July 21, 2015

Submitted Electronically – e-ORI@dol.gov and e-OED@dol.gov

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32); Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

The Investment Program Association ("IPA") submits the following comments with respect to the rule proposed by the U.S. Department of Labor (the "Department") which would define who is a "fiduciary" by reason of providing investment advice for a fee or other compensation (the "Proposed Conflict of Interest Rule"[1]) and the related proposed Best Interest Contract Exemption (the "Proposed BIC Exemption"[2]). The IPA appreciates the opportunity to comment on this important regulatory action.

The IPA was formed in 1985 to provide effective national leadership for the direct investment industry. The IPA supports individual investor access to a variety of asset classes whose returns have low or negative correlations with the returns from exchange-traded securities and products which invest primarily in exchange-traded securities. Many of these investment opportunities have historically been available only to institutional investors (the "IPA Products").[3] Included among the IPA Products are privately offered real estate private equity funds. The IPA has submitted a comment

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1 U.S. Department of Labor, Notice of Proposed Rulemaking, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice*, 80 Fed. Reg. 21928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2509 and 2510), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28201.

2 U.S. Department of Labor, Notice of Proposed Class Exemption, *Proposed Best Interest Contract Exemption*, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28202.

3 Returns from asset classes that have low or negative correlations to exchange-traded securities and products generally do not move parallel with traded markets. This results in a type of diversification that assists in reducing risk resulting from market swings.

letter concerning certain publicly registered, non-listed investments included among IPA Products (the "Public Products Comment Letter"). This letter addresses a category of IPA Products which are privately offered – real estate private equity funds ("PE Funds"[4]). These PE Funds are more fully described below. For 30 years the IPA has successfully championed the growth and improvement of the IPA Products, which have increased in popularity with financial professionals and investors alike. Today, PE Funds function as a critical component of effectively diversified investment portfolios and serve an essential capital formation function for the U.S. economy.

The IPA serves the investment community through advocacy, collaboration, and education regarding these "direct investments," and by establishing and encouraging enhanced transparency, appropriate suitability screening and use of IPA Products, and best practices on the behalf of the investing public.[5]

EXECUTIVE SUMMARY

The IPA's primary concerns, in connection with the Proposed BIC Exemption, relate to two issues: (i) the Department's apparent substitution of a "legal list" of acceptable (and presumably "worthy") assets in place of its traditional principles-based approach; and (ii) the definition of "Assets." With respect to item (ii), the Department has requested comment on the proposed definition of "Assets" and has specifically asked that commenters who believe that additional investments should be included in the scope of the exemption provide the Department with full descriptions of those products, as well as information supporting the position that the products are a "common investment for retail investors."[6]

The IPA respectfully submits that the retreat from a principles-based approach to a "legal list" of "Assets" available to retirement investors for the purpose of the BIC Exemption will stifle product innovation and deny retirement investors the ability to access new investment categories, structures and products which may provide enhanced financial benefits and/or reduced risks. To avoid the negative consequences of this approach, the Department must have the ability and resources to regularly, continually, and timely consider and analyze new investment products for inclusion as an Asset, which may not be practicable. As a result, the Asset list process will create a category of

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4 The IPA supports additional products, but PE Funds are the only products supported by the IPA that are discussed herein.

5 A more complete description of IPA activities can be found in the Public Products Comment Letter.

6 Proposed BIC Exemption, 80 Fed. Reg. 21967.

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investors who are not able to take advantage of market evolutions and improvements. The IPA, therefore, believes that the "Asset" list approach should be discarded in favor of a principles-based approach.

The IPA also respectfully submits that if the Department determines to proceed with an "Asset" list approach, then PE Funds, as defined and described herein, should be included in the "legal list" of "Assets." This position is supported by the following facts:

- PE Funds are compatible with the objectives of retirement investors in that they can provide superior reliable income, inflation protection, and capital growth to preserve the purchasing power of savings during retirement.

- PE Funds are commonly used securities in the portfolios of retired, accredited investors.

- PE Funds provide retirement investors with access to the same strategy, which is used by the nation's leading public and private pension and endowment plans in that they provide portfolio diversification into an asset class, real estate, which has historically had a low correlation with exchange-traded financial products, thereby reducing portfolio risk and increasing risk-adjusted returns.

- PE Funds provide retirement investors with the opportunity to benefit from professional management of direct investments in real properties by organizations which have significant experience and expertise in the asset class.

- PE Funds have compensation provisions which are driven by active and competitive private equity capital market forces.

- While they do not issue publicly registered securities, PE Funds are nevertheless subject to substantial regulation at the federal and state level, which provides significant investor protections. In addition, broker-dealers are subject to extensive requirements relating to due diligence reviews and determinations of the merits and suitability of PE Funds for individual investors.

- Under existing regulations, access to PE Funds is limited to investors who have the financial resources and knowledge and experience in financial

and business matters to make fully informed decisions regarding the merits and risks of a PE Fund investment.

Despite these facts, PE Funds have not been included in the Department's proposed list of "Assets," making these privately offered and strategically useful investments unavailable to qualified IRA investors. The IPA believes that PE Funds[7] should be included as "Assets" within the Proposed BIC Exemption either by the removal by the Department of a "legal list" of "Assets" or by the inclusion of PE Funds on the "legal list."

The following pages provide a more in-depth description and details of PE Funds and the IPA's recommendations with respect to the Department's proposal.

I. PE Funds Help to Achieve Retirement Investment Objectives

PE Funds are effective investments to help qualified investors achieve their retirement investment objectives. These products:

- Provide a Range of Strategic Investment Alternatives to Target Individual Retirement Plan Needs. PE Funds are not "one size fits all" products, but rather provide a broad range of risk and return attributes. This allows for the appropriate matching of investor needs and objectives with specific products' attributes, while at the same time providing the more universal portfolio benefits described below. The dimensions of PE Fund adaptability to individual retirement objectives includes: accessibility of alternative real estate asset classes (*e.g.*, land, office, industrial, retail, apartment, hotel/hospitality, self-storage, net-lease, and other specialty property types); alternative composition of primary investor returns running the spectrum from primarily income to primarily capital growth; a broad range risk-return attributes (*e.g.*, level of debt financing used to increase potential returns, stage of real property operations from under development to existing and fully leased), and length of capital commitment (*e.g.*, anticipated life of the individual PE Fund typically ranging from three to ten years).

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[7] The descriptions of the PE Funds included in this comment letter are general in nature. Some individual PE Funds may vary from the examples described herein with respect to distribution method, structure, compensation arrangements, and regulatory framework. We believe, however, that they are most representative of the vast majority of existing PE Funds.

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- Provide Superior Income Distributions. Depending on their primary objective, (*e.g.*, income or growth) PE Funds can provide a stable stream of income which can sustain lifestyle in retirement.

- Provide the Potential for Inflation Protection. Inflation is one of the most significant risks to retirement income and the purchasing power of savings. Unlike bond and fixed income portfolios where the purchasing power of invested capital can be eroded by inflation, the asset-based PE Funds can provide capital protection through appreciation of the value of the real estate assets they own. In addition, to the extent inflation induces increases in commercial property rents, the stream of operational income received by PE Fund investors can increase, providing another dimension of inflationary protection.

- Avoid Exposure to the Volatility of Traded Securities Markets. By investing directly in real properties, PE Funds help investors avoid concentrating their portfolios in exchange-traded securities or vehicles which invest in exchange-traded securities, and thereby help to reduce the volatility and market risks associated with such products in investor portfolios.

  Historically, this volatility in exchange-traded securities markets has tended to induce retail investors to sell securities at times of declining market prices and purchase securities at times of increasing market prices, as demonstrated in Morningstar's Investor Return metric. Although such potential volatility goes hand-in-hand with the benefit of total liquidity, as described below, achieving the diversification benefit of low correlation requires including less liquid investments in retirement portfolios.

  Volatility can be particularly detrimental to retirement investors whose retirement portfolios are concentrated in exchange-traded securities and products and who have begun regular withdrawals to sustain their lifestyles. For these investors, when the value of their portfolio has been temporarily depressed due to market volatility while still needing to take distributions to sustain their lifestyle, such distributions will represent a greater proportion of their retirement savings, thereby reducing the future income-generating potential of their retirement savings, and compromising their lifestyles.

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- <u>Enable the Assembly of More Effectively Diversified, and Therefore More Stable, Investment Portfolios by Retirees</u>. PE Funds are a crucial component of a wise retirement, estate and generational planning strategy because they are composed of real assets (*i.e.*, land and commercial real estate) whose returns tend to have low correlations with returns from exchange-traded securities and products comprised primarily of exchange-traded securities. PE Funds provide individual investors with access to professionally managed, commercial real estate ownership which for years has been a fundamental component of the investment portfolios of institutional pension plans and endowments. These institutional investors, operating under "prudent investing" principles, have long recognized the tenets of Modern Portfolio Theory. This theory, first described by the economist Harry Markowitz and subsequently confirmed through observation and quantitative analysis, states that investors can achieve superior risk-adjusted returns by combining assets that have different risk characteristics. This combining of assets can result in a portfolio with less risk than the individual assets comprising it, without sacrificing return potential. A key determinant of the amount of risk reduction is not just the number of assets combined, but more importantly their "correlation." Two asset classes whose returns move in parallel (*i.e.*, when one goes up, the other goes up) are said to have a positive correlation; if their returns move in opposite directions they have a negative correlation. Markowitz's great contribution to investors' wallets was his demonstration that anything less than perfect positive correlation can potentially reduce risk.[8]

  Because PE Funds invest directly in real properties rather than exchange-traded real estate securities, PE Funds provide retirement investors with the opportunity to diversify and stabilize their portfolios of exchange-traded investments, and thereby improve their risk/return profile in the same way professionally managed institutional pension and endowment plans diversify and stabilize their portfolios. These assets have historically shown low correlations with financial assets, and, therefore, are recognized as effective diversifiers.

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8 Burton G. Malkiel, *A Random Walk Down Wall Street*, p. 190, W.W. Norton & Company (9th edition 2007).

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II. Why PE Funds Should be Included on the Department's Proposed Asset List

If the Department does not abandon the "legal" Asset list approach in favor of a principles-based approach to its proposal, then the IPA submits that PE Funds belong on any such list for the following reasons:

- Optionality to Tailor Product Selection to Investment Objectives and Benefits Desired. As previously stated, PE Funds provide qualified investors with a variety of real estate product alternatives which can help achieve retirement investing objectives by providing current income, inflation protection and preservation of purchasing power, capital growth, reduced exposure to the negative consequences of traded market volatility, and a portfolio constructed in accordance with Modern Portfolio Theory and designed to pursue optimal risk-adjusted returns. While suitability requirements limit their use to a segment of the qualified investor pool, within this segment their use is extremely common.

- Finite Life. PE Funds do not have an active secondary market. This, however, does not mean that PE Funds are fully illiquid. Notably, there is a growing market for shares of PE Funds comprised of private equity funds that buy interests in other established funds, and there are certain segments of the market through which secondary sale liquidity is available. More importantly, PE Funds have limited lives (*e.g.*, typically three to ten years) and are comprised of multiple real estate asset investments that either may be sold individually during the life of the fund or at the end of its term. Investors typically receive cash distributions upon each realization event, providing a degree of interim liquidity and full liquidity at the end of the PE Fund's anticipated real estate holding period. However, the inherently illiquid nature of real properties dictates that any real estate investment vehicle designed to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets will by its nature have limited liquidity. So, retirement investors seeking an optimally diversified portfolio cannot achieve that objective without investing in non-listed securities or assets.

- Alignment of Interests with its Investors. Unlike many other investment products, where the fund manager determines the value of assets for purposes of calculating the management and performance fees during the operational stage of the investment, a PE Fund's manager receives its management fee based on a percentage of an investor's commitment to the

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fund during the anticipated investment period (ranging from 1% to 2%), rather than on an estimated value which has not been realized. Further, in a very limited number of programs, if the investment continues beyond the anticipated investment period, the PE Fund requires that this management fee decline to a lower percentage of remaining invested capital thereafter. Likewise, performance fees are based on the PE Fund's realized gains on each of its investments, and are not based on the unrealized increase in the value of the fund's investments.

Where performance fees in a PE Fund are calculated on an investment-by-investment basis, it is possible that, in the aggregate, the partnership's manager (the general partner) may receive a higher percentage of returns than would be determined based on the overall performance of the PE Fund (for example, if the interim property sales produce gains but the final liquidating property sale is at a loss which reduces the overall return from the PE Fund). Typically, such PE Funds include a mechanism that provides an additional investor safeguard to ensure that performance fees do not exceed the agreed-upon percentage of gains. This mechanism, often called a "clawback," requires the general partner to return previously paid performance fees to the investors to the extent they represent more than its agreed-upon profit split.

- Substantial Regulations. As is described in greater detail below, PE Funds, and those who sell them, are subject to considerable levels of regulation by the U.S. Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA"),[9] and the securities regulators of the states in which those products are sold. While the regulations differ to some degree, in general, the regulation of PE Funds addresses topics such as a broker-dealer's thorough, independent due diligence obligation to investors with respect to the PE Fund, disclosure requirements (*e.g.*, prepare and file a private placement memorandum or notice filing with FINRA), and the imposition of investor suitability standards (*e.g.*, a requirement that broker-dealers selling the products assess the suitability of the products for the investor).

- Professional Management Expertise. PE Funds are increasingly attracting "institutional quality" professional asset management companies with

[9] FINRA is an independent self-regulatory organization authorized by Congress to protect investors by ensuring that the securities industry operates fairly and honestly. (http://www.finra.org).

exceptional qualifications in the areas of their asset focus. Due to the real, tangible nature of a PE Fund's assets, its success demands the involvement of programmatic managers with significant experience in operating real estate assets.

- Commonality of Private Investment Vehicles. According to an SEC study, in 2012, private offerings of securities accounted for $1.7 trillion of new capital, while public offerings accounted for $1.2 trillion.[10] In this regard it is noteworthy that a 2015 study observed that: "Advised investors have more diversified portfolios, own twice as many asset classes, have more balanced portfolio asset allocations and use more packaged products for equity exposure compared with non-advised investors."[11] The IPA believes that this greater diversification of asset classes and products among advised investors reflects, in part, a significant use of private placement products such as PE Funds.

  The foregoing is especially notable when comparing the size of the private offering market to the size of the public offering market with respect to certain of the financial instruments that have been designated as "Assets" under the Proposed BIC Exemption. For example, in 2012, there were 32,989 private offerings which accounted for $903 billion in capital raised. During the same period, public debt, which is included as an "Asset" (*e.g.*, corporate bonds offered pursuant to a registration statement) accounted for 1,473 offerings and raised just under $1.0 trillion in new capital. To the extent that commonality was a factor in the Department's determination to include corporate bonds as an "Asset," privately offered instruments compare favorably with respect to commonality.[12]

III. PE Fund Structure and Purpose

A PE Fund is an investment vehicle that makes real estate-related investments, typically by acquiring and operating real estate assets in the spectrum from land to income-producing real estate. PE Funds provide a spectrum of product selection

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10 *See*, Vladimir Ivanov & Scott Bauguess, Securities and Exchange Commission, Division of Economic and Risk Analysis, *U.S. Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012*, at 8 (July 2013), available at: https://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

11 *See*, Oliver Wyman, *The Role of Financial Advisors in the US Retirement Market* 11 (Jul. 10, 2015).

12 *Id.* at 9.

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alternatives to enable investors to match the investment to their individual financial situations and objectives. The alternatives include the property type(s) which the PE Fund acquires (*e.g.*, office, industrial, retail, apartment, hotel/hospitality, self-storage, net-lease, other specialty land and property types); geographic location; degree of portfolio diversification (from having a single property focus to using a multi-property strategy); the composition of primary investor returns intended to be provided by the PE Fund (ranging from primarily income to primarily capital growth); risk-return attributes (*e.g.*, level of debt financing used by the PE Fund to acquire properties), and the stage (and therefore return potential) of real property operations ranging from under development to existing and fully leased.

Typically, but not exclusively, PE Fund investors commit to invest a certain amount of money over the life of the fund, and make their contributions in response to "capital calls" from the fund's general partner.[13] Because PE Funds typically do not retain a pool of uninvested capital, a capital call is made when a potential portfolio investment is identified. This process increases the rate of return which investors receive compared with a structure where the full amount of the commitment is made up-front. PE Funds are finite-life investments that typically intend to fully liquidate within three to ten years, as specified in the fund's offering documents. Depending on the objectives of the individual PE Fund, investors will typically receive cash distributions generated by the rental of the properties during the period of portfolio operations and then a final cash distribution when the properties are sold and the fund liquidates. However, where the PE Fund invests in multiple real property assets, investors may receive periodic cash distributions from realized investments and income received by the PE Fund.

IV. Existing Regulation of PE Funds

Interests in PE Funds are typically offered by means of private placements pursuant to an exemption from registration under the U.S. Securities Act of 1933 (the "1933 Act"[14]).[15] PE Funds typically rely on Rule 506(b) (and sometimes on Rule 506(c)

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13 *See*, *e.g.*, Staff Report to the Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, at 7-8 (Sept. 2003) (discussing and contrasting the structure and purpose of private equity funds versus hedge funds), available at: https://www.sec.gov/news/studies/hedgefunds0903.pdf.

14 *See, e.g.*, the 1933 Act, available at: http://www.sec.gov/about/laws/sa33.pdf.

15 Offers and sales of most PE Fund interests are exempted under Regulation D (17 C.F.R. § 230.501 et seq.). Regulation D calls for the electronic filing of Form D with the SEC no later than 15 calendar days after the "date of first sale" of their offerings and, in certain instances, periodically thereafter. Form D requires the names and addresses of the PE Fund's promoters, executive officers, and directors, and certain details about the offering. *See, e.g.*, Form D and instructions, available at: http://www.sec.gov/about/forms/formd.pdf.

starting September 23, 2013), of Regulation D for their private offering exemption under Section 4(a)(2) of the 1933 Act.[16] The Rule 506(b) exemption requires the fund to comply with the following standards: (a) the fund "cannot use general solicitation or advertising to market the securities", (b) the fund "may sell its securities to an unlimited number of 'accredited investors'[17] and up to 35 other purchasers", (c) "all non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment", (d) the fund "must give non-accredited investors disclosure[18] documents that are generally the same as those used in registered offerings", (e) if the fund "provides information to accredited investors, it must make this information available to non-accredited investors as well", and (f) the fund "must be available to answer questions by prospective purchasers."[19]

The fund manager and the general partner of a PE Fund are often professional real estate management organizations or their affiliates, which, with respect to certain PE Funds, may be registered as "investment advisers" under the U.S. Investment Advisers Act of 1940 (the "Advisers Act").[20]

IMPORTANT NOTE: *The term "advisor" in the context of a PE Fund refers to the entity which manages and guides the daily operation of the fund. This entity is typically a company that specializes in the real estate asset class in which the fund invests and is compensated for its services as described herein. This manager of the entity should not be confused with the client-facing "financial advisor" who deals directly with the investor and provides information and makes recommendations with*

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16 *See, e.g.*, Rule 506 of Regulation D exemption of Section 4(a)(2) of the 1933 Act, available at: http://www.sec.gov/answers/rule506.htm.

17 Under Rule 506 of Regulation D, a PE Fund may sell its securities to what are known as "accredited investors." For example, investors can qualify as accredited investors if their "individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000." The term accredited investor is fully defined in Rule 501 of Regulation D, available at: http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=8edfd12967d69c024485029d968ee737&r=SECTION&n=17y3.0.1.1.12.0.46.176.

18 *See, e.g.*, Rule 502 of Regulation D (setting forth disclosure and other conditions applicable to offers and sales made under Regulation D), available at: http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=8edfd12967d69c024485029d968ee737&mc=true&n=pt17.3.230&r=PART&ty=HTML#se17.3.230_1502.

19 *See*, the SEC's discussion of Rule 506 of Regulation D, available at: http://www.sec.gov/answers/rule506.htm.

20 *See, e.g.*, the Advisers Act, available at: https://www.sec.gov/about/laws/iaa40.pdf.

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respect to investments. For purposes of clarity, the IPA will refer sometimes herein to the managers of PE Funds as the "External Manager" or "General Partner."

V. Distribution of PE Funds

A. The Typical Distribution Process for PE Funds

PE Funds are often distributed by broker-dealers that are registered with the SEC, FINRA, and the relevant state securities regulatory authorities. The broker-dealer personnel involved in sales activities ("registered representatives") are also regulated by the SEC, FINRA, and the applicable state regulatory authorities.[21] To a certain extent, investment advisers that are registered with the SEC and the relevant state regulatory bodies (or that are exempt from such registration) also advise clients with respect to investments in PE Funds.

Depending upon the size of the PE Fund offering, the process of distribution of the fund's securities may involve either a single registered broker-dealer or the formation of a selling group of registered broker-dealers. Unlike initial public offerings for exchange-traded securities, PE Funds typically conduct offerings of securities which may last from 6 to 28 months before closing the offering to new investors. Where a selling group is needed, it is formed by a dealer manager, which is a registered broker-dealer. As described below, each participating broker-dealer must conduct due diligence on the offering and an in-depth suitability analysis. Direct investor contact occurs between the registered representatives of the participating broker dealer(s) and their clients, and typically not at the dealer manager level or the External Manager/General Partner level.

Fees charged by broker-dealers relating to the distribution of PE Fund securities are generally one-time, up-front fees payable out of gross offering proceeds. These front-end fees include sales commissions, dealer manager fees, and bona fide due diligence expenses. These distribution costs for analogous publicly registered investment products (*e.g.*, publicly registered, non-listed real estate partnerships and real estate investment trusts ("REITs")) are limited by FINRA to 10% of the gross offering proceeds. Although

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[21] Broker-dealers registering with the SEC must: (a) file SEC Form BD; (b) become a member of a self-regulatory organization (usually FINRA); (c) become a member of the Securities Investor Protection Corporation; (d) comply with all applicable state requirements; and (e) any "associated person" (*i.e.*, any partner, officer, director, branch manager, or employee of the broker-dealer) must satisfy applicable qualification requirements, including passing any required exams and participating in continuing education. *See, e.g.*, the SEC Guide to Broker-Dealer Registration; Registration and Regulation of Brokers and Dealers, Section 15 of the U.S. Securities Exchange Act of 1934, available at: http://www.sec.gov/divisions/marketreg/bdguide.htm.

no such regulatory limits apply to PE Funds, market forces in the broker-dealer community – in large part driven by a recognition of the cost limitations among analogous public products -- have tended to drive distribution costs for PE Funds down to public product levels.[22] The fact that these up-front fees in PE Funds are intended to defray the ongoing services of the broker-dealer and its registered representative, during the three to ten year life of the investment suggests that these fees compare favorably with the annual fees paid by investors to investment advisors based on assets under management for a portfolio comprised only of investments on the Department's proposed Asset list over a comparable multi-year holding period.

B. Federal Regulations Require Thorough Due Diligence and Disclosure in Connection with Offers and Sales of PE Funds

Broker-dealers, whether registered or not, are subject to federal and state securities regulations that are designed to protect investors from fraudulent or deceptive sales of securities. FINRA imposes upon broker-dealers the obligation to conduct a reasonable investigation of the issuer and the securities they recommend in privately placed offerings made pursuant to Regulation D.[23] As such, a broker-dealer has a duty, enforceable under federal securities laws and FINRA rules, to conduct a reasonable investigation of the PE Funds that it recommends. Moreover, any broker-dealer that recommends PE Funds offered under Regulation D must meet its suitability obligations under FINRA Rule 2310 (discussed below),[24] and must comply with the advertising, supervisory and record-keeping rules of FINRA and the SEC. These rules require that broker-dealers conduct due diligence on the products they offer, provide full disclosure, provide fair and balanced communications, and assess the suitability of the offered products, when dealing with investors. A broker-dealer's failure to comply with any of the foregoing may result in disciplinary actions, fines, and/or referrals to the SEC for the violation.[25]

FINRA describes a broker-dealer's duty to conduct reasonable due diligence when offering or selling a product offered under Regulation D, such as PE Funds, as follows:

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22 *See* the IPA Public Products Comment Letter for additional details regarding underwriting costs comparisons among public offerings.

23 *See, e.g.*, FINRA Regulatory Notice 10-22, available at: http://www.finra.org/industry/notices/10-22.

24 *See, e.g.*, FINRA Rule 2310, available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

25 *See*, *e.g.*, FINRA Sanctions Guidelines, available at: http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

> A [broker-dealer] may not rely blindly upon the issuer for information concerning a company, nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation. While [broker-dealers] are not expected to have the same knowledge as an issuer or its management, [they] are required to exercise a "high degree of care" in investigating and independently verifying issuer's representations and claims. Indeed, when an issuer seeks to finance a new speculative venture, [broker-dealers] must be particularly careful in verifying the issuer's obviously self-serving statements. The fact that a [broker-dealer's] customers may be sophisticated and knowledgeable does not obviate the duty to investigate. Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions.[26]

Furthermore, FINRA sets forth criteria that a broker-dealer should investigate regarding the issuer and management of a PE Fund. For example, FINRA states that a broker-dealer should inquire into: (a) the success of past securities offerings by the issuer; (b) pending litigation with respect to the issuer or its affiliates; (c) any previous or potential regulatory or disciplinary problems of the issuer; and (d) the expertise of management for the issuer's business, among other things.[27] In fulfilling its due diligence obligations, a broker-dealer "may retain counsel or other experts."[28] FINRA requires that a broker-dealer verify the qualifications and competence of counsel or experts retained to perform an investigation, while bearing in mind that "the use of counsel or experts does not necessarily complete the broker-dealer's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues or concerns that require further investigation."[29] In addition, FINRA imposes a duty

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26 *See*, FINRA Regulatory Notice 10-22 (internal citations and quotations omitted).
27 *Id.*
28 *Id.*
29 *Id.*

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upon the broker-dealer to maintain records of the process and results to "demonstrate that it has performed a reasonable investigation."[30]

Aside from conducting thorough due diligence of PE Funds and their issuers, broker-dealers must also comply with FINRA's filing requirements for private placements. FINRA Rule 5123[31] requires broker-dealers, selling privately placed products, such as PE Funds, in reliance on an available exemption from registration under the 1933 Act, to file any private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities, or indicate that there were no offering documents used.[32] Typically, private placement memoranda, which comply with Rule 502(b)(2) of Regulation D, contain relevant disclosures that allow an investor to weigh the risks involved with an investment and make a fully informed decision with respect to the investment.

C. Federal Regulations Require Consideration of the Investor's Best Interests

Federal law and FINRA rules require brokers to "adhere to high standards of conduct in their interactions with investors."[33] As a general matter, the suitability requirements of FINRA Rule 2111[34] and of FINRA Rule 2310[35] mandate that broker-dealers have a reasonable basis to believe that a recommended transaction or investment involving securities is suitable for each customer based on reasonable diligence[36] into the investor's investment profile. Broker-dealers must believe that the customer has the financial ability to meet the commitment of the investment. The suitability obligation

30 *Id.*

31 *See, e.g.*, FINRA Rule 5123 (noting that certain filing exemptions apply, such as sales to investment companies or certain accredited investors, among others), available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10753.

32 *See, also*, Regulatory Notice 12-40 (discussing the requirements of FINRA Rule 5123), available at: http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_40.pdf.

33 *See, e.g.*, Securities and Exchange Commission, Study on Investment Advisers and Broker Dealers at 13 (Jan. 2011), available at: http://sec.gov/news/studies/2011/913studyfinal.pdf.

34 *See, e.g.*, FINRA Rule 2111 and FINRA Regulatory Notice 11-02, available at: http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1.

35 *See, e.g.*, FINRA Rule 2310 and FINRA Regulatory Notice 10-22, available at: http://www.finra.org/industry/notices/10-22 and http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

36 For example, broker-dealers have a duty "to conduct reasonable investigation of securities, including those sold in a Regulation D offering." *See*, *e.g.*, FINRA Regulatory Notice 10-22.

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requires that broker-dealers make an assessment of: (1) reasonable basis suitability, (2) customer-specific suitability, and (3) quantitative suitability.[37]

Reasonable basis suitability means that, based on reasonable diligence, the broker-dealer has a reasonable basis to believe that the recommendation is suitable for investors. FINRA views the participation of broker-dealers in a securities transaction as a representation that reasonable basis suitability has been satisfied with respect to that transaction. What constitutes reasonable diligence varies depending on, among other things, the complexity of and risks associated with the security and transaction. Reasonable diligence must provide the broker-dealer (and employees participating in a transaction) with an understanding of the potential risks and rewards associated with the recommended security or transaction.

Customer-specific suitability means the broker-dealer has a reasonable basis to believe that the recommendation is suitable for a particular customer, based on that customer's investment profile. Customer-specific information must be obtained and analyzed when making recommendations to customers.

Quantitative suitability means the broker-dealer with actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions (even if individually suitable) are not excessive or unsuitable in the aggregate in light of the customer's investment profile. FINRA enumerates several factors that might suggest excessive activity, such as turnover rate, cost-equity ratio, and the use of in-and-out trading in a customer's account.[38]

VI. PE Fund Fees and Expenses

The fees and expenses associated with PE Funds can be segregated into two distinct categories: (1) fees and expenses associated with the formation of the fund and the sale of its securities to qualified investors through financial intermediaries (referred to herein as "Offering and Organizational Costs"); and (2) fees and expenses associated with the management and operation of the fund and its assets (referred to herein as "External Management Costs"). The first category of fees and expenses include compensation to the broker-dealers, registered representatives and investment advisers who make investment recommendations to investors. The second category of fees and

[37] *See, e.g.*, FINRA Rule 2111.

[38] *See, e.g.*, FINRA Rule 2111, Supplementary Material, Section .05 "Components of Suitability Obligations."

expenses are paid exclusively to External Management or other third parties and are not related to the process of recommending investments to individual investors.

When evaluating the nature and level of fees and expenses for PE Funds, it is important to understand the overall structure of the management of the enterprise compared with the management of public non-listed and exchange-traded real estate investments (*e.g.*, REITs). REITs can be either internally or externally managed. Simply put, internally managed entities are operated by employees of the entity and the overall costs of management, including the salaries, benefits and incentive compensation of these employees, are subsumed into the entity's reported "general and administrative expense" reporting. In contrast, externally managed entities typically have no employees and instead contract with a separate company experienced in the asset class to provide management services and conduct the day-to-day operations of the entity. The costs of such external management are separately reported (typically categorized by the nature of the service provided – *e.g.*, acquisitions, asset management, property management, etc.) in financial statements as fees paid to the External Manager.

The determination of which management structure, internal or external, to use is made by the issuer. For real estate investment entities, which commence their existence by way of private offerings that have not yet raised capital nor made investments, external management structures are preferred. They avoid the challenge of attempting to attract an experienced management team and incur the associated full overhead expenses for a company which has not yet raised capital, acquired a portfolio, or generated revenues over which to spread such employment costs. Therefore, PE Funds are typically, but not exclusively, externally managed.

Separate and apart from the Offering and Organization Costs associated with the formation of the product and the private offering and issuance of interests in PE Funds (which include legal and accounting representation and printing of offering documents, among other expenses), there are a variety of fees and expenses charged in connection with operation of the PE Fund.

While not all PE Funds are subject to the same fees and expenses, which may vary depending on the specific activities of the PE Fund, examples of the types of fees and expenses payable by most PE Funds to the External Manager or other third-party service providers include: acquisition fees for the selection, evaluation, structuring, and purchase of real estate assets; the reimbursement of expenses incurred in connection with the selection, purchase, development, or construction of properties; an asset management fee based on a percentage of the cost or value of the PE Fund's assets; property management fees, oversight fees, and construction management fees; a financing

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coordination fee as a percentage of the amount of any original financing or refinancing coordinated by the External Manager; a service fee for the provision of administrative services to the PE Fund's investors; disposition fees rendered in connection with the sale of PE Fund assets; and performance and incentive fees (sometimes subject to a hurdle rate). As earlier noted, there are some conflict ameliorating factors relevant to certain of the aforementioned fees.[39] Further, as previously described, the fees described above as being paid to the External Manager of a PE Fund would typically be paid to the External Manager of an exchange-traded REIT or in the form of compensation, benefits and related overhead to employees of an internally managed exchange-traded REIT.

VII. Liquidity of PE Funds

PE Funds do not have an active secondary market. This, however, does not mean that PE Funds are fully illiquid. Notably, there is a growing market for shares of PE Funds comprised of private equity funds that buy interests in other established funds, and there are certain segments of the market through which secondary sale liquidity is available. As previously indicated, PE Funds have limited lives (*e.g.*, typically three to ten years) after which the real estate asset(s) are sold and the proceeds are distributed to investors. Where the PE Fund is comprised of multiple real estate asset investments, properties may be sold individually during the life of the fund or at the end of its term. Investors typically receive cash distributions upon each realization event, providing a degree of interim liquidity and full liquidity at the end of the PE Fund's anticipated real estate holding period.

The fact that PE Funds do not offer the full liquidity associated with products, such as mutual funds, is a critical reason why they should be included in retirement portfolios. As retirement accounts are generally designed for long-term holding, there is no reason why a less liquid investment would be *per se* improper. In fact, the lack of immediate liquidity discourages "churning" and "market timing" and further reduces the investments' correlation to the stock market, all enhanced features and characteristics of a long term, patient retirement planning perspective.

Further, the inherently illiquid nature of real properties dictates that any real estate investment vehicle designed to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets, whether it be an institutional separate account or comingled fund, or a PE Fund, will, by its nature have limited liquidity. So, retirement investors seeking an optimally diversified portfolio cannot achieve that

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39 *See*, section II.

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objective using solely exchange-traded REITs or mutual funds which invest in exchange-traded REITs and real estate companies.

Finally, as previously observed, the potential portfolio volatility which, of necessity, accompanies portfolios of directly or indirectly owned exchange-traded securities, which, therefore, are subject to the vagaries of the traded markets, can force investors who are taking retirement plan distributions to effectively liquidate their investments at times of depressed market conditions, thereby jeopardizing the future income-generating potential of their retirement savings and compromising their lifestyles.

VIII. Additional Bases for the Department to Include PE Funds in the Exemption

A. The Department Should Discard the Legal List of "Assets"

A list of "Assets" will deprive investors of choice and will render the Department unable to easily adapt to market changes. New investment products are continually introduced to the market. It is not feasible to expect that the Department will have the means or ability to regularly and continually consider and analyze new investment products for inclusion as an Asset. As a result, the Asset list process will create a category of investors who are not able to take advantage of market evolutions and improvements. Further, this will result in those investors being precluded from seeking the same return available to other investors or from being able to diversify their investment portfolios on the same basis as other investors. This outcome could both lower returns and increase risk through lack of portfolio diversification—the exact opposite of the Department's objectives.

Some of the emerging products supported by the IPA demonstrate this precise principle. PE Funds, for instance, share many of the same structural qualities as -exchange-listed real estate investment trusts, but have not yet captured the same level of market interest. IPA believes that it is only a question of time and that a list of approved "Assets" would effectively hamper the development of this product. Given the evolution of various investment products over the past decades, placing artificial restrictions on what options are open to IRA investors seems designed to tamp down market growth and limit options for investors. Further chilling the availability of licensed, regulated, and supervised professional advice to these very investors is facially inconsistent with the Department's goals.

In the Proposed BIC Exemption, the Department emphasized that it intended to adopt a "principles-based" or "standards-based" approach that "would flexibly accommodate a wide range of current business practices" while minimizing conflicts of

interest.[40] Yet while the Proposed BIC Exemption is designed to accommodate a wide range of compensation, and to be adaptable over time to market changes in the way investment advisers are compensated, the Department abandoned a principles-based approach when it came to the types of assets covered by the exemption. By proposing a fixed list of acceptable "Assets," the Department chose to freeze in time the types of investments that may be offered to retail retirement investors. We urge the Department to reconsider the "legal list" approach, which is inconsistent with the history of ERISA and modern trust law. We urge the Department instead to adopt a flexible, principles-based approach to the types of assets to which the BIC Exemption applies and to allow retail retirement investors to continue to invest in PE Funds.

Until the early 1940s, many states required trustees to select investments from a statutory list of supposedly safe investments (a so-called "legal list"). Painful experience from the Great Depression showed, however, that virtually no investment is immune from risk, and that even the safest bonds and traditional investments could become worthless.[41] Legal lists failed to adapt to changing economic and business conditions, and reflected the since-discredited assumption that past performance is a reliable predictor of risk. As a result, the legal lists tended to prohibit relatively safe investments in companies with an arguably risky past but a stable future, while permitting investment in more risky companies with a stable past but risky future. This history led the drafters of Restatement (Third) of Trusts to conclude that "knowledge, practices, and experience in the modern investment world have demonstrated that arbitrary restrictions on trust investments are unwarranted and often counterproductive."[42]

The modern trend of fiduciary investment principles was driven in part by dissatisfaction with poor investment performance in legal list jurisdictions, and in part by a large body of academic research that resulted in what is known as modern portfolio

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40 Proposed BIC Exemption, 80 Fed. Reg. 21961.

41 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 Real Prop. Prob. & Tr. J. 407 (1992) (summary of the background, development,t and criticism of traditional trust doctrine regarding investments, plus an overview of modern portfolio theory and other modern developments, from the Reporter for the Restatement (Third) of Trusts); H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 Columbia L. Rev. 721 (1976) (describing the disastrous performance of "legal list" portfolios during the Great Depression in comparison to more flexible prudent man jurisdictions).

42 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter); *see, also*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, *supra*; Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U.L. Rev. 52 (1987); B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986).

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theory.[43] Modern portfolio theory demonstrates that portfolios of risky (*i.e.*, more volatile) stocks can be combined in such a way that the portfolio as a whole could be less risky than the individual stocks in it.[44]

ERISA was the first legislation to apply modern portfolio theory to fiduciary standards of investment, and has been an influential landmark in the development of modern fiduciary law.[45] The Department can justifiably be proud of the leading role ERISA has played in applying flexible and modern principles to the investment duties of fiduciaries. In this regard, perhaps the most significant development beyond the adoption of ERISA itself was the express reliance on modern portfolio theory in the final regulations under Section 404 of ERISA:

> [I]t is the Department's view that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk . . . . Accordingly . . . "appropriate consideration" shall include a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio for which the fiduciary is responsible, to further the purposes of the plan, taking into account the risk of loss

43 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, *supra*; H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, *supra*; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, Yale Law School Faculty Scholarship Series (1976); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law II*, Yale Law School Faculty Scholarship Series, Part I (1977) (describing the evolution of trust law, evidence for the notion that modern investment theory may be superior to conventional trust investment structures and has served as evidentiary backing for modern reforms in trust law and the investment duties).

44 A good general discussion of modern portfolio theory can be found in Burton G. Malkiel, *A Random Walk Down Wall Street*, Ch. 8 (9th edition 2007).

45 *See*, W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 Wash. & Lee L. Rev. 335 (1997) (describing how the passage of ERISA prompted the modernization effort of the third Restatement and uniform state laws on prudent investment); Samuel D. Cheris, *Making Responsible Investment Decisions in Light of the Prudent Person Rule*, 14 Est. Plan. 338 (1987) (describing how Congress adopted ERISA after hearing extensive testimony to the effect that traditional interpretations of prudence were too restrictive when applied to employee benefit plans).

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> and opportunity for gain (or other return) associated with the investment or investment course of action.[46]

Most important to the present discussion, the Department emphasized that its approach to prudent investing reflected a conscious decision to depart from legal lists and other traditional, restrictive applications of trust law:

> [T]he Department does not consider it appropriate to include in the regulation any list of investments, classes of investment, or investment techniques that might be permissive under the "prudence" rule. No such list could be complete; moreover, the Department does not intend to create or suggest a "legal list" of investments for plan fiduciaries.
>
> The preamble to the proposed regulation stated (as does this preamble) that the risk level of an investment does not alone make the investment *per se* prudent or *per se* imprudent.[47]

The impartial conduct standards embodied in the BIC Exemption were designed to mirror the ERISA duty of prudence, combined with the duty of loyalty.[48] It would be a mistake (and more than a bit ironic) to require broker-dealers in the retail retirement market to adhere to ERISA's standard of prudence while at the same time preventing them from considering investment products which, under the Department's own prudence regulations, they may be required to take into account in serving the best interests of their customers. Moreover, the Department's list would invariably – and in all likelihood quickly – suffer the same fate as the legal lists of the past, falling behind ever-changing market conditions, failing to adapt to new products and advances in knowledge, and consequently relegating the BIC Exemption to the margins of the retail marketplace:

> Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid

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46 44 Fed. Reg. 31639 (June 1, 1979), reprinted in CCH, Pension and Employee Benefits, Vol. 3, par. 24,038 (2015) (footnote omitted).

47 *Id.*

48 Proposed BIC Exemption, 80 Fed. Reg. 21970.

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> repeating the mistake of freezing its rules against future learning and developments.[49]

However, the "Assets" list does exactly the opposite. It explicitly does act to create by regulation a list of investments that are or are not appropriate. The list places the Department in the position of weighing which investments represent a suitable level of risk and which ones do not, as well as dictating the limits by which certain investors can access investment products in order to diversify their portfolios.

Finally, we would like to point out that in the preamble to the BIC Exemption, the Department said that it expects the best interest standard to be interpreted by courts in light of forty years of judicial experience with ERISA's fiduciary standards.[50] However, if the Department insists on inserting a legal list into the BIC Exemption, and thereby departing from a core principle of ERISA, it would virtually assure that interpretation of the best interest standard will diverge over time from otherwise applicable ERISA fiduciary standards.

B. If the Department maintains the "legal list" it should add the Real Estate Private Equity Funds to that list.

If the Department determines that a return to the "legal lists" of the past best serves the purposes of the Regulation and the BIC Exemption, IPA respectfully requests that the Department include the PE Funds on that list. As noted above, PE Funds are common, indeed ubiquitous, in the retirement investment marketplace and commonly included in many investor portfolios, providing access to investment opportunities once only available to wealthy investors, as well as diversification and protection against market volatility. To accomplish IPA's request in the most clear manner possible, IPA suggests that the list of "Assets" be amended to include "privately placed real estate private equity funds."

The other terms and conditions of the BIC Exemption are already robust and flexible enough to protect retail investors, regardless of the product type. For example, if a recommended investment has different characteristics than "Assets" on the current list – such as less liquidity, lack of a public market, or different fee structure – those characteristics would have to be disclosed and taken into account by the adviser in order to the meet ERISA's fiduciary obligations, and the stringent best interest standard and

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49 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter).

50 Proposed BIC Exemption, 80 Fed. Reg. 21970.

other conditions of the BIC Exemption. Certainly, not all investments would be in the best interest of all retail investors, but the investment adviser's newly imposed fiduciary status combined with the conditions of the exemption already require the adviser to consider those factors before making a recommendation. Since the conditions of the exemption are both flexible and demanding, the Department need not attempt to determine in advance which assets are appropriate to particular retirement investors, or under what circumstances.

Moreover, the definition of "Adviser" in the exemption already requires compliance with applicable federal and state securities laws and licensing requirements with respect to the covered transaction. Thus, for example, any additional disclosure requirements or suitability standards of FINRA or other regulatory authorities with respect to PE Funds are effectively incorporated into the BIC Exemption.[51] Consequently, the exemption is flexible enough to accommodate different types of investments on the "Asset" legal list. At a minimum this should favor the inclusion of PE Funds on the legal list.

A comparison of some of the items on the list of "Assets" with the PE Funds illustrates some of the deficiencies of relying on a pre-established list of products, as opposed to providing a list of factors (and perhaps some baseline criteria) that industry participants can take into account in deciding for themselves whether a product complies with their fiduciary duties under the BIC Exemption and Conflict of Interest Rule. While the Department has expressed some concern about the liquidity of retirement investments, it has nevertheless included products on the legal list which impose penalties if the investor wishes to exit the investment early. To the extent that externally managed PE Funds invest in securities, their fund managers are subject to the fiduciary duties imposed upon investment advisers under the Advisers Act. Like any of the "Assets" that are sold by a broker-dealer or investment adviser (as defined by the Advisers Act), including corporate bonds, exchange traded funds and interests in registered investment companies, those selling the PE Funds are also subject to the basic FINRA-imposed suitability and disclosure requirements (in the case of brokers)[52] or the Advisers Act-imposed fiduciary standards (in the case of investment advisers). Any justification or authority the Department has for including some investment products as "Assets" while excluding others, such as the PE Funds, is far from clear.

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51 *See, e.g.*, FINRA Rule 2111 and Rule 2310, discussed above at section V. B. and C.

52 Of course, broker-dealers selling certain of the financial products currently included as "Assets" may be subject to additional federal and state regulatory obligations.

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IX. Other Suggestions to Make the BIC Exemption More Workable

A. The Department should reconcile its use of "best interest" with the existing guidance regarding ERISA's fiduciary obligations in order to avoid inconsistent and confusing interpretations.

In the preamble to the Conflict of Interest Rule, the Department states that the best interest standard "is not intended to add to or expand the ERISA section 404 standards of prudence and loyalty as they apply to the provision of investment advice to ERISA covered plans", but is instead intended to apply existing ERISA standards of prudence and loyalty to the IRA market.[53] Similarly, the preamble to the Proposed BIC Exemption provides that the best interest standard is intended to mirror the ERISA duty of prudence, combined with the duty of loyalty.[54] Yet the language of the best interest standard does not exactly mirror the standards of prudence and loyalty from ERISA section 404. While we understand that the Department believes that its departures from a literal blending of the duties of prudence and loyalty are simply uncontroversial glosses on those duties under existing law, it is not reasonable to expect that the differences in language between ERISA section 404 and the best interest standard will not lead to different meanings in the hands of courts and litigants. Accordingly, if the Department truly intends for the best interest standard to mirror the duties of prudence and loyalty under ERISA, it should do so directly by using the same words, or through a cross reference to the duties of loyalty and prudence under ERISA. Any additional explanatory gloss, such as "based on investment objectives, risk tolerance, financial circumstances and needs" of the investor, and "without regard to the financial or other interests" of the adviser and related parties, should be covered in the preamble or through examples, rather than in the text of the best interest standard itself.

B. The Department should clarify the use of typical revenue sharing payments.

The preamble to the Proposed BIC Exemption states that the Department intends for the BIC Exemption to facilitate the continued use of types of fees and compensation common in the retail market, including brokerage commissions, 12b-1 fees, and revenue sharing payments. One of the conditions of the exemption is that a financial institution's policies and procedures must not authorize compensation or incentive systems that would tend to encourage individual advisers to make recommendations that are not in the best interest of retirement investors. The final BIC Exemption should make clear – through

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53 Proposed Conflict of Interest Rule, 80 Fed. Reg. 21938.

54 Proposed BIC Exemption, 80 Fed. Reg. 21970.

safe harbors or examples – that such common forms of compensation, by themselves, do not "tend to encourage" advisers to make recommendations that are not in the best interest of investors or otherwise fail to meet the best interest standard.

C. The Department should re-evaluate the timing of the contract requirement between investor and investment adviser.

We are also concerned that the requirement that the adviser enter into a written contract with the retirement investor *prior to* making a recommendation is impractical. Given the breadth of the concept of a "recommendation" under the Conflict of Interest Rule, advisers may be unwilling even to talk to a retirement investor without first requiring the potential investor to sign a written contract. Prospective investors may well be intimidated or generally put off by an adviser requiring them to sign a detailed contract at the beginning of their first conversation.

Moreover, the prior-to requirement could encourage some advisers to preface their introductory conversations by stating that they are speaking to the investor only with respect to her non-IRA or non-plan accounts, bringing out the contract only if the investor later says she wants to invest from her IRA. Either way, the prior-to rule leads to unintended results.

We believe that the written contract requirement should be revised to require a written contract prior to the receipt of any compensation to which the BIC Exemption is intended to apply. In that way, if the contract satisfying the exemption isn't in place before the compensation is received, the compensation would not be covered by the exemption. But advisers and potential investors would be free to have preliminary conversations without the need for a written contract. This would also eliminate any confusion about when the adviser is providing advice and when she may just be providing investment education that does not require the adoption of fiduciary status.

D. The Department should expand the "seller's carve-out" to include sophisticated IRA and 401(k) plan investors.

The rationale for providing a seller's carve-out for large plans in the Conflict of Interest Rule should be extended to sophisticated plan participants and IRA owners. A participant or IRA owner with a large balance, or with substantial assets or income, should be able to understand after basic disclosure that a broker or other sales representative is selling a product, and that there is no reasonable expectation of a fiduciary relationship. At some level of account balance or other measure of sophistication, a plan participant or IRA owner should – subject to similar disclosure

obligations – be treated the same as a large plan for purposes of a carve-out from the Conflict of Interest Rule.

Conclusion

PE Funds are an investment category which can provide important benefits to retirement plan investors, including income, inflation protection and capital growth to preserve the purchasing power of savings during retirement. The conceptual basis of PE Fund investing resides in Modern Portfolio Theory and derives from the historically low correlation between directly owned real estate assets and exchange-traded securities. PE Funds provide individual investors with access to the same diversification strategy used by the nation's leading public and private pension and endowment plans to increase risk-adjusted returns from retirement portfolios. As an investment category, PE Funds provide a range of strategic real estate investment strategies to address the needs and objectives of individual retirement plans, and are a commonly used tool in the portfolios of accredited investors.

The controls and requirements imposed upon those who distribute PE Funds and upon the products themselves (*e.g.*, SEC and FINRA guideline requirements as to the suitability, disclosure, and due diligence of both the offering and the issuer) provide a high standard of investor protection. Importantly, existing regulations already limit PE Fund investing to accredited investors and those with the financial sophistication and experience to evaluate the risks and merits of any individual PE Fund.

PE Funds provide liquidity via a finite holding period, at the end of which the true value of the investment is realized by all investors in the PE Fund. Limited interim liquidity is a necessary attribute of investing in real properties, an asset class which is inherently illiquid. Yet, such relative illiquidity is necessary to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets. An optimally diversified retirement portfolio cannot be constructed using solely exchange-traded REITs or mutual funds which invest in exchange-traded REITs. Including PE Funds or other forms of direct real estate investment in a portfolio of exchange-traded financial assets constitutes "prudent" investing, and the definition of "Assets" should not deny accredited investors access to these commonly used funds.

For all of the reasons set forth above, the IPA urges the Department to revise the Proposed BIC Exemption in order to include PE Funds within the scope of the BIC Exemption either by doing away with a legal list of "Assets" or by adding the PE Funds, as defined above, to that list. We appreciate your time and attention in ensuring that

retirement investors are provided with the broadest array of investment options, while taking all reasonable measures to avoid conflicted advice.

Respectfully submitted,

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