June 5, 2015

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Office of Regulations and Interpretations,
Employee Benefits Security Administration,
Attn: Conflict of Interest Rule,
U.S. Department of Labor,
200 Constitution Avenue NW.,
Washington, DC 20210.

Subject: RIN 1210-AB32

Ladies and Gentlemen;

This is in response to the proposed rule "*Definition of the Term 'Fiduciary'; Conflict of Interest Rule--Retirement Investment Advice*" ("COI Proposal").

DALBAR has studied and analyzed various aspects of investments, investment managers, advisors and services for nearly 40 years. Of particular interest to the subject of the COI Proposal is DALBAR's work in measuring the effect and causes of the actions taken by investors. Each year, for the last 21 years, DALBAR has measured and reported on the underperformance of investors in relation to returns that are theoretically possible through applicable indices.

For mutual fund equity investors, the annualized 20 year underperformance[1] has ranged from 3.96% to 10.97% below the S&P 500 index. For the most recent 20 year period measured (2014), the underperformance was 4.66%, representing $388 billion annually in present value dollars.

This response to the COI Proposal is largely based on the knowledge and experience gained from analyzing investor underperformance and is intended to accomplish four objectives:

- Confirm investor underperformance and show that it is greater than estimates made in the COI Proposal. This will also show that the root cause of underperformance is not poor investment selection but is the timing of when investments are made or withdrawn and the factors that drive this behavior.
- Report on the effectiveness of regulatory strategies that have been tried and the unintended consequences of these actions.
- Provide a forecast of the effect of the COI Proposal on underperformance and the most likely unintended consequences.
- Outline regulation that is needed to reduce underperformance based on DALBAR's work and on the 2007 RAND study[2] that reported massive investor confusion regarding the titles used by sales and investment professionals.

[1] Source: DALBAR Quantitative Analysis of Investor Behavior (2015)

[2] The U.S. Securities and Exchange Commission (SEC) commissioned the LRN-RAND Center for Corporate Ethics, Law, and Governance to conduct a study that included investors' understanding of the differences between investment advisers' and broker-dealers' financial products and services, duties, and obligations.

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Scale of Underperformance

DALBAR's analysis of investor behavior confirms the existence of a problem of underperformance. The following table from the most recent Quantitative Analysis of Investor Behavior (2015) shows the underperformance in the various investment classes[3].

	Annualized Investor Returns[4]					
	Equity Investors	Asset Allocation Investors	Fixed Income Investors	Annualized Inflation	Annualized S&P 500	Annualized Barclays Aggregate Bond Index
30 Year	3.79	1.76	0.72	2.70	11.06	7.36
20 Year	5.19	2.47	0.80	2.28	9.85	6.20
10 Year	5.26	2.25	0.69	2.13	7.67	4.71

It should be noted that investor underperformance is present in all investment classes, therefore proving that the failure is not primarily one of poor asset allocation.

The estimated annualized underperformance in dollar terms for the 20 year period is presented below.

	Investor Returns	Index Return	% Under-performance	Total Assets ($Billions)	$ Under-performance ($Billions)
Equity	5.19	9.85	(4.66)	8,316	388
Fixed Income	0.80	6.20	(5.40)	3,469	187
Asset Allocation	2.47	6.20	(3.73)	1,352	50
Total				**13,128**	**625**

The total underperformance shown by actual history is $625 billion that far exceeds the estimates given in the "Fiduciary Investment Advice Regulatory Impact Analysis".

[3] Underperformance is not measured for cash and cash equivalents such as money market funds since the dollar denominated value is subject to immeasurably small changes.

[4] **Returns are for the period ending December 31, 2014**. *Average equity, bond and asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs.*

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Our analysis further shows that underperformance occurs primarily during market stresses as illustrated by the top ten periods of underperformance in the last 30 years shown in the table below.

Top 10 Months with the Most Acute Underperformance				
Rank	**Month**	**S&P 500 Return %**	**Average Equity Investor Return %**	**% Under-performance**
1	**October 2008**	-16.80	-24.21	-7.41
2	**March 2000**	9.78	3.72	-6.06
3	**October 1987**	-21.54	-26.87	-5.34
4	**January 1987**	+13.47	+9.35	-4.12
5	**August 1998**	-14.46	-18.47	-4.01
6	**September 2008**	-8.91	-12.75	-3.84
7	**November 2000**	-7.88	-11.33	-3.45
8	**April 1997**	5.97	2.75	-3.22
9	**November 1997**	4.63	1.48	-3.14
10	**July 1989**	9.03	5.91	-3.12

We conclude from this that underperformance is attributable to factors that are correlated to market stresses. This means that there is little or no effect on underperformance by uncorrelated factors such as bad investment advice or incentives paid to advisors and other conflicts of interest

Analysis of underperformance shows the following are the primary causes.

Major Causes of Equity Investor Underperformance		
Cause	**% Contributed to Underperformance**	**Underperformance ($Billions)**
Lack of Availability of Cash to Invest[5]	0.72	60
Need for Cash (planned and unplanned)[6]	0.90	75
Fund expenses (including management fees)	1.05	88
Voluntary investor behavior underperformance[7]	1.99	165
Total	**4.66**	**388**

[5] Lack of availability of cash represents the investor return that is lost by delaying the investment.

[6] Need for cash represents the percentage of investor return that is lost or gained by withdrawing the investment before the end of the period being measured.

[7] Voluntary investor behavior generally represents panic selling, excessively exuberant buying and attempts at market timing.

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The causes of underperformance shown here are consistent with extensive other research that reports on the inadequacy of retirement savings (Lack of availability of cash) and that defines plan leakage (Need for cash) as another major cause of inadequacy.

We also can confirm that some portion of this underperformance is due to poor investment advice, a small part of which is attributable to advisors who operate outside of a regulated fiduciary standard. The portion of underperformance that is due to an inadequate regulated fiduciary standard is, however, not material. We estimate that less than 0.3 percentage points of the 4.66% underperformance is due to such an inadequacy.

Incentive compensation and other conflicts of interest actually improve the goal of retirement security. This is because the incentives encourage behaviors that are in the investors' best interest. These include:

- Start investing sooner. Incentives are earned earlier and investor returns are generally greater.
- Remain invested. Incentives continue to be earned and investor does not try to time the market (which is rarely successful).
- Delay withdrawals. Incentives are not terminated and investor returns are generally greater.
- Invest more aggressively. Incentives are generally greater as are investor returns.
- Invest prudently. Client is retained as are the incentives. Investor returns are generally greater.

Discouraging or prohibiting such incentives may yield reductions in expenses but the far greater cost is the effect on the retirement savings rate and the withdrawal from savings programs, and thus the ability of workers to have a secure retirement.

The most severe problem, by far, are the poor choices made by investors and by the responsible plan fiduciaries acting on their behalf. The controllable causes of these poor choices are the deceptive titles that sales professionals are permitted to use. These deceptive titles mislead a majority of investors to believe that sales professionals are actually advisors. As discussed later, disclosures are totally ineffective in correcting the assumptions made from a title. Titles such as "financial advisor", "investment professional", "investment fiduciary" or similar titles and abbreviations lead investors to make poor choices that would not have been contemplated if the title was "sales professional".

History of Regulatory Strategies

The problem of investor underperformance has been recognized for several decades and a number of regulatory strategies put in place to address this. Unfortunately many of these regulations rely on a level of attention, knowledge and caution by investors and the responsible plan fiduciaries who act on their behalf. This is unfortunate because the investors and responsible plan fiduciaries rarely have the requisite attention, knowledge and caution so regulations fall short of achieving their intended benefits.

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Examples of these regulatory strategies are:

- Disclosures. Disclosures have been ineffective because they interrupt the decision making process and are treated as encumbrances. Disclosures are swept aside and focus is put on the investor's goals and aspirations. In addition they are difficult for most investors to understand, interpret or use effectively.
- Education. Education has largely failed because most attempts involve teaching investors the arcane language and constructs of investments instead of replacing the arcane with the comprehensible. Rare indeed is the investor who cares to understand the difference between sales charge and an underwriting discount.
- Enforcement. The Pension Protection Act of 2006 included provisions to ensure compliance with revised investment advice requirements through an annual independent audit. The cost of compliance and audit and pricing parameters made it unprofitable for most professionals to use the resulting exemption. Since existing laws and regulations were preserved, there was very little uptake, most favoring to rely on existing regulations.
- Fee Disclosure. As with other disclosures, fees are difficult for most investors to understand. Additionally, they have a corrosive effect on the standard of care provided to investors. Fee disclosures cause a lowering of fees, causing cost reduction measures. The effect of widespread cost reductions is spending less time with each client, resulting in a lowered standard of care.

In addition industry initiatives have been focused on improving investor performance. These have met with some success and should be encouraged by regulations.

Examples of industry initiatives are:

- Pre-packaged Solutions. These come in the form of target date funds and other specialized asset allocation investments. Regulations are needed here to properly match the solution to the investor's needs and to change the investment strategies when market conditions change.
- Computer Models. These are very effective at matching investors' needs and goals to an appropriate strategy. Current regulations are too burdensome, thus making this technology very rare and expensive for the investor.
- Online tools. These provide powerful solutions but are of use only to investors with sufficient interest to seek them out and sufficient tenacity to supply the required data and complete the process. Regulations that offer protection from making reasonable assumptions can make these tools easier to use and reach a larger group of investors.

Unintended Consequences

The COI Proposal does not address the most severe controllable cause, and will not correct the intended problem and as presented would cause several undesirable effects:

- Lower the standard of care for all by making accommodations for the disruptions the proposed changes would cause. Those who offer a superior standard of care today will be forced to lower their standard to remain cost competitive.
- Make it more difficult for investors and responsible plan fiduciaries to make prudent choices. If all practitioners become fiduciaries or pseudo-fiduciaries without changing current practices it will be difficult to recognize the best.

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- Punish the best practitioners with added burdens while failing to identify or remove the worst.
- Add to the burden of disclosures that investors must navigate to get to the information required to make prudent decisions.
- Reduce or fail to increase the number of experts who deliver investment advice to the investing public by making the business more costly.
- Proposed exemptions exacerbate a serious existing problem. The problem is practitioners' use of similar or identical titles or designations that imply a fiduciary standard but are free to create circumstances that allow the standard to be ignored. Responsible plan fiduciaries expect practitioners who use titles or designations containing terms such as "advisor" or "fiduciary" to always be operating at a fiduciary standard of care.
- Erratic compliance as firms seek the lowest cost and lowest risk method of responding to the regulation, in the absence of an effective method of enforcement.
- Drive the professionals who currently provide investment advice or education to the path of least resistance, which in this case is to simply add to existing disclosure language that is generally ignored by both professional and client.
- Make the national problems of inadequate retirement savings and leakage from retirement plans more acute by reducing the funding that is currently being used to combat them. This lowered funding will occur at a time when the coverage by traditional pension plans (DB Plans) is contracting.

In Summary

The COI Proposal is certain to cause massive confusion and needless changes, while providing little or no discernable benefit. Forcing the inclusion of persons into a regulated class based on a complex definition of services provided is ineffective. Regulation is far more effective when the persons being regulated have an exclusive privilege of using titles that are easily understood by the public and carries with them, standards of care that the public expects. This concept of exclusive privilege in how a professional is described, connected to standards of care is in successful use in most other professions.

> *A more effective course of action that will actually increase returns to investors is to enforce a standard of care for all who hold themselves out to be advisors, fiduciaries, etc. Such a standard is the Prudent Expert Rule*[8] *that is already widely established. Under such a regulation, advisors would be required to maintain evidence of all professional decisions consisting of investment education, recommendations, or actions on behalf of a plan or its participants to make available, acquire, retain or dispose of a security.*
>
> *Our recommendation is to replace the current proposal with a simple regulation that requires any person that uses any title that implies that they provide investment management, advice or education to always operate under the Prudent Expert Rule.*

[8] The Prudent Expert Rule requires "*acting in the interests of clients with the care, skill, prudence and diligence under the prevailing circumstances that a prudent expert acting in a like capacity and familiar with such matters would act*."

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This course of action is supported by the 2005 RAND study that found massive confusion among investors. The report showed that investors gave 449 titles used by 323 individuals. Recognizing the meaning each such title or understanding disclosures among them is an insurmountable burden for consumers.

The suggested change would be non-disruptive to investors who receive professional advice today and enable others to make informed choices of who should be engaged to help make investment decisions. Practitioners who choose not to accept the standard of the Prudent Expert Rule, would simply cease using misleading or deceptive titles.

As a practical matter, no amount of regulation or enforcement can prevent one willing person from advising another who seeks their advice. The practical solution is to prohibit unregulated persons from holding themselves out to be advisors or fiduciaries and hold the regulated persons to an appropriate standard of care as a prudent expert. This course of action would require no expensive restructuring of the investment community and would be self policing.

Most importantly, this approach would not reduce the funding for an urgently needed resource to improve retirement security, by inadvertently limiting compensation paid to the experts.

Thank you for your consideration,

Louis S. Harvey
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