

August 7, 2018

Attn: Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: Regulation Best Interest, Investment Adviser Interpretation, and Form CRS Relationship Summary

Dear Mr. Fields:

We appreciate the opportunity to comment on the economic analysis underlying the Securities and Exchange Commission's (SEC) (i) proposed new standard of conduct for broker-dealers making recommendations to retail customers ("Regulation Best Interest"); (ii) clarified standard of conduct for investment advisors ("Investment Adviser Interpretation"); and proposed relationship summary provided to retail investors by broker-dealers and registered investment advisors ("Form CRS—Relationship Summary").¹ Except where necessary for clarity, we will treat the proposed regulations, and the economic analysis that motivates them, as complementary efforts and not attempt to distinguish between them.

The Economic Policy Institute (EPI) is a nonprofit, nonpartisan think tank created in 1986 to include the needs of low- and middle-income workers in economic policy discussions. Separately, the EPI Policy Center signed a letter with other organizations addressing weaknesses of Regulation Best Interest. In the current letter, we focus on the SEC's economic analysis of the proposed regulations.

Specifically, in this comment letter we address the following questions posed by the SEC:

- *Is the concept of "gains from trade" appropriate for capturing the economic impact of the proposed regulation on the broker-dealers and their retail customers? Are there alternative economic concepts that we should consider? Is the example that illustrates how the concept of "gains for trade" works useful for understanding the economic impacts of the proposed regulation?*
- *We request comment on our characterization of the benefits of proposed Regulation Best Interest. We believe that the proposed rule achieves its main benefits by ameliorating the agency conflict between broker-dealers and retail customers. Do commenters agree with our characterization of the benefits? Are there other benefits of the proposed rule that have not been identified in our discussion and that warrant consideration? Are the assumptions that form*

¹ Regulation Best Interest, 83 Fed. Reg. 21574, May 9, 2018; Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers—Request for Comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg. 21214, May 9, 2018; Form CRS Relationship Summary: Amendments to Form ADV—Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, 83 Fed. Reg. 21416, May 9, 2018.

the basis of our analysis of the benefits appropriate?

- *We request comment on our characterization of the costs of the proposed Regulation Best Interest. We believe that the best interest obligation through its component obligations would impose direct costs on broker-dealers. Furthermore, we believe that depending on how broker-dealers chose to comply with the best interest obligation, the proposed rule may impose costs on retail customers. Do commenters agree with our characterization of the costs? Are the assumptions that form the basis of our analysis of the costs appropriate?*
- *Do commenters believe that the alternatives the Commission considered are appropriate? Are there other reasonable alternatives that the Commission should consider?*

Overview

Conflicts of interest between buyers and sellers are commonplace. Many salesmen, including brokers and car dealers, are paid on commission. However, it has long been recognized that markets for professional advice are different from markets for automobiles because information asymmetries are inherent in these transactions.

For this reason, markets for professional advice are highly regulated and often impose an affirmative duty on professionals to act in their clients' interest, while specifically prohibiting transactions that involve conflicts of interest. For example, doctors operating under a duty of care to patients cannot be compensated by pharmaceutical companies for prescribing specific medications. These regulations are imperfect, however. In most states, doctors may be wined and dined by pharmaceutical companies and offered other inducements, as long as these are not contingent on prescribing medications.

It is currently legal for some financial professionals, notably broker-dealers, to present themselves as disinterested advisors while recommending products or services that are clearly worse for investors but more lucrative for sellers than available alternatives. When broker-dealers present themselves as "advisors" in order to sell investment products and services for which they receive commissions, it is as if pharmaceutical representatives were not just influencing doctors and patients through gifts and advertisements, but selling drugs directly to patients while presenting themselves as healthcare professionals.

Regulators can address conflicts of interest directly or indirectly. They can ban sales commissions and other forms of variable compensation that can bias the advice offered by financial professionals, or they can require disclosure of such conflicts on the assumption that better-informed clients will look out for their own interests. They can also impose a standard of duty to clients, which can range from a relatively weak obligation to recommend "suitable" products and services (the current standard for broker-dealers and insurance agents) to a more stringent fiduciary duty to put clients' interests first (the current standard for certified financial planners and registered investment advisors).

The SEC has proposed a set of rules that rely heavily on disclosure. It is often assumed that disclosing conflicts of interest is a weaker remedy, but less likely to introduce economic distortions, than banning

problematic transactions in the first place. This may not always be the case, however. Disclosure requirements can be onerous, and disclosure may not only be ineffective, but counterproductive. For example, detailed disclosures can serve to bury important information, or disclosure of conflicts can be interpreted by consumers as evidence of honesty. Disclosure can make sellers more comfortable recommending products and services that are not in buyers' best interests, and it can make clients less comfortable rejecting these recommendations at the risk of giving offense.

Conversely, prohibiting conflicted transactions does not entail a *societal* cost, even if there are costs to some professionals and firms, if these transactions involve rent-seeking as opposed to wealth-generating behavior.

Stricter rules, along the lines of the Department of Labor's (DOL's) fiduciary rule, require professionals to put clients' interests first, directly curtail conflicted transactions, and limit the "advice" or misinformation provided to clients. The DOL rule was a logical extension of fiduciary obligations imposed on registered investment advisors and certified financial planners, but was vehemently opposed by financial industry groups. In contrast, the regulations proposed by the SEC have been met with a shrug from the industry lobby.²

In its economic analyses motivating the proposed regulations, the SEC has taken its cue from industry, ignoring evidence from experts, including its own advisors. As will be detailed below, it has accepted as given the answers to key questions it should be asking, including whether the "advice" offered by broker-dealers to clients is of value and whether more consumer choice is always better. It has focused primarily on improving transparency to enhance trust, and has framed its proposed regulations as a potential win-win for industry and consumers. The SEC has conflated costs to businesses with costs to consumers and society, even though the regulations are designed to reduce rent-seeking behavior that benefits some businesses *at the expense of* consumers. Finally, it has ignored the fact that bad products and services crowd out good ones.

Biased advice is costly to investors

The White House Council of Economic Advisors (CEA) during the Obama Administration estimated that conflicted "advisors" steered retirement savers to products with one-percentage-point lower annual returns net of fees than otherwise similar products.³ The CEA analysis focused on funds in Individual Retirement Accounts, most of which are rolled over from 401(k) plans. CEA estimated that \$1.7 trillion in IRA assets was invested in products sold by commission or under other arrangements that created conflicts of interest, costing retirement savers \$17 billion annually. The total cost to retirement savers stemming from conflicted advice is likely to be higher, because this estimate only includes IRAs, not 401(k)s and other retirement savings vehicles. Similarly, DOL estimated that underperformance associated with conflicts of interest in the mutual funds segment alone could cost IRA investors between

² Benjamin Bain, "In Whose Interest Is SEC 'Best Interest' Broker Rule?" *Bloomberg BusinessWeek*, April 27, 2018.

³ Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings*, February 2015.

\$95 billion and \$189 billion over 10 years and between \$202 billion and \$404 billion over 20 years.⁴ Retirement savers are often financially unsophisticated, though they are not the only investors who fall prey to conflicted advisors. Many retirement savers roll over 401(k) funds to IRAs, despite the fact they tend to have higher fees than 401(k)s.⁵

Based on a thorough review of the potential costs and benefits of different regulatory strategies, the DOL determined that all financial professionals recommending products or services to retirement savers should have a fiduciary duty to these clients. The DOL fiduciary rule was enforceable by DOL and private action, including class-action lawsuits. It also generally prohibited financial professionals advising retirement savers from receiving commissions and other payments that varied according to the products or services being recommended.

SEC approach differs from DOL rule

In response to similar concerns about conflicts of interest in the market for investment products and services, but more responsive to industry concerns, the SEC has staked out what appears to be a middle ground, drafting proposed regulations that rely on disclosure and a vague standard of conduct. Among other things, the SEC proposals specify that brokers must act in the “best interest” of clients, limit the use of terms like “financial adviser,” and require financial professionals to provide clients with short descriptions of their legal obligations to the client and of their compensation structure.

The SEC’s proposed rules would essentially replace the DOL rule for retirement savers, which was left to languish by the current administration before being vacated by a Fifth Circuit Court decision. Though overlapping, the scopes of the regulations are not identical. The DOL rule, unlike the proposed SEC regulations, only protected retirement savers, though spillover effects were expected. The DOL rule, however, unlike the proposed SEC regulations, extended to all professionals offering investment advice and products to retirement savers, not just broker-dealers and registered investment advisors.

Consumer advocates and a dissenting commissioner have questioned whether the SEC’s proposed regulations offer consumers meaningful protections or simply preserve the status quo.⁶ Though some egregious practices may be curbed by the proposed regulations, their practical impact is unclear

⁴ DOL, “Regulating Advice Markets: Definition of the Term ‘Fiduciary’—Conflicts Of Interest—Retirement Investment Advice,” Regulatory Impact Analysis for Final Rule and Exemptions (“Regulatory Impact Analysis”), April 2016.

⁵ Charles A. Jeszeck, “Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans,” Testimony Before the Subcommittee on Health, Employment, Labor and Pensions, Education and Labor Committee, House of Representatives, U.S. Government Accountability Office (GAO), March 24, 2009; GAO, “401(K) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest,” Report to the Ranking Member, Committee on Education and the Workforce, House of Representatives, January 2011; GAO, “401(K) Plans: Labor and IRSCould Improve the Rollover Process for Participants,” March, 2013.

⁶ Elizabeth Warren, “Worried about broker conflicts? The SEC is n’t,” *Bloomberg News*, August 6, 2018; Kenneth Corbin, “Battle lines drawn over SEC best interest proposal,” *Financial Planning*, May 16, 2018; Kara M. Stein, “Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers,” U.S. Securities and Exchange Commission Public Statement, April 18, 2018.

because the SEC does not define “best interest,” the rules rely heavily on disclosure, and enforcement is likely to be weak.

It is not clear how the SEC’s proposed “best interest” standard differs from the current “suitability” standard for broker-dealers offering incidental advice.⁷ The best interest standard would prohibit broker-dealers from steering clients toward clearly unsuitable investments. However, broker-dealers are already prohibited from doing so under the current standard. While the suitability standard prevents broker-dealers from, for example, recommending highly risky investments to risk-averse clients, it does not prevent them from promoting higher-cost but “suitable” investments when similar lower-cost investments are available.

The SEC’s proposed regulations, unlike the DOL rule, do not prohibit commissions and other forms of variable compensation that create conflicts of interest between financial professionals offering advice and their clients. Enforcement is also weaker under the proposed SEC rules. Investors would not be able to sue brokers for violating the standard, but would only have recourse to private arbitration under the auspices of the Financial Industry Regulatory Authority (FINRA), an industry-funded body.

Industry counterarguments

The DOL’s short-lived fiduciary rule accelerated the flight from high-fee products and broker-dealer services in favor of lower-cost products and unbiased advice. Industry lobbying against the rule therefore focused on the loss of products and services resulting from the rule, claiming that small investors would be harmed. Specifically, the industry claimed that a loss of revenue from commissions and other variable compensation would cause firms to reduce the free “advice” offered to small investors and indirectly limit investment options, harming investors. However, it failed to show that investors would actually be harmed by the loss of conflicted “advice” and the products whose sales depend on it.

In other words, industry relied on the standard argument against regulation, that it would hurt those it was intended to help. Generally speaking, regulation should be avoided if it is difficult to enforce; if compliance is costly for all actors, not just bad actors; and if it incentivizes unproductive activities. There is little credible evidence, however, that the DOL’s fiduciary rule, if it had survived, would have created more problems than it solved. For example, there is little evidence of frivolous lawsuits successfully brought against financial advisors who are already held to a fiduciary standard.⁸ Likewise, designing new compensation structures to comply with the DOL rule may have been costly, but these are sunk costs, not a reason to rescind the rule. In any case, industry surveys routinely exaggerate the cost of complying with proposed regulations because there is little cost to crying wolf.

⁷ Broker-dealers who specifically charge for investment advisory services, who advertise themselves as financial planners, or who provide financial plans to customers must adhere to a stricter fiduciary standard under the Investment Advisers Act of 1940 (SEC, “Certain Broker-Dealers Deemed Not To Be Investment Advisers,” 17 CFR Part 275, April 12, 2005).

⁸ Consumer Federation of America, “Industry Claims That DOL Fiduciary Will Unleash Flood of Litigation Don’t Hold Water,” June 15, 2015.

Disclosing versus prohibiting conflicts

There is considerable evidence that many retirement savers and other individual investors have a poor grasp of investment basics. They fail to fully grasp the advantages of diversification or the effect of seemingly small differences in fees on long-term outcomes. They believe that bull and bear markets cancel out over time, or that target-date funds fully shield them from market risks. They naively interpret excess returns as a sign of a good investment going forward. They are lulled into a false sense of security if stock returns are high, fail to rebalance in the wake of rallies, or gamble on all-stock portfolios. At the opposite extreme, some invest very conservatively or lock in low returns by selling in the wake of market downturns.

These problems cannot be solved through boilerplate disclosures. Investors, for example, are already warned that “past performance may not guarantee future results,” but many understand this to mean that “past performance is no guarantee, *but maybe a good indicator*, of future results.” This conflicts with the efficient markets hypothesis in economics that asset prices should reflect all publicly available information, such that past performance should give no indication at all about expected risk-adjusted returns, though it may be an indicator of volatility.

Similarly, many unsophisticated investors assume that “you get what you pay for” with higher fees. However, research has shown that net returns from active management are lower than net returns from passive investments for small investors, suggesting that people are naively overpaying for and over-investing in actively managed funds marketed to small investors, especially broker-sold funds.⁹

This is not to suggest that in a competitive market there would be no active management. Passive investors and less-skilled active investors are free riders who take advantage of the research and talent of skilled active managers, without whom asset prices would become completely untethered to expected earnings. In an equilibrium with knowledgeable investors, we would expect returns from active and passive strategies to be equal. The fact that actively-managed funds marketed to small investors tend to perform poorly reflects a market distortion—naiveté—or a “principal-agent problem” in economics parlance, which results in enormous transfers from investors to the financial industry.

Is more choice always better?

As noted, in combatting the DOL’s fiduciary rule, industry focused on evidence that the rule would limit the range of products and services offered to retirement savers, including incidental “advice” offered to clients by broker-dealers.¹⁰ The short-lived DOL rule did affect the mix of products and services

⁹ See, for example, Jonathan Reuter, “Revisiting the Performance of Broker-Sold Mutual Funds,” SSRN Working Paper, November 2, 2015; Nikolai L. Roussanov, Hongxun Ruan, and Yanhao Wei, “Marketing Mutual Funds” SSRN Working Paper, December 26, 2017.

¹⁰ See, for example, U.S. Chamber of Commerce, “Fiduciary Rule: Initial Impact Analysis,” September 7, 2017.

marketed to investors, accelerating a flight from high-fee products and broker-dealer services in favor of lower-cost products and unbiased advice from fiduciary advisers and “robo-advisors” among others.¹¹

It is not clear whether the rule resulted in fewer choices for investors, rather than different choices. In any case, the SEC appears to have accepted the industry argument that more choice is inherently better, ignoring evidence that choice overload can hinder decision making. This is especially true in retirement savings decisions and other contexts in which decision-making is difficult due to complexity and asymmetric information.¹²

Admittedly, the government is not generally in the business of limiting consumer choice for its own sake, even if this might make many consumers better off.¹³ However, if limiting conflicted investment advice indirectly results in better but possibly fewer investment options, this is a desired outcome, not a valid argument against such limits. Simply put, we should not mourn the loss of products and services that are only competitive if recommended by conflicted advisors.

In any event, disclosure of conflicts and a “best interest” standard of conduct, if they had their intended effect, should have a similar impact on investment options, because broker-dealers would not recommend overpriced products and fully-informed consumers would not buy them. The fact that the industry is not strenuously lobbying against the SEC’s proposed regulations suggests that it believes these rules to be ineffective, not that their ostensible goal is different from that of the DOL fiduciary rule.

Do costs to businesses equal costs to society?

Government agencies are required to consider the potential costs and benefits of new regulations. Often, these cost-benefit analyses involve weighing the costs to businesses (such as the cost of installing filters on smokestacks) against the benefits to society (such as the effect of cleaner air on public health, property values, and tourism). However, taking into account the costs to businesses is appropriate only if these costs are assumed to be passed on to consumers and if the direct costs to businesses are easier to measure than the indirect costs to consumers.¹⁴

¹¹ Brian Menickela, “The DOL Rule - It Was The Best Of Times, It Was The Worst Of Times,” *Forbes*, August 21, 2017.

¹² Sheena Sethi-Iyengar, Gur Huberman, and Wei Jiang, “How Much Choice is Too Much? Contributions to 401(k) Retirement Plans,” in Olivia S. Mitchell and Stephen P. Utkus (Eds.) *Pension Design and Structure; New Lessons from Behavioral Finance*, Oxford University Press, 2015; Shlomo Benartzi and Richard H. Thaler, “Heuristics and Biases in Retirement Savings Behavior,” *Journal of Economic Perspectives*, Volume 21, Number 3, Summer 2007, Pages 81–104; Shlomo Benartzi and Richard H. Thaler, “Naive Diversification Strategies in Defined Contribution Saving Plans,” *American Economic Review*, Vol. 91, No. 1, March 2001, pp. 79–98.

¹³ Barry Schwarz, *The Paradox of Choice; Why More is Less*, New York: HarperCollins, 2004.

¹⁴ Cost-benefit analysis is conceptually similar to analyzing the effect of policies on Gross Domestic Product (GDP), taking into account externalities and the value of non-market goods and services but ignoring intermediate goods and services. GDP should, in theory, be equal to Gross Domestic Income (GDI), so another way of analyzing the effect of policies is to measure their impact on incomes. Though GDP and GDI are imperfect measures of social welfare, any policy that reduces GDP or GDI should have other benefits, such as reducing poverty or saving endangered species.

In the current context, there is only one measure that truly matters: how proposed regulations will affect investors' risk-adjusted returns net of fees. This, appropriately, was the main focus of the CEA and DOL economic analyses. In contrast, the SEC's focus on the current market for investment goods and services, which takes up hundreds of pages of the economic analyses accompanying the proposed regulations, is simply a distraction.

To the extent that regulations reduce rent-seeking behavior—efforts to obtain economic gain without reciprocating benefits to society—the cost to businesses should be ignored. Furthermore, if some businesses lose but others gain, it is only the net cost that is passed on to consumers.

This is worth emphasizing. A regulation that corrects a market failure—in this case, an information asymmetry between financial professionals and unsophisticated investors—is, by design, costly to businesses that thrive on taking advantage of the market failure. The cost to these businesses is not, however, a societal cost, except to the extent that compliance is costly for all businesses and these costs are passed on to consumers. Only in this case must the costs to businesses be weighed against the benefits to consumers. Otherwise, one firm's loss is another's gain, and society clearly benefits from correcting the market failure.

The DOL fiduciary rule was unquestionably costly to some financial firms. Though the rule has been abandoned, it accelerated a trend toward lower-cost investment options and fee-based financial advice. These disruptions to the status quo were, however, welfare-enhancing because some firms were profiting at the expense of investors. As a result of the DOL rule, these investors could avail themselves of better products and services since they were no longer preyed upon by conflicted "advisors."

Is conflicted advice valuable?

Rather than consider the evidence that much "advice" from broker-dealers is worse than no advice at all, the SEC accepts as given that this "advice" is valuable, conjuring up a scenario where it could be even more valuable if transparency fostered trust.¹⁵ Though the SEC recognizes the existence of a principal-agent problem, it offers as an example a broker's failure to exert the level of effort the retail customer expects in providing advice "tailored to their specific investment objectives, financial situation, and needs" of a customer. In this scenario, the advice offered is already valuable, but ameliorating agency costs would "result in the firm providing advice at a level of quality that better matches the

In practice, it is sometimes easier to assess the direct impact of policies on businesses rather than their indirect impact on consumers. Thus, the costs to businesses of complying with a regulation are sometimes weighed against the estimated benefits to society, on the assumption that the costs to businesses are passed on to consumers. However, it is inappropriate to count both the costs to businesses and to consumers. It is also inappropriate to count costs to businesses that are not passed on to consumers, such as losses to businesses resulting from regulations curbing rent-seeking behavior that harms consumers.

While externalities and non-market goods and services loom large in environmental regulation, they are often ignored in cost-benefit analyses of financial regulation. This comment letter will not delve into these issues, though it is worth noting that improving workers' retirement security is generally thought to have positive externalities.

¹⁵ Regulation Best Interest, p. 221.

expectations of its retail customers.”¹⁶ Later, the SEC acknowledges that the principal-agent problem may manifest itself as a financial firm steering customers to products with higher fees than alternatives with similar risk-return profiles. However, the SEC never considers that “advice” offered may not just be of lower quality than expected, but worse than no advice at all.¹⁷ Instead, the SEC expresses concern that “retail customers who are aware that financial firms are likely to be conflicted may choose not to seek advice even when conflicted advice would make them better off than no advice at all” and therefore “may forgot valuable investment opportunities.”¹⁸

This seems disingenuous. We wonder if the SEC, if asked to regulate medical advice from unlicensed quacks, would express concern that mistrust unfortunately leads patients to avoid snake oil salesmen.

Elaborating on this scenario, the SEC describes a situation where advisory services offered by broker-dealers are valued by customers more than the minimum price at which firms are willing to supply them. The question then becomes how the difference will be split—in economic terms, how gains from trade will be shared—before and after agency conflicts are ameliorated. In this happy situation, the SEC notes that both parties could benefit from ameliorating conflicts of interest if transparency gives customers greater confidence in, and willingness to pay for, investment advice.

Aside from the sanguine assumption that the advice is useful to begin with, the SEC does not explain why a vague standard of conduct or disclosing conflicts is preferable to prohibiting conflicted advice in the first place.

We would not normally expect conflicted investment “advice” to have value, because broker-dealers are not generally incentivized to sell lower-cost products and services, as might happen in more competitive industries where some salespeople might specialize in bulk orders. As CEA noted in its report, *The Effects of Conflicted Investment Advice on Retirement Savings*, forms of compensation that generate conflicts of interest—revenue-sharing arrangements such as 12b-1 fees, front-end loads, and back-end sales loads, etc.—generally create financial incentives to steer investors to higher-cost funds and to engage in excessive trading.¹⁹

Thus, much of the “advice” provided by broker-dealers not only lacks value, but is actually harmful, steering savers to higher-cost products and costly services that will reduce their future standard of living compared to how they would fare in the absence of this “advice.” This may be true whether or not, in the absence of conflicted “advice,” investors would have availed themselves of more paid or free advice from more impartial sources.

¹⁶ Regulation Best Interest, p. 220.

¹⁷ Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar, “The Market for Financial Advice: An Audit Study,” NBER Working Paper No. 17929, March 2012; John Chalmers and Jonathan Reuter, “Is Conflicted Investment Advice Better than No Advice?” NBER Working Paper No. 18158; Antoinette Schoar, “We Put Financial Advisers to the Test—and They Failed,” *The Wall Street Journal*, October 27, 2016; U.S. Government Accountability Office, “401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants, March 7, 2013.

¹⁸ *Ibid.*

¹⁹ Council of Economic Advisers, *op. cit.* p. 7.

This also begs the question of whether “incidental” advice can be costly to provide and tailored to individual investors. The SEC assumes that investors need one-on-one investment advice tailored to their individual needs. Such “bespoke” advice is costly to produce and must be paid for, either directly—by hiring fee-based advisors, or indirectly—through commissions paid to broker-dealers and other financial professionals who provide incidental “advice” in the course of their regular business. Though we are not lawyers, it seems to us that costly advice tailored to individual investors should trigger fiduciary obligations in the Investment Advisers Act, which only exempts “incidental” advice provided by broker-dealers.

In any case, as we have noted, it is unlikely that broker-dealer commissions actually pay for useful advice. Most of the advice retirement savers and other small investors benefit from is generic, and the marginal cost of disseminating it is negligible. The fact that generic advice resembles a public good suggests that it should be—and is—provided by government agencies and nonprofit organizations. However, since appraising and absorbing such information can be difficult and time consuming, bad information from conflicted advisors can be worse than superfluous, it can be harmful to small investors, making them less likely to avail themselves of useful advice.

To the extent that small investors could actually use one-on-one advice, it is often to counter misinformation from conflicted advisors. Beyond that, financial technology is making it easier to provide low-cost investment advice tailored to individuals’ risk preferences. Meanwhile, advice from unbiased sources is available free or at low cost from library books, newspapers, and online—including from the SEC itself. This is all that many investors need, given the ready availability of low-cost, broadly-diversified, mutual funds.

Some investors, of course, do benefit from advice tailored to their specific needs. But there is no reason to believe that this advice will be more affordable if paid for indirectly through broker-dealer commissions. Hiring a fiduciary advisor may cost more up front than paying broker-dealer commissions, but the advice received is of better quality. In reality, the value of broker-dealer “advice” is likely to be negative.

Under what special circumstances might advice offered by conflicted advisors be of value to consumers?

- If reputation matters—that is, if consumers who are not themselves able to judge the quality of advice are able consult sources who are; or if the quality of advice can be judged after the fact and this information is shared.
- If employers benefit from hiring employees who care about professional integrity because they are more motivated and require less monitoring.
- If advisor and client interests happen to be aligned. This might be the case, for example, if retirement savers are myopic and financial professionals convince them to save more.

While there are undoubtedly some brokers who offer valuable advice for the above reasons, others clearly do not. The industry lobby—despite the considerable resources at its disposal—has failed to show that conflicted “advice” is, on net, valuable to investors.

Moreover, there is little reason to believe that effectively prohibiting conflicts of interest would cause a reduction in any valuable advice offered to investors. As a result of effective regulation, the financial industry's reputation would improve, scaring off fewer potential investors; the industry would attract and retain more people who care about professional integrity; and the industry would still have an incentive to encourage people to save more.

Ignoring evidence and expert testimony

In drafting these regulations, the SEC ignored evidence and expert testimony, including from its own advisors. In 2013, the SEC's Investor Advisory Committee recommended that all personalized investment advice to retail customers be governed by a fiduciary duty. Though the committee also called for improved disclosure, it emphasized that it did not believe that disclosure was sufficient to address the harm that could result when broker-dealers were free to offer "advice" that put their own interests ahead of the interests of their customers.²⁰ Similar views were presented by a cross-disciplinary panel of experts at a 2017 meeting of the Investor Advisory Committee, where Dr. Sunita Sah of Cornell University discussed perverse effects of disclosure in health care and Department of Veterans Affairs bioethicist Lisa Lehmann discussed why disclosure was no substitute for a duty of care to act in a patient's or client's best interests.²¹

As these and other experts have shown, there is strong evidence that disclosure is not only often ineffective, but can be counterproductive. Unsophisticated investors lack the ability to interpret the disclosure and may view it as evidence of honesty or feel a social obligation to ignore it. As the SEC itself noted in its analysis of one of the proposed regulations, disclosure may even induce a "panhandler effect," whereby clients may go through with a transaction in response to social pressure to meet the professional's financial interests.²² The SEC also noted that disclosure could have an effect on the behavior of financial professionals through "moral licensing"—the belief that they have already fulfilled their moral obligations through disclosure, and "strategic biasing"—the desire to compensate for an anticipated loss of profit from disclosure.²³

The SEC, however, treated this as evidence in support of requiring marginally better disclosure, rather than more effective measures. There is little evidence that the SEC has taken the experts' advice seriously. For example, the SEC notes the panhandler effect, while ignoring advice from Dr. Sah and others on ways to mitigate the problem by, for example, distancing disclosure from any personal contact

²⁰ SEC Investor Advisory Committee, "Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty," 2013.

²¹ Securities and Exchange Commission Investor Advisory Committee Minutes of the Meeting on December 7, 2017. A webcast of the meeting is available here: https://www.sec.gov/video/webcast-archive-player.shtml?document_id=120717iac.

²² Daylian Cain, George Loewenstein and Don Moore, "The Burden of Disclosure: Increased Compliance with Distrusted Advice," *Journal of Personality and Social Psychology*, 104(2): 289-304 (2013).

²³ Form CRS Relationship Summary, p. 248. These effects are described in further detail in Daylian M. Cain, George Loewenstein and Don A. Moore, "When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest," *Journal of Consumer Research*, Vol. 37, No. 5 (February 2011), pp. 836-857.

between advisors and potential clients.²⁴ In the proposed regulations, the SEC only requires that firms deliver a relationship summary to retail investors “before or at the time the retail investor first engages the firm’s services.”²⁵ Instead of addressing perverse effects, the SEC focuses on making disclosures easier to read by, for example, eliminating small print and unnecessary detail—measures that will only be effective if consumers can make good use of the information.

In contrast, in drafting its fiduciary rule, DOL noted that “available academic and empirical evidence strongly suggest that disclosure alone will be ineffective at mitigating conflicts in financial advice.”²⁶ DOL cited evidence that existing disclosures were rarely read or taken seriously, especially by unsophisticated investors. Worse still, DOL cited studies showing that disclosure of financial professionals’ conflicts of interest could backfire, for example making it more likely that consumers would chose a more expensive mortgage loan.²⁷ ²⁸ Similar effects have been found in doctor-patient and dentist-patient relationships, with biases appearing more pronounced in longstanding relationships.²⁹

Conclusion

In 2016, DOL addressed a gap in protections for retirement savers, many of whom are steered to high-cost products and services by broker-dealers and other financial professionals misrepresenting themselves as disinterested “advisors.” Unlike certified financial planners and registered investment advisors, broker-dealers do not have a fiduciary duty to clients and can legally steer them to higher-cost products and services that are not in their best interest as long as these are broadly “suitable” for retirement savers. The DOL rule imposed a fiduciary duty on all financial professionals offering advice to retirement savers, enforceable through class-action lawsuits. It also banned forms of compensation that created conflicts of interest, with certain exceptions.

The DOL fiduciary rule came under attack from industry groups, which argued that it would limit the products and services available to retirement savers while imposing significant compliance costs on industry that would be passed on to consumers. These arguments persuaded the current administration to delay the DOL rule and the Fifth Circuit Court to vacate it, even though the rule had been upheld in

²⁴ SEC Investor Advisory Committee, “Articles on Disclosure and Transparency by Sunita Sah for SEC Investor Advisory Committee Meeting on December 7, 2017.”

²⁵ Form CRS Relationship Summary, p. 13.

²⁶ Regulatory Impact Analysis, April 2016.

²⁷ James Lacko and Janis Pappalardo, “The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment.” Federal Trade Commission Bureau of Economics Staff Report, February 2004.

²⁸ For an overview of the evidence from experimental studies cited by DOL, see George Loewenstein, Daylian M. Cain and Sunita Sah, “The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest,” *The American Economic Review*, Vol. 101, No. 3, May 2011, pp. 423-428.

²⁹ Janet Schwartz, Mary Frances Luce, Dan Ariely, “Are Consumers Too Trusting? The Effects of Relationships with Expert Advisers,” *Journal of Marketing Research*, Vol. 48, No. SPL, November 2011, pp. S163-S174; Don A. Moore, Daylian M. Cain, George Loewenstein, and Max H. Bazerman provide a cross-disciplinary overview in *Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine and Public Policy*, New York: Cambridge University Press, 2005.

earlier court decisions. In response, the SEC has proposed a set of weaker regulations that rely heavily on disclosure and have not been attacked by industry for limiting consumer options.

However, the relevant question is not whether consumers lose access to certain products and services currently being offered. After all, if the goal is to restrict “advice” steering savers to poor investments, any effective regulation will reduce conflicted “advice” and make overpriced or lower-quality products less competitive. Rather, the question is whether consumers gain or lose from changes in products and services resulting from regulation, including newly-available products and services and impartial advice that was previously buried under misinformation.

It is undoubtedly true that with effective regulation consumers will be offered less *bad* advice and fewer *unnecessarily expensive* products and services, and that companies and individuals engaged in such practices will be negatively affected, though other financial actors stand to gain. This is the purpose of the regulation, after all.

Does anyone truly believe that conflicted advisors help resolve information problems, rather than contributing to them? We are inclined to agree with authors Helaine Olen and Harold Pollack that everything most people need to know about personal finance can fit on an index card—unless, that is, they have been misled by conflicted advisors.³⁰ One of the authors’ nine index card tips was to seek financial advice only from professionals held to a fiduciary standard.

The financial-industry lobby failed to credibly demonstrate that there was a societal cost to the DOL rule, as opposed to a cost to some financial professionals and firms. Government regulators should not be in the business of protecting industry profits if these come at the expense of consumers. Industry groups failed to even clear a lower bar—demonstrating that a significant number of consumers would be hurt, even if most benefited.

Critics of regulation often say government should not be in the business of picking winners and losers. However, the same may be said of a failure to act if the playing field is not level. The government is, in effect, enabling bad actors at the expense of those who provide unbiased advice and sell products that are in clients’ true best interest.

Exempting broker-dealers from registering as investment advisors and acting as fiduciaries if their advice is “incidental” to the conduct of their business and they receive no special compensation for it is a loophole that has proven very harmful to retirement savers and other investors. If this advice were truly “incidental,” then eliminating forms of compensation that create conflicts of interest would not affect the practice. Broker-dealers in the course of normal business could still advise clients to save more and steer them to appropriate investment vehicles as a goodwill and reputation-enhancing gesture.

In framing the issue, however, both the industry and SEC assume that the “advice” offered by broker-dealers and other conflicted financial professionals is costly to provide, valuable to investors, and tailored to the individual. The industry used this frame to argue that the DOL in curtailing commissions

³⁰ Helaine Olen and Harold Pollack, *The Index Card: Why Personal Finance Doesn't Have To Be Complicated*, New York: Penguin Random House, 2017.

and other forms of variable compensation would put this “advice” out of reach of small investors. The industry never bothered to explain why affordable “advice” can only be provided by conflicted professionals acting in the guise of disinterested experts to clients often unaware that they are paying for this supposed service.

The SEC has adopted the industry’s framework in arguing for additional disclosure and a vague “best interest” standard that appears to have no teeth. In the SEC’s rosy scenario, the impact of these regulations would only be to enhance trust, thereby improving the quality of valued advice and increasing investors’ willingness to pay for it. In other words, in the SEC’s win-win scenario, good advice gets even better!

In theory, disclosing conflicts could have the same effect as banning them. In practice, we know this will not happen. If disclosure *were* effective—if transparency enabled investors to avoid products and services that were not in their best interest—this would also affect the choices investors were presented with. The fact that the industry has been largely silent or supportive of the proposed regulations suggests that they know they will have little effect on their bottom line or on investors’ choices.

The SEC also assumes that “advice” offered by conflicted professionals is valuable in its cost-benefit analysis. A cost-benefit analysis is not the only metric by which we should judge public policy. A redistributive policy, for example, may be defended on equity grounds even if it is slightly inefficient, such that the losses to higher-income households somewhat exceed the gains to lower-income households. However, the only arguments made against regulating conflicts of interest in investment advice hinge on consumers being harmed by limiting the advice they receive and products and services they are offered. Industry claims that these supposed costs outweigh the gains to consumers are far-fetched and based on no credible evidence.

Effective regulation—in whatever form it takes—*should* reduce the biased “advice” received by consumers and make the market for investment products and services more competitive. This in turn *should* crowd out higher-cost and lower-quality products and services, while expanding opportunities for businesses offering better options. Whether or not consumers are left with fewer choices, they will benefit from better ones.

Respectfully,

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