MEMORANDUM

To: File Nos. S7-07-18, S7-08-18, S7-09-18

From: Eric Diamond, Senior Advisor to Chairman Jay Clayton

Re: Standards of Conduct for Investment Professionals

Date: March 26, 2019

On March 7, 2019, Eric Diamond (Senior Advisor to Chairman Clayton) participated in a call with Sarah Bessin (Associate General Counsel, Investment Company Institute) regarding, among other things, the SEC's proposed rules and interpretation relating to standards of conduct for investment professionals. Following the call, Sarah Bessin provided the attached information.

Summary of ICI Data on Mutual Fund and IRA Ownership

This document has four main sections: (1) updated information on the use of load and no-load mutual funds; (2) background information on mutual fund–owning households, including their demographic characteristics and sources of mutual fund ownership; (3) analysis provided to the Department of Labor with regard to the impact of the fiduciary rule on small-account owners; and (4) background information on individual retirement account (IRA) investors, including the financial services firms where they hold their IRAs.

1. Updated Data on Use of Mutual Fund Share Classes

The Investment Company Institute provided background data in our comment letter to the Commission, SEC Proposals on Standards of Conduct for Investment Professionals, and we update two key findings below with 2018 data:

- Rather than obtaining financial services through more traditional commission-based arrangements, investors have increasingly paid investment advisers asset-based fees for financial services. In part because of the shift toward asset-based fees, the percentage of long-term mutual fund total net assets held in front-end and back-end load share classes fell from 27 percent at year-end 2007 to 12 percent at year-end 2018. By contrast, at year-end 2007, no-load share classes accounted for 51 percent of long-term mutual fund total net assets, rising to 71 percent by year-end 2018.
- Two factors likely explain most of the shift in mutual fund assets away from load share classes. First, the increased use of investment advisers that charge an asset-based fee has resulted in an increase in sales of no-load share classes. Second, 401(k) plans and other retirement accounts, which often invest in no-load share classes, have bolstered assets and flows to these share classes. Gross sales to no-load mutual funds that have zero Rule 12b-1 fees have grown to 87 percent of total gross sales to long-term mutual funds in 2018 from 61 percent in 2007.

2. Background Information on Mutual Fund Investors

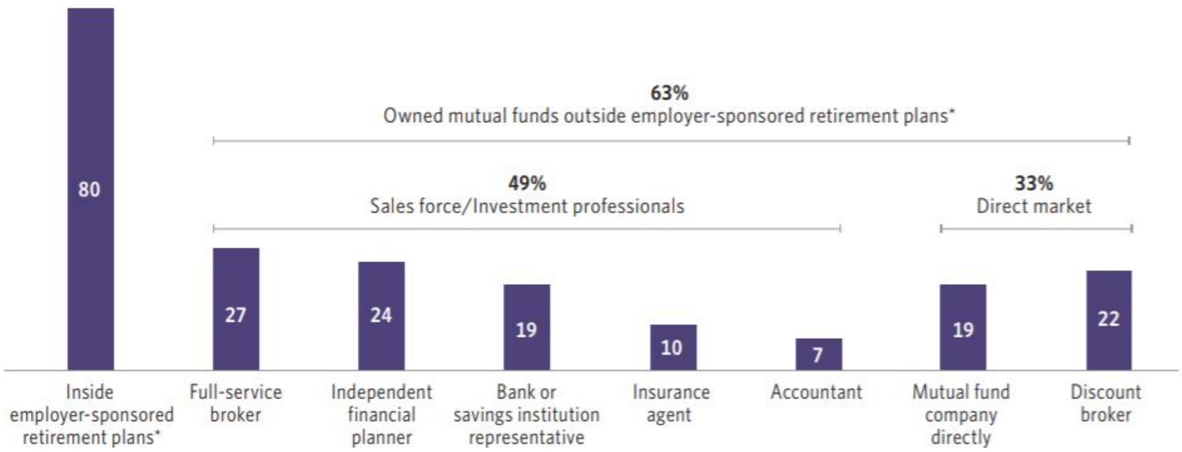
There are 56 million US households owning mutual funds, representing nearly 100 million individual investors (see *ICI Research Perspective*, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2018"). These households hail from a wide range of incomes and ages, and are saving to meet a variety of financial goals (see *ICI Viewpoints*, "Mutual Funds: Rated E for Everyone").

Mutual fund–owning households hold their mutual funds through a variety of distribution channels, with 80 percent owning mutual funds inside retirement plans at work, 63 percent holding funds outside such plans, and 43 percent holding mutual funds both inside and outside employer-sponsored retirement plans. Those holding mutual funds outside employer-sponsored retirement plan accounts access funds through a variety of financial services professionals, ranging from full-service brokers to independent financial planners to discount brokers to directly with mutual fund companies (see Figure 3.1, below).

FIGURE 3.1

Sources Used by Mutual Fund–Owning Households to Purchase Mutual Funds

Percentage of US households owning mutual funds, 2018



* Employer-sponsored retirement plans include DC plans (such as 401(k), 403(b), or 457 plans) and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).

Note: Multiple responses are included.

(This figure is from *ICI Research Report*, "Profile of Mutual Fund Shareholders, 2018".)

Sources of mutual fund ownership vary with age, and younger mutual fund–owning households are more likely to own funds through employer-sponsored retirement plans, while older households are more likely to hold funds outside those plans (see Figures 10, 11, and 12, in *ICI Research Perspective*, "Characteristics of Mutual Fund Investors, 2018"). Supplemental tables to the "Profile of Mutual Fund Shareholders, 2018" report provide additional detail on this variation.

Figure 6.7 in the supplemental tables highlights how sources of mutual fund ownership vary by the age of the head of the household. For example, 38 percent of mutual fund–owning households aged 65 or older indicate that full-service brokers are a purchase source, with 15 percent indicating full-service brokers are their primary purchase source. In contrast, 16 percent of mutual fund–owning households younger than 35 indicate that full-service brokers are a purchase source, with 8 percent indicating full-service brokers are their primary purchase source. Similarly, 34 percent of mutual fund–owning households aged 65 or older indicate that independent financial planners are a purchase source, with 17 percent indicating independent financial planners are their primary purchase source. In contrast, 15 percent of mutual fund–owning households younger than 35 indicate that independent financial planners are a purchase source, with 3 percent indicating independent financial planners are their primary purchase source.

Figure 6.7
Sources Used to Purchase Mutual Funds by Age
Percentage of US households owning mutual funds by age of household head, 2018

	Younger than 35	35 to 54	55 to 64	65 or older
Source of mutual fund ownership				
Only inside employer-sponsored retirement plan	46	39	38	26
Only outside employer-sponsored retirement plan	19	14	15	36
Both inside and outside employer-sponsored retirement plan	35	47	47	38
Purchase sources through which funds are currently owned[1]				
Inside employer-sponsored retirement plans (total)	81	86	85	64
Inside DC retirement plans (total)	80	84	83	63
401(k) plan	72	76	73	45
403(b); state, local, or federal government plan	17	21	24	24
Inside employer-sponsored IRA[2]	6	7	10	5
Outside employer-sponsored retirement plans (total)	54	61	62	74
Sales force (total)	34	47	51	62
Full-service broker	16	24	27	38
Independent financial planner	15	22	27	34
Bank or savings institution representative	16	18	22	22
Insurance agent	5	10	11	14
Accountant	6	6	6	8
Direct market (total)	31	30	32	39
Mutual fund company directly	14	17	20	24
Discount broker	23	20	22	25
Primary mutual fund purchase source				
Inside employer-sponsored retirement plans	69	67	66	40
Outside employer-sponsored retirement plans	31	33	34	60
Sales force	20	24	24	43
Full-service broker	8	8	8	15
Independent financial planner	3	9	8	17
Bank or savings institution representative	7	4	5	8
Insurance agent	0	2	2	2
Accountant	2	1	1	1
Direct market	11	9	10	17
Mutual fund company directly	5	4	4	6
Discount broker	6	5	6	11
Source of first mutual fund purchase				
Inside employer-sponsored retirement plan	61	68	66	48
Outside employer-sponsored retirement plan	39	32	34	52

[1]Multiple responses are included.
[2]Employer-sponsored IRAs include SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs.

Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey

Sources of mutual fund ownership also vary with household income. Figure 7.7 in the supplemental tables highlights how sources of mutual fund ownership vary by household income. For example, 32 percent of mutual fund–owning households with household income of $150,000 or more indicate that full-service brokers are a purchase source, with 12 percent indicating full-service brokers are their primary purchase source. In contrast, 22 percent of mutual fund–owning households with household income less than $50,000 indicate that full-service brokers are a purchase source, with 8 percent indicating full-service brokers are their primary purchase source. Little variation occurs in the use of independent financial planners across households with different incomes. Twenty-nine percent of mutual fund–owning households with household income of $150,000 or more indicate that independent financial planners are a purchase source, with 10 percent indicating independent financial planners are their primary purchase source. Twenty-four percent of mutual fund–owning households with household income less than $50,000 indicate that independent financial planners are a purchase source, with 11 percent indicating independent financial planners are their primary purchase source.

Figure 7.7
Sources Used to Purchase Mutual Funds by Household Income
Percentage of US households owning mutual funds by household income,[1] 2018

	Household income[1]			
	Less than $50,000	$50,000 to $99,999	$100,000 to $149,999	$150,000 or more
Source of mutual fund ownership				
Only inside employer-sponsored retirement plan	39	43	38	29
Only outside employer-sponsored retirement plan	36	21	17	11
Both inside and outside employer-sponsored retirement plan	25	36	45	60
Purchase sources through which funds are currently owned[2]				
Inside employer-sponsored retirement plans (total)	64	79	83	89
Inside DC retirement plans (total)	63	76	81	88
401(k) plan	49	62	75	81
403(b); state, local, or federal government plan	19	22	20	24
Inside employer-sponsored IRA[3]	3	6	8	8
Outside employer-sponsored retirement plans (total)	61	57	62	71
Sales force (total)	46	43	49	58
Full-service broker	22	23	28	32
Independent financial planner	24	23	22	29
Bank or savings institution representative	16	18	19	24
Insurance agent	10	9	8	14
Accountant	6	7	4	8
Direct market (total)	27	28	34	41
Mutual fund company directly	16	14	20	24
Discount broker	18	21	22	27
Primary mutual fund purchase source				
Inside employer-sponsored retirement plans	58	65	63	57
Outside employer-sponsored retirement plans	42	35	37	43
Sales force	30	25	27	31
Full-service broker	8	9	9	12
Independent financial planner	11	8	10	10
Bank or savings institution representative	7	6	5	5
Insurance agent	3	1	2	2
Accountant	1	1	1	2
Direct market	12	10	10	12
Mutual fund company directly	6	4	3	5
Discount broker	6	6	7	7
Source of first mutual fund purchase				
Inside employer-sponsored retirement plan	54	67	63	62
Outside employer-sponsored retirement plan	46	33	37	38

[1]Total reported is household income before taxes in 2017.
[2]Multiple responses are included.
[3]Employer-sponsored IRAs include SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs.

Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey

3. ICI Analysis Provided to DOL Regarding Impact of Fiduciary Rule on Small-Account Holders

ICI's July 21, 2015 comment letter, Regulatory Impact Analysis; Definition of the Term "Fiduciary"; Conflict of Interest Rule–Retirement Investment Advice, noted that the Department of Labor (DOL) RIA ignored the economic impact of moving investors to fee-based accounts:

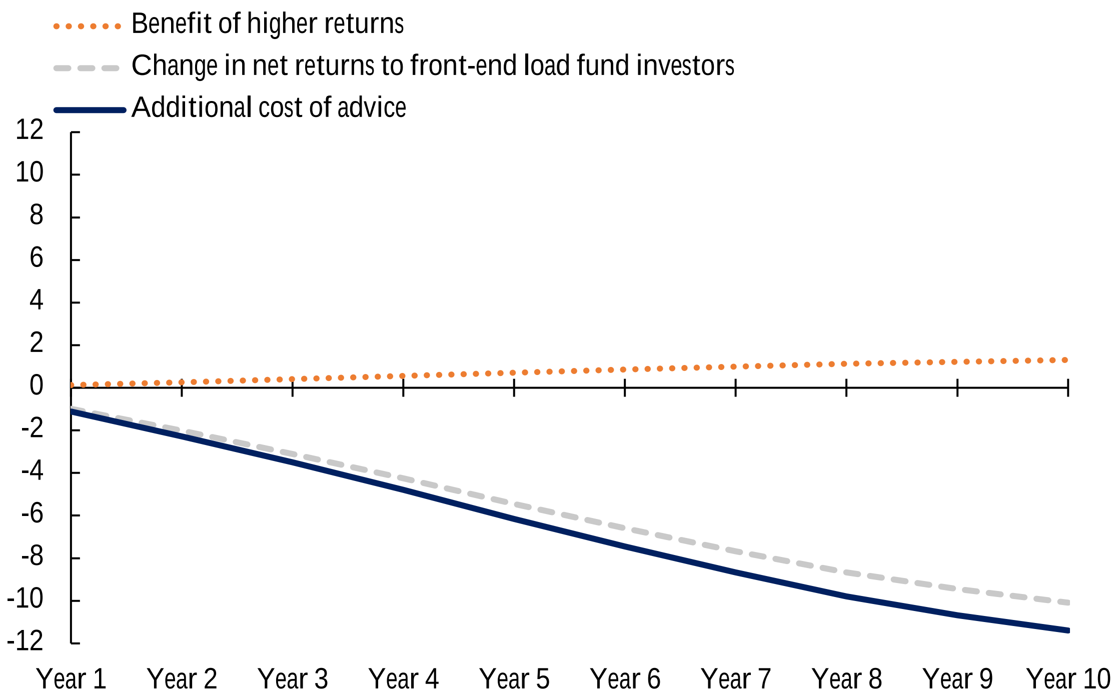
> The Department of Labor's evaluation of the impact of the fiduciary proposal focuses solely on the costs of advice and assistance paid through a fund—pursuant to an up-front sales charge and 12b-1 fees, for example. But the Department fails to consider how these costs compare to the costs that investors incur when they pay a financial adviser directly for advice (for example, using an asset-based fee that an investor pays directly to a financial adviser) rather than paying through a fund with a front-end load or a 12b-1 fee. In doing so, the Department exaggerates the benefits from lower loads resulting from its proposal and ignores possible costs that investors could incur if they move to fee-based advice.
>
> The RIA calculates that IRA investors currently pay between 26 and 28 basis points per year in front-end loads, in addition to fund expenses. Most front-end load funds have a 12b-1 fee which also is used to compensate the broker and the brokerage firm for their services. The average 12b-1 fee for front-load funds, on an asset-weighted basis, is about 24 basis points. Adding together both the annualized load costs of 26 to 28 basis points and the 12b-1 fees, the total annual cost for the services provided by brokers and their firms to investors in front-end load funds is about 50 basis points a year.
>
> The Department predicts that its BIC Exemption will induce brokers to reduce loads by about 65 percent over the next two years. As the Institute points out in its accompanying comment letters, the BIC Exemption is unworkable; even if it could work, it would impose prohibitive costs on brokers. Brokers subject to the Exemption's many new limitations, burdens, and costs, as well as its increased exposure to liability, are likely to seek to move many of their clients to fee-based accounts. Such accounts, however, require much greater level of time and engagement through frequent rebalancing of investors' accounts a level of service that is unnecessary for an investor with a modest balance who is typically better off as a buy-and-hold investor. This additional ongoing engagement results in higher and ongoing expense for the investor.
>
> Assuming that investors in broker-sold funds move to fee-based accounts, the costs these investors will pay will likely rise over time. A recent study by Cerulli Associates finds that fee-based accounts—the most likely alternative to brokerage accounts—cost investors 111 basis points per year on average, in addition to fund expenses. Using the asset levels in the RIA (Table 3.4.2-1 Row B) and assuming that the current proposal causes investors to move from front-end load funds to fee-based accounts over time at the rate based on the turnover in broker accounts as estimated in the RIA (Table 3.4.1-2), the additional fees that investors pay to financial advisers on assets that are currently in front-end load funds could reduce investor returns by $1.1 billion in the first year, rising to more than $11 billion a year in the tenth year.

Assuming a net increase in returns for investors using brokers equal to the difference in the three-year relative return between retail no-load and front-end load share classes, investors would receive a benefit of higher returns of $760 million in the first year rising to $1.31 billion in the tenth year, as shown in Figure 8. Combining the effects of the costs of higher payments to financial advisers and higher returns that investors receive, the proposed rules would result in a net loss to fund investors. In the first year alone, the net loss would be $1.1 billion. That loss would grow to $10.1 billion a year by the tenth year as more clients are moved to fee-based accounts.

Figure 8

Annual Effect on Investors in Front-End Load Funds of Higher Fees Paid to Fee-Based Advisers

Billions of dollars a year



Source: Investment Company Institute

ICI's July 21, 2015 comment letter, [Regulatory Impact Analysis; Definition of the Term "Fiduciary"; Conflict of Interest Rule–Retirement Investment Advice](), also noted that the DOL RIA failed to account for investors, especially small investors, losing access to advice and guidance:

In its estimates of the cost of its proposed rule, the Department focuses only on administrative or compliance costs. It does not measure any harm that can occur if it adopts the proposed rule—including the risk that at least some retirement savers could lose access to advice and information they currently rely on to meet their savings goals.

If the problems with the proposed fiduciary definition and the BIC Exemption are not addressed, we expect that significant numbers of investors should be expected to lose access to the guidance, products, and services that they currently receive from brokers. Financial advisers, regardless of their standard of care, are unlikely to work in an environment of greater costs, limitations, and exposures to liability for less compensation. Indeed, many broker-dealers are likely to exit the market for retirement advice under the proposed rule. The Department thus ignores the impact of its proposed rule on the quality and appropriateness of investment choices that retirement savers must make.

ICI research finds that IRA investors rely on financial professionals to assist with rollovers, creating a retirement strategy, and determining withdrawal amounts. We also find a positive correlation between investors' use of financial professionals and investors' willingness to take financial risk. Indeed, in its justification of an earlier rule change, the Department said that retirement investors who do not receive investment advice are twice as likely to make poor investment choices as those who do receive that advice. The benefits of advice—and, conversely, the harm of losing access to advice—are significant.

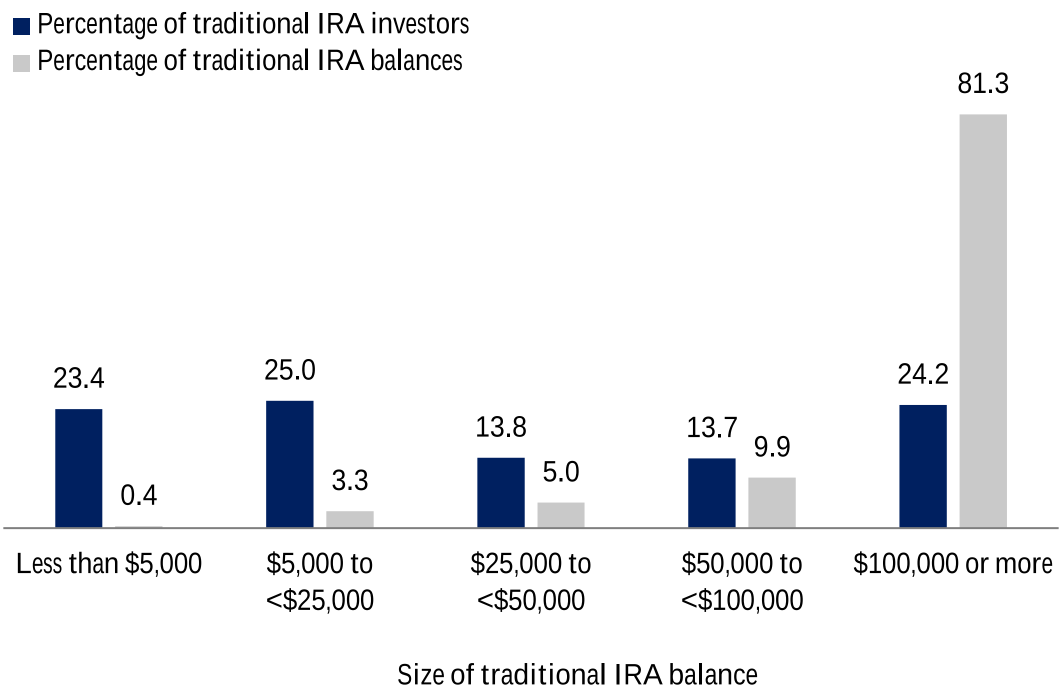
Retirement investors may be left with no choice but to seek asset-based fee accounts to obtain the investment assistance that they need. But as we have already established, the cost of investing through those accounts can be greater—not less—than the cost of investing with brokers.

Moreover, fee-based accounts may not be available to low- and middle-income IRA investors who cannot meet minimum account balance requirements. Currently, fee-based advisers often require minimum account balances of $100,000 because, even with a 1 percent fee, accounts with fewer assets generate too little income to make the provision of ongoing advice profitable. As shown in Figure 9, 76 percent of traditional IRA accounts in The IRA Investor Database™ have less than $100,000 in them. And low- and middle-income households are more likely to have IRA balances below $100,000, as shown in Figure 10.

Figure 9

Distribution of Traditional IRA Investors and Traditional IRA Amounts

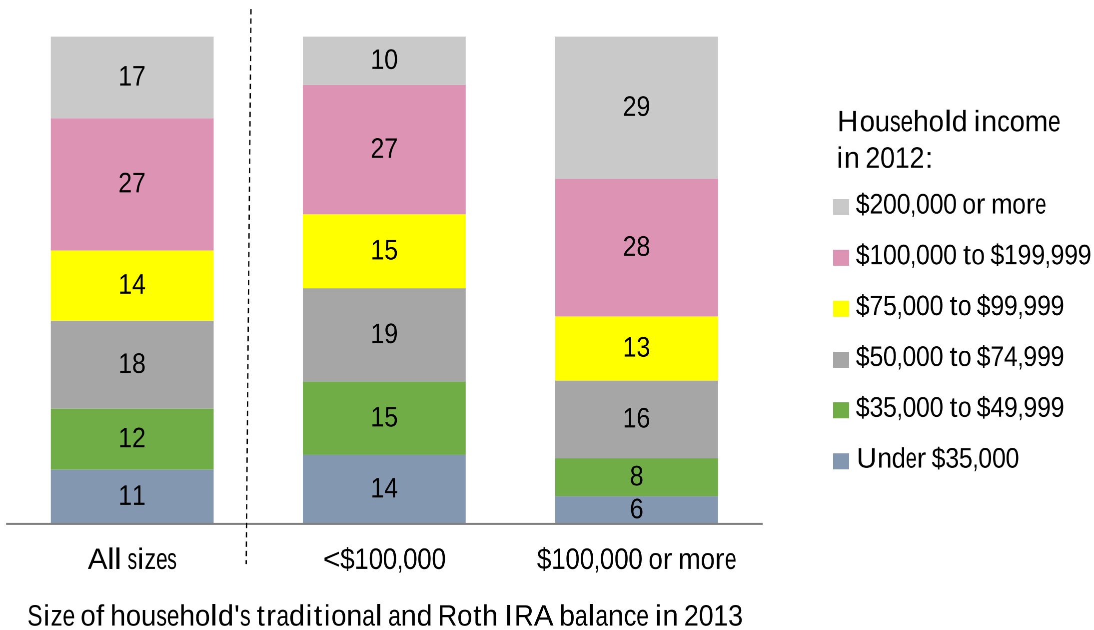
Percentage of traditional IRA investors and percentage of traditional IRA balances by size of traditional IRA balance, 2013



Note: The sample is 9.8 million traditional IRA investors aged 25 to 74 at year-end 2013. Components may not add to 100 percent because of rounding.

Source: The IRA Investor Database™

Figure 10
Households Owning Traditional and/or Roth IRAs
Percentage by household income and household IRA balances



Note: In 2013, 65 percent of households with traditional or Roth IRAs had balances of less than $100,000 and 35 percent had balances of $100,000 or more.
Source: ICI Tabulation of Federal Reserve Board 2013 Survey of Consumer Finances

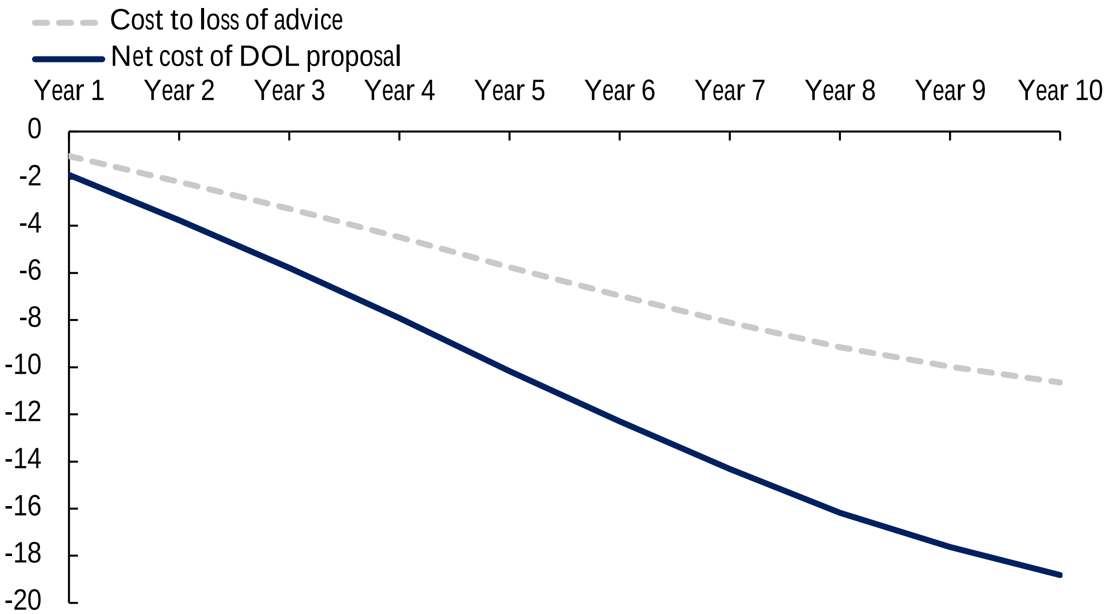
Other market participants may seek to overcome the proposed rule's barriers and find ways to serve retirement savers who now rely on broker-dealers. It is entirely foreseeable, however, that many IRA investors would no longer be able to obtain advice under the proposed rule. If these investors, over time, lose access to advice and service, their accounts are likely to earn lower returns in the future. These lower returns could occur, for example, through poor asset allocation decisions, poorly timed investment decisions, penalties for early withdrawals, or incorrectly calculated required minimum distributions. Even if these individuals no longer have to pay for services, the net loss on their accounts would have a negative impact.

Assuming that investors with less than $100,000 in IRA balances no longer have access to advice because the BIC Exemption is not workable, then over time these investors are likely to experience lower returns because of poor asset allocation and market timing, or because they incurred tax penalties by taking early withdrawals. Factoring in the lower performance for these investors, and adding to the additional costs for the other 81 percent of IRA assets that would shift to fee-based accounts, it is possible that the net loss from the proposal, if adopted, could impose annual losses to investors mounting to nearly $19 billion a year within 10 years (Figure 11).

Figure 11

Annual Effect on Investors If They Lose Access to Financial Advice

Billions of dollars a year



Source: Investment Company Institute

We are, of course, unable to quantify another significant potential cost to the current proposed rules. As we discuss in our comment letters, the BIC Exemption likely will create significant barriers for investors—particularly investors with small account balances—seeking out advice and assistance, even outside the broker market. Increasing information barriers and transaction costs certainly would reduce the ability of IRA investors to move from one adviser to another or from one fund provider to another, further harming investors.

Responding to a subsequently released DOL Q&A on small investors, ICI's September 24, 2015 comment letter, Regulatory Impact Analysis; Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice/ZRIN 1210-ZA25: Proposed Best Interest Contract Exemption, noted:

Our July 21 comments letter pointed to a fundamental flaw in the Department of Labor's Regulatory Impact Analysis: the analysis does not measure any harm to IRA investors if the Department adopts the proposed rule. For example, IRA investors would be harmed if they lost access to advice and information that they currently rely on to meet their savings goals.

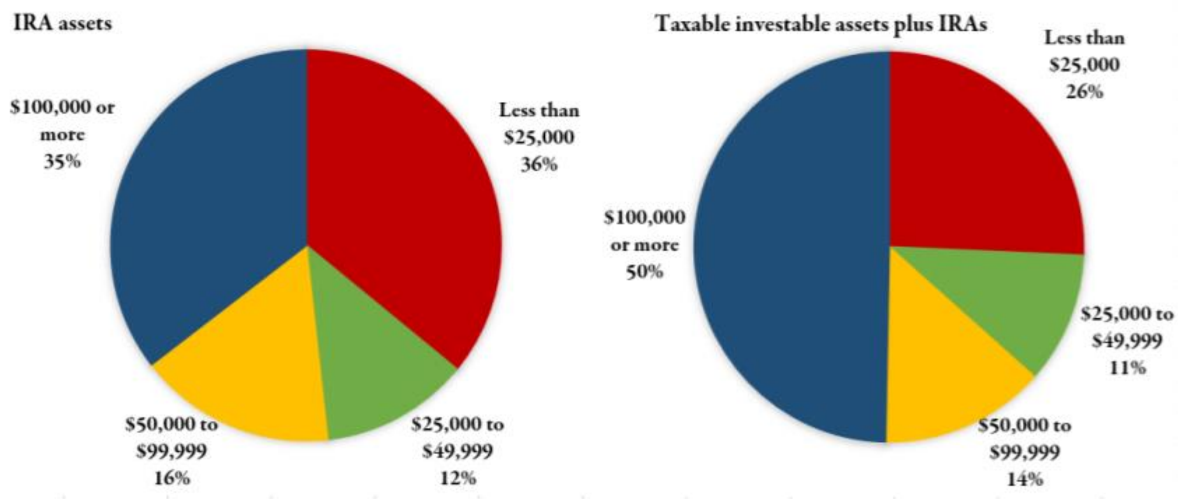
We said that if the Department does not correct the many flaws with the proposed rules, we expect that significant numbers of investors could lose access to the guidance, products, and services that they currently receive from brokers. The unfortunate result of the Department's rules will be that many retirement investors may be left with no choice but to seek asset-based fee accounts to obtain the investment assistance that they need. Fee-based accounts, however, may not be available to many investors who cannot meet minimum account balance requirements. Currently, fee-based advisers often require minimum account balances of $100,000. We provided data demonstrating that 76 percent of traditional IRA accounts had less than $100,000.

The Department of Labor published a Q&A on "small savers," which it defines as holders of IRAs with balances of less than $25,000. That Q&A states that "[m]ore than two-thirds of small-IRA owners are wealthy and upper-middle-class households for whom these IRAs generally represent only a single component of a larger financial portfolio . . . These are households that generally own their own homes as well as other types of financial assets such as job-based defined-contribution plans, stocks, and mutual funds." The Department of Labor then states that is "unlikely that the financial services industry will walk away from the billions of dollars held in small IRAs."

Using data from the Federal Reserve Board's 2013 Survey of Consumer Finances, which the Department of Labor cites, we tested the Department's implied conclusion that most owners of small IRAs could obtain financial advice by combining their IRA balances with other parts of "a larger financial portfolio" to meet fee-based advisers' minimum account balances. We find that among households with IRAs, 64 percent have total household IRA balances (combining traditional and Roth IRAs) of less than $100,000 (see figure below). Even after including taxable investable assets that IRA investors could bring to a financial adviser, half of IRA-owning households would not have sufficient assets to meet the typical $100,000 minimum account balance required by fee-based advisers. This finding is not surprising because, except among the very wealthiest households, net worth is largely composed of home equity and job-based retirement assets, neither of which is an investable asset for the purposes of engaging a fee-based adviser. We still conclude that significant numbers of investors will lose access to guidance, products, and services that they currently receive from brokers and will suffer significant harm if the problems with the proposed fiduciary rule are not addressed.

Household Holdings of IRAs and Taxable Investable Assets by Amount of Assets

Percentage of IRA-owning households, 2013



Note: IRAs include traditional and Roth IRA assets held by the household. Components do not add to 100 percent because of rounding.

Source: Investment Company Institute tabulation of Federal Reserve Board 2013 Survey of Consumer Finances

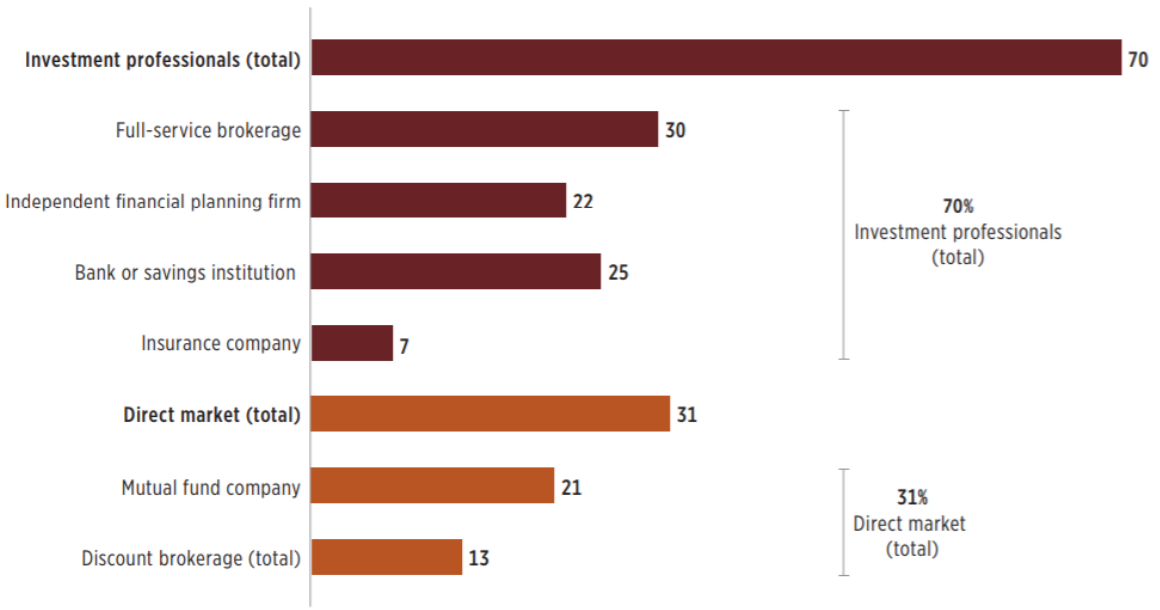
4. Background Information on IRA Investors: ICI Annual IRA Owners Survey

Nearly 43 million US households own IRAs, the most common being traditional IRAs (see *ICI Research Perspective*, "The Role of IRAs in US Households' Saving for Retirement, 2018"). Traditional IRA–owning households hold their IRAs at a variety of financial services firms ranging from full-service brokers to independent financial planners to discount brokers to directly with mutual fund companies (see Figure 19, below).

FIGURE 19

Traditional IRAs Are Held Through a Variety of Financial Institutions

Percentage of households owning traditional IRAs, 2018



Note: Multiple responses are included.

Source: Investment Company Institute IRA Owners Survey