

# Morgan Stanley

July 21, 2015

Office of Exemption Determinations  
Employee Benefits Security Administration  
Attention: D-11712, D-11713, D-11850

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Attn: Conflict of Interest Rule  
Room N-5655

U.S. Department of Labor  
200 Constitution Avenue, NW.  
Washington, DC 20210

**Re: Comments on the Department's Fiduciary Definition Proposal  
ZRIN 1210-ZA25; RIN 1210-AB32**

Ladies and Gentlemen:

On behalf of Morgan Stanley, Morgan Stanley Smith Barney LLC and Morgan Stanley & Co. LLC (collectively, "Morgan Stanley"), this comment letter responds to the U.S. Department of Labor's ("Department") request for comments on the proposed Definition of the Term Fiduciary, the Best Interest Contract Exemption, the Exemption for Principal Transactions in Certain Debt Securities, and related proposed exemptions published in the Federal Register on April 20, 2015 (the "Fiduciary Proposal" or "Proposal"). This letter is being submitted simultaneously to both the Office of Exemption Determinations and to the Office of Regulations and Interpretations in response to their respective requests for comment.

## **I. Morgan Stanley Background Information**

Morgan Stanley is a leading full service global financial services firm.<sup>1</sup> Since its founding in 1935, Morgan Stanley has been a client oriented organization providing a range of financial

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<sup>1</sup> Morgan Stanley (NYSE: MS) is a global financial services firm that, through its subsidiaries and affiliates, provides products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. Morgan Stanley Smith Barney LLC (doing business as "Morgan Stanley Wealth

services and advice to corporations, institutions and individuals. It has developed an employee code of conduct that stresses the primacy of client interests over those of the company or individual employees, and has articulated four “Core Values” that guide our business approach, the first of which is “Putting Clients First.”<sup>2</sup>

Morgan Stanley’s wealth management division, Morgan Stanley Wealth Management (“Wealth Management”), has approximately 16,000 financial advisers throughout the United States servicing approximately 6.6 million wealth management accounts with over \$2 trillion in client assets. Wealth Management provides services to individual retirement accounts (“IRAs”) and qualified retirement plan accounts through both brokerage accounts with transaction based pricing (e.g., commissions, selling concessions), and investment advisory accounts where customers pay an annual fee based on the value of the assets in the account. Where we act as a broker, in addition to transaction execution, we also offer investor education, research and personalized information about financial products and services through our financial advisers.

Morgan Stanley’s institutional securities business segment provides financial services to a diverse group of corporate and other institutional clients globally, primarily through wholly owned subsidiaries, and also conducts sales and trading activities worldwide, as principal and agent, and provides related financing services on behalf of institutional investors. Morgan Stanley’s investment management business segment offers products and strategies to institutional investors worldwide, including corporations, pension plans, endowments, foundations, sovereign wealth funds, insurance companies and banks through a broad range of pooled vehicles and separate accounts.

## **II. Summary**

Morgan Stanley is comprehensively regulated under the federal securities laws, including examination and oversight by the U.S. Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA”). Whether acting in a brokerage or advisory capacity, Morgan Stanley must observe high standards of commercial honor and just and equitable principles of trade. In accordance with these regulations and our Core Values, Morgan Stanley supports the development of a uniform “best interests” of the customer standard applicable to *all* personalized advice about securities to retail customers, regardless of account type. By introducing an additional standard of care applicable only to retirement accounts, the Proposal will add to consumer confusion and result in regulatory and operational inefficiencies.

Morgan Stanley respectfully believes that a new, uniform fiduciary standard, promulgated by the SEC, is the most comprehensive way to enhance consumer protection across all retail account types. If the Department adopts its Fiduciary Proposal before the SEC takes action, it will

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Management”) is registered as a broker-dealer and investment adviser with the SEC and a member of FINRA and the NYSE. Morgan Stanley & Co. LLC is registered as a broker-dealer with the SEC, a member of FINRA and the NYSE, and registered as a futures commission merchant with the CFTC.

<sup>2</sup> The remaining Core Values are “Doing the Right Thing,” “Leading with Exceptional Ideas,” and “Giving Back.”

exacerbate the current lack of uniformity in fiduciary standards.<sup>3</sup> Thus, Morgan Stanley respectfully asserts that any Fiduciary Proposal await (and be consistent with) prospective SEC rule making.

Morgan Stanley strongly agrees with the Department that retirement investors should have access to transparent and unbiased investment information. However, in its current form, the Department's Fiduciary Proposal will curtail access to many beneficial services and products available to retail retirement investors. That is because, if the Proposal is adopted as written, firms and their representatives will become fiduciaries for virtually any retirement plan or IRA investment service and will be required to either: (1) comply with a Best Interest Contract ("BIC") Exemption, which we believe is unworkable and which unduly restricts the universe of permissible investments (and is not currently available for many retirement plans), or (2) curtail investment information provided through existing retirement plan and IRA brokerage options. Of course, under the Proposal retirement savers and sponsors of retirement plans could still access advice by enrolling in fee based advisory programs that do not rely on the BIC, but these types of programs may not be appropriate or cost effective for all consumers. Retirement savers should not lose the choice of accessing some level of personalized information and guidance at no additional cost when paying transaction fees in a traditional brokerage account as a result of the Proposal.

If the Department proceeds with the Proposal before SEC rule making, the following clarifications and adjustments are critical to make the Proposal practically and operationally workable, preserving consumer choice and achieving the consumer protection goals that both Morgan Stanley and the Department share. As we detail below in the body of this letter, those needed changes include:

- Extending the applicability date of the final rule. Even working diligently, firms will need more than eight months from the issuance of the final rule to implement the extensive systems, procedural, and contractual changes necessary to comply with the Proposal. We therefore request extension of the applicability date until 24 months following the publication of the final rule.
- Revisions to the BIC Exemption to make it truly "principles based," which include: (1) clarifying how and when firms and financial advisers may receive differential compensation, (2) adopting a feasible disclosure scheme that provides meaningful information at the most appropriate time, and which does not result in retirement clients getting less timely trade execution than other clients, (3) allowing a full range of permissible "Assets," and (4) clarifying and tailoring the contractual requirements of the BIC so that contracts do not have to be entered into before any recommendations occur and so that the warranties do not create excessive litigation risk. Without meaningful changes to the BIC Exemption, retirement savers will have significantly limited access to the

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<sup>3</sup> In the IRA market alone, the Department's Fiduciary Proposal could affect more than 34 million individual accounts holding over \$7.4 trillion dollars. Most consumers who maintain both retirement and non-retirement accounts will not want to restrict the IRA portion of their assets to a limited product or service set (such as an advisory flat fee model, significantly limited brokerage products and services, or potentially receiving no investment guidance at all).

transaction based model of obtaining investment education and assistance that many consumers currently utilize.

- Changes to the definition of a fiduciary to ensure that routine sales interactions (including responding to Requests For Proposals) and the provision of basic investment-related information do not transform a financial institution into a fiduciary, necessitating fundamental changes to, and placing limitations on, the ability to provide beneficial information, products and services. We have proposed an alternative facts and circumstances test that focuses on the reasonable belief of the advice recipient. Alternatively, we have suggested specific language changes that include eliminating the “specifically directed to” provision and introducing the concept that the advice recipient must reasonably rely on a recommendation. In short, in whatever approach is adopted, the factual context should indicate a fiduciary relationship rather than a sales relationship.
- Providing a new “carve-out” for rollover discussions that complies with FINRA Notice 13-45. Notice 13-45 imposes a framework to ensure that rollover discussions are fair, balanced and not misleading while at the same time preserving consumers’ access to information to assist them in making informed choices. In the absence of such a carve-out, the BIC Exemption should be revised to address the full array of rollover advice (in particular, its application to distribution advice and selecting the rollover vehicle).
- Revisions to the Principal Transaction Exemption to allow firms to better provide liquidity to consumers, which is especially important during market downturns and periods of market volatility. These revisions include: (1) expanding the exemption to cover additional types of debt and some equities, (2) eliminating the requirement for two price quotes, and (3) eliminating or clarifying certain terms and conditions (e.g., “moderate credit risk” and “sufficiently liquid”).
- An expanded counterparty carve-out (the “seller’s exception”) that allows financial institutions to market services and provide investment information to all markets – large employers, small employers, participants in 401(k) plans, and IRAs.
- A modification to both the BIC and Principal Transaction Exemptions which allows a financial institution to rely on the Exemptions for so long as they act in “good faith and with reasonable diligence” in their compliance efforts and mitigate any compliance errors within a reasonable period upon discovery. This standard was adopted by the Department’s 408b-2 regulation, and should similarly apply here in light of the Proposal’s complexity and compliance requirements.

These and additional recommended changes to the Proposal are set forth in detail in the remainder of this letter. Implementing these critical changes to the Proposal will not undermine the Department’s stated goals, but will instead ensure that retirement investors have continued access to beneficial investment information. We appreciate the opportunity to provide comments on the Proposal and look forward to a constructive dialogue with the Department to ensure that retirement savers are protected from conflicts of interest and continue to have access to quality investment assistance and advice.

### **III. The Department Should Refine Its Proposed Definition of Fiduciary**

We believe that the Department's proposed definition of fiduciary is overly broad and should be replaced with a facts and circumstances "reasonable belief" standard as described below, which will allow for consumer access to basic information and allow financial advisers to educate, inform and sell products and services. If the Department does not adopt this proposed alternative approach, we believe the changes set forth below (which introduce the concept of "reasonable reliance") must be made to the Department's functional definition in order to protect valid educational, marketing and sales activities.

Under the Proposal, virtually any conversation or written correspondence with a current or prospective client about an investment, a distribution or rollover, or the hiring of an investment adviser or manager, could be a fiduciary act since the communication needs only to be "specifically directed" to the individual and does not need to be tailored to their particular needs. Routinely, such conversations will include general ideas, hypotheticals, suggestions or proposals, and there could be some basic understanding that the information may be considered by the client or prospect. However, these basic interactions are all that is needed to become a fiduciary under the Department's Proposal – regardless of whether the educational or sales-related information serves as a material basis for the consumer's decision or is in any way individualized to their circumstances.

The implications of this broadened definition are sweeping. Because the BIC Exemption may be unworkable to avoid otherwise prohibited transactions, this broadened definition threatens to deprive consumers, particularly IRA holders, of basic information or drive them into programs and fee structures that may not be appropriate for their investment needs if firms limit or stop providing brokerage services. Some examples of valid, routine activities of financial institutions and advisers which we are concerned could be deemed to be fiduciary activities under the Proposal include:

- Ordinary communications involving any kind of discussion, comparison or identification of available investment options, strategies, advisers or managers. For example, a financial adviser communicating with a prospective client could become a fiduciary by making suggestions about or comparisons between alternative advisory account programs offered by Morgan Stanley.
- The simple act of distributing research reports that analyze particular securities to a large group of clients or potential clients might be a fiduciary action since it could be viewed as "specifically directed to" the consumer.
- Presenting a sample 401(k) investment option menu in connection with an RFP response for retirement plan services.
- Responding to a plan participant's questions about which available investment options under their 401(k) plan fit in a particular asset class.

In each case, it is unlikely that a client would be willing to enter into a contract before receiving such basic information. We are particularly concerned that, as noted above, even if financial institutions were to limit their retirement account offerings to only asset based fee advisory programs (that do not require an exemption because conflicts are eliminated through offsets or fee credits), merely suggesting those programs to a prospect or existing brokerage client could be deemed to be fiduciary advice for which no practical sales exemption is available. None of the preceding activities are fiduciary activities under current law, and revisions should be made to the Proposal in order to clearly permit these activities and communications to continue, as they provide important and necessary information to consumers.

Furthermore, the broad coverage of the Proposal is particularly troublesome in the institutional space. Under the Proposal many ordinary course investment discussions could be viewed as “recommendations” and thus as investment advice, such that even discussions with the sophisticated asset manager of a large plan (which is already protected by ERISA’s rigorous fiduciary regime) may need to comply with a carve-out to avoid fiduciary status. Morgan Stanley points to the Department’s statement set forth in the Fact Sheet accompanying the Fiduciary Proposal that additional protections are not needed for large plans “managed by financial experts who are themselves fiduciaries” and are “under a duty to look out for the participants’ best interests.” Moreover, the Department acknowledges that such fiduciaries already understand “that if a broker promotes a product, the broker may be trying to sell them something rather than provide advice in their best interest.” Accordingly, the Department’s own view appears to be that the Proposal should not consider such transactions fiduciary investment advice. Rather, conversations with such large plans should be presumed not to be investment advice without regard to any carve-out.

To best address these concerns about the breadth of the definition, the Department should refine the Proposal to allow for consumer access to basic information and allow financial advisers to educate, inform and sell products and services. Specifically, we suggest that the Department delete the currently proposed functional test found in 29 CFR 2510.3-21(a)(2)(ii) and replace it with the following –

(ii) Renders the advice in a manner where the advice recipient reasonably believes that such person is acting in their best interest in providing such advice and is not acting in an educational, marketing or sales capacity. This determination is based on the relevant facts and circumstances. Under this clause, relevant factors include the individualized nature of the advice provided, the reliance placed on it by the advice recipient and any disclosures provided to the advice recipient; however, no single factor shall be determinative.

This approach addresses the Department’s key concerns about potential gaps under the current regulation’s 5-part test. Under this test, a person could still be a fiduciary even if they disclaimed fiduciary status, but then acted in a way to create consumer reliance (e.g., provided individualized and specific recommendations). It would also cover service providers that make important, personalized, “one time” recommendations. But this approach would protect valid educational, marketing and sales activities. In addition, adopting this approach would still require a seller’s carve-out since the carve-out provides a clear exception from fiduciary status and this test would still be appropriately factual.

If the Department does not adopt the alternative approach suggested above, then the necessary changes to the proposed functional definition of fiduciary include: (1) eliminating the “specifically directed to” prong of the investment advice definition, or, alternatively, limiting its application to communications directed to a specific client so as not to pick up general communications (e.g., research, market reports and other materials sent to a large client base), and (2) adding a requirement that the advice given be “reasonably relied on” by the consumer or a “material” factor in the consumer’s investment decision rather than information simply provided “for consideration.” Thus, 29 C.F.R. 2510.3-21(a)(2)(ii) would be revised as follows:

Renders the advice pursuant to a mutual written or verbal agreement, arrangement or understanding that the advice is individualized to, ~~or that such advice is specifically directed to~~, the advice recipient for consideration and is reasonably relied on or material in making investment or management decisions with respect to securities or other property.

In addition, the Department should eliminate the valuation prong of the “covered advice” portion of the definition, which is overreaching because it does not even require that a recommendation or call to action be made. The Department has already explicitly carved out ESOP valuations from this prong, and it is our understanding that ESOPs were the Department’s primary concern behind making valuations into “investment advice” in the first instance. It is unnecessary to make an unspecified group of benign valuation activities fiduciary actions under the Proposal. At the very least, if this prong is retained, then the Department should provide specific examples in the definition of what it considers to be the abusive valuation practices at which this prong is directed.

Finally, in response to the Department’s request for comments, Morgan Stanley would support using FINRA’s definition of “recommendation” and its related interpretations, provided that in any final rule the Department clarify that the term is not applied in a way that is broader than the current application by FINRA.

#### **IV. The Department Should Clarify and Expand the Carve-outs from its Definition of Fiduciary**

Because of the broad definition of fiduciary, even if that definition is modified as described above, it is also crucial that the carve-outs be expanded to apply more broadly and to provide specific relief for services to small employers and to IRAs. This would be consistent with the Department’s original 2010 proposed fiduciary definition.

##### **A. Counterparties Carve-out**

Limiting the counterparty carve-out to ERISA plans with more than 100 employees or fiduciaries that manage more than \$100 million in employee benefit plan assets is arbitrary and will chill the communication of important basic investment information and valid sales activities to small employer plans and IRAs. The Department has cited no evidence that small employers and the participants in their plans (many maintained by the professional firms of doctors, lawyers, accountants, or consultants) or IRA holders are uniformly unsophisticated and unable to evaluate and consent to sales activities. In fact, it is contradictory to assume that such consumers will be

able to digest and understand the voluminous disclosures required under the Department's BIC Exemption, but will be unable to understand a simple disclosure which explicitly discloses in plain English that with respect to a particular transaction, the adviser is merely acting as a seller of products or services, and not as a fiduciary.

The carve-out should be extended and made available to additional parties under a wider variety of circumstances. Specific recommendations include:

- The counterparty carve-out should be extended to sales to smaller ERISA plans and to IRAs. This is particularly crucial for small employers since there is effectively no small employer defined contribution plan relief under the BIC Exemption (i.e., the BIC only covers plan sponsors of non-participant-directed plans with fewer than 100 participants). In the event the Department is reluctant to broadly extend the counterparty carve-out to all ERISA plans and IRAs, there should be, at a minimum, a carve-out for larger IRAs similar to the "accredited investor" standard widely used in the financial services industry, and defined under the federal securities laws. Under the federal securities laws, securities may not be offered or sold unless registered with the SEC or exempted from registration. Certain securities offerings that are exempt from registration (e.g., most alternative investments) may only be offered to investors who are *accredited investors*. The primary purpose of the accredited investor standard is to protect potential investors from risk by identifying investors that have sufficient financial sophistication and resources to understand and bear the risks associated with more complex or risky investments. Customers that meet this high standard, which include high-net-worth individuals and large companies, are given special status under the securities laws. Such sophisticated investors should be able to purchase the same assets in their IRAs as they are able to purchase in their non-retirement accounts. Finally, another alternative would be to permit the extension of the counterparty carve-out to smaller plans and IRAs if such clients receive an alert similar to that described in the Preamble to the BIC Exemption as a "cigarette warning"-style disclosure.
- The Department should clarify that the counterparty carve-out applies to the provision of *all* services (the ambiguity is created by the fact that the carve-out focuses on transactions, such as sales, purchases, loans and contracts, rather than straightforward services arrangements).
- The representations under the carve-out should be required prior to the time the transaction occurs, not prior to the time a recommendation is made. This is in line with current practice under FINRA and SEC guidance, and we believe comports with the way in which clients prefer to do business (e.g., a number of conversations may take place, and then the client decides to go ahead with a particular transaction, such that requiring the representations before each recommendation would be unwieldy).
- Some investment transactions take place over a period of time. To simplify the carve-out, any requirements regarding representations relating to the number of participants and assets under management should be met prior to the initial transaction and such obligations should not be continuous in nature.



- The \$100 million assets under management standard should be revised to include any type of assets under management, rather than be limited to only employee benefit plan assets, and lowered to \$85 million (the Department’s dollar threshold under its QPAM Exemption, which is widely utilized with clients with which the counterparty carve-out may also be used).
- The counterparty carve-out should apply to referral programs. Many financial institutions have programs that provide compensation to professionals (e.g., lawyers or accountants) for referrals (as regulated by SEC Rule 206(4)-3). Under these programs, an estate planning lawyer might refer their client to a financial institution for investment services or advice relating to their IRA and other non-retirement assets. Under the Proposal, such referrals would likely be considered fiduciary advice because they could be construed to be a recommendation of an investment adviser or manager. Yet the referral would not be subject to the counterparty carve-out because IRAs are not included. These referral programs are beneficial to consumers as they involve recommendations by the consumer’s other trusted professionals. Furthermore, they are already regulated by the SEC, which requires extensive conflict disclosures to the consumer, but would not be covered by the counterparty carve-out, as currently contemplated.

## **B. Swap Transaction Carve-out**

This carve-out does not sufficiently cover the entities that play a role in bilateral and cleared swap transactions such as clearing brokers, IRAs and commingled vehicles (e.g., bank collective trusts or hedge funds holding ERISA plan assets). Additionally, the carve-out conflicts with recently issued guidance (Advisory Opinion 2013-01A), where the Department indicated that clearing brokers would not be deemed fiduciaries to the extent they exercised certain close-out rights (provided the underlying transaction was governed by an applicable prohibited transaction exemption). Accordingly, Morgan Stanley asks that the Department expand the swap transaction carve-out to cover IRAs, pooled funds that hold plan assets, and clearing firms. These expansions will better capture the scope of participants currently entering into such transactions and prevent service disruption.

## **C. Platform Carve-out**

The courts have recognized that constructing and offering an investment product with investment options is not a fiduciary act, and we believe the Department should do the same.<sup>4</sup> Indeed, no financial firm could establish a fiduciary relationship to an ERISA plan or IRA when it constructs its products and platforms – there is no relationship with any plan or IRA at that time. Creating an “exception” to the definition of investment advice for “platforms” is an indirect way for the Department to suggest that merely constructing and offering a platform to defined

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<sup>4</sup> See *Hecker v. Deere & Company*, 556 F.3d 575 (7th Cir. 2009) (Fidelity not a fiduciary where it merely “played a role” in the choice of investment options and plan sponsor retained ultimate authority over which options to include); *Leimkuehler v. American United Life Insurance Co.*, 2013 WL 1591450 (7th Cir. 2013) (standing alone, insurer’s act of selecting funds and share classes for inclusion in investment options menu was not a “functional fiduciary” act where provider never exercised right to make substitutions in a way that could give rise to a claim).

contribution plans is fiduciary in nature and requires a carve-out. Even more troubling is that the platform carve-out is not applicable to IRAs or self-directed brokerage accounts offered to qualified retirement plans. This creates a negative implication that the mere offering of an IRA or self-directed brokerage account whereby consumers can invest in a range of common investments is somehow a fiduciary function.

As a result, the platform exception should be significantly reformulated and revised to cover additional commonplace circumstances as follows:

- The Department should make clear that it interprets the definition of fiduciary such that offering a platform of investments to consumers does not constitute a fiduciary act at all. This would mean that the Department would clarify in the Preamble to the final rule that the construction of platforms, and their offering to the public, is not investment advice and therefore does not need a “carve-out” from the definition of advice. This interpretive guidance should be extended to IRAs and self-directed brokerage accounts, many of which offer nearly limitless investment opportunities.
- If the Department retains the carve-out approach, then IRA and self-directed brokerage account platforms must be included in the carve-out. If not, then it could be impossible for financial institutions to avoid fiduciary status for IRAs and self-directed brokerage accounts even if they offer non-fiduciary “self-directed/execution only” IRAs/accounts (i.e., if any limits are placed on the available universe of investment options, a platform may be created).

Without relief on this fundamental issue, IRA and qualified retirement plan clients may have no brokerage services available to them.

#### **D. Selection and Monitoring Carve-out**

Morgan Stanley believes that the Proposal must allow for the provision to plan fiduciaries of a sample 401(k) line-up and educational information about investment selection. Thus, we recommend that the Department clarify that the presentation of 401(k) line-ups and related education is covered by this carve-out where criteria for identifying funds is specified by the plan fiduciary, regardless of who provides the 401(k) line-up and information or whether it is offered in connection with making a platform available.

Wealth Management acts as broker of record on many plans which have assets held on a third party’s platform, and Wealth Management financial advisers may provide education at both the participant and plan sponsor level. Unless the carve-out is clarified and is applicable to such “broker of record” situations, plan fiduciaries using Wealth Management as the broker of record will not be able to seek basic investment education relating to the identification of investment products that meet objective criteria or the provision of objective financial data and comparisons to independent benchmarks. This would disadvantage small employers which are particularly in need of investment information and assistance, and in turn disadvantage their plan’s participants who may not have an appropriately constructed fund line-up.

Finally, this carve-out should be expanded to IRAs as otherwise individual consumers will similarly be denied basic investment information such as the ability to have a platform provider identify available investment products that meet consumer provided selection criteria.

#### **E. Valuation and Reporting Carve-out**

If the proposed prong of the basic definition which makes valuations into fiduciary advice is not eliminated as requested above, this carve-out should be clarified and expanded such that any regularly provided account statement, or statement provided in connection with a distribution, is not investment advice regardless of whether it is required by law. In many instances valuations are provided for other client service oriented reasons, such as through a financial planning tool or on statements which are not specifically produced as required by law. Rendering such statements of value as fiduciary in nature seems unnecessary and will reduce the usefulness of such tools to clients, without a significant benefit. Clients should be more concerned about the values provided for reporting purposes, and the Internal Revenue Service (“IRS”) is already charged with monitoring the behavior of firms in connection with required reporting, and has a panoply of recently revised rules (i.e., the IRS’ “hard to value asset” revisions to its Form 5498 and 1099-R reports) designed to detect and prevent deficiencies in this area.

#### **F. Education Carve-out**

Morgan Stanley appreciates that the Department has proposed to formally extend the participant education “safe harbor” set forth in Interpretive Bulletin (“IB”) 96-1 to IRAs. However, we are concerned that the new limitation on identifying investment options that fit into asset classes will restrict the flow of other factual information that is vitally important to consumers.

For example, as proposed, a call center conversation could not even identify to the participant which funds offered under a 401(k) plan fit any particular asset class. Providing asset classes without examples, or requiring participants to navigate the internet alone for additional information, will not help participants. This basic information should be available so consumers can construct a diversified portfolio. Absent this information, the utility of any educational materials provided would depend in large part on the individual’s degree of investment sophistication. This limitation on identifying investment options also conflicts with the Preamble to the Proposal where the Department cites the need for investor help as a cause for its revisiting its regulatory definition. The current “safe harbor” under IB 96-1 has operated well for nearly 20 years, connecting participants with the practical information most individual retirement investors seek, without the need to bring a relationship to a full stop in order to insert the contract and disclosure regime proposed by the BIC Exemption.

A further unintended consequence will be the inability of firms to provide any specific investment solutions with respect to lifetime income options. The Department is making efforts to promote lifetime income options for defined contribution plans, but under the Proposal financial advisers would have no ability to suggest appropriate annuities or other payout strategies without becoming fiduciaries to plans and having to rely on the complex and costly BIC Exemption, which

many advisers will avoid unless it is revised. This will frustrate the very behavior that the Department wishes to promote.

### **G. Add a Rollover Carve-out**

The Department should also encourage robust distribution and rollover education and information and should provide greater clarity defining the line between distribution and rollover education and distribution and rollover advice. Therefore, Morgan Stanley strongly recommends that the Department enact a workable rollover sale “safe harbor” based upon FINRA Regulatory Notice 13-45.

Specifically, where a firm follows the principles of Notice 13-45, that discussion should be covered by the education carve-out. The FINRA notice imposes a standard of care on rollover discussions to ensure that rollover discussions are fair, balanced and not misleading. As Notice 13-45 acknowledges, although IRAs may entail higher fees, there are other reasons why they are desirable to individuals including the services, investments and control they offer. In addition, many individuals simply do not want to be connected to their former employer, or to take the chance that if that employer goes out of business the plan will be abandoned and the individual will lose the ability to access their retirement savings when they need them. As a result, opening an IRA may be in the best interest of the participant, despite a potential increase in cost, but firms may be unable to provide rollover assistance as any resulting compensation would constitute a prohibited transaction. Absent such a “safe harbor” from fiduciary status, firms will be forced to try to comply with the BIC Exemption, which currently does not provide a workable framework for rollover discussions (in particular, because many of these discussions take place with individuals who are not yet clients of the firm, and thus entering into a contract before discussions commence is not feasible).

Without a rollover carve-out, firms may no longer be able to provide important information to individuals at a crucial juncture in their retirement savings efforts (i.e., upon retirement or other termination of employment), and this lack of information could lead to increased “leakage” from the tax-qualified retirement system. The marketing of retirement account products (both IRAs and qualified retirement plan self-directed brokerage accounts) and rollovers into retirement accounts, and the proactive education that financial advisers provide about their benefits, acts to counter the impulse of individuals to take and spend their retirement savings. This impulse can be especially pronounced in connection with changing or losing one’s job. Unfortunately, and to the detriment of America’s retirement saving and in consequence its future retirees, unless they receive more clarity defining the line between education and recommendation, firms may have to curtail their activities in this area.

### **V. The Department Should Revise the Best Interest Contract Exemption**

Morgan Stanley agrees with the Department that the BIC Exemption should be a “principles based” exemption that preserves consumer access to existing investment services and “broadly permit[s] firms to continue common fee and compensation practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers.” Indeed, Morgan Stanley would support a truly “principles based,” workable BIC

Exemption that: (1) establishes broad consumer protections, including enhanced disclosure and a “Best Interest” standard applicable to IRAs, (2) mitigates conflicts of interest when advice is provided, (3) permits the receipt of a range of direct and indirect compensation, but does not require “fee leveling” at the Adviser or firm level, and (4) preserves consumer choice by covering transactions involving a wide range of “Assets.”

However, as currently proposed, certain requirements and conditions of the BIC Exemption render it practically and operationally unworkable and are inconsistent with a “principles based” approach. Importantly, among other issues noted below, the Department should clarify that no “wet” signature is needed on contracts under the BIC Exemption for existing clients (i.e., firms can re-paper existing client relationships via negative consent), and should revise the Exemption so it only requires two parties to the contract, not three. Furthermore, changes must occur with respect to the disclosure regime, which currently includes a point of purchase disclosure requirement that will hinder client execution and will be extremely difficult if not impossible to implement, and which departs from the Department’s more workable disclosure precedents (e.g., under section 408(b)(2)). Moreover, unless substantially clarified, the BIC Exemption could result in Financial Institutions having to completely revise their compensation structures to ensure the fee neutrality of the individual Adviser. True Adviser level fee neutrality and the reformulation of the “reasonable compensation” standard may require fundamental changes in the compensation structure of many financial products firms offer, some of which are controlled by independent third party product issuers. We are also concerned that the mandated contractual warranties expose firms to significant new litigation risks and are duplicative and unnecessary as part of a Best Interest standard of care.

Finally, Morgan Stanley believes that the BIC Exemption and Principal Transaction Exemption must be modified so that Financial Institutions can rely on the Exemptions for so long as they act in “good faith and with reasonable diligence” in their compliance efforts and correct any errors within a reasonable time period after detection. Given the complexity of the Exemptions and time frame for implementation, a good faith compliance standard coupled with the ability to cure defects upon knowledge of those defects is needed. This concept of good faith compliance is found in several Department precedents including regulations for the very recently finalized service provider exemption and participant disclosure regulation, and the insurance company general account regulation. *See* 29 C.F.R. § 2550.408b-2(c)(1)(iv)(F)(2), 29 C.F.R. § 2550.408b-2(c)(1)(vii), 29 C.F.R. § 2550.404a-5(b)(1), and 29 C.F.R. § 2550.401c-1(i)(5). Expecting perfect compliance with such complex conditions is unrealistic and should be tempered by good faith and cure provisions that encourage firms to use the BIC Exemption and Principal Transaction Exemption.

In the absence of changes to address these issues, Financial Institutions will not be able to rely on the BIC Exemption. As a result, many IRA owners and plan participants may end up being denied access to meaningful investment information they have until now received through their brokerage relationship (and only being offered a truly self-directed IRA or retirement plan account or paying for advice through a fee based advisory relationship). The result will be less information, more cost for certain consumers, and a contraction of the broker-dealer business model, all of which runs counter to the intent of Congress as reflected in Dodd-Frank.

## A. Written Contract – Making Compliance with the BIC Workable

The Department should provide guidance that encourages compliance with the BIC Exemption by facilitating the ability of Financial Institutions to come into compliance. This will benefit consumers. Required changes include:

- The Department should confirm that the BIC Exemption itself does not require a new physical “wet” signature of the client to bring pre-existing account contracts into compliance. It should be up to the Financial Institution to determine how its existing contracts can be modified to create an enforceable obligation between the parties, and if such a binding obligation can be done by “notice” and negative consent to a current client then it should be permitted. The new contractual provisions and warranties all flow to the benefit of the client. Thus, it would actually *harm* consumers if their firms had to “chase them down” and obtain their fresh signatures before they were able to avail themselves of the protections of the BIC Exemption.
- Currently, client agreements are entered into by the client and the Financial Institution – Advisers do not sign these agreements. Where a Financial Institution is the provider of the product or service (either on its own or through a representative), only the Financial Institution needs to be a party. Requiring the Adviser to sign as a party will unnecessarily complicate account opening for clients, and will create disruptions in client service upon an Adviser’s termination of employment and where a new Adviser serves the same client. This problem will be exacerbated by the common industry practice of having teams of financial advisers service the same consumer. Clearly, the Financial Institution’s signature is all that is needed to establish liability for both the firm and its Advisers. As a result, the Department should eliminate the need for the Adviser to sign new or existing contracts. (For independent brokers, the opposite should be true – just the Adviser should sign without the Financial Institution.) A way to address this practical issue in a way that should work for all types of relationships is to merely require the employer service provider to be a party to the contract.
- The timing of the contract requirement must be revised. As proposed, the BIC Exemption requires contracts to be executed before any advice is given. It is not practical or feasible for a financial adviser to persuade a customer to sign a contract *before* the client knows what they might be buying. Instead, contracts should be executed before transactions are entered into and can apply retroactively to the time of advice similar to existing suitability standards. This is the timing requirement included in the Department’s proposed Principal Transaction Exemption, and we urge the Department to include it here.
- The prohibition on contract provisions that limit liability should not extend to limitations on punitive or consequential damages. Such limits preserve the consumer’s right to be fully compensated for actual losses. Limitations on liability caused by third party acts or omissions should also be permitted. Firms should only be responsible for the losses they cause.

These changes are necessary in order for the BIC Exemption to be a workable solution. Without these changes, the IRA marketplace (and small employer participant-directed plan marketplace) will be limited to a “one size fits all” solution that unnecessarily deprives the consumer of the ability to pay for brokerage services on a transaction by transaction basis.

## **B. Written Contract and Warranties – Eliminating or Paring Back Warranties**

The BIC Exemption’s requirement that specific provisions be included in a written agreement between the Retirement Investor, Adviser and Financial Institution makes the Exemption unworkable and must be modified. Chief among the required provisions are that the contract include a fiduciary acknowledgement and an agreement to follow the BIC Exemption’s Impartial Conduct Standards – which include the Best Interest standard, reasonable compensation and an obligation not to mislead the Retirement Investor. In addition, the contract must include warranties that the Adviser and Financial Institution will comply with law, have policies and procedures designed to identify and mitigate conflicts of interest, and not have compensation programs that “would tend” to encourage Advisers to make recommendations that are not in the Best Interest of the Retirement Investor. Finally, the contract must disclose Material Conflicts of Interest.

The Department notes that the written contract requirement “is the cornerstone of the proposed exemption” and that it creates an enforcement scheme for both ERISA plans and IRAs. The BIC Exemption bolsters this notion by prohibiting certain types of contractual provisions that could relieve the Adviser and Financial Institution from liability and limiting class actions in court.

The written contract requirements simply go too far and must be pared back substantially in order for the BIC Exemption to be workable. Our comments are as follows<sup>5</sup>:

- No written contract Impartial Conduct Standard (i.e., the Best Interest, reasonable compensation, no misleading statements requirements) is necessary or appropriate for ERISA plans. ERISA already imposes a statutory fiduciary duty standard on Advisers. A contractual Impartial Conduct Standard will create a duplicative standard of care that will expose service providers to state and federal claims over the very same conduct – a result that ERISA’s exclusive remedy scheme is designed to avoid.
- For IRAs, the Impartial Conduct Standards should be revised and limited to a Best Interest standard – the reasonable compensation and misleading statements provisions should be dropped because they are already covered by a Best Interest standard. No Adviser could act in the Best Interest of the client yet recommend investments that are too costly or lie or mislead the consumer, but it is possible that arbitrators and courts will seek to widen the already broad duties the Best Interest standard entails. Thus, we are concerned that these provisions could lead to additional allegations by plaintiff’s lawyers when all that should matter is whether the Adviser acted in the Best Interest of the client.

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<sup>5</sup> These comments should be read to apply to the Department’s proposed amendments to PTEs 75-1, 77-4, 84-24 and 86-128, which are being amended to include Impartial Conduct Standards.

- Material Conflicts of Interest should be disclosed to consumers, but in a separate document rather than the contract. Otherwise, the contract will have to be updated frequently as products and services made available to the ERISA plans and IRAs are revised.
- The warranty provisions should be eliminated as they create the risk of wasteful litigation. Indeed, a Financial Institution could have well-trained and supervised Advisers acting in the Best Interest of their clients, but the firm would be exposed to class action claims if every aspect of the Department’s detailed policy and procedural requirements are not met. We think a true “principles based” exemption should focus on protecting consumers by requiring Best Interest conduct by the Adviser, but it should not involve a redundant “belts and suspenders” approach that results in unnecessary litigation exposure.
  - In no event should these requirements be couched as contractual warranties – essentially a guarantee of perfect compliance. It would be more appropriate to recast the warranties as general exemption conditions and not actionable contract provisions.
  - If retained as contractual requirements, the Department should modify the “warranty” requirement to a “good faith representation” requirement. As noted, this is the same approach that the Department adopted in its substantially less complex 408b-2 and other regulations.

### C. Fee Neutrality for Advisers

Fee neutrality should not be imposed upon Advisers. The warranty requirements and related Preamble discussion of appropriate Adviser compensation models suggest that the Best Interest standard could require that Financial Institutions compensate individual Advisers equivalently regardless of the products and services in which the client invests (“fee neutrality”). Indeed, each of the five examples highlighted in the Preamble describe examples of compensation structures where the individual financial adviser has no meaningful financial conflict of interest with the plan or IRA. In addition, the warranty condition itself prohibits any “different 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 the Retirement Investor.” *See* 80 Fed. Reg. 21971(emphasis added).

Virtually any program of compensation that varies at all by type of investment could *tend* to create adverse incentives.<sup>6</sup> For example, many Advisers in the industry earn a flat percentage of the compensable revenue that the Adviser generates, regardless of the product sold or its affiliation with the Adviser’s Financial Institution (referred to as a “neutral compensation grid”). However, different products generate different amounts of compensable and non-compensable revenue to

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<sup>6</sup> Indeed, the Department recognized in commenting on the level fee requirement that applies to individual advisers under the section 408(b)(14), saying that “almost every form of remuneration that takes into account the investments selected by participants and beneficiaries would likely violate the fee-leveling requirement...” Participant Investment Advice Final Regulation and Class Exemption, 74 F.R. 3822, 3826 (January 21, 2009).



the firm. Financial Institutions like Morgan Stanley employ measures to manage conflicts associated with such inherent differences in compensation by product, including sales practice surveillance and supervision, fee caps and client disclosure. Even with rigorous controls, however, virtually every broker-dealer's current compensation model would be prohibited under a broad reading of this standard, which is clearly at odds with the Department's stated goal of "proposing a set of exemptions that flexibly accommodates a wide range of current business practices" that "permit firms to continue common fee and compensation practices." *See* 80 Fed. Reg. at 21929.

Importantly, the Department has previously recognized that Advisers are able to accommodate conflicts of interest while acting in a prudent fiduciary capacity and should continue to do so. For example:

The investment advice provider does not recommend investment options that may generate for the fiduciary adviser or any employee, agent or registered representative, or any affiliate thereof, or any person with a material affiliation or material contractual relationship with the foregoing, greater income than other options of the same asset class, unless the adviser prudently concludes that the recommendation is in the best interest of the participant or beneficiary....

*See* Participant Investment Advice Proposed Regulation 73 F.R. 49896, 49930 (Aug. 22, 2008).

Furthermore, FINRA has closely scrutinized the compliance regimes of broker-dealers and recently published best practices for identifying, mitigating and managing conflicts of interest. Broker-dealers with compliance programs following this framework should meet the requirements of any truly "principles based" exemption. More specifically, in order to better understand how firms manage conflicts of interest, as well as to identify potential problem areas and effective practices to manage conflicts, in July 2012 FINRA began a review of conflicts of interest management practices at a number of firms (including Wealth Management). The Department's Preamble statements on this aspect of the BIC Exemption appear to be informed by the FINRA report which was the result of that review, FINRA's October 2013 Report on Conflicts of Interest (the "Conflicts Report").

In the Conflicts Report, FINRA set forth its observations regarding firms' approaches to identifying and managing conflicts of interest in three areas: (1) enterprise-level frameworks to identify and manage conflicts of interest; (2) approaches to handling conflicts of interest in manufacturing and distributing new financial products, and; (3) approaches to compensating their associated persons, particularly those acting as brokers for private clients. Specifically regarding compensation practices, FINRA noted the following effective practices to address compensation-related conflicts of interest:

- firms avoid creating thresholds in their compensation structures that enable financial advisers to increase their compensation disproportionately through an incremental increase in sales;

- firms' supervisory programs include specialized measures to assess whether financial advisers' recommendations may be influenced by thresholds in a firm's compensation structure;
- firms minimize compensation incentives for financial advisers to favor one type of product over another;
- for comparable products, firms refrain from providing higher compensation, or providing other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue sharing agreements;
- firms monitor the suitability of financial advisers' recommendations around key liquidity events in an investor's lifecycle where the impact of those recommendations may be particularly significant (e.g., investor rolls over his pension or 401(k)), and;
- firms adjust compensation for employees who do not properly manage conflicts of interest.

Significantly, FINRA noted its expectation that firms should consider the practices described in the Conflicts Report and implement strong conflicts management frameworks. FINRA further noted that, given the pervasiveness of conflicts of interest and the potential for customer harm, it will continue to assess firms' conflicts of interest management practices and the effectiveness of those practices in protecting customers' interests (in this regard, FINRA included conflicts of interest in its 2015 Regulatory and Examination Priorities Letter). Finally, and perhaps most significantly, FINRA noted that if firms do not make adequate progress on conflicts of interest management, it will evaluate potential rulemaking in this area.

Wealth Management's own compliance program includes many of the effective practices cited in the Conflicts Report. Extensive enterprise-level programs are in place to review new investment products for potential conflicts prior to distribution. Moreover, Wealth Management has compensation and supervisory controls in place for financial advisers that identify and mitigate key conflicts of interest. These compensation and supervisory controls are subject to review by FINRA, and to the extent that FINRA finds any deficiencies, they are noted and remediated as necessary.

The Department should clarify in the final BIC Exemption that enterprise-wide programs that effectively mitigate conflicts of interest, like Wealth Management's, meet the requirements of the Exemption. Absent this essential clarification, the BIC Exemption will force broker-dealers into a "one size fits all" business model that in turn will limit the guidance and options available to clients, as further described above.

#### **D. Fee Neutrality for Financial Institutions**

The Department should clarify that reasonable compensation does not require the receipt of level compensation, including mutual-fund related compensation, at the Financial Institution level. If identical fee arrangements are required across thousands of mutual fund complexes and other investments, the BIC Exemption will be unworkable for this reason alone. Moreover, the Department should clarify this point explicitly so that firms are universally on notice of the BIC Exemption's requirements.

The BIC Exemption as drafted appears to allow Financial Institutions to receive varying levels of compensation for different investments. This is demonstrated by the fact that the proposed Exemption includes no conditions or warranties mandating level fees at the firm level. The Department makes its intent particularly clear in the Preamble to the BIC Exemption where the Department specifically notes –

The Best Interest Contract Exemption ... would provide prohibited transaction relief for the receipt ... of a wide variety of compensation forms as a result of investment advice provided to the Retirement Investors. ... The types of compensation payments contemplated by this proposed exemption include commissions paid directly by the plan or IRA, as well as commissions, trailing commissions, sales loads, 12b-1 fees, and revenue sharing payments provided by either the investment providers or other third parties to Advisers and Financial Institutions. The exemption also would cover other compensation received by the Adviser, Financial Institution or their Affiliates or Related Entities as a result of an investment by a plan ... or IRA, such as investment management fees or administrative services fees from an investment vehicle....

80 Fed. Reg. at 21966-67.

Notwithstanding the clarity of the Preamble, however, we are concerned that the Department (or a court or arbitrator) may construe the “reasonable compensation” requirement included in the Best Interest standard (see Section II(c)(2)) to require consistency in the fees that mutual fund companies and other third parties pay firms. We note that the section only requires that the total compensation received by the Financial Institution be reasonable in relation to the total services provided to the plan or IRA. This should not be deemed to mandate identical fee relationships between Financial Institutions and the thousands of mutual fund companies and other third party investment providers. Fees differ for a range of reasons, including the types of services the Financial Institution provides to the fund complex, and the relative market power of the parties to the agreements. It is critical that the reasonableness of compensation be defined as a market based fee in total. This is, of course, consistent with the Department’s own prior guidance, and that of the courts. *See* Information Letter to John DiVincenzo (Dec. 9, 1986); Adv. Op. 2002-08A (selection of service provider involves assessment of quality of services, reasonableness of charges in light of services provided, and cost of comparable services in the market); *McLaughlin v. Bendersky*, 705 F. Supp. 417, 421 (N.D. Ill. 1989) (service provider's costs and profits are irrelevant to determining whether compensation is reasonable).

## **E. Disclosure**

Morgan Stanley strongly agrees that delivering understandable and timely investment information about fees and potential conflicts of interest is an appropriate requirement of fiduciaries relying on the BIC Exemption. However, as proposed, the BIC Exemption would establish an overly complicated and costly point of purchase and annual disclosure regime, along with continuous website disclosure, that cannot be implemented by the proposed eight month Applicability Date. Instead, the disclosure requirements should be revised to a pre-transaction

“cigarette warning” and a direction to additional disclosures that build off of the requirements of the Department’s existing regulations under section 408(b)(2).

Under the current Proposal, firms must provide a detailed written disclosure to the Retirement Investor prior to the execution of each recommended purchase of an allowable “Asset” (a “pre-purchase disclosure”). The disclosure must contain the all-in cost and anticipated future costs of recommended Assets in a chart. This chart would include the “total cost” to the Retirement Investor for 1-, 5- and 10- year periods expressed as a dollar amount, assuming an investment of the dollar amount recommended by the Adviser, and reasonable assumptions about investment performance, which must be disclosed. Additionally, a webpage must disclose the direct and indirect material compensation payable to the Adviser, Financial Institution and any Affiliate for services provided in connection with each Asset (or, if uniform across a class of Assets, the class of Assets) that a Retirement Investor is able to purchase, hold, or sell through the Adviser or Financial Institution, and that a Retirement Investor has purchased, held, or sold within the last 365 days, the source of the compensation, and how the compensation varies within and among Asset classes. Finally, the Financial Institution must also provide an additional comprehensive annual disclosure report detailing the client’s annual fees and direct and indirect expenses, and the firm’s and the Adviser’s direct and indirect compensation.

The information required is so complex that it will likely confuse rather than inform consumers, and the requirement of trade by trade pre-purchase written disclosures may delay execution of clients’ transactions.

1. The key difficulties with the Pre-Purchase Disclosures:

- The written pre-purchase disclosure requirements are operationally complex, costly, and may materially disadvantage those retirement consumers who cannot transact until their receipt. A majority of Wealth Management’s retirement clients have not authorized Wealth Management to deliver documents to them electronically via email and still choose to receive disclosure documents and account statements by mail. The requirement to disclose transaction-specific information pre-purchase may prevent clients from executing their transactions at the price that they intend. It could also potentially even restrict them from purchasing the securities that they want, if there is delay caused by the requirement to deliver the written disclosure before accepting the client’s order. It should be noted that over the past ten years, on average, the S&P 500 moved by more than 1% in a single day over 65 days within each calendar year. Furthermore, by the time such a detailed, client-specific pre-purchase disclosure is able to be prepared in accordance with the BIC’s current content requirements, the Asset’s total cost may have changed, requiring new disclosures, and this could, in its circularity, cause us to simply be unable to execute transactions in certain securities. Finally, clients may receive the disclosures when they are no longer in a position to review or respond to them – and thus they may miss out on the desired opportunity.

In this regard, mutual funds are just one example to demonstrate the challenges in complying with the current pre-purchase disclosure requirements. For mutual funds, the price of the security is not known at the time an order is placed. Rather, the fund is priced

at the end of the day and all orders received prior to market close receive the ending day prices. At the time that an order is entered, the client may be making a new purchase of a specific amount (in which case all that is unknown is the number of shares that the amount represents) or could be selling shares and using the proceeds to make a new purchase (in which case the sales proceeds and the new purchase amount are not known until the close of business). Because of this uncertainty, it is unworkable to provide the detailed transaction-specific pre-purchase disclosure.

In addition, most firms' current systems for delivery of transaction-specific disclosures (e.g., confirmation statements, prospectuses) are triggered based on a transaction being entered and executed in the firm's order entry system. As such, firms would need to design and build entirely *new* systems to trigger the delivery of a paper or electronic disclosure at a point *prior to* when an order is entered or processed.

- The 1-, 5- and 10-year cost information requirement that is based on rate of return assumptions is also unworkable and in many cases unnecessary as drafted. Return assumptions will need to be made for every single mutual fund, equity security, debt security, and other Asset. Every Financial Institution may come up with different return assumptions – making cost comparisons across firms impossible and possibly misleading. Furthermore, it is unnecessary to require such projections for stocks, bonds, ETFs and other investments that only generate transaction based, and not trailing, compensation. Moreover, this requirement is also problematic where we act as broker of record with respect to a retirement plan held at a third party provider, as plan size and investment make up will vary over time, and there is no way to meaningfully predict those changes.
- Finally, the disclosure regime's emphasis on cost may lead consumers to make decisions on that basis alone. While important, cost is certainly not the only component of what makes an investment appropriate for a particular client. This focus, especially when complicated by the previous point regarding return assumptions, renders the current pre-purchase disclosure requirement imprudent.

## 2. Suggested revisions for the Pre-Purchase Disclosures:

- The pre-purchase and website disclosure requirements should be revised to a pre-transaction disclosure that builds off of the requirements of the Department's regulations under section 408(b)(2). A section 408(b)(2) regime would fully inform consumers of the services provided and potential conflicts, and would disclose direct and indirect compensation, including the identity of the payer of indirect compensation and the amount (or formula or estimate) of the indirect compensation.<sup>7</sup> Morgan Stanley would

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<sup>7</sup> Additionally, if private placement investments are permitted under the BIC Exemption, the Department should allow firms to provide the disclosure information regarding private placements to customers as part of an offering. Public websites are not an option for private placements because general solicitations are generally not permitted for these types of investments under the securities laws. Instead, customers should receive the necessary disclosures along with the offering materials for any particular private placement in advance of the client's commitment to purchase the private placement.

support the Department should it choose to move, as contemplated in the Preamble, to a “cigarette warning”-style approach to the pre-purchase disclosure. In addition to the language proposed in the Preamble (80 Fed. Reg. at 21974), the disclosure could specifically refer clients to a website disclosure that tracks the requirements of the regulations under section 408(b)(2). Morgan Stanley believes that firms could implement policies and procedures to ensure that each client is directed and given time to review the information on the website prior to the execution of the client’s first transaction with the firm, and through our monthly and quarterly statements, or other written communications, be reminded that the information is available for review and that the client should contact their Financial Institution or Adviser for more information.

- In the alternative, the Department should consider working with the industry to create a static disclosure piece which describes the various asset classes available in retirement accounts, and addresses the issues which the Department believes the public does not understand (e.g., the ongoing revenue streams received in connection with mutual fund sales). Firms could then tailor this piece to their business models and ensure delivery at the onset of a client relationship and on an ongoing basis.

3. Suggestions for the Annual Disclosure Requirement:

- Given existing required disclosures to clients about their investment costs and expenses (e.g. client confirmations, mutual fund share class disclosures, prospectuses etc.), coupled with the enhanced pre-transaction disclosures recommended herein, the BIC’s annual disclosure requirement is duplicative. The annual disclosure requirement should either be eliminated or pared back substantially.
- It is unworkable in many instances to produce the required client-specific fee information using exact dollar amounts by investment, and the split in compensation between the individual Adviser and Wealth Management is simply not currently systemically available on an account by account basis. An alternative may be to provide the type of information found on a Form 5500 Schedule C to IRA clients who otherwise do not receive such reports. Schedule C requires reporting of "indirect" compensation received by plan service providers, in addition to the "direct" compensation paid to the service provider by the plan. For this purpose, "indirect compensation" includes any compensation received by a service provider from sources other than directly from the plan or plan sponsor "in connection with services rendered to the plan during the plan year or the person's position with the plan." Some examples of reportable indirect compensation described by the instructions to Schedule C include fees and expense reimbursement payments received by a person from "investment funds," finder's fees, float revenue, brokerage commissions, soft dollars, other transaction based fees received in connection with transactions or services involving the plan, and "non-monetary" compensation such as gifts and meals.
- If the annual disclosures are not eliminated then the annual disclosure requirement should not apply to any investments to which the Financial Institution or an Adviser has not served as a fiduciary. In this regard, it currently appears that the disclosure requirements of the BIC Exemption would apply to *all* assets in a particular IRA, regardless of whether the

Financial Institution or an Adviser provides advice on those assets or whether those assets were brought by the client from another firm to the Financial Institution. Furthermore, in no event should exact dollar amounts be required to be disclosed for specific investments where the Financial Institution is compensated through an asset based fee. Finally, the Department should clarify that any pre-purchase or annual required disclosures only apply to compensation earned by the Financial Institution, its Advisers and its Affiliates, as opposed to any party receiving compensation in connection with a particular investment.

## **F. Scope of the BIC**

There are critical revisions and clarifications to the scope of transactions covered by the BIC necessary to “preserve broker-dealer business models” consistent with the Department’s stated intent. Changes are needed to accommodate fulsome consumer choice in the type of investments available and to cover recommendations in connection with investment or distribution strategies. In the absence of such changes to its scope, firms may be unable to comply with the BIC Exemption even if the Department adopts other suggested modifications (e.g., to the BIC’s disclosure requirements).

Issues relating to the scope which need to be addressed include:

### **1. Covered Assets, Activities & Compensation:**

- The BIC Exemption should not be limited to certain approved “Assets.” Such limitation needlessly restricts consumer investment choice and is unnecessary given the other comprehensive consumer protections contained in the Exemption. The Department should consider substituting its often used phrase “securities or other property” for the term “Asset.” Under the current Proposal, many investments that are utilized by consumers are not included in the list of permitted Assets. These include alternative investments (e.g., hedge funds and private equity funds), options, municipal bonds, structured products, futures contracts, precious metals, and foreign equities, foreign bonds and foreign currencies. Furthermore, the treatment of UITs, a common retirement account investment, seems unclear. Yet, the Department has consistently eschewed a “government approved list” of investments and under its recognition of modern portfolio theory, the Department has acknowledged that there is and can be a role for derivatives and other forms of sophisticated investments.<sup>8</sup> Furthermore, the Department’s approved list of Assets cannot possibly keep up with the evolution of investment options (e.g., what happens when the “next ETF” or other “next generation” product comes along and is not a permissible “Asset”?). So long as a Best Interest standard, coupled with a reasonable enforcement and

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<sup>8</sup> IRAs are prohibited from investing in any work of art, rug or antique, metal or gem, stamp, most coins, and any alcoholic beverage under the Internal Revenue Code section 408(m). However, in general the Department has embraced modern portfolio theory, which holds that individual investments will not be considered per se prudent or imprudent, but will be evaluated in light of the whole portfolio of investments that the plan holds. *See e.g.*, Preamble to Reg. 2550.404a-1 at 44 F.R. 37255 (June 26, 1979). Indeed, the Department has acknowledged the role that derivatives may play in a plan’s investment. *See Adv. Op. 2013-01A*. Defining approved Assets using a narrow list of “common” investments is a departure from the Department’s guidance and would even be a departure from the Code’s prohibited investment list.

oversight scheme, is in place, no restrictions should be placed on what assets are covered by the BIC. Investors should be able to construct retirement portfolios that contain a diverse range of assets if they are appropriate and in the best interests of the particular client, and the exclusion of certain investments could result in unnecessarily disadvantaging retirement accounts.<sup>9</sup> Moreover, an unintended result of this restrictive definition is that consumers may indirectly invest in assets that would otherwise be excluded under the definition (e.g., derivatives) by investing through a permissible mutual fund or ETF wrapper, which will increase the consumer's cost of these strategies (i.e., it would be cheaper to do this directly but they are being forced to do so indirectly at a higher cost as they have to pay for the wrapper).

- The BIC Exemption also needs to be clear that it covers the fees for services that are collateral to the investment advice provided pursuant to the Exemption (e.g., recordkeeping, custody, account maintenance).
- The BIC should be available for “riskless principal” transactions, which are functionally similar to agency transactions.

## 2. Covered Parties:

- Often plan sponsors are not the ones making investment decisions. Therefore, the BIC Exemption should be clarified to cover advice directed to all fiduciaries of covered plans, such as trustees and investment committees for example, and not just plan sponsors.
- The BIC Exemption should also be available for advice to sponsors and fiduciaries (including trustees) of small and large employer participant-directed plans. Including advice to small employer participant-directed plans in the BIC is crucial since they currently are also not eligible for the counterparty carve-out. As proposed, small employers have essentially been “carved-out” of the opportunity to receive both sales pitches and investment selection assistance. As noted above with respect to platform investment selection and monitoring, the negative impact on clients will be especially pronounced for “held-away” business (i.e., where Wealth Management is the broker of record with respect to plan assets which are held on another financial institution's investment platform).
- We also recommend that the BIC Exemption be expanded to cover large plan sponsors of over 100 participants to avoid a bifurcated compliance model. Otherwise firms will be vulnerable to “foot faults” and operational difficulties in monitoring whether the plan participant number fluctuates over or under 100 participants.

## 3. Recommendation of Strategies:

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<sup>9</sup> For example, alternative investments are often incorporated into an investor's portfolio as a diversification and risk management strategy because they can help lessen the correlation of a traditional portfolio to the stock market, potentially reducing the effects of market volatility.



- The application of the BIC Exemption to distribution and rollover conversations should be clarified. It appears that once amounts are rolled into an IRA, a firm can rely on the Exemption to apply to the Adviser's recommendations on how to invest amounts rolled over. However, the BIC should be clarified to state that if its terms are followed it can also apply to the distribution advice itself and the advice on where the rollover should go (e.g., an IRA offered by the firm). As noted with respect to the rule itself, it seems unlikely that individuals will want to sign a contract prior to receiving that preliminary advice, and thus without relief, both within and outside of the BIC context, individuals may no longer be able to receive guidance with respect to a crucial rollover decision.
- The BIC or other appropriate exemption should be clarified to allow for the recommendation of Advisers and managers. Recommending an Adviser or a discretionary manager – including the Adviser's own firm – is investment advice under the Proposal and thus would seemingly require either the counterparty carve-out or reliance on the BIC Exemption. In the context of sales presentations, this appears to contradict the Department's regulations at 29 CFR 2550.408b-2(f), examples (1), (3) and (4). If the person making the recommendation receives a fee (e.g., a portion of a wrap fee) then that person likely needs exemptive relief. However, a recommendation of a manager or Adviser should necessarily be subject to different disclosures and reporting than the recommendation of the purchase of a security or property under the BIC, and should not require the prior execution of a contract. The "cigarette warning"-style approach described in the Preamble, in combination with an explicit disclosure that the Adviser receives compensation in connection with the recommendation of a manager or Adviser, should suffice to inform and protect consumers (both inside and outside of the BIC Exemption). No annual reporting would be necessary or useful to the consumer.

#### 4. Clarification of Application to Discrete Activities:

- The BIC Exemption should be clarified to make clear that where the Financial Institution and Adviser do not provide advice, and merely carry out a direction from the client, compliance with the BIC Exemption is unnecessary. In other words, that the BIC need not be relied upon to execute a client's self-directed purchase or sale transaction within an account which would otherwise be "BIC compliant," or to implement a client's independent decision to open an account. All of the conditions of the BIC Exemption should be revised accordingly (e.g., clarifying that the warranty, disclosure and data retention requirements do not apply to transactions in Assets where the Financial Institution or Adviser did not provide advice). Otherwise, clients may be forced to open up additional "execution only" accounts, potentially at additional cost (e.g., account maintenance fees).
- The BIC Exemption similarly needs to clarify whether and to what extent one time investment advice requires a Financial Institution to engage in ongoing compliance with the BIC Exemption. In our view, a simple account opening disclosure and a Best Interest standard should be sufficient for such limited engagements, even if the underlying investment pays the firm an ongoing fee for investment management or distribution.

## **G. Disclosure to the Department and Recordkeeping**

Morgan Stanley does not object to the general requirement to maintain data necessary to demonstrate compliance with the BIC Exemption. However, Morgan Stanley strongly feels that no trade secret or proprietary business information should be available to the Department in order to document Exemption compliance. Typically this information must undergo legal review and could be subject to protections that ensure its non-disclosure to the public. As such, we recommend that this provision be clarified such that no trade secret or proprietary information is required to be maintained or disclosed to the Department under this section.

## **H. Data Request Available to the Department**

We respectfully submit that the requirements of Section IX – Data Request (i.e., to create and maintain Inflow, Outflow, Holdings and Returns information) are burdensome and unnecessary given the other protections afforded by the BIC Exemption, including the contractual obligations, Impartial Conduct Standards, warranties and the resulting private rights of action; the provision of meaningful disclosures directly to the Retirement Investor; and the requirements of Section V - Disclosure to the Department and Recordkeeping, which provides an abundance of information for the Department to monitor compliance. Therefore, we request the elimination of this section of the BIC Exemption.

## **I. Pre-Existing Transactions Exemption**

Morgan Stanley strongly objects to imposing conditions on continued relief for investments that occurred prior to the applicability of the new Proposal; in particular, the condition that no advice be given after the Applicability Date on assets purchased prior to the Applicability Date. If the original transaction was not prohibited, there should be no ongoing conditions imposed. In fact, by requiring that no additional advice be given, the Financial Institution would not be acting in an investment advice fiduciary capacity and would not need to rely on the Exemption. Furthermore, requiring that no advice be given will harm consumers as they will lose access to the investment-related information provided via their brokerage relationship and force the consumer to choose a new, potentially more costly, advisory relationship if they need assistance with their plan and/or IRA accounts. This was not the bargain when they began their relationship with the Financial Institution and it should not be forced upon them now.

In addition to permitting advice, no restrictions on assets (i.e., no “Asset” limitation) should be imposed for pre-existing assets. Otherwise, non-conforming assets must be removed from the account prior to the Applicability Date. This may not be possible without the client providing written consent and may not be feasible without causing the client to incur a loss. As a result, we believe that such subset of assets must be subject to the proposed grandfathering suggested above (i.e., they remain subject to the rules in effect prior to the Applicability Date).

Finally, we ask that the Department clarify that firms do not need to rely on the Pre-Existing Transactions Exemption if they provided no advice or recommendations with respect to pre-existing assets. No conditions should be imposed on assets currently held by a Financial Institution if it was directed to acquire such assets for our client, or the assets transferred in from

another firm (i.e., we provided no advice or recommendations on the appropriateness of those assets), but those assets are held in an account which would otherwise comply with the BIC Exemption.

In sum, we believe that all assets purchased prior to the Applicability Date of the regulation should be subject to the rules in effect before the Applicability Date. If these modifications are not made, then we request that transitional relief be granted to liquidate pre-existing positions for cash without the advice related to such liquidation requiring compliance with all of the contract and disclosure conditions of the BIC Exemption. At the very least this transitional relief must be available for liquidation of investments that do not meet the definition of Assets under the BIC Exemption.

## **VI. The Principal Transaction Exemption for Debt Securities Should be Expanded**

Morgan Stanley supports the creation of a principal trading exemption. As discussed below, being able to conduct principal transactions in a timely and cost effective manner provides important liquidity benefits to our customers – benefits that are especially critical in market downturns. We are concerned that if the BIC Exemption is not made workable many IRA and qualified retirement plan clients will move away from transaction based brokerage accounts to advisory programs where as a practical matter firms would not be able to provide advice or recommendations on principal transactions. Even if, as a threshold matter, the BIC Exemption is reformed, we are concerned that the proposed Exemption for Principal Transactions in Certain Debt Securities (the “Principal Transaction Exemption” or “Exemption”) is not workable as a result of the limited scope of the Exemption and the conditions it imposes on Financial Institutions. As a result, Retirement Investors would have diminished access to products, liquidity, and competitive pricing, ultimately harming the very Retirement Investors the Department is seeking to protect. We urge the Department to expand the scope of the Exemption to additional securities and to modify key conditions that make the Exemption as proposed unworkable. In doing so, we urge the Department to consider the critical liquidity role that Financial Institutions play in the marketplace, and the comprehensive existing SEC, FINRA and MSRB rules that govern these transactions.

As a starting point, the Principal Transaction Exemption only applies to a limited list of products, which we believe will either preclude Retirement Investors from purchases and sales of numerous non-exempted securities altogether, or force these investors to transact in such securities in a more expensive and less efficient manner. With respect to those limited products currently permitted under the Exemption, Financial Institutions may be unable to continue to purchase or sell those products on a principal basis since the conditions imposed render the Exemption practically unworkable. These products may not be available to Retirement Investors through other market makers or participants at competitive prices or at all, which could materially impair liquidity for investors when seeking to buy or sell securities. In addition, the Principal Transaction Exemption is not drafted to fit into the existing regulatory and interpretive framework, which already imposes investor protection rules and policies related to pricing, execution and suitability of transactions that apply when Financial Institutions like Morgan Stanley act as principal or provide investment assistance. Rather, the proposed Exemption would subject Financial

Institutions to inconsistent and incompatible regulatory standards, some of which are impossible to comply with for the reasons discussed below.

Set forth below are Morgan Stanley's recommended revisions to the Principal Transaction Exemption. We believe that these changes will serve the best interests of Retirement Investors and the marketplace at large. We begin by providing you with some background information on the role Morgan Stanley plays as liquidity provider to the fixed income markets, generally, and Retirement Investors, specifically. In this context, we discuss the consequences of restricting the role of a liquidity provider, which will result from the Proposal. Next, we outline the various FINRA and MSRB rules on transaction execution, pricing and suitability that comprise the existing regulatory framework governing Financial Institutions. It is against this background that we set forth our recommendations for revisions to the Principal Transaction Exemption.

### **A. Impact on Investor Liquidity**

We respectfully do not believe the Principal Transaction Exemption adequately accounts for how the fixed income marketplace operates, with a substantial number of debt cusips often traded by a relatively small number of Financial Institutions. One should not assume that Retirement Investors can turn to third party financial institutions to purchase or sell their securities. These other firms may be unable to provide liquidity on favorable pricing terms or at all if, for example, the firm does not make markets in the security in question or is facing balance sheet or risk constraints. As a result, like other investors, Retirement Investors often rely on their broker-dealer to be willing and able to purchase or sell securities when the investor needs or wants to transact, and in particular in times of distress or when illiquid securities are involved.

Morgan Stanley, acting through its Wealth Management and institutional securities businesses, is one of the largest firms participating in the fixed income markets across product types and market conditions and routinely trades fixed income securities acting as a principal with its clients. These principal trades include trades with its Retirement Investors for which it is not a fiduciary. The ability of Retirement Investors to access liquidity on both the bid and offer side of the market is particularly critical in periods of market distress, dislocation or increased volatility. This is true now more than ever as market participants' balance sheets are constrained due to regulatory considerations and the cost of regulatory capital, with the result being diminished liquidity across product types in what was already a less liquid market (i.e., compared to equities). If Morgan Stanley and other liquidity providers are effectively compelled to act only in an agency capacity as a result of the Proposal, then investors may be unable to liquidate their positions in a declining market – the time most critical to them – or if they are able to do so, it may be delayed and at considerably worse execution quality.

As a result, if Morgan Stanley becomes a fiduciary to almost all of these investors - as could be the case under the Proposal - then the Principal Transaction Exemption must be expanded and simplified so as to allow Retirement Investors continued access to products and liquidity at competitive pricing.

## **B. The Existing Regulatory Regime Governing Broker-Dealer Pricing, Execution and Suitability is Robust**

When considering the Principal Transaction Exemption, specifically the proposed new pricing standards,<sup>10</sup> it is important to take into account the fact that the fairness of broker-dealer pricing of securities, including fixed income securities, is highly regulated by FINRA and the MSRB.<sup>11</sup> Under the current regulatory and interpretive framework, broker-dealers are subject to best execution and fair pricing standards under various FINRA and MSRB rules. FINRA Rule 5310 (best execution), for instance, imposes an obligation on broker-dealers to use reasonable diligence to ascertain the best market for a subject security (excluding municipal securities) so that the resultant price to the customer in the transaction is as favorable as possible under prevailing market conditions. Further, FINRA Rule 2121 imposes a fair pricing obligation on broker-dealers in connection with transactions effected on a principal basis and restricts the amount of mark-up or mark-down a broker-dealer may charge from the prevailing market price. With respect to municipal securities, MSRB Rule G-18 (effective December 7, 2015) will subject broker-dealers to best execution obligations similar to those under FINRA Rule 5310. MSRB's best execution rule will be in addition to MSRB's fair pricing rule (MSRB Rule G-30), which requires broker-dealers to exercise diligence in establishing the market value of the security and the reasonableness of the compensation received in the transaction (such FINRA and MSRB rules and interpretive guidance thereunder concerning fair pricing, mark-ups/mark-downs and best execution are collectively referred to herein as "Pricing and Execution Rules").

Firms like Morgan Stanley are required to have robust controls and policies and procedures to ensure compliance with applicable Pricing and Execution Rules. Among other controls, Morgan Stanley has developed a series of reports that compare its fixed income executions against third party executions reported through FINRA's online reporting system, Trade Reporting and Compliance Engine ("TRACE") or MSRB's Real Time Transaction Reporting System ("RTRS"), as well as Morgan Stanley's own executions with other parties. These reviews are performed by Wealth Management's Risk Department, which is independent from the business. Wealth Management will adjust trade prices if such reports identify trade executions that do not comply with Pricing and Execution Rules or otherwise satisfy the firm's pricing policies and controls. The Wealth Management Best Execution Committee provides additional oversight, examining quality of execution, among other responsibilities, in light of regulatory obligations. The Compliance unit monitors the performance of certain oversight reviews. Finally, FINRA actively surveils reported executions for compliance with the applicable Pricing and Execution Rules and brings actions to enforce such Rules. Moreover, investors have access to reported trade prices on TRACE and MSRB's Electronic Municipal Market Access System ("EMMA") as an additional layer of protection and transparency against which their executions may be validated.

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<sup>10</sup> See Section II(c) (2), "The Adviser and Financial Institution will not enter into a Principal Transaction...if the purchase or sales price of the Debt Security (including the mark-up or mark-down) is unreasonable under the circumstances" and Section III(d), Pricing.

<sup>11</sup> While municipal securities do not provide tax benefits to retirement accounts, in certain market conditions they may be an appropriate investment. Moreover, certain municipal securities are taxable and are likely to be purchased by retirement accounts.

In addition, it is important to note that FINRA and MSRB impose suitability obligations on broker-dealers when recommending securities (*see* FINRA Rule 2111 and MSRB Rule G-19, collectively, “Suitability Rules”). Firms maintain policies and procedures to comply with Suitability Rules and often utilize additional controls, such as minimum eligibility rules or maximum concentration requirements tailored to individual investors’ risk tolerance and investment objectives, as part of the financial adviser’s suitability review and determination. Among the policies maintained by Wealth Management is a policy that prescribes which investors can be solicited to purchase which corporate and municipal instruments and in what concentration levels. The policy establishes categories of instruments largely based on credit ratings and sets client eligibility guidelines for each category according to the investors’ risk profile.

The Fair Pricing and Execution Rules and the Suitability Rules are part of a well-established regulatory framework that serves to protect investors, including Retirement Investors. On this basis, Morgan Stanley believes that the Department should consider the standards from the Fair Pricing and Execution Rules and the Suitability Rules when establishing the contours of the Principal Transaction Exemption in lieu of new and potentially conflicting standards or substantial limitations on status quo principal trading.

### **C. Recommended Revisions to the Principal Trading Exemption**

In light of both the nature and function of the fixed income markets, as well as the equity markets, and the substantial existing regulatory controls on pricing, execution and suitability discussed above, the following changes should be made to the Principal Transaction Exemption in order to preserve Retirement Investor access to liquidity and quality executions in financial instruments in which these accounts have traditionally invested.

- The types of fixed income products available under the Exemption should be expanded to include high yield debt, convertible bonds, securities issued by non-U.S. entities (including, without limitation, emerging market and foreign currency denominated securities), securities whose issuers are not organized as corporations, and instruments that are exempt from registration under the Securities Act of 1933 (the “Act”) such as certificates of deposit, commercial paper, bank notes issued under Section 3(a)(2) of the Act and municipal securities. In addition, Financial Institutions should be permitted to execute principal transactions in securities issued by affiliates. Morgan Stanley sees no basis for limiting access to principal transactions to the limited class of debt securities set forth in the Exemption and contends that existing regulatory requirements protect Retirement Investors as they protect other non-Retirement Investors transacting in these securities. For those fixed income products not covered by the Principal Transaction Exemption, Retirement Investors may receive inferior pricing or may be unable to transact in the products since Morgan Stanley’s prices cannot be made available alongside third party prices, if any.
- The conditions relating to “moderate credit risk” and “sufficiently liquid” are ambiguous terms that should be eliminated since the Principal Transaction Exemption imposes a broad Best Interest standard of conduct and remedial scheme for IRAs. Investors should not be precluded from holding higher credit risk or less liquid products in retirement accounts

where such products are appropriate for the investor. Excluding these securities from the Principal Transaction Exemption harms Retirement Investors by eliminating competitive prices and a source of liquidity from major market participants, thereby reducing competition and increasing the likelihood of poor execution quality for Retirement Investors, or by rendering such instruments completely unavailable. As noted above, principal transactions in these securities remain subject to applicable Pricing and Execution Rules, as well as Suitability Rules and controls which are tailored to investor risk tolerance and investment objectives. These rules and controls should be adequate to protect Retirement Investors in the same way they protect non-Retirement Investors.

- The Principal Transaction Exemption should be expanded to include equities and preferred securities that are included within the scope of Regulation NMS promulgated by the SEC. These are the most liquid and transparent of markets where registered market makers are required to provide continuous two-sided quotes, markets are fully consolidated enabling a national best bid and offer (“NBBO”) for each security to be calculated and disseminated, trades are reported and compensation disclosed. Execution quality is readily discernable and enforced. Trade executions are compared to the NBBO and those executions at prices inferior to the NBBO are reviewed and adjusted when appropriate. As with fixed income securities, orders in equities and preferred securities are subject to regular and rigorous reviews by the Wealth Management Best Execution Committee. Furthermore, market centers are required by Regulation NMS to publicly and regularly disclose prescribed information related to execution quality and each broker-dealer is required to disclose prescribed information related to its order routing practices. *See* 17 CFR 242.605 and 606. While much trading in the equity markets is done on an agency basis, broker-dealers and their affiliates should not be precluded from acting as principal where doing so would satisfy the firm’s obligations under applicable Pricing and Execution Rules that adequately protect Retirement Investors.
- The pricing standard under the Principal Transaction Exemption should be aligned with the applicable Pricing and Execution Rules. Specifically, Financial Institutions should be required to use reasonable diligence to ascertain the best market for the subject security so that the resultant price to the customer in the transaction is as favorable as possible under prevailing market conditions. As mentioned above, firms have rigorous controls in place to meet their obligations under applicable Pricing and Execution Rules, and imposing a new standard under the Exemption would create confusion and impose significant costs without attendant benefits due to the adequacy of existing requirements and controls.
- Firms should not be required, and may not be able, to provide additional information related to the amount of mark-up or mark-down beyond disclosures required by applicable securities rules. The mark-up or mark-down on a transaction includes not only the financial adviser’s compensation (e.g., sales credit) but also any spread that may have been charged or, for inventory positions, any profit or loss incurred, by the trading desk. While the sales credit component is known, the calculation of any desk profit or loss on the trade is not readily determinable, for example, because securities in inventory may have been acquired at different times with different cost bases, or the position may be hedged along with many other positions such that the hedge cost allocable to the particular position is not

readily known. Moreover, depending on how it is calculated, the amount of any mark-up or mark-down can change between the time of the Exemption's required disclosure and the time of execution based on changes in the prevailing market price. Making matters more challenging, there is no NBBO or exchange marketplace for fixed income securities as exists for equity securities, and therefore, broker-dealers cannot look to a single established price that can be used to calculate a firm's mark-up or mark-down on any given trade. Accordingly, should the Department proceed with some requirement to disclose mark-up or mark-down, firms would need considerable guidance on methodology given the complexity around making such calculations. Finally, any disclosures prescribed by the Department could conflict with disclosures required by applicable SEC, FINRA and MSRB rules and proposals.<sup>12</sup>

- The requirement that two other counterparties provide pricing is not workable and should be eliminated. The two-quote requirement is inconsistent with current market structure and applicable FINRA requirements, which instead impose a more flexible diligence standard. Firms may not be able to obtain two quality quotes, but may, for example, be able to establish the prevailing market value of the security by reference to similar securities or financial benchmarks. Given the substantial number of fixed income cusips, it is not always the case that there are multiple market makers. For example, an investor may hold an illiquid security which only Morgan Stanley may stand to purchase. In that instance, there may not be two available quotes. In situations where a firm can obtain two quotations, there is no assurance that the quotes will be at reasonable levels, as could be the case if the quote provider is not a market maker. Quotes could be “throw away” (or worse predatory) and offer little value and should not be considered in the pricing of a security. Moreover, firms like Wealth Management operate “open architecture” platforms where offerings from third parties are displayed in a “stack” along with Wealth Management's internal prices for viewing by its financial advisers and traders who execute at the level representing the best execution. Traders also have access to prices through alternative trading systems or “ATS's” and other electronic communication networks or “ECN's” in order to perform diligence necessary to establish the price of the securities in trades with its customers. Furthermore, absent a centralized platform across firms to review quotes, imposing a requirement on each Financial Institution to obtain and review two quotes is impracticable at best and will delay or prevent execution. As a result, the two-quote requirement may adversely affect the price at which the security can be purchased and lead to a circularity with respect to disclosures (as described above with respect to the BIC Exemption), increase costs, and narrow the universe of securities for which the Principal Transaction Exemption is available.
- Syndicate transactions should be permitted under the Principal Transaction Exemption. Syndicate offerings are heavily regulated and utilize robust offering documents which disclose the compensation to the underwriter and the features and risks of the security, among other items. Further, fixed price offerings have the added benefit of uniform pricing across all investors. Finally, these securities may be more expensive or unavailable

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<sup>12</sup> We note that both FINRA and the MSRB have proposed rules that would require additional confirmation disclosure of the price differential between “paired trades.” See FINRA Notice 14-52 and MSRB Regulatory Notice 2014-20.



in the secondary market, so retirement account clients may be disadvantaged by not receiving access to primary market offerings.

- The exemption requires that the contract affirmatively state that the Adviser and Financial Institution are fiduciaries “with respect to any investment recommendation to the Retirement Investor regarding Principal Transactions.” We recommend that the Department clarify that Advisers and Financial Institutions are required to affirmatively agree that they are fiduciaries only with respect to: 1) those recommendations which render an Adviser and Financial Institution a fiduciary under the Proposal; and 2) the transactions that are subject to the fiduciary recommendation and not any other transactions of the investor.

Morgan Stanley urges the Department to adopt the above-listed suggestions in amending the Principal Transaction Exemption, which is unworkable as proposed and operates to the detriment of the very investors it is designed to protect. In doing so, the Department should look to the existing regulatory and interpretive framework around pricing, execution and suitability of transactions in setting standards that are compatible and not in conflict with the current state of operations in the marketplace. Unless changes are made to address these issues as well as those issues discussed above, Financial Institutions will not be able to avail themselves of this exemption for the benefit of their retirement account clients. This will result in Retirement Investors having diminished or no access to the products or liquidity to which they are accustomed today. As a consequence of the Proposal, Retirement Investors will be forced to purchase and sell fixed income and other products outside of the Principal Transaction Exemption on what may well be a more expensive or limited agency basis or through a self-directed brokerage account where they cannot receive investment assistance from a financial adviser.

## **VII. Potential Streamlined Exemption Should be Approached Cautiously**

Morgan Stanley believes that the Department’s focus should be to make the Proposal workable rather than adding another exemption at this time. The Department sought comments on whether it should propose a streamlined exemption for certain “high quality,” low fee investment products. The Department did not propose any specific approach because of their acknowledged difficulty in designing the exemption.

Although additional exemptive relief for low cost products may have some appeal and role in the marketplace, we are concerned that such an exemption might restrict consumer choice. Firms may seek to rely on a less complex and costly exemption rather than comply with the BIC Exemption even though many consumers may prefer to be in potentially more expensive actively managed mutual funds that could have returns that exceed benchmark for passively managed or index offerings that might fit the exemption. It is well established that cost is not the sole criteria when investing and higher costs can be offset by the opportunity for greater returns, credit quality, and other relevant factors. *See* 29 C.F.R. § 2550.404a-1(b); *Braden v. Wal Mart Stores, Inc.*, 588 F.3d 585, 596, n.7 (8th Cir. 2009) (acknowledging that higher fee funds could be chosen for “higher return, lower financial risk, more services offered, or greater management flexibility” and holding a fiduciary would not breach its duties simply because “cheaper investment alternatives exist in the marketplace”); *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (“[N]othing

in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems).”). In any event, at this time Morgan Stanley believes that the Department’s priority should be to work with the industry to make the Proposal workable.

### **VIII. Coverage of Insurance Products Under Multiple Exemptions**

The Proposal will make it difficult for consumers to access beneficial insurance products. Historically, financial advisers have been able to offer fixed and variable annuities to ERISA plans and IRA holders without the risk of being a fiduciary. Under the Proposal, firms would have to rely on multiple exemptions that will significantly raise compliance burdens and costs. Coverage for sales will vary depending upon both the type of product and the type of purchaser. For example, the sale of registered insurance products (i.e., variable annuities) to IRAs would be covered only by the BIC Exemption, but sales of similar products to fiduciaries of small employer participant-directed plans would not be covered by the BIC Exemption, and would be covered only under Class Prohibited Transaction Exemption 84-24, which, under the Proposal would be amended to include a new Best Interest standard.

While most of the issues outlined earlier in this letter apply equally to annuities, there are unique complexities associated with complying with the proposed BIC Exemption for annuity sales. These complexities will discourage financial advisers from offering insurance products, including products that have beneficial features such as lifetime income features – a policy goal that the Department is seeking to promote. Specific concerns relating to annuity sales include:

- Complying with the requirements to disclose acquisition, ongoing and disposition costs at the time of a sales presentation will be impractical. Annuities are sold with a myriad of optional riders and features with varying costs and benefits (including lifetime income options offered with variable annuities). It will be impossible to provide cost disclosures for every combination of the underlying funds and for each optional feature across the wide range of annuities offered through Financial Institutions. The result will be fewer products and less consumer choice as distributors of insurance products necessarily will be forced to severely limit their offerings. Furthermore, overemphasizing the legitimate cost of lifetime income guarantees could cause consumers to devalue the obvious benefits of these products.
- Many of the data elements that the Proposal will require broker-dealers to collect and disclose are not standardized among insurance companies or the DTCC. Despite numerous efforts among broker-dealers, insurance companies and the DTCC since 2007 to establish an industry data utility to collect and disseminate uniform, up to date variable annuity information—those efforts have failed because of difficulties and insurmountable hurdles in obtaining accurate data on older products, rapid innovation of new products and a lack of common/uniform technology. Without this functionality, firms such as Wealth Management will not be able to comply with the data request requirements of the BIC Exemption.

- There are a number of product features that are unique to annuities such as the ability to internally transfer investment sub-account allocations from one sub-account to another, and the ability to make additional payments to an annuity after the initial sale. The Proposal would present difficult, if not impossible, operational obstacles to the continued utilization of these features which have been standard product features in the annuity industry for decades.
- The Department should also clarify that the Proposal does not apply to a client continuing to hold an annuity issued prior to the availability of the BIC in a brokerage IRA or other retirement account. Although numerous transitional issues have been noted above, the problems for annuities are more pronounced as these assets by their nature more often require ongoing guidance after their purchase, whether for the reallocation of underlying investments or the exercise of rights available under the contract that arise after issuance.

Generally speaking, without substantial changes to the BIC Exemption, annuities that offer the promise of lifetime income protection will simply not be available to IRAs since they would not be sold through the BIC Exemption and could not be offered on either a purely self-directed basis or through an advisory program. Wealth Management does not believe that variable annuities could or should be offered on a completely self-directed basis given the complexity of the products and the consumer's need for education and assistance. Indeed, consumers who have no access to guidance concerning their annuity may elect to surrender it in favor of another arrangement, potentially triggering surrender charges that impact their retirement savings.

Furthermore, Wealth Management and many other firms currently do not offer variable annuities through advisory programs because the annuity products generally are offered on a commission basis and do not have an appropriate share class for use with fee based advisory programs. In fact, the few annuity products that have been designed for use with fee based advisory programs are designed for tax efficiency rather than for guaranteed income and may not generally be appropriate for tax-favored accounts like IRAs. The current universe of annuities designed for use with fee based advisory programs generally do not offer robust optional benefit features and guarantees that support lifetime income as are available through traditional commission based accounts.

Therefore, legacy variable annuity products should continue to be covered by Class Prohibited Transaction Exemption 84-24.

## **IX. Conclusion**

Morgan Stanley appreciates the opportunity to comment on the Department's Proposal. Our firm's Core Values embrace putting clients first. We believe that the Department and Morgan Stanley share many common goals, and that a "best interest" standard should govern our relationships with retail consumers, including retirement investors. We also support clear and understandable disclosure, and strong controls and systems to identify and manage potential conflicts of interest.

However, Morgan Stanley is concerned that -- absent significant reform -- the Proposal's attendant costs to both consumers and firms outweigh its intended benefits. As noted throughout this letter, the costs to retirement savers include investor confusion, more limited investment choices and information, potentially higher costs associated with products that remain available, and disadvantageous execution in comparison to non-retirement account clients who do not have to wait to receive written pre-purchase disclosure. Likewise, there will be material compliance costs across the industry associated with implementing and complying with the Proposal and the Best Interest Contract and Principal Transaction Exemptions. These costs, such as the cost of "re-papering" millions of existing IRA client account agreements and building systems to compile and deliver voluminous disclosures, should be cause for concern by policymakers in that they may ultimately increase the costs to consumers.

As a result, Morgan Stanley continues to believe that a uniform fiduciary standard promulgated by the SEC is the most comprehensive and appropriate way to enhance consumer protection across all retail account types. If, however, the Department moves forward before SEC action, we urge the Department to revise the Proposal in the manner described herein so that its costs and benefits are more closely aligned and consumer choice is preserved.

We would be happy to discuss our comments in detail with the Department.

Sincerely,



Anne Cooney,  
Managing Director & General Counsel of  
Morgan Stanley Wealth Management