

ECONOMIC CONSEQUENCES

of the US Department of
Labor's Proposed New
Fiduciary Standard



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I. INTRODUCTION

Following the withdrawal of a similar proposed rule on Broker-Dealer conflicts of interest in 2010, the Department of Labor (“the Department” or “DOL”) recently issued a new proposed regulation governing conflicts of interest in the retirement savings industry.¹ In general, this rule would impose a new fiduciary responsibility on Broker-Dealers (BDs) and investment advisers servicing retirement accounts, and would label as prohibited any transaction where a conflict of interest is deemed to exist. BDs and investment advisers would therefore be forced to either dramatically change their current business models in order to avoid such conflicts altogether, or navigate the challenging demands of the new Best Interest Contract Exemption (BICE), which allows certain conflicted transactions to proceed under very particular conditions, or some combination thereof.

This report explores the likely economic impact of the proposed rule, focusing on the perspective of independent BDs.² It is a critique of the Department’s Regulatory Impact Analysis which, as we will show, fails to engage directly with what the rules specifically require affected entities to do to comply from a business process standpoint, and consequently dramatically underestimates their cost. The Regulatory Impact Analysis also relies on a questionable reading of academic studies to assert across-the-board gains on more than a trillion dollars of assets, resulting in enormous purported benefits. At the same time, it dismisses outright the evidence of benefits that investors receive from BDs and Registered Investment Advisers (RIAs) that justify the costs of these services, along with the clear evidence that this new rule will result in less access to advisory services for small and medium-sized investors.

The outline of the report is as follows: Section II reviews the Department’s cost estimates and presents the results of our original work to estimate the expected expense to businesses. Section III points out the Department’s questionable assumptions about the rule’s likely benefits for investors, and

¹ <http://www.dol.gov/ebsa/regs/conflictsofinterest.html>.

² See Section I A below for a description of independent broker-dealers.

discusses additional costs to investors that the Department either missed or ignored. Section IV discusses the impact of the rule on the industry, including the likelihood of significant consolidation as a result of resulting compliance burdens. Finally, Section V discusses likely effects on investors, especially those with relatively small assets who will find it increasingly difficult or impossible to obtain investment advising at an affordable price.

A. BACKGROUND ON INDEPENDENT BROKER DEALERS

Independent Broker Dealer (IBD) firms operate a distinct business model that aims to help investors by providing comprehensive and affordable financial services. The IBD financial advisors are self-employed business owners (classified for tax purposes as independent contractors) and often serve a distinct geographic region where they have community ties and a local reputation. The IBD business model is designed to serve the financial needs of Middle America. IBD firms service all types of investors, ranging from accounts in the thousands of dollars to those in the millions. This gives the IBDs the ability to cater financial advice to individual needs and offer a wide range of investment products. They primarily engage in the sale of packaged products, such as mutual funds and variable insurance and annuity products, and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their financial advisor.

B. OUR METHODS

This report represents a close reading and critique of the Department's Regulatory Impact Analysis, acknowledging the wealth of comments already published on this topic.³ To inform this work, Oxford conducted its own data gathering with the help of the Financial Services Institute (FSI),⁴ the professional organization that represents independent financial services firms and independent financial advisors.⁵ Specifically, we did the following:

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- 3 It is important to note that this report is an economic analysis of the rule's likely impacts. While we consulted with FSI lawyers and believe that we are not misrepresenting the rule's requirements, this is not a legal analysis. Where we report interpretations of the rule's likely effects—frequently necessary because the Department does not make clear its own intended meaning—these reflect comments we've received from knowledgeable individuals in our interviews.
 - 4 This work was conducted under contract with and financially supported by FSI.
 - 5 Formed in 2004, FSI promotes a responsible regulatory environment for more than 100 independent financial services firm members and their 160,000+ affiliated financial advisors

- Conducted interviews with nearly three dozen executives from 12 companies that employ either directly or by contract BDs and RIAs who would be impacted by the proposed rules. The companies were typically independent BD firms, and the individuals interviewed were all senior executives within these organizations.
- Followed up with a group of six of these firms to obtain detailed cost estimates based on their expectations about the impact of the proposed rule. The cost categories were developed collaboratively during the interview process,
- Interviewed executives from clearing firms regularly used by independent broker dealers and financial advisors to get information about pass-along costs connected to technology and disclosure upgrades that would be required under the new rule.
- Analyzed possible responses to and expense predictions related to the proposed rule using an online survey of FSI members.
- Reviewed the Department's Regulatory Impact Analysis in detail, as well as other researchers' existing work on this topic.

Our interviews revealed that even very experienced securities lawyers are uncertain what the requirements of the proposed rules will mean in practice, and therefore have trouble estimating their likely costs. In having unanswered questions about the Department's proposed rule, however, our interviewees are not alone: according to a Sutherland report,⁶ the Department of Labor itself has solicited responses to 170 questions related to its own proposed rule.

C. BACKGROUND ON THE NEW RULES

The major effect of the proposed rules would be to impose a fiduciary duty on those in the financial industry servicing retirement accounts, including BDs, RIAs, and plan sponsors.⁷ Generally, plan sponsors and RIAs already have a fiduciary duty to plan participants and beneficiaries, although with somewhat different specific requirements and under different regulatory structures. Importantly, adhering to the Securities and Exchange Commission (SEC)'s

who provide affordable, objective advice to Main Street Americans. For more information, visit financialservices.org.

6 Sutherland (2015). "Legal Alert: DOL Has Many Questions About its Fiduciary Reproposal." <http://www.sutherland.com/NewsCommentary/Legal-Alerts/174358/Legal-Alert-DOL-Has-Many-Questions-About-its-Fiduciary-Repropos>

7 For example, sponsors of employer based plans like 401(k)s.

current fiduciary standards for RIAs does not in itself insure compliance with the Department's proposed standard. Nevertheless, the Department estimates that the firm costs imposed by the proposed rules on RIAs and plan sponsors will be only \$1,000-\$10,000 per year, even for large firms. However, the Department's own calculations admit that the burden on BDs will be much larger.⁸

Under the Department's proposed standard, any transaction in which a financial advisor, or his or her firm, has a conflict of interest (i.e., would receive more compensation if the investor were to make the transaction) would be labeled a Prohibited Transaction (PT). In order to go forward with such a transaction, an advisor would require a Prohibited Transaction Exemption (PTE), the most significant of which under the proposed rules is the Best Interest Contract Exemption (BICE). Essentially, this would require the advisor and the client to enter into a contract where the advisor promises to act in the undefined "best interest" of the client (including vague provisions like not receiving "excessive" compensation). Importantly, these contracts would be enforceable through state contract law courts,⁹ opening the door to unforeseeable litigation costs.

Making use of the BICE would also impose myriad other duties on firms, including recordkeeping and reporting requirements and forecasting investors' cost burden over the following decade. In its Regulatory Impact Analysis, the Department never explains precisely what firms would have to do to comply with the rule. This, coupled with the Department's creation of a new enforcement mechanism through the state courts has generated a great deal of concern.

In essence, the proposed rule seems to envision two paths for firms: they can either shift their business practices entirely to avoid any material conflicts, or bear the heavy costs of implementing BICE contracts. As a start, avoiding Prohibited Transactions would seem to require those firms currently operating (any part of their retirement business) under a commission structure, in which customers pay per transaction performed, to shift entirely to a fee-based compensation system, in which customers pay a fixed amount based on their assets under management. It is not clear that this shift is truly in the interest of small investors.¹⁰

Moreover, even if all commission-based transactions were eliminated other firm-level conflicts would remain because of the prevalence of payments received

8 See section II A below.

9 The regulations specifically allow for arbitration to settle individual cases, but class action cases would be able to go forward in court. See Section II B below.

10 See Section V A below.

by BDs from vendors and other product providers. Eliminating these payments would substantially reduce the ability of BDs to fund the supervisory, training, and compliance functions needed to maintain integrity in the market. Ultimately this would either restrict asset choice or raise costs to retirement account investors as firms trim their catalogs to ease compliance burdens. Many firms, especially in the independent market we interviewed, have unavoidable conflicts relating to certain classes of assets that they sell directly from originators, especially insurance and annuity products. In many cases, these products are a core differentiator of a BD firm from its competitors, and reflect a core piece of the BD's business, that can also involve managing clients' other retirement, and possibly non-retirement, savings. These assets are sold today by different firms both under suitability and under existing fiduciary standards. However, they appear to be fundamentally incompatible with the Department's proposed new fiduciary standard, and under that regime, their sale would require a BICE.

At the same time, the Department does not allow BICE to be applied at all to trades involving important classes of (generally less liquid) assets commonly held in retirement accounts today.¹¹ Some of these assets are fundamentally conflicted in the manner discussed above (and also, owing to their specialized nature, generally cannot be purchased without the assistance of a financial advisor), and likely would be excluded from retirement accounts altogether under the proposed rules.

All this leads to a situation where some individual investors will likely be forced to have both BICE-based and fiduciary (Prohibited Transaction avoiding) retirement accounts, as well as perhaps non-retirement accounts with the same advisor.¹² This has the potential to create great confusion over when an advisor is acting as a fiduciary and when he or she is acting in a client's best interest, and over how an advisor should take into consideration information from the client's other account(s) when operating under a BICE. Again, the uncertainty is compounded by the Department's lack of clear definitions and interpretations and outsourcing of enforcement to contract law court.

A main recurring theme of this review is that the Department does not appear to have clearly described what specifically it is asking BD and RIA firms to do. Even in its estimates of the costs of the proposed regulations, it does not specify what firms will need to do to comply. We review these cost estimates in the next section.

11 Including, for example, non-traded Real Estate Investment Trusts, or REITs, and non-traded Business Development Companies, or BDCs.

12 See Deloitte, 2015, "Report on the Anticipated Operational Impacts to Broker-Dealers of the Department of Labor's Proposed Conflicts of Interest Rules" for more discussion of the difficulties and confusion likely to arise from having multiple client accounts.

II. COST CALCULATIONS

In this section, we first review the Department's estimates of the costs of the new rule, which are mostly contained in chapter 5 of the Regulatory Impact Analysis. Overall, we find the Department's estimates to be vastly understated, especially for smaller firms, and we question the assertion that costs for RIAs will be trivial. Following this, we present our own cost estimates based on detailed interviews and a cost survey with independent BDs which would be affected. Most of these costs imposed by the new rule will be passed on to investors in the form of higher fees for services.

A. DOL'S COST ESTIMATES

The Department's Regulatory Impact Analysis considers a number of categories of compliance costs, including those for three principal groups of affected entities: BDs, RIAs, and plan sponsors. Costs for other entities, including call centers and asset providers, are also discussed but are generally asserted to be minimal and are not quantified.

In the case of RIAs and plan sponsors, the Department asserts the costs of the proposed rule would be trivial: \$5,000-\$49,000 in startup costs and \$1,000-\$10,000 in on-going costs. Since the focus of our work was entirely on BD firms, we do not have data to directly dispute these numbers, however we note that the BDs we spoke with are also dual registrants, i.e., they also employ Investment Adviser Representatives ("IARs")¹³ working under existing fiduciary standards. As a result, our interviewees generally believed and were very concerned that the investment adviser parts of their businesses would require significant attention and resources to ensure compliance as well.

With regard to BDs, we do not generally challenge the Department's estimates of the number of affected entities, specifically that there are roughly 4,410

13 For the purposes of this discussion, we employ standard industry terminology. A Registered Investment Adviser (RIA) refers to a firm or company providing investment advice to consumers. An Investment Adviser Representative (IAR) is a person who works at such a firm or company and provides advice and aids in account set up and transactions for consumers.

BD firms, of which only 59% of the small and medium ones do business with retirement accounts. We do not have any reason to doubt these universe numbers, though we note that it would be preferable to have more reliable data on which to base the estimates.

1. DOL COST CATEGORIES

The Department identifies four areas of compliance costs that affected BDs would incur. These are:

- Firm costs
- Errors & omissions insurance
- Switching/Training cost
- Additional PTE/Exemption Costs

We consider each in turn.

a. Firm Costs

Firm costs represent the bulk (70%) of the Department's total 10-year expense estimates (in what we consider the Department's most plausible cost estimate, Scenario A with 3% discounting). However, the Department never defines precisely what it considers firm costs to entail or include. Nor does it explain in a straightforward way what it envisions the key compliance burdens for firms will be. Instead, the Department quotes from industry comment letters about different proposed rulemakings, especially from a Securities Industry and Financial Markets Association (SIFMA) letter about a proposed SEC rule.¹⁴ The Department declares that “while there will be substantive differences between the Department's new proposal and exemptions” and the SEC's proposed rule, “there are also some similarities between the cost components in the SIFMA survey and cost that will be incurred by BDs to comply with the Department's new proposal.”¹⁵

According to the Regulatory Impact Analysis, the SIFMA letter on which the Department's cost calculations are based considered two categories of costs:

- “The cost of developing and maintaining a disclosure form and customer relationship guide” including “any (i) outside legal counsel costs, (ii) outside compliance consultant costs, (iii) other out-of-pocket costs, and

¹⁴ <http://www.sifma.org/issues/item.aspx?id=8589944317>

¹⁵ Ibid., p. 161

(iv) employee and staff-related costs.” SIFMA members estimated this to have a startup cost of \$2.8 million, and an on-going cost of \$631,000. And,

- “The costs required for BD firms to develop and implement a new, comprehensive compliance and supervisory system.” This includes “(i) information technology suppliers and vendors; (ii) information technology systems; (iii) communications, marketing, business review and risk review; (iv) training materials; (v) reviewing and updating all existing client contracts and client disclosures; (vi) reviewing and updating of sales surveillance tools; (vii) publishing and distributing revised policies and procedures; (viii) reviewing...impacted marketing materials; and (ix) updating exam test modules.”¹⁶ SIFMA members estimated this to have a startup cost of \$5 million and an on-going cost of \$2 million.

Given these inputs, the Department’s “Scenario A” estimates the startup costs for large BDs (those with more than \$1 billion of capital) at \$5 million, and on-going costs at \$2 million. The Regulatory Impact Analysis states that “the Department has also added some additional costs for items that do not appear to have been included,”¹⁷ but in fact it appears to have left out roughly a third of the costs SIFMA reported.¹⁸

Next, the Department, asserting that the SIFMA data applies only to the large BD firms (although this is not how SIFMA presented its estimates), extrapolates from this the costs to medium and small BD firms. Specifically, it assumes costs for medium firms will be 13.3% of the costs to large firms, and for small firms, 4.8%. This is based on questionable extrapolations from an Investment Adviser Association (IAA) survey.¹⁹

The Department believes however that “there is a reason to be concerned that the SIFMA submission significantly overestimates the costs of the new proposal,”²⁰ and marshals alternate estimates from an IAA comment letter to create a “Scenario B” estimate in which firm costs are only 21.81% as high. Under this scenario, small BD firms will incur startup expenses of only \$53,000, with on-going costs of \$21,000. The Department describes scenario A as an “over-estimate” and says that “scenario B is a more reasonable estimate, but probably also overstates costs.”²¹

¹⁶ Ibid., p. 161

¹⁷ Ibid., p. 164

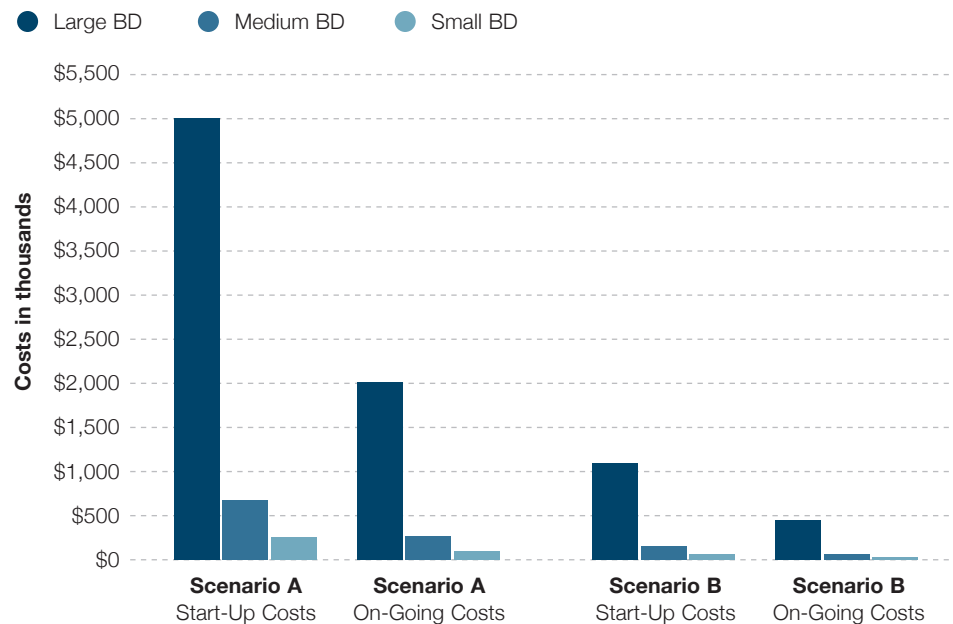
¹⁸ The Department also references a Charles Schwab comment letter on Financial Industry Regulatory Authority (FINRA) Rule 2111, which estimated compliance costs of \$5.5 million.

¹⁹ This is based on ratios for different size categories of RIAs.

²⁰ SIFMA, op. cit., p. 162

²¹ Ibid., p. 164

Chart 1. Summary of DOL Cost Estimates



b. Insurance Costs

The Department estimates that insurance premiums will rise approximately 10%, or \$300 a year, for 290,000²² BD representatives, and some plan service providers. However, only half of these expenses are asserted represent true economic costs of the rule. The rest, according to the Department, is simply a transfer from BDs to wronged investors who receive insurance payouts. In general, we believe that these insurance costs miss the key point: the increased costs from litigation and litigation risk created by this new rule, which we discuss below. In general, these litigation costs loom far larger than the \$150 per BD representative the Department estimates. Moreover, it appears overly simplistic that insurance will address all the compliance and litigation risks associated with this complex rule. Many errors and omissions policies have exclusions for claims under ERISA. One would more reasonably expect that if complex rulemaking which invites class-action lawsuits were implemented, then insurance carriers will respond with a combination of higher premiums and coverage carve outs.

²² This represents 82% of those now providing services to Individual Retirement Account holders, according to the Department. Some of the BDs that are dual-registered as RIAs already have insurance that covers them as fiduciaries, and it is assumed that their insurance premiums will not be affected by the new rules.

c. Switching/Training Costs

The Department estimates that the burdens of the new rules will lead 11,000 Registered Representatives to transition to IAR status in the first five years, and 5,500 to transition in each subsequent year. The Department estimates that the costs for each switch will be approximately \$5,600.

d. Additional PTE/Exemption Costs

The Department estimates costs associated with the various paperwork requirements of the new and updated exemptions. Of greatest interest here is the cost of the BICE. The Department estimates that the BICE will require 86 million disclosures to be distributed in the first year, and 66.4 million annually in subsequent years. It is unclear where these numbers come from. The Department estimates that the costs associated with these disclosures will be approximately \$77.4 million in the first year and \$29.2 million in subsequent years.

These numbers appear to be calculated on a per document basis (or perhaps by sheet of paper), but many of the costs involved are really incurred on a per firm basis. Using the Department's ratio that costs for medium size firms are 13.3% of those incurred by large firms, and small firm costs are 4.8% of large firms, and its estimate of the number of impacted BDs, the implied costs of BICE contracts per firm are shown in the table below. To say the least, these costs seem low, with small BDs assumed to incur less than \$8,000 a year for "producing and distributing the disclosures and complying with the recordkeeping conditions of the PTE, including staff time to create the original disclosure templates and update IT systems." In some instances, data purchase requirements alone would be substantially higher than the total recurring cost estimate put forth by the DOL.

Table 1. DOL Cost Estimates of BICE Contracts*

Size definition		One-time	Recurring
Large BDs	Over \$1 billion in capital	\$436,447	\$164,655
Medium BDs	\$50 million to \$1 billion in capital	\$58,047	\$21,899
Small BDs	Up to \$50 million in capital	\$20,949	\$7,903

* DOL estimates of costs to BDs for implementing BICE contracts using DOL ratios of number of affected BDs and cost ratios between small, medium, and large firms. According to the Regulatory Impact Analysis, this includes producing and distributing the disclosures, complying with recordkeeping requirements, including staff time to create the templates and update IT systems.

2. GENERAL COMMENTS

The Department's cost estimates are unreliable even on their own terms. The estimates are based at their core on a SIFMA comment letter for a different proposed rule, but also simply ignore one-third of the costs SIFMA estimates. Then, on a very thin basis, the Department declares that these costs apply only to the largest firms and assert that costs for smaller firms will be only a tiny fraction of this amount. Despite this, the Department goes on to say that this is likely an overestimate owing to strategic reporting by SIFMA, and proceeds to reduce this total by 78% for a "Scenario B" estimate, again with little quantitative basis. Additional costs for insurance, training, and implementing the PTEs are presented as an afterthought and are themselves unreasonably low. Estimated costs for all other affected entities, including RIAs and plan sponsors, are assumed to be minimal with little supporting evidence.

Table 2. Comparison of DOL Scenario A and Scenario B Cost Estimates. (Dollar values in thousands.)

Firm Size and Type	SCENARIO A		SCENARIO B (21.81% of A)	
	Start-Up Costs	On-Going Costs	Start-Up Costs	On-Going Costs
Large BD	\$ 5,000	\$ 2,000	\$ 1,091	\$ 436
Medium BD	\$ 663	\$ 265	\$ 145	\$ 58
Small BD	\$ 242	\$ 97	\$ 53	\$ 21

3. DISCOUNTING: A TECHNICAL POINT

In general, the costs and benefits of the proposed rule should be discounted at the same rate, although conducting sensitivity checks using more than one rate, each applied uniformly to both costs and benefits, is also desirable.²³ The Department discounts the benefits to investors at a nominal rate of 5.6%.²⁴ By contrast, the Department's cost estimates appear to be discounted in real terms, as the projected costs do not rise over time with inflation, and are performed using 3% and 7% discount rates.²⁵ The version with 3% discounting

23 The principle that costs and benefits be discounted at the same rate is fundamental to cost benefit analysis; otherwise, it would be easy to justify a policy with greater costs than benefits in each year simply by discounting costs more than benefits. Put another way: what is actually being discounted is the net impact (benefit minus cost) in each year. A higher discount rate will tend to favor proposals whose benefits are realized upfront and costs realized later and vice versa for a lower discount rate.

24 See also Section III A below on the inclusion of compound interest in the Department's benefits calculations. Note that the "benefits" are actually "gains to investors," not pure social economic benefits—see section III D below.

25 The Office of Management and Budget sets rules for discounting in agency economic impact

is consistent with the discount rate used in the benefits section and an average 2.6% projected inflation rate, and we focus on this estimate in the remainder of this paper. The version with 7% discounting, however, is inconsistent with the discounting in the benefits section. Perhaps unsurprisingly, the Department's preferred cost estimate uses 7% discounting.²⁶

B. OUR COST ESTIMATES

Oxford conducted twelve interviews with FSI member firms to assess the likely business impacts and consequent costs²⁷ attached to the proposed rules. We also reviewed evidence that other researchers have gathered on this topic,²⁸ and information provided by a broader group of IBDs in an online survey. Following these interviews, we also conducted a detailed survey by email with seven firms who were willing to attempt to break startup costs into detailed categories. Of these seven BD firms, three were in the Department's large category (capital in excess of \$1 billion), three were in the small category (capital less than \$50 million), and one was medium sized with capital falling somewhere in between.

Oxford's interviews and cost analysis focused on first-year startup costs because these were more easily identifiable at this early stage. However, that does not mean that the recurring compliance costs will not be high as well. For example, it is very expensive to build the system architecture necessary to process the data feeds from third-party sources needed to aggregate required compliance data (a startup cost). But each year thereafter compliance data will still need to be purchased (recurring costs). Similarly, Oxford's costs estimates do not include the substantial business disruption costs that are also anticipated. As shall be described later, these costs will probably be so significant that industry consolidation will likely result. One unintended consequence might be that this will give the remaining firms greater pricing power, resulting in higher costs for investors.

analyses. See <https://www.whitehouse.gov/sites/default/files/omb/assets/a94/a094.pdf> and https://www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/circular-a-4_regulatory-impact-analysis-a-primer.pdf. It specifically sets out these 3% and 7% real discount rate scenarios, but they are to be applied to both costs and benefits.

26 DOL, op. cit., p. 178

27 These are our best estimates but are subject to significant uncertainty related at least in part to the use of poorly defined terms in the DOL proposed rule.

28 Notably Deloitte (2015) "Report on the Anticipated Operational Impacts to Broker-Dealers of the Department of Labor's Proposed Conflicts of Interest Rule Package" which report considered the BD industry as a whole, not just Independent BDs.

1. CATEGORIES OF COSTS RELATED TO THE PROPOSED RULE'S REQUIREMENTS

In order to gain a better understanding of the costs of the proposed rule, we held numerous discussions with experts from independent BD firms. We assembled the following cost categories that the proposed regulation will impose on BD firms: Data collection; modeling future costs and returns; disclosure requirements; record keeping; implementing BICE contracts; training and licensing; supervisory, compliance, and legal oversight; litigation. We believe this list is more comprehensive and provides greater accuracy for estimating costs compared to DOL's cost categories.

Table 3. Comparison of OE and DOL Estimated Cost Categories

OE	DOL
1. Data collection	1. Firm Costs
2. Modeling future costs and returns	2. Errors & omissions insurance
3. Disclosure requirements	3. Switching/ training cost
4. Record keeping	4. Additional PTE/ exemption costs
5. Implementing BICE contracts	
6. Training and licensing	
7. Supervisory, compliance, and legal oversight	
8. Litigation	

The remainder of this section will tackle these in turn, and provide estimates of the likely dollar costs related to each.

a. Data collection

The new rule will require firms to obtain and disclose copious amounts of compensation and performance data that they do not currently possess and in some critical areas does not exist in a form required by the Department's proposal. Some of the data will be available within the firms themselves; however gathering it will require the creation of new data systems and controls to ensure accuracy. Some of the data will need to be purchased from third party vendors. Importantly, for almost every firm we spoke with, it would be necessary to both purchase some data from third party vendors, as well as to generate new data internally, and then to marry these data together.

The average estimated cost of setting up new system interfaces to accept data feeds is \$570,000, with a median cost of \$250,000.

b. Modeling future returns and costs

The proposed rule requires firms to estimate costs to the investor associated with holding an asset for a ten-year period. Developing the logic for these estimates and building systems to create them is a substantial burden on firms.

Our survey did not separately estimate this cost category. It is generally contrary to industry standards to make projections for asset classes, and many of those who have commented on the proposed rule believe that it is in conflict with existing Financial Industry Regulatory Authority (FINRA) stipulations,²⁹ which would need to be amended. Notwithstanding the regulatory inconsistency that would result if the DOL's proposed rule were imposed, the cost to firms of obtaining and disseminating historic expense and future performance projections is substantial and cannot be accurately projected at this point. Much of this data would need to be purchased from independent research firms that provide historic and comprehensive data on the many thousands of products available to investors; and then system interfaces would need to be created to provide this information at the required account level. These would require significant information technology investments.

DISCLOSURES OF “COSTS” FOR NON-MARKET TRADED ASSETS.

According to those we interviewed, the proposed rule as written seems to be related primarily to mutual fund products, and it is not always clear how the rules would be applied to other asset classes. For example, it is not clear what the 10-year cost disclosure would be for annuity products. Moreover, some annuity products, such as variable rate annuities, are essentially a portfolio of investment products; each one potentially subject to disclosure requirements. Clearly these products have costs associated with them, and their creators and distributors are compensated for the value they provide. However, unlike mutual funds where specific fees are charged on a regular basis as a share of the value of the investment, the income stream from an annuity is fixed, and its on-going “cost” to the investor is only really measureable against an alternative investment. This is one more example of the confusion and uncertainty associated with the proposed rules.

c. Disclosure requirements

The new rules require firms to make extensive disclosures to investors of material conflicts of interest including sales loads, redemption fees, exchange

29 See FINRA Rule 2210(d)(1)(f).

fees, account fees, management fees, distribution fees, operating expenses, and other expenses. Currently, this information is already being provided to investors in the form of a prospectus. Instead, the DOL is requiring firms to maintain a public webpage that makes aggregate fee data available.

The average and median estimated cost of disclosure requirements in our survey is \$870,000.

DISCLOSURE ISSUES. Firms expressed deep concern about the proposed rule's requirements to disclose extensive compensation data on public websites. Given disruptions already expected in the industry as a result of the rule, interviewees feared that competitors would actively mine disclosed data in order to determine compensation structures and poach talent. Similar concerns were expressed over now-proprietary information involving payments received from vendors. Both kinds of disclosures will contribute to the consolidation in the industry that the rules are already expected to drive, with many small firms forced out of business by high compliance costs and the decreased ability to serve small accounts (see Section V below). In addition, much of the information mandated by the DOL under the proposed rule does not currently exist in the aggregate and existing information technology infrastructure will need to be substantially modified at the firm level in order to comply with reporting requirements.

d. Record Keeping

The new rules require firms to keep records of the above information for six years and make it available on request. Based on the company interviews that were conducted, none of the respondents indicated that they currently track, record, and report historic data of this type. Hence entirely new infrastructure would need to be created.

The average estimated startup cost of the recordkeeping requirements is \$200,000, and the median cost \$150,000.

e. Implementing BICE Contracts

The cost of implementing BICE contracts is potentially enormous. Some of this is the simple cost of designing the new contracts, but the more significant expenses are the amount of time related to creating them and the operational

challenges that these contracts will likely impose. For example, relationships between potential investors and financial advisors take time to develop and the imposition of complex contracts prior to executing even a single transaction would severely disrupt existing business development practices. All of these soft and hard costs need to be quantified.

The Department seems to view the contracts as a mere nuisance, whose cost can be quantified based on the number of pages that need to be printed.³⁰ It specifically states “the cost estimates do not include time or disruption costs for the situation where phone interactions between advisors and investors are interrupted (or switched entirely to e-mail, print, or in-person) in order for the investor to first sign the contract.”³¹ In the case of new clients,³² this is because “these situations already arise in the current environment. New clients call up brokers and paperwork and agreements have to be filled out and signed before the broker will conduct the transactions.”³³

It is unclear how the Department believes this rule will result in large increases in investor returns if BICE contracts are just one more piece of paper that has to be signed. Our interviewees strongly believe that the new contracts would require significant time on the part of representatives, with more than nominal associated costs. There was also concern about having to sign contracts before even beginning a discussion, which was thought not to be conducive to long-term trust.

Perhaps emphasizing the uncertainties involved in this topic, there was considerable variability in expected costs in implementing a BICE contract. Part of the variation in BICE contract cost estimates was related to the differing ways each firm used to classify disclosure costs. In some instances almost all disclosure costs were attributed to the public disclosure web site. In other instances, disclosure costs were allocated to both the public disclosure web site and the BICE contract.

Our survey estimates an average cost of \$4.5 million for implementing a BICE and a median cost of \$400,000.

30 DOL, op. cit., Sections 5.7 and 5.5.4 of the Regulatory Impact Analysis.

31 Ibid., p. 176

32 For existing clients, “during the transition period...firms should be able to plan ahead and put updated contracts in place for their current clients.”

33 Ibid., p. 176

GRANDFATHERING ISSUES. There is significant concern over how existing accounts will be “repapered” with BICE contracts in the final rules. On the one hand, contacting every existing customer, including possibly those with small accounts opened years previously, is potentially extremely cumbersome and expensive. On the other hand, allowing existing accounts to continue without BICE contracts until the next active trade or consultation creates a perverse incentive not to contact existing clients.

f. Training and licensing

In its analysis, the Department included training and licensing costs for registered representatives to transition to IAR status. While this is an important component of training costs, in reality the new rules will impose considerably larger costs as staff throughout the organization need to be trained as to how the new regulations would affect their work.

Not surprisingly, this is an area with considerable variability between firms, with the smaller firms generally reporting lower training costs.

Our survey estimates an average training cost of \$800,000 per firm, and a median cost of \$580,000.

g. Supervisory, compliance, and legal oversight

The new rule will undoubtedly require significant oversight to ensure compliance, especially with the risk of litigation discussed below. Systems will need to be developed, and lawyers and other compliance officers hired or retrained.

Our survey estimates an average cost for this category of \$210,000, and a median cost of \$138,000.

h. Litigation

Perhaps the greatest concern of BDs we spoke to—likely because it is the area with the greatest inherent uncertainties—is the potential costs of litigation. While the proposed rule allows for arbitration of individual disputes, it also exposes firms to potential class-action liability.

Our interviewees gave countless examples of potential and often trivial litigation

that the rule seems to invite. For example, imagine that Firm A purchases data regarding mutual fund experience from a well-regarded independent source. The data is received on the first day of the month. At the end of the first week of the month, disclosure reports are mailed to Firm A's clients but those notices did not reflect the most current information received about mutual fund performance because of an overlap in the processing of the data received on the first day of the month and the mailing of disclosure notices at the end of the week. Is the firm now liable for any damages that might be connected to the dated information? As a second example, what is meant by a "reasonable" rate of compensation as required by the BICE? During the interviews that we conducted, companies expressed concern regarding a wide number of such questions and expressed profound concern about the potential litigation (particularly nuisance class action lawsuits) that may result.

Importantly, from an economic perspective, the full cost of all this may be far larger than the ultimate amount spent on litigation—although that could end up being quite large as well. The cost of the uncertainty caused by the proposed rule could be far greater, as firms waste resources and forgo opportunities because of the risk of litigation. For example, firms may give up on product lines or exit the retirement savings market altogether.

The Department assumes that Error and Omission insurance costs for some BD representatives will increase by 10%. This appears to be a wild underestimation of the potential costs of litigation, and the uncertainty it fosters as a result of the proposed rule.

Because of the extreme uncertainties surrounding litigation risk, we did not attempt to quantify it in our survey, and our total start-up cost estimates (presented below) exclude this potentially most significant cost category.

"We estimate total start-up costs will be nearly \$3.9 billion dollars, nearly 20 times DOL's preferred estimate."

2. COST SUMMARY

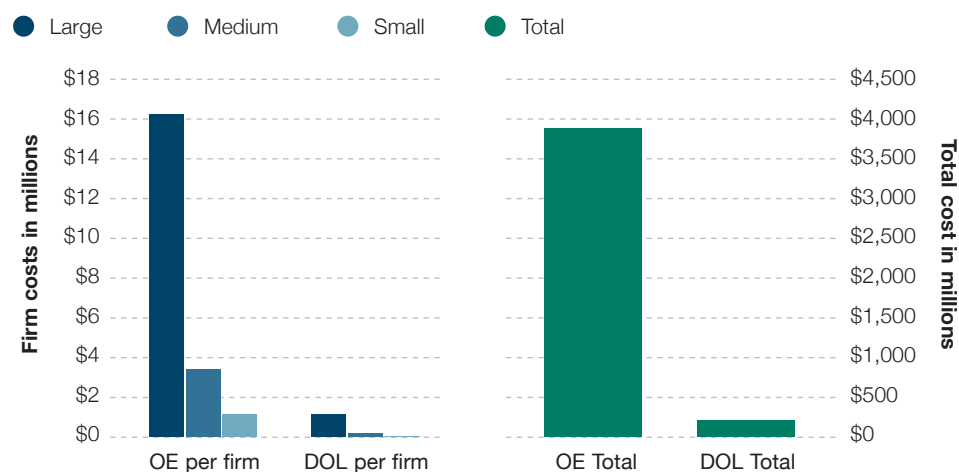
In total, we estimate the proposed rule will result in startup costs ranging from \$1.1 million to \$16.3 million per firm, depending on firm size. This is based on firm survey results that ranged from \$930,000 to \$28 million. The largest firms can expect the highest costs. Table 4 below presents the average startup costs by firm size, along with the DOL estimates for comparison. It is important to note that smaller firms often assume (perhaps naively) that some of the large technology platform providers on whom they depend will be the ones to "figure out" all of these compliances costs and simply pass those costs along to the BDs as a higher per transaction fee amount. Note that in our discussions with some of the technology platform providers, it was not at all clear that the transition would work in this fashion.

Table 4. All-In Startup Costs for Firms

		Our Estimates			DOL high estimates			DOL preferred estimate		
	DOL # of firms	Per firm	Total	Ratio	Per firm	Total	Ratio	Per firm	Total	Ratio
Large	42	\$16,266,000	\$683,172,000	1.0	\$5,000,000	\$210,000,000	3.3	\$1,091,000	\$45,822,000	14.9
Medium	137	\$3,350,000	\$458,950,000	1.0	\$663,000	\$90,831,000	5.1	\$145,000	\$19,865,000	23.1
Small	2,440	\$1,118,000	\$2,727,920,000	1.0	\$242,000	\$590,480,000	4.6	\$53,000	\$129,320,000	21.1
			\$3,870,042,000	1.0		\$891,311,000	4.3		\$195,007,000	19.8

The cost estimates that we present are based upon a detailed examination by several independent BDs of the likely expenses that they would incur should the proposed rule be implemented. Based upon Oxford's interviews, it appears likely that independent BDs may in fact be underestimating their first year startup costs. As independents, these firms are likely to rely on third-party technology platforms to clear and settle accounts. Rightly or wrongly, the expectation of many of those interviewed was that large portions of year one startup costs will be borne by these technology platform service providers and passed along as higher transaction costs. Hence if this view proves correct, then what other BDs might consider an upfront start-up cost, an independent BD might consider as an expected increase in recurring costs.³⁴

Chart 2. All-In Startup Costs for Broker-Dealer Firms



³⁴ Compare our estimates, for example, to Deloitte (2015) "Report on the Anticipated Operational Impacts to Broker-Dealers of the Department of Labor's Proposed Conflicts of Interest Rule Package." On pp. 23-24 of that report, they estimate average startup costs for all (not just independent) BDs at \$38.1 million for large, and \$5-\$23.1 million for medium BDs, 2.3 and 1.5 times our estimates respectively. Their estimates involved a larger sample of interviewees (18 firms in total), and made estimates for on-going costs as well.

It is important to note that many critical business disruption costs—some of which reflect the true economic costs of the rules and others which likely would not—were also identified but not quantified. These could include: disruptions to sales models; shifting clients from commission to fee-based accounts; opportunity cost of selling fewer, more commoditized products; reductions in payments from third-party vendors, among others. All of these impose costs and disruption to businesses as well.

It should also be noted that the Department cost estimates to which these numbers are most compared are what the Department calls “firm costs.” The Department’s firm costs specifically exclude E&O insurance costs, switching/training costs, and costs of implementing the exemptions. As we discuss above, our cost estimates exclude potential litigation costs, which we expect to be far in excess of the Department’s E&O insurance cost estimates. Moreover, firm costs represent roughly 80% of the Department’s total cost estimates, and a larger share of start-up costs.

We do not wish to over-emphasize the precise figures presented here. First, as we’ve noted throughout, there is a great deal of uncertainty among respondents both about what the practical substantive requirements of the new rules will be, and what the costs of these will be. Second, our sample size is small and only consists of independent BDs (although as we noted above, there are reasons to believe startup costs for independent BDs will be low relative to others). Thus, it’s possible these estimates are too high; it’s also possible they are too low.

A significant point to take from this exercise is that our estimates exceed the Department totals by significantly larger margins for small and medium firms—specifically, 4.6-5.1 times as high—as for large firms—3.3 times as high. This should come as no surprise because, as discussed above, the Department’s basis for estimating costs for small and medium firms as a share of large firm costs is particularly thin, being based on a single comment letter for a different proposed rule. Where the Department estimates that medium firms’ costs will be only 13.3%, and small firms only 4.8% of large firms’ costs, our estimates are 20.6% and 6.9% respectively (see Table 5).

Table 5. Comparison of Department and OE ratios of startup costs by size category of BD

	OE estimate	DOL estimate
Large	100.0%	100.0%
Medium	20.6%	13.3%
Small	6.9%	4.8%

In general, while this is only a limited cost comparison, we find that total costs are several multiples—roughly 4.3 times—higher than what the Department estimates in its most expensive scenario (scenario A), and almost 20 times higher than the Department's preferred figure (in scenario B). Applying these ratios to the Department's total 10-year cost figures of \$5.6 billion under scenario A would yield a total 10-year cost of \$24 billion.

III. BENEFITS CALCULATIONS

The Department calculates “gains to investors” of the new rule in Section 3.3 of the Regulatory Impact Analysis. It focuses entirely on front-end loaded mutual funds where it believes the evidence for gains from eliminating conflicted advice is most developed.

Below, we first review the assumptions behind the Department’s alleged gains, and discuss critiques of the underlying basis in academic research. Next, we discuss some of the value provided by financial advisors that the Department disregards. Following this, we discuss some of the aggregate costs to investors of the proposed rules in other asset classes besides the front-end loaded mutual funds the Department focuses on. Finally, we discuss the distinction between gains to investors and true economic benefits, and the potential sources of the Department’s purported gains.

A. THE DEPARTMENT’S CLAIMED GAINS TO INVESTORS

The Department’s calculations regarding gains for investors rely on the huge size (\$1.5 trillion) of front-end loaded mutual fund holdings. These enormous purported benefits, taken at face value, could justify almost any policy intervention. Specifically, the Department assumes that eliminating conflicts of interest on retirement accounts will eventually result in approximately 0.5% higher annual returns on all front-end load mutual funds held in IRAs. These benefits would ramp up over the first ten years of implementation (as older funds, supposedly tainted by conflicts of interest, work their way out of retirement accounts), averaging out to approximately 0.25% higher returns on the roughly \$1.5 trillion (averaged over the next ten years) in front-ended load mutual funds. This works out to roughly \$4 billion of benefits per year. In total, the Department asserts \$39.8 billion of gains to investors over ten years.³⁵

³⁵ There are technical considerations here about compound interest and discounting. In our view, the Department is incorrect to compound the benefits of the rule (without compounding the costs); however because they discount these returns at a rate roughly equal to the rate of

The 0.5% increased returns on assets is a fundamental assumption of the Department's benefits calculation. It is based on several academic studies that claim to show lower returns to investors receiving conflicted advice relative to investors who self-direct their accounts or receive nonconflicted advice. Such studies are inherently difficult to implement, although researchers have used sophisticated techniques to attempt to control for unobserved differences between investors, difficult to observe or measure services of advisors, and actual risk-adjusted returns to investors rather than returns of funds. The specific studies on which the Department relies have been critiqued extensively elsewhere.³⁶ Suffice it to say that while there is some evidence for the Department's central assertion that conflicts of interest can lead to lower rates of return for investors, the academic consensus is not nearly as absolute as the Department portrays it, and the specific 0.5% higher annual return the Department asserts has a rather thin quantitative basis. Nevertheless, even a considerably smaller assumed increased rate of return, when applied to a base as large as all of the holdings of mutual funds in US retirement accounts, would result in an enormous calculated benefit. (Of course, this assumes no similar across-the-board costs to investors, a point we challenge below.)

B. VALUING THE BENEFITS THAT ADVISORS PROVIDE TO CLIENTS

Numerous others commenting on the proposed rules have discussed the benefits that investors, especially inexperienced investors, receive from financial advisors. These benefits represent both quantifiable hard services, such as rebalancing portfolios and helping investors avoid mistakes attempting to time the market, and softer services, such as encouraging investors to save for retirement, and reassuring them when markets inevitably go down. Several studies have shown the positive effects of investors working with financial advisors, including:^{37 38}

return on assets, the effect is minimal.

- 36 Notably in NERA (2015) "Review of the White House Report Titled 'The Effects of Conflicted Investment Advice on Retirement Savings.'" http://www.nera.com/content/dam/nera/publications/2015/PUB_WH_Report_Conflicted_Advice_Retirement_Savings_0315.pdf. See also Litan, Robert and Hal Singer (2015) "Good Intentions Gone Wrong: The Yet-to-be Recognized Costs of the Department of Labor's Proposed Fiduciary Rule." <http://www.dol.gov/ebsa/pdf/1210-ZA25-00070.pdf>. Investment Company Institute (April 7, 2015) Letter to Howard Shelanski, Administrator, Office of Information and Regulatory Affairs https://www.ici.org/pdf/15_ici_omb_data.pdf.
- 37 Kinniry, Francis, et. al., "Putting a value on your value: Quantifying Vanguard Advisor's Alpha," Vanguard Research, March 2014, p. 4, available at <http://www.vanguard.com/pdf/ISGQVAA.pdf>.
- 38 Merrill Lynch Wealth Management, "Americans' Perspectives on New Retirement Realities and the Longevity Bonus: A 2013 Merrill Lynch Retirement Study," conducted in partnership

- Encouraging investors to save at a higher rate
- Preventing investors from taking withdrawals out of their retirement savings
- Providing objective advice (instead of emotional reactions) to market fluctuations
- Creating a disciplined approach to saving by utilizing a regular investing plan
- Balancing portfolios over time to achieve investment objectives
- Helping investors feel more confident about retirement and more financially knowledgeable
- Addressing investors' myriad, wide-ranging questions, concerns, and strategies to help them achieve overall financial healthy

Litan and Singer (2015)³⁹ attempt to quantify the benefits investors receive from relationships with financial advisors. Citing Vanguard studies, Litan and Singer find that advisors provide 44.5 basis points of added return from timing and rebalancing services. Using the same \$1.5 trillion of mutual fund assets the Department uses to arrive at its large benefits numbers, and assuming that half of investors (on a dollar-weighted basis) lose access to brokers as a result of the rule, Litan and Singer estimate these costs at \$3.3 billion per year. They also hypothesize that the other half of front-end load mutual fund investors are pushed into fee-based accounts, with higher fees amounting to 31 basis points, for a cost of \$2.3 billion per year. Even accepting the Department's claimed 25 basis points of benefits per year, they report a net cost of the proposed rule of \$1.9 billion per year, or about \$20 billion of net costs over 10 years, ignoring compliance costs. They consider alternate assumptions, leading to net costs of the rule of up to \$80 billion over 10 years.

Importantly, the Department claims enormous benefits from the new rule based on the enormous size of the retirement mutual fund market. But the Department ignores the benefits investors receive from brokers, which are similarly large based on the large size of investments.

with Age Wave, January 2013, p. 13, available at http://wealthmanagement.ml.com/publish/content/application/pdf/GWMOL/2013_Merrill_Lynch_Retirement_Study.pdf.
 39 <http://www.dol.gov/ebsa/pdf/1210-ZA25-00070.pdf>

C. COSTS TO INVESTORS IN NON-MUTUAL FUND ASSETS

As noted above, investors receive important benefits from advising services. The reduction in advising that will almost certainly follow adoption of this rule will result in significant qualitative and quantitative losses to all retirement investors, including and especially small investors (see Section V below).

However, by focusing only on mutual funds in its calculations, the Department ignores significant costs the proposed rules would impose on investors interested in other retirement products that would then be considerably harder to obtain. For example, the BICE rules specifically exempt entirely from inclusion in a BICE-covered retirement account certain classes of relatively illiquid assets such as non-traded REITs and non-traded BDCs. These asset classes are typically held by wealthier, more sophisticated investors and are well-suited for retirement accounts because of their illiquidity. The nature of these assets makes it difficult to entirely avoid material conflicts and trade on a non-Prohibited basis.

More generally, the added structures of the new rule will likely lead BDs to curtail their offerings, leading to less overall choice for most investors. A good example is the case of variable annuities, which are an important product to many investors concerned about retirement planning. These annuities are often recommended to investors who wish to diversify portions of their retirement savings out of the direct equity market, or supplement dividend and Social Security income with an annual cash payout. These products are often only available to the public through a BD or RIA. Yet there is considerable uncertainty among the financial advising community as to how they will be able to continue recommending these products to retirement savers under the BICE model. Product manufacturers would have to provide substantially more disclosure information to allow for compliance. Often there is an explicit willingness on the part of the investor to accept a lower return than would historically be projected from stocks because they want to remove some portion of retirement savings for diversifying's sake from the equity markets. Annuities are a very popular retirement product that is usually sold on a commission rather than a fee on assets-under-management basis because it is typically bought in a single, one-time transaction. The BICE requirement would likely make it much more difficult for retirement advisors to offer and retirement investors to buy variable annuities, which are widely regarded as an entirely appropriate tool to diversify retirement savings, and which give investors access to increasingly critical planning features such as guaranteed retirement income and/or guaranteed survivor benefits.

Moreover, there was considerable concern expressed by firms in our interviews that product choice would have to be limited in response to the DOL rule. This would force more retirement savings into volatile equity markets and less in diversified products or products with lower correlations to equities. This has the potential to increase systemic risk in the retirement savings market as savers are increasingly pushed by government regulation into the same set of standardized “low-cost” assets.

D. SOURCES OF THE CLAIMED GAINS TO INVESTORS AND ECONOMIC BENEFITS

As discussed above, based on a questionable reading of academic studies, and rejecting or ignoring evidence for the benefits provided by advisors, the Department asserts that conflicts of interest cost investors 0.5% annually on their mutual fund investments. As the Department notes however, removing these conflicts would create purported “gains to investors” that are not all true social economic benefits of the new rule, but in fact consist of four categories:⁴⁰

- (1) Transfers of surplus to IRA investors from advisors and others in the supply chain
- (2) Other transfers to retirement investors from improved trading decisions relative to counterparties from whom the transfers will come
- (3) Reduction in underperformance from suboptimal allocation of capital
- (4) Resource savings associated with reduced excessive trading

As the Department notes (although it doesn’t attempt to separately quantify these categories), of these, categories (3) and (4) represent true social welfare gains, while (1) and (2) represent transfers from one group to another. We applaud the Department for this effort to consider the ultimate sources of the benefits they assert.

A different grouping of these four categories, however, is more informative: categories (2) and (3) represent pure errors on the part of financial advisors (or others in the supply chain, e.g. mutual fund manufacturers), giving up gains that would otherwise accrue to their clients or that they could capture for themselves. There is no obvious reason why conflicted advisors would be more likely than non-conflicted advisors to give up potential investment gains to the

40 Includes items from lists on pp. 100 and 176 of the Regulatory Impact Analysis.

broader market.⁴¹ The Department appears to broadly agree with this logic, stating that it expects category (2) to be small.⁴²

Categories (1) and (4), on the other hand, represent economic resources being transferred from clients to financial advisors and others in the supply chain. The distinction between (1) and (4), then, is whether those resources represent pure economic rents (1), or whether they represent compensation for economic activity undertaken by the advisors with real associated costs. Because the Department assumes that advisors provide no service of value to customers, they describe any such activity as being essentially wasteful, associated with “excessive trading” (4). The Department does not consider a fifth category:

(5) Expense savings to investors associated with reduced benefits from advising services.

Returning to the Department’s grouping of social benefits versus transfers, this category of “gains to investors” is not a social benefit. Indeed, the cost to investors of reduced benefits from advising services might well exceed the gains, irrespective of other (e.g. compliance) costs of the proposed rule.

To the extent that the proposed rules generate the “gains to investors” that the Department alleges, it is likely that much of these gains are in the form of reduced expense for services no longer received.

More generally, the Department is unclear overall where their claimed gains to investors are expected to come from, and how much of these represent true economic benefits. Again, because the Department is vague about the sources of these gains, it is difficult to assess whether the requirements of the rule are necessary (or sufficient) to obtain them.

41 Indeed, since by assumption conflicted advisors have some ability to capture these gains, we would expect them to be less likely to do so.

42 See p. 100 of the Regulatory Impact Analysis: “the Department believes that transfers to IRA investors in conflicted advice arrangements are likely to come mostly from professional asset managers and others in the financial industry rather than from other retail investors.” There is no obvious reason why category (2) would be small and (3) large.

VI. EFFECTS ON THE INDUSTRY

The Department's proposed rules seek to eliminate payments from third parties that might produce conflicted advice. Many BDs receive sizable payments from third parties, including various vendors, and these payments create firm-level conflicts that must be disclosed in the BICE. These fees (which typically flow to the firm and not the individual advisor) are an important source of firm-level income. For those BDs that support independent financial advisors (FAs) on a consolidated platform this revenue provides their training, compliance, and technology support. If the DOL rule succeeded in reducing this income stream, then FA's would be charged more to join the consolidated platform (and these costs would be passed along to investors). In addition, the compensation of each financial advisor would be publicly disclosed. This would allow very large firms to more easily identify and target specific FAs for recruitment.

Because of the very large infrastructure costs associated with complying with these disclosure requirements (both purchasing and disseminating detailed account, product cost, and performance histories), smaller firms will likely join much larger companies (since it will be easier to share these fixed costs). Many smaller firms hope that the large technology platforms on which they rely to clear and settle accounts will absorb many of these infrastructure costs. We anticipate, based on evidence from the UK, that many of these smaller firms might find that the resulting per transaction costs and/or remaining compliance costs will prove sufficiently expensive that being absorbed by a larger BD or even leaving the industry altogether will become a more compelling alternative.⁴³

All of these trends—reduced third party payments; public disclosure of advisor compensation; high fixed infrastructure costs—to comply with rules will encourage a bifurcation of the industry. Large firms will offer sophisticated platforms that comply with the Department rule and from which financial advisors can continue to operate. But even the surviving large firms will have a huge incentive to offer fewer and more commoditized products. Low

⁴³ See “The impact of the RDR on the UK's market for financial advice” at http://www.cass.city.ac.uk/data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf

cost generic platforms will continue to serve self-directed accounts (and these platforms will continue to receive third-party payments in a completely undisclosed manner).

A. EFFECTS ON INDEPENDENT BROKER DEALERS

There are at least three reasons to think that the proposed rules would hit IBDs particularly hard. First, IBDs are far more likely than larger (“wirehouse”) competitors to use clearing firms to clear some of their transactions, meaning they must both pay for new services and data feeds, as well as integrate multiple sources of data in creating their disclosures. Secondly, IBDs are more likely than wirehouse competitors to work directly with firms that construct specialty retirement assets, such as insurance companies, creating unavoidable conflicts that will require a BICE. Third, IBDs disproportionately serve small retail investors, with lower or no account minimums (currently).

VII. EFFECTS ON INVESTORS

Compensation for brokerage services, both in retirement and non-retirement accounts, generally comes in two forms: fee-based and commission-based, although hybrid compensation models certainly exist as well.⁴⁴ Broadly speaking, commission-based accounts are more appropriate for accounts that trade infrequently, as well as for small accounts since the active management services typically associated with fee-based compensation are less easily supported by low account balances. It's important to note that within the category of commission-based accounts are self-directed accounts, i.e., accounts where individuals direct BDs precisely what assets to buy and sell, without paying for or receiving investment advice. For obvious reasons, such accounts typically only trade in standardized investment products, and are appropriate for more knowledgeable investors who don't require as much advising but whose modest holdings don't warrant the active management of a financial advisor.

It's worth noting that existing SEC and FINRA regulations restrict BDs' use of fee-based accounts, prohibiting the practice known as "reverse churning."⁴⁵ Many of our interviewees expressed concerns about the proposed rule—which encourages fee-based retirement accounts in order to avoid PTs and the BICE—being inconsistent with these reverse churning rules.

A. HIGHER MINIMUM ACCOUNT BALANCES

One potential impact that was mentioned by several of our interviewees, as well as by other commenters on the proposed rules is the loss of access, especially by small investors, to financial advisors. Many in the industry believe that due

44 Much of this draws from Oliver Wyman's (2011) "Assessment of the impact of the Department of Labor's Proposed 'Fiduciary' Definition on IRA Consumers."

45 Churning occurs when a BD managing a commission-based account encourages excessive trading to generate commissions. Reverse churning occurs when infrequently trading investors are pushed into fee-based accounts that are more expensive for them.

Approximately 50% of U.S. households have a retirement account, and the median value of that type of account is \$59,000. This means that if the typical investor wanted to seek advice from a financial advisor for a retirement account, it would cost more than 600 basis points.

to the cost burdens implicit in the rules, firms will shift their business model towards fee-based advising and create a minimum balance for client accounts. These account minimums will effectively force smaller investors into self-advised or robo-advice accounts. As a result, only investors with substantial assets will have access to financial advisors.

One estimate, by Don Trone, who has written extensively about fiduciary standards, puts the expected minimum account balance under the new rule at \$360,000 assuming a 1% fee on assets. He calculates that at a typical advisor would have to dedicate 12 hours per year at a rate of \$175 per hour per client to meet the Department's fiduciary standard. Additionally he estimates compliance and oversight costs to be \$1,500 per year per client. These costs amount to \$3,600 per client per year.⁴⁶ Any account under \$360,000 would have to pay fees greater than 1% of assets, thereby eliminating any potential savings from the implementation of the rule. Importantly, the estimates and methodologies suggested by Mr. Trone were raised and confirmed by several companies during the course of our interviews.

According to the 2013 Survey of Consumer Finances, retirement accounts are the second most-held financial asset in the U.S. after transaction accounts. Approximately 50% of U.S. households have a retirement account, and the median value of that type of account is \$59,000.⁴⁷ This means that if the typical investor wanted to seek advice from a financial advisor for a retirement account, it would cost more than 600 basis points.

It's worth noting that the Department has strongly disputed the conclusion that the new rules will result in loss of access to financial advising by small account holders.⁴⁸ One of the Department's principal claims in this regard is that the new rules will promote innovation in the industry, specifically so-called "robo-advising" services.⁴⁹ Our interviewees, understandably proud of their profession, were highly skeptical of the ability of robo-advising to offer the sort of benefits investors now receive from investment advisers, including the important soft benefit of talking investors through market downturns without cashing out. It's possible that the Department is right that robo-investing will eventually catch on and displace traditional investment models; it's also troubling that the success of the proposed rules is dependent upon such an untested model.

⁴⁶ <http://www.thinkadvisor.com/2015/05/28/don-trone-father-of-fiduciary-the-2015-ia-35-for-35>

⁴⁷ <http://www.federalreserve.gov/econresdata/scf/scfindex.htm>

⁴⁸ See Section 8.3.1 of the Regulatory Impact Analysis.

⁴⁹ See Section 8.3.5 of the Regulatory Impact Analysis.

B. EXPERIENCE IN THE UK

Already, this divide has occurred in the UK financial services industry where similar rules have been passed. In the UK, the Retail Distribution Rule went into effect on January 2013. Before the rule passed, small investors were able access financial advisors at the UK's four largest banks. However, after the rule was put into effect, each bank determined it was too costly to service small investors and created the following guidelines:⁵⁰

- HSBC—Minimum investment of £50,000 with a minimum upfront fee of £950.
- Lloyds—Minimum investment of £100,000 with an upfront fee of 2.5%.
- The Royal Bank of Scotland—No minimum investment with an upfront fee of 1.25% (fee is reduced for assets greater than £500,000) plus a flat fee of £500.
- Barclays—Investors must have at least £500,000 in assets for investment advice from Barclays Wealth Management. Barclays Financial Planning, which previously serviced smaller investors, no longer operates.

A report by Europe Economics found that after the RDR rule was implemented, there was a decline in the proportion of adults who opened investment accounts. What is most alarming about this decline is that it is concentrated in the group of investors with pre-existing savings of £50,000-£99,999 and £20,000-£49,999 respectively.⁵¹

C. MINORITY ACCESS TO FINANCIAL ADVICE

Lower and moderate net-worth individuals are disproportionately minority and single parent households. According to the 2013 Survey of Consumer Finances, the median net worth for a white non-Hispanic family is \$141,900 compared to \$18,100 for nonwhite or Hispanic families. A similar gap exists for single-parent families. Couples reported a median net worth of \$93,000 compared

50 <http://www.telegraph.co.uk/finance/personalfinance/investing/9793587/Banks-New-fees-revealed-for-cost-of-investment-advice.html>. And https://wealth.barclays.com/en_gb/home/wealth-management/who-we-help.html

51 See Europe Economics (2014) "Retail Distribution Review Post Implementation Review." <http://web.archive.org/web/20141230121929/http://www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf>. And FSI Briefing (2015). "Foreign Experiences Indicate DOL Fiduciary Rule Proposal Could Have Significant Unintended Consequences."

to \$14,200 for single-parent households.⁵² A recent study by Prudential found that while most African Americans surveyed considered themselves knowledgeable about financial decisions, they did not see themselves as savers or investors. Only 9% of African American respondents categorized themselves as investors.⁵³ This indicates that there is tremendous potential to expand investment services to African American households. As discussed in Section III B above, financial advisors provide valuable advice to investors. It would be detrimental to limit access to such valuable advice, especially to those households that need it the most.

D. SUMMARY

The evidence clearly suggests that only high net-worth investors will be able to access and afford investment advice from professionals. A study by Oliver Wyman estimated that 7.2 million IRA account holders would lose access to advisory services because of account minimums.⁵⁴ Furthermore, they found that 98% of small investors (defined as having IRA accounts with \$25,000 or less) had a brokerage relationship.⁵⁵ If the proposed rule were passed in its current form, small investors would be forced out of their preferred model for investing and into a model that is less adequate. This divide will potentially worsen the country's struggle with wealth inequality as low and moderate net-worth investors are left to their own devices during market downturns.

52 <http://www.federalreserve.gov/econresdata/scf/scfindex.htm>

53 <http://www.prudential.com/media/managed/aa/AASStudy.pdf>

54 <http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf>

55 <http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf>

VIII. CONCLUSION

A recurring theme of this analysis has been that, in its drafting of the new rules and in the Regulatory Impact Analysis about them, the Department has failed to engage with the nature of the specific requirements it is imposing upon BDs. It has similarly failed to engage with the mechanism by which these requirements will lead to higher investment returns. In estimating the compliance costs of the rules, for example, rather than explaining the tasks and burdens it expects its own rules to impose on firms, the Department substitutes comment letters for different proposed regulations of other agencies. When assessing gains to investors from the new rules, the Department relies on academic studies to assert higher returns without specifying precisely where these returns come from or whether they represent true economic benefits.

We have presented evidence that the Department underestimates compliance costs, that the benefits investors receive from advisors are real and should be given greater consideration, and that the Department's narrow focus on mutual funds neglects other costs imposed by the rules. Further, it appears likely that the proposed rules would lead to significant consolidation in the BD industry, and restrict small investor access to financial advising services.

Nevertheless, the Department may be correct that some action is warranted to address conflicts of interest in retirement accounts. Where its cost-benefit account is insufficient, however, is in showing that the precise requirements it specifies are both necessary and sufficient to address the problems it purports to identify and achieve the benefits it claims.

The Department does make some effort in this direction in chapter 7 of the Regulatory Impact Analysis, "Regulatory Alternatives." To give one example, Section 7.8 considers "issu[ing] a prescriptive, rather than contractual, PTE," that is, offering specific requirements for BDs to satisfy in order to be in compliance rather than relying on the vague standards of BICE. The Department explains that the contractual nature of the BICE is a virtue because it gives a BD firm "broad latitude to design its own policies and procedures, including its own mechanism for determining whether they are being followed and whether applicable fiduciary standards are met." What the Department presents as flexibility is overwhelmingly viewed as lack of clarity by the affected

entities in our interviews. In essence, the Department is outsourcing the task of deciding what constitutes appropriate fiduciary behavior to the firms themselves. More concerning, it is outsourcing the job of determining whether the firms have succeeded in this task to state contract law courts. It is hard to credit the Department's calculations of benefits from standards it seems to so poorly understand.

In sum:

- The DOL has dramatically underestimated the compliance cost of the new rule (about \$195,000 per firm) and how difficult it will be for small firms to survive if it is implemented.
- We estimate the proposed rule will result in **startup costs ranging from \$930,000 to \$28 million per firm**, depending on firm size. These estimates do not include costs to model future returns and costs to investors, or the costs of litigation.
- BDs and investment advisers would be forced to either substantially change their current business models or navigate the byzantine demands of a BICE.
- The rule will result in less access to advisory services for small and medium-sized investors.
- Financial advice will be particularly constricted for low-income and minority investors.
- The proposed rule will result in industry consolidation likely to force small broker-dealers out of business.
- An expanded potential for systemic risk in the retirement savings market as savers are increasingly pushed into the same set of standardized “low-cost” assets.

Our average estimates of the actual costs of the proposed rule include:

- **SETTING UP REQUIRED NEW SYSTEM INTERFACES** to accept data feeds—**\$570,000**, with a median cost of \$250,000.
- **DISCLOSURE REQUIREMENTS** (average and median)—**\$870,000**.
- **RECORDKEEPING REQUIREMENTS**—**\$200,000**, with a median cost of \$150,000.
- **IMPLEMENTING A BICE**—**\$4.5 million**, with a median cost of \$400,000.

- **TRAINING**—\$800,000, with a median cost of \$580,000.
- **SUPERVISORY, COMPLIANCE, AND LEGAL OVERSIGHT**—\$210,000, with a median cost of \$138,000.
- **COSTS TO MODEL FUTURE RETURNS AND COSTS TO INVESTORS**—estimated to be substantial, but not quantified.
- **LITIGATION COSTS**—estimated to be substantial, but not quantified.

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