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Introduction

We have been asked by four major trade associations¹ to review four new studies—some of which were prepared for the Department of Labor (“Department”)—that were recently added to the record in this proceeding.² Before commenting on the studies, it is important to emphasize that in our opinion, the Department performed a lengthy (and unduly optimistic) assessment in its Regulatory Impact Analysis (“RIA”) of the purported *benefits* of its proposed Fiduciary Rule (the “Rule”), but failed to meaningfully address the *cost* side of the equation.

The perceived benefits of the Rule take the form of increasing net returns to investors by removing the alleged conflict of interest, whereas the costs take the form of depriving investors of certain benefits provided by human brokers. Any new study that bolsters the Department’s claimed 25-basis-point benefits from the Rule is not significant in our view, because the RIA is most vulnerable, in our opinions, in its estimate of the costs of the Rule (effectively zero basis points).

With this framework in mind, there is no need to critically evaluate the findings of two of the four new studies. One study by Panis seeks to defend the empiricism of the White House Report on conflicted advice, which was criticized by NERA.³ As noted in our original report, the Department’s analysis *does not rely* on the White House’s Report to bolster its 25-basis-point estimated annual benefits from the Rule. The nexus between the White House’s Report and the RIA is the subject of much confusion in the financial press. The White House Report estimated

1. The trade associations are Chamber of Commerce, Financial Services Institute (FSI), Financial Services Roundtable (FSR), and Securities Industry and Financial Markets Association (SIFMA).

2. Constantijn Panis, Comments on a Review of a White House Report on Conflicted Investment Advice [hereafter *White House Report*]; Jeremy Burke & Angela Hung, Financial Advice Markets: A Cross Country Comparison [hereafter *Cross Country Comparison*]; Angela Hung, Min Gong & Jeremy Burke, Effective Disclosures in Financial Decisionmaking [*Effective Disclosures*]; Jeremy Burke & Angela Hung, Do Financial Advisers Influence Savings Behavior? [*Financial Advisers*].

3. *White House Report*.

that conflicted advice is costing U.S. investors nearly 100 basis points in under-performance per year; unlike the Department, the White House did not estimate the magnitude of the benefits that could be generated by the Rule. No policy intervention can eradicate the allegedly conflicted advice overnight, some policies will reduce costs more effectively than others, and still other policies will impose fewer costs for a given level of benefits.

These topics—the maximum potential benefit of an idealized intervention and the actual benefit associated with the Department’s proposed Rule—are two different issues, particularly when (1) the source of the alleged conflicted advice (load shares paid to brokers) is naturally declining over time,⁴ and (2) it will take time for the allegedly contaminated investments to work themselves out of the pipeline. Interestingly, the Panis study admits that NERA “puts forward a few valid arguments—in particular that the White House report *undervalues benefits from adviser services*.”⁵ Panis agrees with NERA that “while the White House Report acknowledges such potential benefits [from advisers], it does not quantify them and does not account for benefits in its headline results.”⁶ Panis acknowledges that “brokers’ advice may benefit investors by nudging them to think about their needs in retirement; helping them to select a portfolio; bringing awareness of investment strategies; raising issues related to taxes, college savings, and estate planning; et cetera.”⁷ He echoes the conclusion of another academic that “exploring the importance of these benefits is an important topic for future work.”⁸ This assessment is consistent with our contention that the Department failed to perform a rigorous analysis of the costs of its Rule.

Another study not worthy of critical review is the cross-country regulation comparison by Burke and Hung.⁹ (Not to confuse matters, a separate paper by the same authors is reviewed in detail here.) This study seeks to review the impact of similar interventions (as contemplated by the Department) throughout the rest of the world. As Burke and Hung acknowledge, however, the results of these interventions are decidedly mixed. For example, the study finds that the UK regulator’s Retail Distribution Review (RDR)—which among other things imposed mandatory disclosure requirements, banned commissions, increased minimum qualification levels for brokers—decreased the amount of funds flowing into high-charging share classes, but at the same time *may have increased the cost of financial advice*.¹⁰ In particular, Burke and Hung acknowledge “suggestive evidence” that some investors now pay 0.5 percent to 1 percent in ongoing charges compared to pre-RDR trail commissions typically in the range of 0.5 percent to 0.75 percent.¹¹ The authors also acknowledge that “in some cases lower-wealth clients may now find it more difficult to receive advice.”¹² Thus, this study supports our contention that there are

4. Department of Labor, *Fiduciary Investment Advice: Regulatory Impact Analysis*, Apr. 14, 2015, at 116, Table 3.4.1-1, available at <http://www.dol.gov/ebsa/pdf/conflictsofinterestria.pdf> (estimating a “baseline” broker load share, which begins at 134 basis points in 2017 and falls to 101 basis points in 2027).

5. *White House Report* at i.

6. *Id.* at 2.

7. *Id.* at 4.

8. *Id.* at 5.

9. *Cross Country Comparison*.

10. *Id.* at 38.

11. *Id.*

12. *Id.*

likely significant costs associated with the Rule, and that by not quantifying these costs, the Department has not performed a proper cost-benefit analysis.

Because the two remaining studies appear on the surface to bolster the Department's weakness with respect to estimating the costs of the Rule—in both absolute terms and relative to a less restrictive alternative—we review those studies in more detail here. The Hung, Gong and Burke study is a literature review of the efficacy of disclosure rules regarding conflicts of interests and other disclosures in financial industries.¹³ It concludes that disclosure, particularly used in isolation, may not provide sufficient support in helping investors make more informed decisions. In contrast, the authors conclude that disclosure used in conjunction with other tools is deemed to be more effective. This study is material because, if its findings were reliable, they would undermine our proposal to use heightened disclosure rules in the first instance to address the allegedly conflicted advice; but the authors readily concede that they rely largely on purely theoretical analysis and experimental evidence from stylized roleplaying experiments.

The other study worthy of a critical review is by Burke and Hung.¹⁴ This study is a literature review of the influence of financial advisers on their clients' behavior. The authors conclude that, when assessing the benefits of financial advice in terms of higher savings rates, most articles fail to control for what economists call the “endogeneity” problem—that is, clients with a propensity to save more might have a greater propensity to seek out financial advice; failing to account for this aspect could allow one to confuse the causal relation at work. According to the authors, the one study that controls for endogeneity finds that the presence of an adviser is not associated with increased savings by investors. Again, if this finding were reliable, it would undermine our contention that, by neglecting to measure the benefits of human advisers, the Department has embraced a Rule that likely imposes net costs on society; but the study recognizes that financial advisers provide value to their clients, even after controlling for selection.

In fact, as we document below, neither of these new studies contradicts our central conclusion: that simplified, improved disclosure is warranted before imposing the Department's costly fiduciary proposal.

Hung, Gong & Burke: Effective Disclosures in Financial Decisionmaking

Hung, Gong and Burke (HGB) readily concede that, in reaching their conclusions on the efficacy of disclosure rules, they rely largely on purely theoretical analysis and experimental evidence from stylized roleplaying experiments, including various papers by Lowenstein, Sah, and Cain, which were already addressed in our prior report.¹⁵ As explained in our original report, even if one were to take the conclusions of this literature at face value, they are far less supportive of the Department's position than the RIA would suggest: The researchers cited by the Department and HGB emphasize the “enormous opportunities for designing policies that will

13. *Effective Disclosures*.

14. *Financial Advisers*.

15. Robert Litan & Hal Singer, Good Intentions Gone Wrong: The Yet-To-Be-Recognized Costs of the Department Of Labor's Proposed Fiduciary Rule (July 2015) [*Litan & Singer*], at 25-27.

enhance [the benefits of disclosure],”¹⁶ and even make concrete recommendations for enhancing the effectiveness of disclosure that are consistent with our own.¹⁷

Moreover, the “evidence” reviewed in HGB’s literature review is not derived from market-based economic activity in any real-world industry, and therefore offers zero real-world empirical support for the authors’ theories and hypotheses.¹⁸ HGB effectively concede as much with a disclosure of their own:

We would like to include a word of caution on the results reported here. The majority of existing research reviewed is based on *either theoretical modeling or controlled experiment results*. *The external validity of the conclusions drawn from this research is an open question*. For example, the monetary incentive, the cognitive load, and the decision environment are very different when people are estimating the value of a jar of coins as opposed to when they are making a financial decision regarding retirement.¹⁹

It bears noting that we are not opposed to relying on experimental studies to inform economic decisionmaking. The question we raise here is whether the Department should rely *entirely* on experimental studies when considering a proposal that would upend a large segment of the financial services industry.

HGB also rely upon a study by Chater, Huck, and Inderst, which was not rebutted in our prior report.²⁰ Yet as HGB concede, this study found “a significant impact of disclosing adviser incentives.”²¹ Specifically, “laboratory subjects exhibited a strong reaction to the disclosure of biased incentives, showing evident mistrust of advice.”²² Chater et. al. conclude that “[f]ull and transparent disclosure or a ‘health warning’ may be necessary for people to understand the implications of a conflict of interest.”²³ This finding clearly contradicts the Department’s assertion that even simple, clear, and direct disclosure would be ineffective, or even harmful.

HGB also cite to two experimental studies (a 2006 study by Pearson et. al., and a 2012 study by Green and Armstrong), to support their claim that “disclosure of conflicts of interest may cause the unintended consequence of adherence to biased advice.”²⁴ Neither study involves financial services. And both rely entirely upon survey responses to ascertain the purported effect of disclosure on respondents’ perceptions. Like the rest of the experimental literature cited by HGB, they offer no empirical support grounded in anything resembling realistic, market-based activity.

The Green and Armstrong study examined the effect of government-mandated disclosures involving the credentials of dentists advertising implant dentistry, and found that

16. *Id.* at 25.

17. *Id.* at 27.

18. *Id.*

19. *Effective Disclosures* at 9.

20. Nick Chater, Steffen Huck, and Roman Inderst, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, Final Report for the European Commission (November 2010) [*Chater et. al.*]

21. *Effective Disclosures* at 8.

22. *Chater et. al.* at 9.

23. *Id.*

24. *Effective Disclosures* at 7.

participants exposed to the disclaimer were more likely to recommend a dentist lacking credentials.²⁵ These results were derived through interviews with Floridians in a shopping mall who were shown fake advertisements for dental-implant services, and then asked which dentist they would (hypothetically) recommend to others.²⁶ Yet the authors' conclusions do *not* support HGB's position that disclosure should be "used in conjunction with other policy tools."²⁷ Instead, Green and Armstrong advance the extreme position that *all* mandatory disclosures—indeed, *all* restrictions on "commercial speech," up to and presumably including warning labels on cigarettes and prescription medications—should be abolished.²⁸

The Pearson study examined the effect of physician disclosure of financial incentives to patients by sending letters with disclosures to patients of two multispecialty group practices, and then following up with surveys to gauge the effect of disclosure on patient perceptions.²⁹ The authors found that disclosure tended to increase patients' reported trust in and loyalty to their physician group, and also that "[d]isclosure patients were significantly more able to identify correctly the compensation model of their primary care physician."³⁰ The authors conclude that "[t]his study suggests that regulators, policy makers, and physician groups themselves should renew their consideration of disclosure as an instrument to advance the best interests of patients and physicians."³¹ Therefore, the Pearson study fails to support the Department's blanket refusal to consider disclosure as a less-restrictive alternative.

Finally, it bears emphasis that HGB also acknowledge the value of commission-based compensation for financial advisors.

[W]hen an adviser faces complex and specialized products, and effort is required to acquire information on which products suit the consumer's needs best, commission is an incentive to encourage the adviser to expend more effort to identify suitable products for the consumer.³²

This assessment is consistent with our prior assessment that commission-based compensation creates incentives for brokers to offer beneficial advice to investors, including preventing investors from selling funds after a market downturn.³³

Burke & Hung: Do Financial Advisers Influence Savings Behavior?

25. Kesten Green & J. Scott Armstrong, *Evidence on the Effects of Mandatory Disclaimers in Advertising* 31(2) J. PUBLIC POL'Y & MARKETING (Fall 2012) 293-304, available at https://archive.ama.org/archive/AboutAMA/Pages/AMA%20Publications/AMA%20Journals/Journal%20of%20Public%20Policy%20Marketing/TOCS/SUM_2012.2/evidence-effects-mandatory-disclaimers.aspx.

26. *Id.*

27. *Effective Disclosures* at 24.

28. *Green and Armstrong, supra*, Executive Summary.

29. Steven Pearson, Ken Kleinman, Donna Rusinak, & Wendy Levinson, *A Trial Of Disclosing Physicians' Financial Incentives To Patients*, 166(6) ARCHIVES OF INTERNAL MEDICINE 623–628 (2006), available at <http://archinte.jamanetwork.com/article.aspx?articleid=410044>.

30. *Id.*

31. *Id.*

32. *Effective Disclosures* at 5.

33. *Litan & Singer* at 17.

Burke and Hung (BH) recognize that financial advisers provide significant value to their clients. For example, they note at the onset that “[f]inancial advisers can play an important role by helping individuals make better financial decisions and improving their financial situations.”³⁴ They cite a survey by the Investment Company Institute showing that 71 percent of respondents with an ongoing advisory relationship indicated that ensuring that they are saving enough to meet their financial goals was a “major reason” for consulting an adviser.³⁵ In reviewing a study by Hudson and Palmer (2014), BH acknowledge that “the results are *suggestive* of the possibility that formal advisers can improve financial behavior, at least among low-income populations.”³⁶ Similarly, in reviewing a study by Martin and Finke (2014), BH acknowledge that “the results are *consistent with* the theory that financial advisers who provide comprehensive retirement-planning services help their clients improve retirement savings.”³⁷ And they admit that the line of research in studies by Salter, Harness and Chatterjee (2010), Byrne (2007), Clark, Knox-Hayes and Strauss (2009), Smith and Griesdorn (2014), Cho et al. (2012), and Finke, Huston and Waller (2009) “tends to find a positive relationship between the use of a financial adviser and the propensity to plan.”³⁸ BH also review the extensive literature highlighting other (non-pecuniary) investor benefits to professional financial advice, including “retirement confidence, satisfaction with financial situation, and perceptions of progress on financial goals.”³⁹

Yet BH claim that the Martin-Finke and Hudson-Palmer studies, and others like it, cannot rule out the possibility that those who accumulate more in retirement savings are more likely to seek out financial planning services. If true, then the benefits of advisers might be overstated. To support this alternative causal explanation of the observed correlation between the presence of financial advisers and superior financial outcomes, BH offer several findings in the literature indicating those who receive financial advice tend to be wealthier, more educated, older, more financially literate, and tend to have higher income.⁴⁰ For example, a study by Jacobs-Lawson and Hershey (2005) show that demographic factors and individual characteristics such as “future orientation and risk tolerance” influence retirement saving.⁴¹ They correctly note that these savings-oriented individuals have more to gain in improved asset allocation, tax efficiency, and wealth preservation than the average saver. As with the case of testing the impact of private or parochial schools on SATs, this self-selection makes it harder to attribute their superior financial outcomes to the “treatment” of an adviser; some of the improved financial well-being may have occurred in the absence of an adviser.

But as BH themselves recognize, even some of these self-selected individuals have the potential to improve their financial well-being with a financial adviser. For example, BH cite a study by Bernhein (2006), which shows that even though volunteers for a financial-planning program tended to be wealthier than the general American population, “30 percent of married households and 38 percent of single individuals who used the software were undersaving,

34. *Financial Advisers* at 1.

35. *Id.*

36. *Id.* at 6 (emphasis added).

37. *Id.* at 5-6 (emphasis added).

38. *Id.* at 6-8.

39. *Id.* at 9-11.

40. *Id.* at 3.

41. *Id.* at 12.

relative to their recommended levels.”⁴² BH also show that more-educated and wealthier clients are more likely to make trades based on advice from a financial adviser (citing Hoehle et al (2014)), and to incorporate that advice into their savings decisions (citing Bhattacharya (2012)).⁴³ This implies that not only do these self-selected individuals have the potential to improve, but they also have the tools to operationalize the best practices as relayed by advisers.

One study by Marsden, Zick and Mayer (2011) that attempted to control for endogeneity found mixed results in investor outcomes. According to BH’s review, this study found, “*after attempting to control for endogeneity,*” that “meeting with a financial adviser is associated with setting long-term goals, calculating retirement needs, retirement account diversification, use of supplemental retirement accounts, retirement confidence, and higher levels of savings in emergency funds.”⁴⁴ On the other hand, meeting with a financial adviser was not associated with self-reported retirement savings. While the savings effect for non-emergency funds may be negligible, the study seems to suggest that, even after controlling for selection, advisers bring value along a host of dimensions. Despite these mixed results, when summarizing the paper, BH focus on the results with respect to savings, concluding that “there is very limited evidence about a causal link between financial advice and savings.”⁴⁵

In any event, from a technical perspective, it bears noting that the estimated coefficient in an econometric model that regresses savings on the presence of an adviser (the treatment), even one that controls for endogeneity, reveals the *average* effect of the treatment across all individuals subject to the treatment. Thus, while it is possible that average savings did not increase with the treatment of an advisor after controlling for selection, the savings for certain individuals in the sample may have increased significantly; to know that, the authors would need to permit the treatment variable (the presence of an adviser) to vary by individual (using interaction terms). BH do not acknowledge this possibility.

BH also are silent about a financial adviser’s ability to correct behavioral biases relating to market timing or aversion to rebalancing. Recall that either those two benefits acting alone, according to our estimates, swamp the 25-basis-point estimated benefits of the Rule.⁴⁶ BH cite Friesen and Sapp (2007) and Bullard, Friesen and Sapp (2008)—both of which focused on market timing *with respect to buying funds*—for the proposition that “individuals who invest through a broker earn lower returns than those who invest directly.”⁴⁷ The unpublished Bullard et al. paper found that Class B investors from all load funds underperformed a buy-and-hold strategy by 2.28 percent annual, compared with annual underperformance (relative to buy-and-hold) of 0.78 percent for investors in pure no-load funds. This paper posits that “to the extent that funds with recent exceptional returns are more heavily advertised, or brokers recommend such funds, investors will tend to put money in as the fund’s performance is reverting back to the mean.”⁴⁸ Thus, the paper does not speak to a broker’s value added when it comes to preventing clients *from selling funds after a downturn*. Indeed, as we pointed out in our original paper,

42. *Id.* at 4.

43. *Id.*

44. *Id.* at 5 (emphasis added).

45. *Id.* at 9, 18.

46. *Litan & Singer* at 16-20.

47. *Financial Advisers* at 1.

48. Bullard, Friesen and Sapp (2008), at 11.

brokers are incentivized via commissions (which would fall from timing-based sales) to prevent clients from doing exactly that.

Conclusion

The RIA is deficient on the cost side of the cost-benefit analysis. To shore up that deficiency, it needs to find additional evidence that (1) human advisers generate no value for investors, and (2) a less-restrictive remedy in the form of heightened disclosure on broker compensation would be impotent in addressing the allegedly conflicted advice brokers are giving to investors. Neither the HGB paper, nor the (second) BH paper, serves that purpose.

The HGB paper readily concedes that, in reaching their conclusions on the efficacy of disclosure rules, they rely largely on purely theoretical analysis and experimental evidence from stylized roleplaying experiments, including various papers by Lowenstein, Sah, and Cain, which were already addressed in our prior report. And several of their studies relate to the efficacy of disclosure rules in the medical industry, which may not inform disclosure in financial services.

The BH study recognizes that financial advisers provide value to their clients. The one study that BH uncovered that attempts to control for selection offered mixed results—a financial adviser is associated with setting long-term goals, calculating retirement needs, retirement account diversification, use of supplemental retirement accounts, retirement confidence, and higher levels of savings in emergency funds, but not with self-reported retirement savings. It seems like a stretch to deny a vast literature establishing a strong correlation between financial advisers and financial well-being based on this single paper with mixed results.

Having reviewed the four new studies, we continue to reject the Department's claim that upending the compensation structure of brokers will impose zero costs on investors. Indeed, the new studies suggest the opposite. And so long as these costs exceed the modest 25 basis points of benefits per year claimed by the Department, the Rule fails a cost-benefit test.

Sincerely,

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