MORNINGSTAR®

22 West Washington Street
Chicago
Illinois 60602

Telephone: +1 312 696-6000
Facsimile: +1 312 696-6001

August 3, 2017

Office of Exemption Determinations, EBSA, (Attention: D-11933)
U.S. Department of Labor
200 Constitution Ave. NW, Suite 400
Washington DC 20210

Re: RIN 1210-AB82:

Ladies and Gentlemen:

Morningstar, Inc. welcomes the opportunity to comment on the examination of the "Fiduciary Rule" and the questions posed by the department in the July 6, 2017, Request for Information. Morningstar, Inc.'s primary mission is to 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.

We have focused on the questions we are best positioned to answer based on our experiences helping people meet their retirement goals. In particular, we believe, based on our three decades analyzing mutual funds and explaining them to ordinary investors, that we have expertise on how to define new clean share classes if the department were to use them as part of a new streamlined exemption. Like the department, we also believe there is great promise for clean shares, but we caution that defining these share classes too broadly could undermine their effectiveness at helping investors attain access to unconflicted advice.

Are there market innovations that the department should be aware of beyond those discussed herein that should be considered in making changes to the rule?

As the department mentioned in the RFI, the regulated community has been developing new technology to help financial institutions satisfy the supervisory requirements of the rule. We believe technology and innovation can help with an extremely important part of the rule: ensuring that rollovers are in investors' best interests. Further, DOL could help to make these innovations even better. We believe that if the department were to create another streamlined exemption and compliance mechanism, it should still require a focus on ensuring rollovers are in retirement investors' best interests, particularly from a 401(k) or other Title I plan to an IRA. The department should be aware of innovations around documenting and analyzing rollovers as it conducts its review of the rule.

For example, we have developed a best-interests scorecard based on the impartial conduct standards to help firms evaluate whether a rollover is in an investor's best interests. We have focused on assessing investment quality, the fit of a portfolio to a client's needs, and the value

of an advisor's services to the client. We also believe it is important to consider additional factors such as the financial health of an investor and employer, withdrawal accessibility, beneficiary rights, and unique investments in both the employer's defined contribution plan and the IRA.

To ensure that a rollover from a 401(k) to an IRA is in the best interests of a retirement saver, we believe it is critical for an advisor to fully analyze the retiree's 401(k). It is insufficient to examine only the current asset allocation. Rather, the advisor needs to evaluate what the best possible asset allocation in a retirement plan would be and compare that with the client's current allocation within the plan and to the rollover proposal. The assessment should be based on investment quality, investment fees, fit to client, and value of services.

The key problem hindering these innovations is that defined contribution plan data can be difficult for advisors to retrieve. Yes, participants could find their 404(a)(5) plan lineup statements, and advisors could then manually enter this information. However, it would be far faster, cheaper, and more reliable if the data were simply available. To do so, the department could clarify that participants must be able to share their 404(a)(5) statements through their recordkeepers' platforms. Services such as Morningstar's ByAllAccounts and other data aggregators could then help advisors more reliably find these plan lineup disclosures as they work on their rollover solutions. Additionally, the proposal last summer to require sponsors to attach 404(a)(5) statements to their Form 5500 filings would also help by making all the plan lineup data public. However, that data could be dated given that the form is not due until 8.5 months after the end of the plan year and is frequently extended until 10 months after the plan year-end.

In sum, one of the most important new regulatory requirements for advisors is documenting the reasons that a rollover—typically from a 401(k) or other defined contribution plan—is in the best interests of a retirement saver. New innovations can make this process work well for advisors and their clients. However, the department could take additional steps to reduce the compliance burden as they make their assessments of whether a rollover would be in a participant's best interests by leveraging recent innovations.

Do the Rule and PTEs appropriately balance the interests of consumers in receiving broad-based investment advice while protecting them from conflicts of interest? Do they effectively allow advisors to provide a wide range of products that can meet each investor's particular needs?

As we noted in our April 13 comment letter, 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, although this could change if the department adds an additional streamlined 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 lower-quality investments simply because the advisor will receive a larger commission. Fee-based arrangements also improve transparency compared with 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 percentage of their assets for advice.

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 that active mutual fund managers charge. 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 who are working in the best interests of their clients.

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.

In comments to the department, some have argued that advisors may find providing advice to investors with relatively small balances difficult under the rule. We anticipate that the delivery of advice for this segment will change and that technological innovations in the digital advice sector will fill any gap, so these investors will not be abandoned or de-emphasized. 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.

To what extent do the incremental costs of the additional exemption conditions exceed the associated benefits and what are those costs and benefits? Are there better alternative approaches? What are the additional costs and benefits associated with such alternative approaches?

Unfortunately, it is quite difficult to do a cost benefit analysis, but we think it is very likely that the existing rule produces broad benefits that are higher than the costs. Still, that does not mean that the rule could not be further improved to reduce costs to financial-services firms while providing benefits to retirement investors. For example, we proposed in our April 13 comment letter that 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.

Such an approach could help firms avoid the possible costs of litigation, which we estimated at $70 to $150 million, adding an additional 5%-10% in compliance costs above the department's estimates. (Our detailed analysis and assumptions are available in a February 2017 report.[1])

In terms of benefits to investors, we believe that the department's estimate of benefits of reducing conflicted advice is in the right ballpark. See our attached paper, *Early Evidence on the Department of Labor Conflict of Interest Rule: New Share Classes Should Reduce Conflicted Advice, Likely Improving Outcomes for Investors*.

What is the likely impact on advisors' and firms' compliance incentives if the department eliminated or substantially altered the contract requirement for IRAs? What should be changed? Does compliance with the impartial conduct standards need to be otherwise incentivized in the absence of the contract requirement and, if so, how?

We believe there needs to be some enforcement mechanism to ensure rollovers are in a client's best interests and to address cases where an advisor has financial incentive to recommend one product over another, even if they are not in the best interests of the client. We have also observed some confusion with the impartial conduct standards because they lack the kind of specificity we see in other parts of the rule, such as the warranties section. However, an expanded streamlined exemption could work for investors and financial-services firms if it ensured that those using the streamlined exemption do not have incentives that lead them to potentially give conflicted advice to clients.

[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.

What is the likely impact on advisors' and firms' compliance incentives if the department eliminated or substantially altered the warranty requirements? What should be changed? Does compliance with the impartial conduct standards need to be otherwise incentivized in the absence of the warranty requirement and, if so, how?

The warranty requirements are the reason that firms have started to explore clean and T shares, so we believe eliminating them would be a mistake. However, that does not necessarily preclude creating an additional streamlined exemptive class. The "carrot" would then be the new streamlined exemption, while the "stick" would be the full Best Interest Contract Exemption, which includes the full warranties.

Would mutual fund clean shares allow distributing Financial Institutions to develop policies and procedures that avoid compensation incentives to recommend one mutual fund over another? If not, why? Do commenters anticipate that some mutual fund providers will proceed with T-share offerings instead of, or in addition to, clean shares? If so, why?

Clean shares and T shares could absolutely play a role in reducing conflicts of interest. The key for the department is ensuring that clean shares are properly defined so that they do not permit any inducements from asset managers to advisors or distributors to offer one product over another.

Morningstar believes clean share classes should create a level playing field for asset managers, so that advisors evaluate a fund on its investment quality, its role in an investor's portfolio, and its fit to the goals of the investor. Consequently, we view any part of the expense structure of a security that would cause an advisor to recommend that investment over a comparable one as precluding clean status. Accordingly, in viewing the expense structure of a clean share, we would expect to see no inducements that would make the choice of that investment more lucrative to the advisor or advisory firm than another investment, whether offered by the same asset manager or another, in the same investment style or not, and to the same investor, or not. Conversely, the presence of any such inducements disqualifies a fund from clean status.

Specifically, we believe that prohibited fees should include:

1. Distribution fees,
2. Advice fees,
3. External sales charges, whether waived or not, and
4. Any payment that varies by how the fund is distributed (where purchased); amount invested (breakpoints, letters of intent or rights of accumulation, and so on); or who purchases the fund (eligibility)

We also believe that clean shares should not include indirect payments of any kind to fund distributors, including third-party payments, revenue-sharing arrangements, platform fees, or finder's fee. Further, we believe the department should not permit sub-transfer-agent fees when

defining clean shares. Morningstar's view is that all payments for services provided either by the distributor or to the end investor should be external to the expense structure of a clean share class so as not to create an inducement for a distributor to recommend one fund over another.

Nonetheless, we believe that with clean shares, fees for administration, advice, and so on, can and should be charged in conjunction with the purchase, holding, or sale of clean share classes, but these expenses must be wholly external to the share class—that is, not embedded in the net (or gross) expense ratio. An exception would be fund-level administrative expenses that do not vary across a fund's share classes and are not paid to a distributor, such as fees for board services, which should not create an inducement.

Using this definition of clean share, we believe the department could construct a new exemptive class that serves investors and reduces compliance costs for financial-services firms. The key is ensuring that the clean shares really do eliminate the risks of conflicted advice.

As for T shares, there are more than 100 active T shares as of this letter's writing and more than 800 that have been registered but have no inception data. We believe that T shares will likely be transitional. Clean shares require a good deal of work to roll out, as the department is aware, while T shares do not require as much adjustment and are a step toward the level compensation we expect to see with clean shares, without removing external sales charges.

How would advisors be compensated for selling fee-based annuities? Would all of the compensation come directly from the customer or would there also be payments from the insurance company? What regulatory filings are necessary for such annuities? Would payments vary depending on the characteristics of the annuity? How long is it anticipated to take for an insurance company to develop and offer a fee-based annuity? How would payments be structured? Would fee-based annuities differ from commission-based annuities in any way other than the compensation structure? How would the fees charged on these products compare to the fees charged on existing annuity products? Are there any other recent developments in the design, marketing, or distribution of annuities that could facilitate compliance with the impartial conduct standards?

There are already 88 fee-based annuities from 25 carriers, including 13 newly issued fee-based annuities, and more could be developed soon depending on the final shape of the fiduciary rule. Advisors selling fee-based annuities work with their clients to determine the fee that they will charge the investor and collect the fee directly from the client. Generally, the fee is a set percentage of the value of the assets and the assets can include the annuity and other investments. Although fee-based annuities eliminate compensation from the insurance company for a given sale, carriers would still pay technology and platform fees to dealers. The conflicts of interest would be elevated from the advisor level to the firm level. Further, the logic of an ongoing fee for a product that is designed to be held until death, has fairly narrow investment options, and usually has an implied put option makes much less sense than an

ongoing advice fee for a portfolio of mutual funds or other investments that must be rebalanced regularly.

In terms of the structure of payments in fee-based annuities, fees paid to the advisor would be handled between the advisor and the investor and could be structured in any number of ways. For variable annuities, we believe the base contract will remain more or less unchanged with the same subaccount options and optional benefits (living and death). The main difference would be the contract fees, for the commission-based version would have higher fees collected by the insurer to allow for the advisor to collect the applicable commission. With the fee-based contract, the fees would be lower in the contract, as the insurer is not responsible for providing compensation to the advisor.

For fixed indexed and fixed annuities, there will be additional challenges moving to a fee-based structure. Currently, these types of annuities do not collect a specific fee that is used to compensate the advisor. Instead, the insurer creates interest rates and index crediting options that are provided at a level of profit that allows the insurer to pay the compensation to the advisor. Actuaries develop these prices, and there is little to no transparency on how the rates and crediting options are priced. For example, consider a simple fixed annuity that provides a guaranteed fixed rate for five years at 3% interest. With a traditional fixed annuity, there might be a commission of 2% paid to the advisor. This commission means the insurer must be able to invest the dollars from the investor in a way that they are able to earn more than what is being paid out to the investor and what is being paid to the advisor (and have some profit left for the insurer). However, if an insurer moves to a fee-based contract, there are fewer fees that are paid by the insurer, thus resulting in higher rates for the investor, but the advisor would need compensation directly as part of the sale. In sum, a shift to fee-based annuities means that the fees charged by the insurer will go down, but the investor will pay advisory fees, and it is unclear what the net change will be for the investor.

Another development the department should understand is that dealers are using a level commission payout on the typical commission-based annuities so that there is no favoritism based on compensation. However, there are still conflicts at the firm level, as a dealer still has an incentive to push advisors to recommend annuities with higher commissions.

Clean shares, T-shares, and fee-based annuities are all examples of market innovations that may mitigate or even eliminate some kinds of potential advisory conflicts otherwise associated with recommendations of affected financial products. These innovations might also increase transparency of advisory and other fees to retirement investors. Are there other innovations that hold similar potential to mitigate conflicts and increase transparency for consumers? Do these or other innovations create an opportunity for a more streamlined exemption? To what extent would the innovations address the same conflicts of interest as the department's original rulemaking?

As we noted in our April 13 comment letter, 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-interests 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-interests 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.

If the Securities and Exchange Commission or other regulators were to adopt updated standards of conduct applicable to the provision of investment advice to retail investors, could a streamlined exemption or other change be developed for advisors that comply with or are subject to those standards? To what extent does the existing regulatory regime for IRAs by the Securities and Exchange Commission, self-regulatory bodies (SROs) or other regulators provide consumer protections that could be incorporated into the department's exemptions or that could serve as a basis for additional relief from the prohibited transaction rules?

Potentially, such harmonization could work to protect investors and reduce compliance burdens. However, the department identified several problems in the preamble to the rule that it rightly addressed. First, there were many ways that advisors had misaligned incentives, which in turn can lead to advisors giving conflicted advice to clients. Second, the flow from 401(k) and other defined-contribution plans was not necessarily in retirement savers' best interests, and all those rollovers merited additional scrutiny. The details of the updated standards would be critical for assessing whether an additional streamlined exemption would protect investors.

Thank you again for the opportunity to comment and for taking the time to consider leveraging new innovations to improve the fiduciary rule. Again, we believe clean shares have great promise but the details on what qualifies as a clean share will make an enormous difference to how well retirement investors benefit from them.

Sincerely,

Aron Szapiro
Director of Policy Research
Morningstar, Inc

MORNINGSTAR®

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

Aron Szapiro,
Director of Policy Research

Paul Ellenbogen,
Head of Global Regulatory Solutions

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.

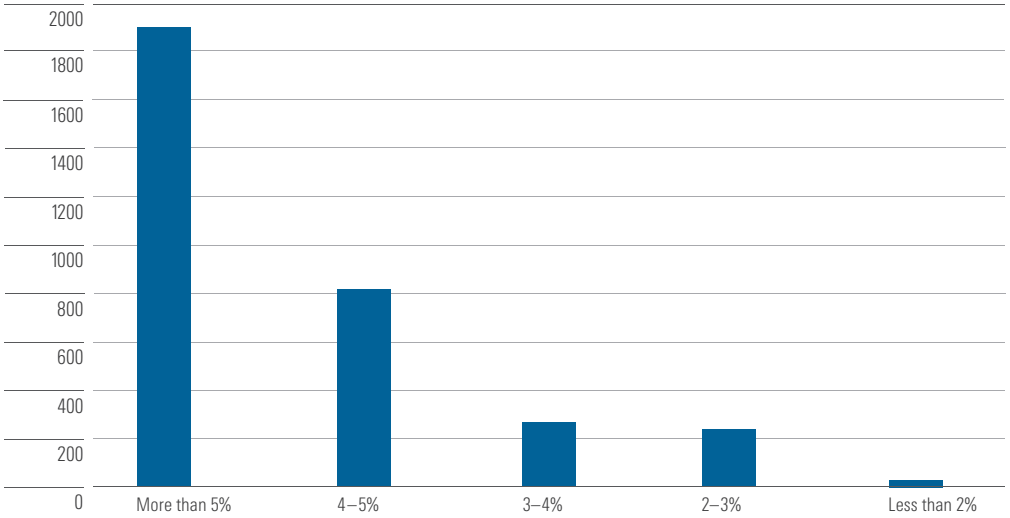
T Shares Reduce Conflicts of Interest in Commission-Based Sales, and Some Investors Will Likely Save on Fees

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.

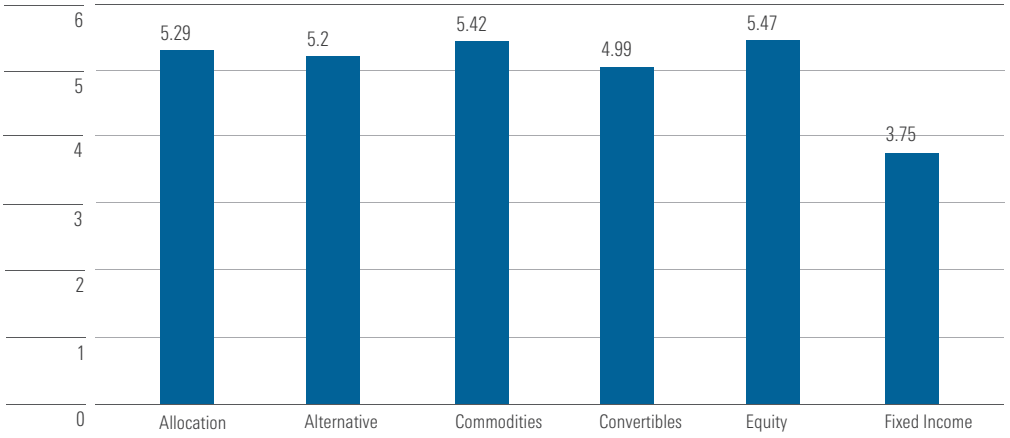
Furthermore, the loads in traditional A shares do not simply vary between funds, but they are systematically linked to asset classes, aligning incentives for advisors that might be at odds with appropriate asset-allocation recommendations. For example, average A share loads are about 1.72 percentage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

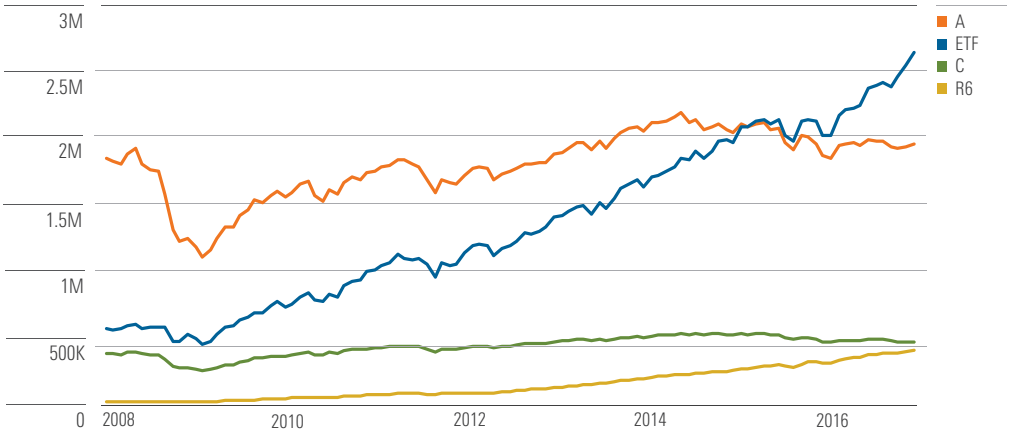
Exhibit 3: Differences in Fees Between A, T and Clean Share Classes

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.

Disclosures

The information, data, analyses and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages or other losses resulting from, or related to, the information, data, analyses or opinions or their use. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. Investment research is produced and issued by subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with and governed by the U.S. Securities and Exchange Commission. Past performance is not indicative and not a guarantee of future results.

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.

Morningstar Analyst Rating™

The Morningstar Analyst Rating™ is not a credit or risk rating. It is a subjective evaluation performed by Morningstar's manager research group, which consists of various Morningstar, Inc. subsidiaries ("Manager Research Group"). In the United States, that subsidiary is Morningstar Research Services LLC, which is registered with and governed by the U.S. Securities and Exchange Commission. The Manager Research Group evaluates funds based on five key pillars, which are process, performance, people, parent, and price. The Manager Research Group uses this five pillar evaluation to determine how they believe funds are likely to perform relative to a benchmark, or in the case of exchange-traded funds and index mutual funds, a relevant peer group, over the long term on a risk-adjusted basis. They consider quantitative and qualitative factors in their research, and the weight of each pillar may vary. The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. A Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's conviction in a fund's prospects for outperformance. Analyst Ratings ultimately reflect the Manager Research Group's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months. For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to global.morningstar.com/managerdisclosures/.

The Morningstar Analyst Rating (i) should not be used as the sole basis in evaluating a fund, (ii) involves unknown risks and uncertainties which may cause the Manager Research Group's expectations not to occur or to differ significantly from what they expected, and (iii) should not be considered an offer or solicitation to buy or sell the fund.