RAND Report

Potential Economic Effects on Individual Retirement Account Markets and Investors of DOL's Proposed Rule Concerning the Definition of a 'Fiduciary'

STEVEN GARBER, JEREMY BURKE, ANGELA HUNG, AND ERIC TALLEY

RAND LABOR AND POPULATION

RR-1009-DOL
February 2015
Prepared for the Department of Labor

RAND's publications do not necessarily reflect the opinions of its research clients and sponsors. RAND® is a registered trademark.

Preface

In October 2010 the U.S. Department of Labor (DOL), Employee Benefits Security Administration (EBSA) proposed a new rule, 29 *Code of Federal Regulation* (CFR) Part 2510, "Definition of the Term 'Fiduciary'—Proposed Rule" (the Proposed Rule; U.S. DOL, EBSA, 2010) that would redefine the circumstances under which organizations and individuals are considered to be "fiduciaries" by reason of giving investment advice to an employee benefit plan, a plan participant, or an individual retirement account (IRA) holder. A key objective of the Proposed Rule is to reduce the incidence of self-dealing by broker-dealers and their associated representatives in the course of providing investment advice.

Among the comments received in response to the Proposed Rule were two reports from consulting firms that focused on potential unintended negative consequences for individuals who save for retirement through traditional and Roth IRAs. EBSA's Office of Policy and Research asked RAND to review and analyze economic issues raised by those two comments and provide its thoughts on the validity and policy implications of predictions made therein. This paper is RAND's response to that request.

The work reported here was undertaken in 2012 and was sponsored by the DOL. The report should be of interest to DOL staff; staff of other federal agencies that have regulatory responsibilities related to financial markets, such as the U.S. Securities and Exchange Commission; broker-dealers who provide advisory services related to IRAs; and economists and policy analysts with interests related to potential effects of conflicts of interest for financial advisors and potential policy responses.

This research was undertaken within the Center for Financial and Economic Decision Making (CFED). The mission of CFED, a part of RAND's Labor and Population research division, is to understand how people in the United States and around the world collect and think about financial information and how successfully they match their financial decisions to their interests and goals. CFED's researchers are dedicated to finding solutions that can improve the decisionmaking that affects the financial well-being of individuals, families, and nations. RAND Labor and Population has built an international reputation for conducting objective, high-quality, empirical research to support and improve policies and organizations around the world.

For more information about CFED, contact the Director, Angela Hung, by email at Angela_Hung@rand.org; by phone at 310-393-0411; or by mail at the RAND Corporation, 1776 Main Street, P.O. Box 2138, Santa Monica, CA, 90407-2138. More information about RAND is available at www.rand.org.

Table of Contents

Preface ii
Tables iv
Summary v
Acknowledgments vii
Abbreviations viii

Chapter 1. Introduction 1
Chapter 2. Legal and Regulatory Background 3
Chapter 3. Do Conflicts of Interest Currently Affect the Behavior of Financial Advisors? 5
Fischel and Kendall's Conceptual and Theoretical Arguments 5
Empirical Evidence Offered by Fischel and Kendall to Support Their Claims 7
Fischel and Kendall Arguments About Investor Benefits from Firms' Reputational Concerns 8
Conceptual and Theoretical Arguments 8
Empirical Evidence Offered by Fischel and Kendall to Support Their Claims About Reputational Concerns 8
Implications of Other Literature 9
Summary 9
Chapter 4. Industry Responses to Adoption of the Proposed Rule 11
Industry Responses to Increased Costs and Elimination of Some Revenue Sources 12
Additional Industry Costs Resulting from New Fiduciary Status 13
Lost Revenues Resulting from Prohibition of Some Revenue Sources 15
Effects of the Proposed Rule on Investors Claimed by Oliver Wyman and Fischel and Kendall 15
Increases in Fees 15
Increases in Minimum Account Balances 17
Eliminating "Commission-Based" Advisory Services 17
Major Contractions in the Investment Advice Industry 18
Other Predicted Reductions in Service Offerings 18
Chapter 5. How Would Adoption of the Proposed Rule Affect the Well-Being of Retail IRA Investors? 20
An Analytic Approach to Drawing Inferences About Effects on Retail IRA Investors 20
An Illustration of the Approach 21
Summary 25
Chapter 6. Conclusion 26

References 28

Tables

Table 5.1. Effects of Implementation of the Proposed Rule on Sophisticated and Unsophisticated Investors 27

Summary

In October 2010, the Employee Benefits Security Administration (EBSA) of the U.S. Department of Labor (DOL) published in the *Federal Register* a Proposed Rule that would broaden the circumstances under which organizations and individuals are considered to be "fiduciaries" by reason of giving investment advice to an employee benefit plan, plan participant, or individual retirement account (IRA) holder. The primary objective of the rule is to protect retirement investors from "self-dealing"—namely investment advisors acting in their own interests to the detriment of their clients' interests—by financial services firms such as broker-dealers and individuals who offer advice to retirement investors.

Two of the comments on the DOL proposal focused on potential undesirable effects of adopting the rule on investors who save for retirement through traditional or Roth IRAs. We analyze predictions made in these two comments, relying on standard principles of microeconomics and available empirical literature. We also present and illustrate a framework for predicting the effects of adoption of the Proposed Rule on the well-being of IRA investors.

One of the two comments argues that—despite the existence of financial incentives for advisors to self-deal—advisors rarely, if ever, act on these conflicts of interest. More specifically, that comment argues that incentives stemming from competition among broker-dealers for clients and the desire of these firms to have good reputations prevent self-dealing. In turn, they argue that—because self-dealing is currently rare or nonexistent—the adoption of the Proposed Rule would offer essentially no social benefit. We review these arguments and find them unconvincing. Moreover, we discuss empirical literature, which the commenters do not discuss, that does support the conclusion that self-dealing is, in fact, sufficiently widespread that substantial social benefits could result from reducing the prevalence of self-dealing. We then consider the potential effects of adopting the rule, including effects on the behavior of broker-dealers and effects on the well-being of IRA investors.

If the Proposed Rule were adopted, some forms of advisor compensation linked to particular investment transactions on behalf of IRA investors—a full list of which has yet to be determined—would be newly prohibited. For example, adoption of the rule would prohibit some forms of payments from third parties (such as sellers of financial products to broker-dealers) that are conditional on their clients investing in ways that benefit these third parties. Moreover, adoption of the Proposed Rule could increase some costs to broker-dealers, such as costs of monitoring advisor behavior for compliance with the DOL rule and costs of additional lawsuits and liability insurance. Eliminating some current sources of revenues and increasing their costs may cause broker-dealers to respond with efforts to increase revenues from allowed sources, reduce costs to serving the IRA market, or both. Costs might be reduced, for example, by reducing the

“intensity” of advice provided to IRA clients, which we define as the average time and effort advisors devote to serving individual clients. Revenue enhancements might involve increases in advisory fees that would be allowed under the Proposed Rule. At the present time, however, scant empirical information is available about (a) the proportion of current IRA-related revenues of broker-dealers that currently result from transactions that would be newly prohibited under the rule and (b) how much adoption of the rule would increase broker-dealer costs. As a result, we analyze potential effects qualitatively.

The two comments predict that if the rule were adopted, then retail IRA investors would be harmed in several ways. Specifically, the comments claim that these investors would be harmed by the following: less advice about which investment products to include in their IRA portfolios, higher minimum account balances, increased advisory fees, less help in setting up IRAs, decreased levels of contributions to their IRAs, and some investors closing their IRAs. Our analysis suggests that it is likely that some or all of these undesirable effects would result if the proportion of revenues currently derived from sources that would be newly prohibited by the rule, or if the cost increases attributable to the rule, would be sufficiently large.

We then consider how adoption of the rule could affect the well-being (or “utility”) of IRA investors. We use a particular set of assumptions that seem plausible in light of economic theory and empirical information from a variety of studies. Although our specific conclusions are sensitive to the use of alternative sets of plausible assumptions, the general implications of our analysis appear to apply broadly. These implications include (a) effects of the Proposed Rule on IRA investors result from the effects of adopting the rule on several outcomes affecting investor welfare, such as fees, rates of return on IRA portfolios, amounts of time investors spend dealing with their IRAs, and levels of contributions that investors make to their IRAs; (b) effects of the Proposed Rule on investor well-being are likely to differ substantially across different types of IRA investors (such as those with different levels of financial capability); and (c) some investors may be made better off and others made worse off by adoption of the Proposed Rule. Available information, however, is inadequate to estimate how much any particular group of investors is likely to be helped or harmed by adoption of the rule.

Acknowledgments

This work was sponsored by the U.S. Department of Labor, Employee Benefits Security Administration. We thank our colleagues Noreen Clancy, Jack Clift, Jeffrey Garnett and Joanne Yoong for helpful comments and suggestions. The RAND Labor and Population review process employs anonymous peer reviewers, including at least one reviewer who is external to RAND. Two anonymous reviewers provided thorough and constructive feedback on the draft of this paper, and we are grateful to them for helping us improve it.

Abbreviations

CFED	Center for Financial and Economic Decision Making
CFR	Code of Federal Regulation
DOL	U.S. Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act
FK	Fischel and Kendall
IAR	Investment Advisor Representative
IRA	Individual Retirement Account
IRC	Internal Revenue Code
OW	Oliver Wyman
PTE	Prohibited Transaction Exemption
RIA	Registered Investment Advisor

Chapter 1. Introduction

In May 2011, 37 million (31.2 percent) and 18.6 million (15.7 percent) U.S. households owned traditional and Roth IRAs, respectively. The traditional IRA accounts had mean and median assets of $118,000 and $42,500, respectively; the corresponding figures for Roth IRAs were a mean of $41,100 and a median of $20,000 (Investment Company Institute, 2011a, pp. 2, 7). Encouraging U.S. households to save for retirement and helping them invest those funds wisely given their financial means and retirement goals are major social concerns. This paper considers these concerns in the context of a recent proposed policy initiative of the U.S. Department of Labor (DOL).

Specifically, in October 2010, DOL's Employee Benefits Security Administration (EBSA) proposed a rule that more broadly defined the circumstances under which organizations and individuals are considered to be a "fiduciaries" by reason of giving investment advice to an employee benefit plan, plan participant, or individual retirement account (IRA) holder (U.S. DOL, EBSA, 2010). In response to "The Definition of the Term 'Fiduciary'—Proposed Rule" (henceforth the Proposed Rule), the DOL received numerous comments, including two that predicted undesirable, unintended consequences for IRA investors if the rule is adopted. In this report, we review and assess the predictions contained in these two comments in response to a request from the EBSA.

Oliver Wyman (2011; henceforth OW) and Fischel and Kendall (2011; henceforth FK) raise several issues concerning how financial service providers may respond or react to the DOL's Proposed Rule. More specifically, the OW and FK comments focus on putative effects of the Proposed Rule in the markets for professional advice concerning traditional and Roth IRAs. Our analysis focuses on potential effects in these markets and the corresponding implications for investors in traditional and Roth IRAs.

The concerns raised by OW and FK pertain to two categories of potential effects of the Proposed Rule. First, OW and FK consider industry responses that would affect the prices, quality, and quantity of services provided to retail investors as they open IRAs, decide how much to contribute to them over time, and choose particular assets to include in their IRA portfolios. Second, OW and FK consider transition and ongoing costs borne in the first instance by the industry because of broker-dealer responses to adoption of the Proposed Rule.

The remainder of this paper is organized as follows. Chapter Two provides background on the Proposed Rule and other legal and regulatory issues. In Chapter Three, we then consider, and find unconvincing, FK's arguments that broker-dealers and their associated representatives rarely, if ever, self-deal despite financial incentives to do so because of competitive and reputational considerations. In Chapter Four, we describe our conceptual framework for considering potential industry responses to adoption of the Proposed Rule and employ this framework to review and assess several claims by OW and FK about industry responses. Chapter Five considers potential effects of adoption of

the Proposed Rule on the well-being of retail investors, effects that are likely to differ substantially across investors. In Chapter Six, we offer an overview of our analysis and conclusions.

Chapter 2. Legal and Regulatory Background

By way of background for our analysis, this chapter describes the legal and regulatory context underlying the effects of the Proposed Rule on the opportunities and incentives of industry-side participants in the retail IRA markets, which we refer to as “broker-dealers and their associated representatives.”[1] The Proposed Rule is intended to avoid problems that could potentially stem from conflicts of interest by prohibiting some forms of compensation that give these firms and individuals financial incentives to place their interests ahead of those of their clients.

The statutory foundation of the law pertaining to retail IRA markets is the Internal Revenue Code (IRC), which—subject to exceptions described presently—prohibits fiduciaries from engaging in transactions that involve self-dealing. A transaction is considered to involve self-dealing under the IRC if that transaction benefits the fiduciary financially. Under the IRC, violations of prohibitions on self-dealing are subject to an excise tax of 15 percent of the “amount involved”[2] or 100 percent of that amount if the violation is not corrected[3] in a timely fashion.[4]

The general prohibition of self-dealing, however, does have explicit exemptions; these are known as prohibited transactions exemptions (PTEs). For example, and perhaps most important for our analysis, PTE 86-128 allows fiduciaries to be compensated through “commissions” for transactions involving common investment products, such as mutual funds, securities, and insurance products. It is our understanding that for the purposes of PTE 86-128, allowed “commissions”[5] include investor payments that are

---

[1] ERISA defines a person as follows: “(9) The term ‘person’ means an individual, partnership, joint venture, corporation, mutual company, joint-stock company, trust, estate, unincorporated organization, association, or employee organization” (29 U.S.C. 1002). Thus, both natural and artificial persons can constitute fiduciaries.

[2] Section 4975(f)(4) of the IRC defines the term “amount involved,” generally, as the greater of (a) the amount of money and the fair market value of the other property given or (b) the amount of money and the fair market value of the other property received in such transactions. For purposes of the first tier excise tax, the fair market value is determined as of the date on which the prohibited transaction occurs, whereas, for purposes of the second tier excise tax, the fair market value is the highest fair market value during the taxable period described in § 4975(f)(2).

[3] Section 4975(f)(5) of the IRC defines “correction” as undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

[4] The statute identifies the correction as being “timely” if it is done within the “taxable period,” which in turn Section 4975(f)(2) defines as the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of (a) the date of the mailing of a statutory notice of deficiency, (b) the date on which the first tier excise tax is assessed, or (c) the date on which correction of the prohibited transaction is completed.

[5] In the context of IRAs, the word “commission” means different things to different organizations such as the Employee Benefits Security Administration (EBSA), the U.S. Securities and Exchange Commission, and industry groups. Regarding industry groups, Investment Company Institute (2011a, p. 215, Glossary),

directly related to particular transactions (such as one-time front-end loads) but they do not allow ongoing payments (such as trailing commissions—periodic fees paid for investments held in an investor's IRA). Moreover, for the purposes of our analysis, we assume that implementation of the Proposed Rule would not result in the overturning or preemption of any existing PTEs.

Finally, although the actions that constitute prohibited transactions under IRC Section 4975 might also violate other laws that apply to fiduciaries (e.g., federal and state securities laws and state common law), being labeled a "fiduciary" under the Proposed Rule would not in itself provide a basis for meeting the definition of a fiduciary under these other laws. Personal liability on the basis of meeting the definition of a fiduciary under the Employee Retirement Income Security Act (ERISA) would come only from violation of the ERISA fiduciary standards with respect to ERISA plans[6] (but not IRAs). Similarly, liability based on the definition of "fiduciary" under the IRC would come only from violations of the fiduciary self-dealing and third-party compensation prohibitions in IRC 4975. Under the common law, which differs across states, fiduciary status typically confers on investment advisers and broker-dealers legal duties of loyalty and prudence (or "care") (U.S. Securities and Exchange Commission, 2011, pp. 45, 51), but these duties would arise from the broker-dealer meeting the definition of a fiduciary under the relevant state law, not under the proposed regulation. Nevertheless, we cannot rule out the possibility that this view will be challenged in court with at least some investment advisers and broker-dealers being sued and incurring litigation costs.

---

for example, defines "commission" as "[a] fee paid to a broker or other sales agent for services related to transactions in securities." To limit confusion in what follows, we usually avoid using the term "commission" in this review. A notable exception is that we do use the term "commission-based"—which is often used by OW and FK—to describe a common type of advisory relationship when using this term helps us explain claims by OW and FK and our assessments of those claims.

[6] Under ERISA, the two primary fiduciary duties can be described as follows: The duty of loyalty provides that a fiduciary shall discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries (ERISA section 404(a)(1)(A); codified at 29 U.S.C. 1104(a)(1)(A)). The duty of prudence provides that a fiduciary must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" (ERISA section 404(a)(1)(B); codified at 29 U.S.C. 1104(a)(1)(B)). In some circumstances, other fiduciary duties apply, such as a duty of candor or disclosure and a duty to follow the plan's requirements. The duty of prudence—which is violated for giving bad, rather than conflicted, advice is usually subjected to a judicial process inquiry. That is, a fiduciary generally cannot be sued for giving advice that turns out to be bad, unless the plaintiff can show that the advice was not the product of a reasonably prudent investigation. An often-quoted explanation is

> [C]ourts have construed the "prudent person standard" under ERISA as an "objective standard, requiring the fiduciary (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions." (*United States v Mason Tenders Dist. Council of Greater N.Y.*, quoting *Lanka v O'Higgins*)

Chapter 3. Do Conflicts of Interest Currently Affect the Behavior of Financial Advisors?

The Proposed Rule is aimed at protecting investors from professional advice that fails to serve their interests because of the presence of financial rewards to broker-dealers and individuals providing professional advice for recommending and selling investments that do not best serve the objectives of their clients. FK (2011, p. 21, para. 49) makes explicit a helpful distinction in this regard, and this distinction is used as we go along. In particular, FK distinguishes "*potential* conflicts of interest" [emphasis added]—namely financial incentives for firms and advisors to deviate from advice that would best serve their clients' interests—from "*acting on* these conflicts to the detriment of customers" [emphasis added].

Neither FK nor OW dispute the existence of *potential* conflicts for "commissioned-based" broker-dealer models (advisory or discount). FK argues, however, that firms and advisors rarely, if ever, *act on* their conflicts of interest, summarizing this claim by writing: "market discipline protects investors" (FK, 2011, p. 22, para. 50). The FK argument is that market competition and financial benefits of firms and their representatives having reputations for faithfully serving their clients' interests prevent broker-dealers and advisors from acting on their conflicts in ways that harm their clients. The FK argument is unconvincing, however, as we explain presently.

Fischel and Kendall's Conceptual and Theoretical Arguments

FK (2011, p. 22, para. 51) argues that competition among broker-dealers enables those who put their clients' interests first (i.e., do not act on potential conflicts of interest) to gain customers from companies that do not similarly refrain from self-dealing. It seems, however, that this argument would pertain only to fairly sophisticated investors (or those taking cues from them). Less sophisticated investors are unlikely to be able to assess effectively which broker-dealers refrain from self-dealing or act on their conflicts of interests less often than their competitors do.

More specifically, FK (2011, p. 22, para. 51) writes that broker-dealers "can earn sales by pointing out" shortcomings of other firms and that there are substantial "opportunities for investors to readily seek 'second opinions.'" It is not clear, however, how credibly or at what cost broker-dealers can effectively "point out" the shortcomings of their competitors, which seems more difficult the less sophisticated investors are. Moreover, it is doubtful that investors who cannot assess the quality of the advice they

receive[1] could identify and access sources of objective, unbiased, and credible second opinions or effectively determine what the costs of that advice would be.

FK (2011, pp. 24–25, para. 53) also discusses three theoretical articles[2] that illustrate the possibility of losing customers because of acting on conflicts of interest. Even FK's own descriptions of these studies, however, do not suggest that competition substantially reduces the prevalence of self-dealing or that it reduces its frequency to acceptable levels. More specifically, as described by FK, (a) Bolton, Freixas, et al. (2007) concludes that "competition reduces the gains from lying" (but not, we point out, that competition eliminates or even greatly reduces lying)[3]; (b) Krausz and Paroush (2002) concludes that competition makes it easier for "dissatisfied investors to transfer from one financial advisor to another" (but perhaps not, we point out, easy enough to impose major market penalties on those who act on their conflicts) and competition leading to business losses results in "reducing the incentive to deceive" (but may not, we point out, suffice to reduce deception substantially or to acceptable levels)[4]; and (c) Patron and Roskelley (2008) concludes that real estate "agents are less likely to suggest aggressive bargaining strategies [for their clients] when there is little market competition."

In sum, it seems likely that, other things equal, putting clients' interest first will tend to enable broker-dealers to gain new customers—albeit only to the extent that investors can accurately assess differences across broker-dealers in this regard. The theoretical arguments of FK, however, do not suggest that the strength of this incentive suffices to eliminate self-dealing or even to reduce its prevalence to acceptable levels.

---

[1] Australian Securities & Investment Commission (2006) found that Australian consumers were rarely able to detect "bad advice" induced by conflicts of interest involving advisor compensation, namely advice that was subjectively judged to have failed to consider important factual issues, did not fit the client's needs, or was likely to leave the client worse off.

[2] Strictly, the analyses in Krausz and Paroush (2002) are not entirely theoretical. In particular, in addition to offering and mathematically analyzing a theoretical model, to develop a better feel for the implications of their model, they perform simulations of the model calibrated with data from Israel.

[3] It is important to note how the reputation costs are modeled in Bolton, Freixas, et al. (2007). In particular, after selecting a product, an investor can immediately detect when he has been given bad advice, and a bank's reputation is known to all potential investors. In reality, it can be very difficult for investors to judge whether the advice they receive is good advice, especially for the large numbers of investors who struggle with financial literacy. Even if investors could make that judgment, it would most likely take several years to do so. The assumption that a bank's reputation could be known to all potential investors is likewise unrealistic, but evidence indicates that reputation and "word-of-mouth" are important in the financial service sector. For example, Hung, Clancy, et al. (2008) finds that more than 75 percent of investors who use a financial service provider found their provider through referral, either professional or personal.

[4] In the Krausz and Paroush (2002) model, highly risk-averse investors with relatively small accounts are particularly vulnerable to exploitation. The authors present simulation evidence calibrated to Israeli banking data that suggests increased competition may reduce the effects of conflicts of interest for investors who have high relative risk aversion, but it will not improve matters for investors with low relative risk aversion.

Empirical Evidence Offered by Fischel and Kendall to Support Their Claims

FK offers four pieces of empirical information to support their claim that competition greatly limits or eliminates acting on conflicts of interest. First, FK (2011, p. 22, para. 50) asserts that

> The revealed preference of investors themselves for commission-based investment services with respect to IRAs provides *perhaps the most powerful evidence* that, even in the presence of potential incentives for broker-dealers to behave opportunistically with respect to their clients, market discipline protects investors. [emphasis added]

Investors' choices of advisory services reflect, however—in addition to their preferences—such factors as fees, the sizes of their IRA portfolios, and the fact that many investors misunderstand how and how much they actually pay for advice. More specifically, large numbers of retail investors may currently choose "commission-based" advisory relationships—from among a limited range of alternatives, including entering into a fee-only advisory relationship and foregoing professional advice—largely because they fail to understand or appreciate the hidden costs of a commission-based relationship.[5] Moreover, many investors are unaware of how and how much they pay for financial advice ("Commissions Win the Day over Fees," 2011) and are confused about the nature of their advisory relationships (Hung, Clancy, et al., 2008).

Second, FK (2011, p. 22, para. 51, first bullet) argues that the industry is highly competitive because of the existence of thousands of broker-dealers competing to provide "financial planning and investment advice." The existence of thousands of firms seeking business from the same potential customers for the same or similar services does not, however, undermine or refute our view that competition among providers of investment advice may not suffice to eliminate acting on conflicts of interest. This is not sufficient because investor information about the quality of advice offered by different firms is far from perfect or complete (as is assumed in models of perfect competition, for example), which greatly limits the ability of the market to penalize firms that act on their conflicts of interest.

Third, FK (2011, p. 22, para. 51, second bullet) reports that "[p]ublic financial filings by companies in the industry consistently indicate a high degree of competition." This argument and the four specific examples of statements on financial firms' annual reports are unpersuasive. The word "competitive" means something different in the business world than it does in economic theory. More specifically, in the business world, the word "competition" connotes rivalry among firms seeking more business in a particular market, no matter how well the operation of this market serves consumers or promotes economic efficiency. In contrast, in economics the word "competition" often connotes

---

[5] Partially supporting our interpretation, namely that perceptions of the value of financial advice may differ substantially from actual value, FK (2011, p. 22, para. 50) writes, "[m]oreover, half of all mutual fund shareholders indicated they had ongoing relationships with financial advisers, illustrating the continuing value investors *perceive* in their relationships with financial service providers" [emphasis added].

"perfect competition," which is a set of idealized conditions (assumptions) under which markets produce economically efficient outcomes.[6]

Fourth, FK (2011, p. 22, para. 51, third bullet) reports that "[a]verage fees for mutual funds" have declined "dramatically and consistently" over time. Such trends in prices, however, are not in and of themselves evidence of extensive competition. This is because competitive models of pricing predict that (in equilibrium) prices will approximate costs, not that prices will decrease over time (unless costs decline over time).

Fischel and Kendall Arguments About Investor Benefits from Firms' *Reputational* Concerns

FK also considers the effects of reputational concerns on the prevalence of advisor self-dealing. Their arguments do not, however, provide any substantial reason to believe that reputational concerns—alone or in combination with competitive forces—result in acceptable levels of self-dealing.

Conceptual and Theoretical Arguments

FK (2011, p. 25, para. 54) writes:

> if a firm develops a reputation for low-quality service, its clients will be less likely to use that firm's services in the future, and will be less willing to recommend the firm's services to others. In the context of financial services firms, this provides an incentive for those firms to provide high-quality service to their clients, even in the presence of potential conflicts of interest.

We agree that firms with better reputations for providing "high-quality service to their clients" will, other things being equal, attract more customers and that this mechanism represents an incentive to increase the quality of their services, or at least those aspects of quality that are apparent to prospective customers. FK does not, however, claim that reputational concerns result in low or acceptable levels of self-dealing. In fact, as discussed above in the context of the effectiveness of competition in limiting self-dealing, the ability of broker-dealers to build reputations appears to be greatly limited by the inability of unsophisticated investors to assess the quality of the advice they receive.

Empirical Evidence Offered by Fischel and Kendall to Support Their Claims About Reputational Concerns

FK offers two examples of empirical evidence to support their claim that market rewards for having a good reputation with investors greatly limits or essentially eliminates acting on conflicts of interest.

---

[6] Moreover, statements to investors in SEC filings, such as form 10-Ks, about extensive competition seem to involve no substantial downside for reporting companies and could help protect them from investor and derivative lawsuits alleging that they misled investors in their financial filings.

First, FK (2010, p. 26, para. 56, first bullet) reports that many companies say in their U.S. Securities and Exchange Commission filings that their reputations are very important to them. It is likely to be true that broker-dealers do value good reputations with actual and potential clients. Even if true, however, this does not imply that many (or even any) companies have earned good reputations by consistently refraining from acting on their conflicts of interest.

Second, FK (2010, p. 26, para. 56, second bullet) reports that referrals from current or past clients are important to generate new business, and referrals will not occur if their reputations are not good. Again, even if referrals are highly desirable (as suggested by Hung, Clancy, et al., 2008) and are more common for broker-dealers that deserve good reputations, this does not imply that most, or even many, broker-dealers, actually do promote referrals by consistently refraining from acting on their conflicts of interest.

Implications of Other Literature

Findings of several studies that FK do not address in this context suggest that acting on conflicts of interest is much more commonplace than FK indicates.

First, the results of two studies that involved trained auditors posing as ordinary clients of financial advisors indicate that commissions and associated conflicts of interest lead to the provision of some advice that does not well serve clients' interests (Australian Securities & Investment Commission, 2006; Mullainathan, Noth, and Schoar, 2010). Moreover, Charles River Associates (2002) finds evidence of compensation mechanisms affecting market shares in directions that would be expected if advisors do act on their potential conflicts of interest.

Second, other studies indicate that the hidden costs of bad advice are reflected in lower rates of return for investors (Bergstresser, Chalmers, and Tufano, 2009; Christoffersen, Evans, and Musto, 2012). Note especially in this regard that even if—as those authors cannot rule out—investors receive intangible benefits from professional advice (e.g., time savings or peace of mind) along with lower returns, this does not contradict the evidence of lower returns.

Last, evidence from the psychology literature indicates that even when a person is attempting to behave ethically, he may not understand the extent to which self-interest is biasing his judgment (Moore and Loewenstein, 2004). Furthermore, Moore, Tanlu, and Braverman (2010) finds that once a biased opinion has been formed, providing self-interested incentives to be unbiased may not overcome the original bias, in part because individuals are unaware of the subtle effects bias have on their decisionmaking processes. Self-serving bias may also lead people to unconsciously overvalue evidence that supports their position and downplay evidence against (Bazerman, Morgan, et al., 1997).

Summary

FK argues that acting on potential conflicts of interest is too rare to raise substantial policy concerns, and, thus, that potential benefits to investors of implementing the

Proposed Rule would be insubstantial. Their arguments and the purported evidence supporting them is unconvincing, and findings from studies FK do not discuss support the view that acting on potential conflicts of interest is fairly widespread and is costly to investors. Thus, it is not appropriate to dismiss the Proposed Rule as obviously failing a cost-benefit test on the basis that there could be at most minor investor benefits to adopting it.

Chapter 4. Industry Responses to Adoption of the Proposed Rule

In this chapter, we first develop a conceptual framework to consider how the industry may respond to the adoption of the Proposed Rule. We then use this framework to assess OW and FK claims about the effects of adopting the Proposed Rule. We also use this framework in Chapter Five to analyze potential effects of the rule on the well-being of retail IRA investors.

We define the effects of the Proposed Rule on any outcome as the level of that outcome *with* the rule (equivalently, if the Proposed Rule is adopted) minus the level of that outcome *without* the rule (equivalently, if the Proposed Rule is not adopted). Thus, we—along with the Department of Labor in the Proposed Rule, OW, and FK—conceptualize for cost-benefit analysis purposes comparing the state of the world under the Proposed Rule with the *status quo*.[1]

Adoption of the Proposed Rule would eliminate some sources of revenue currently available to nonfiduciaries and would increase broker-dealer costs of serving the retail IRA market. The likely effects of such changes on the service offerings and fees facing retail investors can be analyzed fairly straightforwardly using widely accepted concepts in microeconomics (specifically, the theories of firms and markets).

To analyze industry responses to implementation of the Proposed Rule, we assume the following:

1. Current rules, competition, and investors' imperfect information about which broker-dealers offer their clients the best values result in a status quo industry equilibrium in which the total revenues of broker-dealers associated with services provided to retail IRA investors at least cover the total costs of providing these services and, because of the information problems facing investors, may involve total revenues exceeding their costs (because competition is not sufficiently effective to eliminate all economic profits).
2. If the Proposed Rule is adopted, some of the IRA-related total revenues of broker-dealers would be lost to them, namely, the revenues associated with transactions involving (organizational and individual) advisor-compensation arrangements that would be newly prohibited under the rule.
3. If the Proposed Rule is adopted, broker-dealers will incur some additional costs associated with compliance and protection from lawsuits alleging failure to satisfy their legal duties associated with fiduciary status.

[1] Analyses of the effects of the Proposed Rule on outcomes are examples of *positive* (or "descriptive") economic analysis, which is often described as "analysis of what *will* be." In contrast, *normative* (or "prescriptive") analyses are often described as "analysis of what *should* be." A cost-benefit analysis is a normative analysis that assumes that the social goal is improving economic efficiency. Predictions about how the policy under consideration will affect outcomes of social concern—that is, positive analyses—are critical components of a cost-benefit analysis.

Broker-dealers will not serve the retail IRA market unless they expect to be able to earn sufficient revenues to cover their costs of doing so.

An implication of these assumptions is that if broker-dealers do not respond to the implementation of the Proposed Rule by changing service offerings to reduce costs or increase revenues from allowed sources, they may not be able to cover their costs. For a broker-dealer who would earn positive profits under the status quo, the revenue losses and cost increases attributable to the rule might not be sufficiently large for the firm's total revenues to fall short of total costs, in which case no response to the Proposed Rule may be required for such a firm to continue to offer the services it currently offers for the same fees. Even such broker-dealers, however, may have to change their service offerings and fee schedules to continue to be willing to serve the retail IRA market because of decreases in their profits result from their competitors' responses to the implementation of the rule. In sum, to continue to offer advisory services to retail IRA investors—equivalently, to cover costs and remain in this business—broker-dealers may have to reduce costs (which in large measure might require reducing levels of service[2]), increase revenues by setting higher levels of fees that are not prohibited, or both.[3]

Industry Responses to Increased Costs and Elimination of Some Revenue Sources

For purposes of discussion, we define two terms pertaining to distinct characteristics of advisory services. First, the "quality" of advisory services pertains to the extent to which broker-dealers and their representatives refrain from self-dealing. More specifically, we will say that the "quality" of advice is higher the greater is the extent to which advisors put their clients' interests first when providing advice. Second, the "intensity" of advisory services pertains to the time and effort devoted by advisors to advising each IRA client on average, with intensity increasing with increases in per-client time and effort.

In discussing potential industry responses to adoption of the Proposed Rule, OW and FK limit their consideration of responses by implicitly assuming that no fundamentally new business models will emerge to serve the retail IRA market as a result of adopting the rule. More specifically, their comments implicitly assume that under the rule the only kinds of advisory relationships will be (see OW, 2011, pp. 5–7) the kinds of relationships that currently exist: (a) fee-based advisory relationships and (b) full-service and discount ("commission-based") brokerage relationships. Within that assumed realm, the comments consider only how broker-dealers may respond by changing (in our terminology) the quality and intensity of the services provided and direct fees paid by investors. In essence, then, OW and FK are imagining that under the rule, broker-dealers will search for sets of services (at different levels of intensity) they could offer to retail IRA investors

---

[2] The pressures to reduce cost if the Proposed Rule is implemented might lead to greater efforts to operate more efficiently—that is, to provide the same levels of service at lower cost.

[3] Note, however, that increasing fees will reduce revenues if demand is elastic.

along with associated levels of allowed fees that they would expect to cover costs given what their competitors are expected to offer and how investors' demand is likely to respond.[4]

Within the conceptual framework just sketched, changes from the status quo of the industry equilibrium as a result of adoption of the Proposed Rule are the combined effects of two outcomes of new fiduciary status: (a) higher costs for broker-dealers and (b) reductions in their revenues. We begin by considering potential effects on costs.

Additional Industry Costs Resulting from New Fiduciary Status

FK considers several kinds of cost increases that could result from the adoption of the Proposed Rule. First, FK argues that the industry or its associated advisors might incur substantial costs of additional training and certification required for advisors to continue to give advice if the Proposed Rule were adopted. More specifically, FK (2011, p. 6, para. 13) writes

> many representatives of broker-dealer firms that currently provide services to IRA investors do not currently hold the certifications necessary to operate as fee-based investment advisors, and that if the Proposed Rule were implemented, these representatives would need to gain additional certification in order to continue to serve their clients or attract new clients.

In this context, FK (2011, p. 6. para.14) refers to the "Series 65" license. It does appear that—to be allowed to charge fees for providing investment advice if the Proposed Rule were adopted—many financial advisors who would become fiduciaries would need to become certified as investment advisor representatives (IARs) or registered investment advisors (RIAs). The requirements for IAR or RIA certification differ, however, from state to state.[5] Passing the Series 65 exam (or the Uniform Investment Advisor Law

[4] The possible emergence of fundamentally new business models for serving IRA investors would be especially salient, if as OW and FK predict (see Major Contractions in the Investment Advice Industry below), adoption of the Proposed Rule would result in major declines in the size of the industry. The potential financial rewards for developing and implementing viable new business models are likely to be extremely large; thus, we anticipate that both incumbents and potential new providers of advice to retail IRA investors would devote substantial time and effort to trying to develop new, profitable business models. This effort would be challenging even for industry insiders with unusually rich knowledge of the industry, costs, behavior of retail investors, and so on. Thus, we can do no more than speculate about what new business models might emerge. One seemingly plausible possibility is that incumbents or new entrants will offer in unbundled form services that are currently offered only as packages (or "bundled") by broker-dealers. Unbundling might, for example, involve separate provision of help in setting up IRAs, deciding how much to save, choosing investment products, and so on. Such unbundling would allow investors to purchase only the services they think are worth the costs to them, which could promote economic efficiency. Perhaps, however, some unbundled services cannot be priced in a way that will find enough customers to cover the costs of providing these services. If so, organizations that are not motivated by profit if they participate in this market (e.g., employers, foundations, other not-for-profits, government agencies) may offer such services for no charge or for prices that many investors would be willing to pay, thereby mitigating any harmful effects of industry responses for at least some retail IRA investors.

[5] See, generally, North American Securities Administrators Association, *Exam FAQs*, n.d.

exam)—along with passing a background check and paying fees—suffice for certification in most states. Most of those states, however, allow individuals to qualify without passing the Series 65 exam if they have passed other specified exams or hold other specific certifications.[6]

FK (2011, p. 6, para. 14) reports that an average of 50 hours per applicant is a "conservative estimate" of the preparation time required to take the Series 65 exam. We have searched but found no studies of the costs of obtaining Series 65 certification. RIA Compliance Consultants[7] (*Frequently Asked Questions About the Series 65 Examination*, n.d.), however, advises people to "[p]lan to spend between 45 and 60 hours and at least four weeks of studying for the series 65 examination." This admittedly limited evidence suggests that the figure of 50 hours offered by FK is reasonable.[8]

FK (2010, p. 4, para. 11) also writes, "[u]ndoubtedly, financial service providers and their representatives would incur significant compliance costs in complying with new regulations." Additional compliance costs would include, for example, costs associated with broker-dealers developing new corporate policies, communicating these policies to

---

[6] See, North American Securities Administrators Association, "When Can I Register as an Investment Adviser Representative if I Haven't Taken the Series 65, or Series 66 in Combination with the Series 7?" *Exam FAQs*, n.d.

> Most states will allow an individual to substitute one of the following certifications for passing the exam: CFP – Certified Financial Planner (granted by the CFP Board of Standards); CIC – Chartered Investment Counselor (granted by the Investment Adviser Association); ChFC – Chartered Financial Consultant (granted by the American College); PFS – Personal Financial Specialist (granted by the American Institute of Certified Public Accountants); and CFA – Chartered Financial Analyst (granted by the Chartered Financial Analyst Institute).

[7] RIA Compliance Consultants describes itself as follows:

RIA Compliance Consultants is a team of industry experienced professionals dedicated to working with investment advisors who are also committed to implementing good compliance and risk management strategies. By working together, RIA Compliance Consultants helps investment advisors navigate the maze of investment advisor compliance regulations and find the best ways to satisfy their obligations. (RIA Compliance Consultants, *About Us*, n.d.)

[8] The 50 hours of preparation time per examination taker assumption is one piece of FK's illustrative calculation of the industrywide cost of more than $295 million (which they characterize as "necessarily a rough approximation") derived by assuming that (a) 60 percent of 300,000 registered representatives nationwide would take the Series 65 exam once each, and (b) the value of an hour of preparation time is the "2009 median hourly wage of personal financial advisers" of $32.79 (FK, 2011, pp. 6–7, para. 14). Regarding (a), we have no basis for second-guessing the 300,000 figure (for which no source is provided by FK). We should expect that the number of people choosing to take the Series 65 exam will not be dramatically different from the number of people who can be employed giving financial advice if the Proposed Rule is adopted. We have no basis, however, for assessing the degree to which numbers of professional financial advisors would decline in response to adoption of the Proposed Rule. Regarding (b), using a wage rate (or average hourly earnings) of an individual to approximate the social cost of an hour of that person's time is standard practice in cost-benefit analysis, and using the median hourly wage rather than the mean seems appropriate (and, perhaps, a bit conservative) in that the median is not sensitive to very high figures that are likely to characterize personal financial advisors who do not serve the retail IRA market. Finally, we have no basis for judging the representativeness of Primerica's ratio of series 65 license holders (namely, 233) to registered representatives (16,000); note, however, that this ratio is not used in the calculation of the $295 million estimate.

their associated advisors, and monitoring compliance. Moreover, FK (2011, p. 5, para. 11) suggests that firms will incur additional costs of defending lawsuits enabled by their fiduciary status and "fiduciary liability insurance." As discussed in the context of legal and regulatory background, broker-dealers may well incur additional litigation costs because of their newly conferred fiduciary status. Moreover, broker-dealers may purchase additional liability insurance in response to what they perceive as additional liability exposure resulting from adoption of the rule.

Lost Revenues Resulting from Prohibition of Some Revenue Sources

If the Proposed Rule were adopted, (compliant) broker-dealers would lose some proportion of the IRA-related revenues they currently receive. Neither OW nor FK provide any information about the revenue sources that would be prohibited if the Proposed Rule were adopted or their importance to broker-dealers; in fact, these questions are currently unanswerable. Nonetheless, it appears OW and FK assume that if the Proposed Rule were adopted, broker-dealers would lose a substantial proportion of all of their IRA-related "commission-based" revenues.

Effects of the Proposed Rule on Investors Claimed by Oliver Wyman and Fischel and Kendall

OW and FK predict numerous adverse impacts on investors from the adoption of the Proposed Rule, including increased fees, increased minimum account balances, and reduced access to advice. In the following sections, we discuss each of these possibilities.

Increases in Fees

OW and FK state in various places in their comments that investors' "expenses" or "costs" associated with receiving advice would increase as a result of the Proposed Rule.[9] It seems clear from their comments, however, that the investors' "expenses" or "costs" to which they refer are limited to fees paid directly to broker-dealers by retail IRA investors. Stated differently, the "direct fees" on which OW and FK focus exclude other investor costs of receiving advice from broker-dealer representatives, such as indirect fees.[10] Moreover, if retail investors obtain lower returns (or bear excessive risk) on their investments because of self-dealing, then these shortfalls in returns are also properly

---

[9] For example, FK title a section of their comments "Expenses Paid By IRA Investors Would Likely Rise Significantly Due to the Proposed Rule" (FK, 2011, p. 7).

[10] OW acknowledges the existence of indirect fees in writing that

> the current brokerage model that has developed to serve IRA accounts is incompatible with this requirement [under the Proposed Rule that "firms and their associated representatives may not receive different levels of compensation based on investment choices of retail investors in protected IRA accounts"], often involving both direct and indirect fees, such as shareholder servicing fees, sales and distribution fees, revenue-sharing and other fees. (OW, 2011, p. 14)

viewed as investor costs of receiving advice. In sum, the *full costs* to investors of a "commission-based" brokerage arrangement may currently comprise direct fees, indirect fees (some of which may be prohibited if the rule is adopted), and reduced investment performance (because of self-dealing). Thus, an assessment of the effects of adopting the rule on investors should consider the effects on indirect fees and investment performance along with effects on direct fees. In considering investor costs or expenses, however, OW and FK focus on direct fees.[11]

Both OW and FK claim that direct fees (although they use the terms "costs" and "expenses") paid by IRA investors should be expected to increase as a result of adopting the Proposed Rule. This claim is plausible as long as the rule would eliminate a substantial portion of broker-dealers' current revenue or substantially increase their costs. This is true because (according to our conceptual framework) elimination of some revenue sources or increased compliance and litigation costs would be expected to lead broker-dealers to seek out ways to increase revenues, and direct fees appear to be one of the leading candidates for consideration in that regard.

Moreover, in several places in their comments, OW and FK (a) argue that adoption of the Proposed Rule would lead to large increases in investors' costs or expenses associated with receiving advice through broker-dealers, and (b) conclude that these cost or expense increases will price many retail investors out of the market for IRA-related financial advice. It appears that the latter argument (b) may be correct despite the fact that the validity of the former (a) is questionable if "costs" and "expenses" include indirect as well as direct fees.

It seems likely that substantial increases in direct fees—which may or may not result from adoption of the rule—could lead to substantially reduced demand for professional financial advice by retail investors no matter what happens to full costs as a result of the adoption of the Proposed Rule. Demand could be reduced because direct fees appear to be the most (and perhaps for many investors, the only) salient component of full costs; for such investors, direct fees are the key "price" to which their demands for advisory services respond.[12] More specifically, many investors are likely to *perceive* large price

[11] For example, while considering only direct fees, FK (2011, pp. 11–12, para. 24) provides a numerical example purporting to demonstrate high costs to investors resulting from the adoption of the Proposed Rule. Specifically, FK (2011, p. 11, para. 24) assumes that 66 percent of IRAs "are held in accounts with commission-based brokerages" and claims that

> if the Proposed Rule led to even a 1 basis point increase in annual costs relative to assets for these investors, it would generate $277 million (= 4.2 trillion X 66% X 0.01%) in additional expenses for investors annually, or over $2 billion over 10 years in current dollars, using a discount rate of 7%.

This example appears incomplete, however, in that it ignores potential decreases in *indirect* fees and improvements in portfolio performance that might also result from adoption of the Proposed Rule.

[12] Barber, Odean, et al. (2005) argues that over the past several decades, investors have become less willing to invest in funds with high front-end load fees, but they have not become more sensitive to operating expenses despite a dramatic increase in the latter.

increases (namely increases in direct fees) no matter what the effect of the rule is on their full costs of receiving professional financial advice.[13]

Increases in Minimum Account Balances

FK also predicts that adoption of the Proposed Rule will lead to increases in minimum account balances, thus preventing some IRA holders from continuing to receive professional advice. Specifically, FK (2011, p. 12, para. 25) writes, "[b]ecause the revenue generated by low balance accounts is small, an increase in costs would likely mean that these firms would increase minimum account balance requirements for IRA investors." We have no empirically grounded basis for predicting whether minimum account balances would increase if the Proposed Rule were implemented. Within our conceptual framework, however, minimum account balances would increase if (and, perhaps, only if) broker-dealers would be unable to create a set of service offerings that could be purchased by IRA investors at fee levels that could cover broker-dealers' costs, while retaining the minimum account balances that exist under the status quo.

Eliminating "Commission-Based" Advisory Services

OW predict that full-service or discount brokerage arrangements, which they also refer to as "commission-based," will cease to exist, and IRA investors will be offered only fee-based advice. Specifically, OW (2011, p. 13) writes: "*Under the proposed rule, Oliver Wyman expects retail brokerage firms would presume that current brokerage account and service offerings would create a fiduciary duty, and respond by limiting the provision of help and investment services to the fee-based advisory model only*" [italics in original].

Thus, OW predicts that if the Proposed Rule were adopted, then IRA investors would not be able to receive professional investment advice through what they call "commission-based" advisory arrangements and would be left with fee-based advice as their only alternative. If so, then another claim of OW and FK would imply that many or most IRA investors would be harmed by adoption of the rule. Specifically, in different places in their reports OW and FK state that retail investors "prefer" commission-based arrangements with their financial advisors, thereby suggesting that investors who would not have access to such arrangements if the Proposed Rule were implemented would necessarily be worse off.

In support of their claim about investor preference, OW (2011, p. 11) writes, "[i]nvestors represented in the study group overwhelmingly use the brokerage

---

[13] FK (2011, pp. 13–14, para. 29), citing Ernst & Young (2011, p. 7), writes, "[a]s reported by analysts at Ernst & Young, under the new rules . . . it seems likely that the mass market and the typical bank customer will not be enthusiastic about paying the sort of fees that make offering the advice attractive." This claim is consistent with our analysis—despite the fact that the Ernst & Young (2011) report pertains to policy developments in the United Kingdom, not in the United States—as long as we interpret "will not be enthusiastic about paying" as "will decline to pay and thus forego services" and if adoption of the Proposed Rule would, in fact, lead to substantial increases in direct fees.

relationship model as opposed to a fee-based advisory model, with 22.4 million or 88% holding brokerage IRAs." As discussed, however, choices made by investors reflect not only their preferences but also their opportunities and available information. In the present context, this means that most IRA investors have chosen "commission-based" arrangements because of their preferences as well as other considerations, including the fees they believe they are paying for advice and the sizes of their IRA portfolios.

Major Contractions in the Investment Advice Industry

FK (2011, pp. 13–14, para. 29) writes

> As reported by analysts at Ernst & Young, under the new rules . . . simplified advice becomes a major economic challenge, requiring a radically reduced cost base if it is to present a solution for the mass market. . . . There is a real possibility that the independent advisory sector, as we know it, will shrink significantly. (citing Ernst & Young, 2011, p. 9)

We think it is likely that many broker-dealers and investment advisors would exit the IRA market if the Proposed Rule were adopted only if the proportion of current revenues that would have to be replaced or increases in costs were fairly substantial.

The number of professional advisors needed to serve the IRA market would be expected to decrease as a result of adopting the rule to the extent that broker-dealers exit the IRA market or take other steps to reduce their IRA-related advisory activities. The size of any effect of implementing the Proposed Rule on numbers of professional advisors serving the IRA market cannot be predicted, however, because of a lack of sufficient empirical information. Even major reductions in numbers of financial advisors serving the IRA market would not necessarily be economically undesirable, however, because the numbers of professional advisors serving the IRA market currently may be too high from an economic efficiency perspective. Much of the current demand for financial services may be attributable to many retail IRA investors overvaluing these services because these investors do not understand the fees they are paying (directly or indirectly) or the associated costs of advisor self-dealing.

Other Predicted Reductions in Service Offerings

FK and OW suggest that reductions in service offerings, higher direct costs for IRA investors, higher minimum account balances, and decreases in the numbers of investment advisors will result in IRA investors receiving fewer services of different types. More specifically, they predict that retail investors will

- Receive less help in setting up IRAs (because providing such help is costly to broker-dealers, and fewer IRA investors will pay the prices required to receive advice about IRAs)
- Receive less investment advice (because fewer retail investors will have professional investment advisors)

- Reduce their IRA contributions and open fewer new IRAs (FK, 2011, p. 12, para. 25, writes, “because, as described above, prices for financial services would likely rise, the Proposed Rule would be likely to cause some individuals to choose not to open IRA accounts or to invest less in them.”)
- Close some IRAs (OW, 2011, p. 16, writes, “we believe that a large number of small balance investors forced to switch to a new firm to access the advisory channel would be likely to take a cash distribution rather than successfully re-invest in a new IRA.”).

We cannot assess these claims for two major reasons. First, we have no basis for gauging the extent of the adjustments that broker-dealers would have to make—which may include cost reductions, revenue increases, or both—to operate profitably if the Proposed Rule were adopted. Second, even if we did know how much broker-dealers would have to reduce costs, increase revenues, or both to operate profitably under the rule, we would have no basis for predicting whether the cost reductions would involve lesser availability of particular advisory services that currently are bundled in “commission-based” advisory relationships, such as those claimed in the four bullet points.

Chapter 5. How Would Adoption of the Proposed Rule Affect the Well-Being of Retail IRA Investors?

In this chapter, we consider how the adoption of the Proposed Rule would affect the well-being (or "utility") of retail IRA investors. To do so, we draw on discussions about potential industry responses and several studies discussed in Burke, Hung, et al. (forthcoming). We conclude that adoption of the rule may make some investors better off (increase their utility) and other investors worse off (decrease their utility), but available empirical information is inadequate to quantify these effects for any particular group.

As we detail in this chapter, available information—both theoretical and empirical—suggests that the Proposed Rule would differentially affect IRA investors, depending on their levels of financial capability. Thus, it seems necessary to consider separately the welfare effects on individuals with high and low financial capability. In principle, to quantify effects of the Proposed Rule on investors, one would want to (a) identify groups of investors for which the welfare effects are likely to be similar within groups and dissimilar across groups, (b) estimate in dollar terms the average change in utility within each group, and (c) determine the number of investors in each group. With that information, the social benefits or costs of the rule associated with effects on retail IRA investors could be estimated.[1] Available empirical information, however, is inadequate for quantifying the welfare effects on particular investors, no less quantifying the value of the aggregate gains to those investors who would benefit and the aggregate losses to those who would be made worse off.

An Analytic Approach to Drawing Inferences About Effects on Retail IRA Investors

To analyze welfare effects for different groups of investors, we decompose the question of overall welfare effects on investors into pieces we can think about (theorize) directly and, ideally, about which existing literature provides useful guidance.

In this analysis, we focus on the effects of the adoption of the Proposed Rule on retail IRA investors who would receive professional financial advice without the rule. We further assume that without adoption of the rule, (a) some advisors will self-deal to some extent and (b) investors who do receive advice will follow it and make some investments that are not best suited to their circumstances and retirement goals. Moreover, we assume

[1] More specifically, the social benefits or costs of adoption of the rule on all retail IRA investors jointly could then be calculated as follows. First, estimate for each investor group the number of investors in the group and the (monetized) average effect of adoption of the rule on the utility of investors in that group. Second, for each group, multiply the number of investors by the average effect on those investors, which would represent the total social benefits or costs for that group. Finally, add up over groups the welfare effects for each group.

that all relevant investors who receive professional advice do so through what OW (2011, p. 6) calls a "brokerage" relationship (full service or discounted).

To simplify the analysis and exposition, we explicitly consider only four outcomes underlying the well-being of a retail IRA investor:

1. Actual total (direct plus indirect) fees paid to receive professional advice, whether or not these total fees are understood by the investor
2. Rate of return on the investor's IRA portfolio
3. Time spent making financial decisions regarding IRAs
4. Amounts contributed to IRAs.[2]

Thus, the first outcome (total fees paid) and any reductions in the second outcome (rate of return) resulting from advisor self-dealing account for the "full costs" of receiving advice as defined above. The third outcome (time spent) involves investor time devoted to making decisions about IRAs, some of which may be saved by receiving professional advice. The fourth outcome (amounts contributed) exemplifies several other outcomes whose levels could be sensitive to whether an investor receives professional advice, including "coaching" to contribute amounts consistent with the investor's age, retirement goals, and so on.[3]

An Illustration of the Approach

To analyze the issue at hand, one must (explicitly or implicitly) make additional assumptions. We now detail the assumptions we use to analyze effects on investor well-being. This set of assumptions appears plausible to us on the basis of our review of pertinent theoretical and empirical literature. Undoubtedly, other sets of assumptions also would be plausible. Thus, our analysis illustrates a general approach to thinking about effects of the adoption of the rule on investor welfare. At the least, using this particular set of assumptions enables us to illustrate the complexity of the question of aggregate welfare effects and the kinds of factors that are expected to determine this outcome. We present and discuss the illustration in sufficient detail to enable readers to alter our assumptions and consider the qualitative implications of alternative assumptions.

In what follows, we assume that

1. For the same service levels of advice as would exist without the rule, with the rule, direct fees would increase (to make up broker-dealer revenues lost on newly prohibited transactions and any cost increases).
2. For the same service levels of advice as would exist without the rule, with the rule, indirect fees would decrease (namely indirect fees associated with transactions that would be newly prohibited if the rule were adopted).

---

[2] We are not aware of any empirical evidence that financial advisors actually do influence investors' decisions about how much to contribute to their IRAs. We nonetheless consider the possibility that advisors do, in fact, induce many investors to contribute more than they otherwise would contribute because industry sources claim that this is true, and we think it is plausible.

[3] Other potential desirable effects of coaching include opening up IRAs and not closing them.

3. Because of the first assumption, and the apparent focus of many investors on direct fees (because indirect fees are not understood by or are not salient to many investors[4]), if the rule were adopted, some investors (who would receive advice without the rule) will choose to forego professional advice,[5] thus decreasing the *quantity* of (or the number of IRA investors receiving) professional advice.
4. The *quality* of professional advice would increase if the rule were adopted because of less self-dealing by advisors, implying higher rates of return for those who continue to receive advice than they would experience without the rule.[6]
5. The *intensity*[7] of professional advice would
   a. *Decrease* for those continuing to receive advice (e.g., less coaching to contribute more to IRAs) as a result of broker-dealers choosing to lower their costs of providing advice
   b. *Decrease to zero* under the rule for those foregoing advice.
6. On balance, total advisory fees borne by investors receiving advice would decrease because of reductions in indirect fees and advice intensity (outweighing increases in direct fees).
7. The two types of IRA investors are "sophisticated" and "unsophisticated" investors:
   a. *Sophisticated* investors who receive advice follow that advice, which lowers their rates of return on their IRAs when their advisors self-deal. They do not use (or benefit from) professional advice (coaching) to open IRAs, to keep open existing IRAs, or to contribute amounts appropriate to their

---

[4] Barber, Odean, et al. (2005) empirically investigates investor responses to different kinds of fees and argues that over time investors have become increasingly sensitive to front-end loads (which are often large and salient), but investors have not become sensitive to operating expenses (which can be masked by the volatility of fund returns). Many investors are confused about the total cost of financial advice ("Commissions Win the Day over Fees," 2011) and are confused about the nature of their advisory relationship (Hung, Clancy, et al., 2008).

[5] The literature provides some guidance regarding factors other than fees that influence whether investors choose to receive professional advice. Hung and Yoong (2010) finds that people with low financial ability are more likely to solicit advice about investment decisions, and Hackethal, Inderst, and Meyer (2010) finds that investors are more likely to rely on advice when they are less confident in their own financial expertise. In addition, other research suggests that the market for advice may be somewhat segmented, with many capable individuals investing autonomously and with many less capable investors (Gil-Bazo and Ruiz-Verdú, 2008, 2009) or investors who receive extra utility from advice (Del Guerico, Reuter, et al., 2010) relying on financial advisors. An exception is the working paper by Calcagno and Monticone (2011), which finds that higher financial literacy reduces the probability of investing autonomously. Finally, Hortacsu and Syverson (2004) finds that investors who purchase through brokers may be less able or less willing to invest on their own.

[6] Substantial empirical evidence suggests that financial advisors are influenced by their compensation schemes (Australian Securities & Investment Commission, 2006; Mullainathan, Noth, and Schoar, 2010) and that investors who purchase through advisors earn lower returns than those who invest autonomously. See, for example, Bergstresser, Chalmers, and Tufano (2009) and Christoffersen, Evans, and Musto (2012).

[7] As defined in Chapter Four, "intensity" refers to the extent of advice received by each investor (intensive margin), not the number of investors receiving advice, which we refer to as "quantity" of advice (extensive margin). In particular, we have defined "intensity" as the average amount of time and effort per IRA client that advisors spend working on behalf of these clients.

circumstances and retirement goals. In sum, with or without the Proposed Rule, sophisticated investors benefit from professional advice *only* in terms of saving time,[8] and without the rule, they sacrifice investment returns because their advisors act on their conflicts of interest.

b. As is assumed about sophisticated investors, *unsophisticated* investors benefit from time savings (with or without the rule), and without the rule, they lose potentially higher returns on their investments because of advisor self-dealing. Unlike sophisticated investors, however, without the rule, unsophisticated investors also benefit from help in choosing investment products (relative to making these choices without professional advice) and from coaching to open IRAs, contribute appropriate amounts, and so on.

Thus, we have defined *sophisticated* and *unsophisticated* investors implicitly in terms of which of the activities of professional advisors help or harm them.[9] Our assumptions imply that without the rule *sophisticated* investors would earn returns at least as high as those they receive through a financial advisor if they were to invest on their own.[10]

Table 5.1 presents our theory- and literature-based conclusions about likely (qualitative) effects of the adoption of the Proposed Rule (again, outcome with the rule minus outcome without the rule). It considers (in different rows) four groups of IRA investors, namely the four combinations defined by whether investors would continue to receive professional advice with the rule (receive or forego) paired with the two types of investors (sophisticated or unsophisticated). For each of these four situations, we consider (across the columns) *effects of adopting the rule* on the four outcomes that underlie the utilities of investors: total advisory fees, rates of return on an IRA portfolio, time spent by investors dealing with their IRAs, and the amounts investors contribute to their IRAs. Each cell in the table reports our (necessarily tentative) conclusion about how an outcome would be affected by the adoption of the rule.

To further explain the table and illustrate the kind of reasoning involved in filling out its cells, consider first the case of a sophisticated investor who would continue to receive advice if the rule were adopted. As indicated in the table, we conclude that if the rule were adopted, such an investor would benefit—other things equal—from lower total advisory fees than without the rule. This reduction in advisory fees would result from reductions in service intensity because of the efforts of broker-dealers to reduce the cost of serving each retail IRA investor. Moving across the columns, we also predict that this investor (a) would benefit in terms of rate of return on his or her IRA portfolio because of

[8] Although low financial capability appears to positively associated with reliance on advice, some investors who use a financial advisor may be capable but time constrained (Investment Company Institute, 2007; Hackethal, Haliassos, and Jappelli, 2011).

[9] Whether a particular investor chooses to forego professional advice and how well he or she does is likely to be affected by the availability of many resources available to all investors such as the online "retirement savings calculator" (Kiplinger, Retirement *Savings Calculator,* n.d.) and other resources that can be found, for example, by a Google search of "how much do I need to save for retirement?"

[10] Of course, sophistication would more realistically be assumed to take on many discrete values or to vary along a continuum (i.e., take on many, not just two, values). The assumption of only two types of investors is a useful distortion of reality that simplifies the discussion while allowing us to make our key points.

reduced prevalence of advisor self-dealing (implying higher quality advice) because of adoption of the rule, (b) might increase time spent dealing with his or her IRA to make up for broker-dealers reducing the intensity of their services, and (c) would experience no change in IRA contributions because (by assumption) sophisticated investors do not change their behavior in response to coaching. Putting the pieces together, whether a sophisticated investor who continues to receive advice is made better off or worse off by adoption of the rule depends on the combined effects of the utility changes associated with the effects on the four outcomes. In this case (first row of the table), one would conclude that the investor is better off under the rule as long as the decrease in total advisory fees and the increase in rate of return because of the adoption of the rule increase utility by more than the decrease in utility associated with any extra time the investor would spend dealing with his or her IRA.

Next consider a sophisticated investor who would forego professional advice if the rule were adopted. As indicated in (the second row of) the table, total advisory fees would decrease to zero because no professional advice would be received, and (by assumption) it would not have an effect on IRA contributions. Moreover, we think it likely that this investor would benefit from a higher rate of return on his or her IRA portfolio by not having to rely on conflicted advice but would tend to be worse off because of having to spend more time dealing with his or her IRA.[11] In sum, this type of investor would be better off if the rule were adopted only if the sum of the utility increments associated with lower fees and higher rates of return would outweigh the decrement in utility due to spending more time dealing with his or her IRA.

Turning to unsophisticated investors, first consider those investors who continue to receive professional advice under the rule. As indicated in the third row of Table 5.1, we would expect (as with sophisticated investors who continue to receive advice) that (a) their total advisory fees would be lower if the rule were adopted, (b) the rate of return on their portfolios would be higher because of less self-dealing than without the rule, and (c) time spent might increase somewhat. Unlike sophisticated investors (who are assumed not to respond to coaching), these unsophisticated investors might decrease their levels of contributions to their IRAs because of reduced advisor time and effort devoted to coaching. In sum, this type of investor would benefit from the rule only if the increments to utility from lower fees and higher returns would outweigh the utility decreases associated with extra time spent dealing with their IRAs and decreased contributions to their IRAs.

The fourth and final case is that of unsophisticated investors who forego professional advice. These investors would benefit from reduction of advisory fees to zero. It is unclear whether the rates of return on their portfolios would be higher or lower than under the status quo if the rule were adopted, however. More specifically, although unsophisticated investors likely experience lower returns than are possible without the

[11] Hackethal, Haliassos, and Jappelli (2011) suggests one reason investors may be willing to receive lower returns through a financial advisor is that they are too busy to manage their investments on their own.

rule because of advisors acting on conflicts of interest, unsophisticated investors may or may not be capable of getting higher returns than they would without the rule if they forego professional advice. Finally, these investors would tend to be made worse off by adoption of the rule because of (a) additional time spent dealing with IRAs (if they keep them open or, looking further into the future, open IRAs at all) and (b) lower levels of contributions to their IRAs (assuming, as we do, that investors tend to contribute less than the amounts that would maximize their utility).

Summary

This chapter has analyzed qualitatively how adoption of the Proposed Rule would affect the well-being of different types of retail IRA investors who receive advice without the rule (i.e., under the status quo). To develop and illustrate our main points, we employed a particular set of assumptions that seem plausible based on economic theory and available empirical evidence. The main points are that (a) effects of the Proposed Rule are likely to differ substantially across different types of retail IRA investors, (b) effects of adoption of the rule on investor well-being depend on effects of the rule on several outcomes, and (c) available information is inadequate to conclude whether any particular kind of investor would be made better off or worse off by adoption of the rule.

We have argued that welfare effects for particular investors depend on the effects of adopting the Proposed Rule on several outcomes. In our illustrative application, these outcomes are total advisory fees, rates of return on IRA portfolios, time spent by investors dealing with IRAs, and—as an example of potential effects of coaching by advisors—levels of contributions to IRAs. We have argued that the effects of adopting the Proposed Rule would differ depending on investor sophistication and, if the rule were adopted, whether investors would choose to continue to receive professional advice. For all four of the situations analyzed, we found that adopting the rule not only would tend to improve at least one outcome for an investor but also would worsen at least one of the other four outcomes. Thus, it seems that any aggregate prediction of the likely effects of the rule on the welfare of retail IRA investors would best consider multiple types of investors for whom adoption of the Proposed Rule would affect multiple determinants of investor well-being. We are unable, however, to conclude whether any particular kind of investor would be made better or worse off by adoption of the rule.

Chapter 6. Conclusion

This paper reviews and qualitatively evaluates the economic predictions contained in comments from OW and FK in response to the DOL's "Definition of the Term 'Fiduciary'—Proposed Rule." We also propose and illustrate a conceptual approach to analyzing effects of adoption of the Proposed Rule on investor welfare.

One of the comments argued at length that—because of broker-dealers' incentives stemming from competition and reputational concerns—financial advisors rarely, if ever, act on their conflicts of interest. If so, there would be little, if any, benefit to adoption of the rule. We find this claim and supporting arguments and evidence unpersuasive. Moreover, substantial empirical evidence indicates that many financial advisors are influenced by their compensation schemes in ways that harm investors.

The comments also predicted that adoption of the Proposed Rule would substantially increase the costs borne by retail IRA investors, particularly because of increases in direct fees. Direct fees for advice might well increase in response to adoption of the rule, although we have no empirical basis for assessing the likelihood of such an effect. Because—as indicated by other empirical literature—direct fees are highly salient to investors, a substantial increase in direct fees would likely result in fewer investors choosing to receive professional financial advice. Even if direct fees do increase substantially, however, this does not mean that investors' full costs of advice would necessarily increase. Indirect fees could decline and IRA portfolio performance could improve because of rule-induced reductions in advisor self-dealing.

Additionally, investors who continue to work with a financial advisor may receive less advice if broker-dealers respond to adoption of the rule by reducing the amount of time and effort devoted to each client to reduce their costs of providing IRA-related advice. Investors who no longer receive financial advice are likely to have to spend more time managing their retirement savings.

A key question is how adoption of the rule would affect the well-being or welfare of investors. Effects of adopting the rule on IRA investors could be different for different types of investors and also could depend on whether investors would receive professional advice if the rule were adopted. Previous research and a simple framework that we propose and illustrate suggest that the effects of the Proposed Rule depend on the effects of adoption of the rule on several outcomes affecting the well-being of IRA investors. Such outcomes include total fees, rates of return on IRA portfolios, time investors spend dealing with their IRAs, and the amounts investors contribute to their IRAs. It may be that adopting the rule would help some IRA investors and harm others. Without considerably more information, we cannot predict whether the benefits to IRA investors would outweigh their costs for any particular type of IRA investor or in the aggregate.

Table 5.1. Effects of Implementation of the Proposed Rule on Sophisticated and Unsophisticated Investors (effects = levels with the rule minus level without rule)

A. Sophisticated Investors

	Component of Investor Well-Being			
	Total Advisory Fees[a]	**Rate of Return on IRA Portfolio**	**Time Spent by Investor**	**IRA Contributions (Due to Professional Coaching)**
Continue to receive advice	Lower (due to intensity decreases) but still positive	Higher (due to less self-dealing than without the rule)	No difference or higher (higher would be due to decreased intensity)	No change
Forego advice	Lowered to zero	Higher (due to absence of self-dealing when no advice is received)	Higher (no help from advisors)	No change

B. Unsophisticated Investors

	Component of Investor Well-Being			
	Total Advisory Fees	**Return on Portfolio**	**Time Spent by Investor**	**IRA Contributions (Due to Professional Coaching)**
Continue to receive advice	Lower (due to intensity decreases) but still positive	Higher (due to less self-dealing than without the rule)	No difference or higher (higher would be due to decreased intensity)	Lower (due to intensity decrease)
Forego advice	Lowered to zero	Change could be positive or negative[b]	Higher (no help from advisors)	Larger decrease than for those receiving advice (coaching is effective for these investors)

SOURCE: Authors' Analyses.

[a] These are actual fees paid whether or not they are understood by investor; that is, we are assuming that it is actual fees that affect welfare even if it is only direct fees that affect investor choices regarding whether to pay to receive professional advice (because of lack of understanding of indirect or hidden fees).

[b] It is far from clear whether unsophisticated investors would earn higher returns on their own than they would if they receive conflicted advice.

References

Australian Securities & Investment Commission, *Shadow Shopping Survey on Superannuation Advice*, Report No. 69, 2006. As of May 30, 2012: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/shadow_shop_report_2006.pdf/$file/shadow_shop_report_2006.pdf

Bazerman, M. H., K. P. Morgan, et al., "The Impossibility of Auditor Independence," *Sloan Management Review*, Vol. 38, No. 4, 1997, pp. 89–94.

Barber, B., T. Odean, et al., "Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows," *Journal of Business*, Vol. 78, No. 6, 2005, pp. 2095–2119.

Bergstresser, D., J. M. R. Chalmers, and P. Tufano, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," *Review of Financial Studies*, Vol. 22, No, 10, 2009, pp. 4129–4156.

Bolton, P., X. Freixas, et al., "Conflicts of Interest, Information Provision, and Competition in the Financial Services Industry," *Journal of Financial Economics*, Vol. 85, No. 2, 2007, pp. 297–330.

Burke, J., A. A. Hung, J. W. Clift, S. Garber, and J. K. Yoong, *Impacts of Conflicts of Interest in the Financial Services Industry*, Santa Monica, Calif. RAND Corporation, forthcoming.

Calcagno R., and C. Monticone, *Financial Literacy and the Demand for Financial Advice*, Moncalieri, Italy: Center for Research of Pensions and Welfare Policies, CeRP Working Paper, 2011. As of May 30, 2012: http://dx.doi.org/10.2139/ssrn.1884813

Charles River Associates, *Polarisation: Research into the Effect of Commission Based Remuneration on Advice*, 2002. As of November 1, 2011: http://www.fsa.gov.uk/pubs/other/pol_res1.pdf

"Commissions Win the Day over Fees," *American Banker*, Vol. 176, No. 94, 2011, p. 8.

Christoffersen, S. K., R. B. Evans, and D. K. Musto, *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, Charlottesville, Va: Darden School of Business Working Paper No. 1393289, March 8, 2012.

Del Guercio D., J. Reuter, et al., *Broker Incentives and Mutual Fund Market Segmentation*, Cambridge, Mass.: National Bureau of Economic Research, NBER Working Paper Series, No. 16312, 2010.

Employee Retirement Income Security Act of 1974 (ERISA) (Pub. L. No. 93-406, codified in part at 29 USC § 1002 et seq.)

Ernst & Young, *RaDaR—Life and Pensions Outlook for 2011*, London, UK: Ernst & Young, 2011.

Fischel, D. R., and T. D. Kendall, "Comment to the Department of Labor on a Proposed Rule Regarding Fiduciary Status under ERISA," *Compass Lexecon*, April 12, 2011.

Gil-Bazo, J., and P. Ruiz-Verdú, "When Cheaper Is Better: Fee Determination in the Market for Equity Mutual Funds," *Journal of Economic Behavior & Organization*, Vol. 67, No. 3–4, 2008, pp. 871–885.

Gil-Bazo, J., and P. Ruiz-Verdú, "The Relation Between Price and Performance in the Mutual Fund Industry," *The Journal of Finance*, Vol. 64, No. 5, 2009, pp. 2153–2183.

Hackethal, A., M. Haliassos, and T. Jappelli, *Financial Advisors: A Case of Babysitters?* Frankfurt, Germany: Goethe University Frankfurt, 2011.

Hackethal, A., R. Inderst, and S. Meyer, *Trading on Advice*, Washington, D.C.: Center for Economic and Policy Research, CEPR Discussion Paper: 8091, 2010.

Hortacsu, A., and C. Syverson, "Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry," *Quarterly Journal of Economics*, Vol. 119, No. 2, 2004, pp. 403–456.

Hung, A., N. Clancy, J. Dominitz, E. Talley, C. Berrebi, and F. Suvankulov *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, Santa Monica, Calif.: RAND Corporation, TR-556-SEC, 2008. As of June 1, 2012: http://www.rand.org/pubs/technical_reports/TR556/.html

Hung, A., and J. Yoong, *Asking for Help: Survey and Experimental Evidence on Financial Advice and Behavior Change*, Santa Monica, Calif.: RAND Corporation, WR-714-1, 2009. As of June 1, 2012: http://www.rand.org/pubs/working_papers/WR714-1/

Internal Revenue Code § 4975 (codified at 26 USC § 4975 - Tax on prohibited transactions).

Investment Company Institute, "Why Do Mutual Fund Investors Use Professional Financial Advisers?" *Research Fundamentals*, Vol. 16, No. 1, 2007. As of May 30, 2012: http://www.ici.org/pdf/fm-v16n1.pdf

Investment Company Institute, *2011 Investment Company Fact Book*, Washington, D.C.: Investment Company Institute, 2011a.

Investment Company Institute, *ICI Research Perspective*, Vol. 17, No. 8A, November 2011b.

Kiplinger, *Retirement Savings Calculator,* n.d. As of July 26, 2012: http://www.kiplinger.com/tools/retirement-savings-calculator.html

Krausz, M., and J. Paroush, "Financial Advising in the Presence of Conflict of Interests," *Journal of Economics & Business*, Vol. 54, No. 1, 2002, pp. 55-71.

Lanka v O'Higgins, 810 F.Supp. 379, 387 (N.D.N.Y. 1992).

Moore, D. A., and G. Loewenstein, "Self-Interest, Automaticity, and the Psychology of Conflict of Interest," *Social Justice Research*, Vol. 17, No. 2, 2004, pp. 189-202.

Moore, D. A., L. Tanlu, and M. H. Braverman, "Conflict of Interest and the Intrusion of Bias," *Judgment and Decision Making*, Vol. 5, No. 1, 2010, pp. 37–53.

Mullainathan, S., M. Noth, and A. Schoar, *The Market for Financial Advice: An Audit Study*, Cambridge, Mass.: National Bureau of Economic Research, Working Paper Series, No. 17929, 2010.

North American Securities Administrators Association, "When Can I Register as an Investment Adviser Representative if I Haven't Taken the Series 65, or Series 66 in Combination with the Series 7?" *Exam FAQs*, n.d. As of August 8, 2012: http://www.nasaa.org/industry-resources/exams/exam-faqs/#13

Oliver Wyman, *Assessment of the Impact of the Department of Labor's Proposed "Fiduciary" Definition Rule on IRA Consumers*, New York: Oliver Wyman Group, April 12, 2011.

Patron, H. E., and K. S. Roskelley, "The Effect of Reputation and Competition on the Advice of Real Estate Agents," *Journal of Real Estate Finance and Economics*, Vol. 37, No. 4, 2008, pp. 387–399.

RIA Compliance Consultants, *About Us,* n.d. As of July 26, 2012: http://www.ria-compliance consultants.com/ria_compliance_consultants.html

RIA Compliance Consultants, *Frequently Asked Questions About the Series 65 Examination*, n.d. As of July 26, 2012: http://www.ria-compliance-consultants.com/investment_advisor_investment_adviser_rep_series_65_exam_faq.html

United States Department of Labor, Employee Benefits Security Administration, "Definition of the Term 'Fiduciary'—Proposed Rule," *Federal Register*, Vol. 75, No. 204, October 22, 2010, pp. 65263–65278.

United States Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers*, Washington, D.C.: U.S. Securities and Exchange Commission, January 2011.

United States v Mason Tenders Dist. Council of Greater N.Y., 909 F.Supp. 882, 886 (S.D.N.Y. 1995).