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Good Intentions Gone Wrong: The Yet-To-Be-Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule

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Abstract: *The Department of Labor (DOL) fiduciary rule has been justified based on economic analyses by the DOL and the Council of Economic Advisers (CEA) that are flawed and filled with internal contradictions. These flaws come mostly from "cherry picking" and misreading the relevant economic literature, and from ignoring significant costs to millions of small savers that the rule would impose.*

These costs come largely from (1) small savers losing access to human financial advisors (because small accounts would become uneconomic to serve, and expose advisory firms to new liability risks), (2) small savers being forced into fee-based advisory relationships that cost more than current commission-based arrangements, and (3) small savers and firms not being encouraged to save more, take full advantage of employer matches, or create retirement plans in the first place.

The DOL's Regulatory Impact Analysis (RIA) thus concludes erroneously that the net benefit of the rule would be roughly $4 billion per year (the CEA, making related errors, pegs the benefit at $17 billion). A conservative assessment of the rule's actual economic impact—taking into account the categories of harm noted above that are ignored by DOL and CEA—finds that the cost of depriving clients of human advice during a future market correction (just one of the costs not considered by DOL) could be as much as $80 billion, or twice the claimed ten-year benefits that DOL claims for the rule.

A conservative assessment of the rule's economic impact--taking into account the categories of harm that are ignored by DOL and CEA--finds that the cost of depriving clients of human advice during a future market correction could be as much as $80 billion.

In fact, the decision to stay invested (or not) during times of market stress swamps the impact of all other investment factors affecting long-term retirement savings, including modest differences in advisory fees or investment strategies. "Robo-advice," which the DOL assumes will over time replace human advisors who find it uneconomic to serve small savers under the new rule, cannot effectively perform this critical role. (An email or text message in the fall of 2008, for example, would not have sufficed to keep millions of panicked savers from selling, with devastating consequences for their nest eggs). In effect, the DOL rule wagers the welfare of millions of Americans on the mistaken notion that ending commission-based compensation is better for small savers than assuring them continued access to human financial advice through an affordable and time-tested model.

At a more technical level, the RIA claims (based on flawed assumptions) that the annual benefit from its rule would be $4 billion per year. A conservative reckoning of the same calculation, taking account of the harms overlooked by DOL, however, finds the rule would actually impose net yearly costs of $2 to $3 billion (on the average ten year base of retirement assets). The loss of brokerage advice alone could adversely affect up to 7 million people.

A less costly alternative that would meet the DOL's objectives would be to require enhanced but simple disclosures relating to brokers' compensation from companies sponsoring investment products they sell. The Department's only basis for rejecting this idea is a claim made without any empirical support that investors could not process this additional information if it were made available. This is an extremely slim reed upon which to base an entire rule that could radically change the way investment advice is provided in a $1 trillion segment of the mutual fund market. How can the Department know the efficacy of greater disclosure, without at least first giving enhanced disclosure in the retirement savings context at least a

try? In the end, if it is open to fact-based adjustments in its approach, the DOL will have set in motion a reform process that establishes new protections for small savers without disruptions that would unintentionally harm those it seeks to help.

While regulatory law and best practice generally require less costly alternatives to be pursued, there are also practical reasons for the DOL to take this course. Because of the disruption to the industry that the rule as written will bring—including a forced overhaul of the entire internal compensation systems of brokerage/advisory firms, and massive new paperwork and contracting requirements for millions of clients, under an impractical eight month deadline—the likely result will be an implementation nightmare. Among other things, millions of small savers may be surprised when they are notified in 2016 that new Obama Administration rules mean they are being dropped by longtime advisors, or forced to pay much more via fee-based accounts in order to keep them.

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EXECUTIVE SUMMARY

To paraphrase a well-known adage, the road to a bad place can be paved with good intentions. Such is the case with the Department of Labor's ("DOL") proposed rule that would impose fiduciary obligations on securities brokers and financial advisors providing advice for individual retirement accounts ("IRAs").

Currently, brokers and advisors providing retirement advice must comply with requirements of the Securities and Exchange Commission ("SEC") that their recommendations be "suitable" for investors, taking account of their income, assets, and expressed risk preferences or tolerances. A fiduciary standard would treat brokers and advisors as the functional equivalent of attorneys and physicians, and is being proposed specifically to reduce the costs of supposed "conflicted advice" from brokers and advisors who are compensated by providers of mutual funds and other retirement asset vehicles in ways the Department argues are not fully understood by investors.

The Department's proposal and its accompanying Regulatory Impact Analysis ("RIA") use a variety of assumptions to estimate that this cost reduction—due to an assumed reduction of fees on mutual funds with front-end loads, which are purportedly linked to an underperformance in investors' retirement portfolios—will be roughly $4 billion annually over a ten-year horizon beginning in 2017.[2] Subtracting additional compliance costs of a minimum of $240 million annually, the net benefits claimed for the DOL rule come to approximately $3.76 billion annually, or about 25 basis points (0.25 percent) on an assumed ten-year average investment base of $1.478 trillion.

This study shows that the DOL's benefit estimate (in reality more of *assumption*, than an estimate) is seriously overstated. As demonstrated in Part IV, the alleged underperformance associated with broker-sold funds identified by the RIA in the literature *disappears*—that is, is converted to over-performance—when one shifts from domestic to foreign equities. In addition, changing the time period under study can lead to different results. Accordingly, the empirical foundation upon which the DOL's proposed rule rests is shaky at best.

Like the RIA, a companion study by the Council of Economic Advisers (CEA) selectively cites the academic literature in support of its claim that IRA investors suffer underperformance of 100 basis points per year due to "conflicted advice."[3] The CEA assumes that typical 401(k) plan investors pay fund expenses of only 20 basis points, but that investors pay 130 basis points in fund expenses after they roll their assets over to an IRA. But data from the Investment Company Institute show the real difference in fees is a mere 17 basis points, which casts doubt on CEA's $17 billion cost estimate (to the extent this cost

2. Fiduciary Investment Advice: Regulatory Impact Analysis, Apr. 14, 2015, at 116, Table 3.4.2-1 [hereafter *Regulatory Impact Analysis*], *available at* http://www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf.

3. CEA, *The Effects of Conflicted Investment Advice on Retirement Savings*, (Feb. 2015), *available at* www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

estimate is derived from the fee differential). [4] Moreover, CEA uses an asset base of $1.7 trillion by which to multiply an (inflated) 100 basis points, when the relevant base of assets affected by the proposed rule according to the DOL's study is roughly $1.5 trillion (the average base of IRA investments in mutual funds with a front-end load between 2017 and 2026). It bears noting that the RIA does not rely on the CEA $17 billion estimate to arrive at its $40 billion benefit (over ten years) from the proposed rule, but instead relies on an assumption that its rule would accelerate the decline in load shares paid to brokers, which purportedly are linked to underperformance. Despite the lack of credibility of the CEA's $17 billion estimate and its distant relationship to the RIA's analysis, the figure is still cited by the DOL as a basis for why "the stakes could not be higher" for the government to rewrite the rules governing the retirement investment advice market.[5]

At the same time, the RIA (like the CEA) fails to give proper credit to evidence indicating that its rule would induce brokers either to back away from potentially millions of individuals with modest retirement portfolios ("small savers"), or instead continue to serve them only by charging on a percentage-of-asset ("wrap fee") basis. The DOL has tried to cushion the blow by creating exceptions to its proposed rule called Best Interest Contract Exemptions ("BICE"), which the Department claims will continue to allow brokers to serve clients on a commission basis.[6] But the requirements to qualify for a BICE are so onerous and unworkable that it is unlikely that many brokers will seek an exemption.

We show here that if brokers leave the small-saver segment—as many would because the proposed rules makes it uneconomic for brokers to serve them without charging commissions—their clients would be deprived of multiple benefits that brokers now provide to them. Cumulatively, just these two of broker-provided benefits—coaching to stay invested through market downturns, and assistance in portfolio rebalancing—conservatively total 44.5 basis points annually (see Table 1 below), enough to outweigh the DOL's claimed 25 basis point benefits for its rule, and to even more substantially outweigh a more accurate, lower accounting of the rule's claimed benefits. Advocates of the proposed rule assume naively that "robo advisors" will over time fill the gap so small savers will continue to be advised; but as this report shows, emails and tweets from a robot will not prevent an investor from selling in a panic, and the value of that human interaction during periods of market stress will swamp anything else a small saver does with respect to outcomes and retirement security.

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4. Statement of Investment Company Institute, Brian Reid, Hearing on Restricting Access to Financial Advice, June 17, 2015, at 7 [hereafter *ICI Study*].

5. Statement of Thomas E. Perez, Secretary U.S. Department of Labor Before the Health, Employment, Labor and Pensions Subcommittee Committee on Education and The Workforce U.S. House of Representatives, June 17, 2015, *available at* http://Edworkforce.House.Gov/Uploadedfiles/Testimony_Perez.Pdf.

6. Proposed Best Interest Contract Exemption, Apr. 20, 2015, *available at* http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=28202&AgencyId=8&DocumentType=1 [hereafter *BICE Proposal*].

TABLE 1: FORGONE BENEFITS OF BROKER ADVICE

(ESTIMATED COST OF THE RULE IN ANNUAL BASIS POINTS)

Benefit	Low End	High End	Midpoint	Source
Avoidance of Timing	0	54	27	Vanguard
Rebalancing	0	35	17.5	Vanguard
TOTAL			44.5	

The foregone benefits (or cost) estimates shown in Table 1 conservatively exclude additional benefits attributable to brokers that are ignored by the RIA: documented encouragement to increase savings or to take greater advantage of employer matching plans, and other non-pecuniary benefits. Because these benefits are not easily quantifiable in terms of basis points, they are not included in the table, but they are nonetheless real and should not be dismissed (and they serve to make the quantified estimates above more conservative).

The second broker reaction, turning to the wrap-fee business model, would clearly increase investor costs relative to the commission model (especially for existing small long- term investors), an outcome that the RIA fails to consider. For those clients who are driven to sign up for advisory services under the wrap–fee model, the added cost is estimated here to be 31 basis points per year, which also exceeds the RIA's purported 25 basis point benefit from the DOL rule.

Importantly, our cost estimates conservatively also do not take into account of the prospect that fewer new companies—particularly among small firms that cannot afford to implement a 401(k) program—would create SEP or SIMPLE IRAs, and thus fewer individuals would have access to this kind of savings account.[7]

To get a handle on the *dollar levels of net harm* (as opposed to harm expressed in basis points) imposed by the rule, consider the following example. Assume conservatively that the only assets that are affected by the rule are the $1.487 trillion average base of IRA investments in mutual funds with a front-end load between 2017 and 2026. (In reality, the costs of the rule would be felt by investors who rely on broker assistance without the use of a front-end load.) Assume further that half of investors (on a dollar-

7. Bradford P. Campbell, U.S. Chamber of Commerce, Locked Out of Retirement: The Threat to Small Business Retirement Savings, June 2015, *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/US-Chamber-Locked-Out-of-Retirement-White-Paper.pdf ("Under the DOL's new proposal, even providing a small business with marketing materials containing sample investment lineups for SEP IRAs or SIMPLE IRAs could constitute investment advice, as could providing an individual account holder with certain educational materials that reference the specific investment funds that are available to him or her. *Consequently, small businesses may find it even harder to offer retirement plans than they do today*.") (emphasis added).

weighted basis) lose their brokers as a result of the rule, while the remaining half maintain their brokers but are forced to convert to a wrap-fee compensation model. The *net* annual harm from the rule, *taking account of the RIA's claimed benefits*, would be $1.895 billion (equal to $1.487 trillion x {0.5 x [0.445%–0.25%] + 0.5 x [0.31%–0.25%]}.

The damage from the rule could be even worse. The maximum net harm would arise if 100 percent of investors in this pool of assets lose their brokers, in which case the net investor loss would be $2.899 billion per year (equal to $1.487 trillion x [0.445%–0.25%]). At the other extreme, the minimum net harm under our model would result if 100 percent of investors in this pool maintain their brokers under the wrap-fee model, which generates a loss of $0.892 billion per year (equal to $1.487 trillion x [0.31%–0.25%]). In short, even our lower-bound estimates show that the net benefits of DOL rule are *negative*—that is, cause more harm than benefit—even if one assumes (inappropriately, we argue) that DOL's estimated benefits (without accounting for the costs we identify here) of 25 basis points is accurate.

Our results call for the DOL to go back to the drawing board, and either withdraw its proposal or develop an alternative that stands a reasonable chance of delivering more benefits than costs.

The net benefits (or harm) from the proposed rule alternatively can be understood as the portion of retirement savings in mutual funds that would have to be restrained from market timing in a future substantial market correction to offset the purported benefits of the fiduciary rule claimed in the RIA. Using an illustrative example of a future stock market downward "correction" of 25 percent, we show that brokers need to persuade IRA investors holding a mere 15 percent of IRA account dollars (0.15 x 0.25 x $1.087 trillion = $40.8 billion) to avoid timing the market in order to totally offset the $40 billion in ten-year investor savings claimed by the Department for its proposed rule. Stated differently, if human advisors persuade, roughly, just one in seven clients to stay invested through a market downturn, it totally offsets the claimed DOL rule's ten-year benefits. If instead advisors persuade two of every seven clients to stay invested through such downturns, the harm to small savers from losing this kind of human advice could reach as much as $80 billion, twice the size of the DOL's purported benefits from the rule.

Our results call for the DOL to go back to the drawing board, and either withdraw its proposal or develop an alternative that stands a reasonable chance of delivering more benefits than costs. Fortunately, one alternative clearly would more cost-effectively achieve the Department's objective to reduce the cost of "conflicted advice": enhanced, but simple disclosures relating to brokers' compensation from the companies sponsoring the investment products they may sell. The Department's only basis for rejecting this idea is a claim made *without any empirical support* that investors could not process this additional information if it were made available. This is an extremely slim reed upon which to base an entire rule that could radically change the way investment advice is provided in a $1 trillion segment of the mutual fund market. How can the Department *know* the efficacy of greater disclosure, without at least first giving enhanced disclosure in the retirement savings context at least a try? Enhanced disclosure in the

retirement context could be augmented by the proposals from SIFMA that FINRA, with the approval of the SEC, impose a "best interest of the client" standard for all brokers and advisors, in all contexts, including for retirement accounts.

The DOL and the Obama administration appear to be signaling that the exemptions could be expanded to accommodate the continuation of commissions. What apparently matters most to Labor Secretary Thomas Perez is the best-interest requirement for financial advisors.[8] If that is the case, then the DOL should call for improved, concise disclosure without a lengthy, highly prescriptive rule accompanied by a 240-page RIA (and, in doing so, the Department would be acting in manner consist with the iterative, targeted approach to information technology challenges that the Administration is to be commended for initiating throughout the federal government, as we discuss further below). The benefits from that approach implemented the right way would surely outweigh the relatively modest compliance costs, and then DOL could monitor the results in the years ahead to gauge progress.

I. THE DOL PROPOSAL AND REGULATORY IMPACT ANALYSIS: A QUICK GUIDE

The DOL oversees and sets standards, under the Employment Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC), for anyone who is paid directly or indirectly to provide advice in connection with individual or company sponsored retirement funds. Financial investment professionals, including stock brokers and financial advisors, have a responsibility to recommend investments, consistent with a client's financial status, investment objectives and experience, and risk tolerance, among other factors. The Financial Industry Regulatory Authority (FINRA) enforces this "suitability" requirement.[9]

Many brokers and advisors act as the distribution arms for mutual funds and are compensated for doing so in various ways, including sharing in sales commissions or "load shares," which the Department estimates to be 150 basis points in 2013, falling over time *even without the proposed rule* to 103 basis points by 2026.[10] The Department is apparently not satisfied that these commissions are falling fast enough.

Brokers and advisors are allowed to be compensated by providers of investment products under one of many "Prohibited Transaction Exemptions" (PTEs) established by the Department, or if they do not meet one of the five tests established by the Department by rule in 1975 for defining a fiduciary. The key elements of this test are that the investment advice be given on a regular basis, is customized to the particular circumstances of the client, and that the advice serves as the primary basis for a client's investment decisions.

8. Jaret Seiberg, Guggenheim Securities, Quick Hit: Perez Leaves Door Open for Changes to Fiduciary Plan, June 17, 2015 ("We believe Labor Secretary Perez opened the door for important changes to his fiduciary duty proposal as long as it preserves the best-interest requirement for financial advisors to retirement accounts.").
9. For a summary see http://www.finra.org/investors/suitability-what-investors-need-know.
10. *Regulatory Impact Analysis,* at 113, Table 3.4.1-1.

The Department notes that much has changed in the retirement market since 1975, including the huge increase in assets invested in IRAs and company-sponsored defined contribution ("DC") retirement plans. Financial products have grown increasingly varied and complex. Many individuals investing in retirement accounts do not have investment expertise and are unable to judge who does, the DOL fears, and are not aware of how advisors are compensated.

In 2010, the Department responded to these developments by proposing a more expansive application of fiduciary standards to all retirement investment advisors, but withdrew them after strong opposition. In April 2015, the Department issued a modified version of its 2010 proposal, which excluded certain types of conduct and transactions from fiduciary obligations, but which nonetheless did little to change the core features of the 2010 proposal, which subject to one qualification to be discussed shortly, is designed to prohibit brokers and advisors from receiving any form of compensation from the sponsor of any investment product they might recommend—what the Department calls "conflicted advice"—regardless of the product's past performance.

The Department has concluded that this change in the legal standard is warranted for several reasons:

- IRA (and presumably DC) plan investors deserve special protection because there are no "do-overs" when it comes to retirement investing and drawdowns.

- There is an alleged failure in the market for investment advice, arising from the fact that mutual funds compensate brokers and some investment advisors via load shares when individuals purchase their funds from the brokers or advisors. The Department's RIA calculates that this "conflicted advice" costs investors in load funds $8 billion a year.

- Disclosure of the sources of advisors' compensation is insufficient to offset the market failure, based on purported evidence (drawn from a single experimental study) that investors have little understanding of the nature of their advisors' conflict of interest, and even if they understood this, many investors cannot distinguish good advice from bad.

Accordingly, the Department has proposed to effectively replace mandated disclosures with a broad fiduciary obligation on all brokers and advisors providing investment advice regarding retirement plans.

The proposal contains a number of exemptions, including a "Best Interest Contract Exemption" ("BICE") that would allow brokers and advisors to receive commissions and 12(b)-1 fees from mutual fund companies, but at the same time agree to submit to a series of other requirements, including the clear recognition that they are acting as fiduciaries and agree to charge "reasonable fees", a vague open-ended obligation with seemingly no bounds.[11]

11. The BICE would create a contract-based claim against broker-dealers, which could give rise to a private right of action. The DOL has no enforcement jurisdiction in this space, so its proposal effectively seeks enforcement through private (most likely class action) litigation. As discussed above, FINRA currently enforces the suitability rule. As discussed further in Part V below, FINRA (or some combination of FINRA and the SEC) could enforce something similar to a best-interest standard.

The RIA *assumes* that the application of its new, revised fiduciary standard would eliminate half of the annual $8 billion in claimed under-performance of broker-sold mutual funds with an up-front load relative to load funds sold directly. The RIA comes to its annual $4 billion benefit (half of the potential benefit) by first estimating a "baseline" broker load share, beginning at 134 basis points in 2017 and falling due to increased competition to 101 basis points in 2027. In other words, the RIA estimates, *even without the Department's proposed rule,* that the load share earned by brokers on the mutual funds they sell is projected to decline by 33 basis points over the next decade, beginning in 2017.

So where do the benefits from the proposed rule come from? Based on its reading of the relevant academic literature, which we criticize in Part IV below, as well as original econometric analysis, the RIA concludes that a 100 basis point increase in broker load shares leads to 50 basis points of *under-performance*.[12] The reasoning for the apparent relationship between load shares paid to brokers and under-performance of broker-sold funds is that the load induces brokers to recommend only the funds for which they are compensated (the presence and amount of this compensation is also unknown to the investors), and these funds turn out to systematically under-perform. By eliminating this alleged bias in recommendations through the proposed fiduciary standards rule, over a decade, the RIA argues that all current IRA and defined contribution investors will eventually move to funds with the performance characteristics of funds directly sold by the mutual funds. The RIA also implicitly assumes that while this is happening, brokers will continue to serve all segments of the retirement investment advice market, including small savers.

Table 3.4.1-1 of the RIA suggests that its calculated improved performance differential, which starts out at 10 basis points, eventually will grow to 51 points in ten years, as currently held IRA and defined contribution funds move to the better performing funds. In other words, the RIA believes that it will take a decade before the allegedly contaminated funds work their way out of the investment pipeline. In dollars, the improved performance averages $4 billion annually over the ten year period, which on a ten-year average investment base of 1.487 trillion, minus the a minimum of $240 million in compliance costs, turns out to represent an annualized benefit of roughly 25 basis points or 0.25 percent (equal to $3.76 billion divided by $1.487 trillion).

This study will show that the RIA's benefit estimate is considerably overstated, and moreover does not take account of the even greater costs to investors from either losing access to their current broker because of the rule, or moving to an investment advisor compensated on a more expensive wrap fee basis.

Moreover, as we discuss further below, the Department seems to want to have it both ways with the BICE. On the one hand, it seemingly wants to permit brokers to continue their current compensation

12. It bears noting that one of the studies relied upon by the DOL to document this alleged under-performance finds that broker-sold mutual funds *over*-performed the benchmark for certain classes of funds such as value-weighted foreign-equity funds. Even more significant, the Investment Company Institute finds that the under-performance assumption is reversed when a more recent study window, 2007-2013, is used. See Testimony of Brian Reid before the Subcommittee on Health, Employment, Labor, and Pensions of the House Committee on Education and the Workforce, June 17, 2015, at 3. We offer a more detailed rebuttal of the academic papers upon which DOL relies in Part IV, *infra*.

arrangements so that they will not abandon the small-saver segment of the retirement market, as a 2011 Oliver Wyman study argued in response to the Department's earlier 2010 proposal. On the other hand, it argues throughout the RIA that the only source of quantifiable benefits of the proposal is improved investment performance by clients who gradually move their accounts away from broker-sold load funds, which presumably comes about because the proposed rule eliminates such forms of compensation. The Department cannot have it both ways: either the rule will lead to substantial diminution of broker services to the small saver segment, or the Department will not deliver the benefits the RIA claims for the rule.

The rest of this report is organized as follows: In Part II, we provide a brief background on how brokers are compensated for rendering valuable services. In Part III, we explain how many brokerage firms would likely react to the DOL's proposed rule, either by exiting the segment of the IRA market represented by individuals with modestly sized portfolios, or by switching to a fee-based advisory model for these investors. In Part IV, we estimate the multiple costs to middle-income savers from reduced choices in investment advice resulting from the DOL's proposed rule not considered in the RIA. Part V outlines a less burdensome approach that would much more cost-effectively achieve the DOL's policy objective.

II. BROKERS AND FINANCIAL ADVISORS PROVIDE VALUABLE RETIREMENT SAVINGS SERVICES TO MIDDLE INCOME SAVERS THAT THE PROPOSAL AND ITS REGULATORY ANALYSIS FAIL TO CONSIDER

Over the past four decades or so, middle-income Americans have turned predominantly to tax-deferred investment accounts, either on their own (IRAs), or through company-sponsored defined contribution (DC) plans to save for retirement. When individuals leave their firms or retire from them, they often "roll over" their balances into the IRA accounts. About half of all IRA account balances include some rollover funds.[13] According to a 2011 Oliver Wyman study, 89 percent of IRA assets were held in "traditional IRAs," which includes both contributory and rollover IRAs.[14]

The RIA and accompanying documents on the DOL's website make clear that savers for retirement rely on multiple sources of advice for how to invest their funds.[15] About half rely on family and friends or the Internet, but about the same number rely on paid investment advice from broker-dealers or registered investment advisors, the two groups of professionals whom the RIA acknowledges would be most be affected by its proposed fiduciary standards rules.[16] Despite nodding to the potential impact of the rules on the supply of broker-related services, the RIA largely discounts these effects, and essentially assumes

13. *Regulatory Impact Analysis* at 54 ("Rollovers from employment-based plans account for most IRA funding. Almost half of all IRAs include at least some rollover funds.").

14. Oliver Wyman, Assessment of the impact of the Department of Labor's proposed "fiduciary" definition rule on IRA consumers, Apr. 12, 2011, at 9 (Figure 5).

15. *Regulatory Impact Analysis*, at 53.

16. *Id.* at 55 ("Depending on a RIA's particular customer base and business and compensation model, it may be materially affected by this rule."). We discuss this adverse impact on both brokers and RIAs, and their customers, more fully in the text below.

that brokers continue providing advice to the same clientele as before, but without the conflicts that allegedly lead to their clients to invest in under-performing mutual funds. Before documenting this oversight and critiquing the conclusion about under-performance, we briefly review how brokers are compensated and the nature of their services.

A. Background on How Brokers Are Compensated for Rendering Valuable Services

There are two primary IRA business models that serve individuals with IRA savings accounts: (1) advisory IRAs, which offer continuous advice such as investment-specific advice, portfolio monitoring, and account surveillance; and (2) brokerage IRAs, which involves non-continuous help and investment services with regular access to a broker (for full-service brokerage IRAs) or limited personal contact (for discount brokerage IRAs).[17] Importantly, fees on advisory IRA accounts are almost always structured as a "wrap" fee—that is, the client is charged annually a percentage of his or her account assets. In contrast, brokerage firms are compensated through transaction-specific direct commissions, annual account fees, and various "indirect" sources of compensation (such as marketing and distribution fees, so-called 12(b)-1 fees, paid by mutual funds). Discount brokerage firms get paid the same way as full-service brokers, albeit with reduced fees.

According to the RIA, 41 percent of IRA account holders hold their funds with broker-dealers; for those with portfolios of $10,000 or less, 32 percent have their accounts with brokers.[18] A Deloitte 2014 study, which is posted on the DOL's website announcing the proposed rule and the RIA, indicates that 43 percent of survey respondents' IRAs were held in a brokerage; the study does not provide detail on the type of compensation used.[19]

Brokers provide myriad benefits to investors, including advice relating to broader diversification and risk reduction. The economics literature recognizes that investors voluntarily and knowingly pay fees in exchange for these benefits.[20] Most importantly, brokers prevent investors from engaging in market timing; they assist investors in rebalancing their portfolios; and they encourage clients to fully exploit

17. Oliver Wyman, Assessment of the impact of the Department of Labor's proposed "fiduciary" definition rule on IRA consumers, Apr. 12, 2011, at 6.

18. *Regulatory Impact Analysis*, at 53 (Figure 3.1.1-3).

19. Advanced Analytical & Deloitte, Financial Asset Holdings of Households in the United States, 2014 Update, Table 7, Oct. 13, 2014, *available at* http://www.dol.gov/ebsa/pdf/conflictsofinterestreport3.pdf. The other types of institutions where respondents' IRAs were held include commercial banks (45.7 percent), savings loan/bank (2.1 percent), Credit Union (1.4 percent), Insurance Company (1.5 percent), and Investment/Management Company (0.8 percent).

20. *See*, *e.g.*, Kihn (1996) (demonstrating that mutual funds fees are at least partly explained by a desire on the part of investors for customer service); Chalmers & Reuter (2014) (showing that savers are more likely to seek broker recommendations when they have lower levels of financial literacy); Del Guercio & Reuter (2014) (nearly all mutual fund shareholders indicate that they have had contact with their financial advisor in the prior 12 months, and that they have been receiving investment advice from this advisor for a median of 10 years); Gennaioli, Shleifer & Vishny (2014) ("broker clients may rationally accept lower expected returns in exchange for the broker services they perceive as higher quality, such as the personal trust that comes from repeated face-to-face contact").

their employers' matching programs. The benefit relating to avoiding market timing is paramount in terms of the impact on investment outcomes; whether an investor stays in or not over long time frames swamps the effects of everything else.

In Part IV, we document and attempt to quantify these benefits that brokers and advisors provide, including encouraging their clients to save more than they otherwise would (that is, the potential cost of the rule).[21] Many of these benefits are pecuniary in that they manifest in higher returns for the investor or higher savings. Others, such as piece of mind, are non-pecuniary, but could still justify a fee or even a lower return.

B. The DOL's Proposal Fails to Consider Multiple Benefits Provided by Brokers and Advisors

By narrowly focusing on their compensation arrangements from mutual fund providers, the DOL's proposed rule and the RIA ignore multiple benefits that broker-dealers and registered investment advisors bring to clients. The RIA casually dismisses these benefits: "Although we acknowledge the possibility that factors other than conflicts of interest could be at play, we do not find enough compelling evidence or justification to challenge our conclusion."[22] The Department needs to look harder.

The RIA acknowledges that the brokers deserve "fair compensation" for their services.[23] The report also acknowledges some support in the academic literature for the idea that at least of some of brokers' fees "can be interpreted as fair payment for financial services that yield consumer benefits other than improved investment performance."[24] But without any empirical justification, the RIA goes on to assert that none of this challenges "the robust evidence" that investors "do not understand the cost of their advisor's services and cannot determine whether the value of those services … outweighed their cost."[25]

Moreover, the RIA is completely silent on the well-documented finding that brokers encourage their clients to save and they are successful at doing so.[26] The report also ignores the findings that brokers

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21. *See, e.g.,* Daniel Bergstresser, John Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22(10) REVIEW OF FINANCIAL STUDIES 4129-4156, 4131 ("Brokers may help their clients save more than they would otherwise save, they may help clients more efficiently use their scarce time, they may help customize portfolios to investors' risk tolerances, and they may increase overall investor comfort with their investment decisions."). *See also* LIMRA, Advisors Positively Influence Consumers' Behavior and Sentiment Toward Preparing for Retirement, July 11, 2012, *available at* http://www.limra.com/Posts/PR/News_Releases/LIMRA__Advisors_Positively_Influence_Consumers__Behavior_and_Sentiment_Toward_Preparing_for_Retirement.aspx?LangType=1033 (showing that consumers who rely on financial advisors are more likely to be saving in a retirement plan and to be saving at a higher rate than those without an advisor).

22. *Regulatory Impact Analysis*, at 22.

23. *Id.* at 97 ("Also as discussed earlier, however, available evidence suggests that only a fraction of the performance gap can be attributed to fair compensation for services.").

24 *Id*. at 94 (citing Foerster et al (2014)).

25 *Id.* at 94.

26. *See* Part IV, *infra*.

help reduce investors' tendency to under-diversify in local stocks by overcoming the home-bias effect.[27] The RIA instead infers that because broker fees involve "opaque and complex structures," broker compensation must be unfair. While such a fact pattern (if true) gives rise to the possibility of unfair pricing, it is merely a necessary condition, not a sufficient one, for adopting a rule that, in practice, would make the brokerage commission-based business model uneconomic when serving many investors, especially those with modest retirement portfolios. In any event, any alleged "unfairness" of the brokerage relationship is unrelated to the issue of whether brokers offer valuable services to their clients, which the RIA does not even attempt to itemize, let alone quantify.

The Department's RIA fails to provide any analysis or estimates of the benefits of the human advice that brokers and financial advisors compensated on a commission basis provide. And the bases on which the RIA dismisses these benefits are flimsy at best:

- ***Overcoming Behavioral Quirks***: The RIA cites a single study by Mullainathan et al (2012) for the proposition that brokers fail to prevent investors from behavioral quirks, and if anything make them worse.[28] The authors of this unpublished working paper concede that their results "are intriguing, but they are also only a first step in what is a very important research area."[29] We cite contrary evidence below**.**

- ***Rebalancing:*** The RIA cites a single study by Bergstresser et al (2009) for the proposition that brokers provide investors with no help in allocating their investments across different asset classes at a given point in time.[30] Whether or not this is true, it is independent of the point that good advisors help investors *rebalance over time*. The RIA concedes that advisors offer rebalancing advice, but suggests that such advice could alternatively come from "robo-advisors"[31] or could be achieved at lower cost through a time-denominated fund.[32] The Department's speculation may well be true, but it does not dispute the fact that advisors (including brokers) provide rebalancing advice (which we later quantify).

- ***Avoidance of Market Timing***: The RIA cites a single study by Bullard et al (2008) for the proposition that load investors display significantly poorer timing than no-load investors.[33]

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27. Bergstresser*, supra*, at 4149 (finding that "broker-sold funds are more likely to invest in foreign funds, suggesting that the broker channel may somehow combat the home-bias effect, where investors appear to overinvest in local securities.").

28. *Regulatory Impact Analysis*, at 94.

29. Sendhil Mullainathan, Markus Noeth, & Antoinette Schoar. The Market for Financial Advice: An Audit Study, NBER Working Paper 17929 (2012) at 18.

30. *Regulatory Impact Analysis* at 92. Bergstresser et al (2009) define asset allocation by asking "whether brokers, in aggregate, channel money toward asset classes in a way that reflects an ability to time movements in broad market performance." Bergstresser et al (2009) at 4142. By this definition, asset allocation involves "superior market timing recommendations, shifting between stocks, bonds, and cash in advance of market moves." *Id.*

31. *Regulatory Impact Analysis*, at 231.

32. *Id.* at 102 n.196 ("For example, an advisor might recommend that an IRA investor construct a diversified portfolio by buying several mutual funds (and periodically trading to rebalance the portfolio) in circumstances where the same diversification and expected return could be achieved with less transaction cost by buying a single, internally-diversified fund that offers ongoing, internal rebalancing.").

33. *Id.* at 92.

> But this finding does not indict *broker-sold* funds, in particular, nor does it rebut the proposition that brokers do help investors avoid the dangers of market timing, and as we point later, *have incentives to do this*.

In Part IV, we estimate the value (in basis points where possible) associated with each of these benefits that are so casually dismissed by the RIA. Before doing so, we explain how the proposed rule would undermine a broker's incentive and ability to provide these benefits.

III. DOL'S PROPOSED FIDUCIARY RULE WOULD DISCOURAGE BROKERS AND ADVISORS FROM SERVING SAVERS WITH MODEST PORTFOLIOS, TO THEIR DETRIMENT

The DOL's proposed rule would greatly expand the range of conditions under which an individual who merely provides investment services in a brokerage context would be subject to ERISA fiduciary rules. Faced with this new duty for brokerage accounts, many brokerage firms would likely react either by exiting the segment of the IRA market represented by individuals with modestly sized portfolios (the "small-saver segment"), or by switching to a fee-based advisory model for these investors. The RIA dismisses the first possibility, relegating it to a "transition" problem, and ignores the second possibility entirely. We want to visit each likely response in greater detail, because clients would be adversely affected by both reactions—effects that the RIA essentially ignores.

In response to the Department's 2010 proposal, Oliver Wyman released a thorough study documenting the likely exit of brokers from the small-saver segment of the retirement investment market. Oliver Wyman estimated that because of account minimums imposed by the brokerage firms for access to advisory accounts, over 7.2 million IRAs would not qualify for an advisory account, and that 3.8 million of those accounts would not be serviced on a commission basis under the proposed rule.[34]

The RIA rebuts these conclusions by pointing to two changes from the 2010 rule that are embodied in the 2015 proposal.[35] One claim is that under PTE 86-128, brokers would be able to charge commissions, contrary to an assumption in the Oliver Wyman study.[36] It is curious why the RIA would go to such great lengths in its efforts to quantify the supposed benefits of its rule, which stem from the *induced*

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34. *Oliver Wyman,* at 2, 16-17. Advisor focus groups indicated that broker/dealers have talked about adding account minimum for first time, which would disenfranchise small investors. *See* Investment Insights Online, IBD Forum - DOL Focus, June 10, 2015

35 *Regulatory Impact Analysis*, at 223, 19 n.37.

36. To qualify for this particular exemption, however, brokers would need to supply the Department with substantial information, which could be very costly, although the RIA contains a footnote saying these information conditions do not apply to IRAs. More fundamentally, in describing PTE 86-128, the RIA states that its "relief" only applies to a "fee to such fiduciary or its affiliate for *effecting or executing securities transactions.*" *Id.* at 18 (emphasis added). It is not at all clear that this exemption would cover the existing load paid to brokers to compensate them for the time they spend informing and discussing investment options with their clients, time which goes beyond mere "securities execution." More broadly, according to one commenter, the DOL "has historically been very narrow, slow and rigid in their PTE approach." *See U.S. Chamber of Commerce Vows to Use Every Tool Against DOL Fiduciary Plan,* THINK ADVISOR, Mar. 3, 2015 (quoting David Hirschmann, president and CEO of the Chamber's Center for Capital Markets).

disappearance of the alleged broker distortion in mutual fund choices, if the rule in fact did not prohibit commissions on the sale of load mutual funds. *Put another way, the entire evidentiary rationale for the rule thus depends on individual brokers no longer receiving commissions.*

The Department might respond to this line of argument by pointing to its BICE, which it designed to permit securities and insurance brokerage *firms* to continue receiving commissions, but which does not do so for *individual* brokers.[37] In any event, even if the BICE were more broadly construed (or changed) to cover individual brokers, then the ability of brokers to continue receiving commissions clearly would undercut RIA's empirical analysis of the benefits of the rule, which are predicated on those load-share commissions (and the alleged associated under-performance) going away.

In fact, the BICE carve-out can only be claimed if brokers agree to a series of obligations, which cumulatively mean that relatively few can reasonably be expected to do so. As one seasoned financial professional, Dean Harman, recently testified before a Congressional committee, to qualify for the BICE a broker and his firm would have to:[38]

- Enter into a contract prior to having a meaningful conversation with a potential client, even at an early stage in the process when the broker or advisor is trying to establish personal trust with the client;

- Recommend only assets on an approved list (which, like any other exemptions to Labor's rules, would be difficult to change);

- Provide very detailed disclosures which, among other things, require the broker to make performance projections for the client's investments in order to calculate projected cost ratios, a requirement that could put the DOL rules in conflict with SEC and FINRA rules prohibiting performance objections (we do not reject the idea of strengthened *simplified* disclosures, however, as discussed in Part V*, infra*);

- Provide very detailed and updated, *broker-specific*, disclosures of fees on the Internet;

- Maintain for six years very detailed, prescriptive records on, among other things, the quarterly returns for each advisor's client portfolios;

- Charge "reasonable compensation" for their efforts, without any guidance as to what "reasonable" might be;

37. Proposed Best Interest Contract Exemption, *Federal Register*, Vol, 80, No. 75, April 20, 2015, at 21971.

38. Testimony of Dean Harman (founder and managing director of Harman Wealth Management), before the Subcommittee on Health, Employment, Labor and Pensions of the House Committee on Education and the Workforce, June 16, 2015, at 15-21.

- Live under threat of litigation for failure to enforce contracts for advice, which not only fails to recognize that broker and financial advisors are already regulated by FINRA, but at a minimum will increase the cost of liability insurance for these financial professionals.

In combination, these requirements are so restrictive and potentially costly that few, if any brokers, are likely to adhere to them, especially in their dealings with smaller savers with modest portfolios, in order to receive a benefit—the ability to continue charging commissions—that also is highly restrictive, in that only *firms,* but not *individual* brokers, would be able to receive commissions. Thus, the RIA's dismissal of the Oliver Wyman estimates on the grounds that brokers can continue collecting commissions is much too facile.

More broadly, the RIA assumes naively that brokers *in the absence of a load commission* would continue serving individuals in this segment under the proposed rule. According to the RIA's prediction, investors would move over time to funds that perform more like actively managed funds sold directly. Basic economics implies that many brokers would abandon a substantial number of these small-saver clients when confronted with enhanced legal risks and costs of doing so. Thus, many of these investors would be left without investment advice when rolling over their employer plan funds into IRAs upon leaving their firms or retiring, or in making new contributions. And if investors are left on their own, how can the Department confidently claim they will move, on average, to better performing funds? Maybe that is why the RIA notes that even if the purported benefits of the rule are cut in half, they still exceed compliance costs (ignoring, as we show in Part IV below, the costs to *investors* from losing other benefits provided by brokers).

Alternatively, small savers and other IRA and defined contribution investors who are now served on a commission base could be steered (by the non-defecting advisors) into a compensation arrangement on a wrap-fee basis, charged as a percentage of their account balances. It is without question that these investors would face increased costs from doing so, costs which the RIA totally ignores.

According to Oliver Wyman, an investor's costs associated with a forced transition to the wrap-fee model would increase by approximately 75 to 195 percent, depending on the size of the investor's assets.[39] For example, for an IRA with between $50,000 and $100,000 in assets, the average cost for brokerage accounts is $230; by comparison, the average cost for fee-based accounts is $555, a 142 percent increase.[40] These higher fees would eat away an investor's retirement savings: A hypothetical 40-year old individual with $25,000 in an IRA and 25 years of saving would have an additional $24,000 (8%) of retirement savings available at age 65 under the brokerage model, in comparison to the advisor model.[41] Eight percentage points over 25 years is the equivalent of a cumulative average growth rate (CAGR) of 31 basis points (or 0.31 percent), an amount that exceeds the 25 basis points of benefits the RIA claims for the proposal.

39. *Oliver Wyman,* at 21-23.
40. *Id*. at 22.
41. *Id*. at 23.

Another illustration shows the added costs of forcing small long-term savers to switch from a commission-funded model of advice to a fee-based model. Consider a hypothetical family that invests $100,000 for the long term based on its advisor's initial recommendations and has agreed to pay an upfront commission for advice. The family members are not interested in a "higher level of service" with annual wrap fees; they just want to buy and hold. According to an analysis by the Capital Group, the cumulative ten-year cost of advice under the fee model (a 1.1 percent annual platform fee) is $18,432, whereas the comparable cost of the commission model (a maximum 3.5 percent commission fee on Class A shares with an annual 0.25 percent 12(b)1 fee) is $11,265.[42] In effect, forcing such families to convert to the wrap-fee model would cause them to pay twice for the same investments. It flies in the face of reason to punish small long-term investors in this way, when they are currently doing exactly what the DOL (and all sensible advisors) would want them to do—that is, save via quality funds for the long term at low cost because any load has been amortized and the recurring annual cost of advice is just 25 basis points. It would mean that millions of savers would be harmed by the proposed rule.

The costs to savers from DOL's proposed rule identified in this section are only the beginning. Brokers provide other sorts of valuable advice that are totally ignored in the RIA. Losing that advice would lead to the additional costs as described and quantified below.

IV. The Multiple Costs to Middle-Income Savers from Reduced Choices in Investment Advice Resulting from DOL's Proposed Rule Not Considered in the Regulatory Impact Analysis

The RIA ignores important benefits of brokers that go beyond the choice of a particular fund that will be lost by those investors, including corrections for behavioral quirks such as misplaced attempts to time the market or the failure to rebalance. In addition, without a broker, some investors will save less because they will be less disciplined or fail to match their employers' contributions to defined contribution plans. None of these costs was taken into account in the Department's RIA, which arrived at a modest $240 to $570 million in annual costs of the rule by focusing only on advisors' compliance cost (such as developing and keeping disclosure forms and customer guides).[43] This section concludes by critiquing the Department's interpretation of the academic studies on which it relies to derive its claimed investor savings of $4 billion per year over the next decade.

42. *See* Capital Group, New Fiduciary Regulations May Hurt Middle-Class Investors (assumes a 6 percent annual return and a 0.40 percent management fee).

43. *Regulatory Impact Analysis*, at 8 ("The Department nonetheless believes that these gains alone would far exceed the proposal's compliance costs, which are estimated to be between $2.4 billion and $5.7 billion over 10 years, mostly reflecting the cost incurred by new fiduciary advisors to satisfy relevant PTE conditions.").

A. Middle-Income Savers Who Would Not Use Investment Advisors Because of the Proposed Rule Would Incur Significant Costs

It should not be lost on the reader that some of the best documentation of the benefits of professional investment advice comes from Vanguard,[44] which has been a leader in providing low-cost investments such as stock index funds, which DOL's rule seemingly wants to encourage. Vanguard estimates that advisors are capable of providing added value added for their customers relative to the average client experience of 54 additional basis points for "behavioral coaching" (when weighted across self-directed investors who do and do not engage in behavior consistent with market timing) and 35 additional basis points for rebalancing.

Even if the typical broker or financial advisor who no longer would serve the small portfolio segment of the retirement market because of the rule provided benefits only one third of those provided by the capable Vanguard advisor, or about 30 basis points (equal to 0.33 x [54 + 35]), these forgone benefits alone would exceed the purported annualized benefits of 25 basis points claimed in the RIA.

Vanguard estimates that advisors are capable of providing added value for their customers relative to the average client experience of 54 additional basis points for "behavioral coaching" and 35 additional basis points for rebalancing.

1. Costs Due to Increased Market Timing

Individual investors are known to display certain behavioral quirks, which have been well documented, most prominently in the best-selling book *Nudge*.[45] Humans are naturally emotional, are influenced tremendously by the way a choice is framed, and they try to make complicated decisions with "heuristics" or rules of thumb. Investment advisors are critical in serving as dispassionate observers, counterbalancing the behavioral quirks of individual investors, which can be dangerous to their "financial health." For example, actual investor returns into given funds tend to trail the associated time-weighted fund returns of those by one to two percent, indicating that investors engage in "performance chasing" (that is, buying a fund right after it has performed well).[46]

Some of the best research on the benefits of investment advice comes, perhaps surprisingly, from Vanguard, the advisory firm that introduced the world to index investing. The largest benefits from advisors derive from a category Vanguard calls "behavioral coaching."[47] The report provides examples of what it means by this term: "Persuading investors not to abandon the markets when performance has

44. Vanguard, Putting a value on your value: Quantifying Vanguard's Advisor's Alpha, March 2014 [hereafter *Vanguard Advisor Alpha*]. Available at: http://www.vanguard.com/pdf/ISGQVAA.pdf.

45. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (Yale University Press 208).

46. *Vanguard Advisor Alpha*, at 17.

47. *Id.* at 16.

been poor or dissuading them from chasing the next 'hot' investment—this is where you need to remind your clients of the plan you created before emotions were involved."[48]

To estimate this benefit (the avoidance of market timing), Vanguard analyzed the performance of over 50,000 *self-directed* Vanguard IRA investors over the five years ended December 31, 2012, which includes the downturn of 2008-09 (the control group). Self-directed investors by definition do not use broker assistance. Vanguard compared these returns to the returns of the applicable Vanguard Target Retirement Funds for the same five-year period—these funds serve as a proxy for advisor-assisted funds (the treatment group). They found that investors in the control group who exchanged money between funds or into other funds fared considerably worse than the treatment group. In short, the "treatment" of using an advisor seems to add considerable value.

In particular, the Vanguard study found that the "average" investor who made even one exchange over the entire five-year period through 2012 (accounting for 27 percent of the sample) trailed the applicable Vanguard target-date fund benchmark by 150 basis points.[49] Even self-directed investors who refrained from such activity (accounting for 73 percent of the sample) lagged the Target Retirement benchmark by 19 basis points.[50] To the extent that an advisor can prevent market timing, advisors can be credited with increasing their client's returns by roughly 54 basis points in expectations (equal to 0.27 x 150 basis points + 0.73 x 19 basis points).

This 54 basis points serves as the high end of our estimated benefits of broker advice, with 0 being the lower bound. The mid-point between these two extremes, or 27 basis points, is our working estimate of the value of broker advice against market timing. It bears noting that because brokers continue to earn 12(b)-1 commissions so long as their clients remain in the market, and those 12(b)-1 fees are linked to account values which over time are likely to be greater if clients do not attempt to time the market, brokers have a clear incentive to discourage clients from abandoning the market at rocky times, an incentive that is also aligned with their clients' best long-term financial interest. That incentive would be extinguished under the proposed rule (whose benefits are derived from making certain assumptions about other kinds of incentives built into broker commissions).

Analysis by Capital Group's research department supports the Vanguard findings, and if anything, demonstrates even more dramatically the potentially huge opportunity costs of trying to time the market. For example, the hypothetical value of $1 invested in the S&P 500 Index in 1926 and *continuously kept in the market* through its often-tumultuous ups and downs would have grown to $4,666 by the end of 2013. If the same investor had been out the market during its 45 best months of performance during that long stretch, the investor's nest egg by the end of 2013 would have been just $18, even less than the $21 he or she would have had by keeping that dollar in 30-day U.S. Treasury bills.

48. *Id.*
49. *Id. at* 17.
50. *Id.*

Or consider another set of calculations a "Buy and Hold" investment in the S&P 500 Index by financial analyst Barry Ritholtz for the years 1993-2010:[51]

- The *ten best days* account for *50 percent* of the buy and hold performance (roughly 0.2% of the days from 1993 to August 2010).

- The Classic "*Buy & Hold*" nets $324,330.15**,** but missing the ten best days gives up more than 50 percent of the *Buy & Hold* performance: $156,354.12

And if you are not convinced by all this, consider the recent study by another investment advisor, Dalbar, which found that over the past two decades through last December, the average stock mutual fund investor earned only 5.19 percent, 4.66 percentage points lower than the 9.85 percent return for the Standard & Poor's 500-stock index. The average investor in bond funds did even worse, lagging the Barclays Aggregate Bond index by 4.71 percentage points.[52] This gap between available returns and those actually realized by real-life investors comes from entering and exiting the market at the wrong time rather than staying invested for the long term.

All this is to say that driving investors to funds to avoid claimed under-performance (a result we qualify elsewhere in this study) does not compare to the foregone earnings of an investor who tries to time the market and misses, which the best of professional investors often do. Having a broker or advisor who *calls*, not just sends an email or an investment letter in the mail, to remind investors saving for retirement to stay in the market is extremely valuable, particularly during bad market periods. Such human advice—which would disappear for many investors under the rule and to the extent "robo-advice" replaces human contact, which the rule appears to encourage—can provide huge benefits that swamp the benefit estimates of the proposed rule.

One final way to illustrate concretely the value of investment advice that deters market timing is to ask: What portion of retirement savings in mutual funds would have to be restrained from market timing in a future substantial market correction to offset the purported benefits of the fiduciary rule claimed in the RIA? Consider a future stock market downward "correction" of 25 percent, or one a little more than half as severe as the one that occurred in 2008-09, an event that has occurred twice in the past two decades (the bursting of the "Internet bubble" in 2000 and the financial crash of 2008).[53] Taking the RIA's estimate of IRA assets held in mutual funds with a front-end load in 2017 of $1.087 trillion, and assuming that just one quarter of this amount were sold at or near the market bottom and would not be reinvested until stock prices had recovered their loss, such a correction would wipe out over $250 billion of investor wealth. Compare this to the cumulative $40 billion in purported costs over ten years of investing in mutual funds characterized by conflicted advice. This exercise shows that brokers or

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51. Barry Ritholtz, Missing Best & Worst Days of S&P500, Ritholz Blog, Sept. 14, 2010, *available at* http://www.ritholtz.com/blog/2010/09/missing-best-worst-days-of-sp500/.

52. As reported in Jeff Sommer, *The High Cost of Investing Like a Daredevil*, NEW YORK TIMES, June 7, 2015, *available at* http://www.nytimes.com/2015/06/07/your-money/the-high-cost-of-investing-like-a-daredevil.html?ref=business.

53. *See*, *e.g.*, Yardeni Research, Market Briefing: S&P 500 Bull & Bear Markets & Corrections, June 1, 2015, Figure 2, *available at* http://www.yardeni.com/pub/sp500corrbear.pdf.

advisors need to persuade IRA investors *holding a mere 15 percent of IRA account dollars* (0.15 x 0.25 x $1.087 trillion = $40.8 billion) to avoid timing the market in order to totally offset the $40 billion in ten-year investor savings claimed by the Department for its proposed rule. *And this calculation assumes no other investment benefits are generated by brokers and advisors;* an assumption shown to be highly conservative below.

Put differently, if human advisors persuade *just one in seven clients* to stay invested through a market downturn,[54] it totally offsets the claimed DOL rule's ten-year benefits, which as we have already shown, are spurious. If instead advisors persuade two of every seven clients to stay invested through such downturns, the harm to small savers from losing this kind of human advice would reach as much as $80 billion. For the DOL to risk the withdrawal of such advice without an empirical basis for doing so, when such a loss of advice could impose such outsized costs on small savers, seems inconsistent with its desire to protect the interests of investors.

No less an authority on the stock market than Burton Malkiel, author of the classic *Random Walk Down Wall Street* and a leading advocate of investing in index funds, has recently warned even the Federal Reserve Chair Janet Yellen from encouraging investors to market time. As he states: "… the suggestion that one can tell if stocks are too high or low could induce people to think that it is possible to time the market. *We know that investors generally move money to and out of the stock market at the exactly the wrong times.*"[55]

It is one thing for investors with portfolios of any size to read these words in black and white in a period of market calm or rising trend and nod in agreement, and quite another to hold true to them and fight back one's emotions to sell when the market is seemingly crashing and your retirement nest egg is melting. It is precisely at such times that investors can benefit from hearing an investment professional like a broker-dealer or registered investment advisor who is trained to put Malkiel's words into practice every day. The possibility of receiving that benefit clearly will be reduced under DOL's proposed rule, as many brokers and advisors would find it uneconomic to serve a large class of investors, especially those with modestly sized portfolios. *These potentially hugely important benefits of human advice that many investors, especially those with modest retirement nest eggs, will lose are nowhere accounted for in the RIA.*

2. Costs Due to Less Rebalancing

Vanguard also credits advisors for providing up to 35 additional basis points to their investor clients from *rebalancing* of the mix of equities, bonds and possibly other asset classes.[56] Because a portfolio's investments produce different returns over time, the portfolio drifts from its target allocation. Failing to rebalance (and instead drifting with the markets) implies higher volatility, putting an investor's portfolio at risk of larger losses relative to a balanced allocation.

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54. This assumes for simplicity that clients hold equal-sized accounts.

55. Burton G. Malkiel, *Janet Yellen Is No Stock Market Sage*, WALL STREET JOURNAL, June 2, 2015, at A13 (emphasis added), *available at* http://www.wsj.com/articles/janet-yellen-is-no-stock-market-sage-1433199503.

56. *Vanguard Advisor Alpha,* at 13.

To quantify the benefits from rebalancing, Vanguard identified a rebalanced portfolio with a greater equity allocation that exhibited similar risk as a non-rebalanced portfolio. For example, a *rebalanced* 80/20 stock-bond portfolio exhibits roughly the same standard deviation (a standard statistical measure of variability) as a *non-rebalanced* 60/40 portfolio (around 14 percent).[57] If an investor is comfortable with the higher risk of the non-rebalanced portfolio, she should simply select the higher equity allocation from inception and rebalance to that allocation through time, yielding a higher return. Vanguard found that the difference in returns between the rebalanced 80/20 portfolio and the non-rebalanced 60/40 portfolio was 35 basis points.[58]

Vanguard explains how an advisor can overcome this additional behavioral failure of investors to change the asset mixes of their portfolios when market conditions change: "Whether in bull or bear markets, reallocating assets from the better-performing asset classes to the worse-performing ones feels counterintuitive to the "average" investor. An advisor can provide the discipline to rebalance when rebalancing is needed most, which is often when the thought of rebalancing is a very uncomfortable leap of faith."[59] The Vanguard study concludes that advisors who can direct investor cash flows into the most underweighted asset class "are likely to reduce their clients' rebalancing costs and thereby increase the returns clients keep."[60]

Even if three-quarters of all brokers provided this kind of advice and no longer served investors because of the rule, it would represent an additional 25 basis points (0.75 x 0.35 basis points) of foregone broker benefits, or alternatively, additional investor costs that would nullify all of the gains claimed by DOL for its rule. We use 35 basis points as the high end of our benefit estimate, with 0 being the low end, and 17.5 basis points being the mid-point.

3. Costs Due to Less Saving

Yet another benefit offered by advisors that was neglected by the RIA is the higher savings rates by savers that advisors can help induce. The absence of a broker or advisor offering their services may lead to reduced saving directly because of the loss of counseling, and indirectly because of fewer company-sponsored 401(k) plans. Research from LIMRA, a leading life insurance and financial services trade association, shows that consumers who rely on financial advisors are more likely to be saving in a retirement plan and to be saving at a higher rate than those without an advisor.[61] The survey found that 78 percent of non-retired consumers who worked with an advisor contributed to a retirement plan or an IRA, while only 43 percent of consumers who were not working with an advisor were contributing to their retirement savings. *Even controlling for income*, which is likely positively associated with the use of an advisor, LIMRA found that consumers who work with a financial professional are more likely to be

57. *Id.* at 14.
58. *Id.* at 14, Figure III-2 (equal to the difference between 9.71 percent less 9.36 percent).
59. *Id.* at 15.
60. *Id.* at 15.
61. LIMRA, Advisors Positively Influence Consumers' Behavior and Sentiment Toward Preparing for Retirement, July 11, 2012, *available at* http://www.limra.com/Posts/PR/News_Releases/LIMRA__Advisors_Positively_Influence_Consumers__Behavior_and_Sentiment_Toward_Preparing_for_Retirement.aspx?LangType=1033.

contributing to a defined contribution plan or IRA. Moreover, LIMRA found that 61 percent of investors who work with an advisor saved at a "high rate" (defined as deferring more than seven percent of salary into a retirement plan) compared with 38 percent of investors who did not work with an advisor. LIMRA attributed these differences to the role that advisors play in providing information, recommendation, and guidance.

A more recent LIMRA study from 2015 shows that investors who work with an advisor and have between $50,000 and $500,000 saved in their employer plan contribute more to their defined contribution plans,[62] and they also save more outside of their retirement plans.[63] The latter results may be attributable to the fact that investors with more assets tend to use advisors more frequently. Nonetheless, the study also finds that *"[c]ontrolling for household wealth*, individuals who work with paid financial professionals are more likely to have formal, written retirement plans and to be confident that they are on track with their retirement savings."[64]

The upshot from the LIMRA studies is that to the extent retirement savers with modest portfolios lose the human touch of a broker or financial advisor because of the rule, some of them will lose the benefits in retirement of enhanced saving over their lifetimes. The Department made no effort in its RIA to estimate the magnitude of this benefit or to take it into its benefit-cost calculus.

4. Costs Due to Less Use of Employer Matches

The discouragement of advisory services provided by brokers and financial advisors due to the proposed rule could prevent investors from fully taking advantage of employer matches in company-sponsored 401(k) plans. There is already $24 billion in unused matches left on the table according to Financial Engines.[65] Examining 4.4 million retirement plan participants at 553 companies, the financial consultancy found that one in four employees is missing out on receiving the full company match by not saving enough, leaving an average loss of $1,336 in company-provided matches each year, with some employees giving up as much as $20,000 in employer matches per year.

Failing to fully take advantage of an employer match is another behavior quirk that can be remedied by good advice. The problem seems to be that the default savings rates that are hardcoded by employers are too low. According to Aon Hewitt, the default contribution rate for most plans remains at 3 percent (or less),[66] well below the 10 to 15 percent of annual income that advisors often recommend savers set aside for retirement. Most employer-matching programs offer a 50 to 100 percent match of as much as 6 percent of an employee's salary. Accordingly, a modest increase in savings (from 3 to 6 percent) would

62. LIMRA, Matters of Fact: Consumers, Advisors, and Retirement Decisions (and Results), May 2015, at 4, *available at* http://limraloma.dmplocal.com/dsc/collateral/Facts_about_retirement_decisions.pdf

63. *Id*. at 6.

64. *Id*. at 16 (emphasis added).

65. Financial Engines, Missing Out: How Much Employer 401(k) Matching Contributions Do Employees Leave on the Table, May 2015, available at http://corp.financialengines.com/docs/Financial-Engines-401k-Match-Report-050615.pdf.

66. Aon Hewitt, 2014 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans, at 3, *available at* http://www.aon.com/attachments/human-capital-consulting/2014-Universe-Benchmarks-Highlights_Final.pdf.

trigger the full employer match in most cases. Removing brokers or advisors from the equation means that any efforts to encourage employees to save more through education and personalized outreach would fall entirely on employers.

B. The Benefits Claimed for the Proposed Rule Are Overstated

The RIA's estimate of $4 billion in annual benefits of the rule is based on a series of academic studies cited throughout the analysis purporting to show that investors in broker-sold load mutual funds under-perform mutual funds sold directly. The RIA misuses these studies, however, and in the process, substantially overstates any benefits claimed from them.

Consider first the Christoffersen et al. (2013) paper, which claims to show under-performance by over 100 basis points.[67] In fact, this estimate pertains *only to the year in which the fund is purchased*, but the authors provide no estimate of underperformance during all years for which the fund is held.[68] This is not a minor "detail" which the authors claim but a fundamental oversight that does not permit reliable conclusions to be drawn from this paper about any annualized under-performance of funds associated with conflicted advice over the long run.

In addition, Christoffersen et al. combines data from 1993 through 2009, which may not be representative of the current relative returns from "conflicted payments." To test the robustness of these results, the Investment Company Institute examined fund performance using data from 2007 to 2013, or years covering both the financial crisis and the subsequent recovery (in GDP and stock prices) and found that funds sold with front-end loads *outperformed* Morningstar benchmarks. In particular, the ICI found that the sales-weighted average returns for shares sold with front-end loads outperformed the Morningstar average return for all funds with similar investment objectives by 27 basis points per year.[69] The ICI's analysis calls into question the robustness of any claim of under-performance by broker-sold funds in particular, and at a minimum highlights the sensitivity of the results to the time period examined.

Moreover, the very low R-squares of the regressions (the degree to which their statistical estimates explain the variation in returns) in the Christoffersen study of *just four percent* strongly suggest that some important variables are omitted, which if correlated with brokers' fees, would bias their results.

Another paper the RIA heavily relies upon, authored by Bergstesser et al. (2009), finds that funds sold by brokers under-perform those sold directly for certain types of funds (*e.g.*, domestic equity funds), *but*

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67. Susan Christoffersen, Richard Evans & David Musto, *What Do Consumers' Fund Flows Maximize? Evidence from Their Broker's Incentives*, 68 JOURNAL OF FINANCE 201-35 (2013) ("the average 2.3 [percentage points] payment to the unaffiliated broker" an IRA investor or other customer can expect "a 1.13 [percentage point] reduction in annual performance" of the mutual fund).

68. For further critiques of this and other studies relied upon by the RIA, see NERA, Review of the White House Report Titled "The Effects of Conflicted Investment Advice on Retirement Savings, Mar. 15, 2015, at 6, *available at* http://www.nera.com/content/dam/nera/publications/2015/PUB_WH_Report_Conflicted_Advice_Retirement_Savings_0315.pdf.

69. Reid Testimony, at 3.

over-perform for other types (e.g., value-weighted foreign equity funds). This is hardly consistent with the RIA's claim that brokerage services costs consumers 50 to 100 basis points for the entire mutual fund market. Moreover, broker-sold funds are defined by Bergstesser et al. as those sold by any intermediary, which can include a bank, a brokerage firm, or a non-captive third-party broker; by combining a variety of distribution channels, the study does not permit one to isolate the effects of broker involvement alone.

The RIA also errs by focusing on the average performance of *funds* rather than of *investors in funds*. Yet the returns of any particular fund may or may not reflect the returns earned by investors in that fund, who can trade in and out of funds, nor do any percentage of fund statistics reflect the fact that *investors* can be disproportionately invested in better-performing funds.

For all these reasons, the purported 25 basis point gain from the rule claimed by DOL is overstated, most likely to a significant degree. Because the estimated costs of the rule are significantly larger than the purported benefits, there is no need for us to discount the DOL's benefits, although if that were done, our estimate of the net costs of DOL's rule would be even greater than stated here (and for this reason, our estimate is conservative).

V. A More Cost-Effective Alternative to the DOL's Proposal Exists

Since 1980, Presidents have required Executive branch agencies not only to analyze the benefits and costs of the rules they propose, but also to consider whether less restrictive alternatives are available that could achieve the same or similar objective. Section 1 of President Obama's Executive Order 13563 requires Executive Branch agencies to "identify and use the best, most innovative, and *least burdensome tools for achieving regulatory ends.*"[70] We explain what a less burdensome approach would look like here.[71] Our analysis supports a true best-interest standard, without all of the unnecessary requirements that the DOL has included with it. Our alternative would be less expensive to enforce through FINRA[72] and/or SEC, which are the proper bodies to oversee brokers. And if the DOL is concerned that current disclosures are insufficient, then we suggest a simple route to greater transparency.

A. A Less Burdensome Alternative

The Department is charged under ERISA with protecting the interests of individuals saving for retirement. The Department has carried out this mandate in its proposal by focusing primarily on the disparity in fees and performance between actively managed mutual funds with front-end loads sold by brokers versus actively managed load funds sold directly by fund complexes. The RIA attributes the

70. Executive Order 13563, Section 1.

71. In offering an alternative, we are sensitive to the fact that brokers already have substantial duties to their clients, including loyalty, disclosure and suitability. *See*, *e.g.*, Duties of Stockbrokers to their Customers, *available at* http://www.securitieslaw.com/information/duties-of-stockbrokers.asp.

72. FINRA already regulates brokers under the suitability standard, so there is no reason why it could not oversee the best-interest standard as well.

disparity in investor performance to "conflicted advice" by brokers, and the failure by brokers to disclose how their compensation from mutual funds can distort investor decisions.

But fees and relative performance of particular investments, such as mutual funds, are not the only, or even the primary, factor in the size of individual or household retirement nest eggs. How much is regularly saved, the ability to avoid temptations to time the market, the regular rebalancing of different asset classes to adapt to changing risk tolerances of individuals as they age, and the investment performance of portfolios *net of fees*, all determine the size of investment portfolios individuals or households have available to them when they retire. In focusing largely, or only, on mutual fund fees and performance, the Department's proposal neglects the benefits of investment advice that brokers and advisors can and do have on the other factors that determine the size of an individual's or households' retirement portfolio at any time, including the date on which withdrawals begin.

Whether or not it is intended, the deprivation of that advice due to the proposed rule will thus hurt many investors, especially those with modestly sized portfolios that the rule will render uneconomic for brokers and advisors to continue to service. *Moreover, even if the rule did not cause many brokers to leave the small saver segment of the market*, a more direct, and far less costly alternative to the rule exists, which the Department did not adequately consider.

That alternative would directly address DOL's main complaint about the existing brokerage arrangement in the retirement advice industry—namely, that customers do not know of the compensation arrangements between brokers and the providers of the investment products they recommend. *That market imperfection, however, is easily cured.*

The DOL can easily and at very little cost remedy the awareness problem by imposing stronger and more explicit requirements in the case of retirement accounts that brokers and advisors both orally and in *clear bold writing on a page in front of any written products they provide* state such commission relationships. If need be, the Department could provide specific plain-English language that these disclosures should contain, along the lines of something like:

> Your broker [financial advisor] will be compensated by the [name of the company] if you purchase this investment product, through an initial charge equal to ___ percent of your investment and of any subsequent purchases of this investment product, and through annual "12(b)-1 distribution" charges equal to __ percent of the total amount of your purchases of this investment product.

By explicitly quantifying the amount of compensation at stake, this proposal would directly address one of the critiques of the current disclosure regime leveled by the Department in its RIA.[73]

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73. *Regulatory Impact Analysis*, at 68 ("the disclosures generally do not quantify the conflict that pertains to a particular recommendation [by a broker or financial advisor"). *Id.* at 77 ("Most [IRA] investors do not understand what they pay for advice and for investments, how their advisors are compensated and regulated, the conflicts their advisors might face, now how those conflicts might affect their advice".) *Id*. at 80 ("In addition, investors often do not know what they pay for advice…").

The Department also has outlined additional model disclosures in Appendix I and II to its BICE proposal. The table in Appendix I is similar to the suggestion here, though in tabular form. Appendix II, however, calls for brokers to disclose—in reality, *estimate*—the costs of holding individual assets over a 1, 3 and 10 year time horizon, an exercise that necessarily would require the broker to estimate future performance. We have already noted how this is likely to conflict with existing FINRA prohibitions on making such projections, and in any event, could be subject to manipulation. Accordingly, something like the table in Appendix I would be appropriate, the table in Appendix II would not be.

This is an extremely slim reed upon which to base an entire rule that could radically change the way investment advice is provided in a $1 trillion mutual fund market.

The Department nonetheless elsewhere claims that even if more explicit disclosures were required, apparently *including the ones it recommends as part of the BICE,* the small-saver investors it is most concerned about cannot understand these disclosures. This assertion is an expression in support of government paternalism without recognizing that in other contexts in life, just as important as the one regarding retirement advice, society relies on disclosure to address an information failure. In particular, our government permits citizens to make their own medical decisions that can have much more immediate and life-changing consequences than decisions about where to put their retirement savings.

B. The RIA Lacks Any Real World Empirical Support for Rejecting Greater Disclosure

In any event, the only support in the research literature the Department can muster in support of its assertion that disclosure does not is work a 2011 study by Loewenstein, Cain and Sah, which according to the Regulatory Analysis (at 7), "suggests" that "even if disclosure about conflicts could be made simple and clear, it would be ineffective—or even harmful." But this "study" in fact is no study at all, but a *theoretical paper* advancing one hypothesis, *without any real world empirical support.* This is an extremely slim reed upon which to base an entire rule that could radically change the way investment advice is provided in a $1 trillion mutual fund market.

As for the study itself, it is far less supportive of the Department's position than the RIA would suggest. Even the title of the article highlights both the "pitfalls and potential"[74] of disclosure, while the conclusion states that "people deserve accurate information with which to make informed decisions, so disclosure is inherently desirable," [75] and that "while disclosure has manifest pitfalls, there are also enormous opportunities for designing policies that will enhance its benefits." [76] Finally, as explained

74. George Loewenstein, Daylian M. Cain, & Sunita Sah, *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101(3) AMERICAN ECONOMIC REVIEW: PAPERS AND PROCEEDINGS (2011) 423-428.

75. *Id.* at 427.

76. *Id.*

below, according to a subsequent publication by the very same authors, the disclosure requirements suggested above are consistent with recommendations for increasing the effectiveness of disclosures.

The study presents theories, supported only by limited *experimental* evidence from a few stylized role-playing experiments. Participants in the experiments were recruited through websites, e-mail lists, or from public areas with incentives such as "a 1 in 3 chance of winning a $10 Amazon gift card." None of this experimental evidence is derived from market-based economic activity in any real-world industry, nor is any of the theory or evidence specific to retirement accounts, or even to the financial industry.[77]

The authors theorize that disclosure requirements might negatively influence consumer behavior, hypothesizing a "burden of disclosure,"[78] according to which "advice recipients who learn of an advisor's conflict do become less trustful of advice, yet feel more pressured to follow that advice." [79]

The study's "empirical" support for the burden of disclosure, however, is limited to a similar set of experiments, this time involving (1) dice games offering the chance to earn $5 Starbucks gift cards and similar rewards; and (2) interaction among hypothetical patients and doctors.[80] Once a disclosure had been made public, participants reported discomfort associated with turning down advisors' (biased) recommendations, leading the participants to make suboptimal choices. For example, hypothetical patients, after having a hypothetical doctor disclose a hypothetical financial conflict of interest, reported feeling pressure to accept the hypothetical doctor's recommendation "for fear of insinuating that the [hypothetical] doctor was corrupt."[81]

Yet in subsequent research, the very same authors identify conditions under which the burden of disclosure is ameliorated:

> [T]his increased pressure to comply with advice is reduced if (a) the disclosure is provided by an external source rather than from the advisor, (b) the disclosure is not common knowledge between the advisor and advisee, (c) the advisee has an

77. The authors do illustrate the potential for conflicts of interest using examples from the financial sector, although retirement savings are not mentioned. The authors' references to the financial sector are limited to the first page, and include (1) "accounting firms auditing those corporations [such as Enron and WorldCom, which] were also providing lucrative consulting services that could have been jeopardized by an unfavorable audit;" (2) "credit-rating agencies that evaluated…mortgage-backed securities [and] were hired and fired by firms whose bonds they were rating;" and (3) "the dot-com bubble, [in which] firms that were underwriting IPOs were also giving investment advice to their retail clients." *Id*. at 426.

78. *Id.*

79. *Id.* The authors posit three additional theoretical mechanisms through which disclosure requirements might negatively influence consumer behavior. *Id.* at 424. However, they do not provide support for any of these three mechanisms in their stylized experiments.

80. *Id.* at 425-426; *see also* Sah (2013), *supra*.

81. *Id.* at 425.

> opportunity to change his/her mind later, or (d) the advisee is able to make the decision in private.[82]

Three out of four of these conditions would seem to apply to the disclosure remedy proposed above: The disclosure would come from an external source (the Department); the advisee would presumably have the opportunity to change her mind (reinvest her assets) at any point in time; and, the advisee would presumably be able to make the decision in private. Therefore, the disclosure requirements suggested above are consistent with recommendations of the very researchers on which the Department relies.

C. Policy Implications

For one thing, the kind of "simple and clear" disclosure recommended here *has never been tried* in the retirement savings context, so how can any academic scholar, or the Department for that matter, be so confident that it would be ineffective? At a minimum, before undertaking a major overhaul of the retirement savings market, wouldn't prudence call for at least *trying* a better disclosure standard first, before abandoning enhanced disclosure entirely?

At a minimum, on what basis should the Department be able to put the entire weight of a proposal that would abandon enhanced disclosure on the basis of a single *theoretical* study, when *on the next page*, the RIA cites "data limitations of the academic literature and available evidence" as a reason for relying on the fact that only "some of the gains [from the proposed rule] can be quantified"—and then uses these estimated gains (which as we have documented are overstated) to justify a wholesale change to the entire retirement investment advice market?[83] This is not the kind of balanced judgment an Executive branch agency should make under longstanding Presidential Executive Orders, including the most recent one adopted by this Administration, to impose only those regulations that are the *least burdensome* in meeting any given regulatory objective.

Enhanced disclosure in the retirement advice context in particular could be augmented by a broader alternative recommended by the trade association representing the securities industry: asking FINRA, which regulates all brokerage activities subject to approval by the SEC, not just those relating to retirement advice, to adhere to a requirement that brokers "act in the best interest of their clients," which is essentially a fiduciary standard, but without all of the legal ambiguities, costs and risks posed by the DOL proposed standard.[84]

In particular, the Securities Industry and Financial Markets Association's (SIFMA) proposal defines a "client's best interest as recommendations that reflect the 'care, skill, prudence and diligence' that a prudent person would exercise based on the customer's investment profile." The proposal "would not

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82. Sunita Sah, George Loewenstein, and Daylian Cain, *The Burden of Disclosure: Increased Compliance With Distrusted Advice*, 104(2) JOURNAL OF PERSONALITY AND SOCIAL PSYCHOLOGY (2013,) 289-304, at 289.

83. *Regulatory Impact Analysis*, at 8.

84. Guggenheim, SIFMA Offers Simpler Alternative for Fiduciary Duty, June 3, 2015, *available at* https://guggenheimsecurities.bluematrix.com/docs/pdf/fedfdaa9-a34f-443b-beb5-5cba52d169dc.pdf.

require the advisor to recommend the lowest cost product, but the advisor must disclose and manage the fees as well as avoid and manage any conflicts of interest posed by commissions from various investment products."

This proposal would not disrupt the economics of the commission-based brokerage and financial advisory business, and thus would not deprive investors of the benefits of these relationships, while directly addressing the conflicts of concern to the DOL. It would also standardize the rules for brokers and financial advisors in all investment contexts, and thus not entail the costs of maintaining and enforcing different rules for different kinds of accounts.

This simpler solution would be consistent with the way the Administration, commendably, is going about improving many of the federal government's information technology initiatives: by deploying small teams of technologists and software programmers, working in an iterative fashion, to come up with the right answers, without imposing top-down bureaucratic solutions from the outset.[85] If DOL takes a page from this initiative in writing its rules, it would clearly start by improving disclosure and coupling it with a best interest standard enforced by an expert body like FINRA, without mandating changes in compensation arrangements that would either deprive small savers of valuable investment advice or induce them to switch to more expensive means of obtaining it.

> In the end, if it is open to fact-based adjustments in its approach, the DOL will have set in motion a reform process that establishes new protections for small savers without disruptions that would unintentionally harm those it seeks to help.

CONCLUSION

Perhaps sensing that the DOL proposal was in trouble, the Obama administration went on record in support of allowing commissions to survive. One analyst predicted that a "final compromise that preserves the commission-system is a win for both sides."[86] But if the source of the alleged conflict problem per the RIA is the load share paid to brokers, and if the benefits from the rule flow from removal of these payments (or, put more precisely, from the faster demise of these payments), how can the administration nonetheless claim to be carving out an exception for commissions? The answer, as we shown above, is that this BICE exception is more theoretical than real, and thus the claim that commissions can survive rings hollow.

Fortunately, there is no need for any of this happen. The DOL should modify its rule and put in its place a

85. This initiative is described in Jon Gertner, *Obama and His Geeks*, FAST COMPANY, July/August 2015, pp. 60-66, 90-91.

86. Jaret Seiberg, Guggenheim Partners, Fiduciary Duty Fight for Advisors Returns to Capitol Hill, June 15, 2015.

simpler solution that asks FINRA or the SEC to propose a broader best-interest standard. Under our preferred approach, commissions would be allowed, but disclosure of compensation arrangements would be improved. The net benefits of such an alternative would greatly exceed those associated with the DOL's current proposal. And, in the end, by being open to fact-based adjustments in its approach, the DOL will have set in motion a reform process that establishes new protections for small savers without introducing disruptions that would unintentionally harm the people it seeks to help.

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