

**COMMENT LETTER TO THE DEPARTMENT OF LABOR**

**An Evaluation of the Department's Impact Analysis of Proposed Rules  
Relating to Financial Representative Fiduciary Status**

**COMPASS LEXECON  
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## Table of Contents

I.	BACKGROUND AND SUMMARY OF OPINIONS.....	1
II.	THE DOL’S ANALYSIS OF PURPORTED BENEFITS IS OVERSTATED AND UNRELIABLE.....	4
A.	THE DOL MISAPPLIES FINDINGS FROM THE ACADEMIC LITERATURE .....	5
B.	THE DOL IGNORES OTHER FINDINGS FROM THE ACADEMIC LITERATURE	10
C.	THE DOL ASSUMES BENEFITS IT PURPORTS TO ESTIMATE.....	11
D.	TAKE-AWAY ON THE DOL’S PURPORTED BENEFIT ANALYSIS .....	13
III.	THE DOL’S ANALYSIS OF PURPORTED COSTS IS LIKELY UNDERSTATED AND UNRELIABLE.....	13
A.	THE DOL TOO READILY DISMISSES COSTS LIKELY TO BE INCURRED BY MARKET PARTICIPANTS, INCLUDING THE DOL ITSELF .....	14
B.	THE DOL IMPROPERLY DISMISSES COSTS RELATED TO OTHER UNINTENDED CONSEQUENCES .....	15
C.	THE DOL’S COST ANALYSIS IS FLAWED IN OTHER WAYS THAT RENDER IT UNRELIABLE. ....	21
IV.	CONCLUSION.....	23

## I. BACKGROUND AND SUMMARY OF OPINIONS

1. On April 21, 2015, the Department of Labor (“DOL”) released a “Regulatory Impact Analysis” in support of certain proposed amendments to the rules that identify when a financial representative is deemed to be a fiduciary, as defined in the proposed regulations.<sup>1</sup> The DOL claimed that its proposed amendments “would deliver to IRA investors gains of between \$40 billion and \$44 billion over 10 years,” and that these gains “would far exceed the proposal’s compliance costs, which are estimated to be between \$2.4 billion and \$5.7 billion over 10 years.”<sup>2</sup>

2. Compass Lexecon was asked by counsel for Primerica, Inc. (“Primerica”) to review the DOL’s Regulatory Impact Analysis and to comment on whether it provides a satisfactory and reasonable economic assessment of the likely costs and benefits associated with the proposed amendments.<sup>3</sup> We conclude that it does not. Specifically, we find that the DOL’s analysis grossly overstates the benefits it purports to measure. Moreover, the DOL’s analysis likely understates the costs of the proposed regulation by failing to properly analyze potential unintended consequences. Thus, as a matter of economics, the DOL’s Regulatory Impact

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1. Department of Labor (2015) “Fiduciary Investment Advice: Regulatory Impact Analysis,” April 14, 2015 (“DOL Impact Analysis”).

2. DOL Impact Analysis, at 8. The DOL states: “The Department expects the proposal to deliver large gains for retirement investors. Because of data limitations of the academic literature and available evidence, only some of these gains can be quantified. Focusing only on how load shares paid to brokers affect the size of loads IRA investors holding load funds pay and the returns they achieve, the Department estimates the proposal would deliver to IRA investors gains of between \$40 billion and \$44 billion over 10 years and between \$88 and \$100 billion over 20 years.” The DOL goes on to state, “The Department nonetheless believes that these gains alone would far exceed the proposal’s compliance costs, which are estimated to be between \$2.4 and \$5.7 billion over t10 years, mostly reflecting the cost incurred by new fiduciary advisers to satisfy relevant PTE conditions.” Given the DOL’s focus on the \$40 to \$44 billion range, this comment letter also focuses its discussion relating to benefits on the DOL’s analysis of the potential benefits it expects to achieve within IRA investment in front load mutual funds. However, we note that our concern about the reliability of the DOL’s analysis showing \$40 to \$44 billion also apply to the DOL’s presented in Table 3.4.4-1 and Table 3.4.4-2.

3. A description of Compass Lexecon is contained in the Appendix.

Analysis does not constitute a reliable cost-benefit analysis. Moreover, the DOL's conclusion that the benefits of the proposed amendments exceed the costs is not supported by reliable economic analysis.

3. With respect to the purported benefits, the DOL's analysis relies upon a misapplication of findings from the academic literature and a number of vague and unsupported assumptions which call into question its reliability. For example, the DOL estimates a purported dollar benefit estimate relating to IRA investor holdings in front-load mutual funds. This estimate relies critically on a result from a 2013 academic study that explored investment and performance in mutual funds with front-end loads conducted by Christoffersen, Evans and Musto ("CEM").<sup>4</sup> CEM document an empirical relation between fund flows and performance of front-load mutual funds sold by unaffiliated brokers and the amount of *excess* load shared with unaffiliated brokers. However, the DOL misapplies CEM's findings by incorrectly attributing fund underperformance to the *total* level of the of load fee shared with unaffiliated brokers as opposed to the *excess* load fee shared. Moreover, the DOL goes on to also attribute underperformance to funds sold by *captive* brokers, even though CEM did not find that these funds underperformed.

4. With respect to the potential costs, the DOL's analysis relies upon a number of vague and unsupported assumptions that call into question its reliability. For example, the DOL only offers a dollar cost estimate relating to the most obvious categories of direct costs. The DOL routinely speculates that its estimate is likely overstated but ignores or dismisses additional costs associated with many possible unintended consequences of the proposed amendments.

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4. Susan E. K. Christoffersen, Richard Evans, and David K. Musto (2013) "What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives," *Journal of Finance* 58(1):201-227.

Examples of unintended consequences include the possibility of higher investor paid fees and lower overall savings by IRA investors.

5. Overall, the DOL's Impact Analysis does not provide the public with a reliable estimate of the net benefit (if any) of the proposed regulatory amendments. The DOL's misapplication of CEM's results leads it to overstate, likely by a large amount, the benefit (if any) of the proposed amendments. Moreover, whereas the DOL admits that the \$40 billion to \$44 billion may not be realized, it provides no reliable economic analysis to demonstrate how the proposed amendments would eliminate or mitigate the underperformance it claims exists. The DOL's reliance on vague and unsupported assumptions and its failure to consider appropriately costs associated with unintended consequences likely lead to an understatement of the true costs of the proposed amendments.

6. A broad consensus exists among economists, including those with a variety of different perspectives on the proper role for government regulation, that accurate cost-benefit analysis is crucial to effective policymaking and promotes democratic ends. For example, Professor Cass Sunstein, who until recently served as administrator of the Office of Information and Regulatory Affairs, wrote:

Cost-benefit requirements are of course most easily justified on economic grounds, as a way of promoting economic efficiency and thus eliminating unnecessary and wasteful public and private expenditures. But cost-benefit requirements also have strong democratic justifications. Indeed, they can be understood as a way of diminishing interest-group pressures on regulation and also as a method for ensuring that the consequences of regulation are not shrouded in mystery but are instead made available for public inspection and review. Some of the strongest arguments for cost benefit requirements are not so much economic as democratic in character.<sup>5</sup>

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5. Cass R. Sunstein (1996) "The Cost-Benefit State," University of Chicago Law School Coase-Sandor Working Paper Series in Law & Economics, at 4. *See also* Kenneth J. Arrow, et al. (1996) "Benefit-Cost Analysis in Environmental, Health, and Safety Regulation: A Statement of Principles," American Enterprise Institute, The Annapolis Center, and Resources for the Future, at 3 ("Benefit-cost analysis should play an important role in informing the decisionmaking process, even when the information on benefits, costs, or both is highly

7. A failure to accurately measure costs and benefits has the potential to cause waste, to result in misdirected resources, and to harm the basic functions of government in society. Historically, the importance of accurate cost-benefit analysis has been most noted with respect to environmental, health, and safety regulations, but there is today growing recognition that the same principles apply to financial regulations. For example, Eric Posner, the Kirkland and Ellis Distinguished Service Professor of Law and the Arthur and Esther Kane Research Chair at the University of Chicago Law School concludes:

The importance of developing methods for benefit-cost analysis for financial regulation can scarcely be overstated. In recent years, courts have awakened to the fact that many such regulations lack a sound economic basis and have started blocking them.<sup>6</sup>

## **II. THE DOL'S ANALYSIS OF PURPORTED BENEFITS IS OVERSTATED AND UNRELIABLE**

8. The DOL's \$40 billion to \$44 billion estimate of purported benefits is overstated and fatally flawed for at least three reasons:

- The DOL misapplies findings from the academic literature in its estimate of the amount of underperformance potentially associated with conflicted advice.
  - First, the DOL incorrectly asserts that the level of underperformance associated with purportedly conflicted advice in front-load mutual funds is proportional to the *total*

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uncertain ... The estimation of benefits and costs of a proposed regulation can provide illuminating evidence for a decision, even if precision cannot be achieved because of limitations on time, resources, or the availability of information.”) *See also* W. Kip Viscusi (1996) “Economic Foundations of the Current Regulatory Reform Efforts,” *Journal of Economic Perspectives* 10(3):119-34, at 120 (“Unless mechanisms exist for placing bounds on our risk reduction efforts, we can end up pursuing policies of diminishing marginal impact and diverting resources from more productive uses.”)

6. *See, e.g.*, Eric Posner and E. Glen Weyl (2013) “Benefit-Cost Analysis for Financial Regulation,” *American Economic Review* 103(3): 393-397, at 397

- load that goes to the broker when the literature cited demonstrates that underperformance (if any) is only related to the *excess* load that goes to the broker.
- Second, the DOL incorrectly asserts that front-load mutual funds sold by captive brokers underperform as a result of conflicted advice when the literature cited does not find evidence of underperformance.
  - The DOL ignores findings from the academic literature suggesting that underperformance may be limited to certain investment categories (e.g., U.S. equity, bonds, foreign equities, etc.) of mutual funds and need not be present in all mutual funds.
  - The DOL assumes that the proposed regulatory amendments will mitigate or eliminate underperformance without providing any reliable economic analysis demonstrating that such an outcome is likely.

#### **A. THE DOL MISAPPLIES FINDINGS FROM THE ACADEMIC LITERATURE**

9. The DOL performs a simulation of expected IRA-related savings amounts over the 10 year investment horizon beginning in 2017 and ending in 2026 to calculate the purported \$40 billion to \$44 billion in expected gains.<sup>7</sup> Specifically, the simulation compares aggregate IRA-related savings in front-load mutual funds under a “Baseline Scenario” without the proposed regulatory amendments to various “Alternative Scenarios” which make different assumptions as

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7. DOL Impact Analysis, at 113. The DOL also extended the analysis to 20 years, out to 2036. The same concerns we raise below apply equally to this longer-duration estimate. The DOL also claims that there may be other benefits beyond those quantified, including “improvements in the performance of IRA investments other than mutual funds and potential reductions in excessive trading and associated transaction costs and timing errors (such as might be associated with return chasing).” *Id.*, at 235. However, the DOL has provided no support for any of these claims, nor any quantification of the claimed benefits. As discussed below, one likely result of the proposed amendments would be to push some IRA investors into less tax-advantaged savings accounts. IRAs, unlike taxable savings accounts, impose a substantial penalty for early withdrawal, and as a consequence, investors in taxable savings accounts may have weaker incentives to resist early withdrawal. Therefore, there are plausible reasons why the proposed amendments could have the opposite effect as claimed by the DOL, namely, to incentivize early withdrawal of retirement savings, and the loss of subsequent compounding of returns.

to the benefits of the regulatory amendments. The \$40 billion to \$44 billion in expected savings is calculated as the difference in the predicted total IRA related savings in front-load mutual funds between two of the Alternative Scenarios and the Baseline Scenario.

10. The difference in IRA-related savings in front-load mutual funds results from the DOL's *assumption* that investors will earn higher investment returns in the Alternative Scenarios than in the Baseline Scenario. For example, the DOL assumes that, if the proposed amendments are finalized, IRA investors' front-load mutual fund holdings will experience investment returns between 5.17 percent and 5.91 percent per annum under the Alternative Scenarios. However, absent the regulatory amendments, the DOL assumes that IRA investors' holdings will only grow at rates between 5.07 percent and 5.46 percent per annum.<sup>8</sup>

11. The DOL rationalizes this difference in returns by appealing to the results from a regression analysis published in a 2013 academic paper by CEM. Specifically, the DOL asserts:

An estimate from CEM suggests that for every 100 basis points of the load that go toward an unaffiliated broker's load share, an IRA investor can expect to experience a decrease in performance of 49.7 basis points. For every 100 basis points of the load that go toward a captive broker's load-share, an IRA investor can expect to experience a decrease in performance of 14.5 basis points.<sup>9</sup>

12. Next, the DOL weights the 49.7 basis points and 14.5 basis points estimates by what it claims are the market shares of overall investment in front-load mutual funds sourced from unaffiliated and captive brokers. The DOL concludes that *each 100 basis points in the amount of load received by a broker* is associated with a weighted average reduction of 44.94 basis point

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8. DOL Impact Analysis, at 105 & 113. The DOL analyzes three Alternative Scenarios. As part of its third scenario, the DOL speculates that, as consequence of the proposed amendments, "loads paid by investors immediately fall to zero." *Id.*, at 104. However, the DOL immediately discounts the likelihood of this outcome, and the results of this scenario are not a part of the DOL's conclusion that the benefits of the proposed amendments are \$40 billion to \$44 billion.

9. DOL Impact Analysis, at 114.



in IRA returns.<sup>10</sup> The DOL then uses this 44.94 basis point estimate as an input in its calculation of the increase in the return performance the DOL assumes will result from the proposed amendments. Thus, the reliability of the 44.94 basis point estimate and the implementation of that estimate in the DOL's benefit calculation is a critical component of the DOL's analysis.

13. The DOL applies the 44.94 basis point estimate to its estimate of the *total load* that goes toward the broker's share to determine the amount of underperformance to be used in its simulation study.<sup>11</sup> Specifically, the DOL assumes that front-load mutual funds will experience 44.94 basis points in improved performance as a result of the proposed regulatory amendments for every 100 basis points of *total load* that goes toward the broker. For example, in 2017, the DOL estimates that the average total load that goes toward the broker is 134 basis points. In the Baseline Scenario, the DOL assumes that new investment in 2017 into front-load mutual funds will result in underperformance of 60.22 basis points – 134 basis points times 44.94 basis points divided by 100 equals 60.22 basis points. The DOL assumes that new investments made under the Alternative Scenarios will not experience this 60.22 basis point in underperformance because of the proposed regulatory amendments. The DOL attributes the difference to a purported benefit.

14. However, a review of CEM reveals that CEM's point estimates of 49.7 and 15.4 basis points are associated with the *excess load* that goes toward a broker's load share and not the *total load* that goes toward the broker's load share.<sup>12</sup> *Excess load* is defined by CEM as the load

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10. DOL Impact Analysis, at 114.

11. The DOL's estimates of the total load that goes toward the brokers share are provided in DOL Impact Analysis, at Table 3.4.1-1 in columns (B) and (C).

12. See, for example, Christoffersen, Evans, and Musto (2013) *op. cit.*, at 226 (Table V, entitled "Future Returns and Excess Load Paid to Broker"). See also, for example CEM at 225 quoted herein for exposition: "Do the funds that pay brokers more subsequently perform better or worse? To address this question we run multiple regressions with the *excess* load paid to the broker and excess revenue sharing explaining performance over the next 12 months."

received by the broker, *net of a baseline load amount* for funds in the same category (*e.g.*, “Equity,” or “Fixed Income”), and with similar attributes (*e.g.*, size of total load, mutual fund family size, or fund size).<sup>13</sup> CEM’s focus on *excess* load reflects a hypothesis that a poorer-performing fund may be able to compete by offering brokers *additional* load payments relative to otherwise similar funds, not any claim that all load payments to brokers reflect lower returns.<sup>14</sup>

15. Thus, the DOL misapplies its 44.94 basis point estimate derived from CEM to its estimate of the *total load* that goes toward the broker’s share as opposed to an estimate of the *excess load* that goes toward the broker’s share as originally estimated by CEM. This misapplication of CEM results in an *overstatement* of the purported benefits actually estimated. To see why, consider the following example. Suppose a certain mutual fund in 2017 charges 164 basis points in a front-end load and that the fund shares 134 basis points with a broker as estimated by the DOL.<sup>15</sup> CEM’s regression analysis applies *only* to the amount of *excess* in load fees shared with the broker relative to similar mutual funds. For example, if other funds similar to the fund in question levy an average of 150 basis points in front-end load fees and pay 122 basis points to unaffiliated brokers, then the *excess* load shared for the fund in question (relative to other funds) is only 12 basis points (134 basis points minus 122 basis points equals 12 basis points of excess load shared).<sup>16</sup> Using a proper estimate of excess load shared compared to the total load shared results a reduction in the estimate amount of underperformance from the 60.22

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13. Christoffersen, Evans, and Musto (2013), *op. cit.*, at 216-218.

14. Indeed, CEM state “Flows and returns vary over time and across funds for many reasons, and these reasons could also be important for broker payments. For example, flows, payments, and returns could all be higher for equity funds.” Christoffersen, Evans, and Musto (2013), *op. cit.*, at 216.

15. This example is modeled after the DOL’s prediction that the baseline average load paid by IRA holders will be 164 basis points and the baseline average load share paid to brokers will be 134 basis points in 2017. See DOL Impact Analysis at 113.

16. For ease of exposition, we refer to the load predicted using CEM’s regression model as the average load paid by similar funds. Technically speaking, the proper implementation would be to use CEM’s regression model to fit a predicted load and then to derive the excess load by subtracting the predicted load from the actual load.

basis points assumed by the DOL to only 5.39 basis points—12 basis points times 44.94 divided by 100 equals 5.39. That is, the DOL’s misapplication overestimates the amount of underperformance—and hence, the gains from the proposed amendments—by more than a factor of 11 in this example.

16. Because the DOL applies the 44.94 basis point figure to the total load that goes toward the broker, the DOL’s estimate of the improvement in return performance assumed to follow the implementation of the proposed amendments is dramatically overstated. Moreover, the overstatement in the improvement in return performance is roughly proportional to the estimated dollar amount of purported benefits because the vast majority of the estimated benefits are derived from the assumed improvement in performance.

17. While the actual overstatement of the gains from the proposed amendments would vary from the example above depending on the amount by which a fund’s total broker load payments constitute an *excess* load shared, it is guaranteed that the overstatement is large. This is because an individual fund’s excess loads are defined relative to the total loads of other funds. Thus, only *some* funds can even have *excess* loads, and therefore, only *some* funds can suffer reduced performance as a result of the alleged conflicts of interest. However, the DOL implicitly assumes that *all* front-loads experience excess loads when, as a matter of statistics, as many as *half* of the funds analyzed by CEM may be expected to lack the requisite *excess* load.

18. Separately, the DOL also misapplies the findings of CEM in attributing a 14.5 basis point reduction in investment performance to mutual funds that are sold by captive brokers. (As noted above, the 14.5 basis point figure is used by the DOL as part of the calculation in deriving the critical 44.94 basis point assumption.) While it is true that the point estimate related to captive brokers in CEM’s regression is 14.5 basis points, this point estimate is *not* statistically different

from zero – a finding commented on directly by CEM but ignored by the DOL.<sup>17</sup> That is, CEM’s results indicate that they did not find reliable statistical evidence of underperformance within captive broker front-load funds. The DOL ignores this finding and instead simply assumes that this underperformance exists.

19. Moreover, other evidence in CEM further demonstrates the unreliability of the DOL’s application of the 14.5 basis points. In particular, CEM demonstrate that funds sold by captive brokers do *not* exhibit increased inflows as a result of load sharing arrangements—suggesting the conflicted advice does not play a role in investments recommended by captive brokers. In fact, CEM report that *excess* load payments to captive brokers *reduce* fund inflows.<sup>18</sup> The fact that CEM do not find evidence that *excess* load contribute to captive broker fund inflows is entirely inconsistent with the DOL’s assumption that load-sharing agreements in captive brokered funds incentivize captive brokers to steer customers toward these funds.

## **B. THE DOL IGNORES OTHER FINDINGS FROM THE ACADEMIC LITERATURE**

20. The DOL asserts that other literature is consistent with the CEM results in “direction and magnitude”<sup>19</sup> but this assertion is misleading. For instance, another article cited by the DOL,<sup>20</sup> by Bergstresser, Chalmers, and Tufano (2009) (“BCT”), concludes that while broad U.S. equity and bond funds underperform relative to direct-marketed U.S. equity and bond funds over a particular period of time, there is only *mixed* evidence of underperformance in foreign equity

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17. Christoffersen, Evans, and Musto (2013) *op. cit.*, at 228 (“the coefficient on captive brokerage is not statistically significantly different from zero”).

18. Christoffersen, Evans, and Musto (2013), *op. cit.*, at 220 (Table III).

19. DOL Impact Analysis, at 118.

20. DOL Impact Analysis, at 95.

funds and *no* evidence of underperformance in money market funds.<sup>21</sup> If the results of BCT apply to front-load mutual funds, then a potentially large subset of front-load funds examined by the DOL may not experience the underperformance assumed by the DOL. If so, then once again the DOL has overestimated the prevalence of underperformance even with unaffiliated brokered funds and by doing so, the DOL potentially further overstates the benefits of the proposed amendments.

### **C. THE DOL ASSUMES BENEFITS IT PURPORTS TO ESTIMATE**

21. Notwithstanding the considerations described above, which all render the DOL benefit analysis unreliable and overstated, the *critical* question on the table is not analyzed by the DOL. Namely, would the proposed amendments mitigate or eliminate the underperformance, if any, experienced within front-load mutual funds that share excess loads with brokers? This question is central to the issue at hand given that the vast majority of the purported gains quantified by the DOL relating to front load mutual funds, even in the second scenario, result from an assumption by the DOL that the amendment will increase returns in front-load mutual funds.<sup>22</sup>

22. As noted above, the benefit estimated by the DOL derives from their assumption that the proposed regulatory amendments will mitigate or eliminate underperformance in front-load mutual funds. Importantly, the DOL fails to provide any analysis to demonstrate how the amendments in question will achieve this outcome. Instead, the DOL only suggests that mutual

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21. Bergstresser, Chalmers, and Tufano (2009) “Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry,” *Review of Financial Studies* 4129–4156, at 4138-9 (Table 3) and the discussion at 4140-1.

22. DOL Impact Analysis, at 105 (“Under the second reform scenario, the effect on investment performance constitutes approximately 90 percent of the estimated gain.”) In addition, under certain Alternative Scenarios, the DOL also assumes that IRA investors will experience the additional benefit of paying lower total loads due to the proposed amendments (DOL Impact Analysis, at 105). This claim is entirely unsupported by any reliable analysis. Notwithstanding the lack of support, the DOL assumes includes this secondary benefit in its estimate of \$40 billion to \$44 billion.

funds will in some way be more strongly incentivized to “invest in performance” if advisers’ conflicts of interest are ameliorated.<sup>23</sup> It is unclear what the DOL means by investing in performance, but in any case, the DOL’s impact statement includes no analysis or any reference to other literature demonstrating that funds do not currently attempt to maximize performance, that they could make additional investments that would increase performance materially, or where the money for this additional investment would come from.

23. Moreover, it is unclear whether the DOL believes that this increase in performance would be pervasive throughout the industry, suggesting that even firms that do not underperform today will improve in performance, or whether the increase would be limited to only those funds that currently underperform. In the case of the former, this assumption borders on irrational. If it is the latter, the DOL analysis fails to identify a reasonable mechanism by which current underperforming funds will be disciplined to improve performance. While one potential form of discipline could come from a shift in financial advisers’ tendencies to recommend underperforming funds, this disciplining mechanism can only work if (1) IRA investors consult with financial representatives, (2) these representatives advise them to reallocate their investments, and (3) the investors follow that advice. However, the DOL has provided no study documenting the frequency with which investors consult with financial professionals or the frequency with which those professionals provide guidance that is followed.

24. Moreover, and perhaps most importantly, none of the literature cited by the DOL claims that the proposed amendments or any similar policy would lead to higher investment returns. Simply stated, the literature cited by the DOL does not support its speculative conclusions.

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23. DOL Impact Analysis, at 115.

## **D. TAKE-AWAY ON THE DOL'S PURPORTED BENEFIT ANALYSIS**

25. Overall, the DOL's purported benefit analysis suffers several flaws: it misapplies findings from the academic literature used to substantiate its claims; it ignores findings in the literature indicating underperformance may not be as widespread as suggested by the DOL; and it assumes the benefits it purports to estimate. Each of these flaws is critical and leads to the conclusion that the DOL's benefit analysis is unreliable and overstates the benefits purported to be measured. Perhaps telling of overstatement, the DOL also repeatedly speculates that a substantial portion of these gains, such as 75 percent or 50 percent, will be realized.<sup>24</sup> To date, the DOL has not provided any analysis to rule out the possibility that none of the gains it envisions will actually be realized.<sup>25</sup>

## **III. THE DOL'S ANALYSIS OF PURPORTED COSTS IS LIKELY UNDERSTATED AND UNRELIABLE**

26. The DOL's \$2.4 billion to \$5.7 billion estimate of purported compliance costs is most likely understated and fatally flawed for at least three reasons:

- The DOL only estimates the most direct and obvious costs, while improperly dismissing other costs likely to be incurred by market participants, including the government.
- The DOL improperly dismisses costs likely to be incurred due to unintended consequences.
- The DOL routinely relies on assertions about potential cost levels when reliable data analysis is required.

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24. DOL Impact Analysis, at 8, 101-2, 106, & 216.

25. As noted previously, our concerns about the reliability of the DOL's analysis showing \$40 to \$44 billion also apply to the DOL's presented in Table 3.4.4-1 and Table 3.4.4-2.

## **A. THE DOL TOO READILY DISMISSES COSTS LIKELY TO BE INCURRED BY MARKET PARTICIPANTS, INCLUDING THE DOL ITSELF**

27. The DOL estimates costs of the proposed amendments in four specific categories: “Firm Costs,” “E&O Insurance,” “Switching/Training Costs,” and “Additional PTE/Exception Costs.”<sup>26</sup> According to the DOL, the total cost of compliance with the proposed amendments over 10 years in these four categories is expected to be between \$2.4 billion and \$5.7 billion, a range which reflects two different scenarios regarding “Firm Costs” and two different assumed discount rates over the 10 year period.<sup>27</sup> However, the DOL dismisses or completely ignores the likelihood of unintended consequences from the proposed amendments that are likely to be incurred by market participants that could substantially increase costs.

28. In describing its cost estimates, the DOL repeatedly suggests that the estimates are likely to overstate the actual costs of the proposed amendments, but only rarely mentions any reasons why its estimates might understate the actual costs of the proposed amendments.<sup>28</sup> Importantly,

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26. DOL Impact Analysis, at 178.

27. DOL Impact Analysis, at 178.

28. See, e.g., DOL Impact Analysis, at 157-8 (“The Department believes the higher end of the estimated cost range represents an over-estimate, because it implicitly assumes that existing business models will change only as necessary to come into compliance, and will retain their existing market shares, when in fact new, more cost-effective business models are already gaining market share, and the new proposal is likely to encourage such market improvements ... The lower end of the estimated range incorporates lower available bases, but should not be interpreted as a lower bound because it likewise neglects such ongoing market improvements and the new proposal’s positive effects thereon”); DOL Impact Analysis, at 164 (“Scenario A likely overstates the costs of the proposed regulations and exemptions by a substantial margin. Scenario B is a more reasonable estimate, but probably also overstates the costs because of the flexible standards-based approach of the Department’s new proposal, which would enable firms to comply in the most cost-effective way in light of their current practices and systems”); DOL Impact Analysis, at 166 (“As discussed above even these estimates are believed to be overestimates, possibly by a large margin”); DOL Impact Analysis, at 165 (“[U]sing the IAA ration could lead to an over-estimate of small firms costs, particularly for start-up costs”); DOL Impact Analysis, at 167 (“Subsequent year costs could be even lower as firms already conduct training of their staff”); DOL Impact Analysis, at 174 (“[S]ome of these costs would be offset by firms and individuals that would no longer be required to register as BDs or their representatives”); DOL Impact Analysis, at 215 (“Much of the estimated compliance cost is associated with satisfaction of PTE conditions. The number of advisers who will take advantage of the relevant PTEs is uncertain, however. Some advisers may find it more advantageous to simply avoid PTs. The Department has aimed to err on the side of overestimating the compliance costs”).



the DOL repeatedly dismisses other potential categories of costs likely to be incurred by firms and employees in the industry, including those associated with call centers,<sup>29</sup> creating or updating contracts,<sup>30</sup> and search and training for advisers left unemployed.<sup>31</sup> The DOL also dismisses any costs imposed on financial product providers<sup>32</sup> and costs paid by the government to implement and enforce the proposed regulations.<sup>33</sup>

## **B. THE DOL IMPROPERLY DISMISSES COSTS RELATED TO OTHER UNINTENDED CONSEQUENCES**

29. In contrast with the DOL’s assumption of no costs for the proposed amendments beyond those that are immediate and obvious, the academic literature on regulation demonstrates that well-meaning regulations very frequently have important unintended consequences that lead to additional costs (and/or reduced benefits) relative to what was expected.<sup>34</sup> Unintended consequences are even more likely—and potentially more costly—in the case of financial regulation because financial markets serve as an important conduit for the efficient allocation of resources throughout the economy, and therefore touch many other markets. As one study noted, “The history of U.S. financial regulation, in many respects, is a history of unanticipated

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29. DOL Impact Analysis, at 175.

30. DOL Impact Analysis, at 176.

31. DOL Impact Analysis, at 176, 227

32. DOL Impact Analysis, at 176-7.

33. DOL Impact Analysis, at 215.

34. Some famous examples of unintended consequences leading to additional costs in the literature include: Richard A. Posner (1974) “The Social Costs of Monopoly and Regulation,” *Journal of Political Economy* 83(4):807-27; Sam Peltzman (1975) “The Effects of Automobile Safety Regulation,” *Journal of Political Economy* 83(4):677-726; Robert W. Crandall and John D. Graham (1989) “The Effect of Fuel Economy Standards on Automobile Safety,” *Journal of Law & Economics* 32(1):97-118; and John DiNardo and Thomas Lemieux (2001) “Alcohol, Marijuana, and American Youth: The Unintended Consequences of Government Regulation,” *Journal of Health Economics* 20(6):991-1010.

consequences.”<sup>35</sup> In this case, the proposed amendments would impact the provisioning of IRAs, which the DOL projects would involve approximately \$9 trillion in individual savings.<sup>36</sup>

30. An important category of potential unintended consequences for any regulation that imposes costs on firms (as the DOL admits the proposed amendments do) is higher prices charged to consumers by these firms and the reduced purchasing. Basic economics indicates that any regulation that increases an industry’s costs of serving consumers will lead to higher prices and lower output.<sup>37</sup>

31. All else equal, economic theory predicts that fees charged to investors will rise when additional costs are imposed on firms in the industry for at least two reasons. First, the costs imposed on advisers and advisory firms operating in the industry will be passed on (at least in part) to investors in the form of higher fees.<sup>38</sup> Moreover, higher costs can cause firms to exit the industry or to exit certain segments of the industry, leading to a weakening of the competition that otherwise would drive down fees. As a result, investors facing higher fees would, in turn, likely invest less, or alternatively select other forms of investment that do not have these higher costs and potentially are less tax advantaged.

32. For example, we understand that participants in this rulemaking have indicated that the proposed regulatory amendments will cause certain firms within the industry to significantly curtail their efforts to attract IRA investors with balances below \$25,000. If so, then there would be less competition in the industry for investors that wish to start a new IRA or roll-over another retirement account with a balance below \$25,000. In this instance, fees to these customers may

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35. Charles K. Whitehead (2012) “The Goldilocks Approach: Financial Risk and Staged Regulation,” *Cornell Law Review* 97:1267-1308, at 1268.

36. DOL Impact Analysis, at 115 (citing Cerulli Associates, “Retirement Markets 2014.”)

37. Hal R. Varian (2014) *Intermediate Microeconomics*, 9<sup>th</sup> ed., W. W. Norton & Co., at 438-9.

38. Jeremy I. Bulow and Paul Pfleiderer (1983) “A Note on the Effect of Cost Changes on Prices,” *Journal of Political Economy* 91(1):182-5.

increase. Moreover, the reduction in client service could result in a reduction in the amount of money that today's consumers save in tax deferred IRA accounts. As noted in a separate Compass Lexecon comment, investors that are forced to abandon IRAs as saving vehicles may face an effective tax increase of 32.9 percent or more.<sup>39</sup> But more generally, given the size of total IRA investments in the U.S., even a small reduction in the total amount of IRA investment as a consequence of higher fees has the potential to generate costs to investors that would dwarf the DOL's estimates of the benefits of the proposed amendments.<sup>40</sup>

33. The DOL only briefly addresses these potentially enormous costs associated with lost savings. First, the DOL speculates that new, competitive advisory businesses may enter the industry due to the proposed amendments, thus eliminating any lost savings.<sup>41</sup> However, this claim is inconsistent with commonly accepted economic theory, which teaches that increased costs can create barriers to entry that reduce, not increase, entry by potential competitors.<sup>42</sup> In this context, the proposed amendments would, as the DOL admits, impose additional costs on firms. Larger firms may be able to achieve profitability even with these new costs because of their scale of operations. However, smaller firms may be more likely to struggle, and hence, more likely to exit the industry. At the same time, new entrants are typically smaller firms, and the increased costs imposed by the proposed amendments similarly affect their incentives to

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39. Compass Lexecon (2015) "Comment to the Department of Labor on a Proposed Rule Regarding Investment Adviser Fiduciary Status: Tax Consequences to IRA Investors," July 20, 2015 at 2.

40. Even assets that remained in 401(k)s or other company plans as a consequence of higher IRA adviser fees could reflect losses due to the proposed amendments, since academic literature indicates these accounts are often highly undiversified, whereas IRAs allow a broader range of investments, leading to greater diversification benefits. Schlomo Benartzi (2001) "Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock," *Journal of Finance* 56(5):1747-64.

41. DOL Impact Analysis, at 222 & 228.

42. Dennis W. Carlton and Jeffrey M. Perloff (2005) *Modern Industrial Organization*, 4<sup>th</sup> ed., Pearson Addison-Wesley, at 79-80.

enter the industry. These effects reduce competition, to the detriment of the IRA investors the DOL seeks to protect.<sup>43</sup>

34. The DOL also suggests that any reduction in investment due to the costs imposed by the proposed amendments might be offset by increased investment due to greater investor trust in fiduciary advisers.<sup>44</sup> This claim seems to reflect a notion that, while the proposed regulations will reduce the supply of advice, they will also increase the demand for advice from investors who recognize the better value provided by unconflicted advisers. Such a notion is at least ironic, given that the entire rationale for the proposed amendments is that investors are currently subject to “abuse” by apparently being *too reliant* on conflicted advice.<sup>45</sup> That is, the DOL argues the regulation is needed because investors are too reliant on their financial advisers, but at the same time, the regulation would increase that reliance, driving investors to demand even more advice.

35. Moreover, the DOL claims that “retail investors generally and IRA owners in particular ... cannot effectively assess the quality of the investment advice they receive or even the investment results they achieve ... Individuals over the age of 55 often ‘lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees.’”<sup>46</sup> However, the DOL fails to explain why the same unsophisticated investors the DOL

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43. The DOL describes at length its view that so-called “robo-advisers” will, over time, gain market share from traditional advisory firms. The DOL notes that robo-advisers have lower costs and, at least to date, offer largely unconflicted advice. DOL Impact Analysis, at 230-1. The DOL speculates that, absent the proposed amendments, robo-advisers may become conflicted through competition with traditional advisory firms, which it claims provide more conflicted advice. *Id.*, at 232. The DOL does not explain why the growth of these allegedly unconflicted robo-advisers does not demonstrate that market forces in the current regulatory environment serve to ameliorate conflicts of interest. Nor does the DOL explain its view that increased competition between firms in the future will reduce market efficiency, when the standard presumption in economics is that increased competition increases efficiency.

44. DOL Impact Analysis, at 222 & 228.

45. DOL Impact Analysis, at 59.

46. DOL Impact Analysis, at 59-60.

describes would nevertheless understand the implications of a complex new regulation regarding fiduciary status, and as a consequence, seek to invest more with their advisers.

36. More generally, the DOL fails to fully consider outcomes that have occurred to date from regulation with similar aims to the proposed amendments, such as the Retail Distribution Review (“RDR”), which was implemented in 2013 in the United Kingdom.<sup>47</sup> While there are a number of differences between RDR and the proposed amendments, the available evidence to date appears to indicate higher investment fees as a consequence of RDR and mixed results regarding the number of advisers and regarding investors’ access to advice.<sup>48</sup>

37. In addition to the potential consequences associated with increased consumer fees and the potential for reduced savings in tax-preferred IRAs, the DOL also does not consider at all a wide range of other potential costs. For instance, the DOL has not fully assessed the likely changes in the structure of payments to advisers, claiming only that an arbitrary number may switch to asset-based fee structures.<sup>49</sup> In some instances, a move to asset-based fee structures could lead require investors to pay the same or more in fees as the amount of money they purported save from avoiding underperformance.

38. Moreover, the proposed regulatory amendments may change the type of advice offered by advisers. For example, risk-averse financial advisers may attempt to avoid any potential liability now imposed under the fiduciary regime by only recommending lower cost and less risky securities to investors. After all, financial advisers and their employers may bear more

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47. <http://www.fca.org.uk/firms/being-regulated/retail-investments/faqs> [accessed July 16, 2015]

48. A study commissioned by the Financial Conduct Authority, the regulatory body that developed RDR and enforces it, stated “The evidence currently available implies adviser charges have increased post-RDR, at least for some consumers,” and “Some firms are segmenting their client books and focusing on wealthier customers,” although the study found that this segmenting effect appears to have been relatively small to date. Europe Economics (2014) “Retail Distribution Review Post Implementation Review,” December 16, 2014, at 64 & 66. Similarly, see (stating that “Although the number of advisers has fallen, revenue from regulated businesses for financial advice firms has remained steady, at around £3.8 billion per annum, for the period from 2011 through to 2013.”) Association of Professional Financial Advisers (2014) “The Advice Market Post RDR Review,” June, at 4.

49. DOL Impact Analysis, at 173-4.

downside risk as a result of litigation (justified or unjustified) under the proposed regulatory change. This shift in the type of investment advice may further reduce investors' overall savings by lowering the returns earned on dollars saved because less risky securities tend to provide lower overall returns relative to more risky securities. For example, bonds provide lower expected returns than do equity.

39. Economic theory predicts that financial product providers who currently rely on load-sharing and other arrangements with advisers may also be affected. While the DOL speculates that these firms will “invest” to generate higher returns, these providers may not be able to generate higher returns and may be forced to spend additional funds in marketing to maintain their profitability. These other means may be equally or more costly than the current arrangements with advisers, and may raise other consumer protection issues.<sup>50</sup> In any case, those costs would likely be passed on, at least in part, to investors through higher fees.

40. Similarly, financial product providers that currently rely on load-sharing and other arrangements to sell their products may not be able to reach economies of scale using alternative distribution mechanisms, and as a consequence, may exit the market. If mutual funds or other financial product providers exit the market, IRA investors may not have as many choices, which could lead to suboptimal investment allocations.

41. Finally, academic literature on regulation also indicates that consumer-protection measures like the proposed amendments may lull consumers into a false sense of security by the

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50. Available evidence indicates that mutual fund advertising is effective in driving fund flows, but does not signal superior fund performance. Prem C. Jain and Joanna Shuang Wu (2000) “Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows,” *Journal of Finance* 60(2):937-58. Hence, whatever gains investors experienced as a consequence of mitigating adviser conflicts of interest could be lost through the effects of increased advertising.

notion that government regulators are watching over them.<sup>51</sup> As a consequence, they face incentives to be less careful, thus offsetting in full or in part whatever benefits the regulators may provide. In the context of the proposed amendments, investors may feel they do not need to be as careful with their retirement savings because the government is forcing their advisers to be more careful.

42. We do not hold a view that all of these costs are necessarily likely outcomes of the proposed amendments. Our discussion is only meant to highlight that regulations like the proposed amendments often create additional costs due to unintended consequences, and the DOL's estimates of costs have not substantively addressed the potential for such additional costs.

### **C. THE DOL'S COST ANALYSIS IS FLAWED IN OTHER WAYS THAT RENDER IT UNRELIABLE.**

43. Even putting aside the failure to appropriately consider potential increased costs due to unintended consequences of the proposed amendments, the DOL's analysis of costs also suffers from other limitations that further render it unreliable. First, the DOL repeatedly relies upon unsupported assumptions. For instance, in analyzing the impact of the proposed amendments on advisers' insurance premiums, the DOL assumed a 10 percent increase due to advisers' new fiduciary status.<sup>52</sup> No basis is provided for this critical assumption, even while available evidence indicates that fiduciary status in other contexts has had large effects on the likelihood of

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51. See, similarly, W. Kip Viscusi (1984) "The Lulling Effect: The Impact of Child-Resistant Packaging on Aspirin and Analgesic Ingestions," *American Economic Review* 74(2):324-7.

52. DOL Impact Analysis, at 171.

litigation,<sup>53</sup> and litigation risk in the financial sector has been shown to have material impacts on insurance premiums.<sup>54</sup>

44. The DOL also assumes without basis that rising insurance premiums are the only relevant litigation costs generated by the proposed amendments. The DOL ignores the full cost of litigation necessary to enforce regulations, including attorneys' fees (both plaintiffs' and defendants'), court costs, and opportunity costs for legal resources which otherwise could be employed in other types of cases.

45. While it may be appropriate to rely on assumptions in an economic analysis in certain cases, those assumptions must have at least some justification or basis in order for the analysis to be reliable. As a group of prominent economists stated in evincing principles of cost-benefit analysis, "Quantification of benefits and costs is useful, even where there are large uncertainties ... If the decision maker wishes to introduce a 'margin of safety' into his decision, he should do so explicitly. Assumptions should be stated clearly rather than hidden within the analysis."<sup>55</sup>

46. Separately, the DOL's cost analysis also fails to consider the consequences of the proposed amendments for population subgroups. A careful cost-benefit analysis should analyze not only the total costs of the regulation at issue, but also who ultimately pays those costs, and whether such outcomes are equitable. As a prominent group of economists establishing principles for cost-benefit analysis of regulations stated, "A good benefit-cost analysis will identify important distributional consequences of a policy."<sup>56</sup>

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53. See, e.g., Erik J. Olson (2012) "Shareholder Class Litigation Arising from Mergers and Acquisitions," Association for Corporate Counsel ("Corporate directors are fiduciaries entrusted with the power and responsibility to supervise a corporation's business affairs and obligated to act in the best interests of the corporation and its shareholders ... With rare exceptions, shareholder plaintiffs base their claims on alleged violations of these fiduciary duties.")

54. John E. Core (2000) "The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance," *Journal of Law, Economics, & Organization* 16(2):449-77.

55. Arrow, et al. (1996) *op. cit.*, at 8.

56. Arrow, et al. (1996), *op. cit.*, at 6.



47. For instance, the DOL estimates direct costs to advisory firms and certain employees who may require additional licensure. But the DOL never considers the ultimate incidence of these costs and their implications for different groups of stakeholders or for social equity. As noted above, costs ostensibly imposed on firms will typically be passed on (at least in part) to consumers. Given the DOL's concerns regarding protection of vulnerable groups of investors, the consequences of such an outcome for specific groups of investors would seem highly important. It is very commonly the case that costs imposed by the government on one group are ultimately borne by other industry participants, and economists have developed standard approaches to estimating this "incidence" of government policy.<sup>57</sup> However, the DOL fails to apply these approaches.

#### **IV. CONCLUSION**

48. Though lengthy, the DOL's "Regulatory Impact Analysis" provides no reliable estimates of the costs and benefits of the proposed amendments, and as a consequence, does not justify the costs likely to be incurred by market participants (including IRA investors). Among other limitations in the DOL's benefits analysis, it improperly applies the results of the academic literature upon which it relies and, as a consequence, likely grossly overstates the benefits of the proposed amendments. The DOL's cost estimate is reminiscent of the old joke about the drunkard who looks for his lost keys under the streetlamp because that's where the light is. The DOL only attempts to quantify the most obvious and direct costs of the proposed amendments, while dismissing or overlooking a wide range of potential unintended consequences that could dramatically increase the costs. The history of regulation provides strong reason to be skeptical

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57. See, e.g., Don Fullerton and Gilbert E. Metcalf (2002) "Tax Incidence," in *Handbook of Public Economics* 4:1787-1872.

of the DOL's assumption that the proposed amendments would have no costly unintended consequences.

## **APPENDIX**

Compass Lexecon is an economic consulting firm that specializes in the application of economics to a variety of legal and regulatory issues. Compass Lexecon has a professional staff of more than 325 individuals and fourteen offices throughout the United States, Europe and South America. Compass Lexecon also maintains affiliations with leading academics including several Nobel Prize winners in Economics.

Lexecon, Compass Lexecon's predecessor firm, was founded in 1977 by, among others, then Professor (now Judge) Richard A. Posner of the Seventh Circuit Court of Appeals. Compass Lexecon was formed in January 2008 through the combination of Lexecon with Competition Policy Associates, another premier economic consulting firm. Compass Lexecon is a wholly owned subsidiary of FTI Consulting, Inc., a global business advisory firm. Professor Daniel R. Fischel currently serves as Compass Lexecon's Chairman and President.

Compass Lexecon's practice areas include antitrust, securities and financial markets, intellectual property, accounting, valuation and financial analysis, pension economics and policy, corporate governance, bankruptcy and financial distress, derivatives and structured finance, class certifications and employment matters, damages calculations, business consulting, regulatory investigations and public policy.

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