JB Heaton PC

June 21, 2018

VIA EMAIL

The Honorable Jay Clayton, Chairman
c/o Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: File No. S7-07-18

Dear Chairman Clayton:

I write to update my earlier letter. Again, I write on my own behalf as a financial economist and lawyer (admitted in Illinois and New York) deeply concerned with the protection of retail investors from harmful financial transactions.

In my earlier letter, I drew the Commission's attention to new research demonstrating the psychological tendency of potential investors to link potential investment results with "hard work" and may be exploited by broker-dealers to steer retail investors away from low-cost index products towards expensive, actively-managed funds and their own "stock picks."

The co-authored research, reported in a paper titled "How Active Management Survives" has now been updated. It remains available at SSRN.com at:
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3193640.

We have now added survey results with an even more straightforward test of our hypothesis. The survey was conducted with a sample of 1,004 individuals, roughly 57% male (n = 572) and 43% female (n = 431). All participants were above the age of 30 (roughly 34% between the ages of 45 and 60 and 41% over age 60), with household incomes in excess of $100,000 (20% of the sample earned over $200,000/year). This is the question presented to the new sample:

ABC Fund invests in common stocks listed on United States stock exchanges. Which is more likely?

(1) ABC Fund will earn a good return this year for its investors.
(2) ABC Fund will earn a good return this year for its investors and ABC Fund employs investment analysts who work hard to identify the best stocks for ABC Fund to invest in.

This question evoked an even stronger manifestation of the conjunction fallacy than our prior survey question described in my earlier letter, with 62.8% selecting choice (2).

While many companies make money selling products that are bad for people, the question is, as with smoking and drinking Pepsi, is why people do it when they should know it is bad for them. Our surveys suggest that potential investors incorrectly believe that "active" means "better." Financial industry marketing hints that active management firms know this. Active manager advertising stresses the research and work put into investment products.

Our results provide another reason for regulators to require better disclosures in the financial industry. If the industry cannot be relied on or mandated to act in their customers' interests (admittedly, something we do not require of other companies that sell products that are bad for their customers, like tobacco companies, gambling companies, and soft drink manufacturers), regulators at least could require evidence-based warnings on financial advertisements about the superiority of most passive strategies.

Sincerely,

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