Submitted electronically [EBSA.FiduciaryRuleExamination@dol.gov]

April 13, 2017

Office of Regulations and Interpretations
Employee Benefits Security Administration, Room N-5655
Attn: RIN 1210-AB79; Fiduciary Rule Examination
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210

RE: RIN 1210-AB79; Fiduciary Rule Examination

Ladies and Gentlemen:

Morningstar, Inc. welcomes the opportunity to comment on the examination of the Conflict of Interest Rule and the questions posed in the President's Memorandum of Feb. 3, 2017. Morningstar, Inc. is a leading provider of independent investment research, and our mission is to create products that help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the rule and its possible effect on the financial advice retirement investors will receive.

The department asked a number of questions about ways the rule might enhance or impede the advice retirement investors receive, including whether firms are changing their business models in response to the rule, whether the rule will cause firms to de-emphasize small IRA investors, and to what extent firms are making changes to their investment lineups and pricing in response to the rule. The department also asked about new data or insights on class action lawsuits as an enforcement mechanism.

In general, we believe the early evidence suggests the rule will be positive for ordinary retirement investors. It appears that it will accelerate existing and largely positive trends for investors in the way that wealth management firms deliver advice by 1) encouraging firms to move from a commission-based model to offering advice for an explicit fee; 2) putting additional focus on investment product expenses which are borne by the investor; and 3) encouraging firms to use financial technology to create innovative advice solutions. For their part, asset managers appear to be responding to the rule by offering new share classes that should reduce conflicted advice. In the long term, we expect further innovation in share classes to provide more flexibility to advisors and better outcomes for investors. We also expect distributors to rationalize their investment lineups in response to the rule. (We have attached a recently released white paper, "Early Evidence from the Department of Labor Conflict of Interest Rule: New Share Classes Should Reduce Conflicted Advice, Likely Improving Outcomes for Investors," which provides our analysis of these share class trends.) In response to the department's questions, we have also quantified the range of possible effects of class action lawsuits and suggested an alternative class exemption the department could explore as an additional way to ensure advisors act in the best interests of their clients.

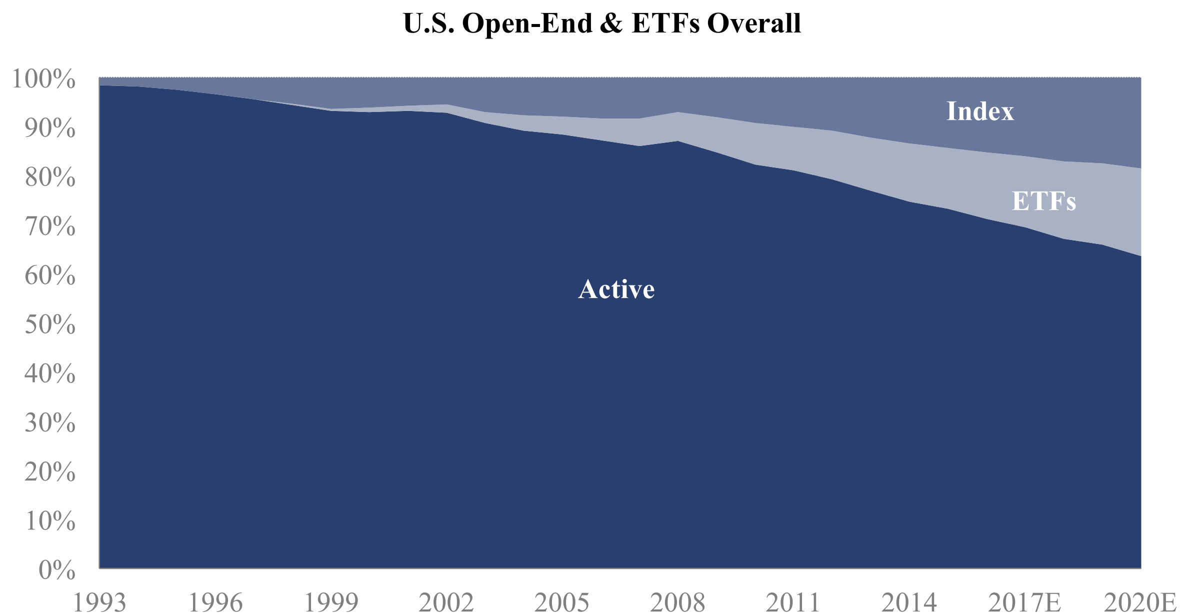
The Fiduciary Rule Should Accelerate Key Trends in Retirement Investment Advice That Largely Help Retirement Investors Achieve Their Goals

As noted above, we believe the rule will accelerate existing and largely positive trends for investors in the way that wealth management firms deliver advice. First, we anticipate that the rule will induce some wealth management firms to move toward a fee-based model rather than selling investments on commission, as they seek to avoid using the full Best Interest Contract Exemption. We view this development as largely good for investors, although it will be important to continue monitoring developments after the rule is applicable. Fee-based arrangements largely reduce conflicts of interest because they remove incentives for advisors to favor particular investments simply because the advisor will receive a larger commission and not because it's a better-quality investment. Fee-based arrangements also improve transparency compared to opaque and varying compensation arrangements that are common when advisors sell traditional mutual fund share classes such as A shares, in which clients pay for advice indirectly through varying front-end loads and ongoing 12b-1 fees. In contrast, in fee-based arrangements retirement investors generally agree to pay a fixed percent of their assets for advice.

We anticipate that with greater transparency, advisors will need to offer advice commensurate with the fees they charge. However, in certain cases commission-based accounts may continue to better serve investors—particularly retirement savers that wish to buy and hold investments for a long period of time—because these arrangements can be less expensive. For example, if an investor paid a 2.5% commission to purchase a fund and a trailer 12b-1 fee of .25%, he would be better off after holding the investment for around 3 years (depending on returns) than if he paid a typical 1% annual management fee, assuming all else equal with regard to the investment, including the quality of advice. Ultimately, we believe that the quality of advice is more important than the form in which it is paid, but making the cost of advice explicit is most likely to help retirement savers assess whether they get their money's worth for the fees they pay.

Second, we expect that the rule will accelerate the flow of assets into lower-cost index funds and exchange-traded funds and, in doing so, put more focus on the fees active mutual fund managers charge. As illustrated by Exhibit 1, index funds and (typically low-cost) ETFs have been growing in market share for years, and we expect the rule to accelerate this growth. Ultimately, with this increased focus on fund costs, more money will stay in investors' pockets, as fees are a drag on returns. Active funds can serve an important role for retirement investors, but these funds will need to compete with passive funds by demonstrating they can achieve higher (or at least uncorrelated) returns compared with passive investments. We also believe active funds will have to reduce their fees to be attractive to advisors working in the best interests of their clients.

Exhibit 1: The Total Market Share of Active, Index, and Exchange-Traded Funds and Projections



Source: Morningstar Direct data feeds.

Third, the rule will create additional opportunities for digital advice solutions, which have been growing rapidly. In fact, the assets in "robo-advised" accounts at the five leading robo-advisors grew from less than $15 billion in 2014, to more than $35 billion in 2015, and to approximately $70 billion in 2016, according to our analysis of Securities and Exchange Commission data and company filings. These solutions fill the gap between no-frills discount brokerages and full-service wealth managers. They may also provide a valuable resource for investors with relatively small balances who may no longer be served by wealth managers. We view the rise of digital advice solutions as a positive for investors as these solutions are democratizing sophisticated asset-allocation models that had been available only to large institutional investors. These digital solutions will continue to evolve to address investors with more sophisticated needs.

In comments to the department, some have argued that advisors may find providing advice to investors with relatively small balances difficult under the rule. But rather than abandoning or de-emphasizing these investors, we anticipate that the delivery of advice for this segment will change and technological innovations in the digital advice sector will fill any gap. We estimate that between $250 billion and $600 billion of assets could eventually shift from being serviced by full-service wealth management to other channels of advice, such as robo-advisors, or hybrid solutions in which clients use a robo-advisor and have access to human advisors as well.

New, Innovative Share Classes Created in Response to the Rule Could Improve Investors' Outcomes

We have observed investment management companies starting to adapt their product offerings to support advisors in their efforts to comply with the rule. Specifically, investment management companies have begun developing two new share classes for their mutual fund offerings: "T shares" and "clean shares." Both of these share classes involve significant changes to the pricing structure of mutual funds and the way investors pay for advice, and we believe these changes will ultimately improve retirement investors' outcomes and their experiences investing. (For a fuller explanation of our observations on these share classes and their benefits to investors, please see the attached Morningstar white paper, "Early Evidence on the Department of Labor Conflict of Interest Rule: New Share Classes Should Reduce Conflicted Advice, Likely Improving Outcomes for Investors.")

Individual investors will immediately realize benefits from the transition to T shares. T shares "levelize" the fees investors pay for mutual funds and thus remove the incentive that financial advisors have to recommend a more expensive fund that may not actually best serve their client's financial goals. We anticipate that mutual fund companies will create more than 3,500 new T shares to help advisors comply with the fiduciary rule. Additionally, we anticipate that T shares will have lower front-end loads than other share classes: We believe that most T shares will have a 2.5% front-end load compared with the average front-end load of 4.85% among the A shares that Morningstar tracks, thereby reducing the price investors pay to purchase mutual funds.

In the long term, we believe individual investors will also benefit the most from a long-term shift to clean shares. Clean shares strip out all fees charged to investors by fund companies and then disbursed to third parties for services (excluding portfolio management). The price of advice will no longer be built in to the numerous fees that investors pay for funds, such as administrative fees, operational fees, 12b-1 fees, and distribution fees. Rather, it will be unbundled and explicitly charged to the investor. This has the immediate effect of increasing transparency, as investors will be able to see exactly how much they are being charged for each service or product. Additionally, as clean shares are not wrapped in a sales fee, they will be cheaper for investors to purchase.

We Estimate a Wide Range of Possible Costs from Litigation

Using several approaches, we have estimated a wide range of possible expenses from class action lawsuits stemming from the Best Interest Contract Exemption ranging from approximately $70 million to $150 million annually. Although we think these litigation costs will be manageable for wealth management firms—adding an increase in compliance costs of about 5%-10% using the department's estimates—they could be quite a bit higher in the near term as firms adjust to the rule and set up systems to determine, demonstrate, and document best interest recommendations. (Our detailed analysis and assumptions are available in a February 2017 report.[1]) We also believe that the class action litigation can serve as a protective measure for retirement savers that individual arbitration cannot address.

Morningstar arrived at these estimates using four approaches to estimate the cost of class action lawsuits. First, we examined historical restitution among the largest wealth management firms during the past six years. Second, we examined the likely premium increases for errors and omission insurance. Third, we examined the Employee Benefits Security Administration's monetary results, which include monetary recoveries and correcting prohibited transactions. Fourth, we examined retirement plan class action lawsuit settlements. Additional details are available in "Financial Services Observer: Weighing the Strategic Tradeoffs of the U.S. Department of Labor's Fiduciary Rule."

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[1] Wong, M.M. "Financial Services Observer: Weighing the Strategic Tradeoffs of the U.S. Department of Labor's Fiduciary Rule." Morningstar Report, Feb. 8, 2017.

Another Possible Approach to Enforcement

In its review, the department asked respondents to address alternative approaches that “could ensure compliance with the standards if they were no longer an enforceable legal obligation.” One potential alternative would be for financial institutions to agree to operate under certain uniform prudence standards, including submitting certain data elements to demonstrate compliance with the prudence standard. We believe that an auditable big-data system provided by a neutral third party for reviewing individual portfolios across a firm, as well as the reasons advisors recommended rollovers to IRAs and in support of advice within IRAs, could substitute for the Best Interest Contract Exemption while still protecting investors. Further, we think that such a uniform prudence standard and data assembly system will likely be developed in any case to help firms defend against lawsuits.

More specifically, instead of using a private right of action to ensure financial institutions meet these standards, an alternative would be to collect data on all clients’ portfolios across several objective factors, quantify whether these portfolios aligned with a best interest standard of advice, and use this large set of data to identify and remediate issues. For example, each client’s portfolio could be scored on key factors such as:

1. Investment quality, which could be measured using a quantitative fund rating, and expenses at the security, portfolio, and plan level;
2. Asset allocation and "fit to goal," which could be evaluated based on portfolio efficiency and distance from a risk-based benchmark; and
3. The value of advice, which could be evaluated based on key factors such as whether an advisor considered risk tolerance and capacity, human capital, goals, other income sources, and dynamic withdrawal strategies in designing a client’s investment strategy.

A third party that evaluated the aggregate data from thousands of portfolios could ensure that a financial institution’s advisors consistently acted in clients’ best interests. Such an approach could be a reasonable way the department could promote a best interest standard in lieu of using a private right of action framework. Further, a prudent process such as the one described, combined with aggregate account-level data, could show that each investment, each portfolio, and each plan is within acceptable bounds for every investor advised by a firm. Further, such a prudent process could also show that any investment, portfolio, or plan that is “out of bounds” has been brought into compliance through corrective action.

By exposing all accounts of a financial institution including investments, portfolios, and plans to an auditor’s scrutiny (akin to Service Organizational Control; SOC 1® and SOC 2®), such systems would replace the likely or potentially skewed samples used in lawsuits or standard audits, which sample a subset of accounts. Rather than a negative determination, a big-data audit would provide a positive affirmation of compliance. That is, instead of having a financial institution responding to a lawsuit by 1) proving that the class of plaintiffs did not receive conflicted advice and 2) that if so, their experience was an exception, the financial institution would pre-emptively prove full compliance.

Using such data and analytics, every investor’s account would be scored to identify those that are outliers or nonconforming to investor needs in terms of investment quality, portfolio fit, and planning value. Provided there was a standard of prudence and reasonableness, a financial institution could at any time provide that its entire book of business was either compliant or being brought into compliance.

Such an audit would, in addition, be both easier to enforce and quicker to conduct, in that it would simply reproduce the firm's own internal audit of client accounts.

Thank you again for the opportunity to comment. Our attached paper on the new share classes asset managers plan to create in response to the rule should also address some of the questions the department asked as it conducts its examination.

Very Truly Yours,

Aron Szapiro
Director of Policy Research
Morningstar, Inc.

POLICY RESEARCH

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

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

April 2017

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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.

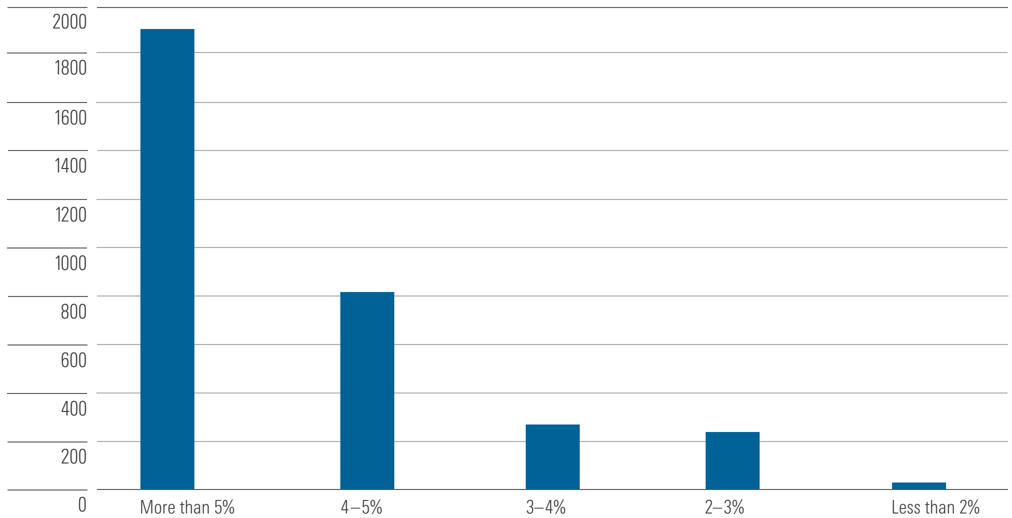
T Shares Reduce Conflicts of Interest in Commission-Based Sales, and Some Investors Will Likely Save on Fees

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.

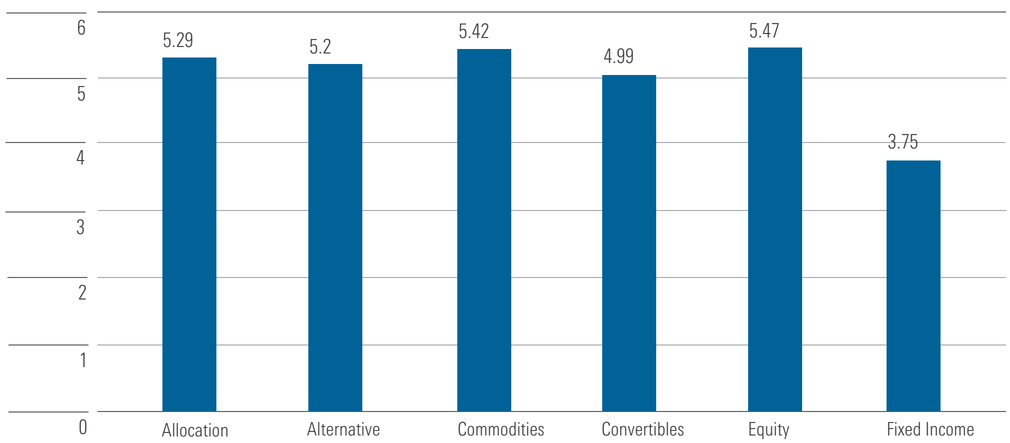
Furthermore, the loads in traditional A shares do not simply vary between funds, but they are systematically linked to asset classes, aligning incentives for advisors that might be at odds with appropriate asset-allocation recommendations. For example, average A share loads are about 1.72 percentage 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. funduniverse. 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.

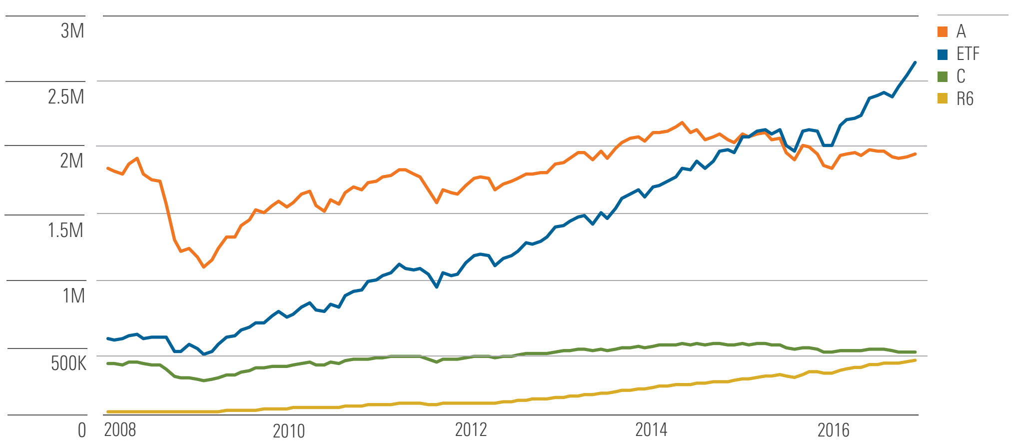
Exhibit 3: Differences in Fees Between A, T and Clean Share Classes

<table>
<tr><th>Fees</th><th>Old A Share</th><th>New T Share</th><th>New Clean Share</th></tr>
<tr><td>Sales Loads for Advisor</td><td>Variable, often 5% or more</td><td>2.5% and uniform</td><td>None</td></tr>
<tr><td>Sales Loads for Brokerage</td><td>Variable</td><td>None</td><td>None</td></tr>
<tr><td>Administrative Fees</td><td>Variable</td><td>Variable</td><td rowspan="4">None. These fees are set and charged by the advisor as an explicit fee for advice.</td></tr>
<tr><td>Operational Fees</td><td>Variable</td><td>Variable</td></tr>
<tr><td>Distribution Fees</td><td>0.25%</td><td>0.25%</td></tr>
<tr><td>Advice Fees</td><td>None</td><td>None</td></tr>
<tr><td>Revenue Sharing</td><td>Variable</td><td>None</td><td>None</td></tr>
</table>

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.

Disclosures

This white paper contains certain forward-looking statements. We use words such as "expects", "anticipates", "believes", "estimates", "Forecasts", and similar expressions to identify forward looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially and/ or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason. Past performance does not guarantee future results.

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