The Impact of the SEC's Best-Interest Rule on Plan Sponsors

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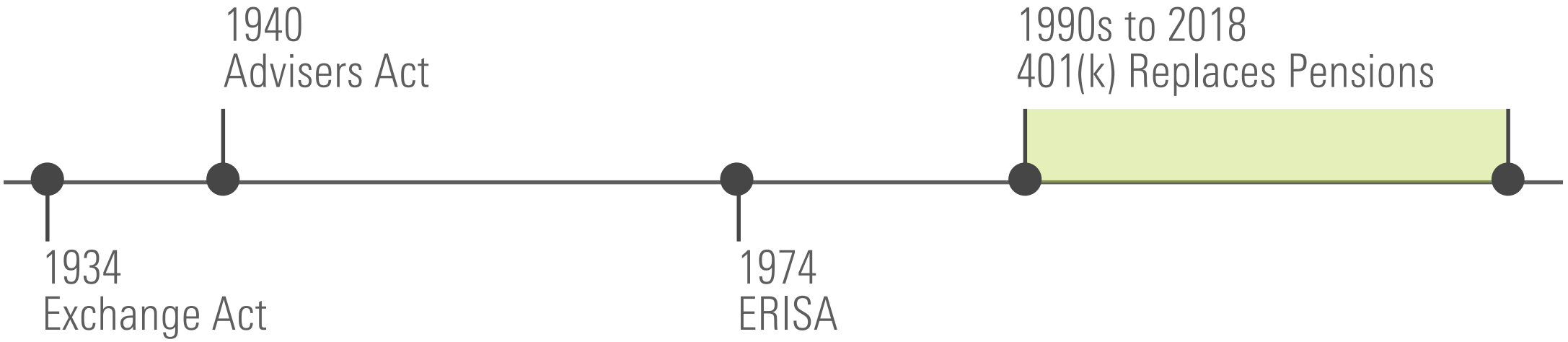
Objectives for Today

- Discuss the context in which the SEC proposed their rule
- Discuss our empirical work on conflicts of interest and the extent to which these conflicts have hurt investors
  - Discuss changes we observe after DOL proposed the "fiduciary" rule on **flows** and **returns** and what this means for fund sponsors and brokers, particularly given recent interest in rollovers out of retirement plans
- Explain how the SEC proposal could affect sponsors and FSIs that work with retirement investors
  - Explain what the SEC proposal means for broker/dealers when interacting with plan participants and rollovers

Introduction: An Uneasy Status Quo

An Uneasy Status Quo

A Brief History of U.S. Financial Advice Regulation



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An Uneasy Status Quo
The SEC approach follows the DOL

- The SEC's proposed standards would take the plan of the DOL's Fiduciary Rule
- DOL's regulatory impact analysis:
  - Showed billions in losses
  - Relied on decade-old data
  - May have missed an evolution in business practice of advisors and AMs

What does Morningstar's data show about conflicts of interest?

What does Morningstar's data show about conflicts of interest?
The DOL's analysis of Conflicts

- DOL relied on data from Christoffersen, Evans, and Musto (or CEM) dating from1993 to 2009 to develop the Fiduciary Rule.
- CEM finds load sharing arrangements increase fund inflows and predict poor performance for investors.
- DOL applied findings to calculate benefits from their rule.

THE JOURNAL OF FINANCE • VOL. LXVIII, NO. 1 • FEBRUARY 2013

What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives

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ABSTRACT

We ask whether mutual funds' flows reflect the incentives of the brokers intermediating them. The incentives we address are those revealed in statutory filings: the brokers' shares of sales loads and other revenue, and their affiliation with the fund family. We find significant effects of these payments to brokers on funds' inflows, particularly when the brokers are not affiliated. Tracking these investments forward, we find load sharing, but not revenue sharing, to predict poor performance, consistent with the different incentives these payments impart. We identify one benefit of captive brokerage, which is the recapture of redemptions elsewhere in the family.

THE DECISION TO INVEST in a mutual fund is usually traced to the investor's preferences and information. However, the vast majority of long-term mutual fund assets arrived through some layer of intermediation (Investment Company Institute (2009), p. 76), which tells us that investors often invite and pay brokers to play a role. In this paper we examine the brokers' role, particularly as regards the incentives arising from their compensation. We investigate how brokers' incentives influence the choice of where to invest, and how this choice works out.

*Christoffersen is from the Rotman School of Management at the University of Toronto and the Copenhagen Business School. Evans is from the Darden School of Business at the University of Virginia. Musto is from the Wharton School at the University of Pennsylvania. Christoffersen gratefully acknowledges financial support from SSHRC, IFM2, and the Canadian Securities Institute Research Foundation. The authors also wish to thank the Q-group for their financial support of this project and the ICI, especially Shelly Antoniewicz, for their assistance with data. We are deeply grateful for comments from the Editor, Associate Editor, and two anonymous referees. In addition, several individuals provided helpful input including Dan Bergstresser, John Chalmers, Peter Christoffersen, Paul Irvine, Marcin Kacperczyk, Randi Naes, Tim Simin, Lu Zheng, and seminar participants at Indiana University, INSEAD, Penn State University, SUNY Buffalo, University of Colorado at Boulder, University of Toronto, University of Utah, University of Vienna, Boston College, 2005 Mitsui Life Conference at the University of Michigan, 2005 Q-Group Meetings in Carlsbad, 2005 Northern Finance Association Meetings, 2006 American Finance Association Meetings, 2006 Financial Management Association Meetings, 2008 European Winter Finance Conference, and Cass Business School Conference 2009. The paper was previously titled "The Economics of Mutual Fund Brokerage: Evidence from the Cross-Section of Investment Channels." Extensive research assistance was needed in matching databases from Eric Turner, Jerome Grenier, John Bromley, and Thibault Webanck. Any remaining errors are our responsibility. Part of this paper was written while Christoffersen was at McGill University and visiting Copenhagen Business School.

Source: Morningstar Data and Research

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What does Morningstar's data show about conflicts of interest?
Results from the CEM Analysis

- **Load sharing incentivizes brokers**
  - Every $1 in load sharing increases flows by $14.20, holding all else equal for unaffiliated brokers.

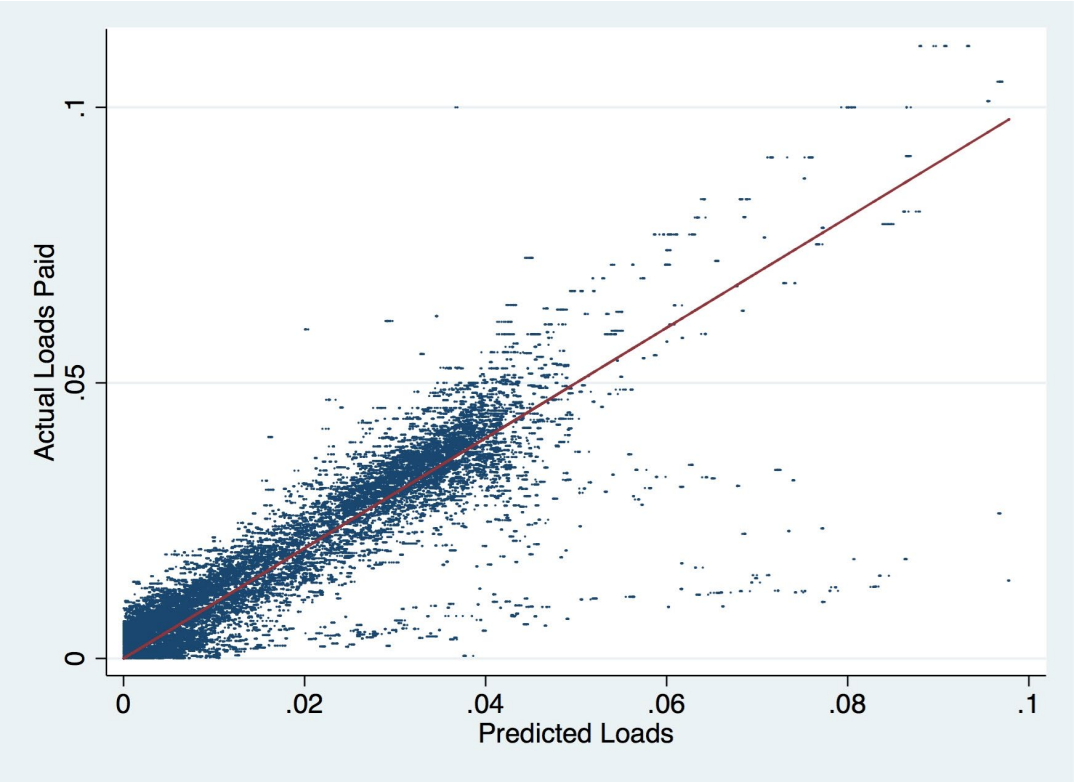
- **Load sharing hurts investors**
  - Every 100 basis points in load sharing reduces future returns by:
    - 50 basis points for funds distributed by unaffiliated brokers.

  - DOL's flow-weighted average suggests that 100 basis points in load sharing reduces future returns by 44.94 basis points.

Source: Morningstar Data and Research

What does Morningstar's data show about conflicts of interest?
Methodology

- Using CEM's methodology, we predict the loads a fund would share with a broker dealer
- We use Morningstar data on flows, categories, and returns to power the model, along with public filings on loads
- To the extent that funds share unusually high loads with broker/dealers, it creates a conflict of interest.
- The difference between the red line and the load a fund actually shares is the lynchpin for our analysis.
- The model is very predictive (the R^2 is ~95%)



Source: Morningstar Data and Research

Did the DOL Fiduciary Rule change fund flows?

Did the DOL Fiduciary Rule change fund flows?
High-level results

- Excess loads, when paid to **unaffiliated brokers**, increases flows to those funds.
- From 2015 to 2017, this relationship is statistically insignificant.
- The effect of excess loads paid to **captive brokers** on inflows is statistically insignificant in both time periods.
- These regressions suggest that the DOL's proposed rule prompted fundamental changes to fund companies' business models.

	2010-2017		**2010-2014**		**2015-2017**	
	coefficient	p-value	coefficient	p-value	coefficient	p-value
Excess load paid to **captive brokers**	0.0074	0.8110	0.0766	0.3980	0.0102	0.7760
Excess load paid to **unaffiliated brokers**	0.0063	0.0420	**0.2805**	**0.0260**	0.0020	0.1940

Source: Morningstar Data and Research

Did the DOL Fiduciary Rule change fund flows?

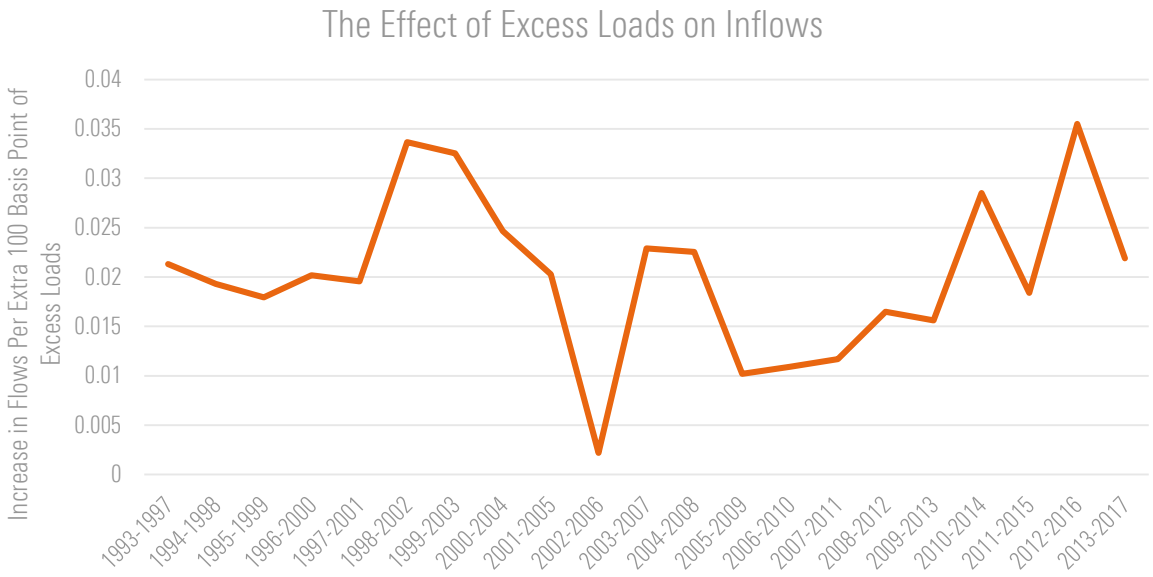
The Fiduciary Rule reduced the power of conflicts to drive flows

- The DOL Fiduciary Rule proposal reduced flows to funds paying excess loads to unaffiliated brokers by about .09% per 100 basis points.
- The DOL Fiduciary Rule helped mitigate the conflict of interest via the unaffiliated broker channel.
- After the DOL proposed the Fiduciary Rule, excess loads paid to unaffiliated brokers increased fund inflows by only about 0.01%.

Source: Morningstar Data and Research

Did the DOL Fiduciary Rule change fund flows?
New Impact or Pre-existing Trend?

- We used the CEM approach for each 5-year period beginning with 1993. For instance, we ran the regression on the data from 1993-97, 1994-98, until 2013-17.
- We do not detect a major, permanent shift in the influence of excess loads on flows until the DOL proposed the fiduciary rule



Source: Morningstar Data and Research

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Did the DOL rule help investors earn higher returns?

Did the DOL rule help investors get higher returns?
Impact of Loads – Before and After DOL

- Excess loads have a statistically significant and negative effect on excess returns.
- Once accounting for lagged and ranked returns, excess loads lose significance.
- Excess loads have a statistically significant and negative effect on excess returns from 2010 – 2014, and a statistically insignificant effect on excess returns in 2015 – 2016.

	2010-2016		2010-2014		2015 & 2016	
	coefficient	p-value	coefficient	p-value	coefficient	p-value
Excess loads	**-.3569**	**0.007**	-0.4856	**0.025**	0.002	**0.994**

Source: Morningstar Data and Research

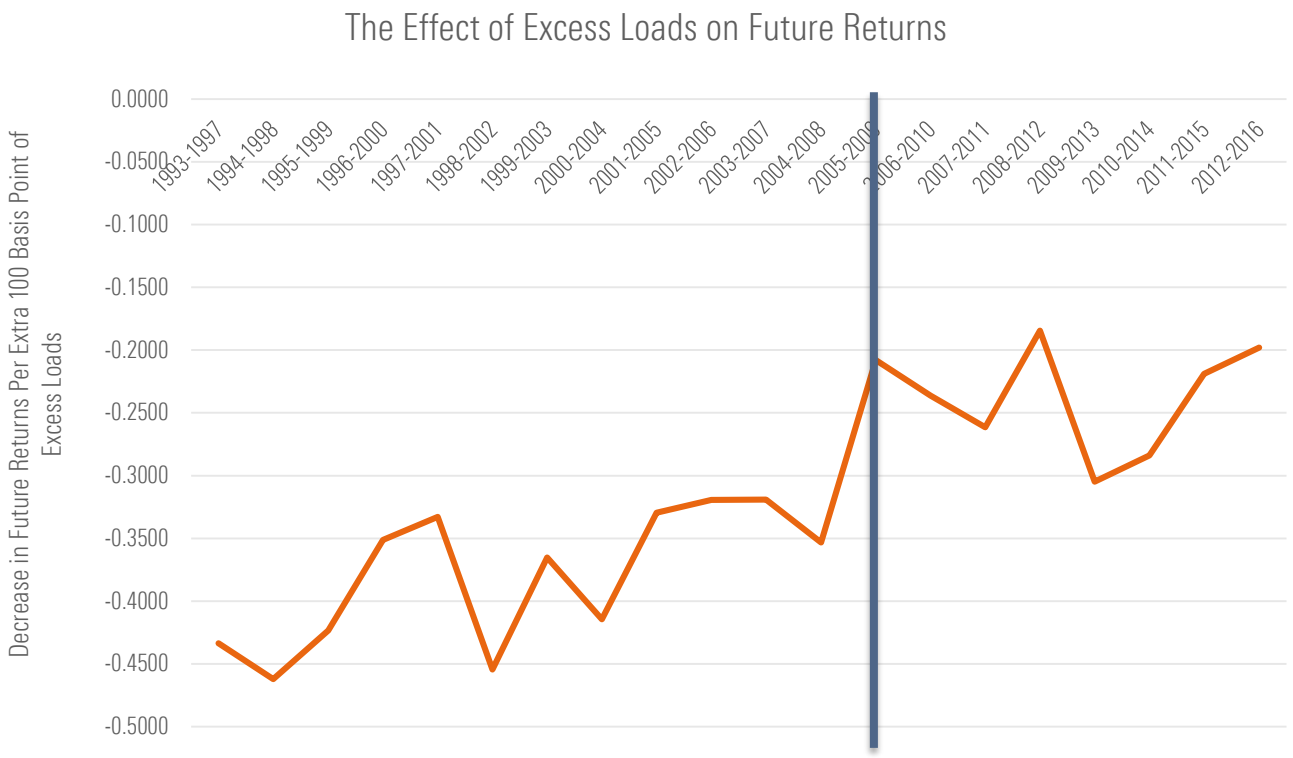
Did the DOL rule help investors get higher returns?
Fiduciary Rule did not change impact of loads on returns

- When we look at the period before and after the Fiduciary Rule separately, we do not see a significant effect of excess loads in either period once we control for lagged returns.
- We confirmed the lack of a statistical relationship with more robust methods.

Did the DOL rule help investors get higher returns?

Excess loads have had a negative effect on future returns over time

- Excess loads used to be statistically significantly linked to worse returns for investors.
- This relationship starts to lose statistical significance around 2010, as marked by the blue line.



Source: Morningstar Data and Research

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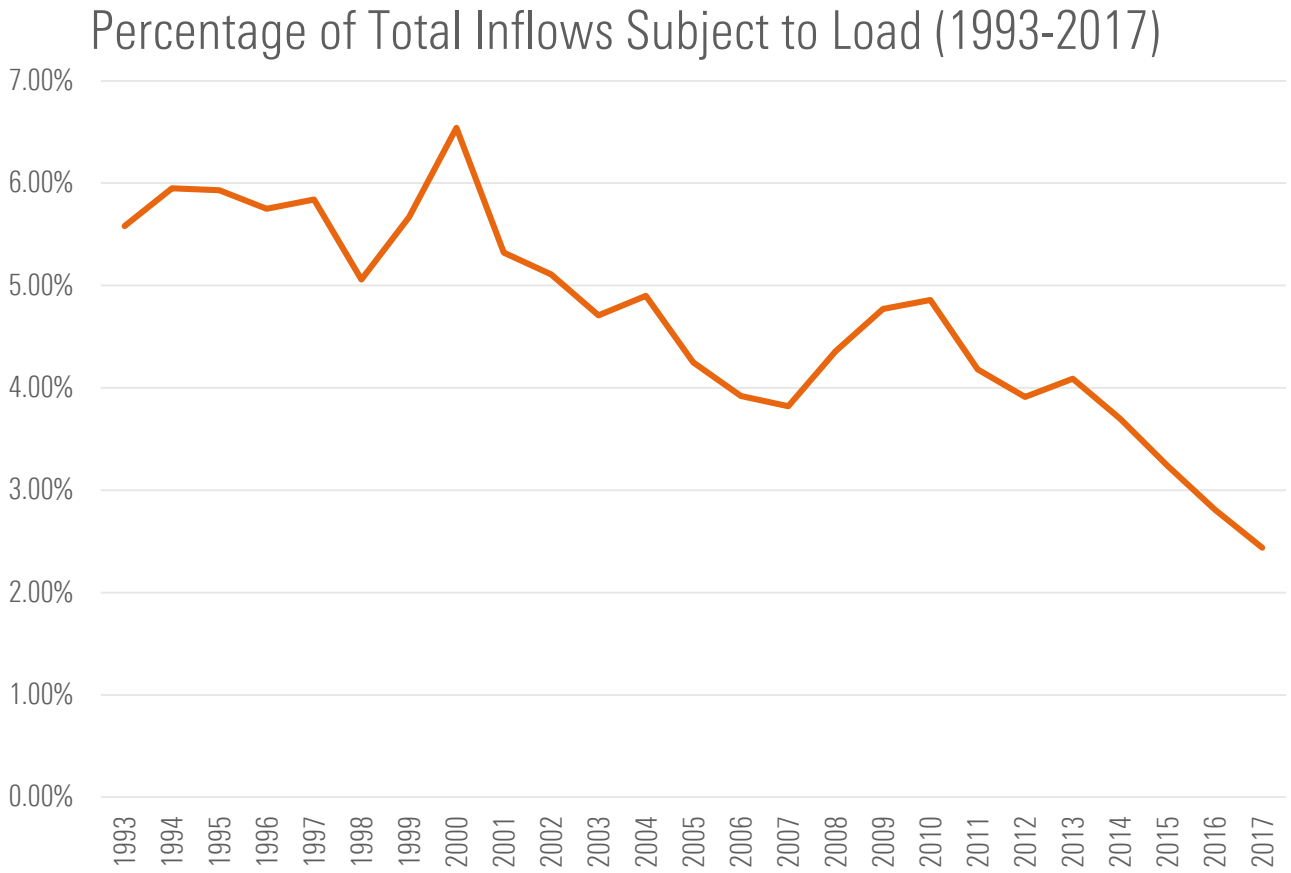
Did the DOL rule help investors get higher returns?

Load sharing payments already in decline



Source: Morningstar Data and Research

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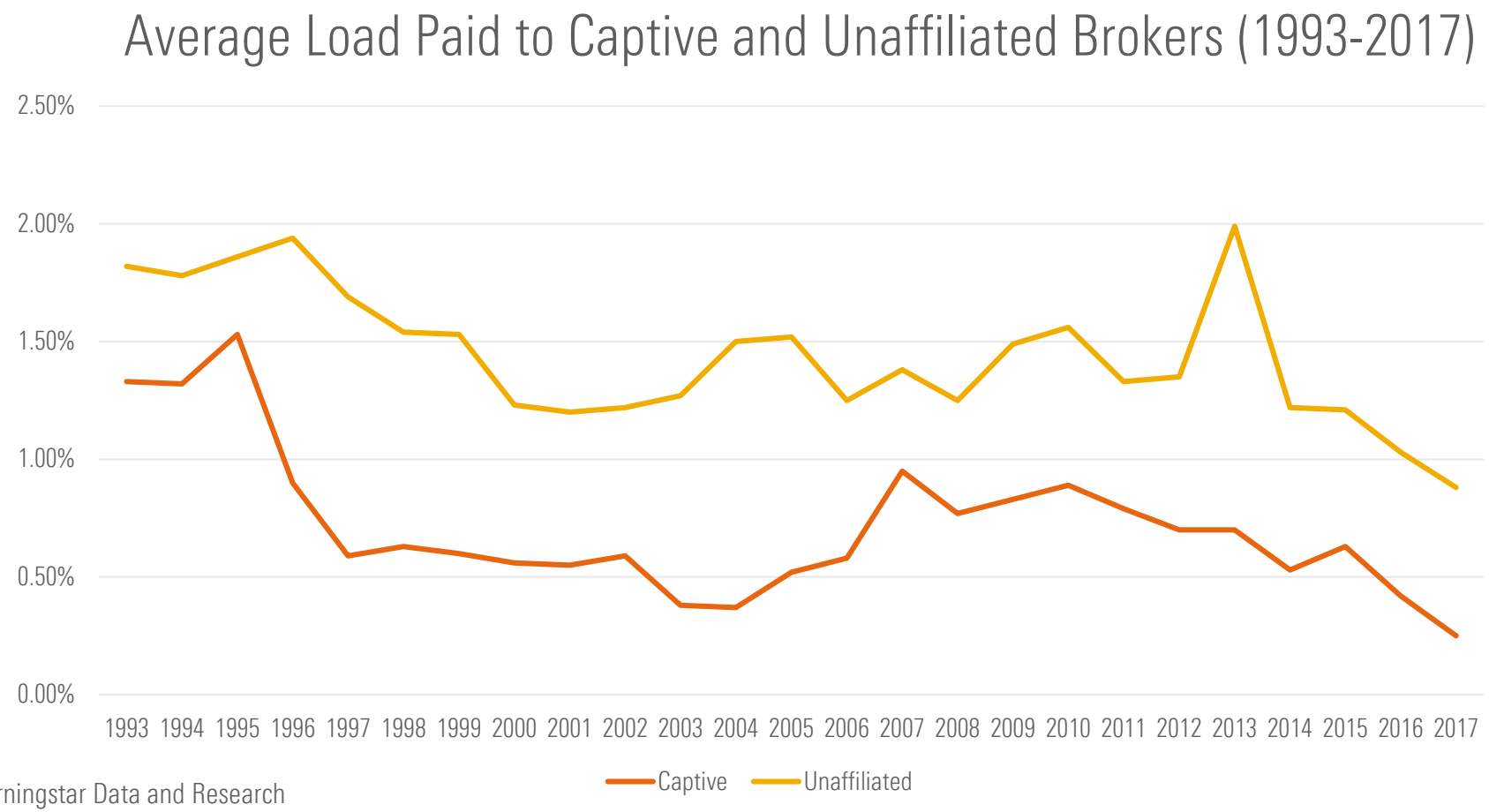
Did the DOL rule help investors get higher returns?
Declining Load Shares



Source: Morningstar Data and Research

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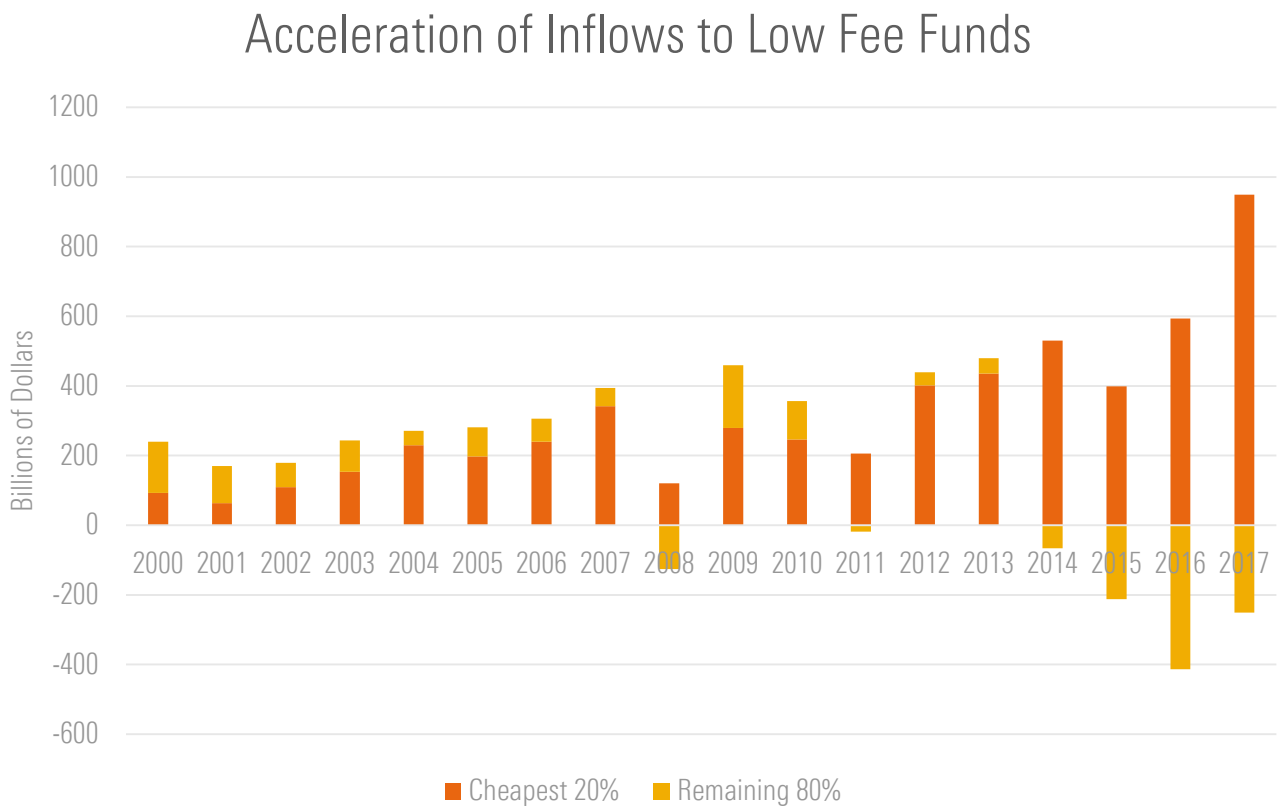
Did the DOL rule help investors get higher returns?
Reasons for trends in the effects of excess loads

- Declining share of mutual fund flows going to funds with loads
- Higher flows to funds with lower expense ratios
- Shift from active to index funds



Source: Morningstar Data and Research

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Conclusions

Reduced conflicts, but load sharing already in decline

- We find:
  - Load sharing impacts flows and returns during the period prior to 2009.
  - The effect of excess loads on flows decreases significantly with the proposal of the DOL rule in April 2015.
  - But, in terms of performance, there is not a statistically significant link after 2010.

- We interpret these results to imply:
  - Trends towards lower cost funds and greater performance accountability were already delivering better results for investors.
  - There was a net benefit of the DOL Fiduciary Rule in reducing flows to funds with excess loads.
  - There is a need for a strong Regulation Best-Interest regime.

What could the proposed SEC rule mean for 401(k) plans and participants?

What could Regulation Best Interest mean for retirement plans and participants?
Who is protected and when?

Retail customer includes: "A person or legal representative of such person who 1) received a recommendation of any securities transaction or investment strategy involving securities from a broker … and 2) uses the recommendation primarily for personal, family, or householder purposes."

- Definition broad and flexible enough to include retirement investments
- Participants in ERISA-covered plans and IRAs
- Are plan sponsors covered?
- "Recommendations" trigger coverage

What could Regulation Best Interest mean for retirement plans and participants?

Form CRS Disclosure

The SEC proposed creating a new disclosure for "retail investors" that would be provided before services are provided by a broker or before services are provided by an investment adviser.

- Retail investor largely means any natural person (including IRAs and trusts held for natural persons)
- Brokers and affiliated persons will not be able to use the words "advisor" or "adviser" in their names or titles.
- Both brokers and investment advisers will be required to prominently disclose their legal status in print and electronic retail investor communications.

What could Regulation Best Interest mean for retirement plans and participants?
Are rollover recommendations covered?

- Proposal consistent with FINRA Rules.
- Securities transactions may also include recommendation to roll over or transfer assets from one type of account to another.
- Regulation Best-Interest does not extend to recommendations of account types generally.

What could Regulation Best Interest mean for retirement plans and participants?
Conflicts of Interest – Not Per Se Prohibited

- Commissions
- Differential compensation
- Third-party compensation
- Proprietary products
- Limited range of products
- Complex product recommendations

What could Regulation Best Interest mean for retirement plans and participants?
Conflicts of Interest and Rollovers – Likely Violations

Recommendations that are made to:

- Maximize broker/dealer compensation
- Further broker/dealer relationships
- Satisfy firm sales quotes or targets
- Win firm-sponsored sales contests

How would Regulation Best Interest intersect with ERISA?

Intersections Between Regulation Best-Interest and ERISA
Plan Sponsor Perspective

- Regardless of whether IRA rollover advice constitutes fiduciary advice, plan sponsors may have the ability – through contract – to prohibit (or restrict) its service providers from providing IRA rollover advice.
- The concern is that the service provider will recommend rollovers to its proprietary IRAs when that may not be the best advice.
- Do plan fiduciaries have an obligation to attempt to prohibit (or restrict) IRA rollover advice?

Intersections Between Regulation Best-Interest and ERISA

Plan Sponsor Perspective – Other Options

- Engage a different service provider – without a potential conflict – to provide plan distribution advice
- Do not provide any distribution advice
- Take no action (subset of not providing distribution advice?)

Summary of the Impact of the SEC's Best-Interest Rule on Plan Sponsors

- Asset managers have moved to distribute mutual funds with fewer embedded conflicts and advisors have put in place procedures to mitigate these conflicts
- DOL's rule accelerated these trends
- The SEC's rule could maintain this momentum toward best interest advice
- As written, the proposal would still require at least some scrutiny on rollovers
- The SEC probably needs to add more definition or coordinate with the DOL to make it easy for plan sponsors to understand their responsibilities

Questions?

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