practice, I can assure you that this is an utterly unrealistic estimate. Similarly, in estimating the cost of using attorneys to write required disclosures, the Labor Department estimated that a simple disclosure would take only one attorney 10 minutes to write. As an ERISA attorney I can assure you that a disclosure that could be part of the basis for a class action lawsuit against a financial entity's entire book of business takes far longer than 10 minutes to write, and is reviewed and debated by far more than one attorney. It does not cost $22.33 to meet that disclosure requirement.

Finally, while the Labor Department makes much of the fact that it offered a lengthy comment period and held public hearings on the rule, it is important to note that all of the comments and hearings were only addressing the proposed rule. Rather than demonstrating an open process, these facts serve to highlight the complexity and ambiguity of the proposal itself. In my experience, it is very unusual for the Labor Department to move to a final rule when literally dozens of major issues regarding a proposal are in dispute. Further, the comments did not present the Labor Department with a binary choice on addressing those issues, but a range of options.

Unfortunately, the Labor Department choose not to provide even a brief comment period on a revised rule, and as a result, the final rule is the first time we have seen how the Department addressed many of these concerns. The dozens of changes are therefore quite surprising. The final rule contains new provisions not even discussed in the proposal, such as making a recommendation as to the type of account a new form of fiduciary advice.

It also makes major changes to the exemptions for new reasons not previously discussed. For example, the proposal removed individual variable annuities from PTE 84-24 (an exemption for annuities and insurance policies) and made only the BIC Exemption available. The rationale then was that such annuities are registered as securities and

therefore should be under the BIC Exemption with most other securities. However, the final exemption removed not just individual variable annuities but also group variable annuities and fixed index annuities from PTE 84-24. The new rationale had nothing to do with status as a security (which the latter two are not), but rather with the Department's apparently new concerns about the marketing of such products.

Given the large number of fundamental and new changes, the Department should have reproposed the rule for a brief comment period—instead, it forged ahead, making educated guesses about how to proceed. This is not consistent with the law or the Executive Orders and guidance addressing the process.

<u>The Big Picture—Regulatory Reform is Needed to Address the Tension between Congressional and Executive Authority:</u>

The Department of Labor's recent fiduciary regulation offers some valuable lessons in the way in which the rulemaking authority is misused by some agencies, as well as the standards, criteria and review process to which this authority is subjected. The rule illustrates two closely related challenges.

First is the inherent difficulty Congress faces in finding the right balance between providing Executive branch agencies the authority needed to administer complex statues while retaining its Constitutional authority to legislate. How does such reform facilitate the work the Labor Department did on the QDIA regulation, but prevent the work it has done on the fiduciary rule?

Second is the hazard inherent in maintaining the kind of broad grants of regulatory authority that have typically been incorporated into Federal laws such as ERISA. As I explained above, and as the Committee detailed in its own report, the regulatory authority here was used in a particularly convoluted way to achieve its objective. I believe it went too far, but that will likely be a matter settled in the courts.

The ongoing tension between Congressional and Executive branch authority remains a political and public policy theme that is increasingly at the forefront of political disagreements. The Labor Department's recent actions may well be addressing an issue worthy of public debate, but the agency has done so by contorting the reasonable limits of the reach of its jurisdiction and unilaterally imposing new and costly requirements on a major part of our economy affecting all of us. Exercising necessary interpretive authority in response to changing circumstances and attempting to legislate through the regulatory process are two very different things, and Congress should be mindful of the latitude it has granted to agencies both in the statutes they implement, and in the regulatory process itself.

It is in the gaps and ambiguities of the allocation of regulatory authority that controversial regulations of the sort we are increasingly experiencing take root. Complex statutes like ERISA, with their origins in an earlier era in which Federal agencies played a much smaller role and to which fairly broad authority was granted, are fertile ground for regulatory

overreach. Federal rulemaking at an agency becomes an attractive policy alternative to Congressional action for an Executive Branch facing Congressional opposition to its views.

This is a very worrisome development, because the regulatory process has relatively few checks and balances compared to the legislative process—the authority of the agency to push forward despite criticism and public outcry is relatively unfettered, except to the extent the agency does not follow the proper process or makes a decision this is "arbitrary and capricious" in the view of a Federal court. While public and notice comment rulemaking provides an opportunity for affected persons to make their views known on the record (at least with respect to the proposed regulation), the reality is that the agency is under no obligation to do more than properly consider those comments. Contrast this to a Congressional debate, where a majority must prevail in votes in two separate bodies against active internal opposition, and must then convince the President to agree or must override his veto with a two-thirds majority. At the end of the day, a Federal agency that intends to make policy and that has the will to proceed is very difficult to stop unless Congress takes a stand, or the courts overturn the action after the fact.

<u>The Fragmented and Not-Easily Enforced Current Regulatory Process Needs Reform:</u>

- **Fragmented Authority**

The ERISA fiduciary regulations also bring to light the problematic nature of the fragmented and sometimes piecemeal nature of the standards and criteria applicable to the promulgation of regulations. The basic procedural standards governing the process date back to 1946 with the Administrative Procedures Act (APA) and remain essentially the same today. The APA, reflecting the concerns of an earlier era, however, primarily addresses the procedural requirements and transparency of the rulemaking process rather than the scope of authority that is exercised or the quality of the supporting analysis or decision making that underlies a regulation. A variety of new requirements have been added through laws, Executive Orders and operational guidelines beginning in the 1980's, such as requiring that the impacts on small businesses be explicitly measured and considered, that any unfunded mandates on State and Local Governments be addressed, and that the regulatory decisions be undertaken on the basis of an evaluation of costs and benefits, including the use of alternatives that provide the most cost effective solution to a clearly defined need.

- **Difficult to Enforce Requirements**

These requirements, however, are often poorly coordinated and lack an effective mechanism to ensure they are fully complied with by regulatory agencies. Some of these requirements are contained in statutes and provide the basis for a legal challenge in the courts if not fulfilled. Others, especially the standards and criteria for a complete and credible economic impact analysis, are primarily within Executive Orders and Office of Management and Budget ("OMB") policy guidance, which provide essentially no means for the regulated community and Congress to ensure they are met. Although the Unfunded

Mandates Reform Act of 1995 contains a requirement for regulatory impact analysis to be developed for rules that are likely to result in an expenditure of $100 million or more by the private sector, it does not specify meaningful standards for the scope or quality of this analysis and provides only for limited judicial review of agency compliance with these requirements. The more in depth and meaningful requirement for regulatory actions to be predicated on and developed on the basis of cost-benefit analysis are established in Executive Order 12866 and the standards for these set forth in OMB Circular A-4. Other related requirements that are in the Federal statutes apply primarily to small businesses.

The absence of a comprehensive set of enforceable standards that governs the quality of regulatory decisions makes it very difficult to hold the regulatory agencies accountable for their actions. Meaningful recourse can typically only be pursued through costly and time consuming litigation. Executive orders and policies often disclaim any private cause of action and thus provide insufficient foundation for success in a legal challenge. Incorporating these various requirements and standards into a single comprehensive law that provides a readily accessible venue to challenge agency actions would go a long way to improving both the quality and accountability of the process.

- **The Role of OMB as Gatekeeper is Conflicted**

The sources of quality control and recourse that currently exist are flawed and inherently weak in the outcomes they produce. The current regulatory review process within the Executive Branch is administered through the Office in Information and Regulatory Affairs ("OIRA") within OMB. While certainly providing some degree of oversight and quality control over "routine" regulations, as well as a venue for affected parties to express their views during the review process, OIRA does not meaningfully protect the public from abuses of the process regarding major regulations because it is part of the Executive Office of the President, which ultimately determines the policies Federal agencies pursue. It cannot, as evidenced by the Labor Department's fiduciary rule, be relied on to impose meaningful standards and control on a regulatory priority that has been identified as a priority by the President to whom it directly reports.

- **Need for Additional Congressional Role**

Of course, Congress can and does provide oversight of the activities of Federal agencies. That is, after all, why we are here today. However, the primary mechanism in the Congressional Review Act has limited utility as a check on regulatory excess. While providing for delayed effective dates to enable some external review and to ensure time for Congress to consider a resolution of disapproval to overturn a regulatory action, such a resolution is subject to a Presidential veto necessitating the requisite two thirds majority to overturn. In the nearly twenty years since the enactment of these provisions, only a single regulation has been overturned through this process. A more robust and accessible form of Congressional review appears to be required to provide more consequential oversight.

Other Calls for Reform

I also want to mention that I serve on the Policy Board of the American Benefits Council (the "Council")[3] which has been working to review the regulatory process (this review is unrelated to the Labor Department rule). The Council formed a board-level Regulatory Process Task Force in the fall of 2015 and I have had the privilege of chairing that task force. The task force has been working on principles to guide us in reviewing the regulatory process and a draft version of that document is attached as an appendix to this testimony.

The Council has separately developed four relevant principles that I commend to the Committee's attention.

First, it is very important that the agencies adopt a "least burdensome compliance" standard that fully incorporates technological capabilities in conjunction with all regulations. Before imposing any new administration or reporting requirements, the agencies should be required to "verify they are unable to achieve the objective in a manner less burdensome on the regulated parties…"

Second, regulatory agencies should adopt a "good faith" standard for purposes of enforcement of many regulations. For example, a "good faith" standard would allow employers to use technology as it becomes available, rather than waiting for regulatory approval, where such adoption in good faith serves the requirements of the current regulations.

Third, the agencies should eliminate duplicative, contradictory or excessive regulations that impose administrative burdens on employers. One way to improve the regulatory system would be to emphasize exception-based regulations that target employers with poor performance rather than imposing burdens on all employers. For example, in employee benefits, many regulations are intended to address real or perceived concerns related to small plan sponsors and yet those small plan sponsors often receive an exemption from the resulting regulations.

Fourth, as previous discussed in my background materials, coordination of rules between Congress and the agencies – and across those agencies – should be improved. Employer-sponsored benefit plans are complex entities that are subject to the jurisdiction of different congressional committees and regulatory agencies. When multiple agencies share rulemaking authority on a particular issue, employers must accommodate differing (and sometimes contradictory) obligations. In addition, after important legislation is enacted, employers must comply with the statutory requirements until regulations are issued.

[3] The American Benefits Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

Future legislation should clearly indicate enforceable timing for issuance of enabling regulations and/or make the statutory requirement effective date contingent on the promulgation of the regulations.

Conclusion:

Thank you Mr. Chairman and Ranking Member Carper for your commitment to reviewing the Federal regulatory process. I believe this Committee could significantly improve the current situation, protect Congress' Constitutional role, and ensure better and more efficient regulation through comprehensive regulatory reform. I appreciate the opportunity to discuss these issues with the Committee, and I would be happy to answer any questions you may have.