

Attached for your review is a memo from Jason Furman and Betsey Stevenson providing background on the potential Conflict of Interest Rule for Retirement Savings. The memo lays out the evidence that (i) consumer protections for investment advice in the retail and small plan markets are inadequate and (ii) the current regulatory environment creates perverse incentives that ultimately cost savers billions of dollars a year. These costs arise from incentives for financial advisors to encourage savers to move from low-cost employer plans to often higher fee IRA accounts, and from incentives to steer savers into higher cost products within the IRA market. Moreover, the current regulatory environment allows fund sponsors and advisory service firms to create incentives for their advisors to recommend excessive churning (repeated buying and selling) of retirement assets and to steer savers into higher cost products with financial payoffs for the advisor.

Academic research has studied the losses to investors stemming from these conflicts, which are detailed in the memo. In summary, studies generally find that investors using financial advisors pay excess fees and that their returns are lower than what they otherwise would be both before and after fees. Research focusing exclusively on the most clear-cut forms of conflict estimate an extreme lower bound on losses of roughly \$6-8 billion per (35 to 50 basis points) for IRA investors. More inclusive, but still quite conservative, estimates of the cost of conflict suggest 50 to 100 basis points of underperformance per year, or losses of roughly \$8-17 billion per year. And an investor receiving conflicted advice who expects to retire in 30 years loses at least 5 to 10 percent of his or her potential retirement savings due to conflicts, or approximately 1 to 3 years' worth of withdrawals during retirement. Finally, the memo also gives an overview of very recent international legislative and regulatory changes that increase consumer protections for investment advice across all types of accounts, not just those for retirement. Notably, many advanced industrialized nations have undertaken much more aggressive action than DOL contemplates: banning conflicted payments (also known as commissions) entirely.

This memo may serve as the basis for a publicly released report on this topic. Please send any comments by 2pm Friday (1/16).

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Subject: Briefing Memo for Senior Advisors - Draft Conflict of Interest  
Rule for Retirement Savings - Please Send Any Comments by 2pm  
Friday (1/16)

THE WHITE HOUSE

Washington

January 13, 2015

MEMORANDUM FOR SENIOR ADVISORS

FROM: JASON FURMAN  
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SUBJECT: Draft Conflict of Interest Rule for Retirement Savings

The American system of retirement savings requires that hard-working Americans navigate a complex array of investment products and services. The products available to any one worker reflect the combined decisions of their current and previous employers, financial service firms, and government regulators. Over the past several decades, the share of Americans' employer-based retirement savings that takes the form of traditional pensions—where investment decisions are made by professionals—has fallen sharply. Today, Americans are largely responsible for choices about how to invest their retirement savings. Defined contribution plans, whether employer-based plans like 401(k)s or Individual Retirement Accounts (IRAs), which require such self-direction, account for the majority of retirement savings. Importantly, few individuals contribute to IRAs directly. Instead, most of the money flowing into these accounts was accumulated in an employer plan and then rolled over when workers change jobs or retire.

In this complex environment, many workers require investment advice. However, the regulations providing the legal framework governing the treatment of investment advice for retirement plan participants were issued in 1975 and have not been substantially updated since then. At that time, traditional pensions dominated the market and 401(k) plans did not yet exist. IRAs were created in the very same legislation (ERISA) that underlay the then-new regulations of investment advice. Few foresaw the massive shift in retirement savings that would occur over the subsequent 40 years. Moreover, with no expectation of the dramatic growth in 401(k)-type plans, there could be no expectation of the dramatic growth in IRA assets nor the importance of the perverse incentives resulting from the disparate legal treatment of employer plans and IRAs.

The memo lays out the evidence that (i) consumer protections for investment advice in the retail and small plan markets are inadequate and (ii) the current regulatory environment creates perverse incentives that ultimately cost savers billions of dollars a year. These costs arise from incentives for financial advisors to encourage savers to move from low-cost employer plans to often higher fee IRA accounts, and from incentives to steer savers into higher cost products within the IRA market. Moreover, the current regulatory environment allows fund sponsors and advisory service firms to create incentives for their advisors to recommend excessive churning (repeated buying and selling) of retirement assets and to steer savers into higher cost products with financial payoffs for the advisor.

Academic research has studied the losses to investors stemming from these conflicts, which we detail in this memo, and summarize below. However it is difficult to bring together the many ways in which conflict creates excess fees and affects returns. Therefore these estimates are both preliminary and designed to be lower bound estimates of the costs to savers

- Studies generally find that investors using financial advisors pay excess fees and that their returns are lower than what they otherwise would be both before and after fees. Research focusing exclusively on the most clear-cut forms of conflict estimate an extreme lower bound on losses of roughly \$6-8 billion per year (35 to 50 basis points) for IRA investors.
- More inclusive, but still quite conservative, estimates of the cost of conflict suggest 50 to 100 basis points of underperformance per year, or losses of roughly \$8-17 billion per year.
- An investor receiving conflicted advice who expects to retire in 30 years loses at least 5 to 10 percent of his or her potential retirement savings due to conflicts, or approximately 1 to 3 years' worth of withdrawals during retirement.

The memo also gives an overview of very recent international legislative and regulatory changes that increase consumer protections for investment advice across all types of accounts, not just those for retirement. Notably, many advanced industrialized nations have undertaken much more aggressive action than DOL contemplates: banning conflicted payments (also known as commissions) entirely.

### **Impact of Conflict on Retirement Savings**

Academic research has clearly established that conflicts of interest affect financial advisors' behavior and that advisors often act opportunistically to the detriment of their clients because of payments they receive from product providers (referred to generically as conflicted payments and in particular cases as load-sharing or revenue-sharing payments).<sup>1 2</sup> Studies generally find that investors using receiving conflicted advice pay excess fees and that their returns are lower than what they otherwise would be, even before the payment of fees is taken into account. Importantly, these studies use experimental or statistical techniques to isolate the role of conflict from other reasons why the saver could earn lower returns. However, by isolating the role of certain types of conflicted fees, these studies necessarily estimate lower-bound estimates of the harm to savers.

Studies primarily examine two types of conflicted fees that are comprehensively measured, namely load-sharing and revenue-sharing payments. They do not consider the harm arising from a suboptimal market structure for the financial advice industry, whereby many firms have organized themselves on the basis of capturing conflicted payments rather than the delivery of high-quality financial advice.<sup>3</sup> With brokers advising on approximately \$2.8 trillion of IRA

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<sup>1</sup> See, for example, Bergstresser et al. (2009), Chalmers and Reuter (2012), Del Guercio and Reuter (2012), and Christoffersen et al. (2013).

<sup>2</sup> This memo uses the term financial advisor broadly to include brokers. The allocation of the harms of conflict to different advice channels is beyond the scope of the memo.

<sup>3</sup> For instance, see the discussion in Del Guercio, Reuter, and Tkac (2010) and Gennaioli et al. (2012).

assets—even more if employer retirement plan assets are included—the scope for harm to investors is large.

One study, which provides the strongest statistical basis for establishing the adverse effects of conflicts, finds that financial advisors systematically direct clients to mutual funds with unusually high conflicted payments and that these funds perform worse (Christoffersen et al. 2013). This study achieves its methodologically robust conclusions by narrowly focusing on only one segment of the market for financial advice where there is high-quality data, rather than the entire market for financial advice. Moreover, the study examines only how financial advisors respond to unusually high or low conflicted fees for one particular class of products and not expected differences in fees across products, which also lead to conflicts of interest. For these reasons, this study isolates only a narrow aspect of the adverse effects of conflicts. It does not quantify any damage that results from advisors recommending (1) funds in sectors with higher average fees or (2) funds that pay conflicted fees over funds that do not. As a result, the estimates from this study applied to the IRA market alone provide a lower bound for the cost of conflict that is unrealistically small and yet still disturbingly large: annual losses of roughly \$6-8 billion (35-50 bps).

Studies that examine conflict more broadly imply a much higher cost of conflicts. It is not uncommon for studies to estimate that the excessive fees and underperformance could be as high as 100 bps, or \$17 billion, per year (see Del Guercio and Reuter 2012; Bergstresser et al. 2004; Chalmers and Reuter 2012; Morey 2003).<sup>4</sup> Put differently, these more inclusive estimates finding 50 to 100 bps of underperformance per year mean that an investor receiving conflicted advice who expects to retire in 30 years loses at least 5 to 10 percent of his or her potential retirement savings due to conflicts. Following commonly used rules-of-thumb for taking retirement distributions, these losses correspond to approximately 1 to 3 years' worth of withdrawals during retirement.

However, even these more inclusive estimates do not capture the entirety of the harm. These studies focus on conflict in one segment of the retail IRA market, but there are several other contexts in which conflicted payments can harm workers. While there is less information on the magnitude of the economic harm, the existence of the problems beyond those in the mutual fund market is well documented.

- *Firms recommend inappropriate rollovers to 401(k) participants to collect fees for managing the assets.* Many firms recommend that prospective clients roll over 401(k) plan assets into an IRA without any knowledge of a client's financial situation and fail to mention the likely possibility that the fees that they would face if they their assets remained in their former employer's plan may be lower (GAO 2011, Bloomberg 2014).
- *Loads encourage advisers to excessively churn their clients' investments.* Research suggests that load payments lead advisers to churn, that is, repeatedly buy and sell assets when additional transactions are unnecessary, and to exhibit poor market timing (Friesen and Sapp 2007; Bullard et al. 2008; Prentice 2011). While the literature finds that churning generally

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<sup>4</sup> Moreover, studies looking at the European and Canadian markets also find significant drags on performance due to brokers (e.g. Hackethal et al. 2011; Jappelli 2011).

leads investors to pay 120 bps in excess fees per year, the extent to which conflicts of interest are responsible for this churning is not precisely estimated.

- *Potentially because of the need to justify the high fees they collect, brokers tend to encourage their clients to invest in actively managed funds that underperform passively managed funds, funds with high past returns, and/or funds with higher-than-average exposure to several forms of market risk.* A study of retirement plan participants concluded that brokers reduce risk-adjusted returns for employees who rely on their advice about asset allocation, at least in part due to the higher fees associated with the products they recommend (Chalmers and Reuter 2012).
- *Advisors steer investors into variable annuities or other complex products with high fees.* Advisers can exploit their clients' low levels of financial literacy by recommending riskier and more complex investments – a strategy that makes it easier to mask underperformance. Gabaix and Laibson (2006) and Carlin (2009) illustrate how financial service providers can profit from transforming simple financial products into more complex products that offer limited additional benefits to investors.

### **Experience in Other Countries**

The current draft Department of Labor proposal represents a middle ground between the outright bans on conflicted payments enacted by many countries and the current U.S. approach, which lacks any meaningful protections in the retail IRA market. The proposal allows businesses to continue using existing, conflicted business models, but requires that they adopt additional consumer protections such as ensuring advisors follow a best interest standard, enacting policies and procedures to manage and mitigate conflicts, and refraining from certain self-dealing transactions. We believe this offers consumers meaningful protections, especially by also newly facilitating enhanced enforcement over violators, thereby holding them accountable.

Generally, other countries' experiences with conflicted investment advice regulation corroborates that the economic harm to consumers justifies government action, and suggests that even far-reaching interventions can be implemented without negatively impacting savers' ability to invest and save for retirement. One early inference to draw from other countries' experiences is that the availability of financial advice for low-balance savers does not appear to have been curtailed in a harmful way. Given that the regulations are less than two years old in each of these countries, evidence on the longer-term potential savings for families or effects on availability of financial advice from these restrictions is not yet available.

#### United Kingdom

In January 2013, the UK issued a new regulation banning all commission payments from mutual fund providers to advisors and advisory firms, and from advisory firms to their advisors, in connection with retail investment advice. Under the regulation, advisors are only allowed to charge the investor a fee, either as a percentage of the amount invested, a fixed fee, or an hourly rate, though their fees can vary based on the level of service they provide to clients or to the mutual fund companies. Mutual fund companies can still price their products differently for

different advisory firms; for example, a mutual fund company could offer lower load fees to shares purchased by a large retail advisory firm compared to a smaller firm.

The ban on conflicted payments along with a new requirement for advisors to obtain higher qualification levels led to concerns that advice would be curtailed, particularly for low-balance savers. However, six months after the effective date for the UK's new regulation, 97 percent of advisors had attained the appropriate level of qualification while the remaining three percent were still studying and on track to complete the credentialing. Moreover, research released by the Financial Conduct Authority (FCA, the UK financial services regulator) found that many retail investment advisors continue to service clients with low-balance accounts.<sup>5</sup> While the FCA also found that some banks have exited the investment advice market for low-balance savers, such firms started to exit even before the regulation passed so it is inaccurate to say that the regulation caused this change.

### Australia

Australia legislated a ban on all prospective conflicted compensation arrangements for advisors and advisory firms. The Australian Treasury also proposed a timeline to grandfather the ban. The legislation became effective in July 2013. Australia also banned non-monetary "soft dollar" benefits to advisors over \$300 AUD that could "influence" the choice of financial product recommendations. Australia also created an explicit duty to act in the best interest of the customer that includes minimum steps for advisors to follow in order to comply, and required advisory firms to adopt policies and procedures that eliminated the conflicts. Since the law was passed, the newly elected conservative government announced a package of changes that went into effect on July 2014 to reduce compliance costs and regulatory burdens for the financial services industry.<sup>6</sup> However, the ban on conflicted payments is still in place. We are not aware of any studies that identify serious harm to the financial services industry or to households with low-balance accounts.

### Other European Countries

Following the United Kingdom and Australia, the Netherlands, Belgium, and Italy have either banned all conflicted payments to advisors or strictly limited them. In 2013, the Netherlands banned conflicted payment to advisors in rendering advice; the ban extends to a wide range of financial products, including investment, insurance, and mortgage products. A court decision in Switzerland recently confirmed that discretionary portfolio managers cannot retain commissions received from product providers. Germany and France have recently considered restricting conflicted payments, but have instead focused on disclosure requirements to attempt to change behavior through increased transparency.

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<sup>5</sup> <http://www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf>

<sup>6</sup> These amendments include the removal of the requirement for an investor to keep renewing contracts with their advisors on a regular basis, streamlining disclosure requirements, and improving the operation of the best interest standard.