

# The Flawed Cost-Benefit Analysis Underlying the Department of Labor’s Fiduciary Rule

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Certain clients of Morgan, Lewis and Bockius LLP that offer financial services to retail investors asked Morgan Lewis to sponsor a study by Craig Lewis of Patomak Global Partners, LLC. This study addresses the cost/benefit analysis underlying the Department of Labor’s Fiduciary Duty Rule, *Regulating Advice Markets: Definition of the Term “Fiduciary” Conflicts of Interest-Retirement Investment Advice, Regulatory Impact Analysis for Final Rule and Exemptions* (April 2016).

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This White Paper discusses certain aspects of the economic analysis that is contained in the Department of Labor’s (DOL) final rule, titled “Definition of the Term ‘Fiduciary’; Conflict of Interest Rule – Retirement Investment Advice” (Fiduciary Rule) and the associated regulatory impact analysis, titled “Regulating Advice Markets, Definition of the Term ‘Fiduciary’; Conflict of Interest Rule – Retirement Investment Advice, Regulatory Impact Analysis for Final Rule and Exemptions” (2016 RIA).<sup>1</sup>

The notion that retirement investors should have access to conflict free advice is a socially desirable goal and regulation that requires investment advisors to consider the best interests of their customers is sensible. The precise form that any such regulation ultimately takes should reflect the costs and benefits of the final policy choice underlying the regulation and, importantly, those of reasonable alternatives that have been considered but not adopted. Based on my reading of the 2016 RIA, the DOL has developed an economic analysis that is comprehensive in its scope, but tends to be dismissive of reasonable and potentially dominating policy choices. Most notable is the DOL’s decision to promulgate the Fiduciary Rule without fully considering the form that similar regulation might take if addressed by the U.S. Securities and Exchange Commission (SEC) – the true subject matter expert in the regulation of broker-dealers.

A second and more concerning problem is that the Fiduciary Rule is informed by an economic analysis of quantified costs and benefits that is simultaneously misleading and incorrect. I provide a revised estimate that reverses the DOL’s quantified “*net benefit*” estimate of \$16.4 billion into a “*net cost*” estimate of approximately \$16.1 billion.

The remainder of the White Paper highlights and discusses gaps in the Fiduciary Rule’s economic analysis. I begin with a brief description of how the SEC conducts economic analysis, following the internal agency best practices outlined in the SEC’s “Current Guidance on Economic Analysis in SEC Rulemakings”.<sup>2</sup> Although the DOL has no obligation to follow the SEC framework, the “Guidance” is written at a sufficiently high level that failing to follow it would leave rulemaking open to legal challenge. Notably, many of the requirements detailed in the Guidance also are contained in President Trump’s Executive Order 13771, “Reducing Regulation and Controlling Regulatory Costs,” which the DOL *is* obligated to follow.<sup>3</sup>

Using the Guidance as a framework, I describe the treatments of the regulatory baseline, the alternatives considered, and the cost-benefit analysis. I then highlight areas where the DOL Fiduciary Rule is inconsistent with the Guidance. This analysis focuses primarily on problems associated with the quantification of costs and benefits as well as important economic effects that are dismissed without fully considering the impact on retirement investors. These include potential loss of access to personal investment advice, the deadweight cost associated with class action

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<sup>1</sup> Dep’t of Labor, *Regulating Advice Markets: Definition of the Term “Fiduciary” Conflicts of Interest-Retirement Investment Advice, Regulatory Impact Analysis for Final Rule and Exemptions* (Apr. 2016), 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> (“2016 RIA”).

<sup>2</sup> U.S. Sec. & Exch. Comm’n, *Current Guidance on Economic Analysis in SEC Rulemakings* (Mar. 16, 2012), available at [https://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf).

<sup>3</sup> Exec. Order No. 13,771, 82 Fed. Reg. 9339 (Jan. 30, 2017), <https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling>.

litigation, and increased compliance costs arising from conflicting regulatory regimes (DOL, SEC, CFTC, CFPB, and FINRA).<sup>4</sup>

## Summary of Findings

- The DOL promulgated the Fiduciary Rule without fully considering feasible alternatives, or dismissed reasonable alternatives without providing adequate justification. In particular, the DOL failed to consider the form that a similar regulation might take if addressed by the SEC – the true subject matter expert in the regulation of broker-dealers.
- The 2016 RIA fails to demonstrate the extent to which brokers actually provide advice that deviates from their clients’ best interests. As a result, the existence of a significant market failure is largely based on anecdotal or relatively indirect evidence.
- The DOL’s quantitative analysis included an error related to its treatment of excess load that, when corrected, results in a calculated net *cost* of approximately \$16.1 billion instead of the DOL’s calculated net *benefit* of \$16.4 billion. Once this mistake is corrected, the quantified benefits are close to *zero*.
- So-called “conflicted funds” only underperform by about 15 basis points. This difference is economically small relative to prior estimates used in DOL analyses and is statistically insignificant. Taken together, this indicates that the possible economic harm associated with underperformance is immaterial.
- The DOL needs to amend its prior conclusions related to its efforts at quantification. To do otherwise would create the appearance of opportunistically framing the economic effects to support the intended policy choice.

## What is Economic Analysis?

Defined at a very high level, economic analysis is the consideration of the potential economic effects of policy choices. At its core, a robust economic analysis reflects a common-sense approach to being thoughtful and transparent about economic effects, including the potential impacts and trade-offs of the regulatory decisions being contemplated.

While I served as Chief Economist at the U.S. Securities and Exchange Commission, the Commission made a number of significant changes to its approach for preparing and communicating the economic effects of its rule makings. These changes are codified in the Guidance, which provides a road map to follow both to ensure that economic analysis is integrated throughout the entire rule development and writing process, as well as the concepts that the analysis should cover.

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<sup>4</sup> Additional regulatory conflict may also exist at the state level as some states have, or are considering legislation that would establish a new standard care.

The primary reason why the “Guidance” was developed is that a number of SEC rules were successfully challenged and overturned on the basis of economic analyses that were deemed by federal courts to be “arbitrary and capricious.”<sup>5</sup> The most recent example was the D.C. Circuit Court’s decision to vacate the Proxy Access Rule. In his ruling on this matter, Circuit Court Judge Douglas Ginsberg notes that “the Commission [SEC] inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”<sup>6</sup>

This is relevant to the Department of Labor’s Fiduciary Rule because the economic analysis, as presented, contains a number of the same deficiencies that were singled out by Judge Ginsberg in his Proxy Access decision. If it fails to address these concerns, the DOL leaves itself open to the same legal challenges the SEC has faced in the past.

### **Elements of an Economic Analysis**

The Guidance lays out four basic elements of a robust economic analysis: (i) identifying the need for the regulatory action; (ii) defining the baseline against which to measure the economic effects of that regulatory action; (iii) identifying alternative regulatory approaches; and, finally, (iv) an evaluation of the benefits and costs of the regulatory action and the principal regulatory alternatives, both quantitative and qualitative.

The first step in developing a rule is to identify why regulation is needed in the first place. This may seem to be an obvious first step, but it is an important one because it places different policy options into context. This can be more difficult than it sounds. Sometimes it can be clear, as with a specific market failure that cannot be solved without regulatory intervention. Here, for example, Congress made the determination in the Dodd-Frank Act that a new standard of care for financial representatives should be explored, and authorized the SEC to undertake a study and, if necessary, to engage in a rulemaking to address it.<sup>7</sup> By contrast, the DOL took the issue up on its own, without a similar Dodd-Frank congressional mandate and without sufficiently substantiating that a problem even exists.

As a next step, a robust economic analysis requires the regulator to develop a full understanding of what the world looks like in the absence of that regulation. This “baseline” analysis is the benchmark against which to measure the potential economic effects of the rule. But even more than that, the baseline analysis is an important way to make sure that the public understands the regulator’s view of the world it regulates. This type of transparency not only motivates remediation of the identified market failure, but also allows the public insight into the information that is animating regulatory action so that the public can evaluate and respond.

Once the regulatory goal and the background against which that goal exists have been explained, the regulator must then determine the best way to accomplish that goal. Here, one must identify

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<sup>5</sup> See *American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

<sup>6</sup> *Business Roundtable*, 647 F.3d at 1148-49.

<sup>7</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

*reasonable* alternative ways to reach that outcome. And, when a final rule is adopted, it must articulate the policy choice, fully engaging with those reasonable alternatives raised in the proposing release or suggested by commentators.

The last step and the most important is the evaluation of the benefits and costs of the rule. Part of understanding the trade-offs of a particular regulatory approach is to discuss the benefits and costs of that action. The first, and most important step, is to develop a general framework of benefits and costs that are relevant to the rule. This general framework should be entirely qualitative and address direct benefits and costs, as well as significant ancillary economic consequences. Once this framework has been developed, the next step is to quantify the elements that lend themselves to quantification. Only those benefits and costs that can *reasonably* be quantified should be. For those benefits and costs that cannot be quantified, one should be transparent about why that is the case, for example, because data is not available that would allow for reasonable estimation.

Moreover, the analysis needs to identify and discuss uncertainties about estimates and avoid the use of boilerplate language. If a regulator has an opportunity to analogize to another regulatory area to develop a quantified estimate, one should be clear about the differences between the two regulatory areas and the impacts those differences could have on the accuracy of the estimates. It is, however, unacceptable to simply reject the evidence because it is imperfect. Even if the analogy is something of an “apples-to-oranges” comparison, a suitable analogy offers insights and may be able to assist in the quantification of the associated costs and benefits. And crucially, it is important to clearly address contrary data or predictions. When contradictory evidence regarding the benefits and costs of a regulatory action exists, one must evaluate that evidence, and if giving greater credence to one side, explain why.

### **Treatment of the Baseline**

In a market as large and broad as the one that provides support for retirement investment, it is inevitable that a subset of brokers will put their own interests ahead of their clients. The baseline needs to document the existence of the market failure, the degree to which brokers act in their own interest to the detriment of their customers, and the economic damages such behavior causes.

The DOL relies on a number of academic studies to document the existence of conflicted behavior. Papers by Mullainathan, Noeth, and Schoar (MNS, 2012) and Chalmers and Reuter (2014) provide important anecdotal evidence. MNS find that mystery shoppers are frequently advised to invest in mutual funds that charge high loads even though similar and lower cost funds are among the alternatives. Chalmers and Reuter find that broker clients that participate in Oregon University’s defined contribution pension underperform self-directed investors in the same plan by 1.5% per annum.

Unfortunately, the academic literature, and as a consequence, the 2016 RIA, is unable to demonstrate the extent to which brokers actually provide advice that deviates from their clients’ best interests. As a result, the existence of a significant market failure is largely based on anecdotal or relatively indirect evidence. If one seeks to empirically demonstrate the pervasiveness of

conflicted advice, it would be important to study differences between investment choices made by registered investment advisers and the direct sale recommendations of brokers.<sup>8</sup>

The DOL analysis attempts to quantify the negative effects of conflicted advice based on a number of academic studies demonstrating that funds with the greatest propensity for conflicts (because they pay disproportionately large loads to brokers) are associated with underperformance of between 0.50% and 1.00% - an estimate that has been revised downward from the DOL's initial estimate of 1% (see the 2015 RIA) based on recent evidence described in various comment letters<sup>9</sup> and Reuter (2015). As described below, one would expect that such a significant downward revision would have led the DOL to consider other, more practical alternatives.

### **Treatment of Reasonable Alternatives**

Executive Order 12866 instructs agencies to “assess costs and benefits of available regulatory alternatives, including the alternative of not regulating. . . [and] select those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impact; and equity).”<sup>10</sup> In compliance with the Order, the DOL considered alternatives from “public comments, hearing testimony, meetings with stakeholders, consultations with other financial regulators, and suggestions from Congress.”<sup>11</sup>

To its credit, the DOL discusses a number of feasible alternatives. The problem is that it dismisses many of them without providing adequate justification. The most egregious example is its decision to act before the SEC based on a need to eliminate “current harms from conflicted advice.” As my analysis in the Evaluation of Costs and Benefits section indicates, this concern is no longer as relevant because the quantified foregone benefits are immaterial.

The 2016 RIA discusses a number of alternatives that were contemplated by the DOL or raised by commenters. In some instances, the DOL takes adequate steps to justify the final policy choice. In other cases, the DOL does not provide adequate justification for accepting or rejecting an alternative or the final policy choice.

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<sup>8</sup> In response to an SEC study on investment advisers and broker-dealers (cited below), Commissioners Kathleen Casey and Troy Paredes argued that one should compare the investment choices made by registered investment advisers and brokers as a way to measure the degree to which brokers acted against their clients' best interests. See Comm'r Kathleen Casey & Comm'r Troy Paredes, Sec. & Exch. Comm'n, Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers and Broker Dealers (Jan. 21, 2011), *available at* <https://www.sec.gov/news/speech/2011/spch012211klctap.htm> (referring to U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers (2011), *available at* <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>). Of course, under ERISA, the activities of a fiduciary are constrained by prohibited transaction rules, so such an analysis still would not provide a direct comparison.

<sup>9</sup> SIFMA, NERA Analysis: Comment on the Department of Labor Proposal and Regulatory Impact Analysis (July 20, 2015), *available at* <http://www.sifma.org/issues/item.aspx?id=8589955443>; Oliver Wyman, *The role of financial advisors in the US retirement market* (July 10, 2015), *available at* <http://www.fsroundtable.org/wp-content/uploads/2015/07/The-role-of-financial-advisors-in-the-US-retirement-market-Oliver-Wyman.pdf>. (“Oliver Wyman”).

<sup>10</sup> Exec. Order No. 12,866, 58 Fed. Reg. 51735 (Oct. 4, 1993), <https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf>.

<sup>11</sup> 2016 RIA at 262.

In what follows, I provide a brief discussion of a number of alternatives that were either accepted or rejected without providing adequate justification.

- *Basing Exemptive Relief on Disclosure Alone*: The DOL concluded it was not prepared to find that written disclosures alone are sufficient to mitigate advisor conflicts.<sup>12</sup> The DOL estimated that compliance with a disclosure only policy could reduce compliance costs between \$9.8 billion and \$17.5 billion over ten years.<sup>13</sup> However, the DOL found that a disclosure alone policy “yields **no** investor gains and fail[s] to justify its compliance cost.”<sup>14</sup> The DOL’s dismissal is puzzling because the SEC, which has a mission of investor protection, primarily relies on disclosure as its first line of defense.<sup>15</sup> Clearly, the DOL has overreached when drawing this conclusion.
- *Arbitration*: The proposed Best-Interest Contract Exemption (BICE) provides that individual claims may be bound by arbitration clauses while class claim must be allowed to proceed in court.<sup>16</sup> Commenters were divided on the proposed BICE. Some objected to the BICE being limited to class claims and others adamantly supported pre-dispute binding arbitration agreements, arguing that arbitration is quicker and less costly. The DOL ultimately chose to allow for arbitration but prohibit class action waivers in the proposed BICE.<sup>17</sup> In support of its decision, the DOL acknowledged that arbitration can generally be more cost-effective than the judicial process, but concluded that the ability for class actions to act as an enforcement mechanism for retirement investors outweighed the cost savings.<sup>18</sup> However, the DOL failed to consider whether an alternative enforcement mechanism to the powers of the IRS or other regulatory bodies was needed. The DOL dismisses the fact that the IRS has meaningful investigative and enforcement powers over IRA prohibited transactions, which potentially could serve as a reasonable alternative to its decision on arbitration.<sup>19</sup> What’s more, although the SEC and FINRA do not have direct enforcement authority under the Fiduciary Rule,<sup>20</sup> the DOL could have analyzed the effectiveness of their enforcement regimes as a comparator, but declined to do so. The DOL also declined to consider the inefficiency of litigation at the state court level with respect to retirement accounts, which one would expect to be empirically instructive in evaluating the BICE’s class action regime.

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<sup>12</sup> *Id.* at 271.

<sup>13</sup> *Id.* at 268.

<sup>14</sup> *Id.* at 271.

<sup>15</sup> Luez and Wysocki (2016) discuss the economic benefits of financial reporting in a recent review paper. Although their paper focuses on a number challenges related to quantification of economic benefits, it clearly articulates a view that the academic community finds financial disclosure to be beneficial, even if it is hard to measure. The inherent challenge in quantifying disclosure benefits does not lead to the conclusion that they are zero.

<sup>16</sup> 2016 RIA at 279.

<sup>17</sup> *Id.* at 280.

<sup>18</sup> *Id.* at 280-81.

<sup>19</sup> Letter from Lisa Bleier, Managing Director & Associate General Counsel, SIFMA, to Office of Regulations and Interpretations, Employee Benefit Security Administration, U.S. Dep’t of Labor, 14 (Apr. 17, 2017), *available at* <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB79/01396.pdf>.

<sup>20</sup> Though the SEC and FINRA do not have direct enforcement authority, they could potentially enforce aspects of the Fiduciary Rule through their authority with respect to firms’ policies and procedures and customer disclosures. This authority may also serve as a powerful alternative to litigation as an enforcement mechanism for the Fiduciary Rule.

- *Waiting for SEC Action:* The DOL acknowledges that some commenters have advised the Department to wait until the SEC has completed its rulemaking obligations under Dodd-Frank because inconsistent rules will lead to increased costs and complexities for participants, beneficiaries, and IRA investors with additional non-retirement accounts.<sup>21</sup> However, the DOL aligns with the consumer group opinion that ERISA and the IRC do not conflict with other financial advice laws, and the DOL chose to proceed without waiting for SEC action.<sup>22</sup> The DOL stated that it consulted with the SEC staff throughout the process of developing the final rule and that the SEC staff provided technical assistance throughout.<sup>23</sup> However, the DOL does not adequately address the costs of proceeding with the final rule before the SEC takes action, merely stating that “waiting for SEC action would impose substantial costs on plan participants and IRA investors, as current harms from conflicted advice would continue.”<sup>24</sup> As Rick Ketchum, former Chairman of the Financial Industry Regulatory Authority observed, brokers are now required to apply a different standard when they provide retirement-related investment advice than when they provide investment advice that is not retirement related.<sup>25</sup> The resultant discordance and negative impacts on holistic financial advice and planning could be avoided if all the relevant regulators apply a harmonized standard.

## Evaluation of Costs and Benefits

The DOL Fiduciary Rule relies on the 2016 RIA to argue that the quantified benefits exceed the quantified costs. It then claims that these estimates are conservative and simultaneously so large that the net *quantified* benefits almost certainly are positive.

Upon closer consideration, there are a number of significant limitations with the DOL efforts at quantification. In what follows, I make the case that the quantified benefits are economically *insignificant* by demonstrating that the DOL benefit estimates are either materially overstated or incorrect.

### *Overstated Benefit Calculations*

The 2016 RIA that supports the Fiduciary Rule considers a subset of the economic benefits that are derived from the elimination of conflicted advice and the anticipated positive impact on future performance.

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<sup>21</sup> 2016 RIA at 286.

<sup>22</sup> *Id.*

<sup>23</sup> Final Rule at 20959. *But see* Senator Ron Johnson, *The Labor Department’s Fiduciary Rule: How a Flawed Process Could Hurt Retirement Savers, A Majority Staff Report of the Committee on Homeland Security and Governmental Affairs* (Feb. 24, 2016) (asserting that the DOL ignored concerns raised by SEC staff and declined to implement a number of the SEC staff’s recommendations).

<sup>24</sup> 2016 RIA at 288.

<sup>25</sup> Richard G. Ketchum, Chairman and Chief Executive Officer of FINRA, *Remarks From 2015 Annual Conference* (May 27, 2015), *available at* <https://www.finra.org/newsroom/speeches/052715-remarks-2015-finra-annual-conference>.

The DOL discusses other economic benefits but does not attempt to quantify them. Unfortunately, this discussion is inconsistent with the Guidance because the DOL does not explain why quantification is infeasible.

The DOL's calculation of economic benefits is based on findings in the academic literature that mutual fund performance is negatively correlated with broker participation. For example, Bergstresser, Chalmers, and Tufano (2009) show that broker-sold domestic equity funds underperform direct-sold funds by 0.27% to 0.88% on an asset-weighted basis and 0.93% to 2.50% on an equal-weighted basis. Del Guercio, Reuter, and Tkac (2010) find that broker-sold actively-managed funds underperform direct-sold funds by approximately 1%. In a related study, Christoffersen, Evans, and Musto (CEM, 2013) estimate that funds that pay "excess loads" to unaffiliated brokers underperform comparable funds by about 50 basis points for every 100 basis points of excess load paid to unaffiliated brokers.

### *Fund Underperformance*

The DOL argues that conflicted brokers place retirement investors in underperforming funds because they tend to pay higher commissions. To the extent that a fiduciary standard can ameliorate broker self-dealing, the DOL expects underperformance to be eliminated. This argument is based on the premise that a fiduciary standard will increase competition among mutual funds for investor assets. If weak funds are unable to attract assets due to poor relative performance, they will eventually be forced out of the market.

The DOL's 2015 RIA assumes that the elimination of conflicted advice will reduce underperformance by approximately 1% per annum. Commenters argued that this estimate was too high based on a number of factors that the DOL failed to consider. Based on commenter input, most notably an updated analysis by Reuter (2015), the DOL reduced its estimate of underperformance in the 2016 RIA to between 0.50% and 1.00%. This reduction was primarily based on the observation that the market for mutual funds has become more competitive and that the level of underperformance has been significantly reduced. Commenters also noted that not all asset classes underperform and that smaller funds are more likely to underperform.<sup>26</sup>

Reuter (2015) reexamines performance differences between broker-sold and direct sold funds over 2003-2014. In this literature, the standard performance measure is "net return" (the fund's after-fee monthly return) plus any 12b-1 fees that broker-sold funds pay for distribution. As Reuter notes "This is reasonable except to the extent that conflicts of interest lead brokers to recommend funds that charge higher 12b-1 fees that broker-sold funds use to pay for distribution." He finds that the degree of underperformance across all actively managed fund classes is 0.18% for value weighted returns and 0.22% for equal-weighted returns.<sup>27</sup> Reuter (2015) also finds that the difference in

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<sup>26</sup> See Letter from David Bellaire, EVP & General Counsel, Financial Services Institute to Edward Hugler, Acting Secretary, U.S. Dep't of Labor, 9-15 (Apr. 17, 2017) ("FSI"), available at <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB79/01398.pdf>; SIFMA at 30-33.

<sup>27</sup> If one only considers "net returns", actively managed fund classes experience underperformance of 0.40% and 0.45% for value-weighted and equal-weighted return, respectively.

performance between broker-sold and direct-sold funds is statistically insignificant based on weighted least squares estimations of net returns plus 12b-1 fees.<sup>28</sup>

The ICI (2017) also looks at underperformance over 2008-2016 by comparing front-end load funds to retail no-load funds.<sup>29</sup> This approach implicitly assumes that all funds that pay a load to brokers have some potential to attract conflicted brokers and that no-load funds are conflict free. Using net return plus 12b-1 fees to measure performance, it finds that front-end load funds only underperformed no-load retail funds by 0.10% to 0.11%.

From a cost-benefit perspective, value-weighted returns are the most appropriate way to measure underperformance because they measure the *aggregate* economic effect. By contrast, equal-weighted returns are useful to the extent that they are able to identify the existence of a potential problem. For example, a finding that equal-weighted returns are associated with greater underperformance indicates that the problem is more severe for small funds.

If one splits the difference between the updated results in the Reuter (2015) and ICI (2017), so-called “conflicted funds” only underperform by about 15 basis points. This difference is economically small relative to prior estimates used in DOL analyses. As noted above, Reuter (2015) also finds that the difference is statistically insignificant. Taken together, this indicates that the possible economic harm associated with underperformance is immaterial.<sup>30</sup>

One of the key points a revised economic analysis must make is to offer a view regarding the underlying cause for the reduction in underperformance. Commenters have offered a number of possibilities – for example, (i) load fees have declined sharply in the recent past and estimates of underperformance based on older time periods will overstate the expected benefits, and (ii) there has been an increase in competition from lower cost substitutes such as exchange traded products and more no-load funds.

The DOL’s new examination needs to discuss whether and to what degree factors such as these have influenced its analysis. To the extent that it disagrees with these observations, the DOL must clearly state its reasoning.

#### *Miscalculation of Costs Associated with Excess Load Payments*

The primary flaw in the DOL’s attempt to quantify benefits relates to its interpretation of “excess” load. It implicitly makes two critical (and inappropriate) assumptions: (i) excess load is equivalent

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<sup>28</sup> Table 6 of Reuter (2015) tests whether there is a performance difference between direct-sold and broker-sold funds. The results are statistically insignificant based on a weighted least squares regression of net return plus 12b-1 fees. Since weighted least squares regression controls for fund size when calculating standard errors, it implicitly provides a test of whether the aggregate economic effect is statistically different between broker-sold and direct sold funds. See written testimony submitted by Jonathan Reuter to Department of Labor’s Conflict of Interest Public Hearing (Aug. 11), *available at* <http://www.dol.gov/ebsa/pdf/1210-AB32-2-WrittenTestimony10.pdf>.

<sup>29</sup> Letter from Brian Reid, Chief Economist, ICI, & David Blass, General Counsel, ICI, to Office of Regulations and Interpretations, U.S. Dep’t of Labor (March 17, 2017), *available at* [https://www.ici.org/pdf/17\\_ici\\_dol\\_fiduciary\\_applicability\\_ltr.pdf](https://www.ici.org/pdf/17_ici_dol_fiduciary_applicability_ltr.pdf).

<sup>30</sup> In any case, the 2016 RIA fails to take into account the value of advice apart from underperformance. A robust economic analysis needs to describe the additional beneficial services brokers provide to clients.

to average front-end load, and (ii) excess load is positive. This is problematic because excess load is a measure of how much a particular fund's front-end load deviates from other funds. By definition, the average excess load is equal to zero. This implies that for every fund with a positive excess load there is another fund with a negative excess load. It then follows that firms that charge higher than expected loads underperform and funds that pay smaller than expected loads outperform.<sup>31</sup> Since these amounts offset one another, the aggregate economic benefit associated with excess loads should be close to zero.<sup>32</sup>

To be more precise, CEM (2013) estimate the relation between “excess” loads and future performance using a two-stage regression model. In the first stage, they estimate a regression of the load paid to brokers as a function of fund and family characteristics and other control variables. The model fits the data well – it has an adjusted R-square of 87.17%. In the second-stage, CEM estimate a regression of the 12-month forward-looking net excess returns (fund return net of a style benchmark) as a function of broker payments, the excess load, and other fund and family characteristics where “excess load” is defined as the *residual* from the first-stage regression.

The problem with the DOL analysis lies in the interpretation of the excess load. Once this mistake is corrected, the quantified benefits are close to *zero*. This is not a problem with the CEM paper, although part of the problem may relate to the following statement in CEM:

“The fitted model shows a significant negative relation between the excess load paid to unaffiliated brokers and future performance: the average 2.3% payment to unaffiliated brokers corresponds to a 1.13% reduction in annual performance, so in that sense, the effect of load sharing is potentially a concern for consumers in this channel.”

The problem here is that, even though CEM discuss their statistical analysis of underperformance (CEM, Table 5) in terms of the *total* load paid to unaffiliated brokers, their analysis is based on *excess load*. The importance of this is that a 2.3% estimate of excess load is an unrealistically large value. To put this estimate into context, an excess load of more than 2.3% would be expected to be observed less than once every 9,090 times.<sup>33</sup> The bottom line is that the DOL analysis compares apples to oranges.<sup>34</sup>

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<sup>31</sup> *Excess load* is the residual from a first stage regression (CEM, Table 2). This implies that excess load has a mean of zero.

<sup>32</sup> Even though the mean excess load equals zero, one cannot conclude that the aggregate economic benefit is *exactly* equal to zero unless one has access to the underlying data and could make the required calculation. It is, therefore, possible that the aggregate economic benefit could be positive or negative. For example, CEM-related benefits could be expected to be *small* and *positive* if excess load is correlated with those fund-style classes displaying the greatest levels of underperformance. This is unlikely for three reasons: (i) CEM include both year and Morningstar investment objective fixed effects in their underperformance regression; (ii) the excess load has mean of zero; and (iii) the average 2.3% payment to unaffiliated brokers corresponds to a value of excess load that would be observed less than 0.0101% of the time.

<sup>33</sup> Appendix A shows that the excess load distribution has mean zero and a standard deviation of 0.62%, an excess load of at least 2.3% has a probability of being realized of 0.011% under the assumption that excess load is normally distributed. A probability of 0.011% is equivalent to an event that occurs once in 9,090 trials (1/0.00011).

<sup>34</sup> It is interesting to note that Christoffersen and Evans respond to a similar observation made by the Investment Company Institute. They submitted a comment letter on September 10, 2015 describing certain concerns with the ICI critique. Their response reflects a defense of their paper's econometric design rather than an attempt to interpret the economic arguments in the 2015 RIA. For example, Christoffersen and Evans are surprisingly silent on the primary

### *Quantified Costs Exceed Quantified Benefits*

My conclusion that the quantified economic benefits described in the 2016 RIA are economically insignificant is based on two separate considerations. The first is that updated analyses of underperformance provided by ICI (2015) and Reuter (2015) demonstrate that recent levels of underperformance are economically small (approximately 15 basis points) and statistically insignificant. The second is to note that a correct interpretation of the CEM (2013) results in an estimate of the economic benefits associated with excess loads that is close to zero.<sup>35</sup>

Since these estimates reflect the DOL's only attempt at benefit quantification, it needs to amend its prior conclusion that the net quantified *benefits* equal \$16.4 billion (\$32.5-\$16.1) to reflect the observation that an updated estimate indicates that the net quantified *costs* are approximately \$16.1 billion (\$0.0-\$16.1). In other words, if quantified economic benefits are close to zero, one is left with the DOL's estimate of quantified compliance costs of \$16.1 billion.

The DOL needs to amend its prior conclusions related to its efforts at quantification. To do otherwise would create the appearance of opportunistically framing the economic effects to support the intended policy choice.

### **Are Brokers Compensated Fairly?**

Another issue that needs to be more fully addressed is the fair price for brokerage services. The 2016 RIA and the Fiduciary Rule do not expend much effort considering whether the loads paid to brokers are fair given the services they provide. In fairness, this is not an issue that can be addressed with the available data. The only realistic way to estimate the fairness of brokerage fees would be to analyze the commissions paid on an individual account basis. For example, it is plausible that brokers place retirement investors into a mix of no-load and load funds. If true, the effective fee can only be estimated across all assets in the entire account.

Another consideration is that, for many investors, registered investment adviser investments are unlikely to represent their entire portfolio. One cannot then infer the overall mix of active and passive investments even if one could observe individual investors registered investment adviser investments.

If all retirement investors strictly prefer passive investments, it would be more efficient to invest exclusively in no-load funds and avoid brokers all together.<sup>36</sup> By contrast, investors that prefer to

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issue of whether the DOL has correctly interpreted the CEM findings. *See* Letter from Susan Christoffersen & Richard Evans to Office of Regulations and Interpretations, Employee Benefit Security Administration, U.S. Department of Labor (Sept. 10, 2015) (responding to Letter from Brian Reid, Chief Economist, Investment Company Institute & Sean Collins, Senior Director, Investment Company Institute to Joseph Piacentini, Director, Office of Policy and Research & Chief Economist, Employee Benefit Security Administration, U.S. Department of Labor (Dec. 1, 2015), available at [https://www.ici.org/pdf/15\\_ici\\_dol\\_ria\\_comment\\_supp.pdf](https://www.ici.org/pdf/15_ici_dol_ria_comment_supp.pdf).

<sup>35</sup> A correct interpretation of CEM (2013) reduces the DOL's benefit calculation in Appendix B of the 2016 RIA from \$32.5 billion to zero.

<sup>36</sup> Bullard, Friesen, and Sapp (2008) find that actively managed funds underperform no-load funds. Based on this evidence, it is tempting to conclude that unsophisticated retirement investors should hold passive, well-diversified

allocate some fraction of their portfolio to actively-managed products may want to seek out a broker (or a registered investment adviser) for advice. Since advice is not free, investors would expect to pay the fair value for any services rendered. Rather than interpreting load fees as evidence of brokers putting their interests ahead of clients, it could simply reflect the fact that investors are willing to pay for advice related to the actively-managed portion of their portfolios.

Moreover, despite the existence of ample evidence that advice leads to increased savings among retirement investors,<sup>37</sup> the DOL declined to consider or attribute a value to the benefits that inure to investors that receive professional advice. NERA's July 2015 comment letter, for example, surveys a number of studies substantiating the value of professional investment advice that were not considered by the DOL.<sup>38</sup> And a study prepared by Advanced Analytical Consulting Group - *commissioned by the DOL* - concludes that DOL economic analysis "understates the importance of these benefits."<sup>39</sup> The study notes that: "brokers' advice may benefit investors by nudging them to think about their needs in retirement; helping select a portfolio; bringing awareness of investment strategies; raising issues related to taxes, college savings, and estate planning; et cetera."<sup>40</sup> The DOL's failure to consider the value of professional advice represents yet another significant shortcoming in its cost-benefit analysis.

The broader question of whether retirement investors should seek active management is different from whether brokers provide conflicted advice. Individuals should be allowed to make the investment choices they prefer.<sup>41</sup> A broker's fiduciary obligation should be limited to acting in a client's best interest conditional on a specific investment objective. A best interest standard should not obligate brokers to recommend specific asset classes or products.

### **Separate DOL and SEC Fiduciary Standards and the Role of Class Action Litigation**

Although there are a number of alternatives that have merit, the most compelling may be *Waiting for SEC Action*. Once the SEC sets a standard, the DOL could then decide whether a harmonized standard is sufficient for its purposes. This is an important consideration because the DOL has no enforcement power with respect to IRAs.

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portfolios rather than relying on brokers for investment advice. Regardless of the accuracy of this statement, it does not inform the discussion of potential conflicts of interest since load fees reflect compensation.

<sup>37</sup> See, e.g., Morningstar, *The Impact of Expert Guidance on Participant Savings and Investment Behaviors* (Aug. 20, 2014) (examining impact of professional advice on retirement savings deferral rates), available at <http://corporate.morningstar.com/us/documents/barrons/Expert-Guidance.pdf>.

<sup>38</sup> NERA, Comment on the Department of Labor Proposal and Regulatory Impact Analysis (July 17, 2015), available at <https://www.sifma.org/wp-content/uploads/2017/05/nera-analysis-comment-on-the-department-of-labor-proposal-and-regulatory-impact-analysis.pdf>.

<sup>39</sup> Advanced Analytical Consulting Group, Comments on a Review of a White House Report on Conflicted Investment Advice (Aug. 21, 2015), available at <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/proposed-regulations/1210-AB32-2/comments-on-a-review-of-a-white-house-report-on-conflicted-investment-advice.pdf>.

<sup>40</sup> *Id.* at 4.

<sup>41</sup> Note that active management investment strategies may be more expensive over the long term, particularly for "buy-and-hold" retirement savers. Not all investors can afford active management, nor do all investors want such services.

The *Waiting for SEC Action* approach is more efficient because if harmonization is deemed adequate, it avoids competing sets of regulations and the additional costs required to ensure compliance with each one.

The FSI comment letter notes that:<sup>42</sup>

“While the Fiduciary Rule allows for arbitration of individual disputes, it also clearly is intended to expose firms to class action litigation, which can be costly to defend even when there has been no wrongdoing. According to the 2017 Oxford Economics Study, the greatest concern of broker-dealers concerning the Fiduciary Rule is the potential costs of litigation. The 2017 Oxford Economics Study demonstrates that FSI members are altering their business models because of the fear of class action litigation that is invited by the Fiduciary Rule. These concerns are not unfounded. In discussing the Fiduciary Rule, SEC Commissioner Michael Piwowar stated, ‘To me, that rule, it [is] about one thing...enabling trial lawyers to increase profits.’ Commissioner Piwowar’s conclusion was bolstered when the American Association for Justice (formerly the American Trial Lawyers Association), the primary plaintiff’s lawyer industry group, issued a press release shortly after issuance of the Final Rule stating that it ‘welcomes’ the Rule.” (internal citations omitted).

Although it is difficult to predict the number of class action lawsuits that will be filed as a direct result of the rule, the lack of clear bright lines regarding prohibited behavior and a general lack of legal precedents will likely result in frequent litigation. It is costly for a financial institution to defend itself, even against meritless suits, and it is common to settle them out-of-court. One recent study by Morningstar estimates that class action settlements could cost the industry as much as \$150 million annually.<sup>43</sup>

The decision to accommodate class action lawsuits, even if investors agree to arbitration, will increase deadweight costs to financial institutions that ultimately will be passed through to investors in the form of higher fees. Since these are likely to be insurable events, all financial institutions will be obligated to purchase insurance to protect against these potential liabilities regardless of whether a firm is at risk.

### **Loss of Personal Advice to Smaller Retirement Investors**

The 2016 RIA recognizes that small retirement accounts may find it harder to obtain investment advice. It downplays the results of a similar change in the U.K. called the Retail Distribution Review (RDR).<sup>44</sup> The RDR was promulgated in early 2013 because the Financial Conduct Authority was concerned that investors were receiving conflicted advice, despite having a best interest standard that is similar to a US-style fiduciary obligation. Among other elements of the rulemaking, the RDR banned commissions. The Financial Conduct Authority found that while the rule eliminates commission-driven conflicts of interest, the number of investment advisors

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<sup>42</sup> FSI, *supra* n.26, at 25.

<sup>43</sup> Morningstar, Costs of Fiduciary Rule Underestimated (Feb. 9, 2017), *available at* <http://news.morningstar.com/articlenet/article.aspx?id=793268>.

<sup>44</sup> See 2016 RIA at 78-92 (addressing U.K. Financial Services Authority (FSA), “Retail Distribution Review: Independent and Restricted Advice” (June 2012)).

declined from a little over 40,000 in 2011 to about 31,000 over the 2011-2014 period. This only serves to widen the “advice gap,” which is the loss of access to investment advice for those investors who rely on affordable services.<sup>45</sup>

The DOL notes that there are significant differences between the RDR and the Fiduciary rule that make a direct comparison problematic. Despite these differences, the analogy should not be dismissed out of hand. Even though the comparison is not perfect, its potential effects need to be fully considered.

Rather than fully engaging on the issue, the DOL response to the RDR seems to be that it is fine if some brokers exit, particularly if the ones leaving are those providing conflicted advice. If this were the case, this would be a desirable outcome. The more likely result is that firms will find it too expensive to provide personal advice.

Firms may instead offer “robo-advice” as a lower-cost substitute. The DOL characterizes the expansion of robo-advisory services as a natural outgrowth of technological innovation. But while the use of a low-cost technology to provide conflict-free investment advice may seem to provide adequate asset management services, the unfortunate consequence is that many retirement investors, including those that are the least comfortable with making investment choices and those that desire annuity providers, may not be satisfied with impersonal robo-advisory services and will prefer hands-on advice, even if the broker’s services are costly. In addition, in April 2016, the Secretary of the Commonwealth of Massachusetts released a policy statement announcing that “fully automated robo-advisers, as currently structured, may be inherently unable to carry out the fiduciary obligations of a state-registered investment adviser.”<sup>46</sup>

If the final rule causes these investors to migrate to fee-based accounts, investors will pay advisory fees which are typically more expensive than brokerage commissions, particularly for buy-and-hold investors.

Even worse, the Rule could cause some investors to go without financial advice. Although one needs to be careful not to assert causation, investors tend to invest less when they do not receive advice. For example, a recent Oliver Wyman study finds that investors that seek advice had a minimum of 25% more assets than non-advised investors, and this difference was even greater for investors with modest income levels.<sup>47</sup>

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<sup>45</sup> See Andrew Clare, Steve Thomas, Omal Walgama & Christina Makris, *Challenge and Opportunity: The impact of the RDR on the UK’s market for financial advice*, Cass Bus. Sch. (June 2013), available at [https://www.cass.city.ac.uk/\\_data/assets/pdf\\_file/0016/202336/The-impact-of-RDR-Cass-version.pdf](https://www.cass.city.ac.uk/_data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf).

<sup>46</sup> Massachusetts Securities Division, Policy Statement on Robo-Advisers and State Investment Registration (Apr. 2016), available at <https://www.sec.state.ma.us/sct/sctpdf/policy-statement--robo-advisers-and-state-investment-adviser-registration.pdf>.

<sup>47</sup> Oliver Wyman, *supra* n.9, at 6 (concluding that individuals receiving investment advice aged 35-54 that make less than \$100,000 per annum have 37.8% more assets than those not receiving advice, while individuals in the same age group that make between \$100,000 and \$250,000 per annum have 25.2% more assets than those not receiving advice).

## **Conclusion**

As described above, the cost benefit analysis performed by the DOL prior to adopting the final Fiduciary Rule has a number of significant shortcomings. In particular, the DOL's quantitative analysis included an error related to its treatment of excess load that, when corrected, results in a calculated net *cost* of approximately \$16.1 billion instead of the DOL's calculated net *benefit* of \$16.4 billion. Not only did the DOL incorrectly estimate quantified benefits, but it also failed to adequately consider all reasonable alternatives for the rule or to provide sufficient justification when it rejected certain reasonable alternatives.

Given these significant shortcomings, the DOL promptly should take steps to delay the implementation of the Fiduciary Rule and conduct a new and more robust cost benefit analysis that conforms to commonly accepted practices. Policymakers engaged in rulemaking concerning a fiduciary standard may want to use this white paper as input for their considerations.

## Appendix A. The Distribution of Excess Load in CEM (2013)

This appendix attempts to quantify the distribution for excess loads from CEM (2013) using summary statistics contained in their Table 1. Since excess load has, by definition, mean zero, the distribution for excess load can be characterized by its variance. In what follows, I illustrate how one can develop an approximate estimate of the variance of the excess load paid to brokers. It is an approximation because I necessarily must make an assumption about the correlation between the load paid to captive brokers and the load paid to unaffiliated brokers.

The first step is to estimate the variance of the *total* load paid to brokers ( $\sigma_{LOAD}^2$ ). Next, one can estimate the variance of the excess load ( $\sigma_{XS}^2$ ) as follows:

$$\sigma_{XS}^2 = (1 - R^2)\sigma_{LOAD}^2,$$

where  $\sigma_{XS}^2$  is the residual variance from the CEM (2013) “load paid to brokers” regression (Model 1, Table 2).

To calculate the variance of total load paid to brokers, I reproduce the relevant items from Table 1 in CEM below.

Reproduced from CEM Table 1				
Variables	Mean	Standard Deviation ( $\sigma$ )	Observations	Fraction of Sample ( $\alpha$ )
Load paid to captive brokers	1.73%	1.60%	25,807	17.25%
Load paid to unaffiliated brokers	2.30%	1.80%	123,824	82.75%

The variance of the load paid to all brokers is calculated as

$$\sigma_{LOAD}^2 = \alpha_{Cap}^2 \sigma_{Cap}^2 + \alpha_{Unaf}^2 \sigma_{Unaf}^2 + 2\alpha_{Cap}\alpha_{Unaf}\rho_{Cap,Unaf}\sigma_{Cap}\sigma_{Unaf}$$

where  $\rho_{Cap,Unaf}$  is the correlation between the loads paid to captive and unaffiliated brokers. Since  $\rho_{Cap,Unaf}$  is not reported, I conjecture that  $\rho_{Cap,Unaf}$  is 0.90. In this sense, one must view my estimate as an approximation. Since the variance increases in  $\rho_{Cap,Unaf}$  and the regression on CEM has an adjusted R-square of 0.8717, my estimate of  $\sigma_{XS}^2$  is a fairly conservative estimate.

The variance of the excess load ( $\sigma_{XS}^2$ ) is calculated as follows:

1. Assuming that  $\rho_{Cap,Unaf}$  is 0.90, the variance of the load paid to brokers is 0.0303%, i.e.,

$$\begin{aligned} \sigma_{LOAD}^2 &= \alpha_{Cap}^2 \sigma_{Cap}^2 + \alpha_{Unaf}^2 \sigma_{Unaf}^2 + 2\alpha_{Cap}\alpha_{Unaf}\rho_{Cap,Unaf}\sigma_{Cap}\sigma_{Unaf} \\ &= 0.1725^2 \times 0.0160^2 + 0.8275^2 \times 0.0180^2 + 2 \times 0.1725 \times 0.8275 \times 0.90 \times 0.0160 \times 0.0180 \\ &= 0.0303\% \end{aligned}$$

2. The variance of the excess load is calculated as follows:

$$\begin{aligned}\sigma_{XS}^2 &= (1 - R^2)\sigma_{LOAD}^2 \\ &= (1 - 0.8717) \times 0.0303 \\ &= 0.0039\end{aligned}$$

3. The standard deviation of the excess load is 0.62, i.e.,  $\sigma_{XS} = \sqrt{0.0039}$ .

Based on the estimated distribution of excess loads, brokers that are paid excess loads that are one, two-, and three-standard deviations from the mean are respectively paid excess loads of 0.62%, 1.25%, and 1.87%. Funds that make these payments would then be expected to respectively underperform by 0.31%, 0.62%, and 0.93% over the next twelve months. Of course, funds that pay unexpectedly low excess fees would be expected to over-perform by the same amounts.