



## Consumer Federation of America

July 21, 2015

Office of Regulations and Interpretations  
Office of Exemption Determinations  
Employee Benefits Security Administration  
U.S. Department of Labor  
200 Constitution Avenue, N.W.  
Washington, D.C. 20210

Re: Conflict of Interest Rule, RIN 1210-AB32  
Proposed Best Interest Contract Exemption, ZRIN: 1210-ZA25  
Proposed Class Exemption for Principal Transactions in Certain Debt Securities  
between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs,  
ZRIN 1210-ZA25

Ladies and Gentlemen:

We are writing on behalf of the Consumer Federation of America (CFA)<sup>1</sup> to express our strong support for the package of rule changes and exemptions proposed by the Department of Labor (DOL) to strengthen protections for retirement savers. The rule proposal addresses a very real problem involving self-interested retirement investment advice, curbs industry practices that eat into Americans' retirement nest eggs, and does so in a way that should allow well-meaning financial professionals operating under a variety of business models to comply. While a few adjustments to the proposal can and should be made to clarify certain requirements and streamline or enhance others, this is a strong regulatory package that will help to ensure that all Americans who turn to financial professionals for advice about their retirement savings will receive advice that puts their interests first and promotes their ability to afford a secure and independent retirement. We urge you to move forward without further delay to finalize this vitally important rule.

### **I. Background**

#### **A. Loopholes in the Current Rule Expose Retirement Savers to Self-Interested Recommendations from Conflicted Advisers.**

The Employee Retirement Income Security Act (ERISA) defines as a fiduciary adviser anyone who “renders investment advice for a fee or other compensation, direct or indirect, with

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<sup>1</sup> The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

respect to any moneys or other property of such plan, or has any authority or responsibility to do so.”<sup>2</sup> When rules were adopted implementing ERISA, however, the DOL included a five-part test that must be met before an individual is deemed to be giving fiduciary investment advice. That five-part test had the effect of significantly narrowing the definition. Of particular concern are provisions requiring that the advice be given on a regular basis and subject to a mutual agreement between the adviser and the advice recipient that the advice serves as the primary basis for the investment decision.

As a result of this regulatory narrowing of the definition, many financial professionals who “render investment advice” to retirement plans and retirement savers “for a fee or other compensation” are not covered by ERISA’s fiduciary duty. In particular, broker-dealers, insurance agents, and other sales-based advisers have used these loopholes in order to preserve their ability to provide services to retirement savers without having to comply with their fiduciary obligation under ERISA to act “solely in the interests” of those retirement savers and “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” The result is that, precisely where the conflicts of interest are most intense and the risks to the retirement saver are greatest, the protections intended by Congress when it enacted ERISA do not apply.

*1. Changes in the retirement landscape since the rules were adopted amplify the risks to retirement savers.*

Such a restrictive application of the fiduciary standard may have seemed appropriate 40 years ago, when the rules under ERISA were enacted, but it is indefensible today. Three changes in particular have rendered it obsolete. The first is the growing reliance on defined contribution retirement accounts in place of traditional defined benefit pension plans. The second is the rise of rollovers out of retirement plans as a significant feature of the retirement saving landscape. The third is the growing complexity of financial products and financial markets. The combined effect of these changes is to render individuals increasingly responsible for making their own retirement investment decisions at a time when those decisions are increasingly difficult to make.

When ERISA was enacted, traditional defined benefit pension plans were far more common than they are today. Thus, the primary recipient of advice under ERISA at that time was likely to be a professional manager of a pension fund. But the retirement market has changed dramatically since then. The number of active participants in private-sector defined benefit plans declined from 27.2 million in 1975 to 15.7 million in 2012. Meanwhile, the number of active participants in private-sector defined contribution plans increased from 11.2 million in 1975 to 75.4 million in 2012.<sup>3</sup> As a result, recipients of advice under ERISA today are far more likely to be individual plan participants than they were when the rules were enacted.

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<sup>2</sup> This obligation is mirrored under the Internal Revenue Code (IRC) for those advising Individual Retirement Accounts (IRAs).

<sup>3</sup> U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin Historical Tables and Graphs (December 2014), <http://1.usa.gov/Rp8Bwu>.

With no particular financial expertise, these individuals nonetheless bear the full weight of responsibility for determining how best to save and invest for retirement, and they bear the full risks of those investments. It should come as no surprise that many turn to financial professionals for advice. But unlike professional pension fund managers, who at least in theory can be expected to understand the gaps in ERISA and the difference between a sales and an advisory relationship, individual retirement savers typically do *not* distinguish between true fiduciary advisers and those who are regulated as salespeople and take advantage of loopholes to escape ERISA coverage for their “advice.” Research has shown, for example, that investors typically cannot distinguish between broker-dealers and investment advisers and that many investors are unable to tell whether their own financial professional is a broker or an adviser even after the differences have been explained to them.<sup>4</sup> Additional survey research has found that retirement plan participants, like investors generally, do not understand the differences in legal obligations among various types of financial professionals and expect all financial advisers to act in their best interest.<sup>5</sup>

Even as the move toward defined contribution retirement plans accelerated in recent years, a hugely profitable new business opportunity emerged, consisting of moving money out of those plans and into Individual Retirement Accounts (IRAs). The opportunity arises when workers change jobs, something the typical worker is expected to do many times over their careers. At that point, a worker who has been saving for retirement through a workplace retirement plan must decide whether to leave their money in their existing plan, move it to their new employer’s plan (assuming that is in option), roll it over into an Individual Retirement Account (IRA), or cash out, which can trigger penalties and tax consequences. The current system poses significant challenges for workers who wish to transfer funds between 401(k) accounts, according to an analysis by the Government Accountability Office (GAO).<sup>6</sup> Workers may find it difficult to assess which option would be best for them. Meanwhile, “waiting periods to roll into a new employer plan, complex verification procedures to ensure savings are tax-qualified, wide divergences in plans’ paperwork, and inefficient practices for processing” transfers between employer plans all add to the complexity of the process.<sup>7</sup>

If the individual looks to a financial professional for advice, chances are high that the adviser will recommend a rollover, offer to take care of the paperwork for the transfer, and possibly even offer to pay a cash bonus for opening the account. Financial firms that don’t manage the 401(k) are eager to capture those assets. After all, even middle income workers who save diligently through a 401(k) plan can manage to amass enough of a nest egg to make them attractive targets for financial firms. Even the firm that operates the employee’s current 401(k) plan may have an incentive to roll them out of that plan and into an IRA if, as is often the case,

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<sup>4</sup> Hung, Angela A., Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi and Farrukh Suvankulov. *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*. Santa Monica, CA: RAND Corporation, 2008, <http://bit.ly/1OrrZ3v>. While this research was conducted in the context of securities laws, it is directly relevant to the issues raised in the DOL rulemaking.

<sup>5</sup> Brown, S. Kathi, *Fiduciary Duty and Investment Advice: Attitudes of 401(k) and 403(b) Participants*, AARP Research, September 2013, <http://bit.ly/1HO5d5f>.

<sup>6</sup> 401(K) PLANS: Labor and IRS Could Improve the Rollover Process for Participants, GOVERNMENT ACCOUNTABILITY, OFFICE, March 7, 2013, <http://1.usa.gov/1iQFeOR>.

<sup>7</sup> *Id.*

they stand to earn more income from those assets when they are invested outside the workplace plan.

An IRA rollover may at times serve the interests of the worker. This is most likely to be the case when the worker's money is in a workplace plan with a mediocre selection of investment options and the worker is considering rolling over into an IRA at a firm with a strong selection of high-quality, low-cost investment options. More often, however, the opposite is likely to be the case. Investment fees are typically lowest inside 401(k) plans, where investment options are chosen by a plan fiduciary and the plan must be operated exclusively for the benefit of participants. No such protections apply in the IRA market.

Despite the often questionable benefits for retirement savers, rollovers today are responsible for moving trillions of dollars out of ERISA plans and into IRAs. Of the 36 million households that owned traditional IRAs as of May 2013, 49 percent (or nearly 18 million U.S. households) reported that their IRA accounts included rollover assets from another retirement plan.<sup>8</sup> Among traditional IRA-owning households with rollovers, 34 percent had undertaken a rollover since 2010.<sup>9</sup> When workers perform a rollover, they often transfer their entire workplace account balance, which can be a sizeable sum. According to the ICI, 85 percent of households undertaking a rollover since 2010 transferred their entire retirement plan balances into traditional IRAs.<sup>10</sup> Moreover, 87 percent of new traditional IRAs in 2012 were opened exclusively with rollovers.<sup>11</sup> And thirteen times as much money was rolled over into IRAs as was directly contributed to IRAs in 2011, according to the Employee Benefits Research Institute.<sup>12</sup> Boston-based research firm Cerulli Associates estimates that workers rolled over nearly \$358 billion from 401(k)s into IRAs in 2013 and that between 2014 and 2018, another \$2.1 trillion will follow.<sup>13</sup>

According to the ICI's mid-2014 data, the source of information retirement savers most commonly turned to in making their rollover decision was a professional financial adviser. Advisers were consulted by 61 percent of traditional IRA-owning households that conducted rollovers, with half indicating they primarily relied on a financial professional.<sup>14</sup>

Financial advisers are able to make rollover recommendations based on their own interests, rather than their customers' interests, because the DOL has taken the position that the recommendations are generally not fiduciary investment advice under ERISA.<sup>15</sup> Among other things, they are typically excluded because they constitute one-time advice, albeit the single most important investment decision many workers will make. The 2013 GAO report provides

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<sup>8</sup> Investment Company Institute, 2014 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, at 139-140, <http://bit.ly/1fFwsEk>.

<sup>9</sup> *Id.* at 140.

<sup>10</sup> *Id.*

<sup>11</sup> Investment Company Institute, 2015 Investment Company Fact Book, A Review of Trends and Activities in the U.S. Investment Company Industry, at 153, <http://bit.ly/1JfuHVf>.

<sup>12</sup> Mark Shoeff Jr., *Navigating 401(k) rollovers*, INVESTMENT NEWS, Mar 2, 2014, <http://bit.ly/1j0F3LI>.

<sup>13</sup> Jason Zweig, *Who's Training Your Retirement Navigator?*, THE WALL STREET JOURNAL, February 14, 2014, <http://on.wsj.com/1hLJxKJ>.

<sup>14</sup> *Id.* at 154-55.

<sup>15</sup> DOL Advisory Opinion 2005-23A, <http://1.usa.gov/1JO1ggT>.

alarming evidence of the tactics that financial services firms engage in through the IRA rollover process to secure workers' assets.<sup>16</sup> For example, financial firms aggressively encouraged rolling 401(k) plan savings into an IRA, and did so with only minimal knowledge of a caller's financial situation. They also often claim that 401(k) plans had extra fees and that IRAs "were free or had no fees," or argued that IRAs were always less expensive, notwithstanding that the opposite is generally true. The report also found that investment firms sometimes offer financial or other incentives to financial advisers who persuade workers to perform a rollover. While some of these practices and the abuses that naturally flow from them could be addressed through better enforcement of existing standards, others are precisely the types of abuses best addressed through application of the ERISA fiduciary standard to rollover transactions.

Both the shift of responsibility for retirement saving onto workers and the trend toward rolling money out of retirement plans into less regulated IRAs have occurred in tandem with a dramatic increase in the complexity of financial markets and financial instruments. Retirement savers today face a dizzying array of investments ranging from the plain vanilla to the exotic. Their options include not only thousands of different mutual funds, but also a wide variety of fixed, variable and equity-indexed annuities, ETFs, REITs, auction rate securities, and more. Many of these products can have highly complex features and cost structures. Evidence suggests that very few retirement savers have the financial expertise necessary to independently assess the available options and determine which are best for them.

2. *Many retirement savers lack basic financial literacy skills, prompting them to seek out financial help and making them vulnerable to bad advice when they receive it.*

Extensive research has documented the disturbingly low financial literacy levels among Americans. It has been shown, for example, that many adults "do not possess basic knowledge of interest rates, inflation or risk, all of which are essential to making well-informed investment decisions."<sup>17</sup> Indeed, as researchers working in this area have pointed out, successful investing requires financial knowledge beyond the basic financial concepts generally tested for in financial literacy surveys. It also requires, for example, an understanding of such topics as "the relationship between risk and return; how bonds, stocks, and mutual funds work; and asset pricing."<sup>18</sup> Unfortunately, the data here is even less encouraging.

Results of the Financial Capability Survey illustrate the problem.<sup>19</sup> To evaluate financial knowledge, the survey included "a battery of questions covering fundamental concepts of economics and finance expressed in everyday life, such as calculations involving interest rates

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<sup>16</sup> 401(K) PLANS: Labor and IRS Could Improve the Rollover Process for Participants, GOVERNMENT ACCOUNTABILITY, OFFICE, March 7, 2013, <http://1.usa.gov/1iQFeOR>.

<sup>17</sup> Chater, Nick; Huck, Steffen; Inderst, Roman; and Goethe, Johann Wolfgang, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, November 2010. (Coordinated by Decision Technology Ltd with participation by Online Interactive Research Ltd.), <http://bit.ly/1RJi4f5>.

<sup>18</sup> Lusardi, Annamaria and van Rooij, Maarten, *Financial Literacy: Evidence and Implications for Consumer Education*, November 2009, <http://bit.ly/1MCYwT2>.

<sup>19</sup> FINRA Investor Education Foundation, *Financial Capability in the United States, National Survey—Executive Summary*, December 2009, <http://bit.ly/1JbtPFz>. See also, Lusardi, Annamaria and Mitchell, Olivia S., *How Ordinary Consumers Make Complex Economic Decisions: Financial Literacy and Retirement Readiness*, September 2009, <http://www.nber.org/papers/w15350>; and Lusardi, Annamaria and van Rooij, Maarten, *Financial Literacy: Evidence and Implications for Consumer Education*, November 2009, <http://bit.ly/1MCYwT2>.



and inflation, principles relating to risk and diversification, the relationship between bond prices and interest rates and the impact that a shorter term can have on total interest payments over the life of a mortgage.” Results ranged from a low of 21 percent correct on a question about bond prices to 70 percent correct on a question about mortgages, but “fewer than half of respondents (46 percent) correctly answered both a question about interest rates and a question about inflation. Less than one-third (30 percent) correctly answered those questions plus a question about risk and diversification correctly. And fewer than 10 percent of respondents were able to answer all questions correctly.” Moreover, evidence suggests that people overrate their financial knowledge. On the Financial Capability Survey, for example, “most respondents gave themselves high scores.”

As the recent financial crisis clearly demonstrated, even some of the most sophisticated institutional investors (pension fund managers among them) lack the financial acumen necessary to accurately assess the risks of the complex and exotic investments available in the market today. Further, as evidence from the Senate’s Permanent Subcommittee on Oversight and Investigations made clear, more than a few of these institutional investors proved ill-equipped to defend themselves against aggressive sales practices that often come at their expense.<sup>20</sup> If even sophisticated pension managers are unable to protect themselves from unscrupulous sales tactics, it stands to reason that ordinary investors don’t stand a chance without the protections afforded by a fiduciary duty. This is particularly true in light of the heavy reliance that retail investors typically place on the recommendations they get from financial advisers.

Unlike professional fund managers who can reasonably be expected to exert independent investment judgment, individual investors are heavily dependent on the recommendations they receive from financial professionals. A 2006 CFA survey found, for example, that among mutual fund investors who purchased most of their funds from a financial services professional, nearly three in ten said they relied totally on that professional’s recommendation without doing any independent evaluation of the fund.<sup>21</sup> Another 36 percent said they relied a great deal on the professional’s recommendation but reviewed some written material about the fund before the purchase.<sup>22</sup> According to the survey, women were significantly more likely than men both to value one-on-one expert advice and to act on that advice without doing any additional research.<sup>23</sup> The CFA survey is consistent with other research, including the financial literacy study conducted by Securities and Exchange Commission (SEC),<sup>24</sup> which has found that investors are heavily reliant on their financial adviser both to explain the disclosures they receive and to recommend a course of action.<sup>25</sup>

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<sup>20</sup> Majority and Minority Staff Report, Permanent Subcommittee on Investigations, U.S. Senate, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, April 2011, <http://1.usa.gov/1RJM4HT>.

<sup>21</sup> Roper, Barbara and Brobeck, Stephen, “Mutual Fund Purchase Practices, An Analysis of Survey Results,” June 2006, <http://bit.ly/1IicqGD>.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors* (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), August 2012. See also, Siegel & Gale, LLC, *Investor Research Report*, Submitted to the Securities and Exchange Commission on July 26, 2012, <http://1.usa.gov/1MfBbss>.

<sup>25</sup> See, e.g., IFF Research Ltd, *Investment Disclosure Research*, prepared for the Financial Services Authority by IFF Research Ltd. (November 2006), <http://bit.ly/1LmSJ6Z>.

Despite the extensive evidence that retirement savers are heavily reliant on the financial professionals they turn to for advice, these individuals may nonetheless find it difficult to prove that a particular recommendation they received from a financial professional was the primary basis for the investment decision they made. It is likely to be even more difficult to prove that there was a mutually understood arrangement between the parties to this effect. Unless there is a written contract between the parties memorializing such an agreement, it is likely to be extremely difficult to prove that any such mutual understanding exists. Moreover, financial professionals may protect against that eventuality by providing disclaimers that their recommendations do not constitute investment advice and that the investor is responsible for making the ultimate investment decision. Alternatively, they may claim that the advice is one-time advice and thus not subject to a fiduciary standard.

These loopholes in the rule's definition of fiduciary investment advice are most likely to be relied on by broker-dealers and insurance agents whose compensation and business practices are most at odds with ERISA's requirement that advice be rendered solely in the interests of the investor. While no one can be considered completely free from conflicts, the sales culture within broker-dealer and insurance firms can be intense. For example, although firms often call their sales reps financial advisors, they typically pay them based not on how well they do for their clients, but on how successful they are in selling investments. Not only do these "advisors" only get paid if their customer executes a transaction, but they will often get paid significantly more to recommend certain investment products over others. In addition, financial firms may set quotas to promote the sale of certain products, base bonuses, payouts or promotions on the adviser's success in meeting those quotas, or otherwise reward advisers for successful sales conduct without regard to its impact on customer well-being.

In light of these intense pressures to sell, the surprise isn't that some sales-based advisers make recommendations that serve their own and the firm's interests rather than the best interests of their customers, but that some do not. As a 2013 Financial Industry Regulatory Authority (FINRA) study of broker-dealer conflicts noted, "While the existence of a conflict does not, *per se*, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly."<sup>26</sup> ERISA was designed to protect retirement savers from the bad advice that can result from these sorts of conflicts, eroding the nest eggs retirees must rely on for income throughout their retirement years. Loopholes in the definition of investment advice have rendered it ineffective in providing that protection.

To sum up, the restrictions on the definition of investment advice under ERISA's rules are at direct odds with retirement savers' behavior, needs, and reasonable expectations. These individuals' lack of financial sophistication, their heavy reliance on financial professionals, and their belief that those professionals will act in their best interest all cry out for the protections of a fiduciary standard. But the five-part test in the rule makes it all too easy for sales-based financial professionals whose businesses are replete with conflicts to evade that standard. Moreover, the DOL's current policy with regard to rollover recommendations means that the single most important investment decision many retirees will ever make, a decision that could dramatically affect their ability to afford a secure and independent retirement, is not subject to

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<sup>26</sup> Financial Industry Regulatory Authority, *Report on Conflicts of Interest*, October 2013, <http://bit.ly/1BgWkQm>.

fiduciary protection. The cumulative effect of these policies is that retirement savers are denied fiduciary protections when they need them most, when the risks are greatest, and when the financial adviser's conflicts of interest are most intense. This is a situation that demands reform.

B. Existing Regulations Do Not Adequately Protect Retirement Savers from the Harmful Impact of Conflicted Advice.

Some have suggested that existing regulations adequately protect retirement savers and that the DOL rulemaking is therefore neither needed nor warranted. In making this argument, they note that broker-dealers are already "heavily" regulated under state and federal securities laws, as well as by FINRA, while insurance agents are already regulated under state insurance laws. They suggest that the current "suitability" standard for broker-dealers already incorporates a best interest obligation that is adequate to ensure that investors' interests are protected. And finally, they point to recent statements from the SEC and FINRA indicating that they will be increasing their scrutiny of practices around rollover recommendations. While increased scrutiny is welcome, it is simply not the case that existing regulations can adequately address abuses, substitute for a strong DOL rule, or justify denying retirement savers the protections Congress intended when it enacted ERISA.

*1. Brokers and insurance agents are regulated as salespeople, not advisers.*

Despite the fancy titles they adopt, broker-dealer registered representatives and insurance agents are salespeople, and they are regulated accordingly. Broker-dealers are regulated under the Securities Exchange Act of 1934, state securities laws, and the rules of FINRA. Their recommendations to customers are covered both by state unfair and deceptive practices standards and FINRA rules requiring them to "deal fairly" with customers. It is as part of their obligation to deal fairly with customers that brokers are required to make only suitable recommendations. Suitability starts with a "know your customer" rule that requires the broker to use "reasonable diligence" to ascertain the "essential facts" about a customer in order to effectively service the account and comply with all laws, rules, and regulations. The standard is triggered when the broker makes a recommendation about a security or a strategy related to investing in securities.

The suitability standard for retail investors is seen as having three distinct parts.<sup>27</sup> The broker must understand the risks and key features of the investment being recommended and must have a reasonable basis for believing it is appropriate for at least some customers. The broker must also have a reasonable basis for believing the investment is suitable for the particular customer to whom it is being recommended based on that customer's investment profile. And, in circumstances where the broker has control of a customer account, it is not enough for an individual transaction to be deemed suitable when viewed in isolation. The broker must also evaluate a series of transactions to ensure that they are not excessive or unsuitable when taken together.

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<sup>27</sup> Recommendations to institutional investors are treated differently. While the first and third parts of the suitability standard outlined here would apply, the broker would not be required to determine whether a recommendation is appropriate for that institution if the institution is seen as capable of independently assessing the suitability of the recommendation.



Insurance agents, regulated under state insurance laws, are subject to a suitability standard when selling fixed annuities that is modeled on, but somewhat weaker than, the FINRA standard for broker-dealers.<sup>28</sup> Among the most significant differences is the lack of a private right of action for violations of the regulation under the insurance suitability standard.<sup>29</sup> As a result, regulatory action offers the only recourse for victims of unsuitable recommendations. In addition, state regulation puts the primary responsibility for determining suitability on the insurer and the insurance producer, who would logically be expected to be highly motivated to approve the transaction. Moreover, the insurance salesperson is an agent of the insurance company and, as such, owes his or her first duty of loyalty to that company, rather than to the customer. And courts have found that insurance agents are not generally required to provide advice in the best interests of their customers.<sup>30</sup>

Just as loopholes in the ERISA rules defining fiduciary investment advice enable brokers to operate outside its strictures with regard to retirement accounts, gaps in securities laws have allowed broker-dealers to offer extensive investment advice in securities accounts without being regulated as fiduciary advisers. This results not from gaps in the statutes themselves, but from the SEC's lax interpretation of the application of Investment Advisers Act of 1940 to brokers' advisory activities. Brokers' exclusion from the Advisers Act turns on whether they receive "special compensation" for investment advice and whether they give advice that goes beyond that which is "solely incidental to" their brokerage activities. As interpreted and enforced by the SEC, however, this solely incidental to exclusion has given brokers free rein to call themselves financial advisers, offer services they describe as investment and retirement planning, and market themselves as if offering investment advice were their primary function.

## 2. *Suitability is a weaker standard than fiduciary duty.*

Clearly, the suitability standard offers protections that go beyond the *caveat emptor* of an unregulated market. However, it is generally agreed, including by those responsible for implementing the rules, that the protections afforded investors under a suitability standard fall short of those offered by the full fiduciary standard appropriately imposed on investment advice.<sup>31</sup> Key differences relate both to the management of conflicts under the two different standards and to the difference between a suitable recommendation and one that is in the best interest of the customer.

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<sup>28</sup> Variable annuities are regulated as securities and insurance, while fixed annuities are regulated exclusively as insurance.

<sup>29</sup> See National Association of Insurance Commissioners, *Suitability in Annuity Transactions Model Rule*, Section I. B.

<sup>30</sup> In *Sewell v. Great N. Ins. Co.*, 535 F.3d 1166, 1171 (10<sup>th</sup> Cir. 2008), the Tenth Circuit held that "absent a special relationship between the insured and the insurer's agent, that agent has no affirmative duty to advise or warn his or her customer of provisions contained in an insurance policy." In *Emerson Electric Co. v. Marsh & McClellan Co.*, 362 S.W.3d 7, 9 (Mo. 2012), the Supreme Court of Missouri held that "[w]hile a broker has a duty to act with reasonable care, skill and diligence in procuring insurance ... a broker has no duty to advise the insured about what insurance he needs or what insurance to buy unless it specifically undertakes to do so. This Court, therefore, rejects Emerson's claim that brokers have an additional duty to find insureds the lowest possible cost insurance available to meet their needs."

<sup>31</sup> Staff Study, U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers*, January 2011, <http://1.usa.gov/1VIB4zw>.

Management of Conflicts: While the fiduciary duty under the Advisers Act is not as stringent as ERISA with regard to management of conflicts, it does at least in theory require advisers to seek to avoid conflicts and appropriately manage those conflicts that are unavoidable. Neither brokers nor insurance agents are subject to a similar overarching obligation to avoid and manage conflicts, although brokers are subject to certain specific restrictions on conflicts such as limits on non-cash compensation. This difference between how suitability and fiduciary duty treat conflicts could be more significant than it is but for the SEC's weak approach to enforcement. Real management of conflicts ought to entail meaningful limitations on practices that can create incentives for advisers to profit at their customers' expense. Instead, the SEC generally appears to default to disclosure as adequate to manage conflicts, even where conflicts are clearly avoidable. The agency has adopted this approach even though there is no evidence that disclosure is effective in protecting investors from the harmful impact of those conflicts, the agency's own financial literacy study demonstrates that investors don't know how to make good use of the disclosures they receive, and some academic research suggests that investors actually experience worse outcomes under a disclosure-based approach to managing conflicts.

Best Interests Standard: Some industry opponents of the rule have argued that there's no need to close gaps in DOL's definition of fiduciary investment advice since FINRA's suitability standard already requires brokers to act in their customers' best interests when they recommend securities transactions or investment strategies to retail investors. Leaving aside the rather obvious point that FINRA rules only apply to securities, and thus by definition cannot substitute for a strong DOL rule, this argument simply does not hold water. Despite the similarity in terminology, there are significant differences between any best interest obligation implied by the suitability standard and a fiduciary duty to act in the best interests of the customer, "without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."<sup>32</sup>

That is not to suggest that there hasn't been progress in recent years to bring the suitability standard into closer alignment with the increasingly advisory role brokers have come to play. Evidence of that can be seen in FINRA's latest update of its standard, which applies the standard both to hold recommendations and to recommendations of investment strategies, not just recommendations of specific transactions.<sup>33</sup> In describing the standard, moreover, the release references case law indicating that a broker's recommendations "must be consistent with his customers' best interests" and notes that this "prohibits a broker from placing his or her interests ahead of the customer's interests."<sup>34</sup>

To support this statement, the release cites a number of cases where FINRA or the SEC has found brokers in violation of suitability because they put their interests ahead of customers', including "a broker whose motivation for recommending one product over another was to receive larger commissions." However, a closer look at the actual cases reveals that a best interest standard is only being cited as a secondary factor in cases that involve more fundamental violations of suitability or fraud. The fact that the broker in question put his interests ahead of the

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<sup>32</sup> This language is taken from Section 913 of the Dodd-Frank Act.

<sup>33</sup> FINRA, Regulatory Notice 11-02, Know Your Customer and Suitability, January 2011, <http://bit.ly/1LnB6DU>.

<sup>34</sup> *Id.*

interests of his customers helps to explain the motivation behind the misconduct, but it is not the primary basis for the regulatory action.

Several of the cases cited involve claims based on the inappropriate sale of B shares of mutual funds, where the B shares were more expensive than other share classes for the investor but paid higher compensation to the adviser. These arguably come closest to a “best interest” case, since they allege that the broker recommended an investment option that was more expensive for the customer because it paid him more. However, the suitability claim in these cases turns not on the fact that there were better, less costly investment options available that could have been recommended, but that the *same* investment option was available on terms that were more favorable to the investor. Moreover, the violations in each case went well beyond inappropriate sale of B shares.

The egregious nature of the violations is perhaps best illustrated by an SEC case, *In re Epstein*,<sup>35</sup> which is among those cited as imposing a “best interest” standard. The case involved a broker-dealer, Epstein, who was found to have recommended unsuitable transactions for the accounts of twelve customers, many of whom were elderly, retired, and financially unsophisticated, with a limited understanding of the applicable fee structures and other attributes of the funds that Epstein recommended. The suitability violations in the case involved mutual fund switching as well as the inappropriate sale of Class B shares of mutual funds. Specifically, Epstein was found to have frequently recommended that customers switch from less expensive mutual funds to ones with higher expense ratios, often triggering new Contingent Deferred Sales Charges (CDSC) that could have been avoided through recommendation of other share classes. In some instances, he deprived his clients of the lower expenses to which they would have been entitled had they maintained their investments and their mutual fund holdings had been allowed to mature into less expensive share classes, sometimes missing automatic conversion by a matter of weeks. He also disrupted existing holding periods (or ones that had already phased out) and restarted entirely new CDSC holding periods with higher expenses that would run for several years, including for elderly customers who might not survive the new holding period. In its review of Epstein’s disciplinary proceeding, the Commission stated that, “Epstein’s misconduct was egregious....[he] exploited his customers’ vulnerabilities in making recommendations that clearly were unsuitable for them.”

The other cases based on inappropriate sale of B shares also involve violations more egregious than a simple failure to act in the best interests of the customer. In the SEC case, *In re Sathianathan*,<sup>36</sup> for example, the broker-dealer Sathianathan was found liable not only for having recommended that his clients purchase Class B shares of mutual funds when they could have invested in lower-cost Class A shares, but also for recommending that a client, who was an inexperienced and conservative investor, purchase mutual funds and warrants on margin using a concentrated position in stock as collateral. In another case that the industry cites, *In re Belden*,<sup>37</sup> the broker-dealer Belden’s recommendation of B shares exposed the investor to tens of

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<sup>35</sup> *In re Scott Epstein*, Securities Exchange Act of 1934, Rel. No. 593428, January 30, 2009, <http://1.usa.gov/1CS3uLq>.

<sup>36</sup> *In re Raghavan Sathianathan*, Securities Exchange Act of 1934, Rel. No. 54722, November 8, 2006, <http://1.usa.gov/1JsJEbs>.

<sup>37</sup> *In re Wendell D. Belden*, Securities Exchange Act of 1934, Rel. No. 47859, May 14, 2003, <http://1.usa.gov/1CL9Lc5>.

thousands in excess charges on a \$2 million purchase. If the investor had purchased A shares, the investor's sales charges would have been waived because of the large size of the investment and the investor would have paid 0.75-0.80 percent less per year. Instead, the investor paid roughly \$52,000 in unnecessary commissions, then paid \$84,000 in contingent deferred sales charges to exchange the B shares for A shares. Despite the fact that several people he worked with said he should put the client into A shares, Belden ignored their recommendations. In his testimony, he acknowledged that his motivation for recommending B shares was the higher commissions they paid and said that he "couldn't stay in business" with lower commissions. In a taped conversation, he said, "I don't deal in A shares."

Three other cases cited to suggest that brokers are already subject to a best interest standard involve similarly egregious suitability violations. In one case, *In re Cody*,<sup>38</sup> the broker-dealer Cody recommended to several investors that they invest significant portions of their portfolios in the mezzanine tranche (eighth in seniority) of mortgage-backed securities. In a clear violation of his obligation under the suitability standard to determine whether the investment was suitable first for any investor and then for his specific customers, he made those recommendations without an understanding of how asset-backed securities are different from conventional fixed income securities, what fundamental factors affect their performance, the risks inherent in the securities, or whether the ABS were suitable for any investor, let alone the investors who sought his advice. Within months the products' credit ratings were downgraded and the investors lost 55 and 65 percent of their investments respectively. Cody's violations didn't stop there. For the next several years, Cody also engaged in a pattern of churning, generating over \$40,000 in commissions in one account and \$36,000 in the other, with roughly \$30,000 of that total going to Cody himself.

In the second case, *In re Daniel R. Howard*,<sup>39</sup> the broker-dealer Howard made unsuitable recommendations to an 85-year-old man who was in poor health, and whose primary need was additional income to pay for his increasing medical expenses. The elderly investor sought investments that carried minimum risk, but Howard put him in speculative "house stocks" in which the brokerage firm made a market. For seven of the ten months at issue, those speculative securities comprised 90 percent of the investor's portfolio. The average holding period for the securities in the investor's account was about 40 days and, on an annualized basis, the account was turned over about 8.5 times. All of these activities were found to be at odds with the investor's stated objectives. After the fact, the broker conceded that his recommendations may have been improper, stating: "[In a high pressure atmosphere like the one that existed at Meyers], you tend to . . . maybe cross over the line. And you tend to maybe make recommendations that, maybe in hindsight, even though you're tempted to blame other people, and you're tempted to say, well, the client agreed to it or the client authorized it, in the full context that doesn't justify it."

In the third case, *Dep't of Enforcement v. Bendetsen*,<sup>40</sup> the broker-dealer Bendetsen made unsuitable recommendations to a woman in her mid-80s who had approximately \$1 million in

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<sup>38</sup> *In re Richard G. Cody*, FINRA NACD, Complaint NO. 2005003188901, May 10, 2010, <http://bit.ly/1VkJOgog>.

<sup>39</sup> *In re Daniel R. Howard*, Securities Exchange Act of 1934, Rel. No. 46269, July 26, 2002, <http://1.usa.gov/1Ly1tWr>.

<sup>40</sup> *Dep't of Enforcement v. Bendetsen*, Complaint No. C01020025, August 16, 2004, <http://bit.ly/1ebly7u>.

assets and whose investment objectives were “conservation of capital with stable income” and “long term growth of capital -- income secondary.” Despite the fact the investor did not indicate that she was interested in engaging in speculative margin and options trading, did not sign a margin agreement, and was not eligible to engage in options trading under the firm’s policies, Bendetsen nonetheless engaged in a series of speculative short sales and option trades on her behalf. As a result of Bendetsen’s complicated trading strategies, the net worth of the account decreased from approximately \$1 million to approximately \$142,000. However, these substantial losses were not readily apparent on the investor’s statements because Bendetsen was creating and submitting false account statements showing a much better picture. The hearing panel reviewing his case found that Bendetsen’s misconduct was egregious and involved a number of aggravating factors, including highly speculative trading that exposed his elderly and vulnerable client to considerable risk, which resulted in substantial losses, and the fact that he attempted to conceal his client’s losses.

While we appreciate the suggestion that brokers should put the interests of their customers first, a reading of these cases simply does not support the contention that brokers are currently being held to a best interest standard by either the SEC or FINRA. Indeed, these cases make the opposite point, calling into question whether suitability is being enforced in a way that provides investor protections beyond a basic fraud standard. These do not appear to be isolated examples. According to *Broker-Dealer Law and Regulation*, written by two of America’s leading securities authorities, Norman S. Poser and James A. Fanto: “In many, if not most, suitability cases, the unsuitable recommendations are accompanied by other violations, including failures to supervise, churning, misrepresentations or omissions, and unauthorized trading.”<sup>41</sup>

Even financial industry participants have generally come to concede that suitability does not offer the investor protections of a fiduciary “best interest” standard. Thus, SIFMA has come forward with an alternative “best interest” standard that, while it falls well short of a true fiduciary standard, takes as its underlying assumption that brokers should be held to a best interest standard when making recommendations to retail investors.<sup>42</sup> In a recent speech, FINRA Chairman and CEO Richard Ketchum also voiced his support for a best interest standard. At the same time as he emphasized “the effectiveness and fundamental integrity of the present FINRA/SEC regulatory structure for broker-dealers,” Ketchum stated that “the clarity of a ‘best interest of the customer’ standard would be an important step forward in encouraging firm compliance cultures that translate to consistent actions to place the interests of the customer first.”<sup>43</sup> Although both Ketchum and SIFMA have stated their support for a best interest standard in the context of securities regulation, and have withheld that support in the context of DOL rulemaking, the fundamental point is relevant to the DOL rulemaking as well: the standards currently being applied to recommendations of brokers and insurance agents are not sufficient to constrain conflicts and protect investors from harmful industry practices.

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<sup>41</sup> Poser, Norman S. and Fanto, James A., “Broker-Dealer Law and Regulation,” Aspen Publishers, Fourth Edition, Section 19.01, describing results of the authors’ survey of FINRA arbitrations from May 2007 to February 2008.

<sup>42</sup> SIFMA, Proposed Best Interest of the Customer Standard for Broker-Dealers, June 2015, <http://bit.ly/1M56eog>.

<sup>43</sup> Richard G. Ketchum, Remarks From the 2015 FINRA Annual Conference, May 27, 2015, <http://bit.ly/1IdZWUo>.



### C. Retirement Savers Suffer Real Financial Harm as a Result of Practices that are Legal Under Existing Regulatory Standards.

When financial professionals place their own interests ahead of the interests of their customers, those customers suffer real financial harm. Even advice that complies with a suitability standard can impose significant, unjustified costs on retirement savers, costs that materially reduce their accumulated savings and threaten their ability to afford an independent and secure retirement. Putting even an approximate dollar amount on that harm is challenging, in part because the same financial firms who demand that regulations be justified based on evidence of harm refuse to provide the data that would permit a more complete analysis.<sup>44</sup> Despite these limitations, evidence of the harm suffered by investors, including retirement savers, under the existing regulatory standards is extensive. It takes a variety of forms, including academic studies, observations of industry practices, and basic market analysis.

Drawn primarily from academic research, the Regulatory Impact Analysis prepared by DOL as part of this rulemaking is based on several sound assumptions:

- That financial and other incentives embedded in the business models of broker-dealers and insurance agents affect the recommendations they make.
- That one such effect is a tendency among sales-based advisers to steer retirement savers into investment options with higher underlying costs and poorer performance than other available options.
- That, over the long term, these excess costs and subpar performance materially reduce retirement savers' accumulated savings and, as a result, the income available to them during their retirement years.

The Regulatory Impact Analysis draws heavily on a series of academic studies that show that conflicted advice tends to lead to eroded returns. Perhaps most telling is a 2009 study by Bergstresser, Chalmers, and Tufano which compared returns of mutual funds sold in the direct channel and the broker channel between 1996 and 2004. Without factoring in distribution costs (loads and 12b-1 fees), the authors found poorer performance for funds in the broker channel in three of four categories of funds examined -- domestic equity funds, bond funds, and money market funds. Only among foreign equity funds did broker channel funds outperform direct channel funds over the period analyzed, and the difference in that case was attributable to the performance within a single large mutual fund family. The authors estimated that investors suffered \$4.6 billion in reduced returns as a result, on top of paying \$9.8 billion a year in 12b-1 fees. They did not estimate the cost of sales loads paid to compensate brokers for their costly advice. Another study cited by DOL (Del Guercio and Reuter, 2014) found that broker-sold funds underperform direct-sold funds by an average of 1.15 percentage points per year after accounting for risk and other factors, which the authors attribute to misaligned incentives in the broker-sold market.

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<sup>44</sup> Mark Schoeff Jr., "Industry stiffes DOL on request for IRA data in fiduciary analysis," *Investment News*, March 4, 2012, <http://bit.ly/1gJX4nQ>.



Extrapolating from these and other academic studies, the DOL Regulatory Impact Analysis estimates that IRA investors who receive conflicted advice could lose out on \$210 billion in retirement savings over the next 10 years and nearly \$500 over the next 20 years just with regard to their mutual fund investments. DOL further estimates that an “ERISA plan investor who rolls her retirement savings into an IRA could lose 12 to 24 percent of the value of her savings over 30 years of retirement by accepting advice from a conflicted financial adviser.” While industry has taken issue with these estimates, we believe they likely significantly understate the scope of the problem. After all, the academic research on which they are based looks primarily at the portion of the retirement market where transparency is greatest, where regulation is most rigorous, and where the available data is most complete.

A recently released study prepared for the Ontario Securities Commission reaches a similar conclusion with regard to both the negative impact of conflicted advice and the need for regulatory action to resolve the problem.<sup>45</sup> Based on a review of existing research regarding mutual fund fees and compensation, the report finds that funds that pay commissions underperform funds that don’t pay commissions “whether looking at raw, risk-adjusted or after-fee returns.” It notes, moreover, that the problem is not related simply to commission-based compensation. “While there is no doubt that commissions engender biased advice,” the report states, “there is ample evidence that other types of compensation can lead to biased advice as well (e.g., faster promotion for advisors selling more proprietary products).” The report finds “conclusive evidence that commission-based compensation creates problems that must be addressed.”

*1. Basic market observation provides evidence of investor harm.*

Basic market observation leads to the same conclusion: that in many instances today investors are advised to purchase investments that are far inferior to other available options, and that this is done legally, in compliance with existing securities and insurance regulations. Examine the range of investment options that brokers and investment advisers might recommend to retail investors – i.e., a particular class of mutual funds or variable annuities – and the vast differences in the features of these investment products becomes readily apparent. Otherwise similar products may, for example, impose different fees on the investor, or achieve comparable investment results with significant differences in volatility, or provide different guarantees, or, in the case of variable annuities, offer the investor a greater or lesser degree of choice among underlying investment options that are of varying quality. Although all of the options within a particular category may be deemed suitable for a particular investor, these differences in features can profoundly impact costs, risks and overall performance. Investors are harmed when they are encouraged to pay excessive fees, receive substandard performance, or are exposed to unnecessary risks because a broker recommended an investment that, while suitable, was inferior to other available options.

Loopholes in the definition of fiduciary investment advice under both ERISA and securities laws leave investors vulnerable to this harm. The most readily observable evidence of such harm arises out of the significantly different costs imposed by otherwise similar

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<sup>45</sup> Weinstein, Edwin. *Mutual Fund Fee Research*, prepared for Ontario Securities Commission on behalf of Canadian Securities Administrators, The Brondesbury Group, Spring 2015, <http://bit.ly/1Sx83g4>.

investments. An adviser operating under a well enforced fiduciary standard must take costs into account when determining which investment is best for the customer.<sup>46</sup> A broker or insurance agent operating under a suitability standard generally does not have to give costs the same consideration; they may legally recommend a higher cost option that compensates them better if the investment itself is generally suitable.

When CFA commented on the Securities and Exchange Commission's Request for Information in July of 2013,<sup>47</sup> we included an analysis of costs of S&P 500 index funds to illustrate the wide range of costs among otherwise virtually identical products and the generally higher costs among broker-sold funds. We focused on index funds because they offer the cleanest example. While minimizing costs is important in all fund types, there is simply no justification for paying high costs in a fund that is designed simply to match the performance of an index.

If you look at data regarding S&P 500 index funds, two things are immediately apparent. The large majority of investor assets in funds purchased outside retirement plans<sup>48</sup> are held in a handful of very low-cost, direct-marketed funds managed by Vanguard (\$139.593 billion), Fidelity (\$58.497 billion), T. Rowe Price (\$17.699 billion), and Schwab (\$15.446 billion).<sup>49</sup> No single broker-sold fund comes close to matching these funds for level of assets under management, and even on an aggregated basis S&P 500 index funds sold by brokers to investors outside retirement plans appear to have far fewer assets under management. When brokers do sell S&P 500 index funds outside retirement plans, those funds appear to carry higher administrative costs than direct-marketed funds, even after the cost of compensating the broker is excluded. This is consistent with the findings of the academic research on which DOL's estimate of harm is based.

In conducting our analysis, we erred on the side of understating such costs by subtracting all 12b-1 fees from the expense ratio. According to the data provided by Morningstar, net expense ratios among the largest direct-marketed funds range from a low of 0.06 percent for the Fidelity Spartan 500 Index Advantage fund to a high of 0.29 percent for the T. Rowe Price Equity Index 500 Fund. While a few no load funds on the Morningstar list have net expense ratios as high as 0.50 or 0.60 percent, most are significantly lower, as one would expect in a competitive market where costs are directly related to performance.

A number of broker-sold funds also have competitive administrative fees, once the broker's compensation is subtracted. But others do not. In these cases, the "benefit" the investor received from investing through a broker is advice to put their money into an index funds with

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<sup>46</sup> We focus on the potential impact of a *well enforced* fiduciary duty because there is little evidence that the SEC actually enforces the securities law fiduciary duty in a way that affords investors the full benefits the fiduciary duty ought to provide.

<sup>47</sup> Letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Elizabeth M. Murphy regarding "Duties of Brokers, Dealers, and Investment Advisers" (File Number 4-606), July 5, 2013, <http://bit.ly/1Jslglq>. (Hereinafter, CFA July 2013 SEC comment letter)

<sup>48</sup> Because we conducted this analysis for a comment on a possible SEC fiduciary rule, we focused on funds held outside workplace retirement plans, including but not limited to funds sold to IRA investors.

<sup>49</sup> This data was supplied by Morningstar, which provided a list of S&P 500 index funds ranked by assets under management and excluding share classes sold through retirement plans or to non-retail investors.

expenses several times higher than the best available funds. The following are a few examples taken from the Morningstar data:

- Investors in the Wells Fargo Advantage Index A pay a maximum front load of 5.75 percent for an S&P 500 index fund with a current net expense ratio of 0.56 percent (0.68 gross). That is roughly twice as high as the expense ratio of the highest cost of the large direct-marketed funds and ten times the expense ratio of the lowest-cost fund. Investors have over \$400 million invested in this share class of the fund.<sup>50</sup>
- Investors hold nearly \$600 million in A shares of the J.P. Morgan Equity Index Fund. This fund charges a maximum front load of 5.25 percent for a fund with a net expense ratio of 0.45 percent (including .25 percent in 12b-1 fees) and a gross expense ratio of 0.94 percent.
- A total of about \$739 million is invested in a series of State Farm S&P 500 index funds, including two A share funds and two B share funds. The bulk of that money (about \$564 million) is invested in the A shares, which have maximum front loads of 3.0 and 5.0 percent and net expense ratios of 0.77 percent.<sup>51</sup>
- An even more extreme example is offered by the Rydex S&P 500 Fund. Investors have approximately \$349 million invested in the largest share class of this fund, which has a net expense ratio of 1.5 percent (including 12b-1 fees of 0.25 percent). That is roughly 20 times the expense ratio on the Fidelity fund and 10 times the expense ratio on the Vanguard fund.

There is nothing inherently more expensive about operating a broker-sold S&P 500 index fund than a direct-marketed fund (other than the cost of compensating the broker, which CFA subtracted from the administrative fee for the purposes of its analysis). Moreover, major market players such as Wells Fargo, J.P. Morgan, and State Farm all have a broad enough customer base that they should be able to offer a competitive product, if they chose to do so. The logical conclusion, therefore, is that the higher fees in broker-sold funds reflect a market where competition is based primarily on factors other than cost. Given the singular role that reducing costs plays in determining performance in index funds, the pressure to keep costs low would arguably be greatest here. Thus, there is every reason to believe that the lack of cost competition evident among broker-sold S&P 500 index funds has the same impact on the sale of other types of investment products that can be sold on the basis of features other than cost alone. As noted by Dr. Michael Finke in the Investment Management Consultants Association (IMCA) comment letter on the SEC request for information,<sup>52</sup> this lack of cost competition among broker-sold funds permitted under the suitability standard may help to explain why broker-recommended

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<sup>50</sup> Some of these investors may have paid lower than the maximum front load, because of breakpoints for example, but we believe the basic point still holds. These investors are paying a premium for questionable advice.

<sup>51</sup> Far less money is held in the B shares, which have maximum deferred loads of 3.0 and 5.0 percent and net expense ratios of 1.17 (including a 0.65 percent 12b-1 fee) and 1.47 percent (including a 0.95 percent 12b-1 fee). This may reflect that expenses of that magnitude are difficult to justify even under a suitability standard.

<sup>52</sup> Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," <http://1.usa.gov/1KgdRZu> (hereinafter "Finke Study").

mutual funds significantly underperform direct-sold funds more commonly recommended by investment advisers operating under a fiduciary standard.

As the DOL has noted in its Regulatory Impact Analysis, excess fees paid by investors who invest based on the recommendation of a conflicted adviser can have a significant impact on the long-term savings of retirement savers. The SEC made a similar point when it warned in a recent bulletin for investors, “Over time, even ongoing fees that are small can have a big impact on your investment portfolio,” reducing returns, shrinking a nest egg, and preventing investors from achieving financial goals.<sup>53</sup> This impact was vividly illustrated in an October 2013 Bloomberg Markets Magazine report regarding data filed with the SEC which showed that “89 percent of the \$11.51 billion of gains in 63 managed-futures funds went to fees, commissions, and expenses during the decade from Jan. 1, 2003 to Dec. 31, 2012.”<sup>54</sup> As the Bloomberg article noted, brokers have an incentive to keep clients in managed-futures funds, even when it is not in the best interests of the client, because they receive annual commissions of up to 4 percent of assets invested and investors pay as much as 9 percent in total fees each year.<sup>55</sup>

While they are important, excess costs are not the only concern associated with advice delivered outside the protections of a fiduciary standard. In our comment letter to the SEC, we also looked at ratings of variable annuities by independent analyst Weiss Ratings to help to illustrate how factors other than just costs can and should be incorporated in recommendations based on a best interest standard.<sup>56</sup> While cost is one factor Weiss incorporates into its ratings, it also includes the availability of a wide selection of mutual fund subaccounts with good performance and the financial strength of the insurance company issuing the annuity. In explaining the basis for arriving at its 10 best list, for example, Weiss explained that, “mutual fund subaccount performance played an important role in the selection process. After all, a variable annuity can have low costs and a strong Financial Strength Rating, while at the same time offering only mediocre fund performance.” Lack of fund choice and high surrender fees were clearly also major factors in determining which annuities ended up on Weiss’s 10 worst list.

A look at the annuities on Weiss Ratings’ 10 worst list again raises the question of whether these funds could even exist in a market where sellers were subject to a best interest standard. For example, the list included two versions of the Polaris Preferred Solution annuity, offered by SunAmerica. Both of the versions on Weiss’s list included just one fund option, which Weiss described as “weak,” and both charged high surrender fees: 9 percent decreasing over 9 years for the Bonus Fund and 8 percent decreasing over 4 years for the L shares. A separate site, Annuity Digest, listed Polaris Preferred Solution as offering a choice of 50 funds,<sup>57</sup> with maximum total expenses of nearly 3 percent, including a maximum mortality and expense risk charge (M&E fee) of 1.15 percent.<sup>58</sup> According to Annuity Digest, the annuity also imposed an 8 percent surrender charge decreasing over 8 years and a maximum commission of 7.5

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<sup>53</sup> U.S. Securities and Exchange Commission Investor Bulletin: “How Fees and Expenses Affect Your Investment Portfolio,” February 19, 2014, <http://1.usa.gov/1I6rpm>.

<sup>54</sup> David Evans, “How Investors Lose 89 Percent of Gains from Futures Funds,” Bloomberg Markets Magazine, Oct. 7, 2013, <http://bloom.bg/1JbuuHh>.

<sup>55</sup> *Id.*

<sup>56</sup> See Weiss Ratings Best and Worst Variable Annuities, <http://bit.ly/1fhAtOy>.

<sup>57</sup> We were unable to determine the reason for the disparity.

<sup>58</sup> See Annuity Digest profile of the SunAmerica Polaris Preferred Solution annuity, <http://bit.ly/1DqdgH0>.

percent. By way of comparison, Annuity Digest lists a number of funds with M&E charges in the 0.2 to 0.4 range, for example, and a number which charge no commissions and no surrender fees. No adviser who was truly motivated by the best interests of his or her customer could justify recommending options such as those on the 10 worst list when high quality, lower cost alternatives are readily available.

*2. Risks of harm are greatest when workers change jobs or leave the workforce.*

Retirement savers are arguably at greatest risk from the harmful impact of conflicted advice when they change jobs or leave the workforce to enter retirement and must decide what to do with the money they have accumulated in a workplace retirement plan. Even those earning relatively modest incomes can suddenly become attractive targets for financial services firms if they've managed to accumulate twenty or thirty thousand dollars or more in a workplace plan. This can be true even for the financial firm that manages the retirement plan if, as is often the case, that firm charges higher management fees for funds sold outside the plan than it does on plan offerings. With trillions of dollars up for grabs from retirement savers making job changes or leaving the workforce, even reputable firms have been shown to engage in aggressive tactics to entice workers to move money out of their pensions and 401(k) plans and into IRAs.

While the ability to siphon trillions of dollars out of workplace plans has been enormously profitable for financial firms, it can be significantly less financially advantageous for those retirement savers who are persuaded to roll their money out of an ERISA plan and into an IRA. Data from the Investment Company Institute (ICI) documents this cost disparity with regard to mutual funds. ICI data indicates that, while average-weighted costs of funds purchased in IRAs are lower than overall fund costs, the average-weighted costs of funds sold through 401(k)s are lower still.<sup>59</sup> Cost disparities are likely to be even greater for investors who are rolled over into a fixed index or variable annuity. Those cost differences can have a major impact on long-term investments.

As noted above, DOL estimates that an investor who rolls her retirement savings into an IRA could lose 12 to 24 percent of the value of her savings over 30 years of retirement as a result of conflicted advice. That estimate is based on research which indicates significant underperformance among broker-sold investments. While industry has taken exception to this estimate, it is based on far from the most extreme example. Here again, real world examples help to illustrate the nature and extent of the harm that investors can and do suffer as a result of conflicted advice.

A recent blog by Joseph M. Belth provides a vivid picture of the kind of abuse that can occur.<sup>60</sup> The blog describes the case of a 78-year-old woman whom he calls Beatrice who was persuaded to roll over her retirement accumulation at College Retirement Equities Fund (CREF) into an IRA containing a variable annuity issued by Guardian Insurance & Annuity Company, a subsidiary of Guardian Life Insurance Company of America. According to Belth's account, which is based in part on an earlier blog by fee-only insurance adviser and actuary Scott Witt,

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<sup>59</sup> Brian Reid, "Getting the Numbers Right on Investment Advice for Retirement Savers," ICI Viewpoints, February 26, 2015, <http://bit.ly/1Kg448s>.

<sup>60</sup> Joseph M. Belth, "Guardian Life Rectifies an Unsuitable Rollover," June 22, 2015, <http://bit.ly/1JcccFE>.

Beatrice was paying expenses of just 41 basis points (0.41 percent) on her CREF investment. That adds up to roughly \$1,350 a year in expenses on her \$325,000 balance. In contrast, the Guardian annuity her money was rolled into imposed 110 basis points of annual mortality and expense charges, 75 basis points of annual investment expense charges, and 20 basis points of annual administrative expense charges for a total of 205 basis points (2.05 percent), totaling about \$6,450 a year. Adding to the cost, the adviser sold 78-year-old Beatrice a rider guaranteeing that the eventual lifetime income from the annuity would be enhanced significantly if she avoided making withdrawals for ten years. The annual cost of the enhanced lifetime income guarantee was 115 basis points, bringing the total cost to 325 basis points (3.25 percent), or about \$10,650 a year.

As if that weren't enough, the adviser rolled over the full \$325,000 accumulation in Beatrice's CREF account, rather than the \$200,000 she had authorized, in what the adviser later claimed was a paperwork error. As a result of that "paperwork error," Beatrice was forced to take required minimum distributions from the annuity in order to avoid draconian income tax penalties. Doing so caused her to forfeit the entire lifetime income guarantee for which she was paying roughly \$4,800 a year. When Beatrice, with the help of Witt, took her concerns to the company and asked for her investment to be refunded minus a \$31,000 surrender charge, the initial response from Park Avenue Securities, which employed the adviser who sold Beatrice the annuity, was to refuse the claim, saying it found no evidence of wrong-doing on the part of the adviser. It noted, among other reasons, that she had received a prospectus and hadn't asked for a refund within the allotted look-back period. It was only after Belth contacted Guardian, indicating that he was planning to write about the case on his blog, that the company agreed to settle the case on terms that are confidential.

*3. Less wealthy, less sophisticated individuals are most likely to be targets of harmful practices.*

Evidence suggests that less sophisticated and less wealthy investors are most likely to suffer the harmful consequences of recommendations that are not based on the best interest of the investor. In a comment letter filed by IMCA with the SEC in response to its Request for Information, Dr. Michael Finke, a professor at Texas Tech University, cited academic studies bearing evidence of this effect:

- A 2012 study found that commission-compensated insurance agents "will consistently recommend higher commission products to less sophisticated consumers, leading to welfare losses that are greatest among those who can least afford to sustain them."<sup>61</sup>
- An earlier study similarly examined financial firms' "incentive to shroud attributes."<sup>62</sup> The researchers described how producers "will rationally segment the market by level of investor sophistication," with less efficient, more opaque products created to "maximize economic rents from less sophisticated consumers" while more competitive products are

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<sup>61</sup> Finke Study at 6 (citing S. Anagol, S. and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," *American Economic Review*, 102(1): 576-593).

<sup>62</sup> Finke Study at 7 (citing X. Gabaix and D. Laibson, 2006, "Shrouded attributes, consumer myopia, and information suppression in competitive markets," *Quarterly Journal of Economics*, 121(2), 505-540).



simultaneously offered to sophisticated consumers. “Examples of product differentiation through opaque characteristics are evident in the mutual fund market.”

- Another study cited by Dr. Finke describes how fund companies use different tactics to attract “less sophisticated investors, who fund families attract through marketing, and more sophisticated, direct-channel investors who are targeted through higher performance.”<sup>63</sup>
- This is consistent, Dr. Finke suggests, with evidence from a separate academic study “that successful mutual funds appear either to gain market share through lower expenses or by increasing opaque fees which are then used to incent advisor recommendations.”<sup>64</sup>
- Finally, Dr. Finke cites research suggesting that the “latitude of recommendation quality allowed in a suitability model is particularly troubling when clients are older and have experienced cognitive decline that may reduce their ability to perceive self-serving recommendations.”<sup>65</sup>

In other words, while opposition to fiduciary rulemaking is often presented as being motivated by concern over the well-being of middle-income retirement savers, the academic literature strongly suggests that it is precisely these less wealthy, often less financially sophisticated individuals who are most at risk from harmful practices permitted under existing securities and insurance regulations and who would benefit most from adoption of a rule closing loopholes in the definition of fiduciary investment advice under ERISA.

#### D. Contrary to Industry Claims, Non-fiduciary Advice is Often Far More Costly than Advice from Fiduciary Advisers.

Financial firms that rely on sales-based compensation have argued that, far from benefiting retirement savers, closing loopholes in the definition of investment advice could drive up the cost of advice, potentially leaving low- and middle-income retirement savers without access to the guidance they need to navigate complex investment decisions. Lack of transparency around the compensation of sales-based advisers helps to maintain this myth that they offer more affordable services than fiduciary advisers. While there are certainly circumstances in which commission-based accounts are more affordable, this is far from universally true.

In assessing the affordability of advisory services, it is important to look at total costs to the investor. First, there is the cost of the advisory services themselves. Second, there is the cost of the investments recommended to implement the advice. In addition, it is important to consider what services the investor receives in return for their payment. When the full costs to the investor are computed, the costs of commission-based advice are often higher. In other cases, retirement

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<sup>63</sup> Finke Study at 7 (citing N.M. Stoughton, Y. Wu and J. Zechner, 2011, “Intermediated investment management,” *The Journal of Finance*, 66(3), 947-980).

<sup>64</sup> Finke Study at 7 (citing A. Khorana and H. Servaes, 2012, “What drives market share in the mutual fund industry?” *Review of Finance*, 16, 81-113).

<sup>65</sup> Finke Study at 6 (citing M.S. Finke and T. Langdon, 2012, “The impact of a broker-dealer fiduciary standard on financial advice,” *Journal of Financial Planning*, 25(7), 28-37).

savers who pay for advice through sales-based fees pay roughly the same amount as is typically charged by fiduciary advisers but receive a lower level of service in return for that payment.

For example, the one percent asset under management fee directly charged by many fiduciary advisers is equivalent to the one percent 12b-1 fee indirectly charged by many brokers. In return, the broker's customers get a one-time transactional recommendation with no on-going duty of care, but they continue to pay the annual one percent fee for as long as they hold the investment. In contrast, the adviser's customers get ongoing account management and, in many cases, comprehensive financial planning for the same one percent annual fee. While the adviser's fees are fully transparent, the broker's fees are hidden in the expense ratio of the recommended investment. This creates the false impression that the broker's services are more affordable when, in fact, the customer is paying the same amount for a lower level of service. If, as the evidence suggests is often the case, the broker also recommends funds with higher expenses, even after the cost of compensating the broker is subtracted, then the increased cost to the investor for non-fiduciary advice are that much higher.

One case where the costs of brokerage services are clearly and unequivocally lower are for a buy-and-hold investor who trades in individual stocks and trades infrequently. Here, the rock bottom prices available for executing stock trades would be hard to match by an adviser charging a typical one percent assets under management fee. This is not, however, a common scenario, particularly for smaller savers, since few investors have sufficient assets that they can get adequately diversified investing in individual stocks. Moreover, even here where the cost benefits of a commission-based accounts are most apparent, some investors may prefer to pay an adviser a management fee in return for the on-going portfolio management they would receive from a fiduciary adviser.

A far more common scenario is the retirement saver with \$5,000 to contribute to an IRA. As rule opponents often point out, advisers who charge fees based on assets under management would be unlikely to serve this client, but other options would be available. The retirement saver could get a recommendation from a broker-dealer, invest the money through a robo-adviser, or pay an hourly fee for a recommendation from a fee-only adviser who specializes in serving middle income clients. Of these options, the broker-dealer recommendation is likely to be most costly, with the magnitude of that increased cost dependent on the particular investment recommended.

A few concrete examples can help to illustrate this point. In each case, we assume a one-time investment of \$5,000, a 5 percent annual return, and a holding period of 10 years.

- Assume the retirement saver consults a broker, who recommends A shares of an actively managed mutual fund with a fairly standard 0.99 percent expense ratio (including a 0.25 percent 12b-1 fee). Given the small size of the investment, the saver is unlikely to qualify for breakpoints and thus would pay the maximum 5.75 percent front load charged by the fund, or \$287.50 right off the top. Assuming a 5 percent annual return, that

investor will have paid approximately **\$850 in total costs and the investor's balance will be approximately \$6,950 at the end of 10 years.**<sup>66</sup>

- If that same investor is recommended a lower cost option, with a 0.75 percent expense ratio, for example, but the same 5.75 percent front load, the investor will have paid approximately **\$720 in total costs after 10 years, and the investor's balance will be approximately \$7,120.** On the other hand, if the investor is placed in a higher-cost alternative, with a 5.75 percent front load and a 1.3 percent expense ratio, the investor will have paid approximately **\$1,020 in total costs, and the investor's balance will be just \$6,740.**
- In some cases, although they are more appropriate for a short-term investment, a broker might recommend C shares, which compensate the broker through a 12b-1 fee (typically 100 basis points) included in the expense ratio. An investor who purchases C shares with no front load but a 1.74 percent expense ratio will have paid approximately **\$1,020 in total costs after 10 years, and the investor's balance will be approximately \$6,850.**
- If the saver invests the money through a robo-adviser, the costs would be dramatically lower. Using Wealthfront as an example, a retirement saver with \$5,000 to invest would pay nothing for the advice (Wealthfront advisory services are free for accounts below \$10,000) and annual expenses of between 0.1 percent and 0.3 percent on the Exchange-Traded Funds (ETFs) in which the money would be invested. Assuming a weighted average expense of 0.2 percent and a weighted average bid-ask spread of 0.1 percent, the saver will have paid approximately **\$130 in total costs at the end of 10 years, and the investor's balance will be approximately \$7,980.**
- Finally, the investor who prefers face-to-face interaction could hire a fee-only planner who charges an hourly fee. Assuming the investor pays an hourly rate of \$250 for an hour of the planner's time, and the planner structures the investor's account with the same ultra low cost ETFs discussed above (weighted average expense ratio of 0.2 percent plus a weighted average bid ask spread of 0.1 percent), the investor will have paid approximately **\$380 in total costs at the end of 10 years, and the investor's balance will be approximately \$7,580.**

Thus, a retirement saver could pay significantly different amounts for a one-time \$5,000 investment over 10 years, depending on what advisory services are used. Those costs can range from approximately \$130 for a robo-adviser to \$1,020 for a broker. And, the higher the cost, the lower the retirement saver's ultimate portfolio balance, with the broker-sold funds resulting in substantially lower final balances compared to balances that result from working with a robo-adviser or fee-only financial planner.

Retirement savers have even more options when they have larger amounts to invest. Consider, for example, the options available to an individual who has just left her job and has \$100,000 saved in the company 401(k) plan. Often, the individual's best option will be to leave

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<sup>66</sup> These examples were developed using the FINRA mutual fund expense calculator and actual funds available in the market today.

the money in the 401(k), where the plan sponsor is likely to have negotiated access to institutional shares with expenses that are lower than those available in the retail market.

- Assume, for example, that a worker is paying a 0.58 annual expense ratio on her 401(k) investments, which was the average cost of a 401(k) stock fund in 2013, according to the Investment Company Institute, and receives a 5 percent annual rate of return. If she leaves the money in her 401(k) for 20 years, she will pay approximately **\$18,400 in total costs, and her balance will be approximately \$236,200 at the end of that time.**
- Few broker-dealers could match those low costs, yet many if not most would not hesitate to recommend that she roll her money over into an IRA. Assume, for example, that the broker recommends A shares of the actively managed mutual fund discussed above with a 0.99 percent expense ratio. With \$100,000 to invest, the investor would qualify for a reduced front load of 3.75 percent. At the end of 20 years, the investor will have paid approximately **\$32,500 in total costs and the investor's balance will be approximately \$209,500.** That's \$14,200 more in fees than the investor would have paid if she'd left the money in her 401(k) plan, and it leaves her with \$26,700 less in her retirement account.
- Even if the broker recommends A shares of a relatively low-cost actively managed fund, with an expense ratio of 0.75 percent, the investor would pay **\$26,000 in total costs, and the investor's balance will be approximately \$220,400 after 20 years.** While this is a significant improvement, it still would cost the investor approximately \$7,600 more than she would have paid if she had left the money in her 401(k) and would leave her with a total balance that is approximately \$15,900 lower than she would have achieved staying in the plan.
- If, on the other hand, the broker were to recommend C shares with an expense ratio of 1.74 percent (including a 100 basis point annual 12b-1 fee), the investor will have paid approximately **\$48,400 in total costs after 20 years, and the investor's balance will be approximately \$187,400.** That's nearly \$30,000 more in fees than she would have paid if she left the money in her 401(k), lowering her account balance by approximately \$48,900.

Not every rollover exposes the investor to higher costs, however. A rollover into a portfolio of very low-cost no load index funds could save the investor money, particularly if the investor is in a 401(k) plan with higher than average costs. So could advice from either a robo-adviser or low-cost fee-only adviser.

- Assume the investor uses Betterment, another robo-adviser that puts its clients into a portfolio of very low-cost ETFs. Betterment charges a 0.15 percent management fee for accounts over \$100,000. If it implements through a portfolio of ETFs with weighted expenses of 0.2 percent and weighted bid-ask spread of 0.1 percent, the investor will have paid approximately **\$11,500 in total costs after 20 years, and the investor's balance will be approximately \$247,000.** Thus, the investor who rolls over her 401(k) into an account at Betterment could actually save \$6,900 relative to what she would have paid in

fees if she left the money in her 401(k), potentially increasing her total balance by approximately \$10,800.

- An investor who chose to roll over her 401(k) into an IRA based on advice from a planner who charges an hourly fee could also potentially reduce her costs and increase her account balance. Assuming that the investor pays an hourly rate of \$250 per hour and spends three hours each year with the planner, and further assuming that the investor invests in a portfolio of low-cost ETFs, the investor could expect to pay roughly **\$15,000 for the advice over 20 years and \$6,720 in fund expenses**. If the investor paid for the advice out-of-pocket, their total account balance at the end of 20 years would be about \$255,000.

As these examples help to illustrate, not only is it possible to offer affordable advice under a fiduciary standard, but advice from a fiduciary will often be significantly more affordable than non-fiduciary advice when the total costs to the investor are taken into account. Finally, we made all these comparisons using fairly standard costs for brokerage recommendations. If the broker or insurance agent recommended an annuity, which often combine very high commissions with very high annual expenses, the differences in affordability of fiduciary and non-fiduciary advice would be that much greater. Small savers who need to make every dollar count when saving for retirement would benefit most from a rule that stands to reduce excess costs such as these.

E. A Well-designed Rule Can Harness Market Forces to Benefit, Rather than Harm, Retirement Savers.

In discussions of the proposed rule, much of the focus has been on how it would change interactions between retirement savers and the financial professionals they turn to for advice. Its potential to change the way financial professionals make decisions about what investments they recommend is certainly a vitally important aspect of the rule proposal. But at least as important is the rule's potential to change the way product sponsors compete, and specifically its potential to harness market forces to benefit, rather than harm, retirement savers. Currently, some investment product sponsors compete based on cost and quality. This is evident from the fact that, in any category of investments you consider, there are options available that offer a high quality investment at a highly reasonable price. And some financial advisers, motivated by their customers' best interests, recommend those investments. It is also true, however, that in every category of investments, there are options available that offer a low-quality or mediocre investment at a very high price. And some financial advisers, motivated by a host of financial and other incentives, recommend those options to their customers. They are able to do so legally under a regulatory system that requires them to make suitable, but not best interest, recommendations.

By imposing a best interest obligation on advisers, and backing it with tough restrictions on practices that undermine that standard, the DOL rule proposal has the potential to change the terms on which product sponsors compete. Those that currently compete by offering lucrative financial incentives to sales-based advisers will have to adapt or risk losing market share under a rule that requires investment products to compete based on serving the best interests of the

retirement saver. Those that already offer a high quality investment product at a reasonable price would be rewarded. Increased cost competition should help to bring down excess costs across the market, and inferior investments that fail to make substantial improvements in quality should eventually be culled from the market. That one change has the potential to deliver dramatic benefits to investors in the form of reduced costs, reduced exposure to unnecessary risks, and improved long-term performance.

## **II. Conflict of Interest Rule**

### **A. CFA Strongly Supports Proposed Changes to the Definition of Fiduciary Investment Advice.**

As discussed above, the current regulatory definition of fiduciary investment advice includes a five-part test that dramatically narrows the definition beyond what Congress intended when it enacted ERISA. This problem is exacerbated by the current staff interpretation that rollover recommendations do not constitute fiduciary investment advice under ERISA. The result is that services that retirement savers perceive and rely on as advice, including recommendations regarding the most important financial decisions many will ever make, fall outside the regulatory protections Congress intended to provide when it imposed a strict fiduciary duty on investment advice to retirement plans and plan participants. Sales-based advisers, including broker-dealers and insurance agents who are not subject to a fiduciary duty under applicable non-ERISA regulatory regimes, are able to exploit these gaps in ERISA regulations to make recommendations to retirement savers that place their own financial interests ahead of those of their customers. All too often, workers' and retirees' ability to afford a secure and independent retirement is put at risk by conflicted advisers' recommendations to invest in high-cost retirement investments that suffer subpar performance and expose the saver to unnecessary risks.

A crucial first step to address this problem is to revise the definition of fiduciary investment advice under ERISA to bring that definition into better alignment with the statute upon which it is based. For the most part, the revised definition proposed by DOL does just that. We are particularly encouraged that the proposed rule replaces the five-part test with a functional definition of investment advice and that it clearly and unequivocally covers recommendations with regard to rollovers. Both are elements we had previously identified as critically important to the rule's effectiveness. Our one concern, discussed further below, is its inclusion of a requirement that the advice be provided "*pursuant to an agreement, arrangement, or understanding* that the advice is individualized or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan assets." (emphasis added) Absent further clarification from DOL, we are concerned that this requirement could be used by conflicted advisers in the same way that the current "mutual understanding" requirement is used to evade their fiduciary obligations to retirement advice recipients.



1. *The rule proposal appropriately defines the conduct that would constitute fiduciary investment advice.*

The proposed rule enumerates four categories of advice that would constitute investment advice subject to a fiduciary duty absent a carve-out and if provided in return for direct or indirect compensation. They are:

- recommendations regarding the advisability of “acquiring, holding, disposing of or exchanging securities or other property,” including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- recommendations regarding the management of securities or other properties, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- an appraisal or fairness opinion regarding the value of securities or other property if provided in connection with a specific transaction involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA; and
- recommendation of a person to provide any of these services for compensation.

In addition to requiring that the financial professional be compensated for the advice, the definition specifies that the recommendations must be “directed to a specific recipient for consideration in making investment decisions.”

In perhaps the most significant of several improvements in the rule over the original 2010 proposal, it makes clear that recommendations regarding whether to take a distribution of benefits or move money out of a retirement plan would be considered fiduciary investment advice, as would advice with regard to how to invest any money that is rolled over or otherwise distributed from a plan. As we have noted many times, decisions regarding whether to move money out of a retirement plan and how to invest the funds when a rollover is elected are among the most important and challenging decisions that retirement savers are likely to face. Those who are early in their careers can lose out on tens or hundreds of thousands of dollars in retirement savings if they choose unnecessarily costly investments that erode their savings over time. Those at or near retirement face even greater risks, since they have little ability to recover from mistakes that could materially affect their quality of life in retirement. Moreover, as discussed above, this is the point not just of ultimate vulnerability for the retirement saver, it is also the point of maximum risk, since it is often the first time average workers and retirees have sufficient savings amassed to make them attractive targets for financial advisers eager to profit at their expense. It is for this reason that including advice about rollovers and benefit distributions in the definition of fiduciary investment advice is of such crucial importance. We applaud the DOL for making this important improvement to the rule proposal and urge the Department not to waver on this point in the face of self-interested industry lobbying to scale back the scope of the rule.

2. *The revised definition is a functional definition that is consistent with the securities law definition of investment advice.*

The revised definition is a functional definition that closely resembles the broadly inclusive securities law definition of investment advice but without its limitation of applying only to securities transactions. It makes the same distinction made under the securities laws between generalized information and particularized recommendations.<sup>67</sup> It does this, first and foremost, by equating recommendations with advice. This equation of recommendations with advice is consistent with how financial firms portray themselves and their services, and it is consistent with how investors perceive those services.

It has been many years since broker-dealers routinely labeled their representatives as sales reps or insurance companies routinely called their annuities salespeople insurance agents. Instead, over the last several decades, broker-dealer registered representatives, insurance agents and others have increasingly adopted titles such as “financial advisor,” “financial consultant,” and “financial planner” to convey to prospective customers that they offer services that go beyond mere sales recommendations. Moreover, these “advisers” typically label their recommendations as investment planning and retirement planning and market those services as if they were designed to put the customer’s interests first. We first commented on this phenomenon in a letter to the SEC in 2000 in which we urged the agency to close the loophole that enabled brokers to market themselves as advisers without being regulated accordingly, but the practice was at least a decade old at that time.<sup>68</sup> PIABA documents similar practices today in a report that contrasts financial firms’ advertising practices with their claims regarding their legal obligations in arbitration.<sup>69</sup> Furthermore, survey after survey has shown that investors do not distinguish between the sales recommendations they receive from broker-dealers and insurance agents and the advice they receive from fiduciary advisers.<sup>70</sup>

This approach of equating individualized recommendations with advice is also an approach that has received broad support in the context of SEC fiduciary rulemaking. In its comment on the SEC’s Section 913 study, for example, SIFMA proposed a definition of investment advice that would capture “investment recommendations that are provided to address the objectives or needs of a specific retail customer after taking into account the retail customer’s specific circumstances.”<sup>71</sup> As we noted in a subsequent comment to the SEC, as long as it

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<sup>67</sup> An investment adviser is defined under the Investment Advisers Act of 1940 as someone who is in the business of giving advice about securities for compensation. Any form of guidance or recommendation regarding specific securities, classes of securities, the advisability or inadvisability of investing in securities, and even advice about the selection or retention of an investment adviser would be considered investment advice under the Act.

<sup>68</sup> January 13, 2000 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan Katz regarding File No. S7-25-99, Certain Broker-Dealers Deemed Not to be Investment Advisers, <http://bit.ly/1Ie0V6U>. See, in particular, the discussion on pages 7-12.

<sup>69</sup> Peiffer, Joseph C. and Lazaro, Christine, “Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty,” Public Investors Arbitration Bar Association Report, March 25, 2015, <http://bit.ly/1FW5H7p>.

<sup>70</sup> See discussion below under Seller’s Carve-Out.

<sup>71</sup> Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murray, Secretary, Securities and Exchange Commission, regarding *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers; Exchange Act Release No. 62577; Investment Advisers Act Release No. 3058*, File No. 4-606, Aug. 30, 2010, <http://1.usa.gov/1LnVQM1>.

captures all recommendations that a reasonable investor would view as being intended to address their objectives and needs based on a consideration of their circumstances, and all services that a broker describes and markets as advisory services, such an approach ought to function reasonably well.<sup>72</sup>

3. *FINRA guidance offers a sound approach to determining what constitutes a recommendation and, thus, fiduciary investment advice.*

In determining exactly what constitutes a recommendation, DOL has looked to guidelines issued by FINRA to help brokers determine whether a particular communication constitutes a recommendation. While the determination of whether a recommendation has been made will always be based on the particular facts and circumstances, we agree with the Department that FINRA guidance provides useful standards and guideposts for distinguishing investment education from investment advice under ERISA. The most directly relevant portion of the FINRA guidance states:

“An important factor ... is whether -- given its content, context and manner of presentation -- a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate.”

This guidance includes four key points that we believe should inform DOL policy with regard to what constitutes a recommendation:

A Call to Action: Inclusion of some form of call to action is key to distinguishing advice from education. So, for example, general information about asset allocation would not be considered advice; a specific recommendation to invest in a particular fund or set of funds in order to achieve a particular asset allocation would be advice. A recommendation not to act, not to purchase or sell a particular investment, or not to rollover a retirement account balance would also be considered a recommendation under this interpretation.

Particularized for a Specific Client: Unless surrounding circumstances dictated otherwise, a generally favorable statement regarding a particular investment or type of investment would not typically constitute investment advice. A statement that the investment would be a good option in light of the individual’s particular circumstances typically would constitute advice. The fact that the adviser might make the same recommendation to more than one client would not contradict the interpretation that the advice was particularized if, in each case, the client reasonably believed that the recommendation was directed at them and based on their particular circumstances.

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<sup>72</sup> CFA July 2013 SEC Comment Letter, at page 8.

Considering Actions in the Aggregate: In considering whether something constitutes a recommendation, and thus fiduciary investment advice under ERISA, it may be necessary to look at a series of actions to determine whether, taken together, they would reasonably be viewed as including a call to action or being particularized to a specific client.

Reasonable Expectation: An overarching principle of the FINRA guidance is that how the communication is likely to be reasonably perceived by the client is of central importance. If the client would be likely to perceive a communication as a call to action or as particularized to their circumstances, that should be enough to trigger the definition.

There is the added benefit that adopting an approach consistent with FINRA guidance would minimize inconsistencies in regulatory approaches for retirement and non-retirement accounts. Should the SEC eventually live up to its pledge to adopt a fiduciary standard for broker-dealers when they provide personalized investment advice to retail clients, it would presumably be based on a definition of investment advice that closely resembles what DOL has proposed here.

4. *DOL should clarify that the stipulation that the advice must be delivered “pursuant to an agreement, arrangement, or understanding” does not require mutual agreement.*

The rule proposal stipulates two conditions that would determine whether communications that otherwise fit the definition of investment advice would be considered fiduciary investment advice under ERISA. The first comes into play where a financial professional represents that he or she is a fiduciary with respect to the advice. This is simple common sense. A financial professional who communicates to clients that he or she is acting as a fiduciary must be held to that standard. To do otherwise would be grossly misleading, would effectively allow and promote misrepresentations, and would be contrary to principles of estoppel. Where no such representation exists, the rule states that, to be considered fiduciary investment advice, the advice must be provided “pursuant to a written or verbal agreement, arrangement, or understanding that the advice is individualized to, or that such advice is specifically directed to, the recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA.” As noted above, we believe this provision could be misinterpreted to recreate the “mutual agreement” loophole that provides one of the key means by which conflicted advisers evade their fiduciary obligations.

The discussion of the issue in the proposing release strongly suggests that this is not the Department’s intention. The release suggests, for example, that this is intended to ensure that, “recommendations made to the general public, or to no one in particular,” would not be treated as investment advice and thus to address “concerns that the general circulation of newsletters, television talk show commentary, or remarks in speeches and presentations at financial industry educational conferences would result in the person being treated as a fiduciary.” The release goes on to state that, “The parties need not have a meeting of the minds on the extent to which the advice recipient will actually rely on the advice, but they must agree or understand that the advice is individualized or specifically directed to the particular advice recipient for consideration in making investment decisions.” The proposing release provides further clarification that, “advisers could not specifically direct investment recommendations to

individual persons, but then deny fiduciary responsibility on the basis that they did not, in fact, consider the advice recipient's individual needs or intend that the recipient base investment decisions on their recommendations. Nor could they continue the practice of advertising advice or counseling that is one-on-one or that a reasonable person would believe would be tailored to their individual needs and then disclaim that the recommendations are fiduciary investment advice in boilerplate language in the advertisement or in the paperwork provided to the client.”

While this additional commentary is reassuring, the regulatory language does appear to leave the door open to evasion. Use of the term “agreement” by definition suggests some degree of mutuality. And, while the release makes clear that advisers could not continue their current practice of using boilerplate disclosures to disclaim fiduciary responsibility, it leaves open the possibility that some form of non-boilerplate disclosure might suffice. We strongly urge the Department to remove any ambiguity on this point and clearly state that, for advice to be considered fiduciary investment advice under ERISA, it is enough that a reasonable person under the same circumstances would perceive the advice to be particularized or specifically directed to them for consideration in making investment or management decisions.

*5. The Department should clarify that firms can market their services without necessarily triggering the definition of fiduciary investment advice.*

Some commenters have raised the concern that firms would not be able to market their services without triggering the definition of fiduciary investment advice. While we believe these concerns have been exaggerated, there is enough ambiguity on the point to justify a clarification. Specifically, the Department should make clear that basic marketing of advisory services does not constitute fiduciary investment advice unless it also includes recommendation of a specific course of action regarding the advisability of “acquiring, holding, disposing of or exchanging securities or other property” or a recommendation regarding the management of securities or other properties. This potential to combine marketing and advice is most likely to arise in the context of a rollover recommendation, where the recommendation to hire the adviser is contingent on rolling money out of a 401(k) and under their management. In such circumstances, the rule should make clear that any recommendations included in marketing messages regarding whether to rollover assets or how to invest such assets would still be considered fiduciary investment advice.

**B. CFA Generally Supports the Carve-Outs from the Definition of Fiduciary Advice Provided in the Proposed Rule.**

The rule proposal provides several carve-outs from the definition of fiduciary investment advice. The most significant of these from the point of view of individual retirement savers are the education carve-out and the seller's carve-out, both of which have been significantly improved since the 2010 proposal, and the platform provider carve-out.

1. *The education carve-out appropriately preserves financial firms' ability to offer bona fide education while ensuring that specific investment recommendations are classified as advice.*

The Department has long recognized the distinction between general education and specific investment advice and both maintains and reinforces that distinction in the current rule proposal. As is the case under current rules, the proposal includes an explicit carve-out from the definition of fiduciary investment advice for *bona fide* retirement investor education. By incorporating and largely maintaining the education carve-out framework that the Department issued in 1996 in Interpretive Bulletin (IB 96-1), the proposal ensures that firms and advisers will be able to provide significant amounts of information and materials to retirement investors without being subject to a fiduciary duty. At the same time, the Department narrows the current policy in one important way: it classes as advice online interactive tools and asset allocation models that direct the user to specific investments. We agree that such tools are appropriately regulated as advice. At the same time, however, we believe adjustments can and should be made to preserve the benefits of such tools while protecting against the risks.

According to the terms of the education carve-out, the definition of fiduciary investment advice will not be triggered as long as an adviser or firm provides to a retirement saver general educational information and materials and not a specific recommendation or specific alternatives upon which to act. Educational information and materials subject to the carve-out are divided into four broad categories: (i) plan information; (ii) general financial, investment and retirement information; (iii) asset allocation models; and (iv) interactive investment materials. The proposed regulation also states that there may be other examples of information, materials, and education services which, if furnished, would not constitute investment advice or recommendations within the meaning of the proposed rule. Thus, the types of information that may constitute permissible investor education are very broad in scope, reflecting the DOL's recognition of the importance of providing retirement savers with materials that can help them make better informed retirement decisions.

The proposal further makes clear that the education carve-out is available irrespective of who provides the information, the frequency with which the information is shared, the form in which the information and materials are provided, or whether an identified category of information and materials is furnished or made available alone or in combination with other categories of investment or retirement information and materials, or the type of plan or IRA involved. As a result, the focus of the carve-out is appropriately on the *content* of the information provided rather than the *form* in which it is presented or its method of delivery.

In clarifying the line between *bona fide* education and investment advice, the DOL has offered an important change from IB 96-1 with respect to the treatment of certain website tools used by financial firms to help savers identify appropriate funds. Many financial firms offer website tools that ask retirement investors to provide specific personal information, including how much money they want to invest, their investment goals, time horizon, and risk tolerance. Based on the personal information that the retirement investor inputs, the saver is provided a "model portfolio," sometimes also referred to as an "Action Plan." Such "model portfolios" or "Action Plans" include various percentages of different asset categories with specific investment



illustrations populating each of the asset categories. For example, an asset allocation model may recommend that an investor hold 15 percent of her portfolio in an international value fund, and populate the international value category with JPMorgan International Value Fund to illustrate how the investor could implement that position. The investor is then presented with the option of hitting an “Act Now” button to implement that “model portfolio” or “Action Plan.”

Current policy under IB 96-1 treats these tools as education rather than advice, so long as the results are accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available and identifying where information on those investment alternatives can be obtained. However, the DOL has expressed the concern that, even when accompanied by a statement that other investment alternatives are available, the act of identifying specific investment alternatives functions as a tailored, individualized investment recommendation. Moreover, without adequate protections against potential abuse, these tools could be used to effectively steer users to particular investments based on criteria other than the best interests of the retirement saver. The GAO identified this as a problem in a 2011 report, stating: “For example, although investment education is defined as generalized investment information, providers may highlight their own funds as examples of investments available within asset classes even though they may have a financial interest in the funds. According to industry experts, participants perceive education as investment advice. Thus, participants may not understand that the provider is not a fiduciary adviser required to act solely in participants’ best interests.”<sup>73</sup>

We agree with the assessment of both the DOL and the GAO that an investor would reasonably view these types of tools, not as general education, but as providing them with a recommendation that is specifically directed at them, that is based on their personal circumstances, and that is clearly designed to be acted upon. In other words, these tools clearly meet the definition of fiduciary investment advice the department has proposed. We also share the DOL’s concern that asset allocation models and interactive investment materials could be used to steer savers to particular investments without regard to the best interests of the saver. Some firms design their interactive tools with care, based on objective criteria and rigorous methodologies. As long as the tools are categorized as education, however, there is no regulatory mechanism available to ensure that this is the case. Instead, a firm could design its model to favor certain investment options whose sale ultimately benefits the firm rather than the investor. This concern is especially pronounced in the retail context, where a firm could steer retirement investors to proprietary products that enhance the compensation paid to the firm or to third-party products that provide the highest revenue-sharing payments to the firm.

Some industry participants have urged the DOL to withdraw its proposed change to IB 96-1, arguing that the tools they offer can be useful to retirement investors and the rules would inhibit their use. One problem is that, because they constitute online-only advice, the tools do not qualify for the best interest contract exemption. While we agree that these tools, if properly designed and with appropriate safeguards, can in fact be useful, we disagree with industry’s proposed solution. Simply maintaining the status quo does not adequately address the very real threat that these tools could be used in ways that are not in users’ best interests. This is of

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<sup>73</sup> Government Accountability Office, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, January 2011, <http://1.usa.gov/1gJXDy2>.

particular concern if they are used in conjunction with rollover recommendations or advice to IRA investors more generally. That said, we do encourage DOL to adopt an approach that preserves the benefits of these tools while protecting against potential abuses.

In developing an approach to achieve that goal, we think it is appropriate to distinguish between the plan and IRA contexts. In the plan context, which is the only context in which IB 96-1 currently applies, a plan fiduciary has already selected the menu of investment options for the plan participants to invest in. That selection process must be made according to a duty of prudence and loyalty. As a result, any steering by an asset allocation model would be contained within, and therefore constrained by, an already approved menu of investment options. And, as a practical matter, because most plans do not have a significant number of investment options for each asset category, an asset allocation models' ability to steer retirement savers to a certain fund would likely be further constrained, particularly in the case when only one fund meets each asset category. The exception is where the plan includes a brokerage menu, where the plan participant has access to a broader universe of investment options. That exception aside, the protections that exist within the plan context decrease both the probability and the scope of the harm that asset allocation models could cause retirement savers.

However, no analogous protections for retirement investors exist in the IRA context, including with regard to rollovers. Because there is no initial narrowing of investment options by a fiduciary, asset allocation models would be free to present illustrations using whatever investment options benefit the firm designing and implementing the model, regardless of whether those options are in the investor's interests. Should that information qualify as education, it would be removed entirely from any fiduciary protections. Doing so would recreate the very problem that the DOL is attempting to solve -- allowing firms to make recommendations that are reasonably viewed by recipients as investment advice but which aren't subject to appropriate protections. Even cautionary disclosures about the availability of other investment alternatives would be unlikely to mitigate the harm that retirement investors would experience if asset allocation models were allowed to identify specific investment alternatives without being subject to appropriate safeguards.

We believe the rule can and should be adjusted to preserve the benefits of these tools while constraining the risks. Recognizing the important distinctions between the plan and retail contexts, one possibility would be to retain IB 96-1 in its current form for use exclusively in the plan context and only where there is a limited menu of investment options (i.e., not in combination with a brokerage window). A different approach would need to be adopted for the retail context. This could include, for example, allowing such tools to be offered in compliance with the best interest contract exemption.

We understand, however, that the DOL has expressed a preference for treating equally the information that's provided in the plan and retail contexts. To accommodate this preference, one option would be to allow asset allocation models to identify specific investment alternatives, but only if all available alternatives within an asset class under the plan or IRA are listed and none is preferred. If this approach were adopted, investors would be unlikely to view the tool's response as a tailored, individualized investment recommendation for action. On the other

hand, the tools would arguably lose much of their value, at least in those circumstances where dozens of funds, or more, might be listed in each asset class.

A different, and in our view better, approach would be to adapt the requirements of the Pension Protection Act regarding online tools to fit this purpose. The PPA appears to include the essential requirements to ensure that recommendations are based on appropriate criteria. For this approach to work, the tools should be permitted to be used either as online only tools or in conjunction with advice from an adviser. We encourage the DOL to consider whether this or a similar approach could be adopted that would preserve the benefits associated with these tools while significantly reducing the risk that they would be misused to steer retirement savers into less than optimal investment options.

2. *We commend the DOL for proposing a narrow seller's carve-out that applies only in the large plan context, and we urge the DOL to maintain this framework in a final rule.*

The rule proposal includes an explicit carve-out from the definition of fiduciary investment advice that allows a financial adviser to make sales recommendations to a fiduciary of a large employer-sponsored plan without being subject to a fiduciary duty. There are two alternative ways in which an adviser can claim relief under the proposed seller's carve-out, one for plans with 100 or more participants and one for plans with at least \$100 million in assets.

- Under the first alternative, an adviser can provide a sales recommendation to a plan fiduciary whose plan has 100 or more participants only after the plan fiduciary has provided a written representation that he or she will not rely on the adviser to act in the plan's best interests, provide impartial investment advice, or give advice in a fiduciary capacity. In addition, the adviser must inform the plan fiduciary of the nature of his or her financial interests in the transaction and must know or reasonably believe that the plan fiduciary has sufficient expertise to evaluate the transaction. These conditions are designed to ensure that the plan participants' interests are ultimately protected.
- Under the second alternative, an adviser can provide a sales recommendation to a plan fiduciary whose plan has at least \$100 million in assets without obtaining the written representation required under the first alternative. However, the adviser must still comply with the other reasonable conditions, discussed above, that are designed to ensure that the plan participants' interests are ultimately protected.

The DOL's stated purpose for this carve-out is to avoid triggering fiduciary obligations on sales pitches that are part of arm's length transactions where neither side assumes or expects that the financial adviser is acting as an impartial trusted adviser, but where the seller is making representations about the value and benefits of proposed deals that might otherwise trigger the definition of fiduciary investment advice. Large plan fiduciaries who meet the conditions of the carve-out are typically financial professionals whose primary responsibilities are to implement and run retirement plans for their employees and who therefore, at least in theory, are likely to have sufficient financial expertise and sophistication to protect their own interests. Because of their heightened expertise and sophistication, they are likely to understand the nature and costs of

sales-related conflicts of interest. Further, they are likely to be able to effectively identify and distinguish sales pitches from advice, and protect themselves and plan participants from the types of harm that can result when sales pitches are perceived and treated as advice. They are also likely to be able to use different financial service providers' sales pitches to the plan's benefit, forcing providers to compete for their business. Finally, they are likely to be able to independently assess the quality of the sales recommendations they receive and make a final judgment that benefits the plan participants.

Because retail investors and small plan fiduciaries typically do not relate to financial professionals in ways that fit the "arm's length" characteristics that the seller's carve-out is designed to achieve, the carve-out is unavailable for them under the proposed rule. Sales recommendations to retail investors and small plan sponsors are often presented as impartial advice that they should trust, and retail investors and small plan sponsors often rely on those recommendations as advice that they should follow. And, because most retail investors and small plan sponsors are not financial experts, they are likely to be unaware of the magnitude and impact of sales-related conflicts of interest and unable to protect themselves against those conflicts. They are also by and large unable to effectively assess the quality of the recommendations they receive and take action based on what is in their best interests. Retail investors may be particularly at risk because they lack the protection of having a plan fiduciary select an initial menu of investment options from which they can invest.

We wholeheartedly commend the DOL for taking this approach to the seller's carve-out, which is a significant improvement over the approach proposed by the DOL proposed in 2010. The 2010 proposal contained an overly broad seller's exception that would have allowed advisers to claim the exception, and escape their fiduciary obligations, so long as they disclosed that they were acting in a sales relationship, that their interests were "adverse" to those of the retirement investor, and that their recommendations were not intended to be impartial. W. Scott Simon, an ERISA fiduciary expert, described the 2010 seller's exception as the "fiduciary exemption that swallows the rule" by allowing current fiduciaries to "absolve" themselves of fiduciary obligations even while making personalized recommendations."<sup>74</sup> Mercer Bullard, the MDLA Distinguished Lecturer and Professor of Law at the University of Mississippi Law School, raised similar concerns when he wrote: "The basis for finding a fiduciary duty is a relationship of dependence, whether through trust, informational disadvantage, relative incapacity, or some combination thereof that results in potential overreliance on the fiduciary's advice. Simply knowing that a fiduciary has a conflict of interest changes none of the factors that make fiduciary standards necessary. It may even exacerbate the client's overreliance on the conflicted fiduciary's advice if the candid admission of the conflict engenders even greater, but still misplaced trust."<sup>75</sup> The effective result of the 2010 proposed seller's exception would have been to create in the retirement investment advice market the same problem that Congress intended to fix in the securities market when it enacted Section 913 of the Dodd-Frank Act, which authorizes the SEC to impose a fiduciary duty on brokers-dealers when they provide personalized investment advice to retail investors.

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<sup>74</sup> W. Scott Simon, "The Fiduciary Exemption That Swallows the Rule," MorningstarAdvisor, May 5, 2011, <http://bit.ly/1TLZPmX>.

<sup>75</sup> Mercer Bullard, "DOL's Fiduciary Proposal Misses the Mark," MorningstarAdvisor, June 14, 2011, <http://bit.ly/1Ie1NZh>.

Extensive evidence demonstrates that retail investors do not understand either the distinction between sales and advice or the differences between various types of financial professionals, and that disclosure, even when combined with education, is ineffective in eliminating this confusion.<sup>76</sup> This is understandable since the sellers routinely call themselves “financial advisors” and “financial consultants,” describe their services as retirement planning, and market those services as if advice were the primary service being offered. While some object to this argument as condescending or paternalistic, the supporting evidence is overwhelming.

In 2005, for example, the SEC commissioned Siegle & Gale, LLC and Gelb Consulting Group, Inc. to conduct focus group testing “to understand how investors differentiate the roles, legal obligations, and compensation among ... brokers, financial advisors/financial consultants, investment advisers, and financial planners.” The purpose of the study was “to provide feedback regarding a proposed disclosure statement developed by the SEC.”<sup>77</sup> That study found that investors:

- were generally “unclear about the distinctions” among the various titles;
- were generally unfamiliar with the term investment adviser; and
- assumed that financial advisors and financial consultants (titles typically adopted by brokers) provided “a broader scope of long-term planning advice” than brokers.

Study participants also provided feedback on a proposed disclosure intended to alert investors to differences between fee-based brokerage accounts and advisory accounts. In general, according to the report on focus group findings, “investors found the statement communicates that differences might exist, but did not do enough to explain those distinctions ... As a result, investors were confused as to the differences between accounts and the implications of those differences to their investment choices.”

Unable to arrive at an approach to disclosure that was likely to be effective, and recognizing “that any future regulatory reform would have to be based on a clearer understanding of the industry’s complexities,” the SEC commissioned the RAND Corporation to conduct a study that could provide the basis for future rulemaking.<sup>78</sup> Among the wide-ranging study’s key findings: the once-clear functional distinctions between brokers and investment advisers had become blurred, investors found it difficult to distinguish between brokers and investment advisers, and they tended to view financial advisors and financial consultants “as being more similar to investment advisers than to brokers in terms of services and duties.” Even when plain English explanations were provided, focus-group participants struggled to understand the differences between a fiduciary duty and suitability standard and “expressed doubt that the

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<sup>76</sup> See, e.g., Hung, Angela A., et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, Rand Corporation, Sponsored by the United States Securities and Exchange Commission, January 2008, <http://1.usa.gov/1nePF0L>.

<sup>77</sup> Siegle & Gale, LLC and Gelb Consulting Group, Inc., *Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures*, Report to the Securities and Exchange Commission, March 10, 2005, <http://1.usa.gov/1MkdujW>.

<sup>78</sup> *Id.*

standards differ in practice.” Moreover, they expected brokers and advisers alike to act in the investor’s best interest.

A 2010 study commissioned by CFA, AARP, North American Securities Administrators Association, CFP Board of Standards and the Investment Adviser Association and conducted by ORC/Infogroup found similar results.<sup>79</sup> For example, 65 percent of 18-34 year olds and 57 percent of households with \$100,000 or more in household income mistakenly thought that “insurance agents” have a fiduciary duty to their clients; 70 percent of 45-54 year olds and 62 percent of college graduates were incorrect in thinking that stockbrokers are held to a fiduciary duty; 76 percent of investors were wrong in believing that “financial advisors” are held to a fiduciary duty; 34 percent, including 41 percent of 18-34 year olds and 45 percent of African Americans, incorrectly thought that financial advice is the “primary service” offered by stockbrokers; and another 27 percent believed that “advice and assistance in conducting transactions are equally important services offered by brokers.” Only 29 percent understood that the primary service of stockbrokers is to “buy and sell stocks, bonds, mutual funds, and other investment products on behalf of their clients, and they give only limited advice that is directly related to those transactions.”

Some attribute investors’ lack of understanding of these key concepts to their failure to make good use of the disclosures provided to them. And, it is true that many if not most investors also are likely to ignore disclosures. For example, the RIA cites the 2008 Rand Study’s interviews of representatives of brokerage firms who reported efforts to clearly disclose conflicts. Several acknowledged that “investors rarely read these disclosures...[F]or many investors, the fact that they were given disclosures was seen as meaningless.”<sup>80</sup> However, this overly simplistic explanation is undercut by the RAND study findings that investors struggled to understand differences in the standard of care even after receiving a plain English explanation and that investors were typically unable to tell whether their own financial professional was a broker or an adviser even after reading brief fact sheets explaining the differences. This is strong evidence that, regardless of what disclosures are provided, retail investors are ill-equipped to make informed investment decisions by themselves, including the decision of whom to rely on for investment advice.

Moreover, a 2012 SEC study of disclosure effectiveness included a survey by Siegel & Gale that tested both investors’ understanding and use of disclosures.<sup>81</sup> Siegel & Gale found, for example, that: among online survey respondents who recalled receiving a conflict of interest disclosure, just over half reported that they fully understood the potential impact on their advisory relationship and only a little over half of respondents who said they understood the conflicts of interest fully or even somewhat actually took action to protect their interests. There was also confusion about how different advisers charge and the unique conflicts that accompany different advisers’ compensation models. When investors’ ability to comprehend actual

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<sup>79</sup> U.S. Investors & The Fiduciary Standard: A National Opinion Survey, ORC/Infogroup, September 15, 2010, <http://bit.ly/1fMAERB>.

<sup>80</sup> *Id*; See also Haziza, Mor and Kalay, Avner, Broker Rebates and Investor Sophistication, September 2014, <http://bit.ly/1LmYXDG>.

<sup>81</sup> Siegel & Gale, LLC, *Investor Research Report*, Submitted to the Securities and Exchange Commission on July 26, 2012, <http://1.usa.gov/1MfBbss>.



disclosures was tested, the results were even more troubling. For example, having reviewed a sample disclosure that begins as follows, “In addition to sales loads and 12b-1 fees described in the prospectus, we receive other compensation...,” just over half (54.8 percent) correctly answered a question about whether the firm gets compensation other than sales loads and 12b-1 fees. After reviewing a sample chart providing information on additional payments the firm receives from mutual fund companies, only 31.8 percent indicated they definitely knew what the term “annual asset fees” means, and another 46.2 percent indicated they thought they knew what it means. But survey respondents were generally unable to determine the significance of the information provided.

The DOL discusses at length in its RIA the extensive academic and empirical evidence that strongly suggests that disclosure alone is ineffective at mitigating conflicts in financial advice. This includes comprehensive research that retail investors are incapable of adequately understanding the implications of disclosed conflicts and factoring that understanding into their choice of adviser and investments.<sup>82</sup> It also cites to evidence showing that conflict disclosures can actually have a harmful impact on investors. Behavioral economists have found for example that, even where investors are able to pay attention to and understand disclosures regarding adviser conflicts, they still may react to disclosures in ways that “backfire,” thus exacerbating the harms that can result from these conflicts.<sup>83</sup> For example, they might interpret conflict disclosures as a sign of honesty or high professional standing, or feel socially constrained from questioning their adviser’s integrity or threatening their livelihood. At the same time, their adviser may feel “morally licensed” to pursue his or her own interests over the customers’ interests after having warned them of the conflicts. One legal academic who has surveyed the literature of broker obligations, conflicts, and disclosure concludes that, “disclosure alone is a frail tool with which to attack the many ills that arise from blatant conflicts of interest in the financial industry.”<sup>84</sup>

Based on the extensive academic and empirical evidence, the DOL has rightly concluded that a rule that relies on disclosure alone to mitigate adviser conflicts, which is what the seller’s

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<sup>82</sup> See, e.g., Hung, Angela et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, Rand Corporation, Sponsored by the United States Securities and Exchange Commission, January 2008, <http://1.usa.gov/1nePF0L>; U.S. Investors & The Fiduciary Standard: A National Opinion Survey, ORC/Infogroup, September 15, 2010, <http://bit.ly/1fMAERB>. See also, Prentice, Robert A., Moral Equilibrium: Stock Brokers and the Limits of Disclosures, Wisconsin Law Review 2011, <http://bit.ly/1MD3JKL>; Chater, Nick et al., Consumer Decision-Making in Retail Investment Services: A Behavioral Economics Perspective, Decision Technology Ltd, November 2010, <http://bit.ly/1MfFaVW>; Robertson, Christopher Tarver, Biased Advice, Emory Law Journal, April 12, 2011, <http://bit.ly/1MfFhKc>; Burke, Jeremy et al., Impacts of Conflicts of Interest in the Financial Services Industry, Rand Corporation, February 2015, <http://bit.ly/1MfFjJ9>. These are just a few of the many studies showing disclosure, even when combined with education, is ineffective at eliminating investor confusion and adequately curing the harms that result from conflicts of interest.

<sup>83</sup> See, e.g., Cain, Daylian, Loewenstein, George, and Sah, Sunita, The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest, <http://bit.ly/1gJYyP6>; Cain, Loewenstein and Moore, Don, The Dirt on Coming Clean, <http://bit.ly/1gJYBu8>; See also Chater, supra; Francesca, Gino, Brooks, Alison W., and Schweitzer, Maurice E., “Anxiety, Advice, and the Ability to Discern: Feeling Anxious Motivates Individuals to Seek and Use Advice,” Journal of Personality and Social Psychology, Vol. 102, No. 3, March 2012, pp. 497-512; Nicholas, Dopuch, King, Ronald R., and Schwartz, Rachel, “Independence in Appearance and in Fact: An Experimental Investigation,” Contemporary Accounting Research, Vol. 20, No. 1, 2003, pp. 79-114.

<sup>84</sup> Prentice, Robert A., Moral Equilibrium: Stock Brokers and the Limits of Disclosures, Wisconsin Law Review 2011, <http://bit.ly/1MD3JKL>.

carve-out does, would be ineffective, would yield little or no investor gains, and would therefore fail to justify the compliance cost associated with requiring increased disclosure. We agree that the research is clear: that investors do not understand the different titles that various financial professionals use, various financial professionals' respective roles and legal obligations, or the nature and implications of the different relationships they might have with various financial professions, including the potential conflicts of interest that exist in those relationships and that disclosure fails to remedy any of these gaps in knowledge. With these significant gaps in knowledge that cannot be narrowed, most retail investors are unlikely to have the financial sophistication necessary to check the quality of advice, detect adviser misbehavior, and adequately protect themselves from conflicts. Absent a reasonable basis for believing that investors will be able to identify and protect themselves from conflicted advice, a broad seller's exemption in the retail context simply cannot be justified.

Similar to retail investors, small plan fiduciaries by and large lack the financial expertise and sophistication necessary to fully understand sales-related conflicts of interest and protect themselves and their employees' retirement savings from those conflicts, rendering them ill-suited for the seller's carve-out as well. The typical small business owner is focused on surviving and being profitable. While many small business owners want to offer their employees a high quality retirement plan, they may not have the time or expertise to properly evaluate their various investment options. As a result, they often rely on what they reasonably believe to be objective, trustworthy advice from financial professionals. There are many firms in the market today that offer advice to small business owners under a fiduciary standard. But in some cases what is presented as advice is actually a sales pitch. Indeed, by the industry's own admission, the small plan market is one in which "retirement plans are sold not bought."<sup>85</sup>

Industry surveys and advertisements acknowledge the fact that small plan sponsors are confused about setting up and running their plans. They emphasize that they are there to help navigate the many complicated decisions small employers have to make. For example, a 2012 survey by Fidelity found that 53 percent of the nation's nearly six million small businesses may not have optimal retirement plans that best fit their needs.<sup>86</sup> In addition, Fidelity found that "many small business owners are struggling to understand the features and benefits of their current retirement plans." The survey of more than 500 small business owners gauged the respondents' understanding of SEP-IRAs, SIMPLE-IRAs and Self-Employed 401(k) plans, and the results highlight the education gap that many small business owners face with regard to their current plans. When asked a series of basic questions about their retirement plan features and benefits, respondents on average answered just 66 percent correctly.

In response to its findings, Fidelity published a Viewpoints article outlining the basic differences in the various plans in order to educate small business owners about their options.<sup>87</sup> In the press release announcing the article, Ken Hevert, vice president of Fidelity Investments,

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<sup>85</sup> See, e.g., Elaine Floyd, "A Quick Guide to Retirement Plans for Small Business Owners," Parks Capital, 2012, <http://bit.ly/1LY6U7H>. See also Five Reasons Small Business Owners Should Establish a New 401(k) Plan, PayChex.com, August 12, 2013, <http://bit.ly/1fYdeKd>; Financial advisor guide to selling small business plans, American Funds, June 2015, <http://bit.ly/1LYbbrV>.

<sup>86</sup> Press Release, "Fidelity® Survey Finds More Than Half of Nation's Six Million Small Businesses May Not Have Optimal Retirement Plans," February 22, 2012, <http://reut.rs/1Kgqcg9>.

<sup>87</sup> Retirement plans for small businesses, Fidelity Viewpoints, June 3, 2015, <http://bit.ly/1RJz1pR>.



highlighted the advisory nature of Fidelity’s services: “To ensure small business owners are in the best plan, Fidelity works closely with them to evaluate their specific retirement savings goals through one-on-one guidance with our investment professionals and educational content online.” In the article itself, Fidelity offered its services to small business owners looking for help, stating: “But what type of retirement plan is the right fit for your business? There are several types to choose from and the options can be confusing.” Hevert was quoted in the article as well, indicating that small plan sponsors don’t understand their options, can’t independently determine what option is best for their unique circumstances, and need help in making those decisions. “Many small-business owners say they want to set up a 401(k) plan because that is the plan they are most familiar with... However, after reviewing their situation, small business owners often conclude that perhaps another plan type, such as a SEP IRA or a Self-Employed 401(k), may be more appropriate,” he said. At the bottom of both the release and the article, Fidelity included the standard disclaimer in tiny font: “Although consultations are one on one, guidance provided by Fidelity is educational in nature, is not individualized, and is not intended to serve as the primary or sole basis for your investment or tax-planning decisions.”

Similarly, Raymond James advertises on its website that, “For many business owners, the question is not ‘Should I implement a retirement plan?’ Rather, it is ‘Which plan is right for my business?’ The choices are many: SEP, profit sharing, 401(k), SIMPLE IRA and defined benefit, to name a few. This web page is designed to resolve some of the confusion caused by the wide range of choices available to business owners like you.... What is the right retirement plan for your business? The retirement plans discussed here illustrate that there are a wide variety of choices available to you as a business owner. With help from your financial advisor – a professional committed to your needs – you can choose the plan that best suits your business retirement plan needs and objectives. Of course, we cannot offer legal advice to clients. Before implementing any plan, you should consult with your tax and/or legal advisors.”<sup>88</sup>

In both cases described above, the disclaimers are directly contradicted by an overarching message that the financial adviser is there to help the business owner cut through the confusion and identify the best option for them. A small business person who doesn’t even know his or her basic options when setting up a plan is highly unlikely to understand the implications of such a disclaimer. After all, everything else in the presentation is designed to send exactly the opposite message -- that the information is individualized and is designed to be acted upon. They are just as unlikely, in our view, to understand and appreciate disclosures relating to sales-related conflicts.

A 2012 GAO report provides further support for the notion that small plan fiduciaries lack the expertise and sophistication necessary to protect against advisers’ conflicts of interest.<sup>89</sup> According to its findings, “Small employers and other stakeholders said that plan options and administration requirements are frequently complex and burdensome and discourage some small employers from sponsoring a plan. For example, some small employers and retirement experts said that the number of plan types and features make it difficult for small employers to compare and choose plans. Representatives of a plan service provider said that too many plan options

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<sup>88</sup> Choosing the right retirement plan for your business, Raymond James, <http://bit.ly/1HealtU>.

<sup>89</sup> Government Accountability Office, Private Pensions: Better Agency Coordination Could Help Small Employers Address Challenges to Plan Sponsorship, March 2012, <http://1.usa.gov/1gK1efq>.

overwhelmed small employers, making it more difficult for them to choose a plan and, ultimately, less likely that they will sponsor one.”<sup>90</sup>

The report also found that small employers have trouble understanding and carrying out their fiduciary responsibilities, and often rely on professionals for advice about what to do. According to the report, “A number of stakeholders indicated that understanding and carrying out a sponsor’s fiduciary responsibilities with respect to their qualified retirement plans presents significant challenges to some small employers. . . . Some small employer sponsors found the selection of investment fund options for their plans particularly challenging. A small employer with a 401(k) plan described the difficulties of selecting appropriate investment options, with an appropriate balance of risk, for a workforce that includes younger and older workers. A number of small business advocates and retirement experts said that not all small employers have an adequate understanding of their fiduciary duties and are not always aware of all their responsibilities under the law. For example, a retirement expert said that small employers that do not consult with plan professionals often lack the time and expertise to understand complicated fiduciary rules under ERISA. One service provider explained that some small employers mistakenly believe that all fiduciary responsibilities and liabilities are transferred to a service provider when they are hired. Another expert noted that some small employers have an exaggerated sense of the liabilities that being a fiduciary carries, and may avoid sponsoring a plan out of fear of being sued by their employees.”<sup>91</sup>

In the report’s recommendations section, stakeholders said more education and outreach are needed to increase awareness of plan options and requirements. Officials of a service provider to small businesses even stated that, “because clients are generally not aware of the retirement plan options available to them, the federal government should provide more education and outreach to improve awareness of the plan types available and rules that apply to each.”<sup>92</sup> Our experience suggests, however, that education alone is unlikely to be effective. A far more effective solution is to ensure that the advice small business owners receive with regard to their plans is delivered under a fiduciary duty and consistent with the best interests of plan participants. That is best achieved through the approach adopted by DOL in its revised rule proposal of limiting the seller’s exemption to large plans. Again, we appreciate the DOL’s willingness to reconsider and revise the applicability of a seller’s carve-out, and we strongly urge the agency to maintain this approach in a final rule.

3. *The platform provider carve-out should be strengthened to better protect against the harmful impact of conflicted payments.*

The rule provides a broad carve-out from the definition of fiduciary investment advice for service providers, such as recordkeepers and third-party administrators, who offer a “platform” or selection of investment vehicles to participant-directed individual account plans. Under the terms of the carve-out, the plan fiduciaries would be required to choose the specific investment alternatives that will be made available to participants for investing their individual accounts. Where that is the case, service providers would not be deemed to be acting as investment advice

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

fiduciaries by virtue of marketing or making available such investment vehicles, without regard to the individualized needs of the plan or its participants and beneficiaries, as long as they disclose in writing that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. We believe this carve-out does not adequately protect against the harmful impact of conflicted payments on the selection of platform menu options.

The selection of plan investment menus is vitally important to plan participants. This determines whether they will have high quality, low cost options available to choose from when they participate in workplace retirement plans. And that in turn can have a dramatic impact on the size of retirement nest egg they are able to amass over a career of workplace retirement savings. But research has shown that the payments platform providers receive from mutual fund companies and other investment product sponsors, and incentives to promote their proprietary products, affect the choices they make regarding selection of investment options for their platforms and can do so in ways that is harmful to plan participants.

A 2011 GAO report raised significant concerns regarding the potential harmful impact of third-party payments to plan service providers on selection of investment options by those service providers. It states: “Several industry experts we spoke with cited third-party payments, also known as revenue sharing, as a potential conflict of interest for service providers involved in the fund selection process for a 401(k) plan. ... According to industry experts, revenue sharing is a widespread practice among 401(k) service providers. As we have previously reported, revenue-sharing payments can be used to offset expenses the plan has agreed to pay and thus be cost-neutral to the plan. However, ... revenue sharing may, depending on the circumstances, also create a conflict of interest if it is not structured to be cost-neutral to the plan and may result in increased compensation to service providers. Industry experts we spoke with explained that this situation creates an incentive for the service provider to suggest funds with higher revenue-sharing payments. Because of these conflicts of interest, the service provider may suggest funds that have poorer performance or higher costs for participants compared with other available funds.”<sup>93</sup> The report noted, moreover, that, “The amount of revenue-sharing payments can vary considerably, both across investment funds and within a fund through different share classes. Documentation we obtained showed revenue-sharing payments from hundreds of share classes of different investment funds that ranged from 5 to 125 basis points (bps). Given this variation, EBSA field investigators told us that a service provider might only recommend or include fund share classes that pay higher revenue sharing and exclude other fund share classes that pay lower or no revenue sharing.”

A Pension Research Council Working Paper raises similar concerns with regard to the harmful impact of conflicts that arise when mutual fund families acting as service providers in 401(k) plans display favoritism toward their own affiliated funds.<sup>94</sup> The study finds that “affiliated mutual funds are less likely to be removed from and more likely to be added to a 401(k) menu. In addition, fund deletions and additions are less sensitive to prior performance for

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<sup>93</sup> GAO, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, January 28, 2011, <http://1.usa.gov/1gJXDy2>.

<sup>94</sup> Pool, Veronika K., Sialm, Clemens, and Stefanescu, Irina. “It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans,” Pension Research Council Working Paper, May 2015, <http://bit.ly/1MfLygb>.

affiliated than for unaffiliated funds.” It finds “no evidence that plan participants undo this affiliation bias through their investment choices.” On the contrary, the study finds that “the reluctance to remove poorly-performing affiliated funds from the menu generates a significant subsequent negative abnormal return for participants investing in those funds.”

These are precisely the sorts of conflicts of interest that this rule is intended to protect against. Moreover, the same concerns that apply to small plan fiduciaries’ ability to assess conflicts in the context of a seller’s exemption apply equally with regard to services from platform providers. And yet, the platform provider carve-out does not even require that these conflicts be clearly disclosed, let alone that they be appropriately constrained. We urge the Department to revise the conditions of the carve-out to address these shortcomings. Ideally, any third-party payments received by service providers relying on the platform carve-out should have to be structured to be cost neutral to the plan. At a minimum, the selection of investment options should have to be based on neutral criteria and those criteria should have to be disclosed to plan fiduciaries, and any financial incentives to favor certain investment products in the selection of menu options should have to be clearly disclosed in a consistent manner. We believe these changes are necessary and appropriate to ensure that plan participants have access to the highest quality investment options.

### **III. Best Interest Contract Exemption**

By closing loopholes in the definition of fiduciary investment advice, the proposed conflict of interest rule expands the population of fiduciary advisers to include many whose compensation practices do not comport with ERISA’s strict prohibition on conflicted payments. The Best Interest Contract Exemption (BICE) is designed to ensure that financial advisers can comply with their fiduciary obligations under ERISA regardless of their business model. It achieves this in part by borrowing from securities law principles, in particular replacing ERISA’s “solely in the interest” standard with a “best interest” standard that relies on mitigation rather than elimination of conflicts. The result is a principles-based rule that is both tough and flexible.

In assessing the rule proposal, we have identified certain fundamental features of the BICE that are in our view critical to its effectiveness. Chief among them are the following:

- The protections afforded by the rule must be legally enforceable.
- They must include a fiduciary duty to act with prudence and loyalty and in the best interests of the customer.
- That obligation must be backed by meaningful restrictions on industry practices that encourage recommendations that are not in the best interest of the customer.
- Compensation must be limited to what is reasonable.

Those features must be included in the DOL’s final rule for the agency to make a proper finding under section 408(a) of ERISA that this exemption is in the interests of plans and their participants and beneficiaries and IRA owners and protective of the rights of participants and

beneficiaries of plans and IRA owners. While there are areas where we believe adjustments can and should be made, we believe the proposed BICE meets this standard. Moreover, additional provisions of the BICE – such as the enhanced disclosure requirements and additional protections for sales from a limited menu of products – reinforce these central components in ways that significantly strengthen the rule.

A. The Protections Afforded by the Rule Must be Legally Enforceable.

If the rule is to achieve its goal of providing meaningful new protections to retirement savers, it must include a mechanism by which firms and their advisers can be held legally accountable for the investment recommendations that they make to retirement investors in both the employee benefit plan and IRA contexts. It is especially critical to create legal enforceability in the IRA context, because ERISA's general fiduciary obligations of prudence and loyalty do not currently apply in the IRA context. While the Code's prohibited transaction rules do apply in the IRA context, neither IRA owners nor the Secretary of Labor can bring suit to enforce those prohibited transaction rules. And the Internal Revenue Service, which does have enforcement authority, does not have the resources to provide effective enforcement of the rule.

The BICE achieves this legal enforceability by requiring that the adviser and the adviser's firm enter into a written contract with the retirement saver prior to providing fiduciary investment advice. This written contract must affirmatively state that the adviser and financial institution are fiduciaries under ERISA or the Code or both with respect to any investment advice to the retirement investor, that the adviser and financial institution affirmatively agree to, and comply with, impartial conduct standards, and that the adviser and financial institution make certain warranties. The contract must also contain certain disclosures, discussed below, and not contain any prohibited contractual provisions.

CFA strongly supports the contract requirement of the BICE, which is crucial to providing legal enforceability, particularly in the IRA market. We recognize, however, that financial firms have raised strong objections to the contract requirement, arguing that, at least as currently drafted, the requirement is unworkable. Though some of these concerns appear to be greatly exaggerated, others appear to be based on at least a grain of truth. We are therefore open to considering alternative approaches as long as the end result is a legally binding obligation that includes the key components of the BICE.

One concern raised by industry relates to timing. It has been suggested, for example, that customers may not be willing to sign a contract before they are ready to implement a financial adviser's recommendations. This could create a chicken-and-egg dilemma, where the adviser can't get a signed contract in place until they have provided recommendations, and can't provide recommendations until a contract has been signed. In our view, it isn't absolutely crucial that a contract be in place before any advice is rendered, as long as the legally binding agreement covering all advice rendered is in place before any investment based on that advice is implemented. As part of any such contract, the firm and its advisers must be required to represent or acknowledge that they are acting in a fiduciary capacity, that they are legally bound by the impartial conduct standards and the warranties in the BIC when their recommendations are implemented, and those standards and warranties apply retroactively to cover the

recommendations themselves. Under such an approach, retirement investors would have the necessary protections in place when it counts, before they act on any advice they receive.

Another argument put forward by many in the financial industry is that getting contracts in place with millions of existing retirement advice customers would be virtually impossible. Their argument seems to hinge largely on the fact that millions of retirement savers will simply fail to respond to requests to sign contracts. Without their signature, firms would not be allowed to provide investment advice pursuant to conflicted compensation models. While we recognize that requiring retirement savers to sign the BIC has benefits – primarily that it alerts them to the legal protections to which they are entitled – it does not appear to us to be crucial to its enforceability. Retirement investors are not the “party to be charged” under the law. Rather, it is the firm and the adviser who are bound by the terms in the contract. In this respect, the contract should be viewed as unilateral in nature, whereby the recommendation is an offer inviting acceptance through performance, and the retirement investors’ implementation of that recommendation is the acceptance. Alternatively, we think it could be possible to achieve the same result without a written contract between the firm, adviser, and retirement saver. Principles of estoppel would dictate that if a firm and its adviser represent they are acting in a fiduciary capacity and complying with the impartial conduct standards and the warranties in the BIC, and a retirement investor justifiably relies on those representations by implementing the adviser and firm’s recommendations to her detriment, the firm and its adviser should be estopped from later denying fiduciary status or having made those representations.

Given that we do not believe retirement investors would have to sign a legal contract for that contract to be enforceable, we think the burdens of getting a legally enforceable document in place could be streamlined, particularly for existing customers. Existing customers could be mailed a change in terms notice outlining the new obligations the firm would be required to undertake under the BIC. As long as no new obligations or restrictions were placed on the customer, this approach should be acceptable. For new customers, we believe firms are likely to have their own reasons to want to get a contract in place, if only to require the customer to sign a pre-dispute binding arbitration clause. Where this is the case, the BIC can and should be included as part of the other account opening paperwork the customer is required to sign. Where this is not the case, the accommodations suggested above with regard to the timing of the contract should be sufficient to address any concerns about getting a contract in place with new customers.

The approaches suggested above address situations in which the retirement saver has a direct relationship with the fiduciary investment adviser. For retirement plan participants, however, the retirement saver may have only an indirect relationship with the adviser through their employer. Since servicing contracts in the plan context are between a firm and the employer, it should be possible to use that contract as the basis for providing plan participants with legally enforceable protections under BIC. For example, instead of requiring all the different prospective parties to the contract to sign that contract, the firm could name the employees as third-party beneficiaries to the contract. Such an approach could significantly reduce the burdens of getting a contract in place. In order to put plan participants on notice that they are entitled to legal protections under BIC, they could be provided with a series of written representations based on the BIC at the time they open an account or (where they are

automatically enrolled) when they receive their first account statement or other paperwork related to the account.

The suggestions provided above are not the sole means of getting a legally enforceable agreement in place. We encourage the Department to explore various alternatives to determine which provide the best combination of workability and legal enforceability.

#### B. The Rule Must Include a Best Interest Standard.

Compliance with the BICE requires adherence to certain specified impartial conduct standards when providing fiduciary investment advice. These include, first and foremost, an obligation to provide advice that is in the best interest of the retirement investor, but also to receive only reasonable compensation in light of services provided and to refrain from making misleading statements. Failure to comply with these standards would result in loss of the exemption, which helps to ensure that they will be taken seriously by financial advisers who rely on the BICE. We strongly support these requirements, which are essential to protect against the harmful consequences associated with conflicted advice. The impartial conduct standards, discussed here, and the required warranties, discussed below, are essential building blocks that reinforce each other, creating a framework of meaningful protections that should help to ensure retirement investors' interests are paramount.

Best Interest Standard: The rule defines best interest advice as advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor. This best interest standard effectively mirrors the ERISA section 404 duties of prudence and loyalty, which have provided effective safeguards for plans and plan participants for forty years. Importing this proven standard into the IRA market will provide retail retirement investors with the same, much needed protections.

Importantly, the proposal makes clear that a recommendation is assessed for compliance with the best interest standard based, not on the outcome of that recommendation, but on the circumstances prevailing at the time the recommendation is made. Thus, hindsight is irrelevant to how a recommendation is gauged. This is both appropriate and directly contrary to claims by some in the financial industry that the rule exposes advisers to liability based solely on the outcome of their investment recommendations. As the Department notes in the proposing release, courts have extensive experience interpreting this standard. In general, they focus on whether the fiduciary employed appropriate procedures to investigate the merits of the recommended investment. Thus, as discussed above, claims that the standard will expose advisers to a flood of litigation have no basis in either the regulatory language or past experience of those subject to the same standard.

Finally, the rule requires that the advice be made “without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.” This “without regard to” language is critically important in the context of conflicted advice, because it provides concrete protections against an adviser’s recommending a product based on personal financial considerations rather than the interests of the customer. Including this

language as part of the impartial conduct standards should help to rein in common industry practices that are designed to pressure or incentivize advisers to recommend products for reasons other than the best interests of the investor. It is worth noting that, when members of the broker-dealer community express support for a “best interest” standard, they typically omit this crucial language, suggesting that the “best interest” standard they support is one that doesn’t actually require meaningful changes in current, often harmful business practices.<sup>95</sup> However, this same language is mirrored in the securities law concept of a best interest standard for fiduciary investment advisers as reflected, for example, in Section 913 of the Dodd-Frank Act. Thus, the rule’s best interest standard is consistent with the standard that the SEC would apply if it were eventually to adopt rules under its Section 913 authority. It is frankly disingenuous for industry groups to state that they support a best interest standard based on securities law principles, then oppose the very standard Congress identified as appropriate for this purpose.

### C. Compensation Must Be Limited to What is Reasonable.

Another critically important component of the impartial conduct standards is the requirement that firms agree that their advisers will not make recommendations in which the total amount of compensation anticipated to be received by any adviser, the firm, or its affiliates will exceed reasonable compensation in relation to the total services provided to the retirement saver. As the DOL makes clear, the reasonableness of the fees depends on the particular facts and circumstances. Although many in the financial industry have expressed a significant amount of bewilderment about what “reasonable compensation” means, how this standard would be applied, and how the industry could comply with it, the reasonable compensation standard is in fact well-established in law and in practice.

As the DOL notes, the obligation to pay no more than reasonable compensation is long recognized under ERISA and the rules promulgated pursuant to ERISA. For example, ERISA section 408(b)(2) allows a plan to pay a party in interest for services rendered if several conditions are met, including if “no more than reasonable compensation is paid therefore.”<sup>96</sup> In addition, ERISA section 408(c)(2) states that nothing shall prohibit plan fiduciaries from “receiving any reasonable compensation for services rendered.”<sup>97</sup> And, shortly after ERISA’s passage, the DOL clarified what constitutes reasonable compensation, stating -- just as it has in this proposal -- that it “depends on the particular facts and circumstances of each case.”<sup>98</sup>

Furthermore, the DOL has reiterated its adherence to the reasonable compensation standard repeatedly. For example, in a 1997 Advisory Opinion, the DOL stated that if a plan service provider receives a payment from a third party, that payment must be taken into account in determining whether compensation paid is reasonable.<sup>99</sup> Moreover, in a 2002 Field Assistance Bulletin, it stated that ERISA’s fiduciary duties require a responsible plan fiduciary, when selecting or monitoring service providers, to engage in “an objective process designed to elicit

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<sup>95</sup> See, e.g., SIFMA, “Proposed Best Interests of the Customer Standard for Broker-Dealers,” June 3, 2015, <http://bit.ly/1M56eog>.

<sup>96</sup> Section 408(b)(2) of the Act, codified as 29 U.S. Code § 1108 - Exemptions from prohibited transactions, implemented through 29 CFR Part 2550.408b-2(a)(2), <http://1.usa.gov/1TO66i3>.

<sup>97</sup> Section 408(c)(2) of the Act, codified as 29 U.S. Code § 1108 - Exemptions from prohibited transactions.

<sup>98</sup> *Id.*, implemented through 29 CFR Part 2550.208c-2(b)(1) through 2550.208c-2(b)(4).

<sup>99</sup> DOL Advisory Opinion 97-15A (May 22, 1997), <http://1.usa.gov/1SxjCEb>.



information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided.”<sup>100</sup>

The standard strikes an appropriate balance, helping to discipline excessive costs but not requiring the lowest cost option in every instance. Experience in the plan context demonstrates that the reasonable compensation standard does not necessarily require the lowest cost option. In fact, the DOL confirmed this principle when it provided guidance under ERISA section 408(b)(2), stating, “a fiduciary need not necessarily select the lowest-cost service provider, so long as the compensation or fees paid to the service provider are determined to be reasonable in light of the particular facts and circumstances.”<sup>101</sup> And, as experience in the plan context further demonstrates, there is a wide disparity in the costs that plan sponsors and participants pay for the services they receive. This has been documented in research by ICI and Deloitte on retirement plans’ all-in costs<sup>102</sup> and in a 2006 GAO report that examined the various fees associated with 401(k) plans.<sup>103</sup> According to the GAO report, while the DOL’s “most recent in-depth review of fees identified some plans with high fees, it determined that they were not unreasonable or in violation of ERISA.”

It is true that in recent years there has been a growth in private litigation relating to various 401(k) fee arrangements, but it is too early to tell what effect those cases will have on 401(k) plan fees more broadly. Because each of those cases is based on its unique facts and circumstances, the results may not offer much clarity. But no one expects courts to require plans to adopt the lowest cost option in every circumstance. On the other hand, the court cases are likely to have a salutary effect on the market, pushing plans to discipline costs so as to ensure that they are meeting the reasonable compensation requirement. Those same dynamics would benefit retirement investors in the retail market.

Indeed, the real reason behind industry’s expressed concern over this “reasonableness” standard is not that it is too vague, in our view, but that it calls into question certain common industry practices that drive up costs to retirement savers. As the DOL states, the reasonableness of a fee must be considered in relation to the value of the services being provided. Under common industry practices, however, an adviser and the adviser’s firm can be paid vastly different sums for providing exactly the same services, depending solely on the particular investment recommended. This is an inherent feature of a market in which products compete to be sold, not bought, and do so on terms that are favorable to the adviser, rather than the investor. The rule would help to rein in such practices by prohibiting advisers and their firms from taking outsize payments for recommending certain products that go well beyond the reasonable compensation justified by the time spent or the difficulty of the analysis behind the recommendation. Similarly, a reasonable compensation standard calls into question the common industry practice of receiving on-going compensation for a one-time transaction. How, for example, would financial advisers justify a one-time recommendation that a buy-and-hold

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<sup>100</sup> DOL Field Assistance Bulletin 2002-3 (Nov. 5, 2002), <http://1.usa.gov/1Mklwt7>

<sup>101</sup> Preamble to DOL Regulation Section 2550.408b-2, Section B-1.(g)

<sup>102</sup> Press Release, “Retirement Plan Fees Vary with Plan Size and Diversified Equity Holdings, Deloitte/ICI Study Finds,” August 20, 2014, <http://bit.ly/1Kgd7Gw>.

<sup>103</sup> Government Accountability Office, Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees, November 2006, <http://1.usa.gov/1OhH5rO>.

retirement investor purchase mutual fund C shares with a one percent 12b-1 fee for the life of the investment, when they provide no ongoing account oversight and have no ongoing duty of care?

Some in the industry have urged the Department to bless existing compensation practices as inherently “reasonable,” on the grounds that they do not violate existing securities and insurance laws and regulations. We strongly disagree. Failure to rein in these harmful practices is just one of the many ways in which securities and insurance regulators have failed to provide appropriate protections for consumers and investors. The DOL rule offers a welcome antidote to their weak and ineffective regulation in this regard. On the other hand, because this requirement does take financial firms into new territory, it may be helpful for the DOL to issue guidance as it implements a final rule that provides examples of the types of compensation practices the DOL would view as running afoul of the reasonable compensation rule.

D. The Best Interest Standard Must Be Backed Up by Restrictions On Industry Practices that Conflict with Customers’ Interests.

The best interest standard is, by its very nature, subject to interpretation. In a business model replete with conflicts of interest, there will be overwhelming incentives to try to justify recommendations that are suboptimal for the retirement investor, but highly profitable for the adviser or the firm. The rule proposal recognizes that the key to making the best interest standard real for sales-based advisers is reining in the practices that encourage these advisers to act in ways that are not consistent with their clients’ best interests. The reasonable compensation and “without regard to” language of the impartial conduct standards should help to achieve that goal. But another crucial component is the BICE requirement that financial firms contractually warrant that they have adopted written policies and procedures that are reasonably designed to mitigate the impact of material conflicts of interest that exist with the provision of retirement investment advice.

To comply, firms must identify material conflicts of interest and adopt measures to prevent those material conflicts of interest from causing violations of the impartial conduct standards. In addition, the financial institution “must state that neither it nor (to the best of its knowledge) its Affiliates or Related Entities will use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differentiated compensation or other actions or incentives to the extent they would tend to encourage individual Advisers to make recommendations that are not in the best interest of Retirement Investors.” This requirement, even more than the best interest requirement itself, will force firms that rely on the exemption to take concrete, meaningful steps to eliminate practices that exacerbate potentially harmful conflicts.

These types of firm compensation policies that reward activities that are harmful to clients’ interests are rampant in the market today.<sup>104</sup> Below are a few examples, taken from firms’ Form ADV Part 2A and other public disclosures discussing affiliated broker-dealer activities:

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<sup>104</sup> See, e.g., Various Firms’ Payout Grids, OnWallStreet.com, <http://bit.ly/1QcCxbj>.

- Wells Fargo: “From time to time, we initiate incentive programs for our Associates, including FAs... FAs who participate in these incentive programs may be rewarded with cash and/or non-cash compensation, such as deferred compensation, bonuses, training symposiums and recognition trips. Portions of these programs may be subsidized by external vendors and/or our affiliates, such as mutual fund companies, insurance carriers, or investment advisers. Therefore, FAs and other Associates may have a financial incentive to recommend the programs and services included in these incentive programs over other available products and services we offer.”<sup>105</sup>
- Edward Jones: “Internal Incentive Programs – We may offer internal incentive programs that may provide financial advisors and branch office administrators with an opportunity to earn additional compensation or prizes.”<sup>106</sup>
- USAA: “In particular, an FAI Representative’s eligibility to participate in certain USAA bonus plans is dependent upon his or her individual performance rating which measures a variety of factors, including...sales of USAA products and services...FAI Representatives may also receive non- cash rewards, such as team meals or conference participation, for meeting individual and/or team performance goals.”<sup>107</sup>
- Northwestern Mutual: “Your Representative may also receive bonus, transition, retention or other compensation ... in connection with the sales and servicing of various investment products. The rate of compensation paid to NMIS registered representatives increases if revenue generated from the sales and servicing of various investment products and advisory services meets or exceeds certain thresholds. As an agent of NM, your Representative accrues production credits arising out of the sale of all risk-based insurance products in the aggregate, including annuities that are being serviced by an advisory program. NM rewards its agents for achieving certain levels of production credits with non-monetary rewards and recognition such as being invited to conferences, receiving gifts and being given preferential service by the Home Office.”<sup>108</sup>
- PNC: “From time to time, PNC Investments initiates incentive programs for its employees including FAs [Financial Advisors] or other PNC Investments representatives. These programs include, but are not limited to, programs that compensate them for attracting new assets and clients or for referring business to our affiliates ... and programs that reward FAs or other PNC Investments representatives who meet total production criteria. FAs or other PNC Investments representatives who participate in these incentive programs may be rewarded with cash and/or non- cash compensation, such as deferred compensation, bonuses, training symposiums and recognition trips. These programs may be partly subsidized by external vendors or our affiliates, such as mutual fund companies, insurance carriers or money managers. Therefore, our FAs or other PNC Investments representatives and other associates may have a financial

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<sup>105</sup> Part 2A of Form ADV Firm Brochure for: Wells Fargo Financial Planning Services, at 10, March 2015.

<sup>106</sup> Understanding How We Are Compensated For Financial Services, at 2, <http://bit.ly/1Vlt0ip>.

<sup>107</sup> Part 2A of Form ADV Firm Brochure for: USAA Financial Planning Services Insurance Agency, Inc., at 5, April 1, 2015.

<sup>108</sup> Part 2A of Form ADV Firm Brochure for: Northwestern Mutual Investment Services, LLC, at 24, April 1, 2015.

incentive to recommend the programs and services included in these incentive programs over other available products and services that we offer.”<sup>109</sup>

- UBS: “Financial Advisors also may receive certain awards based on their production amount, length of service with UBS, business mix and net new assets. ... In addition, Financial Advisors acting as Insured Solutions Consultants (“ISCs”) receive additional production credits for the sales of certain insurance products.”<sup>110</sup>
- Schwab: “In addition, from time to time, one or more categories of our representatives may participate in short-term, temporary incentive programs focusing on a particular class of products or services, including new accounts and new assets to Schwab. ... Certain representatives who demonstrate exceptional performance during the year may also be eligible to earn an annual trip through Schwab’s Chairman’s Club, or other awards. Schwab may develop additional recognition events or programs from time to time.”<sup>111</sup>
- Fidelity: “Fidelity employees may participate in incentive contests and may earn various non-cash rewards based on customer investments in products and services and other criteria, including but not limited to the number of referrals for particular programs or services that they make or customer investments in certain types of products or services. Such reward programs will generally rank representatives or teams against other eligible representatives or teams and determine the eligibility for rewards based on that ranking. Therefore, representatives may have a financial incentive to offer those programs, services or products.”<sup>112</sup>

While not all such incentive programs would necessarily violate the standards, many would. For example, some firms set quotas for the sale of certain investment products and base advisers’ bonuses or payouts on their success in meeting quotas. Such practices would appear to be a clear violation of the rule proposal. Similarly, firms would be hard pressed to justify continued use of contests or other incentives to encourage the sale of particular products or product lines. We strongly support such restrictions as a necessary step to help ensure that retirement investors no longer receive recommendations that are driven by an adviser’s desire to win a contest or receive a bonus, rather than the customer’s financial interests.

The rule proposal also tackles the use of differential compensation, which is so central to the conflicts that can bias sales-based advisers’ recommendations. Specifically, while firms could still pay their advisers differential compensation, those differential payments would have to be based on neutral and objective factors, such as the amount of time necessary to research and implement the investment strategy, and not just on a desire to promote sales of particular investments. This would be a significant improvement from the way compensation is currently provided, which creates incentives to sell products that are not in retirement savers’ interest.

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<sup>109</sup> Part 2A of Form ADV Firm Brochure for: PNC Investments LLC, at 8, May 15, 2015.

<sup>110</sup> Part 2a of Form ADV Firm Brochure for: UBS Financial Planning Services, at 10, March 31, 2015.

<sup>111</sup> Investment Professionals’ Compensation, Schwab, <http://bit.ly/1OrXLxy>.

<sup>112</sup> Introduction to Representatives’ Compensation, Fidelity, <http://bit.ly/1Gw8VLb>.

Below are a few examples, taken from firms' Form ADV Part 2A and other public disclosures discussing how compensation policies create conflicts of interest:

- MetLife: “As a result of such additional compensation being paid for the sale of products or services to implement the Financial Plan, a conflict of interest arises. In other words, the additional compensation gives Financial Planner and MSI an incentive to recommend products and services to implement the Financial Plan based on the compensation received, rather than on a client’s needs.”<sup>113</sup>
- Ameriprise: “Ameriprise Financial Services and the financial advisor receive more compensation on fund or share classes that pay higher fees. Ameriprise Financial Services and the financial advisor generally receive less compensation when the sales charge and/or 12b-1 fee is reduced, waived completely, or where there is no sales charge. Therefore, there is an incentive for our financial advisors to sell a fund from a load fund family or a fund that pays a 12b-1 fee over one that does not ... which may influence your financial advisor to recommend certain funds or classes over others.”<sup>114</sup>
- JPMorgan: “However, our interests may not always be the same as those of brokerage clients, as we may be paid both by them and by other parties who compensate us based upon what the brokerage clients purchase, and our profits and salespersons’ compensation may vary by product and over time.”<sup>115</sup>
- UBS: “The compensation structure may create financial incentives for Financial Advisors to encourage clients to purchase multiple products and service or to choose a method of payment for products and services that generate compensation in excess of that for other products.”<sup>116</sup>
- RBC: “The differences in compensation create an incentive for financial advisors to recommend products for which they receive higher compensation. ... This will add to the overall compensation that we receive and may present a conflict of interest based on an incentive to recommend investment products based on the compensation received, rather than based on your needs.”<sup>117</sup>
- Schwab: “Some of these compensation plans are based on revenue Schwab earns from clients or from product sales, and Schwab may pay a Schwab representative more for selling products or services on which Schwab makes more money.”<sup>118</sup>
- Fidelity: “As disclosed in this document, representatives who offer certain services may receive compensation as a direct or indirect result of your selection of those services.

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<sup>113</sup> Part 2A of Form ADV Firm Brochure for: Financial Planning Services MetLife Securities, Inc., at 11, January 1, 2015.

<sup>114</sup> Part 2A of Form ADV Firm Brochure for: Ameriprise® Financial Planning Service, at 18, March 30, 2015.

<sup>115</sup> Part 2A of Form ADV Firm Brochure for: J.P. Morgan Securities Portfolio Manager Program, at 37, March 31, 2015.

<sup>116</sup> Part 2A of Form ADV Firm Brochure for: UBS Financial Planning Services, at 10, March 31, 2015.

<sup>117</sup> Part 2A of Form ADV Firm Brochure for: RBC Capital Markets, LLC Financial Planning, at 6, March 31, 2015.

<sup>118</sup> Investment Professionals' Compensation, Schwab, <http://bit.ly/1OrXLxy>

This compensation may be more than what the representative would receive if you participated in other programs or services. Therefore, representatives may have a financial incentive to offer certain programs or services.”<sup>119</sup>

Given the pervasiveness of such practices, it should come as no surprise that many financial firms have expressed vehement opposition to this component of the rule. In addition to making false claims that the rule would prohibit differential compensation entirely, they have argued that the restrictions are too vague or unworkable. Even the industry’s self-regulator, FINRA CEO Rick Ketchum, expressed the view that the BICE as currently written doesn’t “really describe a broker-dealer model that I’m aware of.”<sup>120</sup> But that, of course, is precisely the point: the regulation is designed to change current practice, not bless it. By suggesting, as FINRA does in its comment letter on the rule, that differential compensation should be accepted as an unavoidable conflict, FINRA provides a clear an example of why DOL should not defer to securities regulators’ “leadership” in adopting an appropriate standard to govern conflicted advice.

Indeed, if there is a problem with the rule’s provisions regarding differential compensation, it is that they may not go far enough. We are concerned, for example, that allowing differential compensation based on neutral and objective factors may implicitly condone and encourage the sale of more complex, higher cost products, such as annuities, where higher compensation levels could be justified based on the argument that those products take more time than other products to explain and understand. We hope that the other requirements of the BICE would mitigate the potential abuse that could result from improperly relying on the neutral and objective factors language. In our view, however, the only way to ensure that advisers are not tempted to rationalize recommending more complex, high cost products is to level the compensation that they receive for all of the products that they recommend.

Despite the fact that the proposal is crystal clear that differential compensation would be permitted, some industry participants nonetheless have claimed that the only way they could ensure compliance with the policies and procedures warranty would be to fee-level at a firm level. They have pointed to the examples of broad approaches to compensation structures that the DOL has offered to illustrate how firms might satisfy their policies and procedures. While it is true that those examples are rigorous, the DOL made clear that they “are not exhaustive, and many other compensation and employment arrangements may satisfy the contractual warranties.” We also find it ironic that after the DOL provided exactly what the industry asked for -- a principles-based approach that provides firms flexibility to accommodate their various business models -- many industry participants have argued that they need more and clearer guidance regarding how to comply.

Insofar as the industry has gotten one thing right with regard to the policies and procedures requirement, fee-leveling at a firm level would be the clearest, simplest, and most effective way to root out conflicts. Short of that, however, fee-leveling at the adviser and branch manager levels would be the most targeted, bang-for-the-buck approach. Combined with the

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<sup>119</sup> Introduction to Representatives’ Compensation, Fidelity, <http://bit.ly/1Gw8VLb>.

<sup>120</sup> Melanie Waddell, “FINRA’s Ketchum Criticizes DOL Fiduciary Plan,” *Investment Adviser Magazine*, May 1, 2015, <http://bit.ly/1bT12rH>.



rule's restrictions on using quotas, bonuses, personnel decisions and other factors to incent recommendations that are not in a customer's best interests, such an approach would create an appropriate amount of breathing room that would help to insulate recommendations from being based on financial incentives that are designed to serve firm revenue goals.

Some firms already fee-level to varying extents at the adviser level, which suggests it would be eminently feasible to expand on this approach. For example, with regard to mutual funds, Stifel Nicolaus states in its customer agreement disclosures that its "compensation formula does not favor one fund or fund family over another, and commission revenue is paid out to your Financial Advisor on the same basis regardless of the fund family, similar to any commission revenue received by the firm."<sup>121</sup> Likewise, with regard to insurance products, "Stifel's compensation formula does not favor one insurance company's products over another. All commission revenue is paid out to the Financial Advisor on the same basis."<sup>122</sup> While some of those differences in compensation among types of investments may be justified on neutral terms, others arguably would not. However, the fact that some firms have successfully adopted models that move in this direction suggests that still more could be accomplished if there were regulatory pressure to do so.

We hope that, through the comment process and the Department's ongoing engagement with affected parties, new suggestions will emerge for methods of appropriately constraining compensation-related conflicts. If so, we would encourage the Department to provide additional guidance regarding acceptable conflict mitigation practices. One thing that should be absolutely clear, however, is that the industry's preferred approach of requiring disclosure and consent to material conflicts is grossly insufficient. Such an approach would do nothing to actually change the types of firm policies and practices that create and exacerbate conflicts of interest. Furthermore, as discussed above in the Seller's Carve-out section of this letter, extensive academic and empirical evidence shows that disclosure is ineffective at best, and harmful at worst. Accordingly, the DOL should resist any suggested changes by industry to water down the policies and procedures warranty requirement by requiring only disclosure and consent to material conflicts of interest.

#### E. Other Provisions of the BICE Help to Strengthen and Reinforce Its Central, Essential Requirements.

While we view the above provisions as absolutely essential to the BICE's effectiveness, we also strongly support other aspects of the proposed rule that help to reinforce these central components. These include provisions that limit the types of investments that advisers can recommend when they are receiving conflicted compensation, that impose additional requirements with regard to recommendations from a limited menu of proprietary products, and disclosures designed to better inform retirement investors of the costs of their investments and the conflicts that could influence their adviser's recommendations.

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<sup>121</sup> Stifel Account Agreement and Disclosure Booklet, <http://bit.ly/1IehGPw>.

<sup>122</sup> *Id.*



1. *We support strengthened protections to counteract the significant conflicts associated with recommendations of proprietary products and from a limited menu of products.*

The conflicts inherent in sales-based advice can be exacerbated when the adviser sells from a limited menu of products or sells proprietary products, regardless of whether those products are part of a limited menu. To combat the problem, the rule requires a financial institution relying on the BICE to make a specific written finding that the limitations do not prevent the adviser from providing advice that is in the best interest of retirement investors or from otherwise adhering to the impartial conduct standards. Payments received in connection with these limited menus must be reasonable in relation to the value of specific services provided and cannot exceed the services' fair market value, a more specific than is otherwise required under the reasonable compensation standard. Advisers would be required to disclose the extent to which the financial institution places limits on the investment products they are able to offer. And, as an added crucial protection, the adviser would have to notify the retirement investor if the firm did not recommend a sufficiently broad range of investment options to meet the investor's needs. CFA strongly supports the proposed approach which, while it permits recommendations based on a limited menu of products, appropriately protects against the enhanced risks associated with that business model.

While some firms recommend only proprietary products, many others sell proprietary products alongside non-proprietary products. In many such cases, advisers receive additional compensation or other incentives from their firm for selling proprietary products. Even where an individual adviser's compensation is unaffected, advisers may nonetheless be pressured by their superiors to sell proprietary products over non-proprietary products, based on firm revenue considerations. These incentives can make it exceedingly difficult for advisers to provide recommendations that are in retirement savers' best interests.

Firms' ADV Form disclosures illustrate the types of conflicts that may be present when they sell proprietary products:

- Wells Fargo: "Products recommended by us may include proprietary products of us or our affiliates. You should note that we have an incentive to recommend proprietary products because we or our affiliates earn more compensation from the sale of these products than from the sale of non-proprietary products."<sup>123</sup>
- AXA: "Financial Professionals may receive other compensation and benefits related to the sales of proprietary products. Accepting this type of compensation may present a conflict of interest in that there is an incentive to recommend investment products based on the compensation received, rather than on a client's needs."<sup>124</sup>

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<sup>123</sup> Part 2A of Form ADV Firm Brochure for: Wells Fargo Financial Planning Services, at 10, March 2015.

<sup>124</sup> Part 2A of Form ADV Firm Brochure for: AXA Advisors, LLC, at 16, March 31, 2015.

- MetLife: “Thus, your Financial Planner has a conflict of interest when recommending the sale of affiliated securities or insurance products as a registered representative or as an insurance agent.”<sup>125</sup>
- Putnam: “Compensation may include commissions based on the successful sale of particular Putnam funds or strategies/services. Accordingly, Putnam personnel have an incentive to sell Putnam products and services.”<sup>126</sup>
- Ameriprise: “Ameriprise Financial Services has a financial interest in the sales of proprietary products that are manufactured by its affiliates.”<sup>127</sup>
- USAA: “The revenues of FPS and FAI are primarily derived from the sales and service of USAA products and services.”<sup>128</sup>
- RBC: “This may raise a conflict of interest as we may be incented to recommend the RBC Funds over a non-RBC Fund.”<sup>129</sup>

Given the potential harm to investors when firms sell proprietary products rather than superior non-proprietary products, it is appropriate that, before recommending such products, an adviser must satisfy all the requirements of the BICE, including those that apply to recommendations from a limited menu. These additional requirements are necessary and appropriate to protect retirement investors’ interests and ensure that, regardless of the limited options their advisers are recommending from, they are still receiving best interest advice and their particular needs are being met.

*2. We support limitations on the types of investments that can be recommended subject to conflicted compensation.*

The rule proposal restricts the types of investments that advisers can recommend when they receive conflicted advice to a group of specific assets listed in the proposed rule. Contrary to some industry claims, it does not in any way restrict the types of assets that retirement savers can choose to invest in, where they make independent choices about their retirement investments, nor does it restrict the types of investments that advisers can recommend when they do not receive conflicted payments. The DOL’s stated purpose for this listing approach is threefold: first, the list captures those investments that are commonly purchased by plans, participant and beneficiary accounts, and IRAs; second, it ensures that the investments needed to build a basic diversified portfolio are available to plans, participant and beneficiary accounts, and IRAs; and third, the list limits the exemption to those investments that are relatively transparent and liquid, many of which have a ready market price.

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<sup>125</sup> Part 2A of Form ADV Firm Brochure for: Financial Planning Services MetLife Securities, Inc., at 14, January 1, 2015.

<sup>126</sup> Part 2A of Form ADV Firm Brochure for: Putnam Investment Management, LLC, at 23, March 30, 2015.

<sup>127</sup> Part 2A of Form ADV Firm Brochure for: Ameriprise® Financial Planning Service, at 18, March 30, 2015.

<sup>128</sup> Part 2A of Form ADV Firm Brochure for: USAA Financial Planning Services Insurance Agency, Inc., at 4, April 1, 2015.

<sup>129</sup> Part 2A of Form ADV Firm Brochure for: RBC Capital Markets, LLC Financial Planning, at 11, March 31, 2015.

Some in the financial industry have claimed that the list of permissible assets under the BICE significantly and inappropriately restricts what advisers can recommend to their clients, thus hindering their ability to serve their clients. Despite such claims, however, the list of permissible assets that can be recommended pursuant to the BICE is extensive. It includes, for example: bank deposits, certificates of deposit (CDs), exchange-listed stocks, mutual funds, exchange-traded funds (ETFs), exchange-traded Real Estate Investment Trusts (REITs), registered corporate bonds, Treasuries, and annuities. The list of permissible assets does not include: private placements, non-traded REITs, private equity, or hedge funds. For a large majority of retirement savers, such assets have no place in their retirement accounts. Instead, they are traditionally reserved for more sophisticated and wealthier investors, who can sustain significant potential losses without jeopardizing their retirement security.<sup>130</sup> These assets also typically have extraordinarily high fees for investors and, as a result, lofty commissions for advisers and their firms. We therefore agree that the increased risks associated with recommendations of such investments by conflicted advisers outweigh the limited benefits of making them available under the BICE for the small percentage of retirement savers for whom they would be appropriate.

While we commend the DOL for seeking to achieve the vital goals discussed above, the DOL correctly notes that many investment types and strategies that would not be considered permissible assets if invested in directly can be obtained through pooled investment funds, such as mutual funds, which are considered permissible assets. As a result, the list is not nearly as limiting as industry opponents have suggested, but it is also vulnerable to being circumvented and thus may not offer the protections that the DOL seeks to achieve. For example:

- While an adviser would not be able to recommend purchasing private placements or non-traded REITS under the BICE, the adviser could recommend purchasing a closed-end fund holding private placements or non-traded REITS.
- Similarly, while an adviser would not be able to recommend purchasing futures or options (i.e. derivatives), the adviser could recommend purchasing a leveraged ETF to gain the same type of exposure.
- In addition, municipal bonds are not included in the permissible list of assets, ostensibly because most municipal bonds are tax exempt and thus duplicate the tax benefits associated with retirement accounts, thus decreasing their benefit and rendering them ill-suited for a retirement account. Just as in the other cases, however, an adviser could get around this restriction by recommending an open-end municipal bond fund.

These are just a few of the examples that we've come up with to circumvent the list. We have no doubt clever financial advisers and their firms will think of others. On the other hand, if the apparent reasoning for excluding municipal bonds – that they already receive a tax-advantage, which effectively reduces the investor's yield, thus rendering them inappropriate for retirement

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<sup>130</sup> According to the industry's own arguments, such investors are likely to invest through fee-based accounts, which would generally be unaffected by the restrictions.

accounts – were to apply to other tax-preferred assets, tax-deferred annuities would also be excluded from the list of permissible assets.

Because the DOL’s listing approach may not achieve the agency’s goals and is likely to result in an intense and interminable lobbying campaign from various product providers to have their products placed on the list of permissible assets, we think another approach might be warranted. As with other requirements of the BICE, this approach would be principles-based, such that for an adviser to recommend a certain asset pursuant to the BICE, that asset must:

- Have an observable market price (transparent pricing);
- Be capable of being sold in the secondary market at or near its fair market value within a reasonably short amount of time (sufficient liquidity);
- Be transparent and not excessively complex in structure;
- Have a sufficient track-record to demonstrate its utility;
- Not be excessively leveraged; and
- Not provide a redundant or illusory tax-benefit inside a retirement account.

These principles should apply to both the underlying assets within a pooled investment vehicle and to the investment vehicle itself, unless the vehicle provides benefits (e.g., liquid secondary market and transparent pricing) absent in the underlying asset. If a firm can’t show why an asset its advisers are recommending satisfies these principles, there should be an inference that the asset is incapable of satisfying the best interest of any retirement investor.

Based on our review of the proposed asset list, almost all of those assets would satisfy the principles discussed above. However, depending on what underlying assets comprise certain closed-end funds or ETFs, they may not satisfy the principles. For example, if a closed-end fund included non-traded REITs, because the underlying assets do not meet the principles, the asset should not satisfy the principles. In addition, inverse and triple-leveraged ETFs should not satisfy the principles because of their excessive leverage. Furthermore, new, untested products such as exchange traded managed funds (ETMFs), should not satisfy the principles because they don’t have a sufficient track-record to demonstrate their utility and they do not in fact have the transparency that they claim.<sup>131</sup> Finally, tax-deferred products, such as annuities, would likely have trouble satisfying the “redundant or illusory tax-benefit” restriction. We believe a strong principles-based approach, such as the one we have suggested, will better achieve the DOL’s goals, while still allowing firms flexibility to recommend a wide variety of products appropriate to retirement savers.

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<sup>131</sup> While these funds advertise as having “NAV-based trading,” an investor does not actually buy at the NAV at the time of the purchase. Rather, the NAV that the investor is buying (and doesn’t know) is the NAV at the end of the day on which the purchase is made.

3. *Proposed disclosures provide an important supplement to the best interest standard and conflict restrictions.*

The proposed BICE includes a set of required disclosures designed to provide greater transparency around the costs and conflicts associated with retirement investment advice. These requirements directly address the problem, discussed above, that many retirement savers (like investors more generally) do not understand the costs of either the investments they purchase or the services of financial professionals they turn to for advice, do not understand the long-term impact of those costs on their retirement savings, and do not understand either the extent or nature of the conflicts that could bias the recommendations they receive. While disclosure alone is not adequate to ensure that retirement savers can protect their own interests, enhanced disclosure can provide a useful supplement to the proposed rule's other more central protections (e.g., best interest standard, mitigation of conflicts).

Well-designed disclosures can benefit retirement savers in two basic ways. Direct disclosures can alert individuals to issues they might otherwise have ignored, in this case issues regarding costs and conflicts. To achieve this goal they must provide individuals with the information they need, in a form they can understand, and at a time when it is useful to them in making an investment decision. The less the individual has to do to track down and decipher the information, the more likely it is to be effective in supporting informed decision-making. But even where individuals do not make good use of direct disclosures, they can still benefit from the enhanced transparency that public disclosures provide. Public disclosure can be effective, for example, in promoting cost competition that brings down costs even for those who do not make cost-conscious decisions. Public disclosure requirements can also cause firms to abandon practices that, while legal, are embarrassing in a field that likes to promote an image of professionalism and reliability.

The Department's task in creating effective disclosure is made more challenging by the unnecessary complexity of industry compensation practices and by the failure of securities and insurance regulators either to rein in harmful conflicts or to adopt effective cost and conflict disclosures. Despite those challenges, the Department has proposed a disclosure regime that includes both actionable information for individual retirement savers and enhanced transparency that should help to bring the forces of market competition to bear to the benefit of all plans, plan participants and IRA investors. The proposed disclosure requirements include the following key components:

- Website Disclosure

The rule requires that financial institutions maintain a regularly updated and easily accessible public website that shows the compensation payable to the adviser, the financial institution and any affiliate for services provided in connection with each asset made available to plans, plan participants or IRA investors. Disclosures must be provided for each asset made available either currently and over the preceding 365 days. All direct and indirect material costs must be provided for each asset unless costs are uniform across a class of assets, in which case disclosure by asset class would suffice. The compensation may be expressed as a monetary

amount, formula or percentage of the assets involved in the purchase, sale or holding, and the webpage must include a version of the information in a machine readable format.

The required website disclosures are key to providing the transparency that can help to bring market forces to bear on industry practices. As noted above, even investors who never review these disclosures may benefit if the resulting transparency helps to promote cost competition in an area – compensation for advice – that has traditionally been opaque and, as a result, largely immune to these competitive forces. Moreover, we agree with the Department that the requirement that information be provided in machine readable format should make it possible for financial information companies to analyze the cost data and provide information comparing the practices of different advisers and financial institutions. Individual retirement savers and plan fiduciaries alike should benefit from services that help them to evaluate costs and compensation practices.

- Contract Disclosures

The contract mandated under the BICE includes required disclosures with regard to both costs and conflicts. Specifically, the disclosures must identify all material conflicts of interest. These may be described in general terms as long as the contract also discloses that a more specific description of conflicts is available on the financial institution’s website, including a web address where the information can be found, and by mail upon request. In keeping with the requirement to disclose conflicts, the written contract must indicate whether the financial institution offers proprietary products or receives third party payments. Finally, the contract must inform the advice recipient that he or she has the right to obtain complete information about all of the fees currently associated with the assets in which the account is invested, including all of the fees payable to the adviser, financial institution, and any affiliates and related entities in connection with such investments.

SEC focus group research on investors’ disclosure preferences suggest that retirement savers would appreciate these upfront disclosures with regard to compensation and conflicts. For example, one focus group participant stated: “I think that before you start with them that they should be able to disclose what their conflicts are before you even start. I think requiring them to initially tell you what the conflicts are would be an easy way to solve it and have it noted.” Another stated: “I think at the beginning that you have a dialogue with that person, and then right at the time when you’re about to buy something.”<sup>132</sup> It is this potential to cause investors to ask questions or start a discussion regarding costs and conflicts that is likely to be the primary benefit of these contract disclosures.

While we hope that the required contract disclosures will drive advice recipients to ask questions and dig more deeply with regard to costs and conflicts, this is far from guaranteed. General disclosures of the type anticipated here are often overlooked or ignored, particularly as they tend to be written in bland legalese that fails to convey the importance of the information. Given the variety of business models among firms likely to rely on the BICE, however, it seems impractical to try to overcome this problem by proscribing set disclosures. The requirement that

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<sup>132</sup> Siegel & Gale, LLC, *Investor Research Report*, Submitted to the Securities and Exchange Commission on July 26, 2012, <http://1.usa.gov/1MfBbss>.

the web address be included with the disclosures should at least help to ensure that retirement savers who are interested in researching costs and conflicts do not have to go searching far and wide for the relevant information. This requirement to include the web address is essential to the disclosures' effectiveness and should be retained in a final rule.

- Individual Transactional Disclosure

Those who wish to rely on the BICE must also provide detailed cost information in advance of any transaction for which they provide fiduciary advice. The disclosure must cover the all-in costs of the proposed transaction, including the anticipated costs of the investment for 1-, 5- and 10-year periods. These costs must be expressed as a dollar amount and must be based on the dollar amount recommended by the adviser and reasonable assumptions regarding investment performance, which must be disclosed. The disclosures would have to be provided “in a time frame that would enable the Retirement Investor to discuss other (possibly less costly) alternatives with the Adviser prior to executing the transaction.”

Requiring pre-sale, dollar amount disclosures of investment costs has long been a priority of investor advocates. Although the SEC issued a proposal for point of sale disclosure of mutual fund costs during the early years of the Bush Administration, nothing ever came of it. Similarly, the SEC has failed to act on the Dodd-Frank Act's explicit authorization to require pre-sale disclosures for investment products and services, even though its own research shows that investors prefer to receive information in advance of the sale. The transactional disclosures proposed by DOL will help to fill that void by providing retirement savers with actionable information at a time when they are most likely to be able to make good use of it.

The key to providing effective cost disclosure is to report costs in dollar amounts, in a form that is, to the extent possible, easily comparable across assets, and to provide the information at a point where it can be factored into the investment decision. The DOL rule proposal meets all these standards for effective disclosure. First, it requires costs to be disclosed not simply as percentages, but as dollar amounts. This is critical to promoting investor understanding. Research has shown that the “absolute magnitude effect” – the tendency for people to perceive numbers as the absolute value of the quantities inherent in them, and not as the actual statistical figures they represent – can affect investors' perceptions of numerical values such as investment returns and, by extension, costs. As researchers who have examined this phenomenon explained, this causes a person “to perceive a larger change in their portfolio if the return was expressed as 24 percent versus an identical return of 0.24” and to “perceive an even larger change if it was expressed in a dollar amount as long as the change was more than \$24.”<sup>133</sup> The same is certain to hold true for costs, which are more likely to be understood and less likely to be dismissed as insignificant if they are presented as dollar amounts.

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<sup>133</sup> LoMando, Joseph, “Tips 401k Plan Sponsors Can Use to Help Employees Avoid Risk Aversion,” *Fiduciary News*, October 4, 2011. The article discusses several academic papers: “Presenting Investment Results Asset by Asset Lowers Risk Taking,” (Anagol and Gamble 2009); [“Numerical Information Format and Investment Decisions: Implications for the Disposition Effect and the Status Quo Bias,”](#) (Rubaltelli et al., *The Journal of Behavioral Finance*, 2005, Vol. 6, No. 1, 19–26); and “Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience,” (Agnew and Szykman, *The Journal of Behavioral Finance*, 2005, Vol. 6, No. 2, 57–70).” This information is based on the discussion of Rubaltelli et al.



Disclosing costs in dollar amounts also greatly increases the ease of comparison across assets and asset classes. This enhanced ability to compare costs is of critical importance, since many retirement savers are unlikely to understand without guidance whether a particular cost is high or low or somewhere in between. This is true with regard to investment costs, but even truer with regard to costs for advice. As discussed above, a significant percentage of investors currently believe the advice they receive is provided free of charge. Others know they are paying something, but don't know how much. This has protected financial advisers from the cost competition that would come with better disclosure and enable broker-dealers to maintain the myth that their services are generally less costly than those of fiduciary advisers. Finally, requiring the disclosures to be based on the suggested investment amount will further enhance investor understanding.

We are particularly pleased that the Department also proposes to provide disclosures that highlight the long-term impact of costs. This will further increase the likelihood that retirement savers will factor costs into their investment decision. We have heard some in industry suggest that they can't provide these disclosures without violating FINRA rules, presumably because the rule suggests that the firm select (and disclose) a reasonable rate of return in order to calculate the long-term costs when making the disclosures. To the degree that this is a genuine concern, the DOL can easily overcome it by specifying a rate of return for use in making such calculations. This would increase comparability and reduce the risk that firms would use rates of return for this purpose that are designed to minimize the cumulative costs. Given the limitations in these estimates, it would be important to require that the disclosures make clear that these are estimates and that actual costs may be lower or higher. While the resulting information would be an imperfect predictor of long-term costs, it would be a significant improvement over the status quo.

Finally, in providing pre-sale disclosures, timing is crucial. If the goal is to encourage advice recipients to review the information carefully, it is essential that the information be provided, not in a flurry of paperwork at the point of finalizing the transaction but rather, as the proposed rule requires, with sufficient time for the advice recipient to consider the information and factor it into their investment decision. We have long preferred the point of recommendation, rather than point of sale, as the appropriate time for such disclosures. However, while the rule provides somewhat more flexibility with regard to timing of disclosures, it is consistent with the principle of allowing time for consideration and discussion of the disclosed information. Because the information is specific to each transaction, it should be required to be provided with each transaction, and not simply in limited circumstances, such as account opening or rollover.

This pre-sale timing of disclosures, while it has been resisted in the past by industry, enjoys strong support among investors. The SEC Financial Literacy Study states, for example, that: "Generally, retail investors prefer to receive disclosures before making a decision on whether to engage a financial intermediary or purchase an investment product or service."<sup>134</sup> For example, asked about their preference regarding delivery of compensation information, 71.3 percent of survey respondents indicated that they want to receive information on how they will

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<sup>134</sup>Siegel & Gale, LLC, *Investor Research Report*, Submitted to the Securities and Exchange Commission on July 26, 2012, <http://1.usa.gov/1MfBbss>.

pay for services before they begin the relationship. They made it clear, moreover, that they want some time to think about the information. Among those who said they want the information prior to beginning the relationship, just under a third said they want it at least a day or two in advance (32.7 percent) and four in ten (40.8 percent) said they want it at least a week before they begin the relationship.

The Department asks whether a “cigarette style” warning would be as effective as but less costly than actual cost disclosures. While such a warning would certainly be less costly than the proposed cost disclosures, it would also be significantly less effective. Experience tells us that investors are far less likely to go in search of information than they are to read information that is provided to them directly. Indeed, there is no evidence that these sorts of generic warnings have any meaningful impact on investor behavior. We would strongly urge the Department against adopting this far inferior approach. Retirement savers deserve real, actionable information about their investment costs, not boilerplate warnings.

- Individual Annual Disclosure

The proposal backs up its requirement for pre-sale disclosure with a requirement that the adviser or financial institution provide annual cost disclosures to advice recipients covering the costs and compensation associated with all assets purchased or sold by the plan, plan participant or IRA investor over the previous year. The disclosures must: list the price at which each asset was bought or sold; must include a statement of the total dollar amount of all fees and expenses paid with respect to each asset purchased, held or sold during the applicable period; and must include a statement of the total dollar amount of all compensation received by the adviser and financial institution, directly or indirectly, from any party, as a result of each asset sold, purchased or held by the plan, participant or beneficiary account, or IRA, during the applicable period.

While the pre-sale disclosures regarding long-term costs would necessarily be estimates, the mandate to provide annual disclosures would provide an opportunity to provide greater clarity around the actual costs paid by the retirement saver. As such, although our priority is ensuring that retirement savers get good cost information before they invest, the annual cost disclosures would serve as a useful supplement to the pre-sale disclosures.

We have no doubt that industry will suggest, with regard to both the pre-sale and the annual cost disclosures, that it is either not possible or too costly to provide the desired information. But any difficulty in providing these disclosures is driven by the complexity of a compensation system that seems at times to have been adopted with the express purpose of obscuring the costs of financial advice. The disclosures could provide an additional secondary benefit if the obligation to disclose drove industry to simplify its unnecessarily complex compensation practices.

#### *4. CFA supports the rule’s data request.*

A final condition of the BICE is that it requires firms that rely on the exemption to maintain certain data for six years. We strongly support the data request as essential to the

Department's ability to assess the impact and effectiveness of the rule. Financial firms have created a Catch 22 when it comes to adopting regulations designed to improve consumer and investor protections. First, they demand that regulators justify their rules based on a thorough economic analysis. As the DOL knows from direct experience, the firms then refuse to provide the data that would support a robust economic analysis. When the agency produces an economic analysis based on available data, they then cite the data limitations to suggest that the analysis is insufficiently rigorous or otherwise lacks merit, using their own highly selective and skewed data to refute it. The only way regulators can protect against such practices is to build data requests into their regulations, ensuring that they will have access to the information they need to accurately assess and monitor the effectiveness of their regulatory efforts. The rule's data request should go a long way to addressing these concerns.

*5. Industry complaints about the workability of the rule should be taken with a grain of salt.*

Before the Department released its revised rule proposal, the industry's key argument against the rule was that it would make it impossible for financial professionals who receive conflicted payments to serve this market because it would prohibit all conflicted payments. And they maintained that argument even in the face of repeated pledges by DOL officials that they intended to adopt PTEs to permit commissions and other forms of transaction-based compensation. Had concern about their ability to earn conflicted payments been the real issue, release of the BICE should have put that argument to rest. Instead, industry has simply adjusted the rhetoric around their campaign to have the rule withdrawn. Their new mantra is that the rule is "unworkable" and that it will let loose a flood of litigation, with the ultimate effect that it will force advisers who receive conflicted payments to abandon this market. Neither argument holds water, as we discuss in further detail below. Even in those few instances where their concerns have at least some basis in reality, there is nothing industry groups have raised with regard to the workability of the rule that couldn't easily be addressed through the rulemaking process. That is, after all, what the rulemaking process is for. Instead, this line of argument allows firms to oppose the rule without acknowledging that their real fear is that it would force them to change practices that are highly profitable for them, though considerably less beneficial for their clients.

*a) There is no basis for industry claims that the rule will lead to increased litigation.*

Industry has seized on the BICE's contract provision, which provides a means for holding firms and advisers legally accountable, to argue that the rule will "unleash a flood of litigation." While it is true that retirement savers with meritorious claims should find it easier to recover their losses if the rule is adopted, there is simply no basis for the claim that the rule would lead to an upsurge in litigation. To suggest that it would ignore not only the high cost of pursuing claims, and the particular difficulty of pursuing class action lawsuits, but the plain language of the rule itself.

Perhaps the most extreme of the claims with regard to litigation risk is that financial professionals will be vulnerable to lawsuits anytime their customers lose money on an investment they recommended or make less money than they could have made had they invested differently. This is patently absurd. There is no evidence that investment advisers who are

subject to a best interest standard under securities laws face such claims. Indeed, the rule proposal poses even less of a threat of such litigation than the securities law best interest standard, since it does not automatically impose an ongoing duty of care on ERISA fiduciaries. Only where the adviser agrees by contract to provide ongoing account oversight would he or she have to monitor the recommendation to ensure that it continues to serve the best interests of the customer. Absent such an agreement, there would be no ongoing duty under the proposed rule and thus no basis for a claim. Moreover, compliance with the standard would be determined based, not on the outcome of the recommendation, but on whether an impartial expert would view the recommendation as having been made in the best interest of the customer in light of prevailing circumstances at the time of the recommendation. Customers who wish to bring a case based solely on the outcome of the investment would be unlikely to find an attorney willing to represent them. Because of the unlikelihood of success, attorneys whose pay typically depends on the outcome of the claim would have no incentive to take such a case.

With equally little basis in fact, some opponents of the rule have suggested that the provision prohibiting advisers from forcing customers to sign away their right to participate in class action lawsuits represent a broad new expansion of liability. In reality, however, this provision merely reaffirms existing FINRA policy under the securities laws, which already prohibits broker-dealers from placing any such limitations on customer rights. There are two main reasons to believe class actions will remain the rare exception, rather than the rule. The first is that very few cases will lend themselves to class treatment. The second is that even cases that lend themselves to class treatment face significant barriers.

Claims based on violation of fiduciary duty turn on whether the recommendation was in the best interest of the customer. That is a very fact-specific determination that will differ for each customer based on his or her personal situation and needs. However, an attorney seeking to certify a class must prove commonality of the harm suffered throughout the class. As a result, the vast majority of claims based on violation of fiduciary duty simply will not lend themselves to class treatment and will continue to be brought as individual claims in arbitration.

Moreover, class actions face daunting procedural barriers that often prevent such actions from moving forward. First, a judge must approve of the formation of a class and allow the named plaintiff to bring the action on behalf of the class. For this to occur, a representative plaintiff must prove commonality of harm among class members, that the class is so numerous that it is impracticable to bring suit otherwise, that the claims or defenses of the named plaintiff are typical of the claims or defenses of the class, and that the named plaintiff will fairly and adequately represent and protect the interests of the class.<sup>135</sup> Most classes seeking money damages also require a judge to find that issues common to the class members predominate over issues affecting individual members and that a class action is superior to other available methods of adjudicating the controversy.<sup>136</sup> If a class manages to clear these hurdles and is certified by a judge, a defendant can appeal the court's decision, which can tie up the case and increase costs for a named plaintiff and his or her attorneys.<sup>137</sup> The appeals process can delay, and often cripple

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<sup>135</sup> Fed. R. Civ. P. 23(a).

<sup>136</sup> Fed. R. Civ. P. 23(b)(3).

<sup>137</sup> Fed. R. Civ. P. 23(f).

the progress of a class action, turning it into a battle of attrition where the party with the most resources (usually the defendant) wins.

As a practical matter, smaller firms simply do not have a big enough client base to make class treatment worthwhile. Instead, the most likely class action target under the proposed rule would be a large firm that, in clear violation of the rule, adopts policies and practices that encourage their advisers to provide conflict-ridden retirement investment advice. For example, a large firm that continued to use quotas and bonuses to encourage the sale of in-house products across its IRA platform could be vulnerable to class action litigation. Similarly, a large firm could face class action litigation if it relied on the best interest contract exemption to engage in widespread sale of products that are clearly not permitted under that exemption, such as non-traded REITS. These are precisely the sorts of situations where class actions provide an appropriate and effective mechanism to hold firms accountable for compliance with the rule.

For the reasons noted above, most claims brought under the rule proposal are likely to be individual claims. Because the DOL's proposal specifically allows firms to include pre-dispute binding arbitration clauses in their contracts, the vast majority of these claims will likely be heard in the industry-run FINRA arbitration forum rather than in court. Although arbitration is promoted as providing an inexpensive alternative to court, the costs are sufficient to deter even small meritorious claims, let alone the frivolous claims industry argues are a threat under the DOL rule proposal. For example, a combination of filing fees, discovery costs, expert witness fees, hearing session fees, and costs for a court reporter can easily add up to \$30,000 before attorney's fees, according to attorneys who are familiar with the system. Most attorneys work on a contingency fee, which means they agree to front a significant portion of the litigation costs in return for receiving reimbursement and a percentage of any recovery. Cases have to be worth their time, effort, energy and resources, otherwise they aren't going to invest in them. As a result, they have little if any incentive to take cases unless they expect to win and to win an award sufficient to cover the considerable costs of bringing the claim. Alternatively, an attorney can charge by the hour. That can add up very quickly to tens of thousands of dollars in legal bills that all but the wealthiest claimants will be unable to afford. If, despite these deterrents, an investor brings a frivolous claim, that investor may be responsible for paying the other side's attorneys fees, possibly amounting to an additional tens of thousands of dollars.

Furthermore, real-world evidence demonstrates that concerns about the industry's claims regarding excessive litigation risk are drastically overblown. Investment advisers are fiduciaries under the securities laws and thus subject to a best interest standard, yet they do not face an outside liability risk. Many broker-dealers are dually registered as investment advisers and are thus accustomed to operating in a fiduciary capacity, with regard to fee-based or discretionary accounts for example. Moreover, a leading claim brought against broker-dealers in arbitration (regardless of whether they are dually registered as advisers) is violation of fiduciary duty, often based on a claim that the broker held out as providing on-going account management and then failed to do so. Despite this broad fiduciary exposure, FINRA's own dispute resolution statistics show quite convincingly that these broker-dealers are not exposed to excessive litigation risk. In each of the past three years, for example, between 1,873 cases and 2,216 cases that involved breach of fiduciary claims were filed.<sup>138</sup> While significant, this is nowhere near the "flood of

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<sup>138</sup> FINRA, Dispute Resolution Statistics, <http://bit.ly/1ebKRGF>.

litigation” that the industry claims is likely to occur if brokers are subject to a fiduciary duty under ERISA.

We’ve heard these same, baseless industry arguments before, when it was suggested for example that fee-based accounts should be regulated as advisory accounts. The broker-dealer industry claimed that they’d be subject to excessive litigation risk, costs would increase for customers, and they would no longer offer fee-based accounts to investors. Here are just a few examples of the claims the industry made, which bear an uncanny resemblance to the claims they are making today regarding the DOL’s proposed rule.

- According to the law firm Morgan Lewis, “The combination of the views expressed in the adopting release and the media focus on these accounts may expose broker--dealers to heightened litigation risk for fee--based accounts if they elect to continue to offer these accounts absent additional regulatory relief.”<sup>139</sup>
- According to Chip Roame, head of Tiburon Strategic Advisors, a California-based industry research and consulting firm, “This is definitely increasing their reps’ liability. ...We’re going to see firms losing more and more lawsuits.”<sup>140</sup>
- Ira Hammerman, General Counsel of what was then the Securities Industry Association, which became SIFMA, stated that, “Converting fee-based brokerage accounts to advisory accounts “would likely work to the disadvantage of customers, who, as a result, could face increased costs or who could lose their chosen forms of brokerage accounts to the extent their broker-dealer determined not to continue to provide those forms of accounts rather than effect such conversion [to advisory accounts].”<sup>141</sup>
- Marc E. Lackritz, president of the Securities Industry Association stated that, “Placing broker-dealers that offer fee-based brokerage accounts to their clients under an additional, and wholly unnecessary, layer of regulation could have severely limited the availability of these popular accounts.”<sup>142</sup>
- In another letter by Hammerman: “The forced closure of this brokerage pricing avenue would be a major loss of client choice and a significant diminution in both pricing and account management flexibility that clients have come to expect and enjoy.”<sup>143</sup>

This is a mere snapshot of the claims that were made suggesting that regulating fee-based accounts as advisory accounts would lead to increased liability and cost investors access to valued services. Although the SEC bowed to industry pressure, their position was later

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<sup>139</sup> Morgan Lewis Securities Industry FYI, “Implications of the D.C. Circuit’s Decision Vacating Rule 202(a)(11)-1,” April 6, 2007, <http://bit.ly/1CSrDSb>.

<sup>140</sup> Susan Konig, Managers Learn To Live Without “The Merrill Lynch Rule,” WealthManagement.com, <http://bit.ly/1VlhJyp>.

<sup>141</sup> Letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, to the SEC, February 7, 2005, <http://1.usa.gov/1DqoYdi>.

<sup>142</sup> FPA Mulls Action After SEC Ruling, Financial Advisor, <http://bit.ly/1CLoXpF>.

<sup>143</sup> Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to the SEC, June 27, 2007, <http://1.usa.gov/1fhDmPb>

overturned in court. Since the U.S. Court of Appeals for the D.C. Circuit ruled in 2007 that fee-based accounts are advisory accounts, none of the parade of horrors that the broker-dealer industry predicted actually occurred. In fact, the number of fee-based accounts and the level of assets in fee-based accounts at broker-dealers have grown dramatically. Cerulli Associates found that, even after the broad market declines of 2008, the client assets in non-discretionary advisory accounts rose by almost 75 percent from approximately \$329.6 billion at the end of the conversion process in 2007 to \$574 billion in the third quarter of 2012.<sup>144</sup> Meanwhile, the level of fees charged to customers for this service model at the major national firms has stayed flat or decreased since 2007. In short, DOL should recognize that the industry has a long record of crying wolf in this regard and should not give such claims credence that they simply do not deserve.

One over-looked aspect of the rule proposal is its potential to reduce litigation by reducing predatory practices. In a recent letter to members, FINRA's Ketchum noted that firms could significantly reduce their compliance problems and regulatory risks if they would put the interests of their customers first.<sup>145</sup> By requiring firms to take concrete steps to eliminate practices that encourage bad conduct, the rule proposal achieves what FINRA only suggests. Moreover, it would not only require firms and advisers to put customer interests first, it would also require firms to eliminate the practices that encourage advisers to act in ways that are not in the customer's best interest. By reducing the incentives to steer clients into inferior investment options, the rule should reduce abusive conduct. As a result, firms that take seriously their obligation to mitigate conflicts and put the interests of customers first should see their liability risks reduced as a result of the better outcomes they achieve for clients.

While there is no reason to believe the proposed rule would increase the amount of litigation, it should improve the ability of those with meritorious claims to recover losses sustained as a result of abusive retirement investment advice. As a recent study by the Public Investors Arbitration Bar Association documented, the same financial professionals who routinely market themselves as objective advisers putting their customers first immediately drop that pose in arbitration and deny any such obligation. Because the rule proposal would force financial professionals who receive conflicted compensation to sign a contract in which they acknowledge their duty to give fiduciary advice, plaintiffs would no longer have to prove that a fiduciary relationship existed. Instead, it would be enough to show a violation of the standard, rather than that the standard applies.

Financial professionals who take advantage of retirement savers' trust should be held accountable for their abusive conduct. The rule proposal provides that accountability without posing any credible threat of excessive litigation or frivolous claims. Industry claims to the contrary are simply scare tactics designed to cover for their real concern, which is that they simply do not want to be legally accountable for putting the interests of their customers first.

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<sup>144</sup> As referenced in the Financial Planning Coalition letter to the SEC, Cerulli Associates, Cerulli Quantitative Update: Advisor Metrics, Exhibit 1.02 (2012).

<sup>145</sup> FINRA, 2015 Regulatory and Examination Priorities Letter, January 2015, <http://bit.ly/1F8782M>.



- b) *Where justified, concerns about the rule’s “workability” can be addressed through relatively minor revisions to the rule proposal.*

While much of the industry’s argument that the rule is unfounded consists of little more than overblown rhetoric, there are three issues that industry has raised that are based on at least a grain of truth.<sup>146</sup> All can easily be addressed through technical corrections or clarifications.

First, as currently drafted, the rule does not permit financial firms and advisers who receive conflicted payment to provide advice to plan sponsors who are acting on behalf of participant-directed plans with fewer than 100 participants. This results from the fact that advice to such plans does not qualify for either the Seller’s Carve-out or the BICE. Employers would still be able to receive advice from fiduciary advisers who do not receive conflicted payments. And those who are willing to take on some responsibility for selecting investment options will be able to receive non-fiduciary services under the Platform Providers Carve-out. However, there may be small employers who prefer, for whatever reason, to receive fiduciary advice from a financial firm receiving conflicted compensation. The answer is not, as industry suggests, to make the Sellers Carve-out universally available. A better approach is to expand the BICE to cover investment advice provided to sponsors who are acting on behalf of participant-directed plans.<sup>147</sup>

Second, some industry participants have claimed, we believe mistakenly, that the BICE is unavailable for rollover recommendations. Their claim hinges on the strange reasoning that “the exemption applies to advice relating to the purchase, sale, or holding of certain assets,” and that such an “asset-based approach means that the exemption does not apply to distribution or rollover advice.”<sup>148</sup> A rollover necessarily requires the sale and purchase of assets, and so long as the assets being recommended are those that the DOL deems permissible, we see no reason why rollover recommendations should not be covered by the BICE. To the extent the Department believes any clarification would be helpful in dispelling this misunderstanding, however, we encourage you to provide that clarification.

Third, as discussed above, questions have been raised about the timing of the contract and the best way to implement that requirement, particularly with regards to plan participants and existing customers. While we believe the legal enforceability provided by the contract requirement is central to the rule’s effectiveness, we remain open to approaches that would create added flexibility around the timing and mechanisms for implementing that contract so long as they do not dilute or diminish the legal enforceability of the fiduciary obligations.

There have also been some questions as to whether registered investment advisors (RIAs) who recommend rollovers to their customers should be required to claim relief under the BICE

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<sup>146</sup> A fourth issue that has been raised under the mantra of workability -- the question of whether firms could market their services without triggering a fiduciary duty -- is addressed above in the section of the letter devoted to the definition of fiduciary investment advice.

<sup>147</sup> See *supra* Seller’s Carve-out discussion explaining why small plan fiduciaries’ general lack of financial expertise and sophistication renders them ill-suited for the Seller’s Carve-out.

<sup>148</sup> Kent Mason, “Department of Labor’s Re-proposed Definition of a Fiduciary Widely Prohibits Personalized Investment Assistance Even if the Assistance is in the Customer’s Best Interest,” Davis and Harman, LLP, April 20, 2015, <http://bit.ly/1JbLXiI>.

or another applicable PTE. We believe they should. The recommendations that they make affect their own compensation, and therefore pose a conflict of interest. For example, if a client rolls over a \$250,000 account to the RIA and the RIA charges one percent per year for assets under management, the RIA stands to make \$2,500 per year on the client.<sup>149</sup> In contrast, if the client does not roll over her account, the RIA will make nothing. As a result, the RIA's recommendation to roll over poses an acute conflict that would trigger a prohibited transaction that must be adequately protected to ensure that the recommendation is in the client's best interest. Assuming the conflicted rollover transaction meets the requirements of the BICE, the RIA would need to claim relief for only that transaction, as his compensation would afterwards revert to a largely unconflicted payment model. With this analysis in mind, to the extent an RIA provides a recommendation relating to taking a distribution, the BICE should apply.

#### **IV. Principal Transactions Exemption**

The rule proposal includes an exemption to permit investment advice fiduciaries to sell certain fixed income (debt) securities to retirement plans and IRAs out of their inventory. Because advisers who sell out of inventory may be able to dictate unilaterally the price that investors pay and charge them more than is appropriate, enhanced protections are necessary to ensure the transactions being recommended and executed aren't disadvantageous to retirement investors.

##### **A. Principal Trading Poses a Risk of Abuse that Warrants Enhanced Protections.**

Principal trading creates opportunities for advisers to take advantage of their clients. The classic and perhaps clearest example is when an adviser “‘dump[s]’ unmarketable securities or securities that the adviser believes may decline in value into a customer’s account.”<sup>150</sup> However, as we have noted in several comments to the SEC on the matter, “‘While [dumping] might have been the primary potential abuse that principal trading created in simpler times, the potential for abuse arising from principal trades today is far broader and more varied than mere dumping. Advances in technology, speedier transactions, increased market volatility, more diverse trading platforms and other factors have brought benefits to the markets while also presenting more, and more complex, opportunities for principal trading abuses.’”<sup>151</sup>

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<sup>149</sup> This hypothetical assumes the RIA does not receive any third party payments. However, there is a growing wave of RIAs who do receive such payments. *See, e.g.*, Mason Braswell, Custodians payments to RIAs for fund picks raise eyebrows, Investment News, June 26, 2015, <http://bit.ly/1eerBJ0>. In the case in which an RIA receives third party payments, they should be required to continue claiming relief under the BICE, as their conflicts are no different than broker-dealers' or insurance agents', and we find the SEC's approach to this issue, requiring mere disclosure, insufficient to protect retirement investors' interests.

<sup>150</sup> SEC Proposed Rule: Temporary Rule Regarding Principal Trades With Certain Advisory Clients, Release No. IA-3893; File No. S7-23-07, <http://1.usa.gov/1I7aJve>.

<sup>151</sup> September 17, 2014 Letter from Barbara Roper, Director of Investor Protection of Consumer Federation of America, to Securities and Exchange Commission Secretary Elizabeth Murphy, <http://1.usa.gov/1OhNOSA>; *See also* November 30, 2007 letter from Mercer Bullard, Founder and President of Fund Democracy, and Barbara Roper, Director of Investor Protection of Consumer Federation of America, to Securities and Exchange Commission Secretary Nancy M. Morris, regarding File No. S7-23-07, <http://1.usa.gov/1RJM3ng>.

Debt securities are among the investments most commonly sold to investors on a principal basis. This is partly due to the fact that certain debt securities, including corporate bonds, are seen as less liquid than stocks, which is itself a result of a lack of standardization among products.<sup>152</sup> Another contributing factor is a regulatory inconsistency in disclosure requirements that creates an incentive for firms to execute trades in a principal capacity. Under SEC Rule 10b-10, a firm is required to disclose on its customer's trade confirmation the transaction costs the customer paid for stock transactions, regardless of whether the firm executed the transaction in an agency or principal capacity. However, for bond transactions, a firm is only required to provide the customer's transaction costs on its customer's confirmation if the firm executed the transaction in an agency capacity. Thus, if a broker-dealer arranges a bond trade for a customer on an agency basis, the broker must disclose the transaction costs he or she paid, reflected as a commission. However, if a broker-dealer arranges a bond trade for a customer on a principal basis, the dealer has no duty to disclose the transaction costs the customer paid, reflected as a markup or markdown. Thus, a firm can treat functionally equivalent transactions differently depending on how it chooses to characterize the transaction.<sup>153</sup>

Given this regulatory inconsistency, which allows firms to choose whether their clients receive confirmation disclosure of the costs they are paying, it is hardly surprising that firms execute virtually all customer fixed income securities transactions in a principal capacity. This allows firms to effectively withhold information from their clients that their clients would find useful. Consequently, firms are able to charge more than they otherwise would if they provided that cost information to their clients. More broadly, this disclosure loophole has helped to foster a market structure that preferences the trading of debt securities on a principal, rather than an agency basis. The result is an antiquated, over the counter, dealer-driven fixed income market that benefits the bond dealers who have an informational advantage over their customers.

Theoretical and empirical evidence suggests that, as a result of the opacity in fixed income markets, financial intermediaries are able to extract rents from their less sophisticated retail customers by charging them what appear to be excessively high transaction costs in fixed income markets. The price discrepancies further suggest that there are not sufficient protections designed to ensure that principal trades are executed in the best interests of investors, much less designed to ensure that principal trading abuses are rooted out. SEC Commissioner Michael Piwowar arguably has done more than anyone in recent years to highlight the ways in which retail investors have been harmed in fixed income markets. In 2007, Piwowar astutely observed: "Bond markets have been notoriously opaque....The lack of transparency in the bond markets has allowed market professionals – including sophisticated investors, brokers and dealers – to obtain vast sums of money from unsophisticated investors and taxpayers."<sup>154</sup> It is inevitable that, as a result of the market opacity, retail investors are unaware of instances in which principal trades with their broker-dealer were not in their best interests.

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<sup>152</sup> See Remarks by SEC Commissioner Daniel M. Gallagher, A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting, March 10, 2015, <http://1.usa.gov/1OrRW2Y>.

<sup>153</sup> The SEC adopted Rule 10b-10 in 1977. Commissioner Piwowar has referred to this issue as an opportunity to "pick low hanging fruit." Remarks by SEC Commissioner Michael S. Piwowar, Advancing and Defending the SEC's Core Mission, January 27, 2014, <http://1.usa.gov/1Ien0IP>.

<sup>154</sup> Piwowar, Michael S., Corporate and Municipal Bonds, Securities Litigation and Consulting Group, Inc., 2007, <http://bit.ly/1CwCN9V>.

A 2007 paper by Piwowar, Harris, and Edwards examined corporate bond transactions in 2003 and found that the average effective spread on a \$20,000 corporate bond trade was 1.24 percent of the price, making it the equivalent of over two months of the total annual return for a bond with a 6 percent yield to maturity.<sup>155</sup> Putting that cost in perspective relative to today's interest rates, it is equivalent to almost 5 months of the total annual return for a bond with a 3 percent yield to maturity. In comparison to a similar-sized equity trade, Piwowar, Harris, and Edwards found that this cost would be equivalent to an effective spread of 52 cents per share. The researchers also found that trading costs decrease dramatically with trade size, meaning that retail investors generally pay substantially more than institutional investors to trade a bond. This is in stark contrast to equity markets, in which retail investors generally pay lower transaction costs than institutional investors to buy and sell stocks due to the lower price impact of trading smaller amounts.

B. Current Regulatory Efforts, While Helpful, are Insufficient to Ensure Transactions are in Retirement Investors' Best Interests.

FINRA currently has efforts under way both to increase post-trade transparency of markups and to enforce its 5 percent markup policy, which is designed to require firms to buy and sell at prices that are fair and reasonable. In July 2002, Transaction Reporting and Compliance Engine (TRACE) began requiring bond dealers to report transaction data in U.S. corporate bonds in near real-time to what was then the National Association of Security Dealers (now FINRA), which made that transaction data available to the public for free. While overall bond trading costs have fallen as a result of increased price transparency, the evidence suggests that those benefits have not been noticeable for all investors. According to SEC Commissioner Piwowar, while institutional and sophisticated investors have seen their bond trading costs fall, retail investors' trading costs remain high. This is likely because institutional and sophisticated investors know that TRACE exists, know how to access the information on the site, and know how to interpret the transaction information that they find in order to gauge whether they are paying fair prices. Most retail investors, on the other hand, likely do not know TRACE exists and, even if they did, are not in a position to use the website with any reasonable degree of expertise. As a result, they likely are not able to realize the benefits that TRACE can offer.

FINRA has recently proposed to provide certain markup disclosures for same-day trades directly to retail investors, which marks an improvement over the status quo. The information that would be provided to retail investors would no doubt put them in a better position to understand the costs they are paying and to assess whether those costs are reasonable. However, while disclosure is an essential investor protection tool that can increase the likelihood that investors make more informed choices, disclosure alone will not effectively mitigate the risks to retirement investors posed by excessive markups in fixed income markets.

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<sup>155</sup> Edwards, Amy, Harris, Lawrence and Piwowar, Michael, "Corporate Bond Market Transaction Costs and Transparency," *Journal of Finance* 62, 1421-51 (2007), <http://bit.ly/1Bb6y0y>.

Similarly, FINRA recently has engaged in zealous enforcement of its 5 percent markup policy,<sup>156</sup> and has even instituted proceedings against firms for excessive markups and markups that are significantly below the 5 percent threshold.<sup>157</sup> Furthermore, FINRA has recognized that, since the policy was first instituted in 1943, advances in information and communication technologies, and member firms' front and back office technologies, have significantly reduced execution costs.<sup>158</sup> As a result, 5 percent is significantly higher than the average markup, markdown or commission currently charged by most member firms in customer transactions. Despite these efforts, FINRA may not be catching all instances of excessive markups. According to a recent Wall Street Journal article, "Bond-pricing service DelphX LLC found more than 60 transactions between October and November featuring markups above Finra's guideline. One broker paid 21 cents on the dollar for \$50,000 of bonds from now-bankrupt oil and gas concern Endeavor International Corp., when four minutes earlier it had charged an investor 25.1 cents for the same amount of the same bonds, earning a 19.52% markup."<sup>159</sup>

Thus, while we commend FINRA's efforts to improve the fixed income market structure generally, they are insufficient to ensure retirement investors' best interests are being protected when their fiduciary adviser buys from them or sells to them fixed income instruments on a principal basis.

### C. The DOL Has Proposed a Sensible Framework to Protect Retirement Savers from Principal Trading Abuses.

Given the constraints of the market structure and the SEC's apparent lack of appetite to fix even the most basic deficiencies in this market, we sincerely appreciate the DOL's efforts to mitigate the potentially severe conflicts of interest that exist for principal transactions. Unlike the anemic approach to principal trading regulation under securities laws, which is premised on the faulty notion that investors can make an informed choice about engaging in principal transactions if they are provided with prior notice, the DOL's approach does not rely exclusively on disclosure and consent. Instead, it incorporates concrete safeguards to prevent principal trading abuses.

First, we agree that, as with the Best Interest Contract Exemption, there must be a legally enforceable mechanism to hold advisers and their firms accountable for abuses. This includes

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<sup>156</sup> See, e.g., Press Release, "FINRA Fines Oppenheimer \$675,000 and Orders Restitution of More Than \$246,000 for Charging Unfair Prices in Municipal Securities Transactions and for Supervisory Violations," December 9, 2013, <http://bit.ly/1TMfLp9>; Press Release, "FINRA Fines StateTrust Investments \$1 Million and Orders \$353,000 in Restitution for Charging Unfair Prices in Bond Transactions," June 26, 2013, <http://bit.ly/1Dqr0KA>; Press Release "FINRA Sanctions David Lerner Associates \$14 Million for Unfair Practices in Sale of Apple REIT Ten and for Charging Excessive Markups on Municipal Bonds and CMOs," October 22, 2012, <http://bit.ly/1MDksgU>; Press Release, "FINRA Fines Citi International Financial \$600,000 and Orders Restitution of \$648,000 for Excessive Markups and Markdowns," March 19, 2012, <http://bit.ly/1OhP6wW>; Press Release, "FINRA Fines Morgan Stanley \$1 Million and Orders Restitution of \$371,000 for Excessive Markups and Markdowns," November 10, 2011, <http://bit.ly/1Gw02Bb>

<sup>157</sup> Lisa Abramowicz, Bond Markups as Low as 3% Said Excessive to Finra in Trading, Bloomberg, May 16, 2014, <http://bloom.bg/1TMgree>

<sup>158</sup> FINRA Regulatory Notice 13-07: Markups, Commissions and Fees, January 2013, <http://bit.ly/1TMgAOK>.

<sup>159</sup> Katy Burne and Aaron Kuriloff, Regulators Want Data on Bond-Trade Fees, Wall Street Journal, January 13, 2015, <http://on.wsj.com/1SxqZeT>.



acknowledging fiduciary status with regard to the investment recommendation regarding principal transactions; contractually committing to adhere to standards of impartial conduct when providing advice regarding principal transactions; and complying with the warranty requirements. The DOL should make clear that in addition to complying with these requirements when providing advice about principal transactions, advisers and firms must also comply with these requirements when executing principal transactions. Thus, in addition to the advice regarding principal transactions, the actual transactions that flow from that advice that must reflect the retirement savers' best interest. Further, the DOL should clarify that, as part of the warranty requirement, firms must develop policies and procedures that are specifically designed to detect, deter, and prevent disadvantageous principal transactions for retirement savers.

Second, the list of assets that may rely on the principal trading exemption is appropriately narrow and limited to the types of securities that are most likely to be held in retirement accounts and least likely to be subject to principal trading abuses. This includes Treasury securities, agency debt securities, and registered corporate debt securities. Thus, municipal securities cannot claim relief under the exemption. This is appropriate, in our view, since these securities are notoriously involved in principal trading abuses.<sup>160</sup> Furthermore, at least in the case where they are tax-exempt, their tax benefit results in decreased interest and all income distributed from an IRA is still taxable, regardless of the fact the interest was tax-exempt when earned. These factors render municipal securities ill-suited for retirement accounts in most circumstances. In addition, more complex and exotic types of debt, such as collateralized debt<sup>161</sup> and private placements, are also appropriately outside the scope of the exemption.

Next, the proposal requires that the debt securities being bought and sold pursuant to the exemption possess no greater than moderate credit risk and have sufficient liquidity such that the securities can be sold at or near their fair market value within a reasonably short period of time. We believe that these additional protections beyond the list of permissible assets will ensure that the securities being traded on a principal basis have a strong likelihood of meeting their financial obligations and trade in sufficiently liquid markets so that the fairness of the security's price can be ascertained and evaluated. As a practical matter, these protections are highly unlikely to constrain principal trading in Treasury securities and agency debt securities. Treasuries and Ginnie Mae securities are backed by the full faith and credit of the U.S. Government and are therefore considered to possess the lowest credit risk of any securities. Similarly, agency debt

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<sup>160</sup> See, e.g., FINRA enforcement actions, Press Release, "FINRA Fines Oppenheimer \$675,000 and Orders Restitution of More Than \$246,000 for Charging Unfair Prices in Municipal Securities Transactions and for Supervisory Violations," December 9, 2013, *supra*; Press Release, "FINRA Sanctions David Lerner Associates \$14 Million for Unfair Practices in Sale of Apple REIT Ten and for Charging Excessive Markups on Municipal Bonds and CMOs," October 22, 2012, *supra*; Press Release, "FINRA Fines Morgan Stanley \$1 Million and Orders Restitution of \$371,000 for Excessive Markups and Markdowns," November 10, 2011, *supra*; See also Researchers at Securities Litigation & Consulting Group found that investors paid \$10.6 billion in markups across \$2.5 trillion worth of municipal bond trades since 2005, more than half of which were excessive. See also Lawrence Harris and Michael Piwowar, Secondary Trading Costs in the Municipal Bond Market, *Journal of Finance* 61, 1361-1397 (2006), <http://bit.ly/1J3owpC>; Erik R Sirri, Report on Secondary Market Trading in the Municipal Securities Market, July 2014, <http://bit.ly/1xuslwC>.

<sup>161</sup> See, e.g., FINRA enforcement actions against David Lerner Associates (excessive markups of collateralized mortgage obligations) *supra*; Press Release, "FINRA Expels APS Financial, Bars Former President and Former Broker for Targeting an Elderly Investor with Fraudulently Excessive Mark-ups," December 29, 2010, <http://bit.ly/1ebRrgi> (excessive markups in collateralized mortgage obligations and collateralized debt obligations).

securities other than Ginnie Mae have what is widely considered to be an implicit guarantee that the U.S. government will not allow these agencies to default on their obligations. As a result, agency debt securities have minimal credit risk. In addition, there is a large and active secondary market for Treasuries and agency debt securities, which provide investors dependable liquidity.

These creditworthiness and liquidity protections would however affect the extent to which the exemption can be used for corporate debt securities transactions. We view this as a feature, not a bug, in the proposal. This is because, while many corporate debt securities trade in highly liquid markets and have a strong likelihood of meeting their financial obligations (and therefore a low likelihood of default), there are also many corporate debt securities that have a substantial credit risk and that are thinly traded, making them extremely difficult to value objectively. Securities that are difficult to value are, in our view, more likely to be securities that an adviser may be attempting to dump on his clients. As such, the potential for abuse rises with the difficulty of determining whether the transaction was fair. The proposal provides important safeguards against these risks by imposing creditworthiness and liquidity constraints.

We recognize that the DOL is limited in several ways in how it approaches a proper framework to gauge a security's credit risk. This is due to the Dodd-Frank requirement to remove all references to credit ratings from all federal statutes and regulations,<sup>162</sup> and financial regulators' failure to create any substantive metrics by which to assess credit risk.<sup>163</sup> We think that the DOL has done the best it can to set an appropriate creditworthiness standard given these inherent limitations.

One question we have is who would be responsible for making these creditworthiness and liquidity determinations. The release cites to the SEC's rule eliminating credit rating references for Business and Industrial Development Companies (BIDCOs),<sup>164</sup> but the context in which creditworthiness and liquidity determinations are made in that environment is different. A BIDCO has a board of directors that is ultimately responsible for those decisions, with the board often delegating the day-to-day decision-making to a fund manager. An adviser who recommends to an investor that she engage in a certain principal trade for a specific security is unlikely to have the financial sophistication and time necessary to conduct a proper credit analysis, short of depending exclusively on credit ratings or the adviser's firm's dictates. We therefore think that it would be helpful to require that the firm have policies and procedures in place detailing how credit risk and liquidity assessments are being made and ensuring that they are based on objective, verifiable standards.

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<sup>162</sup> Dodd-Frank Act Section 939A, Review of Reliance on Ratings.

<sup>163</sup> See, e.g., April 25, 2011 Letter from Dennis Kelleher, CEO of Better Markets, to the SEC, References to Credit Ratings in certain Investment Company Act Rules and Forms, <http://bit.ly/1CSw8vW> (standards used are "overly vague and must be more detailed and concrete"). See also October 14, 2014 letter from Micah Hauptman, Financial Services Counsel of CFA, to the SEC in the money market mutual fund context, <http://1.usa.gov/1f88FU>; and also April 25, 2011 Letter from Barbara Roper, Director of Investor Protection of CFA to the SEC in the money market mutual fund context, <http://bit.ly/1HEK1wX> (objecting to the elimination of references to credit ratings without providing objective limits on securities that money market funds could invest in, or providing any guidance on the factors, beyond credit ratings, that boards would have to consider in arriving at their assessments of credit risk).

<sup>164</sup> SEC Final Rule, Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Release No. IC-30268; File No. S7-07-11, <http://1.usa.gov/1HLAban>.



Next, regarding the pricing requirements, we strongly support a process that requires an adviser and his firm to articulate not only the reasonableness of a proposed principal transaction but also why a proposed principal transaction is in the retirement investor's best interests relative to available alternatives. With these goals in mind, we support the intent behind the requirements that 1) the adviser and firm reasonably believe that the price at which the security is executed is at least as favorable as a transaction that is not a principal transaction and 2) the price be at least as favorable as prices provided by two ready and willing counterparties.

However, we are concerned that these requirements may not result in executions that are truly advantageous to investors. Regarding the first requirement, it is our understanding that the vast majority of fixed income trading occurs on a principal basis, and therefore there may not be a non-principal transaction price available for comparison. Therefore, we encourage the DOL to consider amending the first requirement to require comparison with transactions on both a principal and non-principal basis. This would help to protect against the risk that firms only execute these trades in their principal capacity and thus escape scrutiny under the first requirement.

Regarding the second requirement, we can envision a scenario in which broker-dealers have a tacit understanding with other firms whereby the firms providing quotes never do better than the initial quote. Any such agreements could be difficult, if not impossible, to detect and more difficult still to prove. If all the firms are executing the transactions in principal capacities, then the first requirement would not act as a backstop protection to the second, and there may be an opportunity for principal trading abuse. Therefore, we encourage the DOL to consider amending the second requirement to require advisers and their firms to cite current market data and articulate why the proposed principal transaction is both reasonable and in the retirement investor's best interests relative to other available alternatives.

Near real-time market data is available on FINRA's TRACE and would provide the basis for assessing the costs and benefits of a proposed transaction. For example, the adviser could examine recent trading of the same security that the adviser recommends executing and, based on that security's recent pricing, propose a price that is fair and reasonable. Assuming no changes have occurred in the market from the time the last trade occurred until the recommendation was made, the proposed price should be extremely close to the last trade price. If there hasn't been recent trading in the same security that the adviser recommends to use as the basis for comparison, the adviser could first find a similar security for which there is a viable price reference, then propose a price based on that reference security. In this instance, the adviser would have an affirmative obligation to prove why the characteristics of the reference security are similar enough to the actual security being transacted such that using the reference security is warranted. We think that forcing an adviser to cite near real-time market data to articulate why the proposed principal transaction is not only reasonable but also why it is in the retirement investors' best interests will offer significant protections against the risk that advisers and firms will recommend and execute principal transactions that are disadvantageous to retirement investors.

Finally, we support the DOL's proposed pre-transaction, confirmation, and annual disclosure. As we've stated previously, disclosure is necessary but it is not sufficient to protect

retirement savers from principal trading abuses. It is worth reiterating one technical point with regard to confirmation disclosures. The proposal requires a financial institution to provide a written confirmation of the principal transaction “in accordance with Rule 10b-10 under the Securities and Exchange Act of 1934 that also includes disclosure of the mark-up, mark-down, or other payment to the Adviser, Financial Institution or Affiliate in connection with the Principal Trade.” As discussed above, Rule 10b-10 does not require transaction disclosures to be provided on a customer’s confirmation if the broker-dealer is acting in its principal capacity, which would likely mean that retirement investors will not receive useful confirmation disclosures.

However, FINRA has recently proposed to require firms to disclose on their customer confirmations the price to the customer, the price to the member of a transaction in the same security, and the differential between those two prices for same-day retail-sized (100 bonds or less or bonds with a face value of \$100,000 or less) trades.<sup>165</sup> If adopted, this proposal would effectively require “riskless principal” transaction markups and markdowns to be disclosed. According to FINRA’s release, its proposal would capture a significant part of the market. Using data from the third quarter of 2013 for corporate bonds, FINRA has observed that over 60 percent of retail-size customer trades had corresponding principal trades on the same trading day.<sup>166</sup> And so, while not a complete solution, a substantial part of the market would receive useful confirmation disclosures.

Perhaps the DOL could take advantage of FINRA’s proposed rules to require heightened confirmation disclosure of pricing information in fixed income securities transactions more generally. The rule could achieve this first by stating that, if the FINRA disclosure rules for same-day trade transactions are finalized, in addition to complying with Rule 10b-10, firms would be required to comply with FINRA’s rule where the requirements of the rule are met. Where the requirements of the FINRA rule are not met, they would be required to provide markup and markdown disclosure requirements based on the amount in excess of or reduced from the “prevailing market price,” as defined by FINRA Rule 2121 and Supplementary Material .02 thereunder. FINRA’s definition of “prevailing market price” should only be used as a fallback option, however, as it allows firms to effectively set the “prevailing market price” they charge or pay for a security in relation to the markup or markdown they charge, thus undermining the purpose of fair and accurate pricing information that these disclosures are supposed to provide.

In sum, we appreciate the DOL’s proposed approach, as it does not rely exclusively on disclosure and consent to protect investors’ interests and instead incorporates concrete safeguards to prevent principal trading abuses. With a few minor technical adjustments, as discussed above, the rule can create an effective framework for ensuring that principal trades are conducted on terms that are truly in retirement investors’ best interests.

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<sup>165</sup> FINRA Regulatory Notice 14-52, Pricing Disclosure in the Fixed Income Markets, FINRA, November 2014, <http://bit.ly/1JbS7iN>.

<sup>166</sup> *Id.*

## V. Conclusion

With this revised rule proposal, the Department of Labor has achieved what many thought to be impossible. It has produced a principles-based rule that strengthens protections for retirement savers but does so in a way that would enable financial firms operating under a variety of business models to comply. The continued opposition of many brokerage, insurance, and mutual fund companies should help to make clear that, too often, these sales-based advisers' claim to support a best interest standard is superficial at best. That support quickly evaporates at the suggestion that they might have to make more than trivial changes to current practices in order to come into compliance.

Those who want to give lip service to support for a best interest standard while maintaining the status quo often argue that securities regulators should take the lead in developing such a standard. There are any number of reasons why this is a ridiculous suggestion on its face. It is DOL, not the SEC or FINRA, that has exclusive authority to write rules implementing ERISA, and only DOL has authority to write rules governing advice to retirement plans. Moreover, while securities play an important role in the retirement market, it is not exclusively a securities market. Insurance also plays an important role, and some of the most troubling abuses relate to other, more exotic investments, such as gold and art. A DOL standard can cover the entire universe of retirement investment advice; a securities-based standard cannot.

Even more fundamental than these jurisdictional questions, however, is the fact that federal securities regulators have an abysmal record of dealing with the complex issues that are the subject of the DOL rulemaking. In the late 1980s and early 1990s, for example, when broker-dealers faced growing competition from financial planners on one side and discount brokers on the other, the SEC and FINRA's precursor, the NASD, showed greater concern for protecting the full service broker-dealer business model than for protecting investors. It was during this era that the agency adopted policies that permitted brokers to rebrand their sales force as advisers, market themselves as advisers, and offer financial planning and other clearly advisory services all while claiming their "solely incidental to" exemption from the Investment Advisers Act. Time and again, NASD argued off of industry's talking points in defending this anti-investor regulatory approach.

For at least 15 years, investor advocates have been urging the SEC to reverse this tide by requiring broker-dealers to comply with a fiduciary standard when providing personalized investment advice. We have identified this as the single most important step the agency could take to improve protections for retail investors. It is only recently that the SEC and FINRA have voiced support for rulemaking, and it is far from clear from their statements on the issue how far they are willing to go to deliver the protections investors want and need. For example, despite external and staff studies supporting rulemaking, a clear authorization from Congress in the Dodd-Frank Act, and statements of support from the current and two preceding SEC chairs, the agency still has not produced a rule proposal, let alone a final rule, and cannot count on broad support among the commissioners for rulemaking. The best interest standard outlined by FINRA in its comment letter and in an earlier speech by CEO Rick Ketchum (discussed in greater detail below) is missing crucial components of a comprehensive, pro-investor standard.

The SEC's failure to adopt a fiduciary standard for brokers when they provide investment advice is symptomatic of its broader failure to adopt strong protections for retail investors. Indeed, even where a fiduciary duty applies under the Investment Advisers Act, the agency shows little inclination to enforce it effectively. Under the Commission's approach to enforcement, the best interest obligation is rarely brought to bear, and conflicts are almost always handled through disclosure rather than more meaningful mitigation. It appears that it is precisely this toothless enforcement that industry has in mind when it purports to embrace a best interest standard. And it is this poor enforcement of the fiduciary standard FINRA appears to be referring to when it suggests that DOL's proposed best interest standard "differs significantly from the fiduciary standard applicable to investment advisers registered under the federal and state securities laws."<sup>167</sup>

The SEC's record regarding regulation of conflicts of interest is no better. Despite years of entreaties from investor advocates, the agency has done nothing to rein in even the most egregious of the conflicts of interest that pervade the brokerage industry. Five years after the Dodd-Frank Act mandated that the agency examine compensation practices and conflicts of interest among broker-dealers and investment advisers, the agency has shown no sign of undertaking any such study, let alone acting on the Dodd-Frank Act's authorization to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." FINRA, which has at least studied the issue, has offered nothing but voluntary "best practice" guidance in response.

Even with regard to disclosures -- the "solution" regulators so often offer when they are unwilling to take more meaningful action -- the SEC's record of inaction is the same. Here again, investor advocates have been pushing for pre-engagement disclosures for brokers and pre-sale disclosures of key information, including costs and conflicts, for investment products for close to two decades. Although the SEC issued a proposal for point-of-sale mutual fund disclosure in the early years of the previous administration, it was withdrawn in the face of industry opposition. A proposal to reform 12b-1 fees suffered a similar fate when industry raised objections. Language in the Dodd-Frank Act mandating a pre-engagement disclosure document for brokers and authorizing pre-sale disclosures for investment products have produced nothing in the way of concrete proposals, despite a staff study showing a clear investor preference for pre-engagement and pre-sale disclosure.

Finally, while the Dodd-Frank Act authorized the SEC to adopt rules to ban or restrict the use of pre-dispute binding arbitration clauses in brokerage contracts, the agency has failed to act on this authority. Had the agency acted, the Department might have had options other than permitting such clauses in the BIC. Investors would have been better served by an approach that preserved their full range of options for resolving disputes.

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<sup>167</sup> July 17, 2015 letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, to the Office of Regulations and Interpretations and the Office of Exemptions Determinations, Employee Benefits Security Administration, Department of Labor, regarding "*Proposed Conflict of Interest Rule and Related Proposals*," RIN-1210-AB32.

There is no question that DOL’s job in drafting this rule would have been easier had securities regulators provided a strong model for the Department to follow. Unfortunately, on issue after issue over the years, federal securities regulators have either backed down in the face of industry pressure or sided with industry and against investor advocates regarding the need for reform. This same tendency has been very much in evidence in FINRA’s response to the DOL fiduciary rule proposal, including both remarks delivered by FINRA CEO Rick Ketchum<sup>168</sup> and FINRA’s recently filed comment letter on the rule proposal. Both echo inaccurate industry claims regarding the confusion that investors would suffer if the DOL adopted a standard that differed from securities law standards and the threat that industry might desert this market if forced to comply. Indeed, the speech and the comment letter taken together call into question FINRA’s oft repeated support for a fiduciary standard that is at least as robust as the standard articulated in the Dodd-Frank Act. And both offer the existing securities standards that investor advocates have found so abysmally inadequate as the model that DOL should follow in adopting rules under ERISA.

FINRA starts by suggesting that a “fractured approach,” in which DOL applies a different standard under ERISA than applies under securities laws, “will confuse retirement investors, financial institutions, and advisers.”<sup>169</sup> In assessing the validity of this concern, it is important to note that an investor who does business with a broker-dealer today might simultaneously have a commission account, where recommendations are subject to a suitability standard, a fee-based account, where recommendations are subject to an Advisers Act fiduciary duty, and a self-directed account, where no duty applies as no advice is rendered. That same investor might purchase insurance products through that adviser in his or her capacity as an insurance agent under a different standard still. FINRA expresses no concern that investors (or financial institutions or advisers) might be confused about the duty that applies to a particular conversation between the investor and his adviser under this array of standards. It is only DOL’s proposal to adopt a fiduciary standard under ERISA, apparently, that creates unacceptable confusion.

FINRA’s critique ignores the fact that Congress intentionally set a higher standard under ERISA for investment advice to tax-advantaged retirement accounts than the standard it set under securities laws. These higher standards are justified to ensure that tax subsidies are not siphoned off by conflicted advisers giving self-serving advice. FINRA’s critique also ignores the much more damaging confusion that would arise if different standards applied to recommendations regarding different types of investments within retirement accounts. But that is the inevitable result of prioritizing a consistent set of standards across different types of accounts over a consistent standard for all products sold within retirement accounts. Of course, the real confusion arises from the fact that investors already assume they are receiving fiduciary advice. Securities regulators have done nothing to address that problem in the 15 years that advocates have called for reform. With its proposal to adopt a securities law solution to an

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<sup>168</sup> “Remarks From the 2015 FINRA Annual Conference,” by Richard G. Ketchum, FINRA Chairman and Chief Executive Officer, May 27, 2015, <http://bit.ly/1If97FQ>.

<sup>169</sup> July 17, 2015 letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, to the Office of Regulations and Interpretations and the Office of Exemptions Determinations, Employee Benefits Security Administration, Department of Labor, regarding “*Proposed Conflict of Interest Rule and Related Proposals*,” RIN-1210-AB32.

ERISA problem, FINRA has nothing to suggest to address this confusion except a call to keep waiting in the hopes that securities regulators will finally find the wherewithal to act.

Those who still hope, as we do, that securities regulators *will* ultimately act to adopt a fiduciary standard for brokers -- as a supplement to and not a substitute for DOL action -- should draw little comfort from FINRA's description of the key elements of such a duty. Here again, FINRA echoes industry talking points when it calls for a "best interest" standard that is not only weaker than the standard proposed by DOL, but weaker than the standard mandated by Congress in Section 913 of the Dodd-Frank Act. Specifically, FINRA's proposed standard (like the standard proposed by SIFMA) would not include the crucial component that advice be delivered "without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."

In a bizarrely twisted argument, even as it calls for a common standard for all securities accounts, FINRA uses SEC's failure to act under its Dodd-Frank authority to argue against DOL's adoption of this same standard for investment advice under ERISA. Its comment letter states: "This principle, borrowed from Section 913 of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), has not been developed under ERISA or the federal securities laws and financial institutions, their advisers and their compliance officers and counsel will be forced to anticipate its intended meaning. ... Since financial institutions and advisers are engaged in a business that will earn compensation for their services, they would not provide investment advice at all if the customer were unwilling to pay the fee. Surely this is not the Department's intent." This is an obtuse reading of the rule proposal, and the Dodd-Frank language, raising serious questions about FINRA's appetite and ability to effectively enforce any fiduciary standard, whether adopted under ERISA or under Section 913 of the Dodd-Frank Act.<sup>170</sup>

The FINRA comment letter is replete with similar examples of FINRA's defense of the status quo. Perhaps most glaring is its proposed treatment of differential compensation. As discussed above, this is the conflict at the heart of the broker-dealer business model that most directly encourages brokers to make recommendations that serve their own financial interests rather than those of their clients. While FINRA purports to support a fiduciary duty that requires brokers to "eliminate conflicts whenever possible," it specifically mentions differential compensation as a conflict that should instead be addressed through "written supervisory procedures" designed to ensure that compensation differences don't affect recommendations. But FINRA itself has argued elsewhere that it "is unclear how a financial institution or adviser would demonstrate that the amount of compensation was *not* a factor in the recommendation." Presumably, it would be equally difficult to prove that it *was* a factor. In short, this is a prescription for maintaining harmful current practices, in which firms are permitted to reward advisers financially for advice that is not in their customers' best interest, all while giving lip service to a best interest standard that reluctant regulators are unlikely to enforce.

The message that comes through in both the Ketchum speech and the FINRA comment letter is that FINRA disputes the implication in the Council of Economic Advisers study, the

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<sup>170</sup> Ketchum made a similar argument in his earlier speech, in which he called into question FINRA arbitrators' ability to resolve claims based on this standard.

DOL's regulatory impact analysis, and the rule proposal itself that the SEC and FINRA's current regulatory approach is fundamentally inadequate and exposes retirement savers to harm. This lack of complacency about the status quo is, of course, precisely what investor advocates find so refreshing in the DOL's proposal. Indeed, the beauty of the Department's proposed approach, in our view, is precisely this: that it recognizes that imposing a best interest standard without also requiring changes to practices that encourage and reward advice that is *not* in the customer's interest is unlikely to deliver meaningful new protections to retirement savers.

Retirement savers who are struggling to fund an independent and secure retirement need financial advice they can trust. Today, neither our securities regulations nor the rules under ERISA provide that assurance. Instead, both sets of regulations expose retirement savers to self-serving recommendations from conflicted advisers who are free to recommend products based on their own financial interests rather than those of their customers. The DOL proposal -- which combines a best interest standard with meaningful restrictions on the practices that undermine that standard -- offers significant progress toward addressing this problem. We can only hope that the SEC will eventually follow the Department's lead and craft a similarly strong and effective rule for non-retirement accounts. But in a nation that faces a retirement crisis, and with DOL ready to act, we cannot afford to wait. We therefore urge you to move forward without further delay to adopt a final rule based on the eminently sound regulatory approach proposed here.

Respectfully submitted,



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