Testimony of Mercer Bullard

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before the

Employee Benefits Security Administration
U.S. Department of Labor

August 10, 2015

Thank you for the opportunity to testify today.

I am going to use my time today to do two things.

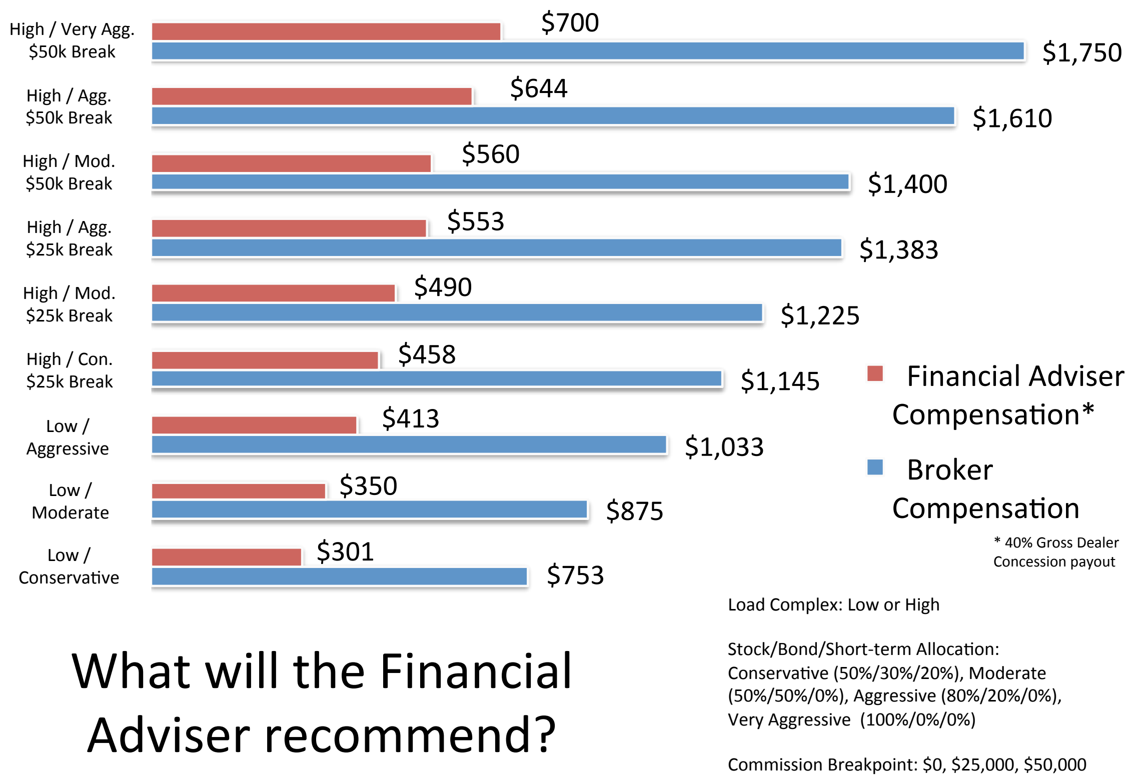
First, I'm going to provide some examples of how broker compensation models can create incentives for financial advisers to give investors bad advice. Second, I'm going to discuss how the Department's rulemaking will actually affect these compensation models. I am going to use mutual funds as the basis of my analysis.

Let's begin with some background on commissions. A typical commission on a small investment in a high load mutual fund would be 5.75%, with 5.00% of that going to the broker, and about 40% of that going to the financial adviser. A low load complex would pay the adviser substantially less. Funds discount commissions at certain investment levels, often at $25,000 or $50,000, which further reduces the payout to the adviser.

Commission-Driven Selling Incentives

If you look at my Chart number 1, you will see different types of commission-driven selling incentives based on a retiree's $35,000 rollover from a 401(k) account. The red line is the adviser's payout, which comes out of the commission paid to the broker, which is in blue. The bottom row assumes that the rollover is invested in a low load complex, and divided 50/30/20, among stock, bond and short-term bond funds. The adviser is paid $301.

Chart 1



The next two rows show that recommending a moderate, 50/50 allocation or aggressive 80/20 allocation between stock and bond funds increases the adviser's payout by $49 and $63, respectively. These increases result from the higher commission charged on the sale of the stock fund.

Now the adviser switches to a high load fund complex that has a low commission breakpoint at $25,000. With the higher commission, the adviser's compensation is increased up to another $140.

Now the adviser switches to a high load fund complex with a higher $50,000 breakpoint. Under the same high commission structure, but with the now higher breakpoint, the adviser is paid up to another $111.

Finally, under a very aggressive, 100% stock fund allocation the adviser would be paid a $700 commission.

What this shows is that the adviser has a financial incentive to recommend:

- More aggressive asset allocations over less aggressive allocations,
- High-load fund complexes over low-load complexes, and
- High-breakpoint fund complexes over low-breakpoint complexes.

Advisers can more than double their compensation based on these three variables alone. Here, the adviser's compensation ranges from $301 to $700.

The adviser could increase his commission to about $1,000 by selling a variable or fixed index annuity, and to more than $2,000 by selling a non-traded REIT.

Incentives to Chase Performance

My Charts 2 & 3 illustrate the adviser's financial incentive to recommend chasing hot funds. The columns of the table under the header "2 Switches" show an investor's $20,000 rollover into an IRA split between a midcap growth fund and a midcap value fund at the start of 2002. The adviser is paid a $460 commission on the initial sale.

Chart 2

Financial Adviser
Switching Incentives

Adviser sells Growth Fund and switches into Value Fund

Adviser sells Value Fund and switches into Growth Fund

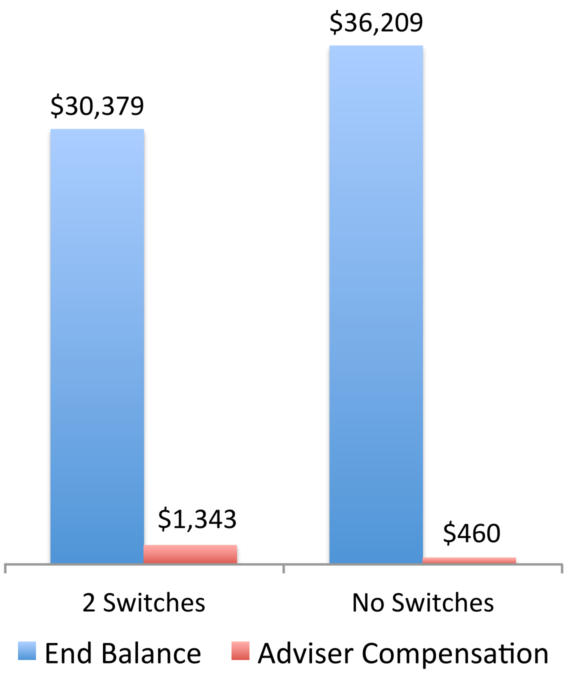
Midcap Growth and Value Funds $10k/$10k Initial Allocation				
Year	2 Switches		No Switches	
	Growth	Value	Growth	Value
2002	$6,728	$8,675	$6,728	$8,675
2003	$0	$20,278	$9,655	$11,715
2004	$0	$24,646	$11,310	$14,239
2005	$0	$26,660	$13,076	$15,402
2006	$0	$30,995	$14,533	$17,906
2007	$0	$29,712	$16,586	$17,165
2008	$16,024	$0	$9,490	$10,948
2009	$23,486	$0	$13,910	$14,936
2010	$30,379	$0	$17,993	$18,216

During 2002, midcap growth funds underperform midcap value funds by 21 percentage points, so at the end of that year, the adviser switches the growth fund balance to the value fund. Growth then outperforms value, and after outperforming by 18 percentage points in 2007, the adviser switches the investor back to the growth fund in 2008. The columns under the heading "No switches" assume that no switches occurred during the period.

If you turn to Chart 3, you can see the effect of the switching on the adviser and the investor. The adviser earns a $200 commission on the first switch and a $683 commission on the second, which brings the adviser's six-year commissions to $1,343. This is almost three times more than the $460 the adviser would have earned by simply staying the course. While the adviser increases his compensation by more than $800, the investor loses more than $5,000.

Chart 3

Financial Adviser Switching Incentives → Adviser is paid an extra <u>$883</u>
Investor loses <u>$5,830</u>



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Final Balances	**$30,379**		**$36,209**	
Adviser Comp.	**$1,343**		**$460**	

Switches:
- Growth to Value End of Year 1
- Value to Growth End of Year 6

There is a substantial literature that shows that this kind of market timing causes mutual fund investors to routinely underperform the funds in which they invest. I did a study with Professors Travis Sapp and Geoffrey Friesen to determine the level of underperformance in load funds and whether using an adviser mitigated this problem.[1] We found that investors in load funds have substantially worse underperformance than investors in funds that did not charge commissions or 12b-1 fees. Some of this underperformance is due to self selection. Some of it is due to misleading fund performance advertising. And some of it is due to what you see in this chart—financial advisers increasing their compensation by chasing performance.

[1] Investor Timing and Fund Distribution Channels (June 2008) *available at* http://ssrn.com/abstract=1070545.

Financial Adviser Payout Grids

Charts 4, 5 and 6 illustrate the incentives created by financial adviser payout grids. Chart 4 is a payout schedule for Janney Montgomery Scott. You can see that the payout jumps from 32% to up to 42% once the financial adviser has generated $300,000 in commissions. The higher rate is generally retroactive, so when the adviser's commission production goes from $299,000 to $300,000, the adviser receives an additional 10% of all commissions during the entire 12-month period.

Chart 4

Payout Grids

JANNEY MONTGOMERY SCOTT

T-5 + Current Month Average Monthly Gross Production	Annualized Gross Production	Grid Rates Effective Through 12/31/11	Changes Effective 1/1/12
Over $83,334	$1,000,000	46%	46%
$66,667 to $83,333	$800,000 to $999,999	45%	45%
$41,667 to $66,666	$500,000 to $799,999	44.50%	44.50%
$29,167 to $41,666	$350,000 to $499,999	44%	44%
$25,000 to $29,166	$300,000 to $349,999	42%	40 % or 42%*
$20,834 to $24,999	$250,000 to $299,999	34%	32%
$18,750 to $20,833	$225,000 to $249,999	28%	25%
Under $18,750	Under $225,000	20%	20%

*FAs who attend the Russell training and obtain specified asset and recurring revenue metrics will receive the higher payout.

If you will turn to Chart 5, you will see how this kind of payout grid creates distorted incentives. As explained in the narrative on the chart, it is the last day of the year, and the adviser is stuck at $299,000 in commissions over the last 12 months.   The broker is switching to a new firm the following week, so this is his last chance to hit the 42% payout.

Chart 5

It is 2:00 pm on December 31. Janney Montgomery financial adviser Bob's 12-month commissions have been stuck at $299,000 for two weeks, and he is switching to a new firm next week.

If he can get his GDCs to $300,000 – just one sale – by the end of the day, he can increase his 12-month payout by 10 percentage points.

A retiree walks in the door with $20,000 to invest. Only a ***100% allocation to a stock fund, executed that day,*** will get Bob to $300,000 in commissions.

What will Bob do? What is Bob *paid* to do?

JANNEY MONTGOMERY SCOTT

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$66,667 to $83,333	$800,000 to $999,999	45%	45%
$41,667 to $66,666	$500,000 to $799,999	44.50%	44.50%
$29,167 to $41,666	$350,000 to $499,999	44%	44%
$25,000 to $29,166	$300,000 to $349,999	42%	40 % or 42%*
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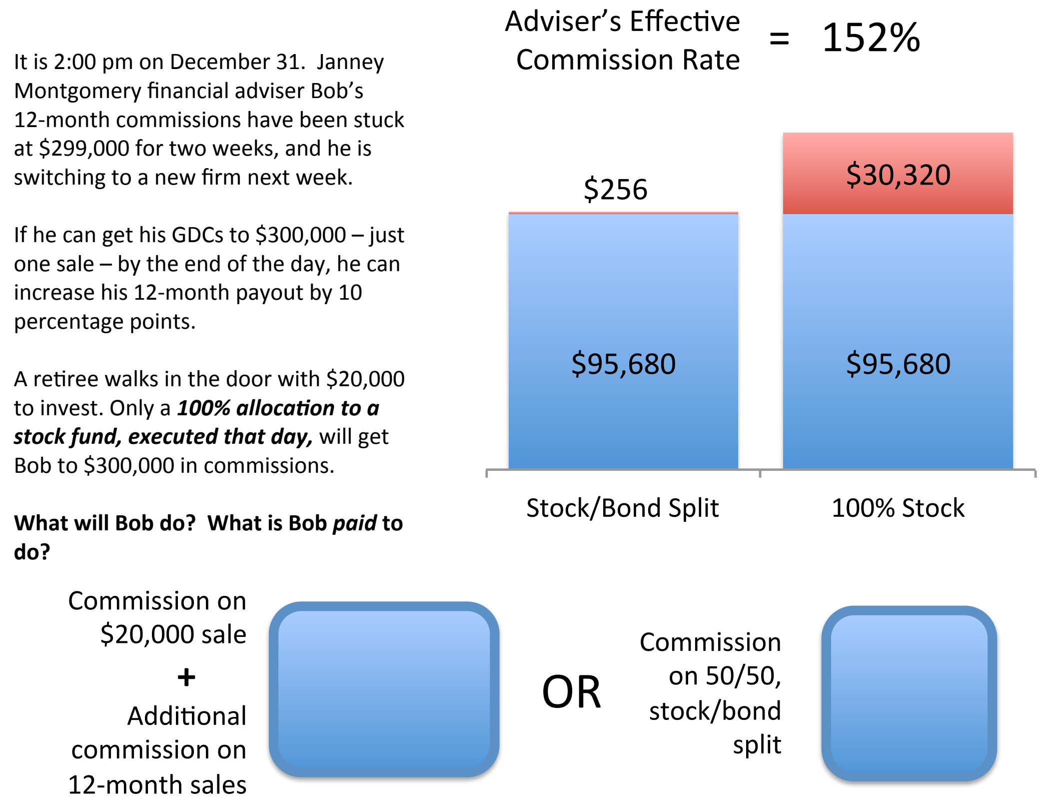
A retiree with a $20,000 rollover walks in the door. The adviser could recommend a 50/50 split between a stock bond and bond fund. But that would generate a commission to the broker of only $800 and leave him short of $300,000 in commissions. Only a 100% equity allocation will get him to $300,000 and the 42% payout.

If you turn to Chart 6, you see the adviser's financial incentives.

Chart 6



He can recommend a 50/50 allocation and earn only $256 on the transaction, or he can recommend a 100% equity allocation ***and earn $30,320***. The broker's commission would be $1,000, which would get the adviser to $300,000 in 12-month commission and trigger the 42% payout.

Recommending the 100% stock allocation earns him $420 on the $20,000 rollover, and $29,900 on the first $299,000 in commissions. ***His effective commission rate on the $20,000 investment is 152%.***

Practical Effect of Current DOL Proposal

My assessment of the actual effect of the Department's current proposal is as follows.

Brokers' selling compensation generally plays out at three levels: the firm, the branch and the financial adviser.

The rulemaking generally will have no effect at the firm level.

The proposal will have little effect on compensation differentials at the branch level. While compensating financial advisers based on the branch's profitability will not be permitted, other branch-level selling incentives will likely be unaffected. Branch-level compensation is important because it is a primary vehicle through which financial advisers are incentivized to sell higher revenue sharing fund complexes.

The proposal will also have a limited effect on selling incentives at the financial adviser level.

1. Financial advisers' selling compensation varies across different compensation groupings. Proprietary funds pay more than platform funds, and platform funds pay more than non-platform funds. The rulemaking will have no effect on financial advisers' incentives to recommend a product in one compensation group over a product in another.

2. Selling compensation also varies across different types of investment products. Variable and fixed index annuities pay more than mutual funds. Non-traded REITS pay more than annuities. The proposal will eliminate advisers' incentives to sell banned product types, such as non-traded REITS. But it will otherwise have no effect on incentives to prefer one product type over another. ***This is important because the proposal will have no effect on improper sales of variable and fixed indexed annuities in IRAs.***

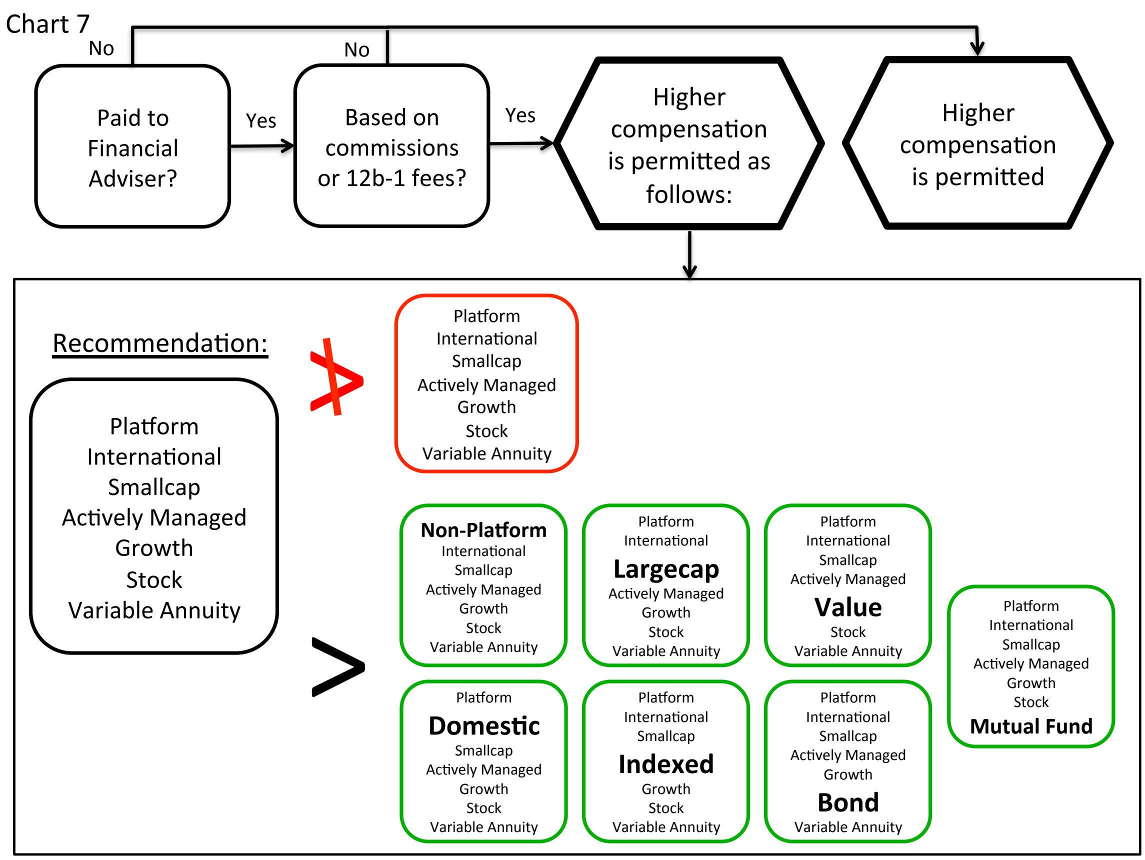
3. Selling compensation varies according to an investment's asset class, as illustrated in my Chart number 1. Financial advisers have financial incentives to recommend more aggressive asset allocations. To the extent that asset classes are narrowly differentiated, the proposal will have no effect on these incentives.

4. Selling compensation varies based on the frequency of transactions, as illustrated in my Charts 2 and 3. Financial advisers have incentives to churn trading accounts and engage in mutual fund and annuity switching. The proposal will have no effect on these incentives.

5. Selling compensation varies based on the level of a fund complex's commissions and breakpoints, as illustrated in my Chart number 1. The proposal will have no effect on these incentives except where a financial adviser is making a recommendation within a narrowly defined asset class.

This summary of the effects of the Department's proposal is illustrated in Chart 7. The question being answered here is when greater compensation can be received as a result of the recommendation made.

When is differential compensation permitted?



Starting in the top left corner, differential compensation is always permitted for branch managers and the firm – only certain compensation paid to the financial adviser would be prohibited.

Moving to the next box, differential compensation that is not based on commissions or 12b-1 fees would generally be permitted. In other words, the proposal generally allows financial advisers to receive differential benefits based on revenue sharing and other forms of non-commission selling compensation.

When a financial adviser is paid commissions or 12b-1 fees, the proposal permits these payments to vary as long as the recommendation is not between investments in the same narrowly defined asset class, in the same type of investment, and on the platform. Between platform and non-platform investment options, between different types of investments, and between different asset classes, differential compensation is permitted. The financial adviser would not be prohibited from being paid more for the recommendation in the black box than any of the recommendations in the green boxes or any other recommendation in which *any one of the seven factors was different.* The adviser would be prohibited from being paid more for the recommendation in the black box and the recommendation in the red box.

My final comment is that even this very limited restriction on differential compensation arrangements will be very difficult to enforce in private arbitration claims. In fact, the most significant effect of the Department's proposal is likely to be an increase the probability that an investor will be able to win a common law fiduciary breach claim in arbitration.

I would be happy to answer any questions you might have.