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INTEREST
COMMENT**

RESPONSE TO PRESIDENTIAL MEMORANDUM ON FIDUCIARY DUTY RULE

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Definition of Term Fiduciary; Conflict of Interest Rule—Retirement Investment

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Thank you for the opportunity to comment on the president’s memorandum directing the secretary of labor to reconsider the fiduciary rule.¹ The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group, but is designed to assist the Department of Labor (DOL) in creating a regulatory environment that will facilitate increased innovation, competition, and access to financial services to the benefit of the public.

The president directed the secretary of labor “to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice” and to conduct a new economic and legal analysis of the rule. That analysis should consider, among

1. The White House, Office of the Press Secretary, “Presidential Memorandum on Fiduciary Duty Rule,” February 3, 2017.

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other things, whether the rule has harmed or will harm investors by limiting their access to financial products and services, whether it will disrupt the retirement services industry in a way that harms investors, and whether the rule will increase litigation and thus expenses borne by investors. This comment responds to the presidentially directed review of the fiduciary rule. The comment raises broad concerns about the fiduciary rule's approach to investor protection, and the remainder of this comment will focus critically on the economic analysis used to support the regulation.

I. THE FIDUCIARY RULE UNDERMINES INVESTOR PROTECTION

The DOL adopted the fiduciary rule with the intention of protecting investors. The rule, however, makes it more costly for financial professionals to work with retirement investors and retirement plans. These costs will be passed on to retirement investors through higher costs and a reduction in available products, services, and payment methods. Coming into and remaining in compliance with the rule has and will continue to consume considerable compliance, information technology, and legal resources, which will be diverted from customer-driven innovation.² The rule's reliance on class actions as an enforcement mechanism subjects firms to hard-to-estimate future costs in litigation that may be without merit but may nevertheless be difficult to defend given the rule's many gray areas.³

The fiduciary standard, as interpreted by the DOL, carries with it obligations and limitations that are not appropriate for every interaction between a financial professional and a retirement investor or plan. As a result, some interactions that would otherwise be beneficial to a retirement investor will be curtailed to avoid incurring the obligations associated with being a fiduciary. For example, any conversation about whether to roll over from an employer plan to an IRA would likely be covered by the rule, unless it were limited to "a mere discussion of the pros and cons of each option."⁴ As another example, customers will not be able to obtain any one-off transaction advice from a call center.⁵ The obligations that go along with the

2. See, for example, Wayne Bloom, Commonwealth Financial Network, letter to Senator Elizabeth Warren, January 30, 2017, https://www.warren.senate.gov/files/documents/DOL_Fiduciary_Rule_Letters.pdf. "I believe the Rule is absolutely well-intentioned, but its unintended consequences have wreaked havoc on our business. Complying with the Rule is impacting every corner of the firm, and our efforts to meet the Rule's tight deadline have consumed the firm's resources, virtually stopped innovation, costing millions of dollars, lost clients, and most importantly, it has impaired our ability to service small investors. Simply stated, while well intended, the Rule's unintended negative impact is beyond anything I have witnessed in my 25+ year career."

3. See, for example, Department of Labor, Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20947 (April 8, 2016). "The contract gives both the individual adviser and the financial institution a powerful incentive to ensure advice is provided in accordance with fiduciary norms, or risk litigation, including class litigation, and liability and associated reputational risk."

4. See, for example, Janet L. Luxton and Gene Paranczak, "The Final DOL Fiduciary Rule: What It Means to Plan Sponsors" (Regulatory Brief, Vanguard, Valley Forge, PA, August 2016). As another small example, although the DOL explicitly exempts general advice from radio personalities, financial professionals who manage money, providing personalized advice based on callers' specific circumstances on the radio while encouraging investors to contact them off-air for additional advice, could be covered.

5. See, for example, "How Will the DOL Fiduciary Rule Affect Call Centers?," ASPAA, July 29, 2016. APSAA reported that 75 percent of surveyed retirement plan providers "plan[ned] to change how their call centers function because of the rule."

fiduciary label under the Employee Retirement Income Security Act (ERISA) may diminish retirement investors' ability to get help outside of the extremely formalized, documentation-heavy parameters set by the DOL.

Regardless of the DOL's acknowledgement that asset-based fees are not the only permissible form of compensation, the fiduciary rule expresses an implicit preference for asset-based fees. Although the DOL afforded exemptions designed to ensure that investment advice fiduciaries could continue to be paid through commissions, the complexity and legal risk of relying on these exemptions makes fee-based compensation more attractive. As a result, firms have an incentive to shift clients to asset-fee accounts, and some retirement investors may pay more than they did in the past when they paid per trade.⁶ Some firms have pledged to continue to offer commission-based options, but these firms may alter course in response to litigation.⁷ Firms using an asset-based fee arrangement may find it unprofitable to serve investors with small accounts. The complexity of the rule and the assumptions that it makes about what works best for retirement investors will materially affect the options available to investors. Although described by the DOL as simply asking that financial professionals act in the best interest of their retirement clients, the rule will change the way that financial professionals already acting in the best interest of their clients interact with retirement clients.

The DOL's rule applies to retirement accounts governed by ERISA and individual retirement accounts (IRAs). Nontax preferred retirement accounts continue to remain within the regulatory jurisdiction of the Securities and Exchange Commission (SEC). Nevertheless, changes made to client relationships by the DOL's rule will profoundly affect client relationships in the rest of the retail investment industry. Moreover, the changes made by the DOL have led to calls for changes in mutual fund share classes and other requests for guidance related to mutual funds—matters within the SEC's regulatory purview and ones that will affect non-retirement mutual fund investors.⁸ The DOL should have deferred to—or at a minimum, coordinated with—the SEC.

The fiduciary rule has already led to substantial changes in the financial services industry. Before additional work and resources are expended, the DOL should reconsider its approach to ensure these changes benefit investors. The need for reconsideration is particularly important because, as the next section of this comment discusses, the DOL's rule is based on a flawed economic analysis.

6. See, for example, Michael Wursthorn, "Game Over for Broker Commissions," *Wall Street Journal*, October 7, 2016.

7. See Gary Iacurci and Christine Idzelis, "Broker-Dealers Split on Commissions in Wake of DOL Fiduciary Rule," *Investment News*, October 30, 2016. "Selling investment products such as mutual funds and variable annuities on commission will require using the best-interest contract exemption, or BICE, which allows for variable compensation if certain standards are met, but which also gives investors the right to bring class-action lawsuits against brokerages if they feel they've been wronged."

8. See, for example, Securities and Exchange Commission (SEC), Division of Investment Management, "Mutual Fund Fee Structures" (Guidance Update No. 2016-06, December 2016). Provided guidance regarding "focused on disclosure issues and certain procedural requirements with offering variations in Fund sales loads and new Fund share classes" in response to the DOL's fiduciary rule; Response of the Chief Counsel, Division of Investment Management, SEC, to the Capital Group Companies, January 11, 2017. Approved "clean shares" to facilitate compliance with the DOL's fiduciary rule.

II. THE ECONOMIC ANALYSIS UNDERLYING THE FIDUCIARY RULE IS FLAWED

In February 2015, the Obama administration’s Council of Economic Advisers (CEA) issued a report, “The Effects of Conflicted Investment Advice on Retirement Savings,” in support of the effort by the DOL to impose fiduciary standards on the giving of investment advice for IRAs and other tax-advantaged accounts.⁹ Soon thereafter, the DOL itself released a regulatory impact analysis (RIA) repeating many of the findings and inferences made by the CEA, in support of the proposed regulation, which was put in place in 2016. These reports were basically a review of academic studies, and—through some stretches of logic and extrapolation—the CEA claimed that about \$17 billion each year was lost to investors because of conflicted advice. This advice, according to the CEA, causes wrong fund selections, excess trading, and other investment errors, and it is self-serving to financial advisers because it is generated by inappropriate forms of compensation paid to them, such as loads and commissions. Indeed, as noted above, the DOL fiduciary rule appears to be intended to lead to changing adviser compensation to be based on a percentage of assets under advisement.

The CEA estimate has been widely cited and is thought to be influential in the case made for the DOL fiduciary rule. Yet, review, analysis, and the introduction of new data reveal that the CEA report is quite weak and should not serve as the basis for such an extensive remaking of the structure of the financial services and retirement industries.

The CEA defines conflicted advice as occurring when payments to the adviser depend on actions taken by the investor—in particular, when they are encouraged through arrangements such as revenue sharing, front-end and back-end loads, and commissions that vary by type of product. It claims that, per se, these arrangements lead to lower returns to investors, by 100 basis points, applied to \$1.7 trillion in supposedly affected fund assets in IRAs. Although the CEA cites several studies, it is mostly relying on two studies by Daniel Bergstresser et al. (2009) and Christoffersen et al. (2013).¹⁰

Bergstresser et al. compares the performance of funds sold through intermediaries with that of funds sold directly to investors over the period 1996–2004. The CEA says that Bergstresser et al. finds that funds sold through intermediaries—who the CEA says are more likely to be conflicted—deliver lower returns, net of operating expenses and adjusted for risk through a complex factor model, on an asset-weighted basis, by 77 basis points for domestic equity funds and 90 basis points for bond funds. Yet, the same analysis finds that broker-sold international equity funds outperform directly sold funds by 183 basis points. It is unclear and concerning why intermediation would lead to different results in different investment classes. Moreover, when the calculations are done in a simpler manner that avoids estimation errors and is like

9. See Executive Office of the President of the United States, “The Effects of Conflicted Investment Advice on Retirement Savings,” February 2015.

10. See Daniel Bergstresser, John M. R. Chalmers, and Peter Tufano, “Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry,” *Review of Financial Studies* 22, no. 10 (2009): 4129–56; and Susan E. K. Christoffersen, Richard Evans, and David K. Musto, “What Do Consumers’ Fund Flows Maximize? Evidence from Their Brokers’ Incentives,” *Journal of Finance* 68, no. 1 (2013): 201–35.

how other studies of this nature are done—just controlling for benchmark category and not using a factor model—the underperformance is much smaller: 27 basis points for domestic equity, 34 for bonds, and -145 for foreign equity.

Christoffersen et al. examines only load funds over the period 1993–2009 and connects the magnitude of payments an intermediary receives for selling a particular mutual fund to inflows and underperformance. Comparing flows for mutual funds with “outlier” (unusually high or low) payments to intermediaries, Christoffersen et al. find that initial inflows are larger for funds with high payments. It finds funds with unusually high payments to intermediaries tend to generate unusually low returns, controlling for fund category—in particular, “the average 2.3% payment to unaffiliated brokers corresponds to a 1.13% reduction in annual performance.”¹¹ Christoffersen et al., however, does not find this effect for brokers affiliated with the mutual funds they are selling or for revenue sharing. Because the estimated effect is just for a segment of the market, is just for initial inflows (not net flows over time), and is not clearly asset weighted, it is not correct for the CEA to extrapolate from this study’s results to the entire \$1.7 trillion IRA brokered funds market.

Moreover, it seems that the DOL’s RIA made a mistake in its use of the Christoffersen et al. study results by multiplying average positive loads on funds by the coefficient of an equation estimated on outlier load payments, which average to zero. The loss to investors therefore is likely to be quite small, based on the correct calculation.

There are several other fundamental problems of interpretative logic and extrapolation that apply to the use of these and similar studies cited by the CEA. First, the studies generally are based on data from an earlier time period, when fund markets were more segmented between broker-sold funds and funds sold without loads directly to investors, and other competing low-cost investment types, such as ETFs, were not common. More recently, an increasing proportion of funds with front-end loads also offer no-load share classes, so there is more awareness of sales costs and, therefore, more competition.

Also, according to National Economic Research Associates (2015), since 2000, expense ratios across all types of funds, by investment and management categories, have dropped significantly; the average front-end load that investors pay also has declined, while nearly all net new cash flow is going to no-load funds.¹² According to the Investment Company Institute (ICI) (2015), based on sales-weighted return (net of expenses, adjusted for benchmark category) data from 2007 through 2013, investors in front-end load shares underperform investors in retail no-load shares by only 21 (one-year return basis) or 6 basis points (three-year return basis).¹³ Moreover, most of the studies used by the CEA in arriving at a 100 basis point average underperformance are not asset weighted.

11. Christoffersen, Evans, and Musto, “What Do Consumers’ Fund Flows Maximize?,” 228.

12. See Jeremy Berkowitz, Renzo Comolli, and Patrick Conroy, “Review of the White House Report Titled, ‘The Effects of Conflicted Investment Advice on Retirement Savings’” (NERA Economic Consulting, March 15, 2015).

13. See Investment Company Institute, letter to the Department of Labor regarding RIN 1210-AB32: Regulatory Impact Analysis, Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, July 21, 2015.

Second, the estimated effects in these studies are “reduced form,” and not “structural.” To evaluate the impact of a change in regulations on market prices and quantities, we need to know the equations for the demand function and the supply function separately (structural) in order to do an economic analysis of policy. But the studies cited by the CEA are reduced form, in that they do not separate out the independent and complete effect of conflicted advice on investment performance; there is no structural model containing the separate supply and demand equations determining price and quantity for advice of different kinds. Such a structural model would be made up of variables explaining fund construction, marketing, different market segments, different forms of adviser compensation, and so on. For example, perhaps the estimated underperformance of load funds is actually payment to the broker for the discovery of new, initially smaller, funds that will eventually have higher returns, or for the tailoring of portfolios to the specific risk preference and personal financial and tax conditions of investors. Admittedly, estimating a structural model is an ambitious project, often requiring instrumental variables and other econometric techniques, yet it is possible to do so, as evidenced by their use in other areas of economic policy analysis, such as monetary, labor, and public finance.

As just stated, none of the studies are directly relevant to the policy question at hand—whether the imposition of a fiduciary standard of the specific type put forward by the DOL will improve investment performance. In fact, it is distinctly possible that the opposite is true—the new fiduciary standard will increase investment costs and thereby worsen performance if asset-based fees become widespread. This is the third problem of interpretation and extrapolation. In particular, consider the comparison done by the ICI (2015).¹⁴ The average asset-based fee that investors incur when they pay a financial adviser directly is currently 111 basis points. By contrast, IRA investors currently pay between 26 and 28 basis points per year in front-end loads and another 24 basis points for the average 12b-1 fee paid to the broker—about 50 basis points total. Although there are many assumptions in these calculations, including rebalancing frequency, and conditions will change in unknown directions after the regulation is in place, a conservative assessment based on current market conditions and practices implies a decidedly negative impact of the fiduciary standard rule on investment costs and net performance.

Fourth, alternative, less intrusive, forms of government intervention, such as enhanced disclosure, need to be considered and even tried before more massive interventions are imposed. Because of the structure of Social Security and the tax code, most IRA holders are in households with middle incomes and higher. These individuals are generally well educated or experienced, and they presumably would be in good positions to benefit from better disclosure of the cost and nature of the compensation paid to financial advisers involved with their IRAs.

Fifth, it is distinctly possible that for certain segments of the market—smaller accounts, more complex financial situations, and so on—advice from investment advisers will simply disappear. The rules applying to the best interest contract exemption in the regulation for conflicted advice and allowing the continued use of commissions are limiting, burdensome, and—perhaps

14. Investment Company Institute, letter to the Department of Labor, 25–26.

more importantly—exceedingly vague.¹⁵ Therefore, this carve-out represents a constraint, cost, and considerable risk to large brokerage firms in the current litigious class-action environment.

The likely consequence of the DOL regulation (and indeed perhaps its real intention) is that most investment advice will be compensated mainly on the basis of percentage of assets. Yet this causes small and difficult retirement investment accounts to be unprofitable to advisers, who will have an incentive to avoid such accounts. This indeed seems to be happening in late 2016 and early 2017, as some brokers reportedly are dropping small accounts entirely or shunting them to robo-advisers and other do-it-yourself forms of investments.

Similarly, because the finalized DOL rule classifies advice on rollovers from an employer-sponsored plan to an IRA as fiduciary advice, even level-fee investment advisers have to comply with a streamlined best-interest contract that requires acknowledging fiduciary status and documenting why the rollover is in the best interest of the client. The documentation must take into account the difference in fees and services between the employer-sponsored plan and the IRA. Because of the increased compliance procedures and potential difficulty in justifying a rollover, it is reasonable to believe that more assets will stay in employer-sponsored plans like 401(k)s, particularly for small accounts.

Whether these induced changes will lead to better or worse investment and retirement savings outcomes for lower-income individuals is unknown, but the changes are clearly not what the market would have produced in the absence of the new regulation. Moreover, this approach of heavy government intervention picks winners and losers in the investment provider marketplace. It is welfare decreasing to those small account holders who prefer and even need personal advice and service and would have liked to consolidate all of their retirement accounts in one location.

III. CONCLUSION

The DOL should embrace the opportunity afforded it by the presidential memorandum to reconsider the fiduciary rule. The 2015 CEA report that DOL and others have used to justify the DOL fiduciary rule is a weak and exaggerated analysis of the academic studies and data on the performance of conflicted advice funds. Moreover, the rule itself will not necessarily have a positive impact on the retirement savings of Americans and is hugely disruptive to established financial and retirement industries. If there is evidence for significant confusion and misinformation about the compensation of financial advisers among investors, then the appropriate solution may be improved disclosure, rather than this massive government intervention. Any regulation in this area should be coordinated closely with the SEC, which has a broader understanding of and longer experience with regulating financial products and services.

15. For example, what is “reasonable compensation”? Does “prudent advice in the investor’s best interest” mean the adviser needs to know, say, the detailed health profile of the advisee? Must the adviser produce a comprehensive balance sheet of all of the advisee’s assets and liabilities?