July 21, 2015

Office of Regulations and Interpretations
Attention: Conflict of Interest Rule
Room N-5655

VIA ELECTRONIC MAIL
e-ORI@dol.gov

Office of Exemption Determinations
Attention: D-11712
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

e-OED@dol.gov

Subject: Conflict of Interest Rule—Retirement Investment Advice (RIN 1210-AB32); and Proposed Best Interest Contract Exemption (ZRIN 1210-ZA25)

Dear Sir or Madam:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to submit comments to the Employee Benefits Security Administration ("EBSA"), regarding its proposals to amend the definition of "fiduciary" in its regulations implementing the Employee Retirement Income Security Act of 1974 ("ERISA") and to authorize exemptions to certain prohibited transaction provisions of ERISA and the Internal Revenue Code ("Code").[2]

CMFI offers the following comments on these regulatory proposals:

[1] The Coalition of Mutual Fund Investors ("CMFI") is a shareholder advocacy organization established to represent the interests of individual mutual fund investors. More information about the Coalition and its activities can be obtained through the CMFI website (www.investorscoalition.com).

[2] *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (April 20, 2015) (hereinafter "Proposed Definition of Fiduciary"); and Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21,960 (April 20, 2015) (hereinafter "Proposed BIC Exemption"). Pursuant to section 102 of Reorganization Plan No. 4 of 1978, the authority of the Secretary of the Treasury to interpret section 4975 of the Internal Revenue Code, involving "prohibited transactions" and the definition of "fiduciary," was transferred to the Secretary of Labor. This section (26 U.S.C. § 4975) applies, in part, to Individual Retirement Accounts ("IRAs").

400 North Capitol Street, N.W. ■ Suite 585 ■ Washington, D.C. 20001
Telephone 202-624-1460 ■ Fax 202-393-5218 ■ www.investorscoalition.com

Definition of the Term "Fiduciary"

EBSA's proposed rule would amend existing ERISA regulations to apply fiduciary standards to broker-dealers and other financial intermediaries when they render investment advice, for a fee or other compensation, to a retirement plan or an Individual Retirement Account ("IRA") owner.

The proposed rule would apply the ERISA "best interest" standard to broker-dealers (and other financial intermediaries) providing individualized investment advice, requiring them and their financial institution to "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution, any Affiliate, Related Entity, or other party."[3]

CMFI believes that many of the mutual funds being sold by the largest brokerage firms are subject to pervasive "pay to play" arrangements in which mutual fund shares are not sold based on their performance or expense ratios, but based on the amount of cash compensation paid to broker-dealers to "move" fund shares to unwitting customers.

The EBSA proposed rule acknowledges these conflicted arrangements:

> Advisers' conflicts take a variety of forms and can bias their advice in a variety of ways. For example, advisers often are paid more for selling some mutual funds than others, and to execute larger and more frequent trades of mutual fund shares or other securities. … These and other adviser compensation arrangements introduce direct and serious conflicts of interest between advisers and retirement investors. Advisers often are paid a great deal more if they recommend investments and transactions that are highly profitable to the financial industry, even if they are not in investors' best interests. These financial incentives can and do bias the advisers' recommendations.[4]

The broker-dealers themselves freely admit the conflicts of interest they are laboring under as they extract payments from funds and their advisers for preferential treatment in their sales programs. As an example, the most recent disclosure document for Wells Fargo Advisors states the following about the need for fund firms to pay additional fees to market their fund shares to customers of Wells Fargo:

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[3] *Proposed Definition of Fiduciary* at 21,938. As noted above, the proposed rule applies to investment advice that is "individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA." *Id.* at 21, 940.
[4] *Id.* at 21,952.

> In addition to the transaction-based commissions received by Wells Fargo Advisors and your Financial Advisor, Wells Fargo Advisors may receive compensation paid by the fund companies, not related to individual transactions, for the ongoing account maintenance, marketing support, educational and training services performed by Wells Fargo Advisors in support of mutual fund sales. … This additional cash compensation may influence the selection of mutual funds that Wells Fargo Advisors and Firm associates make available for recommendation. Wells Fargo Advisors reserves the right to restrict the mutual fund companies that we offer to clients based on payment of additional cash compensation.[5]

Another large-broker dealer—Edward Jones—is just as clear that a fund family needs to "pay up" to receive preferential treatment by the Edward Jones' sales force:

> Most, but not all, of the product partners that pay revenue sharing to Edward Jones have been designated as preferred product partners by Edward Jones. … Additionally, while Edward Jones financial advisors may sell, and our clients are free to select, funds from many mutual fund families, we predominately promote mutual fund preferred product partners. The vast majority of mutual funds, 529 plans and insurance products sold by Edward Jones involve preferred product partners, and, as noted above, most of these product partners pay revenue sharing to Edward Jones.[6]

The EBSA proposal to apply fiduciary standards to broker-dealers and other intermediaries will help to address these "pay to play" business arrangements. However, it will be important for the Securities and Exchange Commission ("SEC") to work on a parallel track with EBSA to update its own broker-dealer regulatory framework, so that any person providing personalized investment advice to an investor holding a non-retirement account is also subject to fiduciary standards.[7]

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[5] Wells Fargo Advisors, *A guide to investing in mutual funds*, at 11-12 (October 2014), *available at* https://saf.wellsfargoadvisors.com/emx/dctm/Marketing/Marketing_Materials/Mutual_Funds/e6244.pdf.

[6] Edward Jones, *Revenue Sharing Disclosure*, at 1, (June 2015), *available at* https://www.edwardjones.com/groups/ejw_content/@ejw/documents/web_content/dweb244757.pdf (hereinafter "Edward Jones Disclosure"). This disclosure document also notes that more than 25% of Edward Jones' net income in 2014 was derived from the receipt of revenue sharing payments from mutual funds and insurance providers ("For the year ended December 31, 2014, Edward Jones received revenue sharing payments of approximately $153.4 million from mutual fund and 529 product partners and $55.9 million from insurance product partners. For that same period, Edward Jones' net income was $770 million.").

[7] CMFI believes that the simplest way to accomplish this goal is for the SEC to eliminate or significantly narrow the current broker-dealer exclusion from the Investment Advisers Act ("Advisers Act") for "incidental" investment advice. Broker-dealers providing any type of personalized investment advice should be registered as investment advisers under the Advisers Act, subjecting them to a fiduciary standard of care that is similar to ERISA. Broker-dealers that provide standard brokerage services (and do not provide personalized investment advice) should

Proposed Best Interest Contract Exemption

EBSA proposes to implement a class exemption from the prohibited transactions rules in ERISA and the Internal Revenue Code for broker-dealers and other intermediaries that meet certain conditions. The proposed conditions for this Best Interest Contract exemption are:

- The financial institution and the individual adviser would be required to enter into a written contract with the retirement investor prior to offering investment advice;[8]
- The institution and the adviser would be required to contractually acknowledge fiduciary status with respect to any investment recommendations made to the investor;[9]
- The institution and the adviser would contractually commit to adhering to basic standards of impartial conduct when providing investment advice to the investor;[10]
- The institution and adviser would be required to affirmatively warrant that they will comply with all applicable federal and state laws regarding their services and that they have adopted written policies and procedures reasonably designed to mitigate the impact of material conflicts of interest;[11] and
- The institution and the adviser firm agree to disclose basic information about their conflicts of interest and the direct and indirect costs of their advice.[12]

In CMFI's view, these new standards will clearly benefit retirement investors by altering the current "pay to play" business model used by broker-dealers and other financial intermediaries. These intermediaries will now have to recommend securities and other assets that are actually in the best interest of their customers instead of themselves. However, these intermediaries will still be able to charge most, if not all, of the fees being charged now for their services, subject only to a general limitation on "reasonable compensation."

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continue to receive commissions or sales loads for rendering these services, as distinguished from "special compensation" under the Advisers Act.

[8] *Proposed BIC Exemption* at 21,969.

[9] *Id.*

[10] *Id* at 21,969-21,970. The Impartial Conduct Standards require that the financial institution and the adviser: (1) will provide investment advice that is in the "best interest" of the investor; (2) will not recommend a security or other asset if the total amount of compensation anticipated to be received will exceed reasonable compensation in relation to the total services provided to the investor; and (3) will not make misleading statements about a security or other assets, the fees to be received, material conflicts of interest, or any other matters relating to the investor's investment decisions.

[11] *Id.* at 21,970-21,972.

[12] *Id.* at 21,972.

If investors are to benefit from a true fiduciary culture when receiving investment advice, then there should not be so many exemptions and carveouts that, in effect, codify the status quo regarding fees. Instead, federal regulators should work to change the mutual fund distribution system, as it has been built on fee structures and business practices that are, by design, in the best interests of financial intermediaries and not investors.

This distribution system provides significant compensation to intermediaries from individual investor accounts, mutual fund assets, and from the profits of each fund adviser. In addition to sales loads of up to 5.75% of fund share purchases (and various other sales load arrangements), broker-dealers also can receive:

- Annual account maintenance fees (also called sub-accounting fees) of between $19 and $25 for each shareholder position held in a fund;[13]
- Rule 12b-1 fees for shareholder servicing of up to 0.25% of shareholder assets; and
- Revenue-sharing payments by fund advisers out of their own profits (or the advisory fees they are receiving) of between 0.05% and 0.50% of fund assets and/or sales.

A great deal of money is being spent by individual investors—both directly and indirectly—to finance this mutual fund distribution system. CMFI conducted a study several years ago and—using conservative assumptions—estimated that these fees together are taking more than $8 billion a year out of the pockets of investors, both directly and indirectly.[14] These payments—especially Rule 12b-1 and revenue-sharing fees—are also being financed by investors who are often not the beneficiaries of the services being provided.[15]

EBSA's Best Interest Contract Exemption would codify these fee structures as long as the actual investment recommendations are in the investor's best interest and the total compensation received meets the general standard of being "reasonable." The Best Interest Contract Exemption would also create a bifurcated regulatory framework, in which different

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[13] This particular fee is the subject of an SEC sweep examination as these payments may have a distribution purpose, but are, more often than not, being paid outside the scope of a Rule 12b-1 plan. *See* Office of Compliance Inspections and Examinations, Examination Priorities for 2014, at 6, January 9, 2014; and Office of Compliance Inspections and Examinations, Examination Priorities for 2013, at 5, February 21, 2013.

[14] *See* Coalition of Mutual Fund Investors, CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts, at 4, August 18, 2010, *available at* http://www.investorscoalition.com/sites/default/files/CMFIWhitePaperAug18.pdf (hereinafter "CMFI White Paper").

[15] For example, a direct investor should not be paying Rule 12b-1 fees for services rendered by broker-dealers to other shareholders within omnibus accounts. Likewise, a direct investor should not have to pay higher advisory fees to offset revenue-sharing payments being made to encourage the sale of fund shares on a particular brokerage platform. The services received by these shareholders are different than the services provided to a direct investor.

standards would apply to providing personalized advice to retirement plan investors compared to investors with non-retirement accounts.

A simpler approach would be to apply the fiduciary standards more strictly, so that investors are not continuing to finance an overly generous mutual fund distribution system. This can be accomplished by more limited exemptions from the prohibited transaction rules. For example:

A. Rule 12b-1 Fees. Federal regulators should consider returning to the pre-1980 position of the SEC, which prohibited the use of fund assets to finance the distribution of mutual fund shares.[16]

Before Rule 12b-1 was promulgated in 1980, this was the SEC's position on the use of fund assets for distribution purposes:

> [T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.[17]

Federal regulators also should consider adopting the proposal made by the SEC in 2010 to permit (or require) brokers to impose sales charges at the investor account level, so that the sales load component of distribution is unbundled from the price of fund shares.[18] This concept should be extended to other fees and charges too, so that investors are paying for the services they need in a transparent manner and other shareholders—such as direct investors—who don't need these services are not paying for them through asset-based charges or fees.

B. Account Maintenance Fees. Mutual funds are the only security that compensates brokerage firms for account servicing, even though SEC and Financial Industry Regulatory Authority ("FINRA") rules already require broker-dealers to track individual positions, provide

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[16] Bearing of Distribution Expenses by Mutual Funds, 45 Fed. Reg. 73,898 (Nov. 7, 1980) ("[The Commission's traditional view is] that it is generally improper under the Act for mutual funds to bear direct or indirect expenses related to the distribution of their shares.").

[17] Bearing of Distribution Expenses by Mutual Funds: Statutory Interpretation, 42 Fed. Reg. 44, 810 (Sept. 7, 1977) (quoting SEC, Statement on the Future Structure of the Securities Markets, 37 Fed. Reg. 5,286 (Mar. 14, 1972)).

[18] *2010 Proposed 12b-1 Rule* at 47,087-47,088 ("Under the proposed elective provision, a fund (or a class of the fund) could issue shares at net asset value (*i.e.,* without a sales load) and dealers could impose their own sales charges based on their own schedules and in light of the value investors place on the dealer's services. In effect, this exemption would allow the unbundling of the sales charge components of distribution from the pricing of fund shares, similar to the existing ETF distribution model.")

regular account statements and tax reports, send transaction confirmations, and prepare suitability analyses for each customer account. Other issuers of securities—such as exchange-traded funds ("ETFs"), corporate equities, and corporate and municipal bonds—are not required under current regulatory rules to make these account servicing payments.

If an investor buys 100 shares of Intel, an Apple bond, or an iShares ETF, these issuers do not typically make any payments to the investor's broker-dealer or retirement plan for holding their securities in an individual account.[19] Instead, the investor pays a commission for buying or selling these securities and, in some cases, an annual account maintenance fee. If an investor is using an investment adviser, he or she likely will pay a percentage of the account's value for the advice being provided. All of these fees are paid by the investor directly to the intermediary at the account level, typically by deducting cash from his or her account balance.

A mutual fund should not be the only security required to pay for shareholder servicing activities by broker-dealers out of fund assets. Funds should not be able to assess charges or deduct fees to reimburse brokers or other financial intermediaries for services already required to be provided under existing regulatory rules. When a fund needs to contract for services to be paid from fund assets, then a competitive bidding process should be used to determine appropriate charges or fees in selecting third–party service providers.

One of the best examples of why competitive pricing is so important can be found in the account maintenance payments being made to broker-dealers by funds. CMFI's research indicates that broker-dealers are typically charging between $19 and $25 for each shareholder account holding fund shares, or an average of about $22 per account each year. This contrasts with the typical cost of between $10-16 for each direct account charged by third-party transfer agents within the mutual fund industry, or an average of about $13 per account each year. The difference between the two averages—$9 per account—is an unnecessary cost for funds and investors.[20] This "gap" would be reduced or eliminated through competitive pricing practices by funds for shareholder servicing activities by broker-dealers and other intermediaries.

The EBSA regulatory proposals impose a limitation on payments received by broker-dealers and other intermediaries offering proprietary products or a limited menu of investment options. Payments under these circumstances must be "reasonable" <u>and</u> may not be "in excess of the services' fair market value."[21] In its written explanation of this requirement, EBSA acknowledges that this requirement is more specific than the "reasonable compensation" requirement in the Best Interest Contract exemption.[22]

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[19] The only exception to this statement are SEC rules that require issuers of certain securities to reimburse broker-dealers and other intermediaries for the cost of distributing proxy materials for shareholder meetings.
[20] *See CMFI White Paper* at 6-7.
[21] *Proposed BIC Exemption* at 21,976.
[22] *Id.*

Since broker-dealers are charging significantly more than fair market value for recordkeeping and shareholder servicing activities, EBSA should clarify its requirements and ensure that any payments for services rendered by a broker-dealer or other third-party intermediary should be at least as favorable to investors (or a retirement plan) as an arm's length transaction with an unrelated or unaffiliated party.[23]

Low Fee Streamlined Exemption

EBSA is also considering a separate and streamlined exemption that would allow financial institutions and advisers to receive otherwise prohibited compensation in certain high-quality investments, subject to certain conditions.[24] EBSA states that this proposed exemption is focused on mutual funds primarily, as the only type of investment widely held by retirement investors that would be "readily susceptible to the type of expense calculations necessary to implement the low-fee streamlined exception."[25]

CMFI has two points to make regarding this proposal. First, an evaluation of suitable mutual funds for this type of exemption should include not just fees and investor costs, but also the performance of the mutual fund. Obviously, passive index funds with low fees would be candidates for an exemption of this type. However, an active equity mutual fund that has compounded returns exceeding a standard market benchmark—such as the Wilshire 5000, the S&P 500, or the Russell 2000—over a very long period of time (i.e., exceeding ten years) should also be considered as long as its fees are within a reasonable range. In other words, mutual fund performance should be part of the evaluation process.

CMFI's second point involves EBSA's question about what types of distribution fees should be permitted for mutual funds that qualify for this exemption. As noted above, CMFI believes that "low-fee funds" should not be subject to Rule 12b-1 fees, account maintenance fees, or revenue-sharing in order to qualify. Broker-dealers and investment advisers should, instead, be compensated on a commission basis or through an asset-based fee charged only to the individual investor's account and not at the fund level. In a true fiduciary framework, each investor should pay for the service(s) he or she desires and not be subsidized by other investors seeking different levels of service(s).

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[23] This is the standard used in other current and proposed prohibited transaction exemptions. *See, e.g.*, *Proposed BIC Exemption* at 21,977 (Proposed Insurance and Annuity Exemption) and Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption (PTE) 75-1, 75 Fed. Reg. 22,021, 22026 (April 20, 2015).
[24] *See Proposed BIC Exemption* at 21,977-21,980.
[25] *Id.* at 21,978.

Conclusion

Thank you for the opportunity to comment on EBSA's regulatory proposals to expand the scope of the ERISA definition of fiduciary and to establish a Best Interest Contract exemption from the prohibited transaction rules.

If you need more information or have questions about CMFI's positions on these issues, please contact me at 202-624-1461 or via email at nielsholch@att.net.

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors