

THE FIDUCIARY RULE CONTROVERSY AND THE FUTURE OF INVESTMENT ADVICE

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One of the signature rulemaking initiatives of the Obama administration was the Fiduciary Rule, which redefined the relationship between retirement investors and their brokers by imposing broad fiduciary obligations on financial professionals who had previously escaped classification as fiduciaries. The Rule was enormously controversial and was eventually struck down by the Fifth Circuit. Despite its demise, the Fiduciary Rule offers important lessons for regulating investment advice. This paper offers an assessment of the Rule in light of the academic literature. It argues that, while the Fiduciary Rule was a well-intentioned and plausible means to confront the well-documented problem of conflicted investment advice, it promised only modest benefits when all relevant costs were considered, and even those benefits were jeopardized by the risk of rising costs related to compliance and liability. A reform agenda aimed at reducing the demand for costly professional advice is likely to deliver greater returns than regulating how that advice is delivered.

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INTRODUCTION

American workers increasingly bear responsibility for making financial arrangements for their retirement through self-directed 401(k) plans and Individual Retirement Accounts (IRAs). Investment decisions that, in the past, might have fallen to a professional pension manager are now made on an individual basis by millions of savers. Unsurprisingly, many savers seek out professional advice as they navigate the challenges of financial planning. A large body of academic work, mostly in empirical finance, has established that this advice is plagued by conflicts of interest and that these conflicts lead many investors to hold investments that underperform. The Obama administration Fiduciary Rule¹ was promulgated with an aim to address these conflicts by transforming how financial advisers are compensated.

The Fiduciary Rule was enormously controversial, garnered thousands of comments, was subjected to days of hearings, and spawned hundreds of pages of news articles and commentaries both in the trade press and in mainstream publications.² The Trump administration halted enforcement of the Rule for eighteen months to review its effects,³ and the rule was ultimately

¹ Following industry practice, I will refer to the entire package of regulations including the Fiduciary Rule, the Best Interest Contract Exemption, PTE 84-24, and other minor rules as “the Fiduciary Rule” when doing so will not lead to confusion. I will also capitalize “Rule” as shorthand for “Fiduciary Rule.”

² See, e.g., Mark Schoeff, Jr., *Labor Department Proposes Controversial Fiduciary Rule*, INV. NEWS (Apr. 14, 2015), <https://www.investmentnews.com/article/20150414/FREE/150419976/labor-department-proposes-controversial-fiduciary-rule> [hereinafter *Controversial Fiduciary Rule*]; Kevin Cirilli, *White House Readies Crackdown on Financial Advisers*, THE HILL (Jan. 22, 2015), <https://thehill.com/policy/finance/230457-white-house-readies-crackdown-on-financial-advisers>.

³ See Jacklyn Wille, *Trump and the Fiduciary Rule: The Uncertainty of What’s Ahead*, BLOOMBERG BNA (Feb. 13, 2017), <https://www.bna.com/trump-fiduciary-rule-n57982083674/>; *The Trump Administration Makes a Surprise Move on Broker Advice for Retirees*, FORTUNE (May 23, 2017), <http://fortune.com/2017/05/23/dol-fiduciary-rule-broker-advice/>; Definition of the Term “Fiduciary”, 82 Fed. Reg. 16,902 (Apr. 7, 2017) (announcing suspension of

struck down by the Fifth Circuit as inconsistent with the statutory language of ERISA.⁴ While the Fiduciary Rule is dead, the movement to protect investors from conflicted advice continues. The Securities Exchange Commission (SEC) recently announced Regulation Best Interest,⁵ which is aimed squarely at the problems the Fiduciary Rule was meant to address. The Fiduciary Rule received little academic attention in its short life,⁶ but a number of lessons can be drawn from the controversy surrounding its adoption as attempts to regulate investment advice continue to gain momentum.

This Article argues that, while conflicts of interest in investment advice are well-documented and have deleterious effects for investors, the Fiduciary Rule, even if it had been allowed to stand, was likely to produce only modest benefits and posed substantial risk to investor welfare. The central insight is that the Department of Labor (DOL) failed to engage with the direct costs of investment advice when designing the Rule and instead fixated on the problem of underperforming broker-sold funds. Properly understood, the net benefit of the Rule is a close question, and design flaws might have resulted in the Rule causing net harm to some investors. The Rule was likely a positive step on balance, but reforms aimed at reducing investors' need for professional advice are likely to have greater benefits than reforms like the Fiduciary Rule that attempt to change how advice is delivered.

The provision of professional investment advice in the United States is subject to a number of problems: investors may be encouraged to buy high-cost products that are profitable for financial advisers but costly to the investors, they might be encouraged to move funds out of efficiently administered 401(k) plans and into high-cost investments, or they may be encouraged to engage in costly reallocations even when their current investment allocations meet their needs. These problems arise because U.S. investors receive financial advice through two legally distinct channels. Some consumers get advice from Registered Investment Advisers (RIAs), who are fiduciaries and must avoid conflicts of interest. Such advice ought to be unbiased and of high quality. But consumers also get advice from brokers, who are not subject to a fiduciary duty and are compensated through sales commissions on the financial products that the investors purchase. These sales commissions lead to conflicts of interest because not all investment products carry sales commissions and some products carry higher commissions than others.

enforcement of the final rule for 60 days); Mark Schoeff, Jr., *DOL Fiduciary Rule Takes Effect, but More Uncertainty Lies Ahead*, INV. NEWS (Jun. 9, 2017), <https://www.investmentnews.com/article/20170609/FREE/170609938/dol-fiduciary-rule-takes-effect-but-more-uncertainty-lies-ahead>.

⁴ Chamber of Commerce v. U.S. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018).

⁵ Regulation Best Interest, 83 Fed. Reg. 21,574 (May 9, 2018).

⁶ For one exception, see Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 387–88 (2017) (arguing that the Fiduciary Rule would better have been left to the SEC); see also Jill E. Fisch, Tess Wilkinson-Ryan & Kristin Firth, *The Knowledge Gap in Workplace Retirement Investing and the Role of Professional Advisors*, 66 DUKE L.J. 633 (2016).

Commission-compensated brokers have incentives to recommend products that are profitable for them, but may not be optimal for the investor. Consumers are not well-equipped to navigate this complex terrain: the distinction between fiduciary and non-fiduciary investment advice is difficult for consumers to understand. Some advisers play both roles, and both brokers and fiduciary advisers provide similar services and use similar marketing.⁷ But conflicts of interest have real consequences for investors. According to a 2015 summary of the literature by the Council of Economic Advisers, mutual funds sold on commission underperform other funds by about one percent annually, a substantial drag on investors' retirement savings.⁸

There have long been calls to hold all financial advisers⁹ to a uniform standard of fiduciary duty, and reforms have periodically surfaced on the SEC's agenda.¹⁰ Beginning in 2010, the Obama administration began a push, through the DOL, which regulates 401(k) plans and partially regulates IRA plans, to subject financial professionals who advise retirement investors to a fiduciary duty to act prudently in the best interests of their clients. This effort culminated in 2016 when the DOL released the so-called Fiduciary Rule¹¹ and the Best Interest Contract Exemption.¹² The Fiduciary Rule expanded the number of professionals who are considered fiduciaries when advising clients to include the vast majority of those giving specific investment advice with respect to retirement accounts.

The Fiduciary Rule was a transformative intervention, affecting a wide swath of the financial services industry. Its most important impact would have been on IRAs, where brokers are the most common service provider.¹³ Subjecting brokers of IRAs to fiduciary status imposes strict requirements on the compensation of these advisers, in effect barring sales commissions. To address concerns that this change to the compensation models of brokers could be too disruptive, the DOL proposed the Best Interest Contract Exemption (BIC Exemption) alongside the Fiduciary Rule. The BIC Exemption

⁷ See, e.g., Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 702 (2010).

⁸ Jason Furman & Betsey Stevenson, *The Effects of Conflict Investment Advice on Retirement Savings*, THE WHITE HOUSE BLOG (Feb. 23, 2015, 9:45 AM), <https://obamawhitehouse.archives.gov/blog/2015/02/23/effects-conflicted-investment-advice-retirement-savings>.

⁹ Throughout, the term "financial advisers" will refer collectively to all providers of financial advice regardless of regulatory regime.

¹⁰ See, e.g., Mark Schoeff, Jr., *Historical Timeline of Fiduciary Duty for Financial Advice*, INV. NEWS (Apr. 5, 2016), <https://www.investmentnews.com/article/20160405/FREE/160409960/historical-timeline-of-fiduciary-duty-for-financial-advice>.

¹¹ See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) [hereinafter DOL Fiduciary Rule].

¹² See Best Interest Contract Exemption, 81 Fed. Reg. 21,002 (Apr. 8, 2016) [hereinafter DOL BIC Exemption].

¹³ OLIVER WYMAN, INC., ASSESSMENT OF THE IMPACT OF THE DEPARTMENT OF LABOR'S PROPOSED 'FIDUCIARY' DEFINITION RULE ON IRA CONSUMERS (2011), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32/oliverwymanreport.pdf>.

permitted brokers to receive commission compensation, provided they satisfy a number of substantive requirements, including a bar on waiver of class action liability and a contractual agreement to act in their clients' best interest.

This paper offers an assessment of the Fiduciary Rule's impact on IRA investors holding mutual funds. While the Rule was well-intentioned, there were reasons to be concerned about its impact on consumers, at least in the mutual fund space. Mutual funds were not the only products covered by the Rule, and there are arguments in favor of the Rule that do not turn on the characteristics of the mutual fund market.¹⁴ Nevertheless, mutual funds are the most important investment products in IRAs,¹⁵ and much of the DOL's empirical case for the Rule was based on academic evidence regarding the mutual fund market.

The academic literature provides damning evidence of the deleterious effects of conflicted, commission-based advice.¹⁶ Mutual funds sold by brokers underperform other mutual funds. But the evidence is limited to comparing the performance of fund portfolios resulting from conflicted and unconflicted advice without observing the *costs* of the conflicted and unconflicted advice that lead to investors holding those portfolios. What matters to consumers is not just the performance of their mutual funds, but their net returns after accounting for the total cost of investing. Conflicted advice may lead to inferior investments, but it may also be cheaper. Simple calculations show that, on a plausible set of assumptions, the all-in cost of conflicted advice—including the associated underperformance—is only modestly higher than the typical cost of unconflicted advice. Shifting investors toward fee-based fiduciary accounts may increase costs for some of them. More importantly, if conflicts of interest could be managed and the underperformance eliminated, the commission model may be cheaper on an all-in basis for many investors. The BIC Exemption was specifically aimed at reducing conflicts of interest while permitting commission-based advice.

Unfortunately, the BIC Exemption had two design flaws. First, the design of the BIC Exemption conflated two separate concepts from the academic literature: the collective underperformance of broker-sold funds relative to other funds and the underperformance of high-commission funds relative to low-commission funds. The most striking result of this confusion is that the DOL's cost-benefit analysis evaluating the anticipated impact of the Rule¹⁷ objectively misread the academic literature, though the result of

¹⁴ See *infra* Part I.E.

¹⁵ See Craig Copeland, *IRA Asset Allocation*, 32 NOTES No. 5 (Emp. Benefit Res. Inst., Washington, D.C.), May 2011, at 2.

¹⁶ See *infra* Part I.B.

¹⁷ U.S. DEP'T OF LABOR, REGULATING ADVICE MARKETS: DEFINITION OF THE TERM "FIDUCIARY," CONFLICTS OF INTEREST – RETIREMENT INVESTMENT ADVICE, REGULATORY IMPACT ANALYSIS FOR FINAL RULE AND EXEMPTIONS (2016) [hereinafter REGULATORY IMPACT ANALYSIS].

this misreading is to understate the benefits of the Rule. More importantly, the misunderstanding also influenced the DOL's thinking on how conflict-mitigating compensation structures should be designed, with the result that some permissible arrangements might fail to resolve conflicts of interest.

Second, the BIC Exemption effectively created differential liability in the form of a private right of action for fiduciary breaches in commission-based IRAs, but not in IRAs that charge a flat management fee. This liability is a powerful deterrent to willful wrongdoing. However, given the immense uncertainty surrounding the Fiduciary Rule, a private right of action risked deterring not just wrongful behavior, but participation in the IRA advisory market on a commission basis altogether. Private liability for fiduciary breaches is risky, because brokers will expect to be compensated for the residual risk through higher fees. This liability therefore risked undermining the modest savings to investors that the Fiduciary Rule promised. Whatever the costs or benefits of a private right for fiduciary breaches in general, attaching a private right of action to commission-based compensation, but not fee-based compensation, creates a strong disincentive to use the former. The entire premise of the BIC Exemption was that consumers may benefit from commission compensation if the conflicts of interest can be managed. Given the stringent requirements of the BIC Exemption aimed at mitigating conflicts of interest, overlaying heightened liability on only one segment of the industry was likely to create more costs than benefits.

With the Fiduciary Rule now defunct, the SEC has stepped in with its own reform proposal: Regulation Best Interest (BI). The regulation is a far more modest intervention. While it largely avoids the risks of the radical changes mandated by the Fiduciary Rule, it carries a substantial risk of doing little to address the real problems facing consumers, while nevertheless carrying significant compliance costs.

Stepping back, it is hard to avoid the conclusion that, whatever the future of fiduciary duties in investment advice, designing a regulatory framework around advice that provides more than modest benefits may be a near-insurmountable challenge. The fact is that full-service investment advice is expensive and, for the vast majority of investors with ordinary needs, the most potent way to improve investors outcomes is not to alter the legal framework under which full-service advice is provided, but to reduce the need for it in the first place. The paper concludes by examining how regulators could achieve significantly stronger welfare improvements by simplifying retirement planning, leveraging existing employer-based accounts, and encouraging the use of low-cost automated investment options. Even a reform to financial services as fundamental as the Fiduciary Rule is far less potent—in terms of improving investors welfare—than reforms that reduce the need for those services in the first place.

The paper proceeds as follows. Part I reviews the regulation of investment advisers, the academic literature on conflicts of interest, and the Fiduciary Rule. Part II presents a simple calculation of the “all-in” cost of

conflicted advice as compared with fiduciary advice, and argues that the difference is modest. Part III argues that the BIC Exemption is flawed in conflating two types of agency problems. Part IV argues that the differential liability regime created by the Fiduciary Rule is problematic, and Part V addresses areas of regulatory emphasis that may ultimately prove more promising.

I. BACKGROUND

This section reviews the mechanics of the Fiduciary Rule, the problems it was designed to address, and the key arguments in favor of the Rule.

A. *Investment Advisers and Brokers*

Retail investors in the United States receive advice from numerous sources, including magazines, television, friends, family, and the internet, but the provision of advice by professionals is subject to two different regulatory regimes. Investment advisers, defined and regulated under the Investment Advisers Act of 1940,¹⁸ provide financial advice to investors, whether individuals or financial institutions, subject to a fiduciary duty to act in the best interest of their clients.¹⁹ Brokers, on the other hand, are regulated by the Securities Exchange Act of 1934 and subject to a lower duty.²⁰ By definition, brokers' primary role is the execution of trading transactions on behalf of their clients, but full-service retail brokers typically provide financial planning and advising as ancillary services and advertise these services to consumers. Brokers are typically held to a duty of suitability²¹—less stringent than a full fiduciary duty—which requires that brokers understand the needs of their clients and the details of the product they are recommending, and refrain from recommending securities that are unsuitable.

The compensation models of investment advisers and brokers are markedly different. Investment advisers are typically compensated via an annual fee charged as a percentage of assets under management. Such advice is commonly described as fee-based. Fee-based compensation separates investment advisers' income from their specific investment recommendations except insofar as their compensation will grow as the balance in the account increases. Brokers, on the other hand, are compensated based on commissions tied to specific transactions. While brokers receive a commission for executing a trade, the main source of income for brokers in the retirement context is sales commissions tied to particular financial products.

¹⁸ See Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2018).

¹⁹ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963) (holding that investment advisers have a fiduciary duty to their clients).

²⁰ See Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa (2018).

²¹ FIN. INDUS. REGULATORY AUTH. Rule 2111 (2014).

In the case of mutual fund transactions, brokers receive three different types of compensation. First, brokers are compensated for selling particular mutual funds through loads—sales commissions paid when the product is sold to the investor.²² Brokers may also receive 12b-1 fees or trailing fees, which are paid annually by the fund as a percentage of assets invested in the fund. These fees provide ongoing payments to the broker as long as the client remains invested.²³ At the institutional level, brokers may also participate in revenue sharing—a direct payment from the manager of the fund in exchange for the broker making the fund available to clients.²⁴

Among broker-sold funds, these types of compensation are set at the fund level as part of the fund's prospectus. Some funds, known as direct-sold funds, offer no sales incentives and are simply not offered to brokerage clients. These funds can be bought directly by consumers through online fund supermarkets or by opening an account directly with a fund company, Vanguard or Fidelity for example. Among broker-sold funds there is considerable variation in the amount of the commission the broker receives.²⁵ This means brokers may receive more compensation for recommending certain types of funds than others and paid nothing at all should they point a client to direct-sold funds. These sales incentives create an agency problem between brokers and clients when clients rely on brokers to make recommendations as to the funds in which they should invest. Such a conflict would be impermissible for an adviser held to a fiduciary duty, but is compatible with a suitability standard.

Brokers' standard of suitability is understood to be substantially less stringent than the fiduciary duty owed by investment advisers to their clients, and the space between the fiduciary and suitability standards gives rise to concern about the quality of brokers' advice.²⁶ Without a fiduciary duty, brokers are free to recommend products that, while suitable for the investor, are not in the investor's best interest, in order to receive compensation for making the sale. Why would investors choose a broker subject to conflicts of interest over a fiduciary investment adviser? There are two reasons: first, it is unlikely that most investors understand the legal nuances of their relationship with their financial advisers, nor is it always obvious to a client who understands the distinction which category their financial planner occupies. While providing financial advice is not supposed to be the brokers' primary

²² Strictly speaking, loads may also be paid when the investment is liquidated or on an ongoing basis. Most loads are paid up front, and most of the DOL's analysis deals with front-end loads. For the sake of simplicity, I will focus only on front-end loads.

²³ See *Mutual Fund Fees and Expenses*, U.S. SEC. & EXCH. COMM'N (Jan. 15, 2013), <https://www.sec.gov/fast-answers/answersmffeeshtm.html>.

²⁴ See Jason Zweig, *Mutual Fund Fees: A Bad Incentive Fades Away*, WALL ST. J. (Feb. 26, 2016), <https://blogs.wsj.com/moneybeat/2016/02/26/mutual-fund-fees-a-bad-incentive-fades-away/>.

²⁵ See Susan E.K. Christoffersen, Richard Evans & David K. Musto, *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, 68 J. FIN. 201, 215 (2013).

²⁶ See Laby, *supra* note 7.

function, many brokers hold themselves out to the public as “financial planners,” and many retail investors rely completely on their brokers’ advice as they plan their investments.²⁷ But mere confusion is not the only issue. Second, many investment advisers have minimum account balances in the six-figures. As a result, for investors with small accounts, a broker may be the most accessible option if they are seeking face-to-face, full-service financial advice.

B. *Broker/Client Agency Costs: Empirical Evidence*

The agency problem between retail investors and brokers with respect to mutual fund investing has been the object of study for decades, both by academics and by regulators. The famous 1962 Wharton study of the mutual fund industry commissioned by the SEC expressed concern about whether sales incentives were actually in the interest of fund investors.²⁸ More recently, the empirical finance literature has focused on the effect of brokers’ sales incentives on the performance of mutual fund investors’ portfolios.

The seminal paper in the literature is Bergstresser, Chalmers, and Tufano (2009).²⁹ The paper compares mutual funds that are distributed through brokers to mutual funds that are sold directly to consumers. The authors find that the broker-sold funds earn lower returns, after adjusting for the level of risk, by about 0.8% depending on the precise construction of the measure. Notably, these returns do not reflect the costs to investors of sales commissions or other distribution fees that directly compensate brokers. That is, the cost that investors pay for advice is not part of the calculation, only the result of the advice: the performance of broker-sold funds themselves. The striking result of the study is that brokerage customers are paying, through loads and distribution costs, for advice that leaves them with a portfolio of funds that, in aggregate, underperform funds they could have purchased without the help of a broker.

Bergstresser et al. also look for evidence that investors in broker-sold funds exhibit better investment skill reflecting professional advice and find it lacking. In aggregate, flows into broker-sold funds show no superior skill at timing the market than investors in direct-sold funds.³⁰ Nor do brokers seem to mitigate the behavioral biases of their clients. Aggregate investment in both broker-sold and direct-sold funds shows a significant tendency to chase past returns by investing in funds with a strong record of past performance.³¹ Given that mutual fund returns tend not to persist, this may reflect irrational behavior on the part of investors. The authors posit that mutual fund brokers

²⁷ See *id.*

²⁸ Christoffersen et al., *supra* note 25, at 205.

²⁹ Daniel Bergstresser, John M.R. Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129 (2009).

³⁰ See *id.* at 4141.

³¹ See *id.* at 4149.

may “sell what they are paid to sell,”³² pushing objectively inferior load funds in order to receive a commission.

Bergstresser et al. note that they are not able to observe other channels through which brokers might deliver value to investors. For example, the impact of brokers on savings rates, market participation, or financial planning services cannot be computed simply by looking at the aggregate performance of mutual funds. Such advice may have considerable value to consumers given the complexity of the retirement planning landscape, and it would be difficult to design an empirical study that could benchmark this value against the cost to consumers. The authors explicitly bracket the question of whether these intangible benefits are sufficient to offset the cost of the conflict of interest.³³

Christoffersen, Evans, and Musto (2013) provide more detailed evidence on the impact of loads on investor outcomes.³⁴ Their study examines different levels of broker compensation within the universe of broker-sold funds, effectively comparing high-commission broker-sold funds to low-commission broker-sold funds. Funds with high initial payments to brokers have higher inflows, controlling for fund characteristics, and worse performance. The authors find that a one hundred-basis-point increase in fund loads is associated with a fifty-basis-point decrease in performance.³⁵ They do not find a statistically significant relationship between revenue sharing and underperformance, which they interpret as giving a broker indirect exposure to the performance of the fund (since the fee is a percentage of the balance invested in the fund). These results are consistent with brokers acting out of self-interest to recommend underperforming funds when they pay a substantial commission.

Mullainathan, Noeth, and Schoar (2012) corroborate these large-scale empirical studies by providing direct evidence of conflicted advice through an audit study.³⁶ In the study, auditors posing as investors seeking retirement advice visited financial advisers serving clients with relatively low account balances.³⁷ The auditors were randomly assigned portfolios with various characteristics and sought advice about whether and how to change their investments. The results of the audits were consistent with significant agency problems. Auditors whose portfolios were designed to demonstrate misconceptions about the market were not dissuaded from those strategies, and auditors with low-cost, high-quality allocations were nevertheless moved into more costly funds that produced value for the brokers. These results tend to

³² *Id.* at 4153–54.

³³ *Id.* at 4155.

³⁴ Christoffersen et al., *supra* note 25.

³⁵ A *basis point* is 1/100th of a percent, and is a convenient unit in discussing investment returns.

³⁶ Sendhil Mullainathan, Markus Noeth & Antoinette Schoar, *The Market for Financial Advice: An Audit Study* (Nat'l Bureau of Econ. Research, Working Paper No. 17,929, 2012).

³⁷ *See id.* at 4–5.

confirm that the relationships between loads and underperformance documented by Bergstresser et al. and Christofferson et al. are causal.

A host of other empirical papers support the empirical results outlined above. The results of ten such papers were marshalled just ahead of the DOL proposing its second draft of the Fiduciary Rule in a report authored by the White House Council of Economic Advisers (CEA).³⁸ The CEA report concluded that “[s]avers receiving conflicted advice earn returns roughly one percentage point lower each year”³⁹ This finding is the cornerstone of the empirical case for the Fiduciary Rule: mitigate the conflicts of interest and consumers will be better off by about one percentage point of investment return each year. The CEA report multiplied this one percent estimate by the aggregate balance of IRAs and concluded that, “[a]n estimated \$1.7 trillion of IRA assets are invested in products that generally provide payments that generate conflicts of interest. Thus, we estimate the aggregate annual cost of conflicted investment advice is about \$17 billion.”⁴⁰ It should be added that, despite the phrasing, this is an estimate of conflicts as applied to mutual funds in IRAs only, not other types of conflicted investment advice.

C. *The Fiduciary Rule and BIC Exemption*

The Employee Retirement Income Security Act (ERISA) is the statute that regulates the design and administration of employee benefit plans. While the statute has numerous substantive and disclosure requirements, the most important part of the statute for the purposes of this paper is the regulation of certain individuals as fiduciaries for a plan. To be a plan fiduciary is to be subject to an extensive set of restrictions on the ways in which one can transact with plan dollars and plan participants. ERISA prohibits most transactions between fiduciaries and plan assets. The DOL issues regulations creating prohibited transaction exemptions (PTEs), which permit otherwise prohibited transactions that meet the requirements of the exemptions. ERISA ordinarily prevents a fiduciary from receiving compensation from plan assets for engaging in particular transactions and receiving compensation paid by parties adverse to the plan. As such, an ERISA fiduciary is barred from receiving sales commissions.

Section 3(21)(A) of ERISA defines as fiduciaries those who give “investment advice for a fee or other compensation” with respect to investments in an ERISA plan.⁴¹ On the face of it, this definition of fiduciary

³⁸ Furman & Stevenson, *supra* note 8.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ ERISA does not directly regulate IRAs, which are not connected with a particular employer, but the Treasury regulations for IRA plans include the notion of fiduciary, and the Treasury has delegated authority to the DOL to define investment advice for the purposes of identifying fiduciaries for IRAs. Reorganization Plan No. 4 of 1978, 5 U.S.C. app. § 1 (2018).

would seem to include most financial professionals who advise clients on how to allocate their retirement assets. Most brokers, for example, provide financial advice and are compensated through trading commissions for doing so. But under ERISA, the DOL is empowered to define “investment advice,” and in 1975 the DOL promulgated a regulation that did so narrowly.⁴² Specifically, a person rendered investment advice only if all of the following conditions were met:

- 1) The person must make recommendations as to the advisability of investing in specific products,
- 2) Advice must be rendered on a regular basis,
- 3) There must be a mutual understanding that the advice will be the primary basis for investing, and
- 4) The advice must be tailored to the needs of the individual plan participant.⁴³

Only if all these requirements are met is the person rendering investment advice, and since fiduciary status turns on the definition of investment advice, these requirements characterize the sort of relationship that would create a fiduciary duty.

Somewhat confusingly, IRAs, which are created by the Internal Revenue Code (IRC)⁴⁴ and are not ERISA plans, nevertheless share a similar set of fiduciary duties,⁴⁵ and the DOL is explicitly granted authority to define “investment advice” for the purpose of determining who counts as a fiduciary for an IRA plan.⁴⁶ The most important difference is that, while an ERISA fiduciary faces class action liability for breaching a fiduciary duty to a plan, IRA fiduciary duties under the IRC are enforced by the IRS via excise taxes. Such enforcement proceedings are rare.⁴⁷ As applied, the DOL’s 1975 definition of investment advice excluded from fiduciary obligations retail brokers for IRAs who were compensated by trading commissions.

The 1975 definition of investment advice was crafted for a world in which the bulk of retirement assets were managed professionally via defined benefit pension plans.⁴⁸ The professional money managers who invested these pension assets were undoubtedly fiduciaries. The narrow definition of investment advice allowed these sophisticated money managers to utilize service providers without subjecting those service providers to a fiduciary duty. In the intervening forty years there has been a rapid shift away from

⁴² Definition of Fiduciary Rule, 26 C.F.R. § 54.4975-9 (2018).

⁴³ *See id.*

⁴⁴ *See* 26 U.S.C. § 408 (2018).

⁴⁵ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 20.

⁴⁶ DOL Fiduciary Rule, *supra* note 11, at 20,954.

⁴⁷ THOMAS ROBERTS, REVIEW OF THE DEPARTMENT OF LABOR’S (DOL) FINAL DEFINITION OF FIDUCIARY: KEY POINTS IBDs, RIAs AND ADVISERS NEED TO KNOW, PERSHING LLC 4 (2016), <https://www.pershing.com/global-assets/pdf/dol-key-points-ibds-riAs-and-advisors-need-to-know.pdf>.

⁴⁸ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 114.

this model of retirement savings, and defined benefit pensions have been largely replaced by defined contribution 401(k) plans and IRAs.⁴⁹ Retail investors are increasingly placed in the role of pension managers for their own retirement. Needless to say, these individuals are far more reliant on the advice they receive from service providers than were professional money managers, but the fiduciary framework of ERISA and IRAs, locked in by the 1975 regulation, did not keep pace with this shifting balance of power, sophistication, and information between investors and service providers.

The Fiduciary Rule expanded the definition of “investment advice” and, by extension, the scope of “fiduciary” under ERISA with the goal of better aligning the need for fiduciary protection with the realities of the investment advice marketplace. “Investment advice” under the Rule included providing

- (1) [F]or a fee or other compensation, direct or indirect . . .
 - (i) A recommendation as to the advisability of acquiring, holding, disposing of, or exchanging securities or other investment property . . .
 - (ii) A recommendation as to the management of securities or other investment property . . . or recommendations with respect to rollovers, transfers or distributions from a plan or IRA . . . ; and
- (2) . . . the recommendation is made . . . by a person who:
 - (i) Represents . . . that [they are] acting as a fiduciary . . .
 - (ii) Renders the advice pursuant to a written or verbal agreement . . . that the advice is based on the particular investment needs of the advice recipient; or
 - (iii) Directs the advice to a specific advice recipient . . . regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.⁵⁰

The Rule went on to exclude from the definition of “recommendation” a host of communications activities related to retirement plans, the most important of which is general financial education that does not reference specific investment options.⁵¹

Several aspects of this definition are notable. First, it tracks intuitive notions of “investment advice” more closely than the 1975 definition. For example, the old requirement that “advice” was only “advice” if rendered on an ongoing basis is eliminated. Rather than have the status of a recommendation as advice turn on the mutual understanding of the parties that it will be the primary basis for investing, the new definition focuses on the

⁴⁹ *Id.* at 116.

⁵⁰ DOL Fiduciary Rule, *supra* note 11, at 20,997.

⁵¹ *Id.*

nature of the communication and the likely perception of the investor: It is enough that there is a recommendation of a particular investment made to a specific individual.

The Fiduciary Rule also clarified that the recommendation to roll assets out of a 401(k) account and into an IRA is itself a fiduciary recommendation, reversing earlier guidance.⁵² This meant that a financial adviser could not recommend that an investor roll assets out of a high-quality 401(k) plan unless the adviser was able to move the assets into investments that, as a whole, provided some benefit to the investor relative to the old plan. This change closed what is otherwise a significant omission in the scope of the fiduciary relationship if assets could be accepted at arm's length into an account with inferior options and only then managed subject to a fiduciary duty.

Finally, the Fiduciary Rule applied to all assets in retirement accounts, and, as such, dealt with more than just securities. While much of the discussion around the Fiduciary Rule has focused on mutual funds, which are typically the regulatory province of the SEC, other asset classes are commonly held in IRAs that are beyond the regulatory authority of the SEC. In particular, annuities are important components of IRAs and not all types of annuities are regulated by the Exchange Act.⁵³ The Fiduciary Rule explicitly swept in non-security investment products in order to apply a fiduciary duty to annuity recommendations.

The relatively intuitive redefinition of "investment advice" included in the Fiduciary Rule nevertheless had seismic consequences for the management of retirement accounts. Brokers, sellers of annuities, and others who would not have been considered fiduciaries under the old rule, became providers of investment advice and thereby subject to prohibited transaction rules. As a result, these professionals who were traditionally compensated via commissions and trailing fees would have been prohibited from receiving these types of compensation, unless an exemption were available. The Fiduciary Rule upended the dominant model of compensation for financial advice in IRA plans. This, of course, was the desired result. It is precisely these compensation structures that create conflicts of interest that lead to bad outcomes for investors.

Concerns about disrupting investors' access to financial advice led the DOL to issue the BIC Exemption at the same time as the Fiduciary Rule. Structured as an exemption to the prohibited transaction rules, the goal of the BIC Exemption was to enable the continued use of commission-based compensation while mitigating concerns about potential conflicts of interest. The BIC Exemption was contingent on the recipient of the compensation entering into a contract with the investor that included numerous protective features. The contract must, for example, acknowledge the fiduciary nature of

⁵² *Id.* at 20,968.

⁵³ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 40.

the relationship with the client, commit to act in the best interest of the client, commit to receive no more than reasonable compensation, and represent that the firm has put in place policies to ensure that advisers are acting in the best interest of clients.⁵⁴ The BIC Exemption also imposed substantive requirements on how conflicts of interest should be mitigated. In particular, the exemption laid out impartial conduct standards that required that the compensation of both the financial institution and the adviser not differ based on the particular investment product recommended to the client.⁵⁵ The BIC Exemption also had enforcement consequences, since the contract would be privately enforceable. While the BIC contract could require individual claims to be arbitrated, class action liability could not be waived or required to be arbitrated under the BIC.⁵⁶ Fiduciary duties in IRAs were not previously subject to private enforcement, so this was a significant change.

If these requirements were met, then the receipt of commission compensation in connection with investment advice to retirement investors was permissible. After the adoption of the Fiduciary Rule, most brokers moved to use the BIC Exemption as the primary means to achieve compliance.

D. *The Demise of the Fiduciary Rule*

The Fiduciary Rule faced fierce opposition from the asset management industry. Ultimately, the rule succumbed to a legal challenge by the Chamber of Commerce brought in the conservative Fifth Circuit.⁵⁷ While other cases against the Fiduciary Rule had been dismissed, the Fifth Circuit panel found that expanding the class of fiduciaries to include brokers was inconsistent with congressional intent and struck down the rule on that basis. In doing so, the court did not consider the costs and benefits underlying the case for the rule. The Trump administration, which had already put the rule on hold, declined to seek en banc or Supreme Court review of the decision, allowing the decision to stand.

Evaluating the Fifth Circuit's opinion is beyond the scope of this paper. Future efforts to regulate investment advice are likely to run through the SEC and be subject to different legal analysis, but these efforts, which include the new Regulation Best Interest, are aimed at the same fundamental goal. The extensive regulatory record associated with the Fiduciary Rule provides important insights that future rulemakers would do well to study. The contribution of this paper is critically to analyze that record, as well as the particular approach taken by the DOL, in hopes of guiding future rulemakings.

⁵⁴ See generally DOL BIC Exemption, *supra* note 12.

⁵⁵ See *id.* § II(c).

⁵⁶ See *id.* § II(f)(2).

⁵⁷ Chamber of Commerce v. U.S. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018).

E. *Reviewing the Case for the Fiduciary Rule*

The details of the DOL's *Regulatory Impact Analysis*, which laid out the empirical economic case for the Rule, are considered in detail below. But before wading into these details, it is worth noting that some arguments for the Fiduciary Rule were given short shrift by the perhaps regrettable fixation on precise cost-benefit analysis. First, both common usage and the perceptions of consumers suggest that the Fiduciary Rule provided a definition of "advice" that better tracked contemporary practices than the existing rule. Second, while the case for the Fiduciary Rule rested largely on empirical studies of mutual funds, the Rule was intended to play a significant role in addressing problems in the annuities market that are likely more acute but also less susceptible to quantification. Finally, this section introduces the cost-benefit case for the Fiduciary Rule that will be the focus of the remainder of the paper.

1. *The Meaning of "Advice"*

While disputes over the Rule are mired in detailed considerations of economic impact, at the heart of the Fiduciary Rule was the definition of the term "advice." While the DOL has been accused of overstepping its authority by expanding the class of actors considered fiduciaries, it is the statute itself, not the DOL, which subjects advice-givers to fiduciary obligations. The Fiduciary Rule merely defined the scope of the term, yet little of the discussion around the Fiduciary Rule was actually about the meaning of the term it defined. This is largely a factor of the context in which agency rulemaking must take place, but one should not lose sight of the fact that, as a matter of common usage and consumer understanding, the definition of "advice" reflected in the Fiduciary Rule was superior to the definition it replaced. While critics of the Rule have portrayed the new definition as a regulatory power grab,⁵⁸ the new definition of "investment advice" was, as a matter of common usage, far closer to what is typically meant by the phrase.

A consumer investor sitting across from a broker who enthusiastically recommends a particular mutual fund with the intention of having the investor commit assets to the fund is highly likely to be understood by that investor as giving "advice" about how to invest. This is especially the case when many brokers hold themselves out as financial planners and even carry the Certified Financial Planner designation, suggesting that what the consumer is receiving is indeed comprehensive financial "advice." Because the presence of a fiduciary duty is a protection for the recipient of advice, one might have expected that it would be the consumer's understanding on which the

⁵⁸ See, e.g., Nick Thornton, *Fiduciary Rule Put to Test in Conservative 5th Circuit*, BENEFITSPRO (Aug. 1, 2017), <http://www.benefitspro.com/2017/08/01/fiduciary-rule-put-to-test-in-conservative-5th-cir>.

meaning of “advice” turned, but the long-standing definition nevertheless turned on a mutual understanding of the nature of the recommendation. Similarly, the requirement that such advice be ongoing suggests, counterintuitively and against common usage, that advice cannot be received on a one-off basis.

That the definition of “advice” offered by the Fiduciary Rule was grounded in common usage does little to settle the question of whether it was sound policy. Nevertheless, when an agency is tasked with defining a term and does so in a way that squares with typical usage, it seems reasonable to conclude that it is at least acting within its intended scope of authority.

2. *Annuities Sales Practices*

The DOL’s *Regulatory Impact Analysis* is largely focused on conflicts of interest in the sales of mutual funds. Because mutual funds are public securities subject to rigorous disclosure requirements, mutual fund data is of extraordinarily high quality with a deep and rigorous empirical academic literature to match. It is therefore possible to make strong claims about problems in the mutual fund industry and back those claims with data. Such data is the lifeblood of the sorts of empirical support that, for better or worse, administrative agencies are expected to provide to justify rulemaking. But the absence of transparency into the functioning of an industry does not imply the absence of problems, and the inability to quantify problems does not suggest that they are small. The sales of certain annuity products, while generally held to a standard of suitability, are subject to state insurance laws that are not uniform either in substance or in diligence of enforcement.⁵⁹ There is evidence that annuities sales are fraught with problems that may well be worse, on a per-investor basis, than those facing the mutual fund market.⁶⁰ Data on annuities, though, is not readily available, and to the extent it is available, it provides less transparency than mutual fund data, and there is little academic empirical literature.

Annuities can play an important role in funding retirement, but the purchase of an annuity with accumulated retirement assets is a large, discreet transaction during which investors are vulnerable to exploitation. Confusing terms, high fees, and significant and non-transparent sales commissions make annuities contracts risky. And unlike high-cost mutual funds, an annuity investor may be locked in by cancellation penalties and so cannot escape a bad situation simply by liquidating the investment and transferring the proceeds to lower-cost options. This combination of features means that rolling over an IRA or 401(k) account into an annuity is a fraught transaction during which a lifetime of prudent, careful investing can be undone with the stroke

⁵⁹ See REGULATORY IMPACT ANALYSIS, *supra* note 17, at 39–43.

⁶⁰ See *id.* at 130–132; Barbara Black, *Curbing Broker-Dealers’ Abusive Sales Practices: Does Professor Jensen’s Integrity Framework Offer a Better Approach?*, 48 WAKE FOREST L. REV. 771, 781–82 (2013).

of a pen. Moreover, unlike mutual funds, many annuity products are beyond the regulatory scope of the SEC, and therefore problems in the annuity market cannot be fully addressed by SEC action.⁶¹

The DOL *Regulatory Impact Analysis* discusses annuities at length, but, unlike with mutual funds, the *Regulatory Impact Analysis* is unable to make strong claims about the savings to annuity investors from fiduciary protections. Thus, the *Regulatory Impact Analysis* rests its quantitative case on problems with mutual funds. It is this quantitative case with which the later sections of this paper take issue. It is important to observe, though, that in raising these arguments this paper speaks only to the impact of the Fiduciary Rule on the mutual fund market.⁶²

3. *The Cost-Benefit Case for the Fiduciary Rule*

The Fiduciary Rule and the BIC Exemption are supported by an extensive *Regulatory Impact Analysis*, which argues that eliminating or mitigating conflicts of interest in investment advice will lead to substantially better returns for investors. As noted above, the CEA report estimates \$17 billion in annual savings to investors. The DOL, using a more conservative methodology, estimates a minimum savings of \$33 billion over ten years.⁶³ The \$33 billion estimate is limited *only* to front-end load mutual funds, and other estimates of benefits range into the hundreds of billions of dollars. These benefits are weighted against compliance costs of between \$10 billion and \$31.5 billion over a ten-year period,⁶⁴ though the DOL argues that more efficient advisory models are likely to evolve that will reduce these costs.⁶⁵

Recapitulating the entire DOL calculation of benefits to mutual fund investors is beyond the scope of this paper, but the basic structure of calculation is germane to the discussion that follows. When computing the impact of imposing a fiduciary duty on brokers advising IRAs, the DOL assumes that investors will benefit because they will no longer receive portfolios that underperform the market.⁶⁶ The DOL explicitly acknowledges that the Rule may not completely eliminate conflicts of interest, and there may still be some drag on portfolios due to residual conflicts of interest,⁶⁷ but given the

⁶¹ While it has been argued that the SEC ought to be the regulator to create fiduciary obligations in investment advice, *see* Krug, *supra* note 6, a challenge to this position is that the SEC cannot reach all annuity products, while the DOL has jurisdiction over all investments in IRA plans.

⁶² *See* Copeland, *supra* note 15, and accompanying text.

⁶³ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 170.

⁶⁴ *Id.* at 306.

⁶⁵ *Id.*

⁶⁶ *Id.* at 170 (“These quantitative estimates are calculated with an assumption that the rule will eliminate (rather than just reduce) underperformance associated with the practice of incentivizing broker recommendations through front-end-load sharing.”).

⁶⁷ *Id.* at 170–71.

scope of the benefits to investors, even a partial mitigation of the conflicts would provide substantial benefits.

In casting the benefit of the Fiduciary Rule as the elimination of underperformance for broker-sold funds, the DOL estimate of investor benefits envisions a post-Fiduciary Rule world in which some investors continue to buy funds on commission, but, because these commissions are no longer structured in ways that create conflicts of interest, investors receive portfolios that perform like direct-sold funds. Critically, the actual cost of investment advice, fiduciary or not, is excluded from the computation, and therefore implicitly held to be constant. This is an especially aggressive assumption because the Fiduciary Rule creates new compliance obligations and liability associated with fiduciary status, both of which are likely to increase the cost of advice to at least some degree.⁶⁸

In assuming that investors will benefit from mitigated conflicts of interest while continuing to pay for investment advice on a commission basis, the DOL is effectively baking the use of the BIC Exemption into its analysis. The critical assumptions are that investors will either get commission-based advice, or fee-based advice at the same level of cost, and that eliminating conflicts of interest will also eliminate the underperformance problem. The next section investigates what happens if these assumptions are relaxed.

II. THE COST OF INVESTMENT ADVICE AND THE CENTRALITY OF THE BIC EXEMPTION

Financial advice is a product for which there is prodigious demand. The empirical finance literature suggests that financial advice procured from conflicted brokers is a low-quality product. The Fiduciary Rule aimed to increase the quality of that product by eliminating the conflicts that distort investment recommendations. When we ban a low-quality product by regulation, do consumers receive a higher-quality product or nothing at all? And if they do receive a higher quality product, does it cost more? If the product costs more, does the benefit of the higher-quality product offset the increase in cost? In an ideal world, disrupting the model of broker compensation would shift assets into direct-sold funds, but retail purchasers of direct-sold mutual funds are older, wealthier, and have more financial sophistication than brokerage clients.⁶⁹ The fundamental policy concern with the Fiduciary Rule, argued repeatedly in the thousands of comments, was that, in an attempt to improve the quality of investment advice, the Rule could end up reducing access to advice. It is unsurprising that an industry seeking to avoid

⁶⁸ See Fisch et al., *supra* note 6.

⁶⁹ John Chalmers & Jonathan Reuter, *What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?* (Nov. 12, 2010) (unpublished working paper) (on file with author).

regulation would make such arguments, but how credible are they? Some simple calculations can shed substantial light on the matter.

There are two costs of broker-advised accounts that are relevant to consumers. First, commission-based compensation imposes direct costs. When an investor chooses a fund that carries a front-end load or 12b-1 fee, these fees are paid by the investor with direct consequences to the account balance. Second, there are agency costs, the underperformance of broker-sold funds, and the differential underperformance of high-commission broker-sold funds documented in the empirical literature. What is ultimately important to investors is the total of these two costs: the loads and the underperformance. In exchange for these costs, brokerage clients receive a bundle that includes both the investment portfolio and whatever services the broker renders in addition to the portfolio, which may include financial planning, risk-calibration, and so on. It is easy to measure the value to a client of an investment portfolio in terms of its financial performance, but it is hard to measure the subjective value of financial advice.

Both the academic literature and the DOL sidestep this issue by focusing only on agency costs. The underperformance of broker-sold funds as measured in the academic literature does not include the reduction in returns due to the cost of loads or distribution fees. By omitting these costs, the academic literature measures the outcome of conflicted advice rather than the cost of the advice itself. This may seem innocuous because advice that steers investors to bad funds seems worthless, but the question is: How much does advice that steers investors to good funds cost? Many investors who purchase direct-sold funds do so pursuant to professional advice, but this cost is also excluded from performance calculations in the academic literature. In part this is a matter of comparing apples to apples. That is, the academic literature looks only at the performance and not at the direct cost for both types of mutual funds. But it is also a matter of empirical necessity; the direct cost of advice for the direct-sold segment of the market is not observed empirically because it is not a part of mutual funds' fee structures. Absent from the academic literature and the DOL *Regulatory Impact Analysis* is an estimate of the total cost of investing with and without a broker. This is a problem because even if conflicted advice is low-quality it may nevertheless be cheaper than other ways of paying for financial advice.

This Part aims to evaluate the cost of investment advice and the potential the Fiduciary Rule had to reduce that cost. First, I present a simple calculation of the all-in cost, including both direct costs and agency costs, of investing with a broker expressed as an annualized fee. This calculation permits comparison between the cost of conflicted advice and the cost of advice in the fee-based model pursuant to which most fiduciary advice is currently rendered. Second, I argue that there are reasons to be concerned that some of what is identified as agency costs in the academic literature might, in fact, be hidden compensation that the Fiduciary Rule might simply have shifted to

another channel. To the extent this is the case, solving the agency problem would not equalize performance between direct- and broker-sold funds.

The calculations show that, even accounting for the underperformance of broker-sold funds, the sum of direct and agency costs of brokerage advice is roughly in line with direct costs typical of fiduciary money management. If conflicts of interest can be mitigated in brokerage accounts, the direct cost of brokerage loads is actually low compared to typical fees for fiduciary asset management. Regulators should be cautious of shifting assets out of brokerage accounts into fee-based accounts, as this may simply swap agency costs for higher direct costs. A reasonable goal of regulation is reducing agency costs while keeping the direct costs of asset management constant. In fact, holding direct costs constant and reducing agency costs is operationalized in the DOL's assessment of the benefits of the Fiduciary Rule in its *Regulatory Impact Analysis*. This put pressure on the BIC Exemption, which was designed to manage conflicts in load accounts. The functioning of the BIC Exemption would have been critical to the success of the Fiduciary Rule.

A. *Estimating the All-In Cost of Commission-Based Investment Advice*

Currently, most fiduciary advisory accounts charge an annual fee as a percentage of assets under management. It is helpful to have some sense of what typical brokerage commissions would look like if they were structured as an annual percentage of assets. At the very least, this provides a benchmark against which new compensation models that evolve in response to regulatory interventions can be judged. It also provides a more concrete sense of the impact of agency costs. This section develops some simple calculations to measure the cost of investing through broker-sold IRAs. The parameters for these calculations roughly track the assumptions of the DOL *Regulatory Impact Analysis*.

To reduce the various costs of the broker sales channel to a single number susceptible to comparison with other forms of money management, I compute the annualized implied cost of a brokered account. Over the course of a career, what annual money management fee as a percentage of assets would leave a retirement saver indifferent between holding a direct-sold mutual fund account (less the annual asset-based fee) and saving through a brokerage account with typical loads and underperforming funds?

In order to make such a calculation, a number of parameters and assumptions are necessary. Table 1 assumes that an investor saves over the course of a forty-year career. Rather than assume a constant savings rate, I allow the amount the investor saves to grow 2% annually, so that the saver is, realistically, putting away more money as her career progresses. Following the *Regulatory Impact Analysis*, I assume annual returns of 6% on the benchmark, direct-sold portfolio in Scenario A. The other scenarios account for the costs of broker advice in various ways.

Investors in broker-sold accounts incur costs through three channels: front-end loads, 12b-1 fees, and a portfolio of lower performing funds. For Class A shares, investors pay loads when assets are committed to the funds in portfolio. Following the DOL calculations, Table 1 uses 1.58% loads, reflecting the current industry average. Class A shares also pay ongoing 12b-1 distribution fees to brokers as a form of additional compensation. Table 1 assumes a typical 25 basis point trailing fee.

Finally, broker-sold funds are known to underperform. If a direct result of investing in broker-sold funds is an inferior mutual fund portfolio, then that cost—whether or not it benefits the broker—is an amount that the investor would be willing to pay an adviser for access to better performing funds. The *Regulatory Impact Analysis* considers the range of numbers for underperformance generated in the academic literature and settles on a range of fifty to hundred basis points. Scenarios B and C of Table 1 take the middle of that range and assume an underperformance of seventy-five basis points before accounting for 12b-1 fees.

The costs attributable to loads depends on the trading strategy of the investor. The loads will be incurred once when the money is initially invested. Thereafter, the investor might hold the fund indefinitely. If the investor reinvests money within the account, then new load fees might be incurred. A buy-and-hold strategy economizes on loads, but rebalancing and moving money between funds is not uncommon, and—of course—brokers have an incentive to encourage such trading. To account for the dependence of loads on trading practices, Table 1 presents two scenarios for broker-sold accounts. In Scenario B, loads are paid only once and funds are held until retirement. In Scenario C, funds are assumed to be held for seven years, thus loads recur annually on one-seventh of the invested assets.

In Scenario D, I explore the impact of loads on investment returns if the broker-sold funds had no underperformance. Scenario D assumes a seven-year holding period and twenty-five basis point trailing fee as in Scenario C but uses the Direct Sold Return rather than the Broker Sold Return. This gives a sense of how loads compare with annualized investment fees, setting aside the issue of underperformance. This is a useful calculation because it reflects the world the BIC Exemption attempted to create wherein loads continue to be a viable means of compensating fund advisers, but conflicts of interest are removed.

With these calibrations in hand, I compute the annualized implied cost of money management under the three brokerage scenarios. I do this by solving for the annual fee (percentage point reduction in returns) that renders the direct-sold account balance of Scenario A in years forty, twenty-five, and ten equal to the balances for Scenarios B, C, and D in the corresponding years. Since a longer holding period diminishes the initial hit of the fund load, annualized costs are lower for longer investment horizons. The cost of brokerage money management, including agency costs, ranges from 1.07%

to 1.58% depending on trading behavior and the time period examined. The direct costs of brokerage investing range from 0.55% to 0.83%.

As a final check, I calculate the cost of investing in a brokered account in a manner that tracks the DOL methodology from the *Regulatory Impact Analysis*. I annualize loads by multiplying the average load by the average load fund turnover. This does not account for growth in savings over a career and abstracts away from the loads attached to the initial deposit of funds. This calculation can be understood as the average expense across a large group of investors at different points in the savings lifecycle. The annualized cost of the brokered account is 1.27%, and the direct cost, excluding underperformance, is 0.52%. These are roughly consistent with the calculations above.

By way of comparison, the average fee for an RIA that offers financial planning services in 2016 was 1.02% overall and 1.18% for a \$50,000 account.⁷⁰ This comparison warrants some caution, though, because some advisers may charge additional service fees for financial planning services.⁷¹ In any case, the all-in cost of a broker-advised account ranges from about the same as fiduciary management to about fifty basis points more. But the calculations also show that, setting aside agency costs (as in Scenario D and the Direct Cost Only line of the DOL methodology), commission-based compensation is less expensive than fee-based management.

A reasonable conclusion from these calculations is that the lower direct cost of commission-based asset management partially, but not completely, mitigates the agency costs. A corollary is that investors seeking full-service financial advice would likely benefit most if the relatively low direct cost of commission-based compensation could be paired with the better performance of direct-sold funds. The BIC Exemption was aimed at achieving precisely this result.

⁷⁰ *Average Financial Advisor Fees & Costs | 2-17 Report | Understanding Advisory & Investment Management Fees*, ADVISORYHQ (2017), <https://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors>.

⁷¹ *See id.*

TABLE 1. THE IMPLIED COST OF INVESTING THROUGH
A BROKER-SOLD IRAS

| Year | Deposit | (A) Direct Sold | (B) Brokered Account (Buy and Hold) | (C) Brokered Account (With Turnover) | (D) Direct Costs Only |
|------|----------|-------------------|-------------------------------------|--------------------------------------|-----------------------|
| 1 | \$ 1,000 | \$ 1,000 | \$ 984 | \$ 984 | \$ 984 |
| 2 | \$ 1,020 | \$ 2,080 | \$ 2,037.29 | \$ 2,035.07 | \$ 2,042.45 |
| 3 | \$ 1,040 | \$ 3,245 | \$ 3,163.12 | \$ 3,156.19 | \$ 3,179.25 |
| 4 | \$ 1,061 | \$ 4,501 | \$ 4,365.72 | \$ 4,351.32 | \$ 4,399.32 |
| 5 | \$ 1,082 | \$ 5,854 | \$ 5,649.33 | \$ 5,624.40 | \$ 5,707.68 |
| 6 | \$ 1,104 | \$ 7,309 | \$ 7,018.44 | \$ 6,979.56 | \$ 7,109.62 |
| 7 | \$ 1,126 | \$ 8,874 | \$ 8,477.73 | \$ 8,421.15 | \$ 8,610.75 |
| 8 | \$ 1,149 | \$ 10,555 | \$ 10,032.15 | \$ 9,953.74 | \$ 10,216.97 |
| 9 | \$ 1,172 | \$ 12,360 | \$ 11,686.90 | \$ 11,582.10 | \$ 11,934.53 |
| 10 | \$ 1,195 | \$ 14,296 | \$ 13,447.46 | \$ 13,311.28 | \$ 13,770.04 |
| 11 | \$ 1,219 | \$ 16,373 | \$ 15,319.57 | \$ 15,146.53 | \$ 15,730.47 |
| 12 | \$ 1,243 | \$ 18,599 | \$ 17,309.27 | \$ 17,093.40 | \$ 17,823.19 |
| 13 | \$ 1,268 | \$ 20,983 | \$ 19,422.94 | \$ 19,157.69 | \$ 20,056.00 |
| 14 | \$ 1,294 | \$ 23,536 | \$ 21,667.26 | \$ 21,345.50 | \$ 22,437.12 |
| 15 | \$ 1,319 | \$ 26,267 | \$ 24,049.25 | \$ 23,663.22 | \$ 24,975.24 |
| 16 | \$ 1,346 | \$ 29,189 | \$ 26,576.32 | \$ 26,117.58 | \$ 27,679.55 |
| 17 | \$ 1,373 | \$ 32,313 | \$ 29,256.23 | \$ 28,715.60 | \$ 30,559.74 |
| 18 | \$ 1,400 | \$ 35,652 | \$ 32,097.16 | \$ 31,464.68 | \$ 33,626.06 |
| 19 | \$ 1,428 | \$ 39,220 | \$ 35,107.69 | \$ 34,372.58 | \$ 36,889.34 |
| 20 | \$ 1,457 | \$ 43,030 | \$ 38,296.87 | \$ 37,447.41 | \$ 40,361.01 |
| 21 | \$ 1,486 | \$ 47,097 | \$ 41,674.19 | \$ 40,697.73 | \$ 44,053.14 |
| 22 | \$ 1,516 | \$ 51,439 | \$ 45,249.61 | \$ 44,132.47 | \$ 47,978.48 |
| 23 | \$ 1,546 | \$ 56,071 | \$ 49,033.65 | \$ 47,761.04 | \$ 52,150.50 |
| 24 | \$ 1,577 | \$ 61,012 | \$ 53,037.31 | \$ 51,593.27 | \$ 56,583.43 |
| 25 | \$ 1,608 | \$ 66,282 | \$ 57,272.20 | \$ 55,639.51 | \$ 61,292.28 |
| 26 | \$ 1,641 | \$ 71,899 | \$ 61,750.50 | \$ 59,910.58 | \$ 66,292.93 |
| 27 | \$ 1,673 | \$ 77,886 | \$ 66,485.00 | \$ 64,417.86 | \$ 71,602.11 |
| 28 | \$ 1,707 | \$ 84,267 | \$ 71,489.17 | \$ 69,173.27 | \$ 77,237.54 |
| 29 | \$ 1,741 | \$ 91,064 | \$ 76,777.14 | \$ 74,189.31 | \$ 83,217.88 |
| 30 | \$ 1,776 | \$ 98,303 | \$ 82,363.79 | \$ 79,479.11 | \$ 89,562.86 |
| 31 | \$ 1,811 | \$ 106,013 | \$ 88,264.72 | \$ 85,056.41 | \$ 96,293.31 |
| 32 | \$ 1,848 | \$ 114,221 | \$ 94,496.35 | \$ 90,935.65 | \$ 103,431.22 |
| 33 | \$ 1,885 | \$ 122,959 | \$ 101,075.93 | \$ 97,131.94 | \$ 110,999.82 |
| 34 | \$ 1,922 | \$ 132,259 | \$ 108,021.59 | \$ 103,661.16 | \$ 119,023.63 |
| 35 | \$ 1,961 | \$ 142,155 | \$ 115,352.37 | \$ 110,539.93 | \$ 127,528.53 |
| 36 | \$ 2,000 | \$ 152,684 | \$ 123,088.28 | \$ 117,785.72 | \$ 136,541.86 |
| 37 | \$ 2,040 | \$ 163,885 | \$ 131,250.35 | \$ 125,416.80 | \$ 146,092.48 |
| 38 | \$ 2,081 | \$ 175,799 | \$ 139,860.68 | \$ 133,452.37 | \$ 156,210.86 |
| 39 | \$ 2,122 | \$ 188,469 | \$ 148,942.48 | \$ 141,912.53 | \$ 166,929.16 |
| 40 | \$ 2,165 | \$ 201,942 | \$ 158,520.14 | \$ 150,818.38 | \$ 178,281.34 |

| Parameters | |
|------------------------|-------|
| Direct Sold Return | 6.00% |
| Broker Sold Return | 5.25% |
| Front End Loads | 1.58% |
| 12b-1 Fee | 0.25% |
| Holding Period (Years) | 7 |

| Annualized Costs Relative to Direct Sold | |
|--|-------|
| 40 year | |
| Scenario B | 1.07% |
| Scenario C | 1.30% |
| Scenario D | 0.55% |
| 25 year | |
| Scenario B | 1.12% |
| Scenario D | 1.35% |
| Scenario C | 0.77% |
| Column 1 | |
| Scenario B | 1.35% |
| Scenario C | 1.58% |
| Scenario D | 0.83% |

| DOL Methodology | |
|-------------------------|--------|
| Load (a) | 1.58% |
| Annual Turnover (b) | 16.80% |
| Total Load (c = a*b) | 0.27% |
| 12b-1 (d) | 0.25% |
| Agency Cost (e) | 0.75% |
| Annualized Cost (c+d+e) | 1.27% |
| Direct Cost Only (c+d) | 0.52% |

B. Mutual Fund Performance and the Hidden Cost of Advice

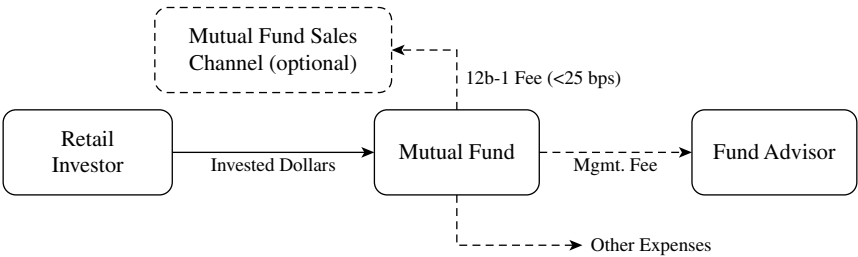
The calculations above assume that shifting from a conflicted model of investment advice to a fiduciary model will eliminate the observed un-

derperformance of broker-advised portfolios. This mirrors the assumptions of both the CEA report and the DOL’s own cost-benefit analysis. Such an assumption is safe to the extent that the underperformance of broker-sold funds is wholly a matter of agency costs between investors and advisers. If these agency problems are solved, the argument goes, then investors will receive better funds, since there is no reason for an unconflicted adviser to recommend an inferior fund.

Some, though certainly not all, of the underperformance measured with respect to broker-sold funds may in fact reflect indirect payment for investment advice. Such payments are hidden direct costs that are difficult to distinguish from agency costs and are confounded with fund performance. To the extent these payments are compensation for investment advising services, restricting these payments via the Fiduciary Rule may result in offsetting increases in compensation through other, permissible channels. Such a shift may well be desirable for reasons such as cost transparency, but bringing hidden compensation into the light is unlikely to lead to a dollar-for-dollar performance improvement for investors in the way that eliminating agency problems might.

FIGURE 1. THE COST STRUCTURE OF MUTUAL FUNDS

Panel A. The Direct-Sold Channel



Panel B. The Broker-Sold Channel

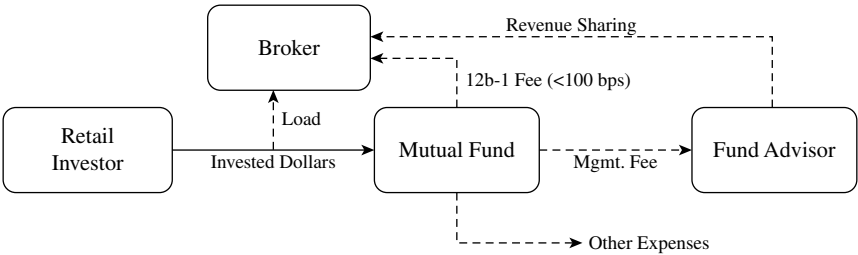


Figure 1 illustrates the various payouts in the broker-sold and direct-sold mutual fund markets. In the direct-sold market, all of the investor’s dol-

lars are initially invested in the fund. The fund will then pay a percentage of its assets to the portfolio manager that actually chooses the fund's investments and an additional amount to cover overhead and other fund expenses. Direct-sold "no load" funds are permitted to charge up to twenty-five basis points in 12b-1 fees to cover distribution costs.

A broker-sold fund will carry these expenses as well but has the additional load and 12b-1 fees associated with compensating the broker. Of particular interest here, though, is revenue sharing. Revenue sharing is the practice of the fund adviser making payments to a broker out of the management fees in proportion to the assets that the broker has sold on behalf of the fund. Since fund advisers are paid based on assets under management, they have an incentive to compensate brokers who bring assets into the fund. Sharing revenue is a direct cost to the fund adviser, and funds that engage in revenue sharing might charge higher fees to offset this revenue sharing payment.⁷²

The existence of revenue sharing in broker-sold funds means that some of the funds' management fees are used to compensate brokers. Since the performance of mutual funds in the academic literature is typically measured net of management fees, fees have a direct impact on mutual fund performance. If funds that engage in revenue sharing have increased management fees to offset the cost of payments to brokers, then these fees could reduce performance as well.⁷³ Table 2 demonstrates the issue.

TABLE 2. COMPUTING NET RETURNS FOR DIRECT- AND
BROKER-SOLD FUNDS

| Direct-Sold Net Returns Calculation | Broker-Sold Net Returns Calculation |
|--|--|
| Raw Fund Returns | Raw Fund Returns |
| – Mgmt. fee | – Mgmt. fee retained by manager |
| – Other fund expenses | – Other fund expenses |
| = Net Returns | – Revenue sharing payment to broker |
| | = Net Returns |

⁷² Indeed, the risk that payments by the fund adviser out of fund fees might be construed as an additional fee charged and paid by the fund is precisely why many funds that use revenue sharing adopt "defensive 12b-1" plans.

⁷³ A significant caveat is that Christoffersen et al., *supra* note 25, do not find a statistically significant relationship between revenue sharing and performance once they control for payments to brokers, but the measured effect is directionally consistent with such an effect and their proxy for revenue sharing introduces some measurement error.

This problematizes the notion that the underperformance of broker-sold funds is entirely a cost of conflicted investment advice. If underperformance is partially a result of indirect compensation to brokers, then it is not a cost of conflicted advice but simply a cost of advice itself. Some portion of underperformance would therefore reflect a direct cost rather than an agency cost. The difference is important: reduced performance due to misaligned incentives between the broker and client can be eliminated by adjusting the broker's incentives without necessarily leaving either the broker or client worse off. But if revenue sharing payments are cut off by fiduciary status, while investors might receive funds that perform better due to lower fees, if brokers make up the lost income from revenue sharing through higher fees in terms of loads, 12b-1 fees, or other compensation that is not part of the performance measure, then investors will not necessarily be better off net of the total cost of investing.

Revenue sharing is a particularly non-transparent type of compensation, and investors may be better off if that compensation is shifted to a channel that investors can more easily observe. Fee transparency to promote a robustly competitive market is generally good public policy. But the Fiduciary Rule and the CEA report regard the underperformance of broker-sold mutual funds as a pure cost attributable to an agency problem rather than an issue of fee transparency. To the extent this is not the case, the benefits of mitigating agency costs may be overstated.

C. The Direct Costs of the BIC Exemption

A final assumption of the above calculations is that commissions are the same with or without the Fiduciary Rule, but the BIC Exemption clearly carried some compliance costs. Firms using the BIC Exemption were obligated to adopt compliance programs to ensure that they were acting in the best interest of clients and to mitigate conflicts of interest.⁷⁴ These requirements caused large providers of financial advice to adopt comprehensive documentation systems aimed at supporting each investment recommendation related to a retirement account as consistent with the client's best interest. The BIC Exemption also required firms to make certain disclosures on a regular basis and created risk of private litigation that may have increased insurance costs.

While these compliance costs were likely modest, increased costs associated with using the BIC Exemption would have been unevenly distributed. The compliance burden imposed by documenting investment choices is higher for small accounts. Documenting that an investment recommendation is in the best interest of the client is similarly costly whether the investment is ten thousand or one hundred thousand dollars. This means that the cost of compliance with the BIC rules fell disproportionately on small accounts. But

⁷⁴ DOL BIC Exemption, *supra* note 12, at 21,007–88.

small accounts are already at the most risk: they are the most likely to receive conflicted advice and the most likely to go without financial advice altogether. Finally, even if the compliance costs associated with the Fiduciary Rule were modest, so is the difference in total cost between conflicted and unconflicted advice.

The empirical evidence strongly supports the view that investors are poorly served by conflicted investment advice. If investors could somehow receive the returns of direct sold funds in well-designed portfolios that met their needs with no increase in direct costs, they would certainly be better off. Taken as a whole, this section raises questions about the extent to which investors were likely to realize those benefits as a result of the Fiduciary Rule. The total cost of conflicted investment advice is quite close to the total cost of unconflicted advice, even on the assumptions of the DOL *Regulatory Impact Analysis*, and these assumptions may be too aggressive: some of what is currently understood to be agency costs may in fact be direct costs, and the use of the BIC Exemption might entail an increase in direct costs. But even if the Fiduciary Rule were fully effective in eliminating all agency costs and all underperformance is an issue of agency costs, it is important to preserve access to the lower direct costs of commission-based advice, at least until more efficient fee models become available. This was the goal of the BIC Exemption. In the next two sections, I note design issues with the BIC Exemption and suggest solutions.

III. THE BIC EXEMPTION AND TWO TYPES OF AGENCY PROBLEMS

The BIC Exemption was designed to permit commission-based compensation, trailing fees, and other types of payment common in current brokerage accounts but that would not be permitted for fiduciary advisers. It functioned by requiring an adviser to enter into a bilateral contract with her client and take substantive steps to mitigate conflicts of interest that might interfere with an adviser's acting in the best interest of the investor when giving investment advice. As detailed above, the BIC Exemption was to be the channel through which investors would receive low-cost advice, and the DOL *Regulatory Impact Analysis* effectively assumed that advice would continue to be rendered at pre-Fiduciary Rule prices pursuant to the BIC Exemption.

The BIC Exemption, as described in the adopting release, conflated two types of agency costs documented in the empirical literature in ways that could interfere with its capacity to eliminate agency costs. In particular, it conflated agency problems that would motivate brokers to advise clients into load funds, as opposed to no-load funds, with agency problems that would motivate brokers to push high-load funds rather than low-load funds from

within the universe of load-bearing funds.⁷⁵ In doing so, the BIC Exemption pushed changes that would address one type of agency problem but not the other. The rest of this section details these concerns.

A. *Within-Market Underperformance and Cross-Market Underperformance*

The empirical record supports two claims regarding broker-sold funds: first, broker-sold funds underperform direct-sold funds, and second, broker-sold funds with high sales commissions underperform broker-sold funds with low sales commissions. Both claims share a theoretical foundation reflecting that brokers have an incentive to recommend funds for which they receive compensation and that this incentive rises with the level of compensation. But they are different claims.

This is most easily seen by noting that either of the two claims could be true while the other is false. One could imagine a mutual fund market where the average broker-sold fund performed just as well as the average direct-sold fund but where brokers pushed funds with relatively high commissions in order to maximize their income. Conversely, one could imagine a market in which broker-sold funds underperformed direct-sold funds as a group, but the commission levels of broker-sold funds had no correlation with their performance. For simplicity, I refer to the claim that broker-sold funds underperform direct sold funds as cross-market underperformance because it compares performance in the direct- and broker-sold market segments. I refer to the claim that high-commission broker-sold funds underperform low-commission broker-sold funds as within-market underperformance since it relates to issues within the broker-sold segment of the mutual fund market.

The BIC Exemption conflates within-market and cross-market underperformance. It does so most clearly in computing the benefits of the Fiduciary Rule in the *Regulatory Impact Analysis*. In those calculations, the DOL uses a measure of within-market underperformance to estimate cross-market underperformance. The result is an estimate of underperformance, and therefore the benefit of the Fiduciary Rule, that is too low, but the issue arises again in the context of the DOL's guidance on avoiding conflicts of

⁷⁵ It is possible that, in eliminating incentives to push high-load rather than low-load funds, the problem of underperforming broker-sold funds would be eliminated. If underperforming broker-sold funds cannot pay brokers to generate sales, then funds might compete only on performance, and the equilibrium in broker-sold funds would track the equilibrium in direct-sold funds with performance being the key sales point. This is one possibility, but the DOL does not make this argument explicitly, and there are reasons to worry that such an equilibrium would not arise. First, part of the underperformance of broker-sold funds is fee-driven, and fees in the broker-sold segment are generally higher. Moreover, the DOL seemed open to allowing brokers to limit menus of fund offerings to particular families so long as incentives over the menu were equalized. This would allow fund families with a reliable brokerage channel to insulate themselves from the full force of competition. In short, while equalized incentives across load funds might mitigate the general underperformance of load funds to some degree, there are reasons to believe it would not eliminate the gap.

interest. There, the DOL suggests fee arrangements as acceptable under the BIC Exemption that address within-market underperformance but not cross-market underperformance.

1. *Mis-Measuring Cross-Market Underperformance*

In its *Regulatory Impact Analysis*, the DOL's primary calculation of the cost of conflicts uses the Christoffersen et al. (2013) study discussed above. In particular, the DOL used an estimate from that paper of the impact of loads on fund performance. Christoffersen et al. find that for every 100 basis points of excess load, which is the residual of a regression of loads on fund characteristics, funds underperform by 44.9 basis points on a pre-load basis.⁷⁶ To get a measure of underperformance of the average load fund, the DOL multiplied this number by the estimated average mutual fund front-end load actually paid to the broker in each year—124 basis points in 2017—to estimate conflict of interest related underperformance of 0.56%, slightly more than half of the CEA report estimate.⁷⁷ The DOL then computed, over ten years, how much better assets invested in IRAs would perform if the drag on performance due to conflicts of interest were eliminated.⁷⁸

The fifty-six basis point estimate for the cost of conflicted advice is, if anything, conservative in light of the academic literature, but it also appears to be based on a misreading of Christoffersen et al. The first mistake is fairly minor: The 44.9 basis point number used by DOL is a regression coefficient, and the regression model in the relevant regression includes a constant. To obtain a correct estimate of the level of underperformance, this constant would need to be added to the product of the load level and the marginal effect of load on performance. The constant is small but would reduce the effect by 1.9 basis points.

The second issue is more fundamental. The Christoffersen et al. paper does not measure the underperformance of broker-sold funds relative to direct-sold funds. It is true that Christoffersen et al. include a calculation in which they multiply the underperformance coefficient by the average load. But the calculation, while a perfectly reasonable way of establishing that the measured effect is big enough to matter (1.31% in Christoffersen et al.), is not the same as the difference in performance between broker-sold and direct-sold funds, and Christoffersen et al. do not claim otherwise. The entire Christoffersen et al. study is based on the universe of broker-sold funds. Their results measure how high-load funds compare to low-load funds

⁷⁶ I am intentionally simplifying here as the 44.9 basis point estimate does not appear in Christoffersen et al., *supra* note 25. Rather, 44.9 basis points is an asset weighted average of two different effects of loads and performance over affiliated and unaffiliated brokers. See REGULATORY IMPACT ANALYSIS, *supra* note 17, at 342.

⁷⁷ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 342.

⁷⁸ *Id.* at 343–44.

among broker-sold funds, not how the performance of broker-sold funds compares to other funds.

This specific calculation in Christoffersen et al. became a matter of dispute when the Investment Company Institute (ICI), a mutual fund trade group, called it a “serious error” in a comment letter.⁷⁹ Christoffersen and Evans replied by pointing out their reason for including the calculation: “we are economically trying to evaluate how a *change* in the load paid to the broker would relate to *changes* in the future performance of the fund.”⁸⁰ But, again, this is a rate of change among broker-sold funds and not a measure of the difference between broker-sold and direct-sold funds. Contra the ICI, this is not a problem with Christoffersen et al. but rather an interpretive mistake made (ironically) by both the DOL and the ICI in applying the paper’s results.

Fortunately for the DOL’s purposes, direct measures of the underperformance of broker-sold funds, including Bergstresser et al. and others, suggest that fifty-six basis points is a low estimate. But the conflation of agency costs within the universe of broker-sold funds and agency costs between broker-sold and direct-sold funds does have other consequences for the Rule and the *Regulatory Impact Analysis*. For example, in computing the benefits to investors, the DOL’s calculations project forward a historical downward trend in sales loads. While lower loads would improve the performance of broker-sold funds net of loads relative to direct-sold funds, the DOL calculations also project that this downward trend would improve the relative performance of broker-sold funds before loads. The reasoning is, apparently, that since—in the mistaken reading of Christoffersen et al.—the performance drag due to conflicts of interest is a function of the average fund load, lower loads on average will lead to better relative broker-sold fund performance. But, even as average loads decline, incentives to recommend a high-load fund over a low-load fund remain. More importantly, though, the confusion extends to the specific policies the DOL seeks to have institutions adopt, as described in the next section.

2. *The Policy Difference between Within-Market and Cross-Market Underperformance*

While the above issues result in an estimate of the benefits of the Fiduciary Rule that was likely too low, conflating the two types of un-

⁷⁹ Letter from Brian Reid, Chief Economist, Inv. Co. Inst., and David Blass, Gen. Counsel, Inv. Co. Inst., to Office of Regulations & Interpretations, U.S. Dep’t of Labor (Jul. 21, 2015), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/00749.pdf>.

⁸⁰ Letter from Susan Christoffersen, Vice-Dean, Undergraduate & Pre-experience Programs, Rotman Sch. of Mgmt. and Richard Evans, Associate Professor, Finance, Darden Sch. of Bus., to Office of Regulations & Interpretations, U.S. Dep’t of Labor (Sep. 10, 2015), <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32-2/02766.pdf>.

derperformance has a concrete policy impact as well. Within-market underperformance and cross-market underperformance are both types of agency costs resulting from conflicted compensation, but they arise from different incentives. Within-market underperformance occurs because some funds have higher payments to brokers than others. Between-market underperformance occurs because some funds carry loads and others do not.

The DOL focused in the BIC Exemption on ensuring that sales loads would be level across the menu of mutual fund options over which a broker is making a recommendation. This is a regulatory solution that addresses only within-market underperformance. This is most evident in Example 4 of the adopting release's examples of permissible ways to manage adviser incentives.⁸¹ In the example, "the institution establishes a commission-based compensation schedule . . . in which all variation in commissions is eliminated for recommendations of investments within reasonably designated categories."⁸² Similarly, a DOL FAQ on the BIC Exemption emphasized the need to ensure that compensation to advisers is level within a particular investment class even if, at the institutional level, some investments provide a higher commission.⁸³ The implication of both is that an adviser could be in compliance with the BIC Exemption by ensuring that, within a category of investment, all investments carry identical commissions.

When the Fiduciary Rule was in effect, a number of mutual fund complexes introduced proposals to offer so-called T-Share classes of mutual funds, all of which would have a sales load of 2.5%.⁸⁴ While T-Shares seem to have been met with a shrug by the brokerage industry,⁸⁵ another fund complex sought to offer "clean shares" that permit brokers to set the load in-house, rather than the load being set by the mutual fund adviser.⁸⁶ The idea behind both proposals was that the mutual fund industry would offer special mutual fund share classes for use in brokered IRAs with a standardized load level (either at the industry or broker level) thereby eliminating any incentive to prefer one fund over another so long as both funds comply with the standard.

⁸¹ DOL BIC Exemption, *supra* note 12, at 21,038.

⁸² *Id.* at 21,039.

⁸³ U.S. Department of Labor, Employee Benefits Security Administration, *Conflict of Interest FAQs*, U.S. DEPARTMENT OF LABOR 7-8 (Oct. 27, 2016), <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf>.

⁸⁴ Joe Rekenhaller, *Lower Cost T-Shares Coming to a Fund Near You*, MORNINGSTAR (Jan. 6, 2017), <https://www.morningstar.com/articles/787395/lowercost-t-shares-coming-to-a-fund-near-you.html>.

⁸⁵ Dan Jamieson, *American Funds, Others, Back Off T Shares as B-D's Face DOL Uncertainty*, FIN. ADVISOR (Jun. 16, 2017), <https://www.fa-mag.com/news/industry-struggles-with-mutual-fund-pay-under-dol-rule-33304.html>.

⁸⁶ Daisy Maxy, *5 Things Mutual-Fund Investors Should Know About Mutual-Fund "T" Shares*, WALL ST. J. (Apr. 9, 2017), <https://www.wsj.com/articles/5-things-mutual-fund-investors-should-know-about-mutual-fund-t-shares-1491791820>.

Some brokers seem to have taken the perceived need to standardize loads to counterproductive extremes. One broker, per the author's conversations with advisers, dropped Exchange Traded Funds (ETFs) from its menu for IRAs, keeping only funds with uniform loads. ETFs are a low-cost option for investing, and brokers are permitted to set sales commissions for ETFs in-house rather than at the fund level. This leads to variations in compensation between load funds and ETFs, which would have created risk under the BIC Exemption. Another brokerage, Edward Jones, announced that it would not offer mutual funds in its brokered IRAs at all, arguing that there was simply not enough standardization across mutual fund loads to be confident that mutual fund recommendations could be conflict-free,⁸⁷ but the firm later reversed course.⁸⁸

The DOL would certainly dispute that anything in the Rule required that every mutual fund offered by a broker carry the same load, but the Rule nevertheless made it clear that standardizing mutual fund loads, at least within particular types of funds, was an important part of compliance. But ensuring that loads are level across all funds in a menu only addresses within-market underperformance. A menu in which all funds carry the same load is still a menu of load funds drawn from the broker-sold segment of the industry, and cross-market underperformance might still be an issue. Reducing the incentive to offer low-performing, high-commission funds is a positive step, but it is still possible that a menu of well-chosen load funds would underperform a similar menu of direct-sold funds. The empirical literature does not offer a clear answer as to whether this is the case. The amount of benefit to consumers from reducing within-market underperformance without addressing cross-market underperformance is uncertain. Below, a means to address both types of underperformance is discussed.

B. Addressing Cross-Market Underperformance through SEC Rulemaking

The underperformance of broker-sold mutual funds is, in part, a function of the bifurcation of the mutual fund market into funds that pay brokers to sell them and funds that do not. Since brokers do not sell direct-sold funds, direct- and broker-sold funds do not compete within a single sales channel. That a broker would not recommend, say, a no-load Fidelity fund is not just an agency problem; rather, it is an issue of market structure wherein a broker cannot be paid for ancillary services to the client if the client does not invest in a fund that carries a load. Addressing cross-market underperformance means ensuring that brokers can be compensated for recom-

⁸⁷ Megan Leonhardt, *Why This Brokerage Won't Let Investors Buy Funds, ETFs in Their IRAs*, TIME MONEY (Aug. 22, 2016), <http://time.com/money/4459130/edward-jones-bans-funds-etfs-in-iras/>.

⁸⁸ *Edward Jones Backtracks on Commissions*, BARRON'S (Jun. 7, 2017), <http://www.barrons.com/articles/edward-jones-backtracks-on-commissions-1496875564>.

mending a no-load fund just as when selling a load fund, but current law does not permit such arrangements. Relatively simple regulatory changes could address this issue and improve the prospects of the Fiduciary Rule to address cross-market underperformance.

Current law bars attaching sales charges to funds aside from those established in the prospectus.⁸⁹ The operative provision is Section 22(d) of the Investment Company Act, which bars “dealers” from selling mutual fund shares at other than at the offering price described in the fund’s prospectus.⁹⁰ Retail brokerages are legally distinct from dealers, but the definition of dealer is murky, and brokerages worry about being designated dealers for the purposes of Section 22(d). As such, brokers can collect commissions on sales of ETF shares and shares of stock at levels set by the broker but can collect only the specified sales commissions for load mutual funds and no commissions at all for mutual funds that do not carry a load.

The SEC has proposed permitting (though not requiring) funds to offer classes of shares sold at the price of the underlying basket of stocks, as in no-load funds, and allowing brokers to attach sales charges to those funds as they see fit. This arrangement is referred to as “externalized sales charges.”⁹¹ Proposals along these lines were made in 2004 and again in 2010, but neither was adopted.⁹² The proposals were motivated by a desire to induce competition among brokers to offer funds at lower loads, address agency problems between brokers and investors by standardizing loads at the broker level, and separate the selection of securities from the fee paid for financial services. The issue of allowing brokers to set loads surfaced again after the adoption of the Fiduciary Rule when American Funds, one of the leading broker-sold fund complexes, received a no action letter from the SEC regarding a plan to offer clean shares, which effectively implements the separation for load-setting from the mutual fund prospectus envisioned in the 2004 and 2010 proposed rules.⁹³ The SEC staff has therefore endorsed the approach of the proposed rules in the form of a no action letter, at least under the circumstances outlined by American Funds. Permitting funds to offer clean shares is helpful for addressing within-market underperformance because it streamlines level commission arrangements, but, even if the proposed rules externalizing sales charges were adopted, clean shares would be opt-in at the fund level.

⁸⁹ See, e.g., *SEC Proposes Changes to Structure for Mutual Fund Distribution Fees*, DECHERT LLP (Aug. 2010), <https://www.dechert.com/> (search “SEC Proposes Changes to Structure for Mutual Fund Distribution Fees”) [hereinafter *SEC Proposes Changes*]. This means that mutual fund loads are set by the fund complex at the fund level and are the same for all brokers who sell the fund.

⁹⁰ 15 U.S.C. § 80a-22(d) (2018).

⁹¹ See *Prohibition on the Use of Brokerage Commissions To Finance Distribution*, 69 Fed. Reg. 9726 (Mar. 1, 2004) [hereinafter *Prohibition on Brokerage Commissions*].

⁹² SEC Proposes Changes, *supra* note 89, at 1, 7.

⁹³ Capital Group Companies, Inc., SEC No-Action Letter, 2017 SEC No-Act. LEXIS 20 (Jan. 11, 2017).

Addressing cross-market underperformance would require adopting externalized expenses for all funds, direct-sold funds included. This would break down the distinction between broker-sold and direct-sold funds and permit brokers to take commission compensation for selling any type of fund. Combined with the BIC Exemption requirements, fully externalized sales changes would address both within-market and cross-market underperformance by requiring brokerages to level commissions across funds and ensuring that all funds could be sold on a commission basis.

It is unclear if the SEC contemplated the possibility that currently direct-sold mutual funds might offer share classes with externalized sales charges or if the direct-sold segment of the market would be interested in offering such shares. The 2004 proposal would have made externalized sales charges mandatory only for load funds.⁹⁴ Nevertheless, it is likely within the authority of the SEC to permit brokers to take sales commissions for direct-sold funds. Even if the SEC were to adopt such a rule, the Fiduciary Rule and BIC Exemption would still play a critical role. Fully externalizing sales charges would make it easier for brokerage firms to eliminate conflicts of interest, but the requirement to do so would come from the Fiduciary Rule and the BIC Exemption.

IV. THE BIC EXEMPTION AND THE COST OF PRIVATE ENFORCEMENT

The foregoing suggests that the BIC Exemption was an essential element in the Fiduciary Rule's plan for reducing the impact of conflicts of interest on investment performance while holding direct costs to current levels. To some degree, the goals of reducing conflicts of interests and holding down direct costs are in tension. Reducing agency problems by regulation means imposing compliance obligations on firms and backing those obligations with some form of liability. To the extent compliance requirements and liability risk generate costs, these costs are likely to be passed on to investors. As discussed above, the compliance costs associated with the BIC Exemption ought to be regarded with caution because small account holders are particularly vulnerable to the risk that increased direct costs could offset lower agency costs. But the BIC Exemption carried another risk as well. The BIC contract created a *de facto* private right of action for fiduciary breaches that does not have a counterpart in the RIA context. While the costs and benefits of private enforcement of fiduciary duties for investment advice are debatable, the BIC Exemption required these terms only for those receiving commission-based compensation. Thus, under the BIC Exemption, commission-based compensation came with private enforcement (including

⁹⁴ The 2004 proposed rule requested comments on a mandatory transition to externalized sales charges, but this approach was rejected in the 2010 proposal. Under the 2004 proposal, only funds that carried loads would be transitioned to externalized sales charges. See *SEC Proposes Changes*, *supra* note 89, at 7; *Prohibition on Brokerage Commissions*, *supra* note 91, at 9734.

class action enforcement) attached, while fee-based advice carried far less risk. This differential liability was likely to increase the direct cost of commission-based compensation relative to fee-based compensation, undermining the role of the BIC Exemption in preserving access to relatively low-cost advice.

It is notable that, in contrast to the rich empirical record that motivated the Fiduciary Rule, the DOL's case for class action liability was quite cursory. It amounted to arguing that, since compliance is desirable, so is vigorous enforcement.⁹⁵ But, particularly when rules are broad and vague, private liability carries a considerable risk of over-deterrence⁹⁶ with a corresponding risk of increasing the cost of advice or decreasing access to advice beyond levels that the DOL would deem optimal. Once the decision to press claims is handed over to private attorneys, issues of enforcement discretion and strategic leniency give way to monetary incentives. This does not, by itself, mean that private liability is uniformly undesirable in financial services. Indeed, as I argue below, class actions in the 401(k) space have largely been a success story. It does mean, though, that private liability should be deployed carefully and thoughtfully so that the costs of over-enforcement do not undercut the benefits of increased incentives for advisers to comply.

A. *Private Rights of Action and the BIC Exemption*

The BIC Exemption required that the adviser and client enter into a contract in which the adviser agreed to act in the best interest of the client and to take steps to mitigate conflicts of interest. As a contract, the agreement would be enforceable by the investor in a private claim against the adviser and this enforceability could not be waived. Per the BIC Exemption, while individual claims could be contractually required to go to arbitration, class action claims must be permitted to be litigated in court.⁹⁷ The DOL, which has few enforcement resources, explicitly argued that private enforceability is an essential part of the protective regime it hoped to create through the BIC Exemption.⁹⁸ The financial services industry objected strenuously to the private enforceability of the BIC Exemption. No other aspect of the Fiduciary Rule attracted more negative commentary.

⁹⁵ REGULATORY IMPACT ANALYSIS, *supra* note 17, at 280 (“Exposure to class claims creates a powerful incentive for financial institutions to carefully supervise individual advisers and ensure adherence to the impartial conduct standards. This incentive is enhanced by the transparent and public nature of class proceedings and judicial opinions as opposed to arbitration decisions, which are less visible and pose less reputational risk to firms or advisers found to have violated their obligations.”).

⁹⁶ See, e.g., Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301 (2008) (offering a helpful overview of when private class action enforcement is desirable).

⁹⁷ See DOL BIC Exemption, *supra* note 12, at 21,041.

⁹⁸ See, e.g., REGULATORY IMPACT ANALYSIS, *supra* note 17.

A private right of action for fiduciary breaches is not a common feature of the regulatory regime for money managers. The fiduciary duty of RIAs, which is paradigmatic in the money management space, is not backed by private enforcement.⁹⁹ Brokers commonly face private claims for breaching the duty of suitability, but these are arbitrated, and the Fiduciary Rule would have greatly expanded the grounds for such liability.¹⁰⁰ The IRC creates excise tax penalties for fiduciary breaches related to IRAs, but these penalties are enforced by the IRS.¹⁰¹ The closest analog to the liability of advisers to IRAs under the BIC contract is probably the liability of 401(k) plan fiduciaries, which does include a private right of action and commonly features class action enforcement.¹⁰² Lawsuits against 401(k) plans frequently challenge the inclusion of particular funds in the plan menu as inconsistent with the fiduciary duty of the plan sponsor. The lessons of these lawsuits are considered in detail below.

The motivation behind creating private liability for commission-based compensation under the BIC Exemption was presumably that the higher potential for agency problems associated with commission-based compensation, relative to fee-based compensation, necessitates a more vigorous enforcement regime. This is not an unreasonable position to take in the abstract, but liability is beneficial only when the costs of imposing the liability regime are lower than the costs of the problems the liability regime is designed to solve. For a number of reasons, there is a substantial risk that the costs of private enforcement outweigh the benefits of inducing better compliance with fiduciary duties in this context.

On the cost side of the ledger, private enforcement, and class action enforcement in particular, would have exacerbated the considerable uncertainty that surrounded the adoption of the Fiduciary Rule. The compensation models that would have been compatible with the Fiduciary Rule had not yet been developed, and the Rule would have led to a period of adjustment in the brokerage industry. Even after these changes resolved, it would have been difficult for brokers to anticipate the theories of liability that might later be used to press class action claims. Class action claimants in 401(k) cases have shown considerable ingenuity under an arguably less stringent legal regime. The term “best interest”—the contractual standard of conduct for advisers under the BIC Exemption—would have needed interpretation by courts. This uncertainty, in turn, would have increased compliance costs associated with the BIC Exemption, not just in absolute terms, but relative to fee-based money management. The documentation and procedures that firms developed to comply with the BIC Exemption were designed not just to

⁹⁹ See *id.* at 279–81.

¹⁰⁰ See, e.g., Laby, *supra* note 7.

¹⁰¹ See REGULATORY IMPACT ANALYSIS, *supra* note 17, at 20–21.

¹⁰² Notably, prior to the Fiduciary Rule, many third party service providers to 401(k) plans were not fiduciaries, and so most class action lawsuits against 401(k) plans have the employer as the defendant.

satisfy DOL regulators but in anticipation of litigation pressed by plaintiffs' attorneys. While a public regulator might give deference to good faith attempts to comply, or issue warnings to avoid certain practices rather than initiate enforcement, plaintiffs' attorneys cannot be expected to do the same.¹⁰³ These compliance efforts would have increased the cost of servicing IRAs and may have pressed firms to either refuse to service small accounts or to service small accounts pursuant to fee arrangements that may be, on net, more expensive than conflicted advice.

Benefits to consumers seem questionable as well. The empirical literature is silent on the issue of private enforcement in money management. The benchmark portfolio of direct-sold funds against which the underperformance of broker-sold funds is measured likely incorporates little advice rendered under fiduciary duties backed by class action enforcement. As an intuitive matter, if brokers complied with the substantive requirements of the BIC Exemption, what would have been the residual conflict of interest that justifies a heightened liability regime? If the industry settled on clean shares, T-shares, or some other transactional compensation scheme where payouts were level across all mutual fund investment options, on what basis could within-market underperformance remain a problem? It is not clear that if the substantive requirements of the BIC Exemption were met there would remain an agency problem that created a substantial risk.¹⁰⁴ Finally, given the BIC Exemption's extensive disclosure requirements, public regulators would have had considerable insight into the operation of advisers, even given a limited enforcement budget.

These considerations are not dispositive, but they at least suggest that it is not obviously the case that a private right of action is optimal in the IRA context. The balance of this section will consider what can be gleaned from experience with class action liability in 401(k) plans and weigh the particular risk of the differential liability regime created by the BIC Exemption.

B. Lessons from 401(k) Litigation

An important precedent for private liability for fiduciary breaches in the context of money management is class litigation involving 401(k) plans. These suits are not uncommon, and 401(k) providers clearly respond to the incentives these suits create. What lessons can be drawn from 401(k) class actions for the Fiduciary Rule?

¹⁰³ Rose, *supra* note 96, at 1328 (deeming this the "inflexibility problem" of private enforcement).

¹⁰⁴ One might argue that commission-based compensation creates an incentive to "churn" investments. That is, even brokers facing level commissions have an incentive to encourage their clients to turn over investments more frequently in order to generate commissions. But this is a mirror image of an agency problem faced by fee-based money management in which an adviser who receives a percentage of assets under management may shirk her duty to service the account at all.

Class action lawsuits alleging excessive fees in 401(k) plans have in large part been a success story. The plans challenged in early cases were very large plans with menus that did not leverage the bargaining power of the plans' considerable assets to obtain low-cost options for plan participants. In *Braden v. Walmart*,¹⁰⁵ for example, a plan with \$10 billion invested offered consumer-grade retail mutual fund shares to plan participants rather than lower cost institutional shares. Similar allegations were brought against the inclusion of some high-cost options in *Hecker v. Deere*,¹⁰⁶ and a 401(k) excessive fee case reached the Supreme Court in *Tibble v. Edison*.¹⁰⁷ These and other lawsuits called the attention of plan sponsors, who do not directly bear the costs of 401(k) investment options, to the issue of high fees. Large plans now bargain aggressively, and the inclusion of retail shares in a large 401(k) plan would be regarded as a significant mistake. Since the initial wave of 401(k) lawsuits, fees in large 401(k) plans have shown a downward trend.¹⁰⁸ Whether there is a causal relationship between the lawsuits and fee trends is uncertain, but there is little doubt that class action lawsuits have done much to focus the attention of plan sponsors on costs. Given these successes, perhaps the DOL anticipates similar benefits to extending class action liability to the IRA space. There are important points of disanalogy, though, that suggest that class action liability is a poorer fit for IRA plans.

First, litigation in 401(k) plans typically turns on the relatively narrow issue of plan fees. This is because fiduciary liability in 401(k) plans is limited in important ways. Under ERISA, 401(k) plans make use of the 404(c) safe harbor,¹⁰⁹ which insulates employers against liability for participants' portfolio selection decisions so long as participants are given a well-designed menu of funds. Thus, in a 401(k) plan, actual portfolio choices are typically not grounds for a class action lawsuit. The relatively limited scope of these cases, despite the broad fiduciary mandate, has the dual salutary effects of focusing the attention of plan sponsors on providing a menu with well-chosen options and ensuring that those options are low-cost. Moreover, the performance of particular investment options evaluated ex-post plays essentially no role in 401(k) lawsuits, avoiding issues of hindsight adjudication of investment choices. There is no analogous limitation of the scope of duties in the IRA space, and so potential class action claims create more risk for advisers and would do less to focus the attention of advisers on the particular issue of costs. The result is that, while 401(k) class action liability creates a significant benefit (a focus on lower fees) at a relatively low compliance cost (investment committees pay close attention to fees), class action

¹⁰⁵ See 588 F.3d 585 (8th Cir. 2009).

¹⁰⁶ See 556 F.3d 575 (7th Cir. 2009).

¹⁰⁷ See 135 S. Ct. 1823 (2015).

¹⁰⁸ See Sean Collins, Sarah Holden, James Duvall & Elena Barone Chism, *The Economics of Providing 401(k) Plans: Services, Fees and Expenses*, 23 ICI RESEARCH PERSPECTIVE No. 4 (Inv. Company Inst., Washington, D.C.), June 2017.

¹⁰⁹ See 29 C.F.R. § 2550.404c-1 (2010).

liability for IRA advisers under the Fiduciary Rule creates heightened liability that is far broader and with correspondingly higher compliance costs.

Second, these compliance costs are multiplied by another difference between the two settings. While 401(k) cases are brought as class actions, they involve only a single plan and a single choice of investment menu. While a 401(k) plan menu affects many investors, the individualized choices of those investors are not at issue because of the 404(c) safe harbor. If a fiduciary breach occurs, it is at the level of the plan sponsor, and therefore compliance efforts can focus on this single point of failure. Arguably, the analogous unit of analysis to a 401(k) plan is a single IRA, not a group of such accounts. The allocation of assets in an IRA is more akin to assembling a 401(k) menu (a plan-level activity) rather than a choice over that menu (done by a participant within the plan). IRA class actions therefore represent not just a broader scope of liability but also significantly more points of potential failure for the adviser to monitor—not just one point of fiduciary failure, but one for each IRA client. This, again, results in higher compliance costs.

Of course, having multiple failure points cuts both ways, increasing both the cost of monitoring and the likelihood of a problem at the investor level. But there are reasons to think that IRAs will benefit less from class action liability than 401(k) plans as well as carry higher costs associated with that liability. High costs in 401(k) plans are the product of an agency problem between plan participants and plan sponsors arising out of the structure of the plans: Sponsors select investment options but do not bear the cost of those options. Creating liability for the 401(k) plan sponsor helpfully aligns the interest of the plan sponsor with plan participants. In the IRA space, though, the agency problem targeted by the Fiduciary Rule arises from the compensation structure associated with load mutual funds. This is a critical difference because, whereas problems in 401(k) plans are due to failures of plan administrators, incentive problems with load mutual funds are a feature of the industry that would be likely to change in response to the Fiduciary Rule by, for example, moving toward level loads across funds. If compensation structures were to adjust at the industry level, the risk of problems at the level of individual advisers would be lower, and the benefits of class action enforcement might be lower as well.

None of this means that a private right of action for fiduciary breach in IRA plans operating under the BIC Exemption would be conclusively welfare-reducing in the IRA space, but it does mean that the case for liability might be weaker than it initially seems because some features of the IRA space increase the costs and decrease the benefits of such liability relative to 401(k) plans. Surely, merely asserting that compliance is important, as the DOL does, is not enough to establish that consumers will, on net, benefit from class action lawsuits. Given the modest savings to investors associated with the Fiduciary Rule, the broad liability that fiduciary duties create, and the uncertainty over what compliance means, liability in private lawsuits, and class action lawsuits in particular, should be regarded with caution.

C. Is Differential Private Enforcement Sensible?

The BIC Exemption applied differently to fee-based and commission-based advisers. Advisers who operate pursuant to standard fee-based arrangements would not ordinarily need to worry about prohibited transactions, but, per a DOL FAQ, the recommendation to roll assets into an IRA would itself have been a conflicted transaction insofar as the adviser would have less to manage on a fee basis if the assets are not rolled over.¹¹⁰ Thus, even an adviser compensated on a fee-only basis would have needed the BIC Exemption. These “level fee fiduciaries” who do not rely on commission compensation were exempt from the requirement of entering into a contract though they were subject to other requirements of the BIC Exemption.¹¹¹ This created a discontinuity in the enforcement regime for fee-based and commission-based advisers. Advisers taking commission-based compensation and advisers taking fee-based compensation were subject to similar substantive requirements under the BIC Exemption, but the BIC Exemption created privately enforceable liability via contract only for the former.

Whatever the merits of private liability for fiduciary breaches in IRA plans as a general matter, this discontinuity in liability based on fee structure is particularly concerning in light of the reality that load-based compensation may prove cheaper for investors if the agency costs of investment advice can be managed. Attaching private liability to load accounts but not to fee accounts would be likely to shift many assets into fee-based accounts to the potential detriment of overall investor welfare. This presents a dilemma for those seeking to reform the duties of financial advisors.

On the one hand, perhaps shifting assets into fee accounts was the goal of this liability regime. That is, maybe the point was to make load-based advising so risky and onerous that advisers will simply move to a fee model where conflicts are less acute. If the heightened liability was an implicit acknowledgement that managing conflicts cannot be achieved, then perhaps forcing firms using commission-based compensation to bear the additional risk of liability was a sensible approach. But if this is the case, then why offer the BIC Exemption at all? The entire premise of the Exemption was to manage the conflicts created by loads. If this is not realistic, then perhaps a Fiduciary Rule without the BIC Exemption was the best option. But, and this is critical, the calculation of benefits offered by the DOL essentially assumed that compensation would be paid as it is now, effectively assuming not just the widespread adoption of the BIC Exemption but similar fee levels as well. The notion that class action liability is meant to scare advisers off fee-based money management is inconsistent with the DOL’s own calculations.

¹¹⁰ See *Conflict of Interest FAQs*, *supra* note 83, at 5.

¹¹¹ See DOL BIC Exemption, *supra* note 12, at 21,004–06.

On the other hand, if the BIC Exemption represented a desirable option for consumers and advisers, then attaching private enforcement to commission compensation but not to other types of compensation seems likely to have reduced access to an option that may have left consumers better off. The BIC Exemption included a host of substantive requirements designed to level incentives across investment products and reduce risk to consumers. Moreover, as noted above, the mutual fund industry showed signs of willingness to organize around products that would have mitigated conflict concerns. If these mitigating requirements ended up being effective, then layering a private right of action on top of the substantive requirements seems likely to impose more costs on advisers than create net benefits for investors.

If expansive fiduciary duties for brokers are revisited in the future, regulators might consider two options to reduce the potential downsides of increased liability. First, regulators could permit advisors to send cases to arbitration, but not insofar as plaintiffs allege failure to comply with the conflict-avoidance elements of the regulation. That is, if the firm is alleged to have violated requirements of that compensation not to induce advisers to favor certain options, then the claim could be brought as a class action; however if the claim alleges only that an option was not in the best interest of an investor without alleging that unbalanced compensation motivated the recommendation, then the claim could be limited to individual arbitration. This liability regime would create benefits in terms of heightened incentives to comply scrupulously with the conflict-mitigating provisions of the regulation. At the same time, firms' compliance costs under such a rule may be lower because conflict-avoidance requirements are narrower than a fully articulated fiduciary duty.

Alternatively, the scope of fiduciary obligation under a future fiduciary rule could be explicitly reduced. The private right of action created by the BIC contract requirement applied not just to conflicts of interest but to issues of duty of care as well.¹¹² One possibility to reduce compliance costs while still preserving class action liability for the most concerning breaches would be to limit liability for claims arising out of negligence rather than conflicts of interest. Even if brokerage accounts are at a higher risk of agency problems due to conflicts of interest, there is no reason to think, based on the academic literature, that brokers are more careless than other types of money managers. Treating the duties of loyalty and care differently has precedent in corporate law, where corporate directors, who are fiduciaries, benefit from the protections of the business judgment rule. The business judgment rule holds that informed, disinterested directors cannot be held liable for deci-

¹¹² See Max Schanzenbach & Robert H. Sitkoff, *Fiduciary Financial Advice to Retirement Savers: Don't Overlook the Prudent Investor Rule 6* (Harvard Public Law, Working Paper No. 16-48, 2016), <http://ssrn.com/abstract=2795037>; Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors Under the Law of Agency*, 27 J. FIN. PLAN. 42, 42 (2014).

sions that are merely careless. A similar bifurcation of duties would be plausible in the investment advice context and give advisers some comfort that, absent conflicts of interest, their investment recommendations would not be subject to judicial second-guessing.

V. REDUCING THE DEMAND FOR HIGH COST ADVICE

The SEC recently promulgated Regulation Best Interest. Aimed at the same broker-client agency problems as the Fiduciary Rule, Regulation BI is a far less sweeping intervention. Where the Fiduciary Rule called on brokers to either forgo sales commissions or subject themselves to the stringent requirements of the BIC Exemption, Regulation BI permits incentive compensation so long as brokers act in the best interest of clients. What, precisely, this means is not clearly defined by the regulation, but Regulation BI offers a safer harbor to brokers who meet certain disclosure requirements and mitigate conflicts of interest. While Regulation BI is still in its first iteration, consumer advocates have expressed concerns that it will do little to address the problem of conflicted advice.

The Fiduciary Rule put consumers at risk by going too far, and Regulation BI risks doing too little. Perhaps regulators can identify a middle ground. But perhaps the real lesson of the Fiduciary Rule is not in the tweaks it suggests to Regulation BI but in the bigger picture: Conflicted advice is expensive for consumers, but so is unconflicted advice. Rather than tweak the duties around advice, a more productive avenue, particularly for the DOL, would be to seek ways to reduce the demand for advice.

There is undoubtedly complexity associated with financial planning. The shift toward defined contribution plans has put responsibility for navigating this complexity on the shoulders of individual retirement savers. Financial planners can add value in navigating these challenges,¹¹³ and for some investors with unique needs, professional advice is likely essential. But professional advice is costly. The all-in cost of investment advice, whether obtained through a commission-compensated broker or through a fee-based RIA, is about 1% annually.¹¹⁴ This cost is in addition to mutual fund management fees, which may add another 1% or more. Those costs are a considerable drag on investors' portfolios. Over 30 years, a 2% fee would consume more than 40% of the initial investment. While addressing underperformance due to conflicted advice is a laudable goal, the foregoing analysis suggests that the savings associated with such changes are likely to be modest at best.

Reducing the demand for professional financial advice has the potential to provide substantially more savings to consumers than reforming the deliv-

¹¹³ See Fisch et al., *supra* note 6, at 672 (presenting evidence of the significant gap in investing acumen between professional financial advisers and individuals).

¹¹⁴ See *supra* Part II.A.

ery of that advice. To be sure, there is a role for professional advice, but the needs of many ordinary investors are relatively straightforward. Paying a substantial fee for advice on which mutual funds to buy is unlikely to be a worthwhile investment for many consumers. A fundamental fact is that an investor who opens an IRA with Vanguard, Fidelity, or another major mutual fund company and invests an appropriate percentage of her salary in a low-cost, target-date index fund is acting near-optimally as is an investor who makes a similar allocation in an employer 401(k) plan. Such investors save on both the direct and indirect cost of investing, avoiding loads and minimizing mutual fund management expenses and avoiding underperformance as well. For policymakers, those types of outcomes, for most investors most of the time, ought to be the goal of a reform agenda. If a substantial portion of the market could be nudged toward such outcomes, the savings would dwarf the impact of the Fiduciary Rule. The question is whether and how this can be achieved.

The balance of this section outlines three areas of regulatory focus that could reduce the need of investors for full-service financial advice. First, the system of tax-favored savings accounts could be simplified and streamlined to reduce unneeded complexity. Second, the existing framework of 401(k) plans could be leveraged to provide simple, comprehensive guidance to most investors. Finally, the growing role of roboadvisers, which provide automated financial advice at a low cost, should be encouraged. While some of these suggestions fall within the authority of the DOL, others would require broader legislation to enact.

A. Reduce the Complexity of the Financial Planning Landscape

At least some of the complexity of managing one's financial life is not a product of the inherent difficulties of tailoring investment strategies to individual needs but is rather a matter of the artificial complexity associated with government-created tax-favored savings accounts. Even early-career savers with utterly ordinary needs confront a menu that typically includes a 401(k), Roth and Traditional IRA plans, health savings and flexible spending accounts, and 529 plans for those with children. Within most of these plans, a participant confronts a number of investment options, and advice on how much to save and how to allocate the savings across asset classes is often not forthcoming. To the extent investors require professional advice to navigate the unnecessary complexity of tax-advantaged retirement savings options, these costs are a subsidy to the financial advice industry paid for out of the tax expenditure inherent in tax-favored savings accounts.

Complexity in retirement accounts is costly along a number of dimensions. An extensive literature suggests that complexity in retirement savings reduces and delays participation, both of which reduce consumer welfare, and a number of proposals exist to streamline and simplify retirement sav-

ings.¹¹⁵ While the justifications for these changes tend to focus on the impact of simplification on participation rates, it stands to reason that an additional benefit is a reduction in the need to pay financial professionals to help navigate the system. If complexity creates a barrier to participation, some will simply not participate while others will reduce that complexity by paying for advice. Reducing unnecessary complexity lowers both costs.

Developing a full-fledged framework to streamline retirement savings is well beyond the scope of this paper, but the most direct approach to simplification is to adopt default savings rules that meet the needs of most investors without the need for those investors actively to make decisions. To this end, regulators should encourage auto-enrollment into 401(k) plans and the automatic investment of those funds in target date options that are suitable for investors' ages. Currently, safe harbors exist that protect employers who adopt such measures, but more should be done to encourage the practice. Since the evidence overwhelmingly favors the use of defaults, a reasonable step would be for the DOL to issue guidance encouraging sponsors to set up automatic enrollment and investment in a suitable default fund as part of their fiduciary duty under ERISA. But simply setting up a default is not enough to ensure investor welfare. As Bubb and Pildes¹¹⁶ note, setting default savings rates that are too low can actually discourage investors from saving at appropriate levels.¹¹⁷ Defaults must be set so that, for the typical investors with typical needs, the amount saved in the 401(k) plan will, if left unaltered, meet their retirement needs. The DOL should encourage industry best practices that encourage firms to develop robust defaults.

B. Leverage Existing 401(k) Plans as Sources of Advice

While the Fiduciary Rule was largely aimed at IRAs, well-run 401(k) plans are likely the best place for most assets for currently-employed individuals. Many of the problems of low-quality investment advice that the Fiduciary Rule was designed to address could be—at least partially—addressed by encouraging existing 401(k) plans to offer full-service advice on a conflict-free basis. All 401(k) plans provide “advice” in the form of menus curated by a fiduciary, and many also provide default investment options and in-person advice via call centers. Since the 401(k) is, for most investors, the centerpiece of their retirement savings, regulators could improve outcomes for many investors by encouraging 401(k) plans to offer comprehensive, conflict-free advice to savers. Since employers are in a position to

¹¹⁵ See, e.g., John Beshears, James J. Choi, David Laibson & Brigitte C. Madrian, *Simplification and Saving*, 95 J. ECON. BEHAV. & ORG. 130 (2013); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 J. ECON. 1149 (2001).

¹¹⁶ See Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593 (2014).

¹¹⁷ *Id.* at 1609.

bargain with service providers, and often have leverage in the form of scale, this advice has the potential to come on terms favorable to the investor.

The emphasis here is on the plans being “well run” as many 401(k) plans suffer from problems similar to those detailed above: costly and underperforming funds. But many large plans are run with considerable efficiency. Ayres and Curtis (2015)¹¹⁸ find that the plan-level fee charged to investors in 401(k) plans, even in a sample that demonstrated numerous problems of cost-efficiency, was only thirteen basis points.¹¹⁹ This cost, which covers the administration of the plan, including any advice offered, can reasonably be compared with the roughly 100 basis points of cost associated with financial advice in the broker-serviced IRA context. Employer-sponsored 401(k) plans are already subject to a fiduciary regime backed by class action enforcement, and this regime is expanded by the Fiduciary Rule. The 401(k) segment of the financial services industry has faced relentless fee pressure over the past several years.

In light of the general superiority of 401(k) plans to broker-managed IRAs, the DOL should be motivated by two policy goals: first, to keep assets inside well-run 401(k) plans when possible,¹²⁰ and, second, to ensure that investors in 401(k) plans receive high-quality financial advice that is as comprehensive as possible. The former takes advantage of the scale and existing fiduciary regime around 401(k) plans while the latter would address concerns about conflicted advice by providing a framework for employers to help employees access advice on an unconflicted basis.

The Fiduciary Rule took a positive step toward keeping assets inside 401(k) plans when doing so benefits investors by making the recommendation to roll assets out of a 401(k) plan subject to a fiduciary duty.¹²¹ Going forward, the DOL should focus on reforms that require brokers dealing with 401(k) assets explicitly to evaluate the relative quality of the 401(k) menu to the brokerage offerings as well as other defined contribution accounts available to a client. This would encourage 401(k) plans to be rolled over into the 401(k) plan of any new employer, which will often be a superior alternative to a brokered IRA. The DOL could also make explicit that in making this determination the cost of loads attached to any funds in the IRA should be considered as part of the total cost of the investments. Funds in 401(k) plans rarely, if ever, carry loads, and loads are a real cost to the consumers that come directly out of the invested funds. Thus, taking loads into account

¹¹⁸ See generally Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and “Dominated Funds” in 401(k) Plans*, 124 YALE L.J. 1476 (2015).

¹¹⁹ See *id.* at 1500 (summing the benchmark and excess plan fees).

¹²⁰ See *id.* (arguing that investors in high cost 401(k) plans ought to be permitted to roll assets into IRA plans to avoid high fees). The argument here is consistent with that view but deals with cases where the fee problems run the opposite direction: When a 401(k) plan is a good value for participants, sound policy ought to discourage rollovers, particularly to high cost broker-advised IRAs.

¹²¹ See DOL Fiduciary Rule, *supra* note 11, at 20,948.

when making rollover decisions would discourage many costly rollovers into brokered accounts and keep more assets in well-run 401(k) plans all while still leaving the option to depart a poorly run 401(k) plan intact.

Increasingly, service providers to 401(k) plans offer financial advice via call centers as an ancillary benefit. Under the Fiduciary Rule, such advice was subject to a fiduciary duty. While ensuring that 401(k) call center advice is unconflicted is a reasonable policy concern, subjecting such advice to a full blown fiduciary duty created substantial risk of liability that caused some companies to cut back on advice. This was unfortunate because this type of financial advice has the potential to address many of the concerns at which the Fiduciary Rule was aimed if it can be expanded to provide investors with comprehensive financial counseling. Basic financial advice should be a standard feature of 401(k) plans along with auto-enrollment and suitable default investments. The reasons mirror the policy justification for employer-run 401(k)s: Employees have a better chance of making good decisions, and in this case of finding high-quality advice, if their employer provides pre-screened options. As always, employers are prone to make mistakes, and policymakers should be cognizant of this, but the existing framework of call center advice that is free to the employee is likely to lead to better outcomes than an employee's attempting to locate advice through a commission-based broker.

While requiring call center advisers to avoid conflicts of interest is reasonable, holding them to a full-blown duty of care risks diminishing access to advice by making it too costly to provide. If call center advice is held to a stringent duty of care, for example, a provider may be unwilling to make recommendations based on a short phone conversation. A rule that enjoins conflicts of interest while protecting advice against ex-post reconsideration based on a negligence standard seems a reasonable way to balance the competing priorities of keeping call center advice available while ensuring that it is not influenced by pernicious financial motives.

The DOL could also do more to leverage the fiduciary responsibilities of plan sponsors to protect investors nearing retirement. A reasonable fiduciary responsible for a 401(k) plan should provide not only a well-designed plan with a carefully chosen menu of investment options but thoughtful exit strategies for retiring and departing employees as well. Currently, departing and retiring employees are often left on their own to rollover their assets. This can lead to costly mistakes at a critical moment in the financial lifecycle. The DOL could provide a safe harbor similar to the 404(c) for plans to suggest a menu of particular IRA service providers or even pre-screened IRA rollover investments as default (or even just recommended) options for employees rolling assets out of the plan.

As a general matter, good faith, conflict-free advice associated with 401(k) plans has the potential greatly to reduce the need for more expensive types of advice. The DOL and other regulators should be cautious about

regulating such advice so stringently that consumers are forced into more expensive options.

C. *Encourage Innovation in Financial Advising*

Finally, the wildcard in discussing the cost of investment advice is the rapidly expanding roboadvisor industry. Many of the traditional services of a financial adviser—asset allocation, selecting funds, and optimizing diversification—are subject to at least partial automation. Roboadvisors offer investors automated advice in choosing direct-sold funds. Companies such as Wealthfront and Betterment that offer these services do so at prices lower than traditional, full-service financial advisers. Some roboadvisor services also incorporate call-center-style personalized advice. Regulators have met the roboadvisor industry with cautious optimism, taking a wait-and-see approach while ensuring that roboadvisors meet the same fiduciary standards as other advisers. These firms provide a promising means for large numbers of individuals to access conflict-free, low-cost advice. The Fiduciary Rule currently accommodates automated financial advice, and the DOL (and SEC) should be vigilant that the competitive threat posed by roboadvisors to traditional advisers does not motivate regulatory moves that disadvantage automated advice.

CONCLUSION

Regulating financial advice is a challenging policy problem. Fiduciary duties are among the oldest and best understood concepts in law, but the interacting complexities of our system of retirement savings, the market structure of mutual funds, and multiple existing regulatory regimes make the imposition of fiduciary duties a challenge. This paper has argued that the Fiduciary Rule, while a good faith attempt to address a real problem, was insufficiently attentive to the direct costs of financial advice and to cross-market underperformance in mutual funds. Investors are most likely to benefit if they receive unconflicted advice rendered on a commission basis at the same or lower cost as in the current regime. While the Fiduciary Rule risked increasing the cost of advice or limiting access, the new Regulation BI risks insufficiently addressing conflicts. After the demise of the Fiduciary Rule, the DOL should consider interventions to reduce the demand for advice as a way to create savings for investors.