Ron A. Rhoades, JD, CFP®

April 11, 2011

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N–5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Proposed Rule, Definition of the Term "Fiduciary"
Rhoades Cmt. Ltr. #1, revised 4/11/2012

Ladies and Gentlemen:

I write to rebut the somewhat misleading testimony offered earlier this month by an opponent to the "Definition of the Term 'Fiduciary'" Proposed Rule. I write in my individual capacity and not as the representative of any firm or organization. I am an attorney who has extensively studied the field of fiduciary law for several years. For ten years I have also served as Director of Research of an investment advisory firm, and I have written extensively on the impact of fees and costs found within pooled investment vehicles on individual investors.

In the testimony of Kenneth E. Bentsen, Jr., appearing on behalf of the Securities Industry and Financial Markets Association, before the recent U.S. Department of Labor Hearing on the Proposed Definition of Fiduciary Regulation, comments were made which could be considered misleading and/or not relevant to the issues being considered by the Employee Benefits Security Administration (EBSA). In the sections which follow, I recite excepts from testimony (as set forth on the sifma.org web site). After each excerpt I discuss how this testimony differs from my understanding of fiduciary law, as well as the economic and practical consequences of the application of the fiduciary standard of conduct.

1. "If one looks only at IRAs and assumes an advisory fee of 100 basis points or 1%, the likely added costs are $43 billion a year, many times the Department's estimates of the costs. These additional costs, when added to the advisory fees that a fiduciary will likely charge its clients, will significantly erode the investment return of these smaller accounts."

Many times the broker-dealer industry has opined that commissioned-based accounts, rather than advisory accounts, are less costly to consumers. They argue that the application of the fiduciary standard will raise fees and costs, which in turn will be borne by investors. In reality, the exact opposite effect occurs.

Unlike (typically non-fiduciary) registered representatives of broker-dealer firms and insurance agents of insurance companies, fiduciary advisors possess the duty to ensure that the total fees and costs associated with any investment product, and with the receipt of investment advice, remain reasonable. Studies proffered by SIFMA and other opponents to the fiduciary standard ignore many of the disclosed and hidden costs of investment products, which fiduciary advisors consider in undertaking due diligence prior to recommending an investment product to a client.

It has been my experience, from working with hundreds of clients over decades, that the client of a fee-only investment adviser nearly always experiences dramatic savings in the fees and costs arising out of investment advice and the investments recommended, when contrasted with the fees and costs of investments sold by "full-service" broker-dealer firms and insurance agents. These savings are typically in the range of 30% to 70%, but can be even higher.

The assertion of a "1% advisory fee" by SIFMA is inappropriate, as this is often the fee charged to those individuals receiving comprehensive financial planning and investment advice. In contrast, many (if not most) of the participants of plans served by fee-only investment advisers enjoy advisory fees which are much lower.

Moreover, SIFMA paints the "1% advisory fee" – even if such a level of fees were true – as an additional burden. In reality, even if such an advisory fee is applied, the total fees and costs borne by a plan participant would likely be less. This is because it is important, when studying the issue of fees and costs, to include in any analysis the often "hidden" fees of pooled investment vehicles. In recent decades increased disclosures have occurred with respect to mutual funds, in particular. As a result, many mutual fund complexes, and the broker-dealer firms who promote the sale of such funds, have sought to shift fees and costs to those not found in the annual expense ratio, nor in the disclosed up-front sales charge (associated with sales of Class A shares of funds, primarily).

For example, Class B shares of mutual funds impose a "contingent deferred sales charge" (CDSC) (i.e., surrender fee) upon the redemption of a fund prior to a specific time period. This CDSC was largely paid out of high 12b-1 fees or other fees found within funds. Of course, the SEC and FINRA finally took action to stop abusive sales practices in this area, as regulators became "concerned that some investors may purchase class B mutual fund shares when it would have been more cost-effective for those investors to purchase a different class of shares".[1]

However, the impact of the commission-based alternative – Class A shares with a front-end sales load, is also quite significant upon individual investors. A 5.75% sales load, for example, possesses a long-term impact on a stock fund's return of 31 basis points a year, assuming the fund is held for 20 years and that the fund possesses an annual rate of return of 10%. Of course, the average investor holds shares of a mutual fund for only a few years, and this turnover of funds with sales loads magnifies the impact of the sales load tremendously. Moreover, most Class A shares possess additional 12b-1 fees of 0.25%, as well as often high management and administrative fees, thereby adding to the high burden of the sales load.

Additionally, many mutual funds have paid for distribution services through the fallacy of "soft dollars" – higher commission payments (than would otherwise be incurred) paid by mutual funds as a

[1] *FINRA Investor Alert*, found at http://www.finra.org/investors/protectyourself/investoralerts/mutualfunds/p005975.

result of trading securities within the fund. As noted by John C. Bogle, Founder and Former Chairman of The Vanguard Group, "Over the past few decades, mutual fund shareholders have paid to brokerage and investment banking firms billions of dollars in so-called soft-dollar commissions that have far exceeded the costs of executing the transactions."[2]

The fact is that most stock mutual funds possess excessively high fees and costs. In a March 1, 2010 *Wall Street Journal* article it was noted: "U.S.-stock funds pay an average of 1.31% of assets each year to the portfolio manager and for other operating expenses, according to Morningstar Inc. … There are other costs, not reported in the expense ratio, related to the buying and selling of securities in the portfolio, and those expenses can make a fund two or three times as costly as advertised."[3]

I would encourage DOL/EBSA, in undertaking any assessment of fees and costs, to consider all of the fees and costs of pooled investment vehicles, including:

> sales loads;
>
> fees and costs included in a fund's annual expense ratio: 12b-1 fees, management fees, and administrative fees;
>
> fees and costs relating to the purchase and sale of securities within the fund, including brokerage commissions (with soft dollar compensation indicated separately), bid-ask spreads, principal trading mark-ups and mark-downs, market impact costs, and opportunity costs due to delayed or cancelled trades; and
>
> opportunity costs arising from the maintenance of cash holdings within the fund.

I further encourage DOL/EBSA, perhaps in conjunction with the U.S. Securities and Exchange Commission, to undertake a study, preferably utilizing professors of finance to conduct an objective survey and analysis, of the total fees and costs investors bear as a result of the various business models today serving retirement plans and/or individual investors. Such a survey and analysis would have to examine several different business models – fee-only and independent registered investment advisers (and their investment adviser representatives), banks and trust companies, independent broker-dealers (and their registered representatives), insurance agents (captive and non-captive), wirehouse broker-dealers (and their registered representatives), and various hybrid models of the foregoing. I am confident that the results of that study will demonstrate that, on average, fee-only fiduciary investment advisers providing investment solutions to retirement plans provide lower-cost investment solutions than those of insurance agents and wirehouse broker-dealers.

I would note that the broker-dealer industry has often opined that the fiduciary standard cannot be utilized to serve smaller investors. I would ask, however, what is the difference between a 5.75%

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[2] Bogle, John C., Perspectives: The End of 'Soft Dollars'? (April 9, 2009). Available at SSRN: http://ssrn.com/abstract=1375715.

[3] Anna Prior, "The Hidden Costs of Mutual Funds," *The Wall Street Journal* (March 1, 2010), available at http://online.wsj.com/article/SB10001424052748703382904575059690954870722.html. For a review of the academic literature and a method of estimating the "hidden fees and costs" of mutual funds, *see* Rhoades, "Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs" (April 22, 2009), available at http://www.josephcapital.com/EstimatingtheTotalCostsofStockMutualFunds200904.pdf.

sales load on a $20,000 investment – which is $1,150 – and the same fee (or less) paid as a flat fee or on an hourly basis to a fee-only registered investment adviser for objective investment advice and, often, additional financial planning services. As I have pointed out in a prior writing,[4] small investors usually receive far more (and better) advice, for far less in total fees and costs, when served by fiduciary financial advisors, in contrast to non-fiduciary advisors. Many fiduciary business models exist which cost-effectively provide investment advisory services to the small investor today.

Why are non-fiduciary investment recommendations so expensive, in comparison to the total fees and costs paid by clients of fiduciaries? This is because fiduciary advisors act <u>not</u> as the representative of a product manufacturer, as in the case of a product distributor (i.e., stockbroker or insurance agent). Rather, fiduciary advisors represent the purchaser – the individual investor.

Who's On Top?

Product Manufacturer	Client
↓	↓
Broker or insurance agent	Investment adviser
↓	↓
Customer	Product manufacturers

Unlike the arms-length product sales business model of broker-dealers, fiduciary investment advisers represent the client. They act as "shoppers" for the client, in addition to trusted advisers. They utilize due diligence to discern all of the fees, costs, and risk characteristics of the investment products they recommend.

And, unlike broker-dealers, fiduciary advisers possess a broad duty to control all of the fees and costs of the investments recommended to the client. SIFMA and other opponents of the fiduciary standard should not roll out incomplete and non-objective studies showing that fiduciary advice results in higher fees and costs, when in fact the opposite is true in most instances.

In conclusion, the higher fiduciary standard, being client-centric and requiring control by the advisor of fees and costs, will result in savings to participants in ERISA plans of tens of billions of dollars a year. Application of the fiduciary standard of conduct will therefore boost the net returns of millions and millions of Americans in their retirement plans, leading to greater retirement security.

[4] *See* Rhoades, "One-Man Think Tank: The fiduciary standard may sink Wall Street's advisors-on-yachts. Should we care?", available at http://www.riabiz.com/a/4598123, and providing several concrete examples of business models in which individual investors receive less expensive, yet more comprehensive and better, advice.

2. <u>"The ability of millions of Americans to save for retirement will be adversely impacted."</u>

In its February 3, 2011 comment letter to EBSA, SIFMA asserted: "Financial institutions will not be able to deliver critical investment tools, information and services, or will only be willing to do so at an added cost to IRA account holders and retirement plan participants. With the number of self-directed plans and IRAs increasing, it is more critical than ever that individuals be provided with low cost tools for retirement planning."

The DOL/EBSA's recent efforts to promote full and meaningful disclosure of fees and costs, and to properly extend the application of fiduciary duties arising under ERISA and the prohibited transaction rules to all providers of advice to plan sponsors and plan participants, should be applauded. While disclosure has its inherent limitations as a means of consumer protection, full and meaningful disclosure can result in greater attention paid by plan sponsors to the fees and costs borne by plan participants.

It has been said that forty percent (40%) of the returns of the capital markets currently are diverted to financial intermediaries, and away from individual investors.[5] If the fiduciary standard of conduct is properly applied to all investment advisory activities, whether the advice is provided to the plan sponsor or to the plan participants, such an inappropriately large diversion of the returns of the capital markets would not occur. Rather than preserve a long-outdated model of product sales (which should go the way of the dinosaurs, although broker-dealers and product manufacturers resist such an extinction event), proper application of the fiduciary standard of conduct will result in disintermediation in the retirement plan sector. One can easily predict that:

(1) Third-party administrators and record-keepers will be compensated on a per-plan and per-participant basis (with some fees imposed on particular transactions, such as loans), rather than receive any portion of investment advisory fees;

(2) Tremendous pressure will be asserted by fiduciary investment advisers (acting as representatives of the plan sponsor and/or plan participant) upon product manufacturers to reduce the "total fees and costs" of pooled investment vehicles, resulting in higher returns to investors.

(3) As more fiduciary investment advisers emerge and compete in the retirement plan universe, increased pressure will exist on investment advisory fees. While the "asset-based percentage" fee structure will likely continue to dominate for several years, over time plan sponsors will grow to understand that the services provided by investment advisers to the plan sponsor are discrete, in the sense that the investment adviser undertakes due diligence and undertakes recommendation on the investment choices periodically to the plan sponsor. Advisors who provide services to multiple plan sponsors enjoy economies of scale in their due diligence efforts. Moreover, the time

[5] *See* Rhoades, "One-Man Think Tank: Four red flags in the SEC's fiduciary report," available at http://www.riabiz.com/a/5816260, noting that "this diversion of profits from the providers of capital to financial intermediaries a drag upon the productive aspects of the U.S. economy. We could also call it financial intermediation run amuck, like a predator let loose without restraint."

required to provide general investor education to plan participants can also be quantified. As a result, the emergence of flat or fixed fees paid by plan sponsors to investment advisers is likely to emerge, further driving down the costs borne by plan sponsors and/or plan participants, and enhancing their returns.

The combined use of model portfolios designed by fiduciary advisors, low-total-fees-and-cost mutual funds chosen by mutual funds, fully disclosed and negotiated investment advisory and other fees, the automated rebalancing of participant accounts, and new means of delivering investor education with the aid of present technologies, can all result in savings and risk reductions and better portfolios. The result is a significant enhancement of the returns of even small investors when participating in 401(k) and other qualified retirement plans.

In summary, SIFMA's assertion that the extension of fiduciary duties will result in diminishment of the ability of individual Americans to save and plan for retirement is wholly inaccurate. In reality, only the high profits of broker-dealer firms and insurance companies will be adversely affected. And individual investors will reap a far greater portion of the returns of the capital markets when the fiduciary standard is applied.

3. <u>"More limited choices."</u>

In his February 3, 2011 comment letter to EBSA, CEO Timothy Ryan, Jr. asserted on behalf of SIFMA: "The proposed regulation will limit access to markets, investment products and service providers. Limited availability and decreased competition will result in higher costs and spreads and adversely impact market efficiency. Service providers and counterparties that choose to continue to provide services to, and trade with, plans and IRAs will incur a multitude of new costs, much of which will be passed on to clients." Specifically, SIFMA further notes: "Investment options will be curtailed. Plans will be prohibited from engaging in swaps, restricted in their use of custody, lending, cash management, and futures strategies, and limited in their access to alternatives."

The "limited choice" argument refuses to recognize the effect of the application of the fiduciary standard of conduct. The fiduciary standard, in essence, does constrain the actions of those providing advisory services and may prohibit recommending certain products or services to a client. This is because the fiduciary standard operates as a restraint on self-serving conduct.

In fact, there are many business models which are inconsistent with the fiduciary standard of conduct. Generally, only specific statutory exceptions exist for certain self-dealing transactions in those limited circumstances where legislatures have found it appropriate to provide for such exceptions:

- Banks were only able to offer proprietary mutual funds to the clients of trust service platforms under specific state statutes permitting their utilization in fiduciary accounts. Even then, most state statutes impose conditions upon the use of proprietary accounts, such as mandatory crediting of fund management fees against investment advisory fees to avoid "double-dipping."

- Principal trading is expressly permitted in limited circumstances under Section 206(3) of the Investment Advisers Act of 1940. However, under the express language of the statute, principal trades can only occur with full disclosure to the client in writing before the completion of the transaction of the capacity in which the investment adviser is acting and obtaining the consent of the client to such transaction.[6] The "ultimate goal" of Section 206(3) is to "prevent trades which are disadvantageous to clients of fiduciary advisors."[7] Indeed, several very early decisions applying Section 206(3) illustrate the fiduciary principle and highlight the requirements of fiduciary law when a fiduciary acts with respect to its own account:

> It is well settled that a fiduciary, as, for example, an agent, who sells his own property to his principal must disclose his cost to the principal so that the principal will know what profits the fiduciary will realize by effecting the transaction.[8]
>
> [An agent must disclose not only that he] is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal [including] the price paid by the agent for the property which he sells to the principal . . . and the price he receives for the property he buys from the principal.[9]
>
> Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.[10]

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[6] Section 206 provides in pertinent part: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

Fundamentally, a principal trade is "self-dealing" – a form of conflict of interest where the fiduciary attempts to wear two hats – one in which it represents the dealer's interest and determines whether to purchase or sell a security to/from the dealer's inventory, and the other in which it attempts to represent the client's interest.

[7] Comment letter of Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, Nov. 30, 2007, available at http://sec.gov/comments/s7-23-07/s72307-18.pdf, at p.1.

[8] *Arleen W. Hughes*, 27 S.E.C. 629, 635 (1948), *aff'd sub nom., Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). In *Arleen W. Hughes* the Commission found that a registered broker-dealer who was also a registered investment adviser violated the antifraud provisions of the securities laws by executing principal trades with her customers without disclosing fully the nature and extent of her adverse interest. Although the registrant had disclosed her principal status in her written agreement with her customers, the SEC determined that such disclosure was inadequate to alert the customers to the potential conflict of interest. The Commission stated: "[I]f registrant chooses to assume a role in which she is motivated by conflicting interests …. she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction." *Hughes*, 27 S.E.C. at 637.

[9] *William J. Stelmack Corporation*, 11 S.E.C. 601, 618 (1942).

[10] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963).

- While the SEC is provided, under the Dodd-Frank Act, with the ability to commence rule-making "as necessary or appropriate in the public interest and for the protection of retail customers" to apply the fiduciary standard of conduct found in the Investment Advisers Act of 1940 to broker-dealers and their registered representatives, and Congress stated that "[t]he receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer," this language only duplicated what was already known in fiduciary law. More importantly, Congress expressly provided that the SEC shall "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." For example, while commission-based compensation is not, in itself, contrary to the dictates of the fiduciary standard of conduct under either state common law or under the Investment Advisers Act of 1940, the SEC could seek to prohibit *variable compensation* – where the compensation paid to a fiduciary advisor varies depending upon the products recommended by the advisor. This form of a conflict of interest is so insidious that it often leads to abuse.
- Congress also noted in the Dodd-Frank Act that the "sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the [fiduciary] standard." However, as stated previously, Congress also empowered Congress to enact rules which prohibit certain sales practices and conflicts of interest, and similar to the actions that states have already undertaken with respect to sales of proprietary funds by bank trust departments many such restrictions could be put into effect.

In summary, the fiduciary standard operates to restrain certain conduct, or prohibit same, as necessary to protect the interests of investors. If certain activities of broker-dealers are restricted or prevented, then so be it. Given the thousands and thousands of securities available today through hundreds of brokers and dealers, there exists little if any need for principal trades or for the sale of proprietary products. Given the inherent dangers of self-dealing (including possible dumping of securities, as well as the problem of setting a favorable price for the client in bond markets which are often highly illiquid) in principal trades, and other forms of transactions which may be prohibited by ERISA, it should be a very lofty burden for broker-dealers and insurance companies to overcome if they seek to engage in conflict-ridden activities.

Moreover, as the late Justice Benjamin Cardoza warned, great caution should be provided before providing "particular exceptions" to the fiduciary standard of conduct and thereby undermining its effectiveness.

Lastly, it should be noted that the U.S. Department of Labor has never been given a mandate to preserve conflict-ridden sales practices, nor to preserve any business model which has become outmoded through the process of time. The DOL / EBSA is well within its statutory mandate to adopt rules which prohibit certain conflict-ridden product sales practices.

4. "This rule would appear to be in conflict with recent action by Congress."

In SIFMA's testimony, Mr. Bentson notes that Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in July 2010, required the U.S. Securities and Exchange Commission (SEC) to conduct a study on investment advisers (RIAs) and broker dealers (BDs) and the standards of conduct applicable to them when providing investment advice. However, rather than the DOL's Proposed Rule being in conflict with recent action by Congress, as suggested by Mr. Bentson, it appears to this observer that the Proposed Rule fosters the application of a fiduciary standard. Congress expressed its intent, through the hearings, to apply a fiduciary standard of conduct to all investment advisory activities as to investments involving retail customers.

Additionally, I would note that the "sole interests" fiduciary standard of conduct found within ERISA, aided by specific prohibited transaction rules, results in key statutory distinctions between ERISA and the Advisers Act's "best interests" standard. These differences will necessarily result in distinctions in specific rules which have been and will be adopted. There is no reason to wait for rulemaking by the SEC to proceed under Dodd Frank, especially given that ERISA generally imposes a stricter form of the fiduciary standard upon fiduciaries.

5. Congress "authorized the SEC to promulgate a rule establishing a *uniform* standard of care for the provision of" personalized investment advice.

Congress did not, as SIFMA suggested in Mr. Bentson's testimony, authorize the SEC to promulgate a rule establishing a "uniform" standard of care. In fact, the word "uniform" is not utilized in Section 913 of the Dodd Frank Act.

Rather, Section 913(c)(9) specifically notes that the SEC should study "the potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers, and persons associated with brokers or dealers— (A) the standard of care applied under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.) for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the Commission and the courts."

Nor is there any indication of any intent by Congress, within the Dodd-Frank Act, to apply "uniform" standards of conduct to advisory services provided to accounts governed by ERISA, which have always been governed by stricter fiduciary standards of conduct than those found in the Advisers Act, as well as by prohibited transaction rules which are absent from the Advisers Act.

6. "SIMFA strongly supported this provision of the Dodd-Frank Act."

Mr. Bentson opined in his testimony that SIFMA "strongly supported" the application of fiduciary standards as authorized by Congress in the Dodd-Frank Act. In reality, SIFMA is late to the table, if it has come to the table at all.

In its testimony before the Senate Committee on Banking on March 10, 2009, the Securities Industry and Financial Markets Association (SIFMA) called for both broker-dealers and RIAs to be held to a "universal standard of care" expressing "fundamental principles of fair dealing." It does not take an academic expert to note that "fundamental principles of fair dealing" are a concept born out of the law pertaining to commercial transactions involving actors in arms-length relationships. Fiduciary status requires much more of those engaged in providing investment advisory services.

Indeed, rather than support the existing fiduciary standard of conduct found under the Investment Advisers Act of 1940, and apply same to broker-dealers and their registered representatives who provide investment advice, SIFMA more recently appeared to "embrace" a fiduciary standard. In reality, SIFMA instead argued for a "new" "federal fiduciary standard." I sounded the alarm on SIFMA's about-face in an article I wrote for Advisor Perspectives on July 21, 2009, "SIFMA's Proposed 'New Federal Fiduciary Standard': Consumer Protection … or 'A Wolf in Sheep's Clothing'?"[11]

In point of fact, SIFMA has long argued for a weaker, disclosure-based standard of conduct, which in reality is not a fiduciary standard of conduct at all. Why are brokers reluctantly embracing rules mandating enhanced disclosures? Broker-dealers are well aware that disclosures, as a means of investor protection, are ineffective[12]; investors usually don't read them, don't understand them, and suffer from a multitude of behavioral biases which render disclosures of conflicts of interest ineffective. Indeed, academic research reveals the "perverse effect" of disclosures of conflicts of interest – such disclosures do not render unbiased advice objective, but rather often lead to even worse advice.[13]

As seen by these few excerpts, SIFMA's "support" for a true, bona fide fiduciary standard of conduct has been either late, weak, or spirited attempts to undermine the bona fide fiduciary standard of conduct itself. These attempts will no doubt continue, and should be resisted by regulators.

7. <u>"Disrupts capital markets" and "Adversely effects the economy."</u>

In the comment letter submitted by Mr. Ryan, SIFMA observed that: "At a time when the economy is making at best a fragile and halting recovery, the adverse effects on the capital markets will be significant and capital currently invested by plans and IRAs in real estate and private equity will be reduced."

In reality, the current system of securities underwriting and commission-based product sales results in distortions in the capital markets system and a misallocation of capital. Economists generally believe that the current financial structure results in wholesale misappropriations of needed capital. Evidence of such is quite apparent – the flow of investor's funds into heavily hyped mortgage-backed securities in recent years, leading in large part to the most recent economic "Great Recession." If most individual investors were represented by fiduciary investment advisers, rather than served by broker-dealers selling manufactured products out of their own inventories, no doubt the risks of such mortgage-backed securities would have earlier become more well-known (as fiduciary investment

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[11] Available at http://www.advisorperspectives.com/newsletters09/pdfs/SIFMAs_Proposed_New_Federal_Fiduciary_Standard.pdf).

[12] See Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future, 51 DUKE L.J. 1397, 1454-89 (2002)

[13] *See* Cain, Daylian, G. Loewenstein and D. A. Moore, The Dirt on Coming Clean: The Perverse Effects of Disclosing Conflicts of Interest, Journal of Legal Studies, January, 1-25, 2005.

advisers possess a duty to discern risks of the investment products they recommend), and the Great Recession may have been alleviated, if not averted in its entirety.

Moreover, less capital is available presently to fuel economic growth, due in large part to the substantial distrust by individual investors of those registered representatives and insurance agents who pose as "financial consultants" and "financial advisors." Indeed, the use of such titles denoting faith and confidence often results in fraud occurring, when fiduciary obligations are not accepted by the "financial advisor." As stated by Professors Angel and McCabe:

> The relationship between a customer and the financial practitioner should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer's financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – *to give biased advice with the aura of advice in the customer's best interest – is fraud*. This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners.[14]

It must be remembered that, fundamentally, an economy is based upon trust and faith. Continued betrayal of that trust by those who professor to "advise" upon qualified retirement plans, while doing so under a purported non-fiduciary standard, will only serve to undermine trust[15] and further undermine the foundations of our economy.[16]

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[14] Angel, James J. and McCabe, Douglas M., Ethical Standards for Stockbrokers: Fiduciary or Suitability? (September 30, 2010). Available at SSRN: http://ssrn.com/abstract=1686756.

[15] "[I]ndividuals continue to trust beyond the point where evidence points to the contrary. Eventually, however, the accumulated weight of evidence turns them towards distrust, which is equally reinforcing." Anand, Kartik, Gai, Prasanna and Marsili, Matteo, Financial Crises and the Evaporation of Trust (November 16, 2009). Available at SSRN: http://ssrn.com/abstract=1507196.

[16] "[S]pecific trust in advice given by financial institutions represents a prominent factor for stock investing, compared to other tangible features of the banking environment." Georgarakos, Dimistris, and Pasini, Giacomo, Trust, Sociability and Stock Market Participation (2009). Available at http://www.aueb.gr/conferences/Crete2010/Senior/Georgarakos.pdf. *See also* César Calderón, Alberto Chong, and Arturo Galindo, Structure and Development of Financial Institutions and Links with Trust: CrossCountry Evidence (2001) ("We use a new World Bank data set that provides the most comprehensive coverage of financial development and structure to this date. We find that trust is correlated with financial depth and efficiency as well as with stock market development.") Available at http://www.iadb.org/res/publications/pubfiles/pubWP444.pdf.

"It is well documented that public trust is positively correlated with economic growth (Putnam 1993; LaPorta, LopezdeSilanes, Shleifer, and Vishny 1997; Knack and Keefer 1997; Zak and Knack 2001) and with participation in the stock market (Guiso, Sapienza, and Zingales 2007a) … we develop a two-period theoretical model in which investors entrust their wealth to a continuum of heterogeneous agents and rely on the agents to honor their fiduciary duty … Trust that arises from the law evolves because investors can rely on the government to make sure that agents honor their fiduciary duty to clients … we consider the effect that professional fees have on the trust that forms in markets … We show that when the value to social capital is relatively low and/or the growth potential in the economy is low, it is never optimal to institute a Coasian plan (absence of government regulation). We also show that ceteris paribus there should be more government intervention in a low trust equilibrium than in a high trust equilibrium." Carlin et. al.

"In our 37 nation sample … growth rises by about 1 percentage point on average for each 15 percentage point rise in trust … Trust, and the social and institutional factors that affect it, significantly influence growth rates. Thus, this research provides a new insight into the way that institutional factors affect economic performance." Zak, Paul J. and Knack, Stephen, Trust and Growth (Sept. 18, 1998). Available at SSRN: http://ssrn.com/abstract=136961 or doi:10.2139/ssrn.136961.

In Conclusion.

The purpose of this letter was solely to rebut various assertions made by the representative organization of the broker-dealer industry. Wall Street and insurance companies seek to retain a flawed business model which fails to serve the public interest, particularly with regard to the retirement savings of millions of our fellow citizens.

We have a problem in America. The world is far more complex for individual investors today than it was just a generation ago. Counter-party risk remains far greater today than just five years ago. There exist a broader variety of investment products, including many types of pooled investment vehicles and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total fees and costs," investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

Proper financial planning and investment decision-making are essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about how to provide for their financial security over the course of their lifetimes, including their retirement years, then the government will have to step in to save people from the consequences of their poor planning.

In the vast majority of the well-regulated capital markets in the world it is recognized that the imposition of high standards of conduct upon financial intermediaries is necessary to provide protection to consumers from unfair, improper, and fraudulent practices. Such protection fosters confidence in the capital markets by investors, which in turn promotes increased investor participation in efficient capital markets.

Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. However, disclosures do not address investors' difficulties in dealing with

"Using data from the US states, we provide new evidence of a positive relationship between trust and economic growth and show that even in a high income country such as the US, in which property and contractual rights are protected more than the low income countries, high trust regions achieve higher economic growth." Dincer, Oguzhan C. and Uslaner, Eric M., Trust and Growth (July 2007). FEEM Working Paper No. 73.2007. Available at SSRN: http://ssrn.com/abstract=999922.

the psychological issues of risk aversion, overconfidence, and cognitive dissonance. Moreover, many investors do not enjoy the intended protections of securities laws because disclosures are either inadequate (as to the quality or quantity of information provided), incomprehensible to the individual consumer (in terms of the language or terminology utilized), or deficient in timing (i.e., coming only after the consumer makes a decision). While efforts have been made to formulate disclosures in "plain English," this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed.

While the enhanced prospectuses and other disclosure document requirements imposed by securities regulators are indeed important, a huge amount of academic research in recent years leads to the inescapable conclusion that, due to various behavioral biases consumers possess, disclosures are largely ineffective (and seldom will be read). Moreover, few consumers possess the resources to hire knowledgeable monitors in order to observe and report on the conduct of the financial advisor. Fiduciary duties overcome the inherent ineffectiveness of disclosures. Hence, it is altogether necessary to impose the fiduciary standard of conduct upon those who provide advice on other people's money. Moreover, the imposition of ERISA's higher "sole interests" fiduciary standard of conduct, and prohibited transaction rules, is important to the retirement security of millions of Americans. The attachment of fiduciary status provides consumers with the ability to trust their financial advisor to act in the consumer's sole interest or best interest, and not the self-interest of the advisor, as to matters consumers do not fully understand (nor can be reasonably expected to understand).

To accept the premise, advanced by many who oppose the fiduciary standard of conduct, that investors are responsible for understanding what they read and then will act prudently thereafter, it is necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. However, consumer ability to understand is not only difficult due to the enormous knowledge base required to undertake decisions in dealing with a highly complex financial world, but also due to bounds upon human behavior that limit the extent to which people actually and effectively pursue utility maximization. Individuals possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure.

Moreover, not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but ... competitive pressures almost guarantee that they will do so. As evidence of the foregoing, many registered representatives, insurance agents, and investment advisers have been trained by consultants to first establish a relationship with a prospective client based upon trust and confidence, long before any discussion of fees or products; such training is commonplace in the securities industry. Indeed, I have received such training – from multiple different practice management and marketing consultants. These consultants are quick to point out the reality that - once a relationship of trust and confidence is accomplished – the "sale" of either the product or the service is then easily accomplished, regardless of any subsequent disclosures which are mandated.

The fact is that we should no more expect the vast majority of individual consumers to be able to successfully navigate today's complex financial world than we would expect them to act as their own attorney or physician.

For many years ERISA's strict fiduciary standard and prohibited transaction rules have protected investors in retirement plan accounts. In recent years the DOL has courageously confronted the insurance lobby and Wall Street, as EBSA has sought to better apply the fiduciary standard of conduct found within ERISA – the strictest standard of conduct under the law – to all providers of investment advice to accounts governed by ERISA.

I urge DOL/EBSA to closely scrutinize the testimony and comment letters submitted by those organizations and firms who continue to fundamentally oppose a bona fide fiduciary standard of conduct and the protections it offers to consumers.

I suggest that DOL/EBSA can, as part of its economic analysis, retain independent and objective professors of finance to discern the fees and costs of various fiduciary and non-fiduciary business models serving the retirement market today.

In summation, I urge DOL/EBSA to adopt the broadened definition of fiduciary, without delay.

Thank you.

Sincerely,

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