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September 23, 2015

Via Email Only

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
e-ORI@dol.gov

RE: RIN 1210-AB32: Conflict of Interest Rule

Ladies and Gentlemen:

I write to support the regulation proposed (the "Proposal") by the Department of Labor (the "Department") to create a uniform fiduciary duty for persons providing personalized financial advice to retirement investors. The Department should finalize the Proposal for four reasons: (i) the harms alleged by the Proposal's detractors have been materially overstated; (ii) the Proposal will better protect retail investors, most of whom lack financial literacy and means to protect their interests; (iii) it will align the law with retirement investors' current expectations; and (iv) it will improve capital allocation in U.S. financial markets.

I. The Proposal's Detractors Overstate the Possible Harms to Investors

The Department should maintain an appropriate amount of skepticism about arguments advanced by some of the Proposal's detractors. Much of the current opposition falls within a long history of financial intermediaries overstating the costs and risks of proposed regulatory measures to delay reforms. For example, many securities firms argued against the elimination of fixed brokerage commissions before 1975, claiming that it would harm retail investors.[1] Afterward, it became clear that these concerns were largely unfounded.

The tradition of interested persons overstating the possible risks and costs of regulatory intervention continues today. In a recent editorial addressing similar fear-mongering over a FINRA proposal to apply data analysis to market practices, the INVESTMENTNEWS chastised the financial services industry for stoking "fear in an effort

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[1] *See* Hans R. Stoll *Revolution in the Regulation of Securities Markets: An Examination of the Effects of Increased Competition* in CASE STUDIES IN REGULATION: REVOLUTION AND REFORM, 29-48 (Leonard W. Weiss & Michael W. Klass, eds, 1981).

to cloud or divert attention from real issues."[2] It recognized that much of the opposition to that proposal was simply groundless and argued that "hiding behind a beneficent canard of client protection is deplorable – and ultimately counterproductive" because it "adds to the distrust the industry is drowning in."[3]

Yet a measured amount of distrust and healthy skepticism may be appropriate. The tendency of financial intermediaries to over-emphasize the costs and risks of reform has been identified as a mechanism intermediaries use to shape their regulatory environments. In a recent article in *The University of Chicago Law Review*, Professor Kathryn Judge of Columbia Law School argues that "the greater the economic stake of financial intermediaries, the more skeptical policymakers should be of their assertions about the potential costs or risks associated with a proposed policy change."[4] The Department should keep this principle and history in mind as it evaluates the public comments.

II. This Proposal Will Protect Retail Investors Who Lack Basic Financial Literacy

The Proposal also serves a real need because most retail investors cannot recognize when their financial advisor has acted against their best interests. Many retail investors may be susceptible to exploitation because they lack basic financial literacy. Recent studies have confirmed that most do not understand basic concepts such as diversification, investment costs, inflation, or compound interest.[5] The Securities and Exchange Commission has expressed concern that certain subgroups, "including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the general population."[6]

Other interventions, such as increased investor education, seem unlikely to solve the problem. At the least, the financial literacy problem does not appear to respond to investor education efforts.[7] Financial illiteracy may persist because the financially illiterate do not recognize their financial illiteracy.[8] Probing the resiliency of financial illiteracy, the FINRA Investor Education Foundation has found that despite "low levels

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[2] INVESTMENTNEWS, *Client Protection Ruse Needs To Stop*, INVESTMENTNEWS (Nov. 16, 2014), *available*: http://www.investmentnews.com/article/20141116/REG/141119928/client-protection-ruse-needs-to-stop.
[3] *Id.*
[4] Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 635 (2015).
[5] OFFICE OF INVESTOR EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, STAFF STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS (2012), viii [hereinafter LITERACY STUDY], available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.
[6] *Id.*
[7] *See* e.g., Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008) (describing the failures of the financial-literacy approach).
[8] These failures may occur because of the Dunning-Krueger effect, which occurs when people tend to overestimate their own knowledge, skills, and abilities because they lack the information and metacognitive skills necessary to recognize their deficits. *See* Joyce Ehrlinger *et al.*, *Why the Unskilled Are Unaware: Further Explorations of (Absent) Self-Insight Among the Incompetent*, 105 ORGANIZATIONAL BEHAVIOR & HUM. DECISION PROCESSES 98, 99 (2008); Justin Kruger & David Dunning, *Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self-Assessments*, 77 J. PERSONALITY & SOC. PSYCHOL. 1121, 1127 (1999).

of financial literacy . . . Americans tend to have positively biased self-perceptions of their financial knowledge," a finding tending to indicate that many may invest under the mistaken belief that they know what they are doing.[9] Given these problems, the Proposal seems well calibrated to improve the quality of investment advice provided to retirement investors.

III. This Proposal Aligns Law with Current Investor Expectations

The Proposal will also better align the law with current investor expectations. Retirement investors now mistakenly believe that the persons providing them with personalized financial advice are required to act in their best interests.[10] When retirement investors find their trust betrayed, they are often shocked to discover that the firms advertising their trustworthiness defend themselves by arguing that they never owed a duty to provide advice in the investor's best interests.[11] The Proposal better aligns the law with investors' default expectations and will make it easier for investors to trust their financial advisor.

IV. This Proposal Will Improve Capital Formation

The Proposal offers significant benefits for the economy as a whole by improving capital allocation by better connecting investor capital with promising business opportunities. Currently, the lack of a consistent fiduciary standard for financial advisors undercuts the efficient allocation of capital by rewarding issuers for inducing financial intermediaries to betray client interests. In a market where some issuers raise more capital by paying larger commissions to financial intermediaries, equivalent opportunities paying lower commissions will raise less capital.[12] Thus, a capital market that rewards issuers for offering high-commission products also forces issuers to compete for capital not only on the underlying merits and risks of the investment opportunities offered but also on how they bias financial intermediaries and secure their most ardent promotion efforts.

The Proposal may reduce this form of value-destroying competition and reduce the pressure on issuers to pay excessive fees to intermediaries by requiring financial

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[9] FIN. INDUS. REGULATORY AUTH. INVESTOR EDUC. FOUND., FINANCIAL CAPABILITY IN THE UNITED STATES: REPORT OF FINDINGS FROM THE 2012 NATIONAL FINANCIAL CAPABILITY STUDY 29 (2013).

[10] *See* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 714 (2012) (explaining that broker-dealers "have assumed a role that causes investors to believe that brokers provide impartial advice"); SEC & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT v (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (explaining that retail investors already "expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests.").

[11] *See* Joseph C. Peiffer, Christine Lazaro, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of A Fiduciary Duty Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard*, 22 PIABA B.J. 1 (2015) (documenting defenses alleging a lack of fiduciary duty).

[12] Issuers do raise more capital by offering larger commissions—or at least believe that they will. If issuers did not believe that they would raise more capital by offering higher commissions, they would not offer them and would keep more of the offering proceeds for themselves.

intermediaries to put client interests first. This may change intermediary behavior by increasing the likelihood that they will recommend products with better expected outcomes, reducing the market imperative for issuers to compete for capital by paying larger commissions. This alteration may free issuers to compete on the merits and risks of their offerings instead of competing over how to bias financial intermediaries. While this will not solve the problem entirely, it will result in a different market equilibrium for issuer efforts to bias intermediaries than would occur absent regulation.[13]

That the Proposal may alter the current market equilibrium for retail capital allocation may be inferred from the vociferous opposition raised by certain issuers of high commission products. Consider, for example, the objections raised by non-traded Real Estate Investment Trusts, a sector that has generally opposed or sought to modify the Proposal.[14] The Department should expect similar opposition from other oversold, high-commission alternative investments.

In any event, reductions in the amount of high-cost alternative investments sold to retirement investors may reduce investor exploitation by limiting opportunities to take advantage of them. Consider, for example, the enforcement issues associated with non-traded REITs. Both "FINRA and State Attorneys General have brought enforcement actions against broker-dealers for abusive practices in the sale of non-traded REITs to unsophisticated investors."[15] Unsophisticated investors may be targeted because of the rich offering fees to be obtained. One recent study found that these non-traded REITs average upfront fees amounting to "13.2% of invested capital."[16] These particular products may tempt more financial intermediaries to betray their clients because the actual fees and expenses involved can be more easily misrepresented to customers since customers do not ordinarily pay the larger commissions directly, rendering the true cost opaque until and unless one reads and understands the fine print.[17]

In addition to harming investors, low standards for personalized financial advice also harms capital allocation process by diverting capital to less productive uses. For example, not only do these non-traded REITs cost retirement investors more, the products have significantly underperformed comparable publicly-traded REITs—indicating that the capital would have been more productive elsewhere. One analysis

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[13] For more on the economics of manipulations and deception, *see* GEORGE A. AKERLOF & ROBERT J. SCHILLER, PHISHING FOR PHOOLS: THE ECONOMICS OF MANIPULATION & DECEPTION 8 (2015) (arguing that manipulation and deception will occur "as long as there are profits to be made from" it).

[14] Along with letters submitted by many others, the Public Non-Listed REIT Council of the National Association of Real Estate Investment Trusts (the "Non-Listed REIT Council") submitted an eight-page letter seeking changes to the Proposal.Letter from Executive Committee, NAREIT PNLR Council, to the Office of Regulations and Interpretations, U.S. Department of Labor (July 21, 2015), available http://www.dol.gov/ebsa/pdf/1210-AB32-2-00638.pdf.

[15] Barbara Black, *Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer A Better Approach?*, 48 WAKE FOREST L. REV. 771, 778 (2013).

[16] BRIAN HENDERSON, PHD, CFA, JOSHUA MALLETT, CPA, AND CRAIG MCCANN, PHD, CFA, AN EMPIRICAL ANALYSIS OF NON-TRADED REITS, SECURITIES LITIGATION & CONSULTING GROUP 2 (2015), available http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf.

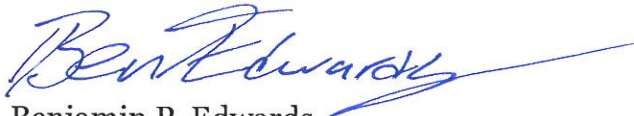
[17] For a discussion of this issue, *see* Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will A Uniform Fiduciary Duty Make A Material Difference?*, 14 J. BUS. & SEC. L. 105, 122 (2014).

found that "non-traded REITs which had listed, been acquired by or merged with a listed REIT or had updated per share values average 6.3% annually compared to 11.6% returns earned over the same period in traded REITs. The economic magnitude of the underperformance is over $45 billion."[18] This underperformance raises serious questions as to whether the non-traded REIT sector attracts capital on its merit or its ability to bias intermediaries by paying above-average fees. To the extent that it attracts capital by biasing intermediaries, other issuers suffer and attract less investor capital than would be expected on the merits of their offerings.

To be sure, the Proposal's limitations and protections for retirement investors will make it more difficult for certain issuers to attract capital by paying more compensation to intermediaries.[19] Yet these limitations should benefit other issuers offering more attractive opportunities by reducing the incentive for financial intermediaries to steer retirement compensation elsewhere in exchange for enhanced personal income. This may shift the competition more toward the individualized merits and risks of particular offerings.

I thank the Department for its leadership on this issue and for the opportunity to comment.

Very Truly Yours,



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[18] BRIAN HENDERSON, PHD, CFA, JOSHUA MALLETT, CPA, AND CRAIG MCCANN, PHD, CFA, AN EMPIRICAL ANALYSIS OF NON-TRADED REITS, SECURITIES LITIGATION & CONSULTING GROUP 1 (2015), available http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf.

[19] While I have spotlighted some of the issues with non-traded REITs above, other high commission products also likely divert capital from more productive uses.