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April 17, 2017

Filed Electronically
Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
Attention: Fiduciary Rule Examination
US Department of Labor
200 Constitution Avenue N.W.
Washington, DC 20210

Re: RIN 1210-AB79; Proposed Rule; Re-examination of Fiduciary Rule

Dear Sir or Madam:

The Investment Company Institute[1] supports the re-examination by the Department of Labor (the "Department") of its fiduciary rulemaking.[2] The President's order directing the re-examination requires the Department to determine whether the rule may adversely affect the ability of Americans to gain access to retirement information and financial advice.[3] Based upon the evidence available to us, there is no question that the rule, if implemented on June 9 as currently written, will harm retirement savers' access to that retirement information and financial advice.

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[1] The Investment Company Institute ("ICI") is a leading global association of regulated funds, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$19.3 trillion in the United States, serving more than 95 million US shareholders, and US$1.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] DOL issued a final regulation defining who is a fiduciary of an employee benefit plan under the Employee Retirement Income Security Act of 1974 ("ERISA") or an individual retirement account (IRA) under section 4975 of the Internal Revenue Code ("Code"), as a result of giving investment advice to a plan or its participants or beneficiaries, or an IRA or IRA owner. 81 Fed. Reg. 20946 (April 8, 2016).

[3] *See* White House memorandum to the Secretary of Labor, dated February 3, 2017 and published at 82 Fed. Reg. 9675 (February 7, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-02-07/pdf/2017-02656.pdf; ("President's Memorandum").

We agree that advice providers should act in their clients' best interest, a point we have made consistently in prior commentary.[4] Indeed, we support a best interest standard of care across both retirement and non-retirement accounts that ensures affordable access to financial advice to help individuals prepare for their retirement needs. Applying the criteria in the President's Memorandum and based on the analysis below, however, the Department must revise or rescind the rule. The final rule was developed based on a faulty and incomplete regulatory impact analysis ("RIA"),[5] is excessively convoluted, and—without significant revision—will harm the very individuals it was designed to protect.

More urgently, the Department must extend the compliance date for the rule to avoid very serious disruption and harm to retirement savers. The Department recently delayed the rule's applicability date rule, but only for 60 days (until June 9, 2017).[6] The Department's re-examination of the rule certainly will take longer than 60 days to complete, as the Department itself acknowledged.[7] While the Department may need additional time to complete its reexamination and make a determination regarding whether to rescind the rule or whether revising it will meet the President's directive, it should not need more time to determine what is obvious already—that the rule is actually harming investors. To avoid significant disruptions for industry and retirement investors alike, the Department must immediately postpone the applicability date until a decision is made as to which course of action (rescind or revise) the Department will take and, if the decision is made to revise, what form the modifications should take. If it does not do so, the rule and certain aspects of the related exemptions will go "live" in June, but could be rescinded or substantially revised a short time thereafter. This serves no purpose, other than to sow confusion in the retirement marketplace and perpetuate ongoing harm to retirement savers. Such an outcome also appears to us to be a direct contravention to the President's direction to the Department.[8] In fact, the Department's decision to have the fiduciary

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[4] *See e.g.*, letter from Paul Schott Stevens, to Office of Regulations and Interpretations, Employee Benefits Security Administration, US Department of Labor (July 21, 2015), available at https://www.ici.org/pdf/15_ici_dol_fiduciary_overview_ltr.pdf.

[5] US Department of Labor, Employee Benefits Security Administration, *Fiduciary Investment Advice Regulatory Impact Analysis* (April 14, 2015), ("2015 RIA"), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/1210-AB32-2/conflictsofinterestria.pdf; and Regulating Advice Markets, Definition of the Term "Fiduciary" Conflicts of Interest—Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions (April 2016), ("2016 RIA"), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf.

[6] 82 Fed. Reg. 16902 (April 7, 2017).

[7] The re-examination "is likely to take more time to complete than a 60-day extension would afford." *Id*. at p. 16905.

[8] The President's Memorandum directs the Department to prepare an updated economic and legal analysis and re-examination of the "rule." Yet, in the preamble to the notice issuing the final 60-day delay, the Department opines "that it would be inappropriate to broadly delay application of the fiduciary definition and Impartial Conduct Standards for an extended period in disregard of its previous findings…" The Department dismisses comments challenging its cost estimates, stating that such challenges "largely echo comments made in response to the Fiduciary Rule when it was proposed in 2015,

rule and Impartial Conduct Standard become applicable prior to completing the review mandated by the President's Memorandum appears arbitrary—particularly in light of the Department's unwillingness to consider social costs to investors and its quick rejection of facts and analysis calling into question its 2016 RIA findings in issuing the bifurcated delay.[9]

Set forth below are the Institute's responses to the questions raised by the President in his memorandum and by the Department relating to the reexamination of the rule. Following an introduction and summary in Section I, Sections II, III, and IV each answer one of the three questions in the President's Memorandum (including certain of the related questions asked by the Department in the proposal to delay).

I. Introduction and Summary of Key Points.

On March 2, 2017, the Department published a proposal to delay the applicability date of the final rule for 60 days[10] in response to an order by the President directing it to engage in a comprehensive review of the final rule and related exemptions and to determine whether the rule may adversely affect the ability of Americans to gain access to retirement information and financial advice.[11] In conjunction with the proposed delay, which was subsequently finalized,[12] the Department requested comments regarding the examination described in the President's Memorandum.

The President's Memorandum establishes the Administration's priority "to empower Americans to make their own financial decisions, to facilitate their ability to save for retirement and build the individual wealth necessary to afford typical lifetime expenses, such as buying a home and

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and that were addressed in considerable detail in the 2016 RIA." 82 Fed. Reg. 16902 at p. 16909. In doing so, the Department seems to ignore its previous admonition that "absent an extension of the applicability date, if the examination prompts the Department to propose rescinding or revising the rule, affected advisers, retirement investors and other stakeholders might face two major changes in the regulatory environment rather than one. This could unnecessarily disrupt the marketplace, producing frictional costs that are not offset by commensurate benefits." *See* preamble to the proposed delay, 82 Fed. Reg. 12319 at p. 12320. Despite this commonsense finding, the Department has decided to do exactly that—setting the stage for two major regulatory changes, which is sure to cause increased and unnecessary market disruption.

[9] The Department states that it intends to review the 2016 RIA's conclusions at a later time. 82 Fed. Reg. at 16909. *See also Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), where the D.C. Circuit found the SEC's proxy access rule to be arbitrary and capricious where the SEC failed to conduct a serious evaluation of costs.

[10] The proposed delay was published at 82 Fed. Reg. 12319 (March 2, 2017). ICI has submitted a separate comment letter regarding the proposed delay. *See* letter from Brian Reid and David W. Blass, to Office of Regulations and Interpretations, Employee Benefits Security Administration, US Department of Labor (March 17, 2017) ("ICI's March 17 Letter"), available at https://www.ici.org/pdf/17_ici_dol_fiduciary_applicability_ltr.pdf.

[11] *See* White House memorandum to the Secretary of Labor, dated February 3, 2017 and published at 82 Fed. Reg. 9675 (February 7, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-02-07/pdf/2017-02656.pdf.

[12] 82. Fed. Reg. 16902.

paying for college, and to withstand unexpected financial emergencies." It also directs the Department to re-examine the rule "to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice," including preparing an updated economic and legal analysis concerning the likely impact of the rule. The memorandum directs the Department to consider the following three questions:

1. Whether the anticipated applicability of the rule has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice;

2. Whether the anticipated applicability of the rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees; and

3. Whether the rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services.[13]

If the answer to *any* of the three questions is affirmative, or if the rule is inconsistent with the Administration's priorities on retirement and savings, the President directs the Department to issue a proposal to rescind or revise the rule.

In fact, the rule runs afoul of *all* the criteria in the President's Memorandum. The rule clearly is inconsistent with the Administration's priority of ensuring that Americans have access to retirement information and financial advice. In addition, the rule has harmed and will continue to harm investors; it has resulted in widely reported market dislocations and disruptions, and it will cause an increase in litigation with consequential barriers to access to retirement information and financial advice. Moreover, the rule is inconsistent with the Administration's priority of empowering Americans to make their own financial decisions.

In short, the rule upends the retirement marketplace and, instead of empowering retirement savers, it substitutes the Department's judgment for what products, services, and compensation structures should be available to those savers. Rather than empowering plan fiduciaries and retirement savers, the rule limits sales engagements, constrains education, impedes important conversations on how to structure distributions from a retirement plan or IRA, and limits choice of products and services, particularly for IRA investors.

The key points supporting our conclusion are as follows:

[13] *See* President's Memorandum at footnote 3, *supra*.

- **The rule will harm investors—causing many to pay more for advice or lose access to advice.** The pending application of the rule is accelerating the shift from commission-based accounts to fee-based accounts, which will cause many investors to pay more for advice. Even worse, the rule will cause many investors to lose access to advice, information, and education, which will result in significant losses to those investors.

  Some investors, particularly those with smaller account balances, will find themselves unable to find a broker willing to serve them and unable to meet the minimum balance required for a fee-based account. Indeed, our members report widespread instances of investors' accounts being "orphaned" by the intermediaries currently serving them. Robo-advisors will not serve in all cases as an adequate substitute for this lost human interaction, particularly for investors who seek guidance regarding event specific questions, such as whether to stay the course or shift investment to cash in time of market downturns or stress, whether to take a withdrawal (or a loan, in the case of a plan), or whether to keep assets in a plan versus rolling them over to an IRA.

- **The Department's speculative foregone benefits projections provide no reasonable basis for concluding that purported investor gains from the rule will offset the harm to investors.** There is no reasonable basis for concluding that the harm to investors caused by the rule will be offset by the Department's speculative foregone benefits projections. First, the Department now acknowledges that its prior conclusions are "uncertain and incomplete," and that its claims of benefits from the rule are based on a limited assessment "of one source of conflict (load sharing), in one market segment (IRA investments in front-load mutual funds)."[14] Second, beyond these limitations, the Department's conclusion of potential gains associated with the rule suffers from the fact that the one negative effect it claims to show (poor front-load mutual fund selection by brokers) is not supported by widely available market data.

  As we describe in our prior comment letters[15]—and despite the efforts of the Department to claim otherwise—there simply is *no basis* for the Department's 2015 assertion that the typical investment in a broker-sold fund underperforms by 100 basis points, or for the Department's

[14] 82 Fed. Reg. 12319 at p. 12320.

[15] *See, for example,* letter from Brian Reid and David W. Blass, to Office of Regulations and Interpretations, Employee Benefits Security Administration, US Department of Labor (July 21, 2015) ("ICI Letter"), available at https://www.ici.org/pdf/15_ici_dol_fiduciary_reg_impact_ltr.pdf; supplemental letter from Brian Reid and David W. Blass, to Office of Regulations and Interpretations, Employee Benefits Security Administration, US Department of Labor (September 24, 2015)("ICI Supplemental Letter"), available at https://www.ici.org/pdf/15_ici_dol_ria_comment.pdf; and supplemental letter from Brian Reid and Sean Collins, to Joseph Piacentini, Director, Office of Policy and Research & Chief Economist, Employee Benefits Security Administration, US Department of Labor (December 1, 2105) ("ICI Letter to Joseph Piacentini"), available at https://www.ici.org/pdf/15_ici_dol_ria_comment_supp.pdf. These letters respond to the RIA supporting the Department's proposed rule. However, because the RIA supporting the final rule was largely unchanged, the analysis in our letters applies to the final rule's RIA.

recent modified view that broker-sold fund underperformance is in the range of 50 to 100 basis points. It is significant that the claim of 100 basis-point underperformance is the foundation for the Department's prior claim that, in the absence of the final rules, investors in front-end load funds will lose $500 billion to $1 trillion in foregone returns during the next 20 years. In fact, that claim is sheer hyperbole, unsupported by the data. As such, the Department should not rely on these estimates as a basis for concluding that the harm to investors caused by the rule will be offset by foregone benefits.

- **The pending application of the rule has already caused dislocations and disruption within the retirement services industry.** As has been widely reported, several large intermediaries have announced a variety of changes to service offerings, including firms announcing that they will no longer offer mutual funds in IRA brokerage accounts; others no longer offering any IRA brokerage accounts at all; firms reducing web-based financial education tools; and others announcing that brokerage services for lower-balance accounts will be discontinued. Even if the marketplace reacts to these dislocations with potential solutions—which is by no means certain—investors who are underserved or forced to pay higher fees in the coming months and years will be left with reduced assets for reinvestment even if the dislocations are remedied in the future.

- **The rule will cause an increase in litigation and an increase in prices to access retirement products and services.** Numerous experts have reported that the expansive fiduciary definition created by the rule, and the obtuse conditions of the Best Interest Contract ("BIC") exemption in particular, will result in increased litigation, particularly in the IRA marketplace. This is the result of the Department's intentional design to use the plaintiffs' bar as its primary enforcement mechanism for ensuring compliance with the rule and BIC. Further, the BIC exemption will encourage litigation in other ways, as the plaintiffs' bar works to flesh out untested standards, knowing that defending such suits will be expensive and raise the potential for large settlements. An increase in litigation will enrich plaintiffs' lawyers but will harm investors, not just through higher prices for access to retirement services, but also loss of such access in many cases.

- **A more comprehensive impact analysis as required by the President's Memorandum will lead the Department to the conclusion that a more targeted and harmonized best interest standard will better protect investors while ensuring the continuation of affordable access to financial guidance to help individuals prepare for their financial needs.** In our view, the RIA suffers from a crucial fatal flaw. Rather than serving as a tool to understand a problem and determine the best solution, the Department started with a predetermined agenda of eliminating perceived "conflicts" in the retirement marketplace and used the RIA to justify that effort. The result is an RIA that focuses on "claims" that support the Department's narrative and that readily dismisses "facts" that raise contrary conclusions regarding that narrative. Most

significantly, the RIA fails to address adequately the "harms" of the rule—a topic of primary importance in the President's Memorandum. The RIA ignores the economic impact of investors losing access to commission-based arrangements and being pushed to fee-based accounts. The RIA also fails to account for the harm to investors from losing access to advice and guidance. In addition to accounting for the foregoing, the Department's impact analysis must include information derived from quantitative or qualitative data focused more clearly on showing the problem that the rule is intended to solve, as well as the anticipated costs and benefits of the rule as a solution.

II. The Anticipated Applicability of the Rule Is Harming Investors by Reducing Americans' Access to Certain Retirement Savings Offerings, Retirement Product Structures, Retirement Savings Information, and Related Financial Advice.

The initial question raised for examination pursuant to the President's Memorandum is whether the rule "has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice."[16] Although the Institute's concerns that the issuance of the rule would harm retirement savers—particularly those with small to moderate account balances—were dismissed by the Department in the 2016 RIA,[17] there can be no denying that the pending application of the final rule is already having a consequential impact on the marketplace. As has been widely reported, several large intermediaries have announced a variety of changes to service offerings, including firms announcing that they will no longer offer mutual funds in IRA brokerage accounts; others no longer offering any IRA brokerage accounts at all; firms reducing web-based financial education tools; and others announcing that account minimums will be raised or that advisory services for lower-balance accounts will be discontinued.[18] Indeed, in many instances, our members have been informed by their intermediary partners that they will no longer service certain account holders in light of the rule. These so-called "orphaned" account holders already number in the hundreds of thousands (and industry

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[16] *See* the President's Memorandum. The Department invites comments on a series of questions presumably intended to assist in answering this question. For example, the Department asks "Are firms making changes to their target markets? In particular, are some firms moving to abandon or deemphasize the small IRA investor or small plan market segments? Are some aiming to expand in that segment? What effects will these developments have on different customer segments, especially small IRA investors and small plans?" "What innovations or changes in the delivery of financial advice have occurred that can be at least partially attributable to the rule? Will those innovations or changes make retirement investors better or worse off?" "What changes have been made to investor education both in terms of access and content in response to the rule and PTEs, and to what extent have any changes helped or harmed investors?"

[17] The Department dismissed these concerns in the 2016 RIA, noting that "estimates of the costs to investors of having to pay more for and/or losing financial advice are based on unsupported assumptions that are contradicted by information provided by other commenters." *See* 2016 RIA at p. 166.

[18] *See* "A Complete List of Brokers and Their Approach to 'The Fiduciary Rule'," *Wall Street Journal*, February 6, 2017, available at https://www.wsj.com/articles/a-complete-list-of-brokers-and-their-approach-to-the-fiduciary-rule-1486413491. *See also* footnotes 22 through 24, *infra*.

participants indicate that the numbers will climb substantially as implementation efforts proceed) and will be left without access to advice. In short, there is now clear evidence that the rule will harm investors in a number of ways. Many will be forced to pay more for advice as they lose access to commission-based arrangements.

A. The Rule Will Cause Many American Workers to Pay More for Advice.

Although the risk of higher costs was largely dismissed by the Department in the 2016 RIA, it is now abundantly clear that the rule is increasing the price of advice and service for investors who have been in commission-based accounts. The Department stated that "the price of advice should not be higher merely because an adviser charges direct fees and avoids prohibited transactions."[19] This would have been true if the cost of providing services to commission-based accounts had remained unchanged following the rule. But the rule itself will increase the cost of providing advice, and will, therefore, cause the quantity of advice at any given price (*i.e.*, the supply of advice) to decline. A decline in supply will lead to a higher market price for advice, and for small accounts the availability of advice and service may drop sharply.

The BIC exemption purportedly was intended to provide for continued offering of commission-based models and, therefore, theoretically not affect the supply of advice services in the IRA market.[20] Yet the final rule's BIC exemption, while somewhat improved from the version proposed in 2015, requires an adviser to comply with a series of complex and abstruse conditions. In our prior letters,[21] we warned the Department that advisers would find it imprudent to subject themselves to the multitude of ambiguous and impractical conditions—accompanied by significant litigation risk—required under the BIC exemption. As we predicted, many advisers have already made determinations that the BIC exemption is unworkable for certain products,[22] that the resultant risk and liability

[19] *See* 2016 RIA at p. 313.

[20] The BIC exemption, published at 81 Fed. Reg. 21002 (April 8, 2016), was issued at the same time as the final rule with the stated intent—subject to its many conditions—of permitting the payment of commissions and other compensation that would otherwise be prohibited under ERISA and the Code.

[21] *See, for example,* letter from David M. Abbey and David W. Blass, to Office of Exemption Determinations, Employee Benefits Security Administration, US Department of Labor (July 21, 2015), available at https://www.ici.org/pdf/15_ici_dol_fiduciary_best_interest_ltr.pdf

[22] Edward Jones announced that it will no longer offer mutual funds and exchange-traded funds in commission-based IRAs. "Edward Jones Shakes Up Retirement Offerings Ahead of Fiduciary Rule," *Wall Street Journal*, August 17, 2016, available at https://www.wsj.com/articles/edward-jones-shakes-up-retirement-offerings-ahead-of-fiduciary-rule-1471469692.

(including the substantial threat of unwarranted litigation) cannot be justified for certain accounts,[23] or that the BIC exemption in its entirety is simply too burdensome.[24]

Consequently, these increased costs of providing commission-based accounts have resulted in a reduction in their supply and an increase in the price of advice to investors in these accounts. For example, some investors who had been in commission-based accounts are being moved to fee-based accounts. While both compensation models (fee-based and commission-based) have their advantages, the commission-based model can be a more cost-effective means to receive advice, particularly for buy-and-hold investors, which is the case for many investors with modest-sized accounts.

As an illustration, Figure 1 compares account balances for a $10,000 initial investment placed in a commission-based account as compared with a fee-based account. In the commission-based account, as in the front-load arrangements now common in the fund industry, the investor pays a front-load fee (of 5 percent in the top panel versus 2.5 percent in the bottom panel) and an ongoing 12b-1 fee of 0.25 percent per year. A 5 percent front load is representative of the maximum front load an investor might pay, while a 2.5 percent load is representative of what an investor who qualifies for a discounted front load might pay. The investor in the fee-based account pays only an ongoing asset-based fee of 1.00 percent per year, which is in line with a recent study by Cerulli Associates indicating that 96 percent of fee-based advisers charge 75 basis points or more a year, and 85 percent charge 100 basis points or more a year.[25]

Figure 1 shows that long-term investors may do better under a commission-based as compared with an asset-based fee arrangement. For example, the top panel shows that an investor who has the choice between paying a financial professional an asset-based fee of 1 percent per year versus a 5 percent front-load fee (plus an ongoing 12b-1 fee) ends up with a higher account balance under the commission-based approach if he or she plans to hold fund shares longer than 8 years.

The bottom panel shows that this break-even point occurs sooner if the investor qualifies for a reduced front-load of 2.5 percent. In that case, if the investor plans to hold the fund shares for at least 5 years, he or she is better off (*i.e.*, ends up with a higher account balance) by electing to pay for financial advice using a commission-based approach.

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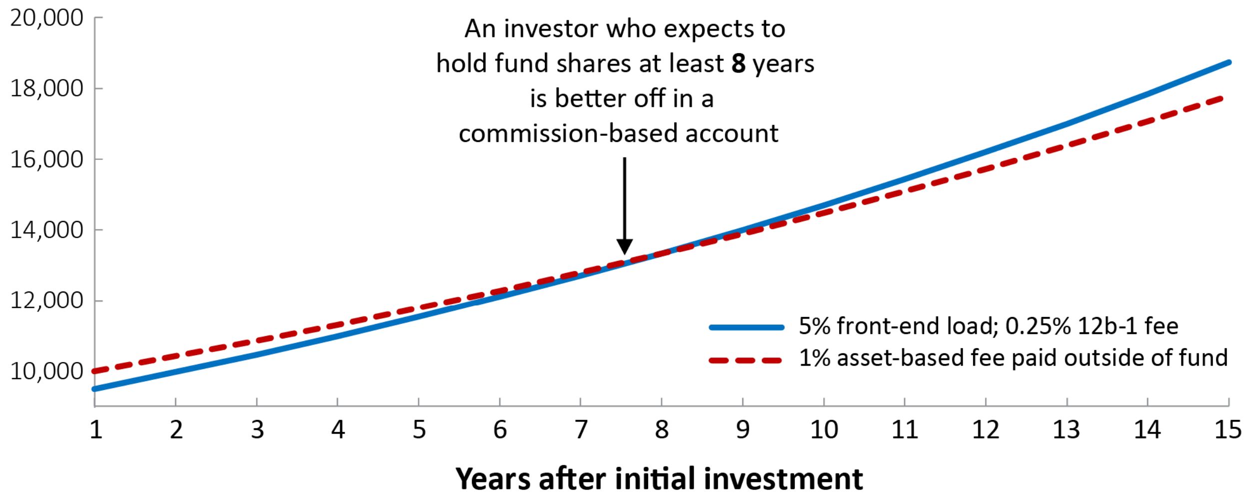
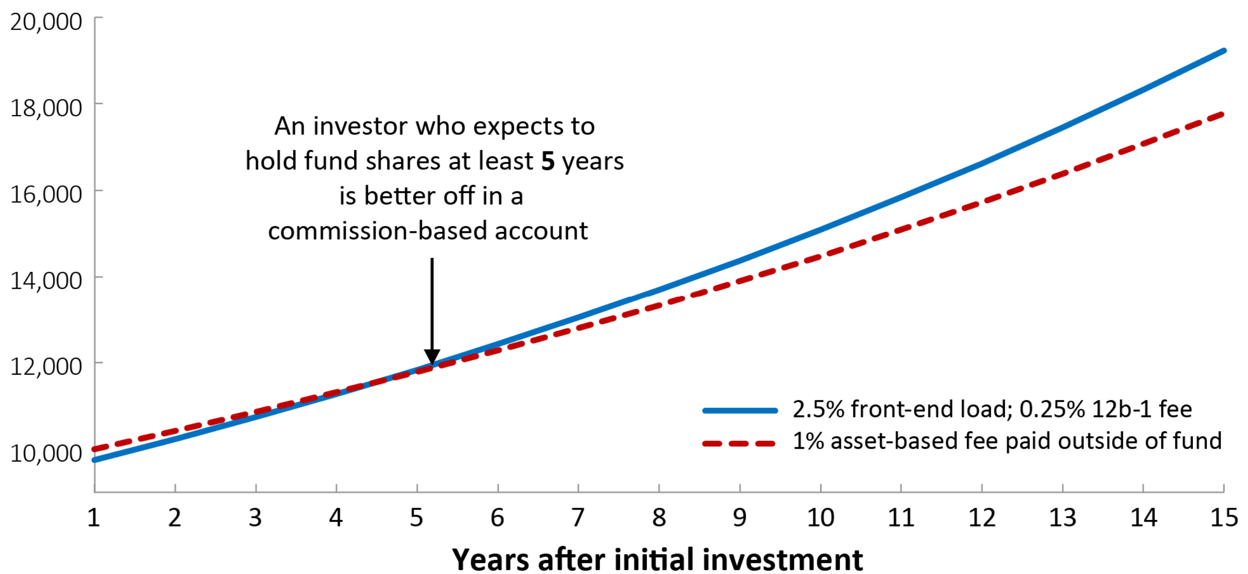
[23] A number of firms, including Edward Jones, have raised the minimum on commission-based IRAs. "Fiduciary ready: Edward Jones Unveils Compliance Plans," *On Wall Street*, August 19, 2016, available at http://www.onwallstreet.com/news/fiduciary-ready-edward-jones-unveils-compliance-plans.

[24] Merrill Lynch and JP Morgan Chase announced that they will no longer offer IRAs that charge commissions, instead limiting new IRAs to those charging retirement savers a fee based on a percentage of their assets. "JPMorgan Chase to Drop Commissions-Paying Retirement Accounts," Reuters, November 10, 2016, available at http://www.reuters.com/article/us-jpmorgan-wealth-compliance-idUSKBN1343LK.

[25] *See* Cerulli Associates, Inc., The Cerulli Report *US RIA Marketplace 2016* at 90–91. For clients with $100,000, 96 percent of the advisers reported charging at least 0.75 percent of assets per year for their services.

Figure 1
Account Balances for $10,000 Initial Investment in Commission-Based Account versus Fee-Based Account*





* Commission-based account assumes the investor pays an upfront sales load of either 5% (top panel) or 2.5% (bottom-panel) and (in both panels) an ongoing 12b-1 fee of 0.25% per year. Fee-based account assumes the investor pays an ongoing asset-based fee of 1% per year.
** Scenario assumes a $10,000 initial investment, including (non 12b-1 fee) fund expenses of 0.75% per year, ignores income and capital gains taxes, and assumes a fund return of 6% per year, of which 5% is capital gains and 1% is income.
Source: Investment Company Institute

B. For Many Investors, the Rule Will Result in Significant Harm in the Form of a Loss of Access to Advice, Information, and Education.

In our prior comment letters, we predicted that the rule would create an "advice gap" for investors, particularly those with small account balances. Over time, investors who no longer have access to advice are likely to experience lower returns because of poor asset allocation and market timing, or because they incur tax penalties by taking early withdrawals.

Anecdotal evidence shows that the rule is already creating such a gap, as investors risk being abandoned by intermediaries, losing access to advice due to intermediaries' business model changes, and having reduced access to information from call centers and websites. While the Department has suggested that new innovations in computerized advice models—so-called "robo advice"—will serve such dislocated investors, it is clear that robo-advice will not be an adequate substitute for many of these investors.

As described above,[26] intermediaries are already in the process of changing their business models in response to the uncertainties caused by the final rule. Despite the 2016 RIA's quick dismissal of these concerns, the changes will cause an "advice gap" for new investors. Fee-based accounts in many cases will not be available to IRA investors who cannot meet minimum account balance requirements (typically $50,000 to $100,000 for human-assisted advice). It is quickly becoming apparent that—just as the Institute predicted—fewer advisers will provide commission-based accounts, and such accounts may be subject to more restrictions.

1. Many intermediaries plan to "abandon" small-balance accounts.

As we predicted, many intermediaries plan to "abandon" or "orphan" accounts deemed undesirable or uneconomic in light of the rule. Distribution partners have already notified many of our members that they plan to resign as broker-dealer of record and in some cases as custodians for certain blocks of business. Some intermediaries have begun the resignation process, while others have not yet done so because they are waiting on the resolution of the rule. A sample of our members[27] reports that

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[26] *See* text accompanying footnotes 18 and 22 through 24, *supra*.

[27] The Institute informally surveyed its members regarding such notifications regarding dealer resignations. Thirty-one out of 32 mutual fund companies surveyed reported either having received orphaned accounts or receiving notices regarding some volume of accounts that will become orphaned. Many smaller mutual fund complexes have not yet received requests from intermediaries asking to resign from accounts. Members have indicated that, depending on the outcome of the rule, they expect the volume of orphaned accounts to increase and that a significant increase could affect their ability to service shareholders. The expectation is that the number of orphaned accounts likely will run into the hundreds of thousands.

the average account balance of those accounts where an intermediary has resigned is $17,138.[28] If the rule is not revised or rescinded, many owners of these orphaned accounts will be left without access to advice, unless they are able to find other intermediaries who are willing to take their accounts. Due to the dominance of intermediary distribution, many funds have restructured their servicing models; they thus are no longer well-equipped to handle a large influx of orphaned accounts and are unable to provide the advice and information that the investors currently receive from their broker relationships.

The final rule also threatens to reduce severely the commonplace exchanges of information currently provided at no cost to millions of retirement savers through call centers, walk-in centers, and websites. Even the most basic information could trigger ERISA fiduciary status and prohibited transactions. While some of this information may be technically excluded from the definition of advice, the rule is likely to cast a chill on the provision of investment education to retirement savers, due to the risk of inadvertently triggering fiduciary status.

2. Robo-advice will not be an adequate substitute.

One mechanism for providing advice that has accelerated as a result of the rule is the so-called robo-advisor (computer-programmed advice delivered online).[29] Robo-advisors are viewed as providing a cost-effective alternative by delivering computer-generated, online advice with little or no human interaction to investors. The Department frequently has touted robo-advice and other online advice as a solution for those investors who may otherwise lose access under the rule.[30]

While online guidance may have a helpful and growing role to play in assisting investors, it is reckless to presume that such services are a suitable substitute for human interaction in many circumstances. Among the five largest financial institutions that offer robo-advice models, only one

[28] This $17,138 figure is the median of the average account balances for orphaned accounts, as reported by 27 of 31 fund companies that were able to report average account sizes for orphaned accounts. This sample of 27 fund complexes is representative of a broad spectrum of the industry: the median size of long-term fund mutual assets under management of these complexes is $116 billion, with the largest complexes having long-term mutual fund assets of more than $1 trillion and the smallest with long-term mutual fund assets of less than $5 billion.

[29] The top five digital advisers in the United Stated managed approximately $44 billion in assets at the end of 2015, growing to an estimated $73 billion in assets just one year later. In 2011, there were 11 digital advisory firms launched in the United States; this number grew to 44 in 2015. KPMG estimates that assets managed through all digital advice platforms will grow to $2.2 trillion by 2020. See "Digital Investment Advice: Robo Advisors Come of Age," *Blackrock Viewpoints*, September 2016. pp. 4–5. See "America is the Realm of the Robo-Advisor," *Statista Digital Market Outlook*, February 2017. *See* "Robo advising: Catching up and getting ahead," a whitepaper published by KPMG in July 2016.

[30] "DOL Secretary Perez touts Wealthfront as paragon of low-cost, fiduciary advice," *Investment News*, June 19, 2015, available at http://www.investmentnews.com/article/20150619/FREE/150619892/dol-secretary-perez-touts-wealthfront-as-paragon-of-low-cost.

provides human-assisted robo-advice for accounts under $50,000,[31] and just two firms provide human-assisted advice for accounts under $100,000.

It is unlikely that robo-advice without human assistance will be a good substitute for the guidance offered by human representatives at financial services firms, particularly in times of market downturns or stress. During such times, an email, text message, or website alert from a robo-advisor may well not suffice to keep millions of concerned savers from selling into a stressed market, with devastating consequences for their accounts. These concerns have been supported by studies.[32] For example, research from Vanguard shows that human contact from advisers helps investors to stay invested in the market for the long-term, instead of trying to time the market.[33]

Finally, the experience of plans offering online advice shows that the Department should be cautious about concluding that robo advice will compensate for the loss of human advice services. As reported by Financial Engines in a study of participants in defined contribution plans who were offered assistance in the form of target date funds, managed accounts, and online advice services, only 5.4 percent of participants utilized the online advice service at least once in the prior 12 months. These participants tended to have higher account balances, with an average age of 45 years, average salary of $91,923, and a median account balance of $72,732. The report states that "[p]articipants who are younger but have higher balances are more likely to use online advice" and concludes that "[t]hese participants may be more engaged, have a stronger desire to be hands-on and be more comfortable using web-based advice services."[34]

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[31] For example, one well-known robo-advisor, Betterment, offers customers with assets of at least $100,000 the option of a consultation with a financial adviser once a year, but that service—called "Betterment Plus"—costs 40 basis points, up from 25 basis points for the digital-only service. For an additional 10 basis points, customers with $250,000 can get "Betterment Premium," which includes unlimited access to Betterment representatives. *See* "Betterment now offering human advice with its robo," *Investment News,* January 31, 2017, available at http://www.investmentnews.com/article/20170131/FREE/170139989/betterment-now-offering-human-advice-with-its-robo. Personal Capital, which also offers human-assisted automated advice for accounts with at least $25,000, charges a management fee of 89 basis points for accounts under $1 million (*see* https://www.personalcapital.com/).

[32] "Obama's Big Idea for Small Savers: 'Robo' Financial Advice," *Wall Street Journal*, July 21, 2015, available at https://www.wsj.com/articles/obamas-big-idea-for-small-savers-robo-financial-advice-1437521976.

[33] Vanguard Research, *Putting a Value on Your Value: Quantifying Vanguard Advisor's Alpha* (September 2016), available at https://www.vanguard.com/pdf/ISGQVAA.pdf.

[34] Financial Engines and Aon Hewitt, *Help in Defined Contribution Plans: 2006 through 2012* (May 2014), available at https://corp.financialengines.com/employers/FinancialEngines-2014-Help-Report.pdf.

3. Studies quantify the impact of loss of advice on investor returns.

While the harm to investors from the loss of advice as described above seems quite clear, a number of studies actually have quantified the impact that the loss of advice has on investor returns.[35] For example, a 2013 Morningstar study[36] attempted to quantify the benefits to consumers of receiving financial advice. They focused on five financial planning decisions and techniques, finding that advice creates value in each of the five categories, for a total increased gain of 1.6 percent, compared to the baseline when no advice is received. An additional Morningstar study showed that financial advice can help investors improve their optimal timing of taking Social Security benefits, adding gains of another 0.74 percent per year.[37] Combining both estimates, these studies suggest that better financial decision making achieved through professional financial advice, can add 2.34 percent annually to an investor's returns.

In 2015, Hal Singer and Robert Litan produced a report[38] analyzing the costs of the rule. They found that commission-based arrangements create incentives for brokers to offer beneficial advice to investors, that the rule "would actually impose net yearly costs of $2 to $3 billion (on the average ten year base of retirement assets)," and that "[t]he loss of brokerage advice alone could adversely affect up to 7 million people." Further, the report finds that "the decision to stay invested (or not) during times of market stress swamps the impact of all other investment factors affecting long-term retirement savings, including modest differences in advisory fees or investment strategies" and that "the cost of depriving clients of personalized human advice during a future market correction…could be as much as $80 billion."

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[35] The American Action Forum more recently attempted to estimate the consumer impact of the rule. It considered the companies that have either left part of their brokerage business or are drawing down their business or moving to fee-based arrangements. It estimates that anywhere from 2.3 million to 14.7 million consumers will face significant changes to their retirement and financial advice. *See* Sam Batkins, "Fiduciary Rule Has Already Taken Its Toll: $100 Million In Costs, Fewer Options," *American Action Forum Insight* (February 22, 2017), available at https://www.americanactionforum.org/insight/fiduciary-rule-already-taken-toll-100-million-costs-fewer-options/.

[36] *See* David Blanchett and Paul Kaplan, "Alpha, Beta, and Now… Gamma," *The Journal of Retirement* (Fall 2013). An earlier version is available from Morningstar at https://corporate1.morningstar.com/uploadedFiles/US/AlphaBetaandNowGamma.pdf.

[37] *See* David Blanchett, "When to Claim Social Security Retirement Benefits," *Journal of Personal Finance*, 11(2), 2012. Also see Wade Pfau, "The Value of Sound Financial Decisions: From Alpha to Gamma," *Forbes*, online edition, available at https://www.forbes.com/sites/wadepfau/2016/05/05/the-value-of-sound-financial-decisions-from-alpha-to-gamma/#7127ba7255df.

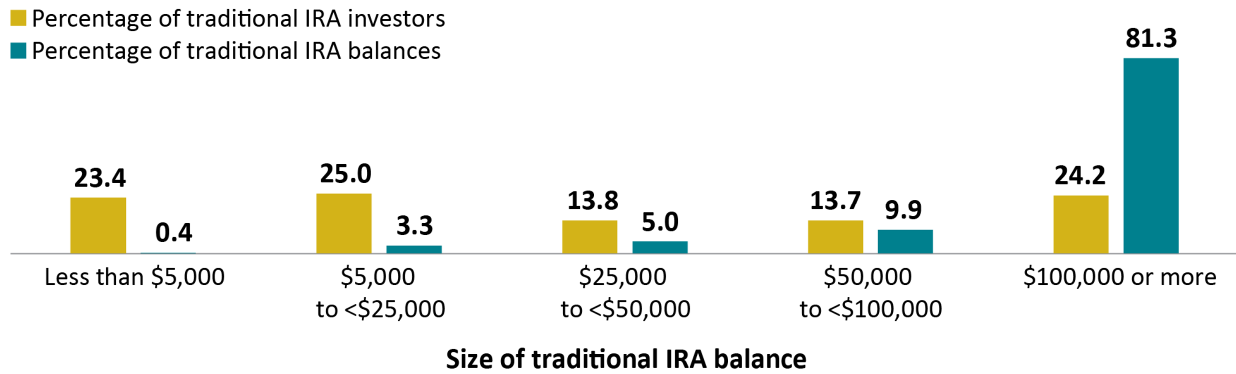
[38] The report, "Good Intentions Gone Wrong: The Yet-To-Be-Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule," is available at http://www.ei.com/support-_proposed_fiduciary_rule-roposed-fiduciary_rule/.

The Department disputed the relevance of these comments in its 2016 RIA by suggesting that the type of small-account investors that were the focus of the studies are not currently getting advice.[39] Each of the Department's examples, however, focuses on ongoing direct advisory relationships and not the type of transactional or event-based services—for example, the types of services provided by brokerage relationships—most likely to be used by investors with small account balances. These investors are most likely to desire and need guidance when first considering a rollover or other distribution from a plan, when considering whether to continue to buy or hold a particular asset, or when deciding what actions to take during a significant market event (*i.e.,* whether to stay invested in the market or whether to continue to hold a particular investment).

As we have said before, fee-based accounts may not be available to IRA investors who cannot meet minimum account balance requirements. Currently, fee-based advisers often require minimum account balances of $100,000 because, even with a 1 percent fee, accounts with fewer assets generate too little income to make the provision of ongoing advice profitable. As shown in Figure 2, 76 percent of investors in traditional IRAs in The IRA Investor Database™ have less than $100,000 in traditional IRA assets. And 22.2 million US households hold IRA assets of less than $100,000, with low- and middle-income households more likely to have IRA balances below $100,000, as shown in Figure 3.

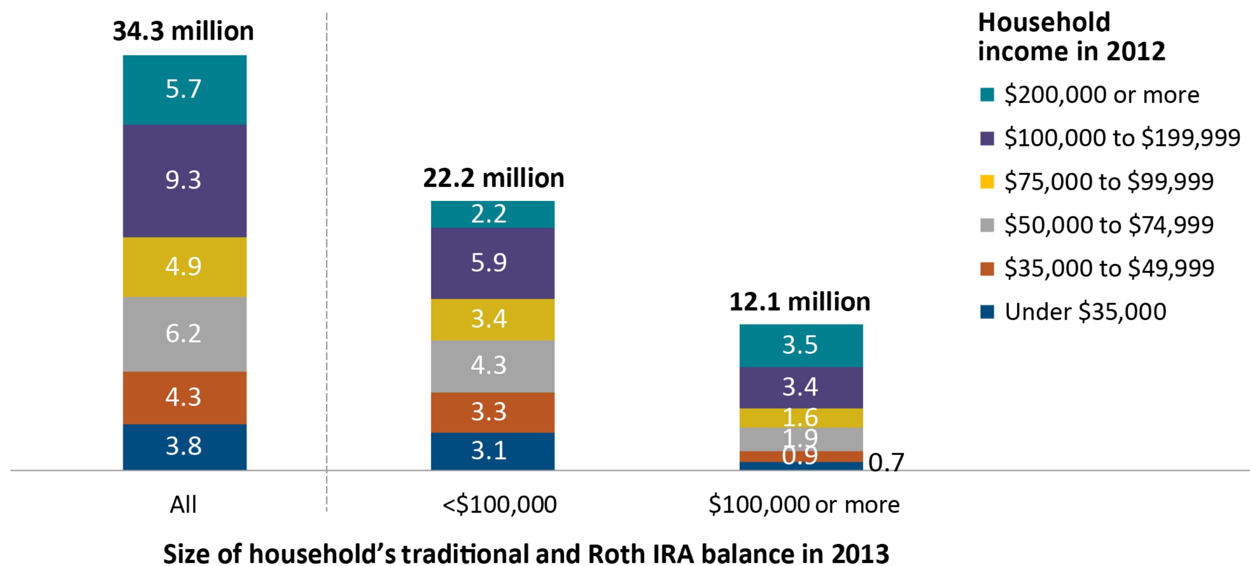
[39] 2016 RIA at p. 314, arguing that "few households with small IRAs or modest means currently report receiving professional advice." This statement does not comport with ICI data. ICI's IRA Owners Survey indicates that 44 percent of rollover households with traditional IRA balances of less than $50,000 consulted a professional financial adviser when making a rollover from an employer-sponsored plan to an IRA. In addition, among households with traditional IRAs, 76 percent of households with IRA balances of less than $50,000 reported holding their IRAs through investment professionals. Among those households, 30 percent held their IRAs through full-service brokers, which amounts to nearly 3.2 million households (ICI's IRA Owners Survey indicates that 13.8 million households have traditional IRA balances of less than $50,000). For information on the survey, *see* Sarah Holden and Daniel Schrass, "The Role of IRAs in US Households' Saving for Retirement, 2016," *ICI Research Perspective* 23, no. 1 (January), available at www.ici.org/pdf/per23-01.pdf.

Figure 2
Distribution of Traditional IRA Investors and Traditional IRA Balances
Percentage of traditional IRA investors and percentage of traditional IRA balances by size of traditional IRA balance, 2013



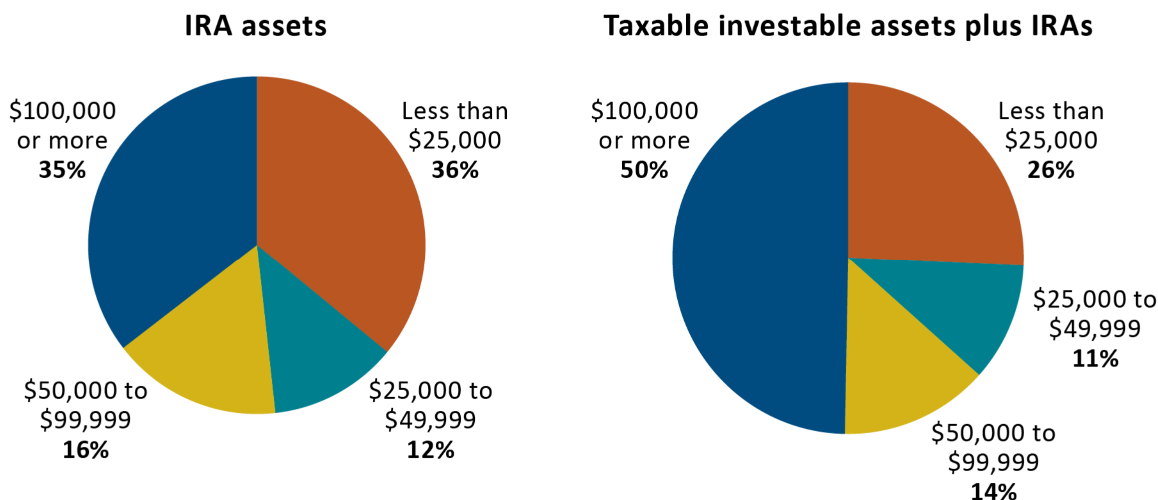
Note: The sample is 9.8 million traditional IRA investors aged 25 to 74 at year-end 2013. Components may not add to 100 percent because of rounding.
Source: The IRA Investor Database™

Figure 3
22.2 Million Households Have IRA Balances Less Than $100,000
Millions of households by household income and household IRA balances



Note: In 2013, 22.2 million, or 65 percent of, households with traditional or Roth IRAs had balances of less than $100,000, and 12.1 million, or 35 percent, had balances of $100,000 or more. Components may not add to 100 percent because of rounding.
Source: Investment Company Institute tabulation of Federal Reserve Board 2013 Survey of Consumer Finances

Figure 4
Household Holdings of IRAs and Taxable Investable Assets by Amount of Assets
Percentage of IRA-owning households, 2013



Note: IRAs include traditional and Roth IRA assets held by the household. Components do not add to 100 percent because of rounding.
Source: Investment Company Institute tabulation of Federal Reserve Board 2013 Survey of Consumer Finances

Moreover, as Figure 4 shows, 64 percent of households with IRAs—almost two-thirds—have total balances of less than $100,000, even when combining all the traditional and Roth accounts in the household. And even after including taxable investable assets that IRA investors could bring to a financial adviser, half of IRA-owning households still would be unable to meet the typical $100,000 minimum. These investors—a much higher proportion than assumed by the Department—are the ones most likely to lose access to advice if the rule moves forward.

4. Concerns regarding likely negative impact is reinforced by RDR in the UK.

Recent experience from the United Kingdom (UK) reinforces the predicted negative impact of the rule on low-balance investors. The Retail Distribution Review (RDR), which went into effect on December 31, 2012, effectively banned commissions on retail investment accounts in the UK and raised qualification standards for advisers. Leadership of the Financial Conduct Authority (FCA) has said that the RDR, while achieving its objectives, "caused advisers to pull away or make their service too expensive for one-off or limited advice."[40] There is now a widely-acknowledged "advice gap" in the UK, with two-thirds of financial products sold without professional financial advice and a marked decrease

[40] *See* "FCA admits RDR contributed to advice gap," *FT Adviser*, July 19, 2016, available at https://www.ftadviser.com/2016/07/19/regulation/rdr/fca-admits-rdr-contributed-to-advice-gap-chujPxa8fmBkivLaaAxxfN/article.html.

in the number of advisers.[41] The FCA has pointed to the higher cost for advice after the RDR as contributing to the gap, as well as unwillingness on the part of some advisers to serve the smaller-account investor.[42]

The Department dismissed comparisons to the RDR, asserting that early results in the UK did not indicate the development of an advice gap and distinguishing the Department's rule as not an outright ban on commissions.[43] These assertions are proving to be false, with the FCA itself acknowledging problems in the UK advice market and firms in the US already making changes to their product and service offerings (in many cases dropping smaller accounts altogether) in anticipation of the rule. While the BIC exemption does not expressly ban commissions, its conditions render commission-based compensation effectively unworkable without significant systemic changes in the marketplace.

C. No Basis Exists for Concluding That the Harm to Investors Caused by the Rule Will Be Offset by the Department's Speculative Foregone Benefits Projections.

Despite clear evidence that the rule is harming and will continue to harm investors, proponents of the rule no doubt will continue to cite previous claims in the 2016 RIA that the final rule would deliver gains for retirement investors by extending fiduciary status and thus mitigating potential conflicts in the marketplace.[44] The Department invites comment on whether such "projected investor gains could be offset by a reduction in consumer investment. . ."[45]

Those purported investor gains—or, in the context of rescinding or modifying the rule, "foregone benefits"—are illusory. There is no reasonable basis for concluding that the Department's speculative projections of foregone benefits will offset the harm to investors caused by the rule. The

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[41] *See* "FCA proposes reforms to close 'advice gap'," *Financial Times*, March 14, 2016, available at https://www.ft.com/content/4324f4dc-e9c8-11e5-888e-2eadd5fbc4a4; "Review launched after 'advice gap' becomes a gulf," *Financial Times*, October 13, 2015, available at https://www.ft.com/content/9d15d668-710b-11e5-ad6d-f4ed76f0900a; and HM Treasury and Financial Conduct Authority, *Financial Advice Market Review – Final Report* (March 2016), available at https://www.fca.org.uk/publication/corporate/famr-final-report.pdf.

[42] *See* "FCA proposes reforms to close 'advice gap,'" *Financial Times*, March 14, 2016, available at https://www.ft.com/content/4324f4dc-e9c8-11e5-888e-2eadd5fbc4a4. According to the *Financial Advice Market Review - Final Report*, "advice is expensive and is not always cost-effective for consumers, particularly those seeking help in relation to smaller amounts of money or with simpler needs. These changes have highlighted concerns that there is an 'advice gap'." *See* HM Treasury and Financial Conduct Authority, *Financial Advice Market Review – Final Report* (March 2016) at pp. 5–6.

[43] 2016 RIA at pp. 77–78.

[44] 2016 RIA at pp. 77–78.

[45] 82 Fed. Reg. 12319 at p. 12323.

Department itself now acknowledges that the 2016 RIA conclusions are "uncertain and incomplete,"[46] and that its claims of benefits from the rule are based on a limited assessment "of one source of conflict (load sharing), in one market segment (IRA investments in front-load mutual funds)."[47] But, beyond these limitations and more significantly, the Department's conclusion of potential gains associated with the rule suffers from the fact that the one negative effect it claims to show (poor front-load mutual fund selection by brokers) is not supported by the data.

1. Investors' Actual Experience with Broker-Sold Funds Contradicts the Department's Sole Basis for Its Rulemaking.

We previously have identified several significant flaws in the Department's RIAs supporting its rulemaking.[48] As we explained, the Department relied upon academic studies showing evidence of a correlation between broker-sold front-load funds and underperformance to support its rulemaking, rather than on undertaking its own studies using recent data. More specifically, the 2015 RIA claims, on the basis of academic studies, that the typical investment in a broker-sold fund underperforms by 100 basis points (Figure 5, Row 1). That claim of 100 basis-point underperformance is, in turn, the foundation for the Department's supposition that, in the absence of the final rules, investors in front-end load funds will lose $500 billion to $1 trillion in foregone returns during the next 20 years.[49] It follows that, if the Department misapplied the studies' findings, the entire basis for its expansive fiduciary rulemaking falls as well.

As we described in previous comment letters, the Department's claimed 100 basis point underperformance is not supported by the data. We compared returns of front-load funds to those of retail no-load funds.[50] For that comparison, we noted that to ensure commensurable return measures, it is necessary to adjust for 12b-1 fees, because investors who want advice services will have to pay for those services whether they use a broker or a financial adviser that is an ERISA fiduciary. It is also necessary to weight returns by either sales or assets to determine whether brokers' advice was causing investors to skew their purchases or holdings toward lower-return funds. On this commensurable basis, we found that over the period 2008–2014, the returns investors earned on front-load funds were just 6 to 7 basis points lower than the returns investors earned on retail no-load funds (Figure 5, Row 2).

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[46] 82 Fed. Reg. 12319 at p. 12320.

[47] 82 Fed. Reg. 12319 at p. 12320.

[48] *See* ICI Letter and ICI Supplemental Letter, at footnote 15, *supra*.

[49] *Id.*

[50] ICI Letter at p. 16.

The 2016 RIA largely rejected the Institute's critique of the 2015 RIA's claims of a clear demonstration that funds sold with front-end loads underperform.[51] Nevertheless, the 2016 RIA reduced its preferred estimate of underperformance to a range of 50 to 100 basis points.[52] This new, lower range is based in part on the Department's independent analysis of fund performance, which reports underperformance of broker-sold domestic equity funds of 59 basis points over the period 1980 to 2015 (Figure 5, Row 3, 2016 RIA(a)).

This estimate is still far too high, reflecting the Department's decision to focus on only a portion of the market: domestic equity funds. IRA investors, like other investors, hold a range of additional types of funds, including international equity, bond, and hybrid funds. ICI's 2015 analysis based its calculations on the assets in all of these types of funds. When the Department undertook its own analysis in the 2016 RIA of fund performance, it found that by including both domestic equity funds *and* "foreign equity" funds, underperformance on a risk-adjusted, asset-weighted basis was just 6 basis points (Figure 5, Row 4, 2016 RIA(b)), little different from the estimates ICI provided in 2015.[53]

The striking difference between the performance measures in Rows 3 and 4 reflects the Department's observation that, over the period of its analysis, broker-sold international equity funds *out*performed direct-sold funds by a wide margin (161 basis points).[54] This fact alone raises questions about whether the measured underperformance of domestic equity funds that the 2016 RIA reports arises from conflicts of interest or from some quite different cause. Presumably, if conflicts of interest cause underperformance, international equity funds should also underperform—not outperform by a significant margin. The 2016 RIA is unable to explain this conundrum.[55] In our view, this is a fundamental inconsistency and weakness in the RIA's analysis that should be explored when the Department undertakes the required additional economic and legal analysis.

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[51] In doing so, the Department stated that the Institute's analysis "is not a direct measure of the impacts of conflicts of interest on investment performance." 2016 RIA at p. 164. This criticism, if valid, applies equally to the Department's own analysis in both the 2015 RIA and 2016 RIA. For example, both RIAs seek to use measures of the underperformance of broker-sold funds as evidence that broker-sold funds embody strong conflicts of interest.

[52] 2016 RIA at pp. 162–163.

[53] When the Department updates its economic analysis, as required by the President's executive order, it should also measure performance on the basis of all assets that IRA investors hold, which would mean redoing the analysis in the 2016 RIA to fold in assets in bond funds and hybrid funds. As noted, it is also appropriate to adjust performance for 12b-1 fees. It is unclear whether the Department did that in its 2016 RIA analysis. If not, that also should be corrected when the Department updates its economic analysis.

[54] 2016 RIA at p. 338.

[55] 2016 RIA at p. 337, footnote 628.

Figure 5
Estimated Underperformance of Broker-Sold Funds, as Reported by Selected Analyses

Row	Source	Under-performance (basis points)	Time period	Asset-weighted?	Adjusted for 12b-1 fee charges?	Risk-adjusted?	Analysis is based on assets in these types of funds:
1	2015 RIA	100	unclear	unclear	no	unclear	unclear
2	ICI 2015	6–7	2008–2014	yes	yes	yes	domestic and world equity,[1] bond, hybrid[2]
3	2016 RIA (a)	59	1980–2015	yes	unclear	yes	domestic equity
4	2016 RIA (b)	6	1980–2015	yes	unclear	yes	domestic and foreign equity
5	Reuter 2015 (a)	64	2003–2012	yes	no	yes	actively-managed domestic equity
6	Reuter 2015 (b)	18	2003–2012	yes	yes	yes	all actively-managed (excluding muni)
7	ICI 2017	11	2008–2016	yes	yes	yes	domestic and world equity, bond, hybrid

[1] World equity is an ICI category that includes funds that may invest primarily in foreign equities, or may invest primarily in a mix of both foreign and domestic equities.
[2] Hybrid is an ICI category that includes funds that invest in a (possibly changing) mix of domestic and/or foreign equities and bonds.

The 2016 RIA refers to an updated analysis of performance produced by Jonathan Reuter (2015).[56] The 2016 RIA claims that "Reuter finds that actively-managed broker-sold domestic-equity funds underperform index funds by 64 basis points per year. This result is smaller in magnitude, but consistent with previous literature showing underperformance in broker-sold domestic equity mutual funds."[57] This is a highly selective reading of Reuter, however. In fact, when Reuter includes all types of funds (except for municipal bond funds), weights the funds by assets, and adjusts for 12b-1 fees, he finds that actively-managed broker-sold funds underperformed direct-sold funds by only 18 basis points (in Figure 5, compare Reuter 2015(a) in Row 5 and Reuter 2015(b) in Row 6).

Finally, in its recent 2017 comment letter to the Department on its 60-day delay rulemaking, ICI updated its 2015 analysis of the performance of broker-sold funds. Using the assets in all types of long-term mutual funds (domestic and international equity funds, bond funds, and hybrid funds), asset-weighting, and adjusting for 12b-1 fees, we found underperformance of only 11 basis points over the period 2008–2016 (Figure 5, Row 7).

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[56] *See* Jonathan Reuter, "Revisiting the Performance of Broker-Sold Mutual Funds," working paper, Boston College and NBER, November 2, 2015, ("Reuter 2015") available at https://www2.bc.edu/jonathan-reuter/research/brokers_revisited_201511.pdf.

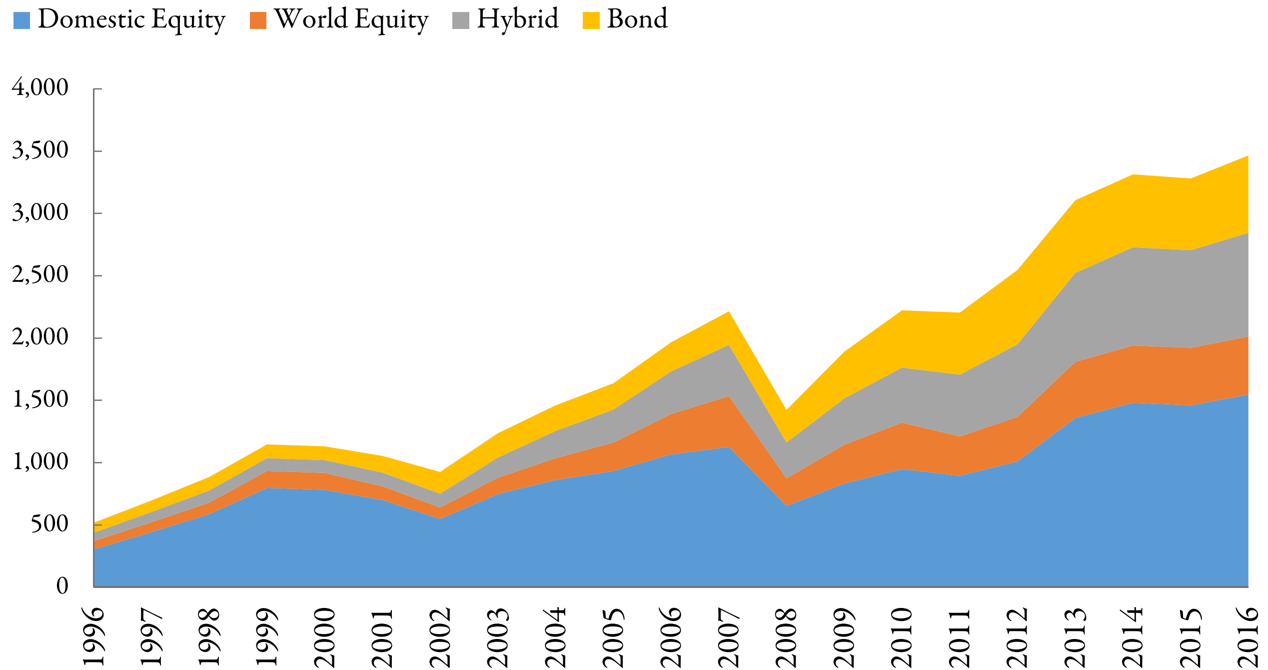
[57] 2016 RIA at p. 166.

We certainly can see no plausible rationale for focusing a performance analysis exclusively on one group of funds—as the Department chose to do in its performance analysis—rather than on the entire spectrum of funds that retirement investors use. The Department's own analysis suggests that a retirement investor who holds only broker-sold international equity funds would have experienced strong outperformance. It follows that a performance analysis that focuses solely on a particular type of fund (*i.e.*, the Department's decision to focus solely on domestic equity funds) will misrepresent the overall experience of retirement investors who hold a mix of types of broker-sold funds (*e.g.*, foreign equity or world equity funds and bond funds, as well as domestic equity funds).

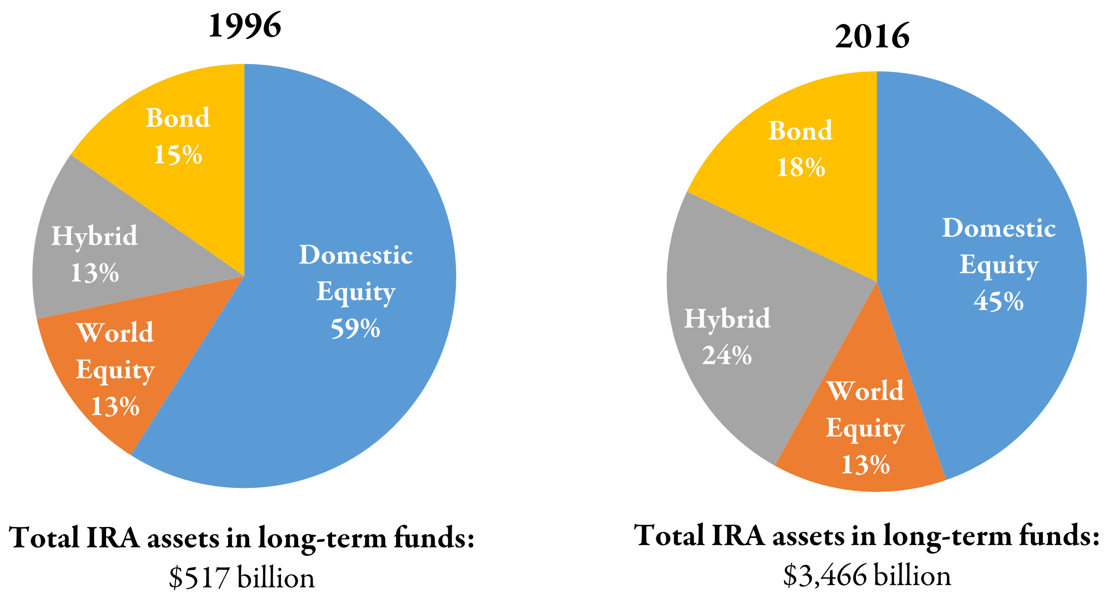
This insight is particularly important because, as Figure 6 shows, the proportion of assets that IRA investors hold in mutual funds has over time shifted toward world equity funds, hybrid funds, and bond funds, particularly since the financial crisis.

The bottom panel shows that this has resulted in a marked shift in the composition of IRA assets in long-term mutual funds. For example, in 1996, nearly 60 percent of the IRA assets in long-term mutual funds were in domestic equity funds. By 2016, that had fallen to 45 percent, and IRA assets in world equity, bond, and hybrid mutual funds accounted for more than half (55 percent) of IRA investors in long-term mutual fund assets. The Department's preferred approach to measuring performance ignores the fact that retirement investors now hold the majority of their IRA assets in mutual funds that are not domestic equity funds.

Figure 6
Long-Term Mutual Fund Assets in Individual Retirement Accounts (IRAs) by Fund Type
Billions of dollars; year-end, 1996–2016



Proportion of total IRA assets in long-term funds, 1996 and 2016



Total IRA assets in long-term funds:
$517 billion

Total IRA assets in long-term funds:
$3,466 billion

Source: Investment Company Institute, "The US Retirement Market, Fourth Quarter 2016," available at www.ici.org/info/ret_16_q4_data.xls

In sum, the broadest, most comprehensive, and most pertinent measures of fund performance—including those provided by the Department itself—offer little support for the Department's contention that broker-sold funds dramatically underperform. We find *no* evidence to support the 2016 RIA's assertion that there is a "substantial failure of the market."[58]

Invalidating the Department's 2015 and 2016 claims of underperformance by broker-sold funds invalidates, in turn, the Department's claim that, but for the final rule, investors in front-load funds will lose $500 billion to $1 trillion in foregone returns during the next 20 years.[59] In fact, that claim is sheer hyperbole, unsupported by the data. As such, the Department should not rely on these estimates as a basis for concluding that the harm to investors caused by the rule will be offset by foregone benefits.

2. The 2016 RIA Misapplied the Academic Research It Cites, Resulting in a Vast Overstatement of Potential Benefits from the Rule.

We have previously identified several significant flaws in the Department's RIAs supporting its rulemaking.[60] As we explained, the Department's analysis leans heavily on results from an academic study by Christoffersen, Evans, and Musto (2013) ("CEM").[61] That paper reported a negative correlation between fund performance and load fees paid by broker-sold funds to brokers. Using a key coefficient in the CEM study, which picks up this negative correlation, the 2015 and 2016 RIAs concluded that the benefits of the fiduciary rule could reach approximately $33 billion to $36 billion over a 10-year period.

As we discussed in our comment letters,[62] the Department's calculations misapplied the results in the CEM study, thus creating a false impression of the relationship between fund performance and the payments of front-end loads to brokers (what CEM call "load sharing").

The CEM approach indicates that a subset of funds—those that paid out to brokers a larger share of the front loads collected—underperformed the average return of their fund category during the next year. The Department in its analysis incorrectly assumed that *all* IRA assets that are invested in front-end load funds suffer from the *same* underperformance, even those that the CEM analysis would indicate are likely to outperform. The Department compounded this error by assuming that its

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[58] *See* 2016 RIA at pp. 9, 96, 158, and 326.

[59] *Id.*

[60] *See* ICI Letter and ICI Supplemental Letter, at footnote 15, *supra*.

[61] Susan Christoffersen, Richard Evans, and David Musto, "What Do Consumers' Fund Flows Maximize? Evidence from Their Broker's Incentives," *Journal of Finance* 68 (2013): 201–235 ("CEM").

[62] *See, for example,* ICI Letter at pp. 13–15.

fiduciary rule would reduce underperformance for *all* broker-sold funds *by an amount that CEM predict would apply only in extreme cases of load sharing*. As we showed by correcting the Department's errors in our comment letter, it is clear that the 2015 and 2016 RIAs overstated any potential benefits by 15 to 50 times.

In the 2016 RIA, the Department rejected the Institute's critique.[63] The Department, taking our discussion out of context, argued that "ICI results affirm the Department's choice for its assumption regarding the effect of load-sharing on performance." This is highly misleading. What we did in our comment letter was to replicate the analysis in the CEM study using more recent data. We found statistical results ("coefficient estimates") very similar to those reported in CEM. We went on to show, however, that even on this basis, once these very similar coefficient estimates were applied to *actual* data on load fees paid by particular funds and the *actual* assets held in each of those funds for 2013, any potential dollar benefits from the fiduciary rule were quite small.

The Department based its rebuttal in part on a supplemental comment letter from two of the CEM authors (Christoffersen and Evans) responding to the Institute's interpretation of their results. In that letter, Christoffersen and Evans challenge some of the statements in our comment letter. They note, for example, that they included fund assets in their key regressions and "effectively the variances in the regression are asset-weighted."[64]

Our point, however, was not about the results in the CEM paper, which stand on their own merits. Rather, it was about how the Department misapplied results from that paper. We discussed at length the Department's critique of our work in a supplemental letter to the Department.[65] That supplemental letter provides detail on how the Department misapplies a coefficient from the CEM study in calculating the economic impact of the final rule. The coefficient measures the response of the excess return on a broker-sold fund to the fund's "excess load," which CEM measure as the difference between the front-load fee that a fund pays to a broker (what CEM call "load sharing") and the front-load fee that one would expect the fund to pay the broker, as predicted by regression results in the CEM study (which for clarity we called "residual load shared"). Thus, the magnitude of any fund's "residual load shared" is typically much smaller than the *total* front load that a fund actually pays to (shares with) brokers. The Department erred by applying the coefficient to the *total* front load paid to brokers rather than to the *residual* load paid to brokers, vastly inflating the Department's estimate of the benefit of its proposed regulation.

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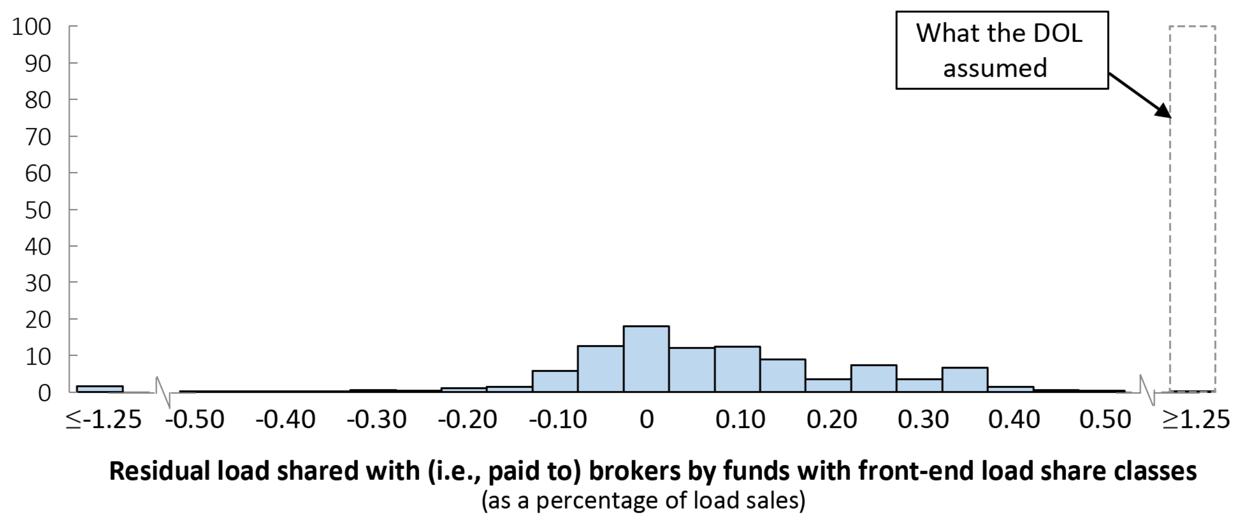
[63] 2016 RIA at pp. 347–348.

[64] 2016 RIA at p. 348, referencing letter from Christoffersen and Evans, Office of Exemption Determinations, Employee Benefits Security Administration, US Department of Labor (Sept. 10, 2015), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/02766.pdf.

[65] *See* ICI Letter to Joseph Piacentini, at footnote 15, *supra*.

Figure 7 illustrates this problem. The figure shows actual data on load funds' assets and their residual loads shared for 2013.[66] The horizontal axis shows the residual loads shared with brokers that are attributable to various funds. Funds with residual loads shared of greater than zero are those the CEM approach would characterize as having greater-than-average loads shared, after controlling for other factors, and thus would predict as likely to underperform. Funds with residual loads shared of less than zero are those the CEM approach would characterize as having below-average loads shared after controlling for other factors. The CEM analysis would predict that these funds would *out*perform. The height of the bars shows the proportion of assets held in load-fund share classes, bucketed according to their residual loads shared as of 2013. Thus, for example, the figure shows that in 2013, about 20 percent of the assets in front-end load share classes had a residual load shared of about zero.

Figure 7
How the 2016 RIA Misapplied Academic Research, Leading the RIA to Vastly Overstate Any Potential Benefits from Its Fiduciary Rule
Percentage of total assets in front-load share classes, bucketed by "residual load shared," 2013



Sources: Investment Company Institute and Strategic Insight Simfund

[66] Our supplemental letter applied the CEM framework to mutual fund data reported to the Securities and Exchange Commission (SEC) on Form N-SAR for the most recent four years (2010 to 2013) that were available to us at the time the letter was written in late 2015.

Figure 7 presents a concrete example of the error the Department commits in the 2016 RIA using 2013 data. It applied a residual load shared of approximately +1.50 percent[67] to 100 percent of the IRA assets it estimated to be in front-load share classes in 2013. This, as the figure demonstrates, is simply untenable. As can be seen in the figure, for the year 2013, virtually *none* of the assets in front-load share classes (whether IRA assets or otherwise) have load sharing payments of greater than 1.25 percent. Thus, what the Department did was to assume that a very high residual load shared applied to 100 percent of IRA assets in front-load funds, when in fact it should have assumed that virtually none of the IRA assets in front-load funds had a residual load shared anywhere close to that level. This led the Department to overstate its benefits estimates by 15 to 50 times.

Nevertheless, the Department, and the consulting firm the Department turned to for assistance,[68] both misapprehend our critique and why it renders the Department's analysis null. For this reason, Appendix A describes step-by-step, using both arithmetic and graphs, how the Department misapplied the results in the CEM study. It shows how to correct the misapplication. It also shows that once these corrections are made, any potential estimated benefits from the rule are quite small.

The way in which the Department misapplied the CEM analysis also can be illustrated by a simple analogy.

Consider, for example, a researcher studying the relationship between life expectancy and excess weight. Controlling for height, age, and gender, the researcher plots predicted weights for the adult population. The researcher finds that for every 10 pounds of "excess" weight—weight above the predicted normal weight given height, age, and gender—an individual's life expectancy falls by 0.5 years. Thus, if the predicted normal weight for a 50-year-old man who is 6 feet, 3 inches tall is 195 pounds, a 50-year-old man of that height who weighs 205 pounds would be expected to lose approximately six months (0.5 year) of life due to "excess" weight.

The researcher wants to show how much a government program encouraging people to lose "excess" weight could expect to add to individuals' lives. The researcher does this by seeking to estimate how much life expectancy declines for those with "excess" weight.

To form this estimate, the researcher multiplies the man's *full* weight (205 pounds) times the variable for the impact of "excess" weight on life expectancy (0.5 year per 10 pounds). This is inappropriate because the life-expectancy variable was calculated as the impact of "excess" weight—not

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[67] 2016 RIA at p. 341, Figure B-1, column C ("Baseline average load-share paid to broker"), for 2013, indicating that the Department assumed a load share payment of 142 basis points or 1.42 percent applied to all of the IRA assets in broker-sold funds.

[68] *See* Karthik Padmanabhan, Constantijn Panis, and Timothy J. Tardiff, "Review of Selected Studies and Comments in Response to the Department of Labor's Conflict of Interest 2015 Proposed Rule and Exemptions," Advanced Analytical Consulting Group, March 4, 2016.

total weight. The researcher erroneously concludes that the government program could add 10.25 years (*i.e.*, (0.5/10) x 205) to the individual's life, vastly overstating the true effect, which is 0.5 years.

Moreover, the researcher compounds the error by applying a similar calculation to *all* 50-year-old men who are 6-foot-3, even those who *already weigh less* than the predicted normal weight of 195 pounds. Since individuals who weigh less than the predicted normal weight are already "outperforming" in the sense that they have greater-than-average life expectancy (given their characteristics), it makes sense for the researcher to exclude them from an analysis that seeks to measure the benefits of the government's weight-loss program. But the researcher instead retains those individuals who "outperform" when calculating the potential benefits of the government's program.

The researcher's logical errors seem eminently clear—but they are analogous to how the 2015 and 2016 RIAs misapplied the CEM results, leading the RIAs to massively overstate any potential benefits from the rule.

In short, the Department has provided no evidence that leads us to alter our views that both the 2015 RIA and 2016 RIA misapplied the results of the CEM study, leading the Department to vastly overstate any potential benefits. We continue to believe that any benefit study, done properly, needs to consider the costs to investors who will lose advice or will pay more under an asset-based fee approach. Until the DOL presents figures that factor in these considerations, the benefit calculations in the RIA are highly suspect at best.

D. A Thorough, Comprehensive, and Balanced Impact Analysis Is Crucial to Moving Forward in a Manner Consistent with the President's Directive.

The Department acknowledges that its estimate of potential investor foregone gains presented in the 2016 RIA "is incomplete because it represents only one negative effect (poor mutual fund selection) of one source of conflict (load sharing), in one market segment (IRA investments in front-load mutual funds)."[69] We discuss above how its analysis of that one market segment does not support its claims of lost foregone gains. The Department now invites comments to "help inform updates to its legal and economic analysis, including any issues the public believes were inadequately addressed in the RIA and particularly with respect to the issues identified in the President's Memorandum."[70]

In our view, the RIA is fatally flowed: rather than serving as a tool to understand a problem and determine the best solution, the Department started with a predetermined agenda of eliminating potential conflicts in the retirement marketplace and used the RIA to justify that effort. The result is an RIA that focuses on "claims" that support the Department's narrative and that readily dismisses "facts" contradicting that narrative. Most significantly, the RIA fails to address the "harms" of the rule—a

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[69] 82 Fed. Reg. 12319 at p. 12320.

[70] 82 Fed. Reg. 12319 at p. 12324.

topic of primary importance in the President's Memorandum. As the Department moves forward in complying with the President's directive, it must at a minimum consider information derived from quantitative or qualitative data focused more clearly on showing the problem that the rule is intended to solve, as well as both the anticipated "costs" and "benefits" of the rule as a solution. Set forth below are some of the considerations that must be incorporated in the more comprehensive impact analysis required by the President.

- As discussed above, the 2016 RIA attempts to provide supportable data describing the magnitude of the *costs* arising from persons and financial services firms from one source of potential conflicts (load sharing). In attempting to support the existence of such a finding, the Department, consistent with the President's directive, should provide data and other information on the *benefits* stemming directly or indirectly from the services provided by these persons and financial services firms. For example, the Department targeted front-end loads or the receipt of 12b-1 fees as creating potential conflicts. Given that, it should also have identified and analyzed the benefits of advice or information that brokers who receive those fees have been providing to investors (for example, through the greater availability of guidance, diverse product offerings, educational tools, and information generally). The Department should then have weighed the harm of investors losing the valuable advice that brokers provide under a commission-based model against any potential benefit from reducing potential conflicts. The 2016 RIA's one-sided perspective creates a significant gap in the Department's analysis that must be remedied.

- The Department also should analyze whether and the extent to which IRA investors are confused about potential conflicts involving the persons or financial services firms providing services to them and the costs that arise from that confusion. As discussed above, there is no evidence of systematic underperformance stemming from the very arrangements on which the Department bases its conclusions of market failure, contrary to the Department's supposition that such potential conflicts necessarily lead to underperformance.

- The Department should include data and other information describing the effectiveness of disclosure to correct any confusion about whether or not a service provider is acting as a fiduciary and about potential conflicts involving the persons or financial services firms providing services to consumers of IRA products and 401(k) participants. While the Department in the 2016 RIA speculates that disclosure alone would be insufficient to protect investors,[71] it provides no data or test findings supporting this supposition.

- The Department should provide data and other information comparing IRA investors' returns (net of gross fees, commissions, or other charges paid to the financial professional) for investors who pay directly for services from persons or financial services firms with those of investors who

[71] 2016 RIA at pp. 268–271.

pay indirectly (for example, through commissions or 12b-1 fees). As discussed above, our review of publicly available data indicate that evidence is lacking that brokers steer their clients to underperforming front-end load share classes. These data contradict the claim in the 2016 RIA that commission-based brokers are pushing clients to weaker performing front-end load funds.

- The Department should provide data and other information describing and comparing the product selections of IRA investors and 401(k) participants based on whether they are served by persons or financial services firms whose fee is paid directly by customers (as an asset-based or fixed fee) or by advisers who are paid indirectly (for example, through commissions, 12b-1 fees or revenue sharing). To the extent the Department believes that differences in fee structure contribute to differences in the types of products offered or recommended, one would expect to see data and other information showing why the types of products offered or recommended may differ.

- The Department should provide data and other information showing the extent to which limiting access of IRA customers to services provided by persons or financial services firms who are paid indirectly (for example, through commissions and 12b-1 fees)—a likely result of the rule—will serve to eliminate or otherwise impede IRA customer access to such accounts, products, services and relationships (for example, through higher costs and account minimums). Such data findings should be segmented by account size, income levels and, to the extent available, race and ethnicity of consumer. Simply put, the Department's 2016 RIA offers little analysis of the limits on future access to guidance, products and services resulting from the Department's rules.

- The Department should include a more complete analysis of implementation costs. The Department did not include any estimate for the amount that "asset providers," including mutual funds, will spend to come into compliance.[72] While such start-up costs are most commonly associated with intermediaries, product sponsors—including mutual fund advisers—also will incur significant start-up costs in preparation for the applicability date. The fund industry already has incurred millions of dollars of costs analyzing the final rule; updating systems, internal processes, policies, and procedures; and developing various products to support intermediary business models. As described in ICI's March 17 Letter, we estimate that they will spend an additional $94 million just to implement T shares.[73]

- The Department should include data and other information describing costs to persons or financial services firms stemming from their potential status as fiduciaries under ERISA (for example, due to increased potential litigation claims and compliance costs). In particular, the

[72] *See* 2016 RIA at p. 244.

[73] *See* ICI's March 17 Letter at p. 21.

Department should incorporate into its analysis, differences in the burden of proof required to defend claims as an ERISA fiduciary and to claim coverage under applicable prohibited transaction class exemptions.

- Finally, we would expect the Department to include analysis of the costs associated with the failure to implement a single harmonized fiduciary standard, including, but not by way of limitation, data and other information describing the types and availability of services (including advice) and securities that would be offered to consumers under a single harmonized fiduciary standard versus the application of dueling standards that is likely to result from the failure to adopt a single standard.

This is not an exhaustive list. Rather, these are just a few of the analyses that are missing from the Department's 2016 RIA that should be included in the impact analysis requested by the President. Inclusion of these analyses will go a long way to ensuring that the Department's decision on whether to rescind or revise the final rule is grounded in thoughtful analysis.

III. The Anticipated Applicability of the Rule Has Resulted in Dislocations or Disruptions Within the Retirement Services Industry That Will Adversely Affect Investors and Retirees.

The second area of inquiry required by the President's Memorandum is the extent to which "the anticipated applicability of the Fiduciary Duty Rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees."[74] "The Department invites comments on whether the final rule and exemptions so far have moved markets or appear likely to move markets in this predicted direction [toward a more optimal mix of advisory services and financial products, beyond just direct compliance activities/related costs and mitigation of existing advisory conflicts and associated changes in affected investment recommendations]."[75] Related to this question, as noted above, the pending application of the rule has already caused dislocations and disruption within the retirement services industry, and is already having a consequential impact on the marketplace in the manner that we predicted in our prior comment letters. The harms to investors include more limited product choice, a move to more costly asset-based arrangements, and an increase in account minimums for commission-based accounts. Indeed, there is no evidence that such movement is leading to a "more optimal mix of advisory services and financial products," as the Department asks.

In ICI's March 17 Letter and as summarized below, we described the impact the rule is having on the retirement market.

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[74] *See* President's Memorandum at footnote 3, *supra*.

[75] 82 Fed. Reg. 12319 at p. 12323.

- As has been widely reported, several large intermediaries have announced a variety of changes to service offerings, including firms announcing that they will no longer offer mutual funds in IRA brokerage accounts; others no longer offering any IRA brokerage accounts at all; firms reducing web based financial education tools; and others announcing that brokerage services for lower-balance accounts will be discontinued.[76]

- We understand from Institute members that many intermediaries have reduced their product offerings, including dropping many smaller mutual funds from their platforms and limiting available options for their investors. In discussions regarding fund offerings, intermediaries have raised the possibility of small investors being disadvantaged by diminished product choice and also diminished service offerings due to the restrictive framework the rule imposes on advisers.

- Under the rule, it is not only significantly more burdensome to maintain commission-based arrangements, but intermediaries have struggled with a number of obstacles that have made implementation particularly more difficult and disruptive for commission-based arrangements (*e.g.*, uncertainty regarding the application of SEC rules, and a short implementation time period).[77]

- Fund companies are developing T shares (or transaction shares)[78] at a significant cost in response to intermediary demand, which intermediaries planned to use as a temporary "fix," until they can develop a better solution.[79] We estimate that costs relating to only one segment of product changes—the creation of T shares—could reach $94 million.[80]

- Clean shares[81] may be a solution for some intermediaries by allowing them to "externalize" commissions, but significantly more time is needed to implement them, and most intermediaries still need time to determine whether clean shares fit their business models.[82]

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[76] *See* ICI's March 17 Comment Letter at pp. 16–18.

[77] *See* ICI's March 17 Comment Letter at pp. 20–22.

[78] T shares generally have a uniform front-end load (similar to an A share), but with a lower commission, generally around 2.5 percent.

[79] *See* ICI's March 17 Letter at pp. 20–21.

[80] *See* ICI's March 17 Letter at pp. 19–22.

[81] Generally, securities law prohibits a fund from selling shares at any price other than as described in its prospectus. Recent guidance from the SEC provides that when certain conditions are met (for example, the share cannot already include a commission), a broker may add its own commission, or "externalize" the commission. *See* SEC Interpretive Letter (pub. avail. Jan. 11, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.

[82] *See* ICI's March 17 Letter at p. 22.

The market disruptions described above[83] are and for the foreseeable future will be substantial and costly, and it is by no means clear that all these disruptions will be temporary. While some of the disruptions described above relate to the transition to a new regulatory regime, most do not. For example, intermediaries are struggling to modify their business models to come into compliance with the rule which has, in turn, stalled mutual funds' compliance efforts. Often intermediaries have approached a fund company with one concept, only to change direction within a few weeks. This uncertainty and absence of final decisions have limited funds' ability to develop and launch products to support the intermediaries' modified business models and strategies. If the current rule were to remain in place, it seems reasonable to assume that at some point (possibly over ten years), the market may settle to a new normal. Some amount of commission-based arrangements would likely continue, whether through the use of T shares, clean shares, a costly proliferation of "one-off" new share classes, or some other not-yet-developed solution.

While one would expect that many of the disruptions noted above will lead to market changes over time, it is by no means certain that such changes will lead to more optimal solutions or when, or for whom the changes are more optimal. The final rule may cause many intermediaries to discontinue service models aimed at retirement investors with small account balances, and many more will cease providing commission-based accounts.[84] Some investors will end up paying more for advice as they are pushed to fee-based accounts, while others will lose access to advice. The investors who have been "orphaned" by intermediaries may be left without any access to advice. It is possible that other market participants may seek to overcome the rule's barriers and find ways to serve retirement savers who now rely on broker-dealers. It is entirely foreseeable, however, that many IRA investors most impacted by such disruptions will never recover from the negative consequences. For example, investors who lose access to advice and service are likely to earn lower returns for the foreseeable future. These lower returns could occur, for example, through poorly timed investment decisions[85] or penalties for early

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[83] Beyond these impacts (of which we already are seeing evidence), the rule is anticipated to result in other more specific harms, including a reduction in sponsorship of plans by small employers due to impediments imposed on selling current small business retirement plan options (*e.g.*, SEP and SIMPLE IRAs) and the loss of valuable shareholder rights (*i.e.*, rights of accumulation, exchange privileges, and breakpoints) for investors who prefer utilizing products offered by a single fund family that offers a broad array of asset classes and strategies. The rule also is having a chilling effect on product sponsors' willingness to provide information about their products to intermediaries, as well as the use of call centers to make such information available to retirement savers.

[84] *See* Sam Batkins, "Fiduciary Rule Has Already Taken Its Toll: $100 Million In Costs, Fewer Options," *American Action Forum Insight*, February 22, 2017, available at https://www.americanactionforum.org/insight/fiduciary-rule-already-taken-toll-100-million-costs-fewer-options/.

[85] A 2013 report finds that "the decision to stay invested (or not) during times of market stress swamps the impact of all other investment factors affecting long-term retirement savings, including modest differences in advisory fees or investment strategies" and that "the cost of depriving clients of personalized human advice during a future market correction…could be as much as $80 billion." *See* Hal Singer and Robert Litan, "Good Intentions Gone Wrong: The Yet-To-Be-Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule," available at http://www.ei.com/support-_proposed_fiduciary_rule-roposed-fiduciary_rule/.

withdrawals. These lost gains will continue to have a negative impact on future earnings.[86] Thus, even if the marketplace reacts to these dislocations with potential solutions—which is by no means certain—investors who are underserved or forced to pay higher fees in the coming months will be left with reduced assets for reinvestment even if the dislocations are remedied in the future.

IV. The Rule Will Cause an Increase in Litigation and an Increase in the Prices That Investors and Retirees Must Pay to Gain Access to Retirement Services.

The President's Memorandum directed the Department, as part of its updated legal and economic analysis, to consider whether the rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services. Related to this question, the Department requests comments on whether market developments and preparation efforts since the final rule and exemptions were published in April 2016 illuminated whether or to what degree the final rule and exemptions are likely to cause an increase in litigation, and how any such increase in litigation might affect the prices that investors and retirees must pay to gain access to retirement services.[87] Numerous experts—from law firms to financial analysts[88]—have reported that the rule, and BIC exemption in particular, will result in increased litigation, particularly in the IRA marketplace. This should come as no surprise. And it would be no mere accidental result. In crafting the rule and BIC exemption, the Department unabashedly noted its very intent to increase litigation and use the plaintiffs' bar as its primary enforcement mechanism for ensuring compliance with the rule and BIC.[89]

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[86] We estimate that the retirement investors' returns could be reduced, conservatively, by $10.9 billion a year as result of the additional fees and lost returns they will incur. *See* ICI's March 17 Letter at p. 17.

[87] 82 Fed. Reg. 12319 at p. 12324.

[88] *See, e.g.,* Jeff Benjamin, "DOL fiduciary rule class-actions costs could top $150M a year," *Investment News,* February 9, 2017, available at http://www.investmentnews.com/article/20170209/FREE/170209902/dol-fiduciary-rule-class-actions-costs-could-top-150m-a-year; Kenneth Corbin, "How should advisers defend against fiduciary litigation," *Financial Planning*, October 13, 2016, available at https://www.financial-planning.com/news/how-should-advisers-defend-against-dol-fiduciary-litigation; Shelby George, "DOL's Fiduciary Rule Poses New Litigation Threat to IRA Advice," Manning & Napier (August 15, 2016), available at https://www.manning-napier.com/Corporate/Insights/ResearchLibrary/Article/tabid/308/Article/514/DOL-s-Fiduciary-Rule-Poses-New-Litigation-Threat-to-IRA-Advice.aspx; Jessica Karmasek, "Class actions will test DOL's new fiduciary rule, attorney says," *Legal News Line*, May 2, 2016, available at http://legalnewsline.com/stories/510719100-class-actions-will-test-dol-s-new-fiduciary-rule-attorney-says; "The US Department of Labor's Final "Fiduciary" Rule Incorporates Concessions to Financial Service Industry but Still Poses Key Challenges," Shearman & Sterling, LLP, April 14, 2016, available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/04/The-US-Department-of-Labor-Final-Fiduciary-Rule-Incorporates-Concessions-to-Financial-Service-Industry-CGE-041416.pdf; and "Fiduciary Rule – Best Interest Contract Exemption," Groom Law Group, April 8, 2016, available at http://www.groom.com/assets/htmldocuments/A-Fid%20Reg%20-%20BIC%20GLG%20Apr.%208%202016%20v1.pdf.

[89] 81 Fed. Reg. 21002 at p. 21021.

Unlike in the ERISA plan context, the Department has no enforcement authority over the new best interest standard of care imposed on IRA fiduciaries under the rule. The IRS's enforcement authority over violations of the IRA prohibited transaction rules is limited, by statute, to imposition of excise taxes and there is no private right of action under the Internal Revenue Code for such violations. Therefore, the Department sought, in effect, to bootstrap a new enforcement mechanism for its best interest standard through state law breach of contract claims, inviting the plaintiffs' bar to take on the role of primary enforcer.

In the case of IRAs and other non-ERISA plans, therefore, the BIC exemption requires an enforceable written contract between the adviser and investor, wherein the adviser agrees to adhere to impartial conduct standards and also must make certain specific warranties including adopting and complying with written policies and procedures reasonably designed to prevent material conflicts of interest from causing violation of the best interest standard. Moreover, the BIC exemption prohibits contractual provisions that would waive or limit the investor's right to bring or participate in class action litigation or that would limit compensatory damages.[90]

In addition to creating a private right of action that Congress did not provide and thus did not previously exist, the provisions of the BIC exemption will encourage litigation in other ways.[91] For example, the best interest standard described in the exemption is nebulous and therefore will invite litigation to test out its parameters. The same can be said for the reasonable compensation component of the exemption's impartial conduct standards. The plaintiffs' bar will be attracted by this new opportunity to flesh out untested standards, knowing that defending such suits will be expensive and raise the potential for large settlements. Adding to the attractiveness of class action suits is the burden of proof, which rests with the adviser (the party relying on the exemption). The burden of proving that a recommendation was "without regard to" the adviser's own financial or other interests would appear to be difficult, if not impossible, to meet when the advice is compensated in any form.[92]

These features of the BIC exemption will likely serve to continue or accelerate current trends in litigation involving ERISA plans. ERISA litigation is on the rise and has proven to be quite lucrative for

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[90] It is well understood that many robo-advisors—a segment of the advice industry that the Department assumes will take up slack from advisers leaving the small-account market—include arbitration clauses in their client contracts. *See* Sean Forbes, "Robo-Advisers Want the Fiduciary Rule, but Not the Litigation Risk," *Bloomberg BNA Pension & Benefits Daily,* March 29, 2017, available at https://www.bna.com/roboadvisers-fiduciary-rule-n57982085892/.

[91] Moreover, minor violations of any of the contractual warranties or other contract terms would appear to give rise to a breach of contract claim, even if the violation would not result in loss of the exemption.

[92] *See* "DOL Puts Fiduciary Rule's Right to Sue Under Microscope," *ThinkAdvisor,* March 13, 2017, available at http://www.thinkadvisor.com/2017/03/13/dol-puts-fiduciary-rules-right-to-sue-under-micros?page=2&slreturn=1490808619; and Greg Iacurci, "DOL fiduciary rule promotes a 'business form of skydiving'," *InvestmentNews,* October 20, 2016, available at http://www.investmentnews.com/article/20161020/FREE/161029986/dol-fiduciary-rule-promotes-a-business-form-of-skydiving.

the plaintiffs' bar. In 2015 alone, 6,925 suits were filed under ERISA and the top ten class action settlements totaled $926.5 million.[93] The sheer number of cases and settlements evidence a pattern of strike suits. In this regard, the Department asks about the impact class action lawsuits have had on ERISA plans and participants, and whether they have been prone to abuse.[94] While such intense scrutiny on plan fees clearly puts pressure on plan sponsors to seek lower-cost arrangements, the fee litigation and settlements also could work to the detriment of plan participants by diverting attention away from other equally-important factors that plan fiduciaries should consider in designing plan investment menus, such as quality of products and services and offering diverse or innovative options.[95] Fear of lawsuits is likely to impede innovation and steer plan sponsors toward a more uniform approach to plan design—including the use of more generic investment options offered through the plan—which is unlikely to be beneficial to retirement savers in the long run.[96]

Analyzing the effect of the BIC exemption's enforcement framework, Morningstar has estimated "a long-term annual range for the industry from class-action settlements of $70 million–$150 million" and predicts that "near-term class-action lawsuit settlements [could] exceed this by a multiple, as firms figure out how to determine, demonstrate, and document best interest."[97] The consequential harm to investors could take multiple forms. For example, the significant costs of increased litigation will either be passed on to consumers through higher fees or result in changes to intermediary business models that, as described earlier, already are leading to loss of access to advice for some investors (*i.e.*, particularly for smaller accounts, the increased risks could outweigh the benefit of keeping the accounts). In this regard, some investors previously served by brokers will be dropped by their intermediaries and will not be able to meet account minimums for fee-based advice. In addition, the increased risk of litigation could amplify the anticipated movement away from commission-based accounts toward fee-based advice, as charging asset-based fees for advice would be one way to avoid the class action suit exposure inherent in the BIC exemption. For those investors who are able to meet account minimums for fee-based advice, some will end up paying more to their advisers than under a commission model, particularly the buy-and-hold investor.

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[93] *See* Nick Thornton, "Top 10 ERISA settlements of 2015," *BenefitsPro*, January 25, 2016, available at http://www.benefitspro.com/2016/01/25/top-10-erisa-settlements-of-2015?page_all=1.

[94] 82 Fed. Reg. 12319 at p. 12324.

[95] *See* Jacklyn Wille, "Uptick in Fee Litigation Reshaping 401(k) Industry," *Bloomberg BNA Pension & Benefits Daily*, June 9, 2016, available at https://www.bna.com/uptick-fee-litigation-n57982073839/.

[96] *See* Marlene Satter, "Litigation is top fear of majority of 401(k) sponsors," *BenefitsPro*, December 6, 2016, available at http://www.benefitspro.com/2016/12/06/litigation-is-top-fear-of-majority-of-401k-sponsor?slreturn=1491314929.

[97] Michael Wong, "Costs of Fiduciary Rule Underestimated," Morningstar (February 9, 2017), available at http://news.morningstar.com/articlenet/article.aspx?id=793268. ("In a bearish scenario, the cost of class-action settlements alone could decrease the operating margin on the advised, commission-based IRA assets of affected firms by 24%–36%.")

For these reasons, it is abundantly clear that the rule will cause an increase in litigation, as the Department apparently desires. It is also clear that this litigation will harm investors, not just through higher prices for access to retirement services, but also loss of such access in many cases.

V. Conclusion.

As explained by the Department in the preamble to its proposed delay, following its examination, it will have four options: allow the final rule to become applicable, issue a further delay of the applicability date, propose to withdraw the rule, or propose to amend the rule.[98] Applying the standards in the President's Memorandum and based on the analysis above, it is clear that the Department must revise or rescind the rule. There simply is no debate that the pending applicability of the rule already is harming retirement investors.

The Department has delayed the applicability date for 60 days, until June 9, 2017. The Department notes that the re-examination of the rule "is likely to take more time to complete than a 60-day extension would afford."[99] While the Department may need additional time to make a determination regarding whether to rescind the rule, or whether revising it will meet the President's directive, it should not need more time to determine what is obvious already—that the rule already is harming investors and must be rescinded or revised. To provide increased certainty and fewer disruptions for both the industry and retirement investors, the Department should immediately clarify that the applicability date is to be postponed until a decision is made as to which of these courses (rescind or revise) the Department will take and, if the decision is made to revise, what form the modifications should take. The alternative is to have the rule and certain conditions of the exemptions become applicable prior to the completion of the Department's re-examination, which would bring chaos and uncertainty to the market.

We oppose in the strongest possible terms the Department's bifurcated approach to delaying applicability of the rule and exemptions, described in the Department's rule published on April 7, 2017 finalizing the 60-day delay. The rule defining who is a fiduciary by virtue of providing investment advice and the associated prohibited transaction exemptions for use by fiduciary advisers are inextricably linked. The Department argues that allowing the definition to go into effect on June 9, 2017, and only requiring compliance with the impartial conduct standards of the exemptions honors the President's directive and addresses financial services industry concerns about the need to comply with the requirements of the exemptions.[100] We disagree. The Department's actions imply that it intends to undertake no meaningful re-examination of the fiduciary rule itself, which is the primary

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[98] 82 Fed. Reg. 12319 at p. 12325. Of course, the Department now seemingly has elected a fifth option, which is to allow the final rule to become applicable before completing the examination directed by the President. *See* text accompanying footnotes 8 and 9, *supra*.

[99] 82 Fed. Reg. 16902 at p. 16905.

[100] 82 Fed. Reg. 16902 at p. 16905.

subject—and target of inquiry—of the President's Memorandum.[101] The expansive fiduciary definition created by the rule is excessively and inappropriately broad, with exceptions that are too limited. Moreover, the best interest standard in particular (which is part of the BIC Exemption's impartial conduct standards) is highly subjective and creates significant liability risk in the context of litigation. It represents a new standard that arguably differs from the existing ERISA duties of prudence and loyalty. The resulting uncertainty and increased liability risk are significant concerns for firms as they evaluate different possible compliance approaches, even without the written contractual warranties (not needed for ERISA-covered plans anyway). Under the Department's approach, firms will be forced to make speculative, uninformed business decisions that are less than optimal—if not harmful—for the businesses and for the customers they serve.

As noted above, the only determination left for the Department is whether to rescind the rule, or whether it can meet the President's directive by revising it. If the Department revises the rule, any modifications to the rule must be grounded in a much more balanced and comprehensive impact analysis. In addition, the Department should consider certain high-level principles as it develops modifications. For example, creating a private right of action and relying on the plaintiffs' bar as a means of enforcement will never serve as a framework for effective rulemaking unless the goal of that rulemaking is to eliminate the very activity the rulemaking is designed to allow. The Department used this bootstrap approach solely because it did not have enforcement authority over IRAs. Promoting litigation as an enforcement strategy brings significant risk, expense and uncertainty.[102] A much better approach is to work with other agencies with enforcement authority over the various market segments to which the retirement industry is subject and develop a best interest standard that is consistent and harmonious with other regulatory regimes. For example, as stated above, we support a unified standard that would apply across various types of savings/investment accounts. More broadly, such a standard must provide clarity on the activities covered; sufficiently exempt ordinary practices like education, marketing and selling investment products and services; must not chill the provision of useful investment information and education; and not impede investor choice over products and services appropriate to their needs. Such an approach would be more consistent with other Administrative directives[103] and reflects the reality that individuals who seek financial guidance often have both

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[101] The Department states that there is "fairly widespread" agreement about the basic impartial conduct standards, and notes the many concerns regarding compliance with the exemptions (particularly the Best Interest Contract Exemption), but it does not acknowledge that there is widespread criticism of the Department's overly broad definition of fiduciary. 82 Fed. Reg. 16902 at pp. 16905–6. The imposition of the new expansive definition itself will cause harm to investors, for example, by causing a chill in the provision of useful investment information and education and impeding investor choice over products and services appropriate to their needs.

[102] As discussed above, such a delegation of enforcement creates uncertainties and burdens on advisers and incentivizes the filing of litigation by the plaintiffs' bar to force quick settlements.

[103] *See* Presidential Executive Order on Enforcing the Regulatory Reform Agenda, issued on February 24, 2017 (stating that "[i]t is the policy of the United States to alleviate unnecessary regulatory burdens placed on the American people" and encourages Agencies to eliminate regulations that "create a serious inconsistency or otherwise interfere with regulatory reform initiatives and policies"), available at https://www.whitehouse.gov/the-press-office/2017/02/24/presidential-executive-order-enforcing-regulatory-reform-agenda; and Presidential Executive Order on Reducing Regulation and

retirement accounts and retail accounts and should be able to receive guidance that reflects consistent and compatible regulatory requirements.

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We appreciate the opportunity to comment regarding the Department's reexamination of the fiduciary rule. If you have any questions regarding our comments, or would like additional information, please contact Brian Reid, Chief Economist, at (202) 326-5917 or brian.reid@ici.org; Sean Collins, Senior Director of Industry and Financial Analysis, at (202) 326-5882 or sean.collins@ici.org; David Blass, General Counsel, at (202) 326-5815 or david.blass@ici.org; or David Abbey, Deputy General Counsel—Retirement Policy, at (202) 326-5920 or david.abbey@ici.org.

Sincerely,

/s/ Brian Reid

Brian Reid
Chief Economist
Investment Company Institute

/s/ David W. Blass

David W. Blass
General Counsel
Investment Company Institute

Controlling Regulatory Costs, issued on January 30, 2017 (directing agencies to identify at least two existing regulations to be repealed for every new regulation proposed), available at https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling.

Appendix A: How the Department of Labor Misapplied the CEM Model

A.1 Summary

Despite repeated attempts by the Investment Company Institute to explain to the Department of Labor how it misapplied a model from a paper by Christoffersen, Evans, and Musto (2013) ("CEM model"),[1] the Department persisted in misapplying that model in the 2016 RIA. Because of the Department's continued errors, this appendix lays out the arithmetic of how the Department misapplied the CEM model, shows how to correct that misapplication, and demonstrates that the Department's misapplication creates a vast overstatement of any potential benefits from the fiduciary rule. We should emphasize that these errors have nothing to do with the CEM paper, which stands on its own merits, but rather are caused by how the Department misapplied the results in the CEM paper.[2]

A.2 Introduction

In earlier comment letters, the Institute noted that the Department had estimated the potential benefits from the fiduciary rule by relying heavily on the CEM model. In particular, the Department relied on a single key coefficient, which it then misapplied to the data. This, as we have previously pointed out, led the Department to vastly overstate any potential benefits from the fiduciary rule.

The CEM model has two regression equations. The first equation is:

$$FLB_i = \alpha_0 + \alpha_1 FL_i + \alpha_2 X_i + \varepsilon_i \quad (1)$$

where FLB_i is the amount of front load (in percentage points) paid to any selling broker by fund i, FL_i is the front load the fund collects from the investor at time of purchase, X_i are other (control) variables, and ε_i is a regression residual. To aid the analysis, we can define the ratio $r_i = FLB_i/FL_i$, which is the proportion of the front load collected that a fund pays out to the broker. If a fund collected a front load FL_i from investors of, say, 5 percent and paid out that entire amount to brokers, then FLB_i = 5% and the ratio r_i = 1.00 (indicating that 100 percent of the front load collected is paid to the broker). If a fund collected a front load FL_i from investors of 5 percent and paid out 80 percent of that to brokers, then FLB_i = 4.00%, and the ratio r_i = 0.80.[3]

[1] Susan Christoffersen, Richard Evans, and David Musto,"What Do Consumers' Fund Flows Maximize? Evidence from Their Broker's Incentives," *Journal of Finance* 68 (2013): 201–235 ("CEM").

[2] As we indicated in earlier comment letters to the Department, we were able to reproduce the statistical results in the CEM paper to a close degree. As we also indicated, though, this simply underscores the errors the Department made in applying the CEM results: even if one starts with more recent data and obtains statistical estimates that are very similar to those in the original CEM paper, the Department's incorrect application of the CEM model still leads it to vastly overstate the potential benefits it calculates.

[3] One reason that the front load paid to the broker can be less than the front load collected from the investor (i.e., that $FLB_i < FL_i$) is that a fund might retain a portion of any front load collected from investors to defray the costs incurred by the fund's underwriter for distributing fund shares.

The second equation in the CEM model is:

$$(2) \qquad XR_i = \beta_0 + \beta_1 \varepsilon_i + \beta_2 Z_i + u_i$$

where XR_i is the fund's excess return (i.e., its net return relative to the net return on the fund's Morningstar category), ε_i is the estimated regression residual from equation (1), Z_i are other (control) variables, and u_i is a regression residual for equation (2). CEM call ε_i an "excess load paid to brokers," in that it measures whether the front-load paid to a broker is above or below what the model in equation (1) would predict, given the front load the fund collects from investors, FL_i, as well as other fund characteristics (as represented by X_i).

As section A.3 shows, the Department sought to estimate the total dollar benefit from the fiduciary rule by multiplying an estimate of the assets in broker-sold individual retirement accounts (IRAs) times the amount by which the Department assumes the rule can reduce fund underperformance. The Department in turn assumes, based on its faulty interpretation of the CEM model, that the change in fund underperformance can be estimated by multiplying the amount by which it assumes the fiduciary rule will lower front-loads paid to brokers times a key coefficient (β_1= –0.4494) that it estimated based on results reported in the CEM study.

This was a mistake. As can be seen in equation (2), the coefficient β_1 from the CEM study applies to "excess loads" paid to brokers (i.e., ε_i), rather than as the Department assumed to the *front load paid to brokers* (i.e., FLB_i). Thus, the coefficient β_1 can be used to study how a fund's excess return, XR_i, responds to a fund's *excess load* paid to brokers (i.e., ε_i). It is inappropriate to instead use β_1 to try to study how a fund's excess return, XR_i, responds to FLB_i.

Figure A1
Factor by which 2015 and 2016 RIAs Overstated Dollar Benefits from the Fiduciary Rule

		Corrected version 1	*Corrected version 2*
1	*Coefficient DOL used:*	β_1	β_1
2	*Coefficient DOL should have used:*	$\beta_1[1-(\alpha_1/r)]$	$.5 \times \beta_1[1-(\alpha_1/r)]$
3	*Factor by which DOL overstated benefits (formula)*[1]	$1/[1-(\alpha_1/r)]$	$1/\{.5 \times [1-(\alpha_1/r)]\}$
4	α_1	0.7563	0.7563
5	r	0.8140	0.8140
6	*Factor by which DOL overstated benefits* [2]	14.1	28.2

[1] Factor by which DOL overstated benefits (formula) is measured as the ratio of the coefficient in row (1) that the Department used relative to the coefficient in row (2) that the Department should have used.
[2] Factor by which DOL overstated benefits plugs into the formula in row (3) coefficients reported in line (4) for α_1 and in line (5) for r. The value α_1 = 0.7563 is derived directly from the CEM study (as documented in section A.3), and the value r = 0.8140 is taken directly from the 2016 RIA.
Source: Investment Company Institute calculations, CEM study, and 2016 RIA

Yet this exactly what the Department did.[4] Since it chose to base its benefit calculations on FLB_i rather than on ε_i, the Department needed to use a coefficient other than β_1. Because it tried to measure the response of fund excess returns, XR_i, to front loads paid brokers by multiplying β_1 times FLB_i—rather than multiplying β_1 times ε_i as it should have—it vastly overstated the potential benefits from the rule.

Figure A1 summarizes the coefficient that the Department used (row 1), the coefficient estimate it should instead have used if it had correctly applied the results from the CEM study (row 2), and the result of using the wrong formula (row 6).

As row 6 shows, the Department's misapplication of the results in the CEM study led it to overstate any potential dollar benefits from the fiduciary rule by a factor of 14 to 28. Section A.4 provides a step-by-step derivation of the *Factor by which DOL overstated benefits* reported in row 6 of Figure A1.

A.3 How the Department Erred: A Graphical Explanation

Before getting into the algebra of how the Department went astray, it is helpful to gain some intuition by looking at actual data from funds' N-SAR reports, the primary data source used by the CEM study.[5] Figure A2 plots actual data taken from the N-SAR reports for 2013.[6]

In the figure, the horizontal axis measures front loads collected by funds, corresponding to FL_i in equation (1) of the CEM model. The vertical axis measures for individual funds three different concepts: (a) front-load collected, which is represented by the solid black 45 degree line; (b) front loads paid to brokers, FLB_i, which are represented as blue circles; and (c) "excess loads" paid to brokers, ε_i, which are represented as red circles.

As seen, the blue dots slope upward to the right, which means that front loads paid to brokers rise as the front load collected from investors increases. This is natural: if a fund collects a 1 percent load, it will pay out to the broker no more than 1 percent. If, in contrast, a fund collects a front load of 4 percent, it can pay out up to 4 percent.

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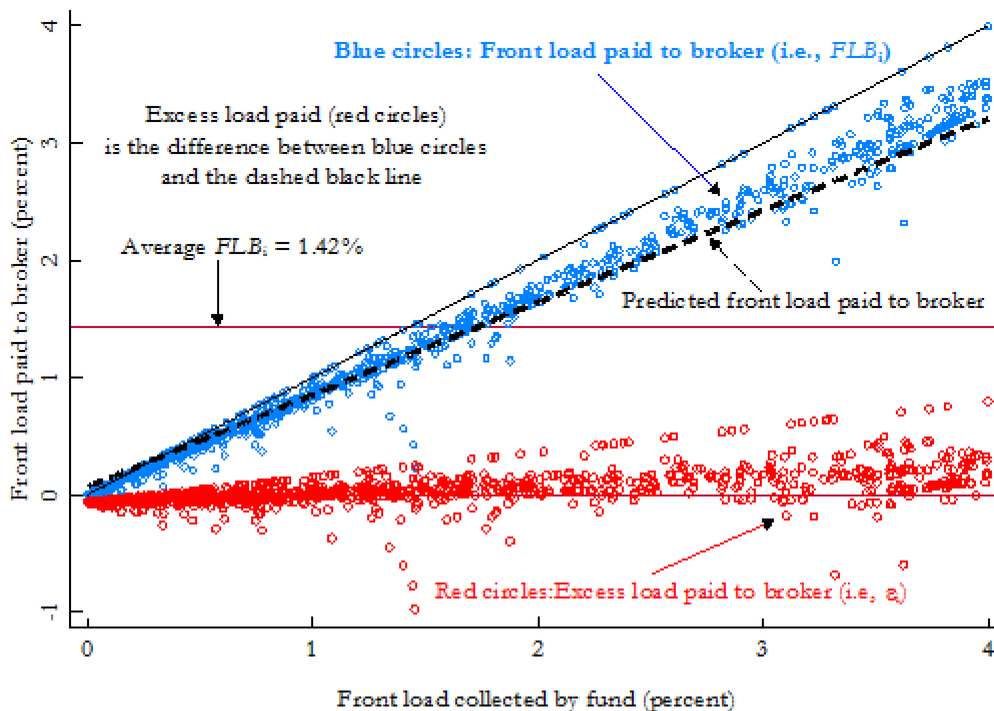
[4] *See* 2016 RIA at p. 341, Figure B-1, which multiplies -0.4494 (the coefficient estimate for β_1 times column C in Figure B-1, which is "average load share paid to brokers (basis points)." Column C reports for 2013 a value of 142 basis points, meaning that the average load share paid to brokers in 2013, as reported by the Department, was 1.42 percent. This cannot possibly be the average value for an excess load payment to brokers, because that average must by definition be zero (the excess load payment variable ε_i in the CEM model is a regression residual, which must by definition average to zero).

[5] As best we can tell, the Department itself never looked at the kind of N-SAR data the CEM study used, nor does it appear to have conducted its own analysis of the N-SAR data. Had it done so, it may well have discovered its error.

[6] The CEM data covered the years 1993-2009. In 2015, ICI updated the CEM study, using N-SAR data for years 2010-2013. At that time, data for 2013 was the most recent year of N-SAR data available from the Securities and Exchange Commission, which is the source of the N-SAR data. The data in figure A1 are for 2013 only and are suppressed above a 4 percent load collected from investors to increase the figure's readability. The suppression has no effect on our analysis or conclusions.

The uppermost (solid black) line in the figure is the 45 degree line. There are some blue dots lying directly on that line. Those represent funds that pay out to brokers all of the load the fund collects (i.e., $FLB_i = FL_i$, implying $r_i = 1.00$). Most of the blue dots lie below the solid black 45 degree line, representing funds where the front load paid to the broker is less than the front load collected from investors (i.e., $FLB_i < FL_i$, implying $r_i < 1.00$).

Figure A2
Front-loads Collected by Mutual Funds from Investors and Paid to Brokers*
Percentage; 2013



* Excludes broker-sold funds that are primarily "affiliated funds"
Source: Investment Company Institute calculations based on N-SAR data

The dashed black line in the figure shows what the CEM model would predict that a fund will pay to a broker, given the amount of the front-load the fund collects.[7] The slope of that line is 0.79, which roughly speaking means that—based on 2013 N-SAR data only—a fund will typically pay out to

[7] In other words, the dashed black line in Figure A2 represents predicted values from equation (1), once coefficient estimates have been obtained for equation (1) by a regression analysis.

brokers 79 percent of the front load the fund collects. This is very close to the result that CEM report for unaffiliated brokers (0.7563) for the period 1993–2009.[8]

The red circles, which are calculated as the difference between the blue circles and the dashed black line, represent the "excess loads" paid to brokers that are implied by the CEM model. A key takeaway from Figure A2 is that as the front load collected rises, the excess load paid does *not* tend to rise. In the figure, the average front load paid to brokers (call that average $\overline{FLB}$) is 1.42 percent, exactly what the Department assumed for 2013.[9] In contrast, the average excess load paid to brokers is zero.

What the Department did to get its vastly overstated benefit estimate was multiply its –0.4494 estimate of β_1 times the average FLB_i, which is 1.42 percent. This seems to suggest that the average broker-sold fund underperformed in 2013 by –0.64 percent. It also seems to suggest that this underperformance could be wiped out by driving *each fund's* front load paid to brokers FLB_i down by 1.42 percentage points, or at least by driving down the *average* front load paid to brokers by 1.42 percent.[10]

But according to the logic of the CEM model, it is the excess front load paid to brokers (the red circles)—*not* the fund's total front load paid to brokers (i.e., *not* the blue circles)—that controls whether a fund underperforms or outperforms. As can be seen in the figure, it is simply not possible to reduce each fund's excess load paid to brokers by 1.42 percentage points. In fact, in the figure, not a single fund has an excess front load paid to brokers of as much as 1.42 percent (all of the red circles are well below the horizontal maroon-colored line that is the average for FLB_i of 1.42 percent). Thus, by multiplying β_1 times the average FLB_i, the Department makes underperformance of broker-sold funds look much worse than what is in fact implied by the CEM model. As Section A.4 shows, correcting for this effect indicates that the Department overstated any potential dollar benefit from the fiduciary rule by a factor of at least 14 times.

Moreover, the Department arguably should have excluded about half of the broker-sold funds (and their assets) from its analysis.[11] As the figure shows, the excess load paid to broker (the red circles) is negative for many funds. These are funds that the CEM model would predict to already be *outperforming* their benchmarks because they make lower-than-expected load payments to brokers. Presumably, since these funds are already predicted to *out*perform their benchmarks, if brokers are directing clients to them, there is no obvious conflict, there should be no policy concerns, and these

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[8] *See* CEM, p. 217, Table II, column 1, summing the coefficients on "Front Load" (0.5561) and the coefficient on "Front Load x Unaffil" (0.2002), which gives 0.7563 as the appropriate estimate of α_1 for unaffiliated broker-sold funds.

[9] 2016 RIA at p. 341, Figure B-1, reporting a value of 142 basis points for 2013 in column C, which is labeled "average front load share paid to broker (basis points)."

[10] In the 2016 RIA p. 341, Figure B-1, compare columns H and I.

[11] The N-SAR data for 2013 in Figure A2 has 1,193 observations for excess load (i.e., the red circles). Of these, 682 (57 percent) are negative (i.e., less than zero).

funds should be excluded from the Department's calculations. These funds (those with red circles less than zero in the figure) have about half the assets in unaffiliated broker-sold funds. Thus, when these funds are excluded from the analysis, as they should be, the Department's estimated dollar benefit fall by half, doubling the 14-fold overstatement to a 28-fold overstatement.

A.4 How the Department Erred: An Algebraical Explanation

According to equation (2) of the CEM model, the effect of a change in a fund's excess load ($\Delta\varepsilon_i$) on the fund's excess return is:

(3) $$\Delta XR_i = \beta_1 \Delta\varepsilon_i$$

CEM find $\beta_1 \approx -0.5$ for unaffiliated brokers.[12] This implies that if a fund has a positive excess load (i.e., $\varepsilon_i > 0$), the fund's return is expected to underperform. If that fund's positive excess load could somehow be driven lower or even to zero, then according to the CEM model the fund's performance would improve. The dollar value of the change in performance from driving the fund's excess load to zero could, according to the logic of the CEM model, be measured by the change in the fund's excess return times the dollars A_i invested in broker-sold IRAs in that fund (or, more precisely, the dollars invested in broker-sold share classes of that fund):

(4) Dollar value from change in excess load paid to brokers $= A_i\ \beta_1 \Delta\varepsilon_i$

Summing this result across all broker-sold funds gives the total dollar value of the change in performance from a change in excess loads paid to brokers:

(5) Total dollar value across all funds = $\sum_i A_i\ \beta_1 \Delta\varepsilon_i$

The Department seems to believe (incorrectly) that equation (5) can be estimated as:

(5') Total dollar value across all funds as estimated by DOL = $A\ \beta_1\ \Delta\overline{FLB}$

[12] *See* CEM at p. 226, Table V, column 4, which reports a regression coefficient of -0.4972 for a regression of excess returns on excess load fees paid to unaffiliated brokers.

where A is the sum of the assets in all IRA assets in broker-sold funds (i.e. $A = \sum_i A_i$), and $\Delta\overline{FLB}$ is the change in the average front load paid to brokers that the Department believes it can achieve under the fiduciary rule. For example, in the 2016 RIA, the Department used $\overline{FLB}$ = 1.24 percent as the predicted average level of the front load that funds would pay to brokers during the year 2017.[13] Thus, if the average front-load paid to brokers is driven to zero under the fiduciary rule (i.e., $\Delta\overline{FLB}$=-1.24 percentage points), the Department would estimate that for each dollar of assets in broker-sold IRAs, investors could gain better performance of $\beta_1 \, \Delta\overline{FLB} = -0.5 \times (-1.24\%) = 0.62\%$ per year from the fiduciary rule.

The Department's incorrect use of equation (5'), instead of equation (5), results in a massive overstatement of any potential benefits from the rule. To see this, rewrite equation (1) as:

(6) $$\varepsilon_i = FLB_i - \alpha_0 - \alpha_1 FL_i - \alpha_2 X_i$$

Next, substitute ε_i in equation (6) for ε_i in equation (2) to find:

(7) $$XR_i = \beta_0 + \beta_1[FLB_i - \alpha_0 - \alpha_1 FL_i - \alpha_2 X_i] + \beta_2 Z_i + u_i$$

Recall that the ratio of front-load payments to brokers divided by the front-load collected is defined as $r_i = (FLB_i/FL_i)$. This definition implies that $FL_i = FLB_i/r_i$. Substitute $FL_i = FLB_i/r_i$ into equation (7) to arrive at:

(8) $$XR_i = \beta_0 + \beta_1[FLB_i - \alpha_0 - \alpha_1 FLB_i/r_i - \alpha_2 X_i] + \beta_2 Z_i + u_i$$

Finally, collect the terms involving the front-load payments to brokers (i.e., involving FLB_i).

This gives:

(9) $$XR_i = \beta_1[FLB_i - \alpha_1 FLB_i/r_i] + \text{other terms}$$

[13] 2016 RIA at p. 341.

which can be simplified as:[14]

$$(10) \qquad XR_i = \beta_1[1-(\alpha_1/r_i)]FLB_i + \text{other terms}$$

Equation (10) shows the effect the CEM model predicts of a change in a fund's *front load payments to brokers* (i.e., FLB_i) on a fund's excess return. It implies that a change in a fund's front load payments to brokers (i.e., FLB_i) on the fund's excess return is:

$$(11) \qquad \Delta XR_i = \beta_1[1-(\alpha_1/r_i)]\Delta FLB_i$$

Since the Department chose to work with changes in the front-loads paid to brokers—rather than working with changes in *excess* front loads paid to brokers—the coefficient it should have relied on was not β_1, but $\beta_1[1-(\alpha_1/r_i)]$.

To determine the total dollar amount by which funds' excess returns would change in response to a change in front-load payments to brokers, multiply equation (11) by each fund's assets and sum across all funds:

$$(12) \qquad \text{Total dollar value across all funds} = \sum_i A_i \, \beta_1[1-(\alpha_1/r_i)]\Delta FLB_i$$

Multiply on the right-side of equation (12) by A/A:

$$(13) \qquad \text{Total dollar value across all funds} = \sum_i (A/A) A_i \, \beta_1[1-(\alpha_1/r_i)]\Delta FLB_i$$

Equation (13) can be simplified as:

$$(14) \qquad \text{Total dollar value across all funds} = A \, \beta_1 \sum_i (A_i/A)[1-(\alpha_1/r_i)]\Delta FLB_i$$

or:

[14] In equation (10), "other terms" involve the control variables X_i, Z_i, the error term u_i and the constants β_0 and α_0. These terms can be grouped together and ignored for the remainder of our analysis because they have no influence on how a fund's excess return responds to the front load that a fund pays to a broker.

(15) Total dollar value across all funds = $A\ \beta_1 \sum_i w_i[1-(\alpha_1/r_i)]\Delta FLB_i$

where $w_i = (A_i/A)$(i.e., fund *i*'s share of total fund assets *A* in broker-sold IRAs). If we assume that the broker front load payout ratio r_i is constant across all funds, equation (15) can be written as:[15]

(16) Total dollar value across all funds = $A\ \beta_1[1-(\alpha_1/r)] \sum_i w_i\ \Delta FLB_i$

or:

(17) Total dollar value across all funds as implied by the CEM model = $A\ \beta_1[1-(\alpha_1/r)]\ \Delta\overline{FLB}$

where $\Delta\overline{FLB}$ is the asset-weighted average change in the front-loads paid to brokers. Since the Department chose to work with changes in the front-loads paid to brokers—rather than working with changes in *excess* front loads paid to brokers—it should have measured aggregate dollar benefits using equation (17) rather than equation (5').

The Department's error in using equation (5') instead of (17) results in a massive overstatement of potential benefits. This overstatement can be measured as the ratio of the total dollar value across all funds as estimated by DOL to the total dollar value across all funds as implied by the CEM model (i.e., the ratio of equation (5') to equation (17)):

(18) Factor by which DOL overstated benefits = $[A\ \beta_1\ \Delta\overline{FLB}]/\{A\ \beta_1[1-(\alpha_1/r)]\ \Delta\overline{FLB}\}$

Simplifying equation (18) gives:

Corrected version 1:

(19) Factor by which DOL overstated benefits (formula) $=1/[1-(\alpha_1/r)]$

[15] Our assumption that the payout ratio r_i is constant across funds helps to simplify the analysis. As should be clear from Figure A2, the payout ratio r_i does in fact vary across funds. In its updated economic analysis, the Department could achieved increased accuracy by *not* assuming that the broker front load payout ratio r_i is constant across all funds, instead letting it vary across funds. However, the Department will find that by letting the ratio r_i vary across funds, the factor by which it overstated benefits will be even larger than the 14- to 28-fold factors we have indicated in this appendix (in fact, this can be proven mathematically even without reference to the data).

The overstatement is massive. The Department assumes $r = 0.814$.[16] From the CEM paper, one can determine that $\alpha_1 = 0.7563$ for unaffiliated broker-sold funds.[17] Based on these values, the amount by which the Department overstated any potential benefits is:

(20) Factor by which DOL overstated benefits = 1/(1-(0.7563/0.8140)) = 14.1 fold overstatement

This justifies the calculation in row 6 of Figure A1 (*Corrected version 1*).

It is easy to conclude that the Department overstated the potential benefits by an even greater factor. The Department implicitly treats *all* broker-sold funds as underperforming. In fact, as previously discussed and as shown in Figure A2, only about half of the assets in broker-sold funds have an excess load $\varepsilon_i > 0$ (about half the red circles are greater than zero). These funds with positive excess load are the funds that according to the CEM model would be expected to underperform their benchmarks.

The other half of the assets are in broker-sold funds that have an excess load $\varepsilon_i < 0$ (the red circles in Figure A1 that lie below the horizontal line at zero). These funds with negative excess loads are expected according to the CEM model to *out*perform their benchmarks, given the loads they pay to brokers relative to what they collect in front loads. Presumably, since these funds are already *out*performing their benchmarks, if brokers are directing clients to them, there is no obvious conflict, there should be no policy concerns, and these funds should be excluded from the Department's calculations.[18] Since these funds have about half the assets in broker-sold funds (as indicated in the 2013 N-SAR data), if they are excluded from the Department's benefit calculation (as they should be), the Department's overstatement of the dollar benefits is double the 14.1 fold overstatement in equation (20):

Corrected version 2:

(21) Factor by which DOL overstated benefits (formula) $= 1/\{0.5 \times [1 - (\alpha_1/r)]\}$

[16] 2016 RIA at p. 345.

[17] *See* CEM, p. 217, Table II, column 1, summing the coefficients on "Front Load" (0.5561) and the coefficient on "Front Load x Unaffil" (0.2002), which gives 0.7563 as the appropriate estimate of α_1 for unaffiliated broker-sold funds.

[18] Presumably, the Department would not argue that it can write a fiduciary rule that adjusts front-loads paid to brokers in such a manner that all broker-sold funds on average *out*perform their benchmarks.

Substituting in the coefficient estimates, as before, implies the Department overstated the potential benefits by at least 28 times.

(22) Factor by which DOL overstated benefits = 1/[(1-(0.7563/0.8140))/2] = 28.2

This justifies the calculation in row 6 of Figure A1 (*Corrected version 2*).