

Early Evidence on the Department of Labor Conflict of Interest Rule:

New Share Classes Should Reduce Conflicted Advice, Likely Improving Outcomes for Investors

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Executive Summary

Most mutual funds offer several share classes designed to appeal to different kinds of investors and for different kinds of sales approaches. These share classes charge different fees in different ways. Traditionally, most individual investors purchased “A shares” through a broker, and this type of purchase included an immediate fee called a front-end load (expressed as a percentage of the purchase) as well as management fees and ongoing fees for distribution expenses, called 12b-1 fees. In response to the Department of Labor’s “Conflict of Interest Rule” (also called “the fiduciary rule”), investment management companies are creating two new share classes for their mutual funds. The first new share class, T shares (or “transactional” shares) will help financial advisors maintain their traditional business model—selling mutual funds on commission—while complying with new rules. The second new share class, “clean” shares, could help financial services companies that wish to shift to a “level fee” model in which advisors’ compensation only comes from a level charge on a clients’ assets and not from any varying third-party payments. In this policy brief, we examine the potential of these new share classes to help investors save for retirement. We conclude that the move to T shares from A shares may reduce conflicted advice and therefore could also reduce other costs for investors and improve outcomes. In addition, this shift could potentially save some investors money on commissions. Finally, a longer-term shift to clean share classes could further enhance transparency for investors.

Why New Share Classes?

Most mutual funds offer several share classes designed to appeal to different kinds of investors and for different kinds of sales approaches. These share classes charge different fees in different ways. Traditionally, most individual investors purchased “A shares” through a broker, and this type of purchase included a front-end load, or immediate fee (as a percentage of the purchase), as well as management fees and ongoing fees for distribution expenses, called 12b-1 fees. Other common share classes include C shares, which do not charge a front-end load but have higher ongoing distribution fees. Increasingly, investors have been moving to new ways to invest, particularly through exchange-traded funds.

In response to the Department of Labor’s Conflict of Interest Rule, investment management companies are creating two new share classes for their mutual funds. The first new share class, T shares (or “transactional” shares) will help financial advisors maintain their traditional business model—selling mutual funds on commission—while complying with new rules. Further, these T shares would feature uniform commissions, reducing or eliminating financial advisors’ conflicts of interest in making recommendations to clients. The second share class, “clean” shares, could help financial services companies that wish to shift to a “level fee” model in which advisors’ compensation only comes from a level charge on a clients’ assets and not from any varying third-party payments. The rule was originally scheduled to be applicable on April 10, 2017, but the Department of Labor has taken steps to delay it until June 9, 2017.

The new rule spurred these new share classes because the rule requires financial services companies to structure financial advisors’ compensation so that they do not benefit more from recommending one fund over another—at least in regard to recommendations for assets in Individual Retirement Accounts. This requirement is in conflict with the traditional way investors buy mutual funds (and brokers or financial advisors sell them) because an A share has a front-end load that investors pay directly to the financial institution selling the mutual funds, some of which the advisors keep as commission, and these loads vary. This variation can create an incentive for advisors to recommend a fund with a higher load as the advisor stands to make more money from such a recommendation. We anticipate that mutual fund companies will create more than 3,500 new T shares in the coming months for advisors to sell to IRA investors, and ultimately this share class may supplant A shares in brokerage accounts as well.

Some financial services companies do not sell mutual funds on commission; rather, they charge a fee for advice as a percentage of assets under management and generally act as fiduciaries. They can choose to comply with the rule by acting as “level fee fiduciaries,” which in turn has spurred the development of “clean” shares. Qualifying as a “level fee fiduciary” could reduce financial institutions’ legal risks but means that fees and compensation may not vary based on the investments advisors recommend. As many mutual funds pay a variety of fees to the financial institutions that sell their funds—and as these fees vary—the Conflict of Interest Rule makes them difficult for financial advisors to offer while qualifying as level fee fiduciaries. For example, the 12b-1 fees

charged to mutual fund investors and paid to financial institutions selling the funds vary from less than 0.25% to as much as 1%. (If an advisor sells any funds with commission or front-end-load, even if the loads do not vary, he or she could not qualify as a level fee fiduciary.)

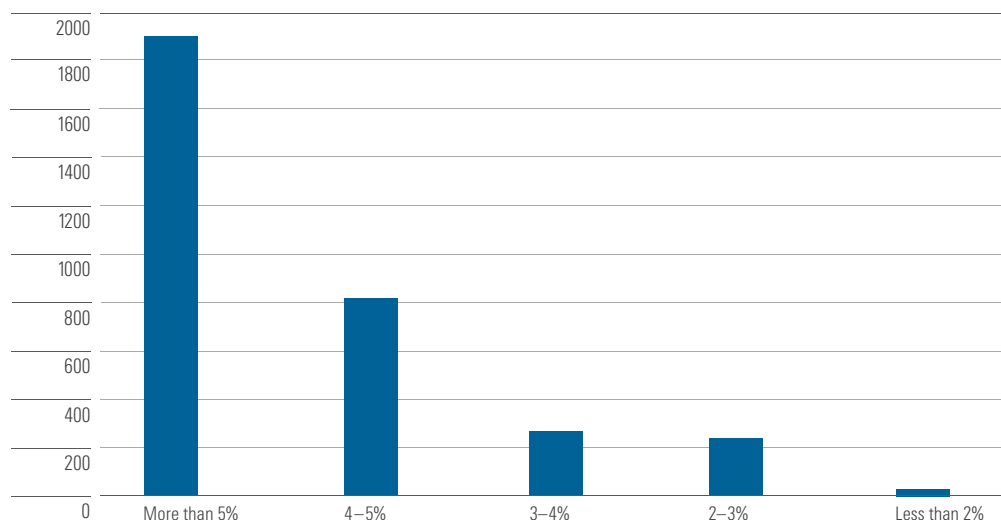
Conceptually clean share classes would simply charge clients for managing their money (and other associated expenses) without indirect payments—fees charged to investors by the fund company that they in turn send to an affiliate or third party for services other than managing a portfolio of stocks or bonds. Clean share classes, which some mutual fund families have already launched, and others are planning to launch, would strip all these indirect payments away, leaving it to distributors to charge investors directly for any services rendered, such as holding their shares, paying out dividends, operating a web site and call center, and so forth.

T Shares Reduce Conflicts of Interest in Commission-Based Sales, and Some Investors Will Likely Save on Fees

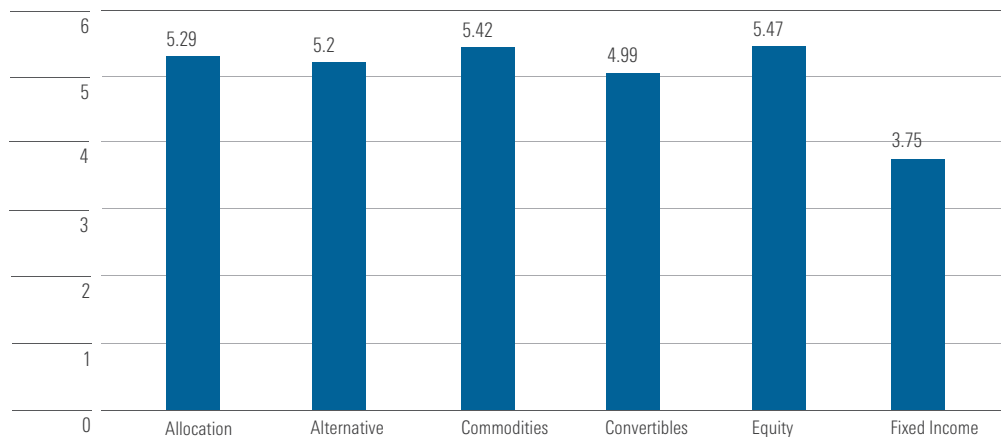
As the Conflict of Interest Rule goes into effect, most advisors will likely offer T shares of traditional mutual funds to retirement investors looking to put retirement savings in an IRA, in place of the A shares they would have offered before. This will likely save some investors money immediately, and it helps align advisors' interests with those of their clients.

The current variation in A share sales loads creates an incentive for advisors to choose funds that might not be in an investor's best interest, but the uniformity from T shares reduces this risk. For example, with an A share, an advisor might receive a higher commission from an emerging-markets bond fund from one family rather than a short-term bond from another, even if an investor would be better off with a low-risk short-term bond fund. In fact, Morningstar's database reveals standard deviation of 1.08% on the 4.85% maximum average load. Using T shares with the same commission structure across all eligible funds, the advisor is more likely to choose the one that is best from a purely investment perspective. However, although T shares reduce conflicts in recommending a fund vis-à-vis A shares, the load still could give incentive to advisors to recommend moving money from one fund to another in order to collect a commission.

Furthermore, the loads in traditional A shares do not simply vary between funds, but they are systematically linked to asset classes, aligning incentives for advisors that might be at odds with appropriate asset-allocation recommendations. For example, average A share loads are about 1.72 percentage points lower for fixed-income funds than equity funds, potentially encouraging advisors to recommend equity funds even when they are not in the best interest of a client with low risk tolerance. See Exhibit 1 for the distribution of front-end loads between about 3,000 A shares in our database, and Exhibit 2 for the differences in loads between mutual funds in different asset classes.

Exhibit 1 Number of Class A Share Offerings with Different Initial Maximum Loads

Source: Morningstar data.

Exhibit 2 Average Class A Share Loads Among Different Fund Types

Note: We exclude tax-preferred funds since they are unattractive to retirement investors holding money in IRAs that are already tax-privileged.

Source: Morningstar data.

Quantifying the increased returns investors can expect because of the shift to T shares from A shares is challenging, but we believe it may be around the 44.9-basis-point increase (per 100 basis points of load) the Department of Labor estimated as the benefit from reducing conflicted advice in its regulatory impact analysis. As a ballpark estimate, we think that the incentives T shares create

to recommend higher-quality funds could add around 50 basis points in returns—30 of which are attributable to manager skill in the form of alpha and 20 of which come from reduced fees—compared to conflicted advice. We arrived at this estimate based on the differences in returns between average funds and those with a Morningstar Analyst Rating of Silver.¹ (The potential benefits are even higher for Gold-rated funds.) Further, we think that a best-interest incentive could save investors about 20 basis points in fees as this is the typical difference between the median A share fund prospectus net expense ratio and the first quartile breakpoint.

In addition, some investors will save money because T shares have lower front-end sales loads than A shares. In general, from early filings, we believe most T shares will have a 2.5% maximum front-end load—that is, the most an investor could pay in up-front fees would be 2.5% of their investment. In contrast, A shares average a maximum front-end load of 4.85% among the more than 3,000 A shares with loads we track in the Morningstar database. This average is left-skewed by a few very low load funds—the median maximum load is 5.25%, and the modal (most common) maximum load is even higher at 5.75%, with 37% of funds charging this amount. However, many investors don't pay the maximum load, and the Investment Company Institute estimates that the average loads investors pay ranges from 0.7% (bond funds) to 1.1% (equity funds).² The reason for this difference is that as investors put more money into a fund, they often enjoy lower fund loads, meaning higher-wealth investors pay less in initial fees as a percentage of their investment. For example, after the most common breakpoint (typically \$50,000), loads decrease on average by about 0.8%. Investors with more than \$1,000,000 to invest often enjoy loads of 1% or less. The same will likely be true for T shares, but we anticipate the decreases in sales charges for investments will start for investments of more than \$250,000, reducing the benefit vis-à-vis A shares for higher-wealth investors. (Additionally, many investors get load waivers because they invest through institutions, workplace retirement accounts, or other privileged arrangements.)

Investors with less money to invest in IRAs could benefit from the shift to T shares from A shares because these are investors that would be more likely to pay the maximum load. In fact, just 5.7% percent of A shares have lower maximum loads than the 2.5% maximum front-end loads we expect to see with T shares. Further, almost all of these unusually cheap A shares charge maximum 2.25% front-end loads, reducing their advantage compared to T shares. It is important to keep in mind that there are no exact figures on the average loads IRA investors pay, nor are there estimates about the statistical distributions of these loads that would reveal exactly which type of investor pays the highest loads. Rather, we know only the stated loads each mutual fund company provides in their regulatory filings. Further, we can only estimate the loads retirement investors actually pay by relying on a variety of assumptions about how the overall loads investors pay translate into IRA investors pay after waivers and breakpoints. (The Department of Labor made conservative assumptions about the average loads investors pay in their regulatory impact analysis of the Conflict of

¹ This estimate is derived from Fama-MacBeth cross-sectional regressions run monthly from 2003 to 2016 on the U.S. fund universe. These regressions control for risks associated with market and style returns in addition to fees. See the Disclosures for important information about Morningstar Analyst Ratings.

² See www.icifactbook.org, table 5.8.

Interest Rule.) For higher-wealth investors (those with more than \$1,000,000), an A share may offer a lower load, but we expect few investors in IRAs (which is what the Department of Labor Conflict of Interest Rule covers) to have these resources for individual funds. Even for these wealthy investors, lower-fee A shares could still pose inherent conflicts of interest compared with T shares.

To the extent that some investors save money from the shift, the differences in fees between the average maximum load for an A share and average maximum load for a T share can add up to bigger differences in savings over time. For example, an investor who rolls \$10,000 into an IRA using a T share instead of an A share in the future would immediately save about \$235 on the average fund, which will instead be invested and grow over time. After 10 years, the investor would have an extra \$465, and in 30 years an extra \$1,789 per \$10,000 invested. T shares also compare favorably with “level load C” shares, which typically have no front-end load but have a 1% 12b-1 distribution fee annually as long as investors hold the investments for about four years.

There are other ways that the change to T shares from A shares might improve investor returns that are even more difficult to quantify. The Conflict of Interest Rule has accelerated efforts by advisory and wealth management firms to prune their product shelves, or lineups of funds that their representatives are authorized to sell. Besides varying in their sales loads, A shares also vary in terms of business arrangements between the fund company (the manufacturer) and the advisory firm (the distributor). As in many other industries, A shares came with payments for “shelf space,” making it more attractive for the distributor to sell certain funds (or funds from certain families) over others.

T shares, on the other hand, are free of such arrangements, also known as revenue sharing or platform fees, which are ultimately paid by investors in the fund. The T share structure thus compels distributors to consider funds based purely on their investment merits rather than any revenue they might receive from the fund manufacturer. Finally, T shares arrive at a time when distributors are acutely conscious of investor costs, particularly the expense ratios of funds, which exist apart from their sales loads. These firms have seen hundreds of billions in investor assets move from funds with higher expense ratios to those with lower ones. For any distributor concerned about the liabilities of high-cost funds (not the least of which is that they tend to underperform lower-cost offerings), the quickest way to prune a product shelf is to cut funds with higher-than-average expenses, and we expect this will compel mutual fund companies to rationalize their lineups and focus on fewer, proven strategies.

Clean Share Classes Would Further Enhance Transparency for Investors

Currently, firms that distribute funds to individual investors, whether in an IRA, a retirement plan, or in a taxable brokerage account, depend on “indirect” payments: money that goes from the investor to the fund company and back to an affiliate or third party for services other than managing

a portfolio of stocks or bonds. Clean share classes, which some families have already launched, and others are planning to launch, would strip all these indirect payments away, leaving it to distributors to charge investors directly for any services rendered, such as paying out dividends, operating a website and call center, and so forth. These clean shares could help firms comply with the Conflict of Interest Rule in two ways. Firms that wish to qualify as level fee fiduciaries need to strip out varying third-party payments of any kind, which could make clean share classes attractive. Firms that wish to continue to sell on commission could set these fees themselves and “levelize” their compensation, similar to T shares.

Unlike T shares, clean shares will not have any sales loads and also won’t have annual 12b-1 fees, leading to greater transparency for investors. As it stands, 12b-1 fees pay for a variety of services, including marketing the mutual fund, printing and prospectuses, producing sales literature, and other shareholder services, as well as, most critically, compensating brokers for providing advice to investors. In the case of C shares, often used by brokers working with clients who have small accounts, these 12b-1 fees are a substitute for an annual advisory fee. And for retirement plan participants, they are a way to pay for operational expenses of the plan. We estimate that investors pay 12b-1 fees of more than \$15 billion per year on their holdings of open-end mutual funds, money market accounts, and variable annuity subaccounts.

The advent of clean share classes won’t eliminate investor fees for these services, but it would allow financial institutions that distribute funds to clearly list how much investors pay for each service, besides asset management, which could have the effect of producing greater competition. In other words, clean shares could result in an unbundling in which asset managers manage assets and charge for this service. Instead of passing fees back to intermediaries, these intermediaries would directly charge for the services they offer. In this environment, investors will have much greater insight into what they are paying for and the advice they are getting for their fees. See Exhibit 3 for a summary of the differences in fees between clean shares, T shares, and traditional retail share classes.

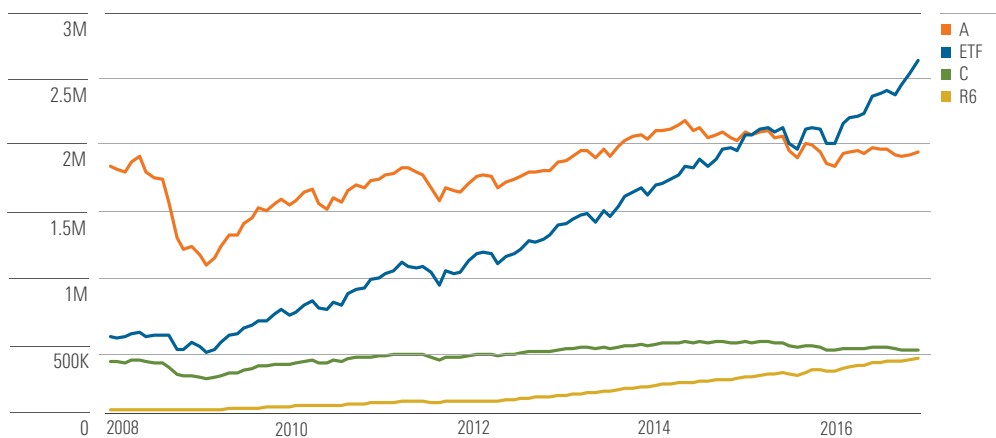
Exhibit 3: Differences in Fees Between A, T and Clean Share Classes

Fees	Old A Share	New T Share	New Clean Share
Sales Loads for Advisor	Variable, often 5% or more	2.5% and uniform	None
Sales Loads for Brokerage	Variable	None	None
Administrative Fees	Variable	Variable	None. These fees are set and charged by the advisor as an explicit fee for advice.
Operational Fees	Variable	Variable	
Distribution Fees	0.25%	0.25%	
Advice Fees	None	None	
Revenue Sharing	Variable	None	None

Source: Morningstar data.

Existing investment options that isolate fees for mutual fund management are already popular, so the introduction of clean shares may simply further an existing trend. Prior to the Conflict of Interest Rule, we observed a strong move away from funds that charge high fees for asset management toward those that charge low fees—particularly passive or index funds. The Conflict of Interest Rule has focused attention on “other” expenses, those that pay for other services rendered to investors. For example, exchange-traded funds have been growing in popularity in part because they are already closer to “clean,” in the sense that they generally charge no 12b-1 fees. However, they are not completely clean because ETFs have operational costs beyond asset management they pass on to consumers in their expense ratios, and some do charge 12b-1 fees. Similarly, we have seen an increase in retirement share classes, intended for retirement plans, which likewise have minimal 12b-1 fees (or none in the case of R6 share classes) indicating that investors prefer choices in which each cost is explicitly broken out. However, R6 share classes are only available for retirement plans and still allow for some “revenue sharing” from management fees that is paid to distributors. Our view is that once these other fees appear separately for more funds as part of the rollout of clean shares into IRAs, investors will be better-positioned to ask how much they pay to whom for what, bringing scrutiny that tends to drive prices down. Exhibit 4 illustrates the flow of funds into select share classes and ETFs during the past decade.

Exhibit 4 Net Assets for Selected Share Class Types and ETFs (in millions)



Source: Morningstar data.

Concluding Observations

Much of the recent discussion around the Department of Labor's Conflict of Interest Rule has focused on whether it will be delayed, modified, or even struck down. We believe that the discussion about the implementation of the rule should focus on what kind of advice individuals will receive and whether it is reasonably priced. Early evidence suggests that the asset management industry is adapting in ways that will benefit investors by reducing conflicts of interest and adding transparency. Further, we think that the move to T shares from A shares may not only reduce what some investors pay directly for advice in the form of commissions, but could also reduce other costs of investing, including fees for asset management and other services. We think that 50 basis points is a reasonable estimate of savings to investors from reducing conflicted advice. Precisely how much T shares will save investors is an open question that we will be able to address more authoritatively after we have some experience with the new regime.

We do not believe that fees are inherently problematic, as long as investors get advice that is worth more than the cost of the advice. In fact, our research into the value of high-quality financial advice finds that it can improve a retirement saver's financial well-being by as much as the equivalent of a 23% increase in lifetime income.³ To the extent that the shift to T or clean share classes enhances fee transparency for investors by making it clear what they are paying for advice, it should encourage financial advisors to provide high-quality advice to remain competitive. Shifting to a T share structure could potentially align advisors' incentives with investors' interests, particularly compared to the uneven and opaque fee structure we observe with A share classes.

In the long term, clean share classes represent the best way to enhance transparency, which is why countries such as the United Kingdom and Australia have moved toward a clean share model. Although T shares are a step in the right direction, the loads could induce advisors to rebalance unnecessarily. Further, T shares impede advisors from trying innovative ways to charge for advice. Using a clean share model, advisors can align the level of advice they provide to their fee, and clients can choose how they would prefer to pay for advice: a flat dollar amount, a commission, or a level fee on assets under management.

³ Blanchett, D., & Kaplan, P. 2013. "Alpha, Beta, and Now... Gamma." *Journal of Retirement*, Vol. 1, No. 2, P. 29. Through a series of simulations, researchers estimate a hypothetical retiree may generate an improvement in utility that is equivalent to 23% more income utilizing a Gamma-efficient retirement income strategy that incorporates the concepts total wealth, dynamic withdrawal, annuity allocation, asset location and withdrawal sourcing, and liability-relative optimization, when compared to a base scenario which assumes a 4% withdrawal rate and a 20% equity allocation portfolio.

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