



Vice-Dean, Undergraduate and Pre-experience Programs

September 10, 2015

Filed Electronically: e-ORI@dol.gov

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Conflict of Interest Rule, Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW, Washington, DC 20210

RE: RIN 1210-AB32: Regulatory Impact Analysis, Definition of the Term “Fiduciary”: Conflict of Interest Rule – Retirement Investment Advice

To Whom It May Concern:

We would like to respond to recent comments by the Investment Company Institute (ICI) on our paper “What do consumers’ fund flows maximize? Evidence from their brokers’ incentives”, *Journal of Finance* 68(2013), 201-235. Our paper has been cited extensively as it relates to the Department of Labor’s proposed Conflict of Interest Rule. In light of this, our paper has come under close scrutiny by stakeholders on both sides of the debate. In the ICI’s recent letter (dated July 21, 2015) to the Office of Regulations and Interpretations at the US Department of Labor, the ICI makes several incorrect claims about the results and interpretation of our paper, so we would like to make clear that our results are correctly calculated and interpreted.

The four concerns regarding our paper that are identified by the ICI in Section II of their July 21, 2015 letter addressed to the US Department of Labor are the following:

1. Our regression analysis is not asset-weighted
2. The data sample stops in 2009 and the market has changed since this period of time
3. Both front load and excess loads are included in the regression explaining flows so we should aggregate the effects of front load and excess loads when evaluating the effect of broker compensation on flows.
4. When we interpret the economic meaning of the coefficient in the return regression in Table V, we should use 0% rather than 2.3% as currently used in the paper.

The first two concerns are common to many other papers in the literature while the last two are specific to the results of our paper. Our discussion below clarifies that the claims made by ICI are incorrect. Regarding the first point, our methodology accounts and adjusts for the variation in funds' assets. Regarding the second, the statistics the ICI chose for its letter are misleading, as is apparent in statistics from the ICI's own website that show that investments subject to loads have grown significantly. Lastly, with regards to the latter two points, both are wrong.

Comment 1. Importance of asset-weighting

All the regressions in the paper use robust standard errors which control for the heteroscedasticity in variance often associated with funds of different size. This implies that for each observation the variance estimate is allowed to vary in proportion to the independent predictors of the regression (which include log asset size) so effectively the variances in the regression are asset-weighted. We also cluster standard errors by each fund so standard errors are allowed to vary fund-by-fund. Lastly, log of asset size is included as a control variable in all the regressions. Thus, the variation in fund assets is addressed thoroughly in our analysis.

Comment 2. Sample period and changes in the industry

The ICI argues that the industry has changed significantly from the end of our sample period in 2009. To illustrate this they show a drastic increase in the number of funds with no-load shareclasses in 2010 compared to load share classes. Figure 1 in their letter shows that the number of funds without no-load shareclasses declines from 49% to 10% (so by extension those with no-load shareclasses increase from 51% to 90%) between 2000 and 2010. This information is however misleading since it is not the number of shareclasses that matters but the dollars in these shareclasses.

The dollars in Load vs. No-Load shareclasses are reported in Table 5.10 in the ICI Factbook 2015, which shows the following (in Billions of \$US):

	2005	2009	2010	2011	2012	2013	2014
<i>Load</i>	2313	2185	2352	2176	2362	2658	2634
<i>Front Load</i>	1728	1750	1882	1751	1893	2148	2116
<i>No-load (Retail)</i>	2404	2666	3069	2991	3469	4144	4625
<i>Load +Retail Noload</i>	4717	4851	5421	5167	5831	6802	7259

The table shows that the dollars in load and no-load retail funds have both increased over time and since 2009 (the end of our sample). The growth in assets held in the no-load channel has outstripped that in the load channel, but the load channel remains a very significant percent of the retail market in terms of assets (~36% in 2014). Within the load channel, approximately 75 to 80% of the load funds are front-end load which is where the analysis of our study focuses. So the count of shareclasses offered by the ICI misrepresents the reality that investments in load funds have grown and remain a significant portion of the retail market.

Also, it is important to note that the no-load channel includes brokers who offer advice and receive payments. Brokers in the no-load channel are paid 12b-1 fees and receive revenue-sharing. Our paper discusses revenue-sharing arrangements as they affect flows and future performance, so our results are relevant to this part of the market.

Comment 3. Inclusion of front-end loads and excess loads in Table III

In Table III of our paper we include both the level of front-end loads and the excess load paid to brokers to explain flows. This is necessary to separate the demand effects of loads from their incentive effects. We know from prior research that individuals respond negatively to high loads, so higher loads reduce inflows. This influence on flows is separate from the incentive effects of the portion of the load going to the broker, and until we published our paper in the Journal of Finance, there was no research study that disentangled the effect of the full load on consumer demand from the effect of the brokers' share of the load on the brokers' incentives. By including both the level of front-end loads (effect of loads on consumer demand) and the excess loads (effect of loads on broker incentives), we separate these two effects.

The ICI incorrectly states in their letter that we should add together the effects of front-end loads on flows with the effect of excess load payments on flows. This would conflate the two effects of loads on flows that we separated, and thus negate one of the primary contributions of the paper, which is to cleanly and separately identify the impact of these additional payments to brokers on fund flows and performance. That is, our inclusion of both the overall front-end load and the excess load paid to the broker is what allows us to cleanly analyze the broker incentive effect. It controls for the level of front-end load payments to allow the apples-to-apples comparison between two funds that charge the same load to consumers but share different amounts of this load with brokers.

Comment 4. Economic interpretation of Table V

In our paper, we run a 2-stage regression where we first explain the level of loads paid to a broker (Table II) and then take the excess load from this regression to explain flows (Table III) and excess future performance looking 12 months ahead (Table V). We use this framework because it is important to control for the many different fund characteristics that influence what a broker is paid. The objective of this two stage set-up is to ensure there are no spurious factors which simultaneously affect both the amount the broker is paid and the fund flows or the amount brokers are paid and future performance. The ICI calls this a "complicated set of computations" but in fact it is a necessary construction to ensure our estimates cleanly measure the incentive effect of additional payments to the broker on flows, and the relation of broker payments to subsequent performance. The first stage regression in Table II explaining the loads paid to brokers has an 87% r-squared, which means it explains 87% of the variance of these payments. This is strong evidence that the first stage eliminates potential sources of spurious correlation and therefore allows a clean measure of the incentive relation between payment, flows, and performance.

The ICI letter then goes on to misconstrue our economic interpretation of the second stage regression in Table V by claiming that we should use the average excess load of zero to scale our coefficient of 0.49. Zero is the wrong scaling measure as we are

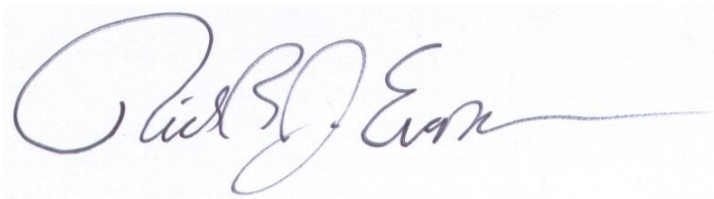
economically trying to evaluate how a change in the load paid to the broker would relate to changes in the future performance of the fund. We chose 2.3% to evaluate this effect economically since this represents the change of moving from no payment to the broker to average payment to the broker (2.3% in our sample). If we multiply this change in broker fees (2.3%) by the coefficient (-0.49), we get the expected effect on changes in the future performance of the fund (-1.13%). The proposed use of scaling by zero is economically meaningless and implies the obvious: if brokers are not given any additional compensation to sell a fund, then there are no additional incentive problems as to which fund the broker sells an investor. The negative and significant coefficient relating excess loads to future performance implies that any positive changes in load payments to the broker (additional compensation for the broker) associate with decreased expected future performance realized by the investor over the following year.

Thank you for your consideration and the opportunity to respond.

Sincerely,



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