JB Heaton PC

VIA EMAIL

The Honorable Jay Clayton, Chairman
c/o Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: File No. S7-07-18

Dear Chairman Clayton:

I write on my own behalf as a financial economist and lawyer (admitted in Illinois and New York) deeply concerned with the protection of retail investors from harmful financial transactions.

I would like to draw the Commission's attention to new research that supplements that of its very capable economic staff. This new research concerns the psychological tendency of potential investors to link potential investment results with "hard work" and may be exploited by broker-dealers to steer retail investors away from low-cost index products towards expensive, actively-managed funds and their own "stock picks."

The co-authored research, reported in a paper titled "How Active Management Survives" and which is available on SSRN.com at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3193640 helps explain how active managers are able to attract and retain investors.

As the Commission and its economic staff know well, much evidence demonstrates the inferiority of most actively-managed funds. No evidence demonstrates that most actively-managed funds - whether managed by stock brokers, managers of active mutual funds, or even the best-known hedge fund managers - reliably beat passive strategies. The overwhelming evidence of underperformance by active managers has generated a strong shift to passive investing by sophisticated investors. Given its poor performance relative to passive indexing, it is difficult to explain just how so many active managers who deliver unimpressive performance at high cost relative to other investment alternatives continue to attract and retain investors.

Our research demonstrates that potential investors fall prey to the well-documented "conjunction fallacy." We sampled 1,001 individuals over the age of 30 who completed a brief, 3-item internet survey. The sample consisted of roughly half male (n = 533) and half female (n = 468) participants above the age of 30 (roughly 50% between the ages of 45 and 60), with household incomes in excess of $100,000 (24% of the sample earned over $200,000/year). Participants were presented with the following choice problem:

> ABC Fund invests in common stocks listed on United States stock exchanges.
>
> Which is more likely?
>
> (1) ABC Fund will earn a good return this year for its investors.
> (2) ABC Fund will earn a good return this year for its investors and ABC Fund was founded by a successful former Goldman Sachs trader and employs Harvard-trained physicists and Ph.D. economists and statisticians.

It is logically impossible (for a simple reason explained in the paper) for choice (2) to be more likely than choice (1). Nonetheless, a high rate of participants fell prey to the conjunction fallacy, with 31% selecting choice (2). This rate is similar to that reported in the seminal study of Tversky and Kahneman (1983) with a sample of statistically-trained graduate students. (Tversky A. and D. Kahneman. 1983. "Extensional Versus Intuitive Reasoning: The Conjunction Fallacy in Probability Judgment," 90 *Psychological Review*, 293-315.) Further results reported in our new paper show that it is likely a belief in a causal connection between hard work and investment outcomes that drives this result and that the result is nearly the same whether participants report knowledge of stock-market investing or not.

The conjunction fallacy explanation for the survival of active equity management has important policy implications, including the wisdom of Regulation Best Interest. Scholars have become more concerned that the financial industry exploits investors, selling investors products that are bad for them. But unlike other firms that sell products that are considered bad for their customers - tobacco, alcohol, and gambling, for example - sellers of active equity management cloak their products in dreams of a more secure financial future and better investment performance. In too many ways, advertisements for financial services are reminiscent of tobacco ads in the 1940s and 1950s.

Understandably, the financial industry fights hard against regulation that would expose the high costs and risks of financial products. Regulation Best Interest would raise the stakes for exploiting the psychological biases of retail investors and make it harder for broker-dealers to steer retail investors to products that have been demonstrated to be inferior to lower-cost alternatives.

Sincerely,

J.B. Heaton, J.D., M.B.A., Ph.D.
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