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September 24, 2015

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Room N-5655
Washington, DC 20210
Attention: Conflicts of Interest Rule

Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Suite 400
Washington, DC 20210
Attention: D-11712 and D-11850

Re: Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice
RIN 1210-AB32

Re: Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption (PTE) 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies and Investment Company Principal Underwriters
ZRIN 1210-ZA25

Re: Proposed Best Interest Contract Exemption
ZRIN 1210-ZA25

To Whom it May Concern:

The Insured Retirement Institute ("IRI") appreciates the opportunity to provide these additional comments with respect to the Department of Labor's notice of proposed rulemaking concerning the Definition of the term "fiduciary" of an employee benefit plan (the "Proposed Regulation"), the related proposed amendment to and proposed partial revocation of prohibited transaction exemption 84-24 (the "Proposed Amendment to PTE 84-24"), and the proposed Best Interest Contract Exemption (the "Proposed BIC Exemption") (collectively, the "Proposal").

This letter is not intended to serve as a comprehensive restatement of all of IRI's comments and concerns regarding the Proposal. For information about IRI's position on subjects not covered in this letter, please refer to the comments previously provided by IRI (including the comment letter submitted on July 21, 2015, oral testimony delivered at the Department's public hearing on the Proposal on August 10 and 11, 2015, and written testimony submitted for the record in connection with the hearing on August 17, 2015), which are incorporated by reference into this letter. The purpose of this letter is to more fully address certain questions and comments raised by Department officials during the hearing regarding the changes to the Proposal we believe are necessary, and to provide supplemental comments on a number of other issues.

We commend the Department for dedicating four days to in-person hearings on the Proposal. The commitment of the Department staff and the witnesses, both to the process itself and to finding a workable path, was clearly evident, particularly in the number of Department staff actively listening to and participating in the discussions with each and every panel. We were encouraged by the Department's sincere and repeated assurances (both during the hearing and in other venues) that the Proposal is not intended to pick winners and losers, and that the Department intends to make changes to address some of the problematic aspects of the Proposal, including changes to make clear that the rule would not ban:

- Specific product distribution models (e.g., brokerage accounts, proprietary sales),
- Specific compensation structures (e.g., commissions), or
- Specific types of products (e.g., annuities that provide important lifetime income guarantees).

We continue to believe the changes identified in our July letter would enable the Department to accomplish its objectives without inadvertently making it harder for consumers to access the guaranteed lifetime income that only annuities can provide and advice about how to utilize annuities to achieve a financially secure and dignified retirement.

EXECUTIVE SUMMARY

The following is an overview of the changes to the Proposal requested by IRI in this supplemental letter:

1. Proposed Amendments to PTE 84-24 (see p. 5)
    a. Restore sales of variable annuities to IRA owners to the scope of PTE 84-24.
    b. Make the other changes to PTE 84-24 requested in our July letter, including:
        i. modifying the definition of "Insurance Commission" to ensure that advisers are not inadvertently prohibited from receiving customary employee benefits, and

ii. clarifying that rollover recommendations are covered by PTE 84-24.

2. Proposed Best Interest Contract ("BIC") Exemption (see pp. 5- 18)

   a. Replace the disclosure requirements in the Proposed BIC Exemption with disclosure regimes already in place under existing DOL, SEC and state insurance rules.

   b. Utilize either the alternate definition of "best interest" included in our July letter or the exact language included in Section 404(a) of ERISA, and make clear that the "best interest" standard does not require only recommendations of the "best product."

   c. Remove the additional conditions for Advisers who sell proprietary or a limited range of products and add a clear statement that selling proprietary or a limited range of products does not violate the Impartial Conduct Standards.

   d. Add a clear statement that commission-based compensation and other standard and customary compensation practices do not violate the Impartial Conduct Standards.

   e. Define compensation for annuity transactions to include "Insurance Commissions" as defined in PTE 84-24 and other forms of direct or indirect compensation customarily payable in connection with similar products, and clarify that "reasonable compensation" for annuities is to be assessed by reference to both the value of services provided by the adviser and the value of the guarantees, benefits and other features provided by the product.

   f. Clarify that, if a Financial Institution uses differential compensation (including, but not limited to, commissions) and other alternative compensation practices, the Financial Institution must maintain practices and procedures reasonably designed to ensure such compensation would not encourage advice that runs counter to the best interest of retirement investors.

   g. Make other changes to the Proposed BIC Exemption, including:

      i. Revising the rules for the contract requirement to (a) eliminate the requirement that the advice recipient sign the contract, (b) require execution of the contract prior to the transaction rather than prior to the recommendation, and (c) provide flexibility for situations in which more than one entity meets the definition of "Financial Institution" to permit the companies to determine which of those entities will sign the contract;

ii. Clarifying that violations of the Impartial Conduct Standards would give rise to a contractual claim by the advice recipient but would not result in loss of the exemption;

iii. Providing meaningful grandfathering relief for (a) "sell" or "hold" recommendations and owner-initiated transactions with respect to annuities issued under current rules, and (b) transactions based on recommendations made prior to the effective date of the Proposal; and

iv. Clarifying the applicability of the Proposed BIC Exemption to one-time and ongoing advice.

h. Provide a mechanism for fiduciaries to correct inadvertent failures to comply with the conditions of the Proposed BIC Exemption.

i. Consolidate all of the conditions applicable to variable annuities in a separate section of the Proposed BIC Exemption.

3. <u>Proposed Regulation</u> (see pp. 18-23)

a. Narrow the definition of fiduciary to apply only when there is a "call to action," as required by FINRA rules.

b. Provide a new carve-out from the definition of fiduciary for product manufacturers (i.e., companies that issue annuities, insurance or investment products) that do not provide investment advice about their products or represent themselves as fiduciaries, even if an individual Adviser appointed as the manufacturer's agent under state insurance law is deemed a fiduciary.

c. Broaden the carve-outs in the Proposal as requested in our July letter, including:

i. Providing a new carve-out for recommendations where there can be no reasonable expectation that the adviser is providing unbiased and impartial advice;

ii. Broadening the counterparty carve-out to make it available for recommendations made to plans of all sizes, as well as individual plan participants, beneficiaries and IRA owners;

iii. Clarifying that the platform provider carve-out applies to IRAs and annuities; and

iv. Permitting the identification of specific investment options in connection with asset allocation models under the investment education carve-out.

d. Extend the implementation period to three years.

e. Update the Regulatory Impact Analysis to include consideration of (a) the proposal's impact on the variable annuity industry and its customers, and (b) the impact on the capital markets and the potential systemic risk to the national economy if the proposal results in an overconcentration of retirement savings in passively managed index funds.

f. Publish a revised version of the proposal for public comment before finalizing the rule to ensure its changes sufficiently address the legitimate concerns raised by IRI and others.

I. Supplemental Comments Regarding Proposed Amendments to PTE 84-24

As a preliminary matter, we reiterate our request that the Department provide exemptive relief for all fixed and variable annuities under both PTE 84-24 and a workable version of the Proposed BIC Exemption (we address the changes needed to make the Proposed BIC Exemption workable below)**.** Like fixed annuities, variable annuities provide guaranteed lifetime income payments that retirees cannot outlive, as well as other guarantees and insurance benefits, and therefore should be treated the same as fixed annuities, with exemptive relief available for all annuities under both PTE 84-24 and the Proposed BIC Exemption. Please see pp. 28-34 of our July letter for detailed information about this request and other changes needed in the Proposed Amendments to PTE 84-24, including (a) modifying the definition of "Insurance Commission" to ensure that advisers are not inadvertently prohibited from receiving customary employee benefits[1], and (b) clarifying that rollover recommendations are covered by PTE 84-24.

II. Supplemental Comments Regarding Proposed BIC Exemption

During the hearing, Deputy Assistant Secretary Tim Hauser posed the following question to IRI Senior Vice President and General Counsel Lee Covington regarding the changes IRI has requested with respect to the Proposed BIC Exemption:

> Suppose that we resolved your operational concerns about the disclosure issues, data retention, and the like under the BIC, that instead of using the "without regard to" language, we just used the…404(a) language about exclusive purpose, that we made it completely clear that you can sell proprietary products. And we

[1] The Internal Revenue Code (the "Tax Code") allows "Statutory Employees" who are "Full-Time Life Insurance Salesmen" to participate in the tax qualified employee benefit plans of their associated insurance companies. We are concerned that compliance with the conditions of PTE 84-24 and the Proposed BIC Exemption would be inconsistent with the requirements for "Full-Time Life Insurance Salesman" status under the Tax Code, thereby depriving thousands of insurance agents and their families of access to important health, welfare and retirement benefits. We do not believe this was the Department's intent, and our requested modifications to the definition of "insurance commission" are intended to avoid this outcome.

> gave you guidance on what those circumstances would be…that the advice would be prudent, the fees in the aggregate would be reasonable in relation to the services and the product…being sold, that there is nothing materially misleading in the communications to the customer. That you give full and upfront disclosure about fees and conflicts, and that you don't incentivize your sales force to act in a way that runs contrary to those precepts. And that you put all of that in the contract, and that's it, that's the proposal and that's your only obligation…you can get these commissions, you can get the standard arrangements, but you are going to make a contractual commitment to your customer to adhere to these fiduciary norms. Would that present…significant workability issues? Is that something that would be feasible?

As Mr. Covington noted in his oral response, the concepts outlined in this question could serve as a framework to build upon to make the Proposed BIC Exemption workable for IRI members, depending on the actual language used to implement these concepts. The following are IRI's views on how to integrate these concepts into the Proposed BIC Exemption in a workable manner, as well as additional modifications we believe are necessary to ensure the exemption does not inadvertently prohibit any particular distribution models, compensation structures or types of products.

A. Resolving Operational Concerns About Disclosure Requirements and Data Retention

<u>Disclosure Requirements</u>

As noted in Section III.C. of our July letter (see pp. 45-50), IRI and its members believe the disclosure requirements included in the Proposed BIC Exemption would provide very little, if any, useful information beyond the disclosures already provided to investors under existing rules. Much of the information included in the Proposed BIC Exemption is already required to be provided to investors under existing SEC and state insurance rules, although, in many cases, the information would be presented in different formats (e.g., SEC rules require disclosure of the amount of fees an investor would pay per $10,000 invested, while the Proposed BIC Exemption would require disclosure of the amount of fees an investor would pay based on their actual account value). Imposing duplicative and inconsistent disclosure requirements would overwhelm and confuse the vast majority of investors, a result that clearly runs contrary to the Department's goal of enhancing investors' ability to understand how much they pay for investment products and advice.

Moreover, these disclosure requirements would be a significant obstacle to broker-dealers and financial professionals seeking to rely on the Proposed BIC Exemption to offer affordable commission-based solutions to small and middle-income investors. These requirements would be extremely onerous, expensive and time consuming to implement, and many of the requirements would be impossible to satisfy. For example:

- With respect to variable annuities, the required point of sale disclosures cannot be calculated based on each investor's actual account balance because fees vary among available subaccounts, and investors have the ability to reallocate their account balances between subaccounts throughout the life of the contract. Revising the Proposed BIC Exemption to use standardized hypothetical account balances and an average or range of fees would resolve this issue.
- With respect to brokerage accounts, the required point of sale disclosures cannot be provided until a specific investment is recommended because brokerage accounts typically provide access to numerous investment options. Providing disclosure about all available investments in this context would be overwhelming and confusing for investors, and would be cost-prohibitive for many firms and advisers. Revising the Proposed BIC Exemption to only require disclosures with respect to investments the adviser actually recommends for the client would resolve this issue.
- The annual disclosure requirements create the potential for significant investor confusion because investors already receive annual statements under other existing regulatory regimes, such as SEC and state insurance rules. These existing rules differ from the annual disclosure required under the Proposed BIC Exemption in a number of ways, including timing (end of calendar year versus contract anniversary), the party responsible for providing the disclosure (issuer/insurer versus adviser), and mechanics (based on standard hypothetical account balance versus actual account balance). Revising the Proposed BIC Exemption to leverage these other existing disclosure regimes would resolve this issue.
- Adviser compensation includes components that are not specifically attributable to particular recommendations, including, among other things, advisers' base salary and employee benefits such as health insurance and access to employer-sponsored retirement plans. It would be impossible to allocate the value of such forms of compensation to individual transactions or customer accounts, and even if such allocation were possible, providing disclosure about these forms of compensation would not be meaningful to consumers.

To implement a workable set of disclosure requirements, the Department should eliminate the point of sale, website and annual disclosure requirements in the Proposed BIC Exemption, and instead leverage existing disclosure regimes established by the Department, the SEC, and the state insurance departments to ensure that plan participants and IRA owners receive simple, succinct, and uniform information about insurance and investment products. The industry has invested significant time and resources to develop the systems and processes necessary to produce these required disclosures. Using these regulations as the basis for disclosure requirements under the Proposed BIC Exemption would facilitate a more manageable transition.

Specifically, IRI believes the Department should permit advisers and firms to satisfy their disclosure obligations for variable annuities and other registered securities by providing the SEC-mandated prospectus, and for other types of annuities by providing disclosure materials meeting the requirements of the current National Association of Insurance Commissioners (NAIC) Annuity Disclosure Model Regulation.[2]

Variable annuity prospectuses contain fee tables that disclose the maximum guaranteed charge for all contract transaction expenses and recurring charges. These amounts are expressed in dollars or percentages of the contract value so purchasers will know what they will pay if they buy the contract. The fee tables also list the range of total operating expenses for the underlying funds offered by the contract. In addition, variable annuity prospectuses contain numerical examples showing in dollars per $10,000 what a hypothetical contract owner would pay for the contract and the maximum fees and expenses charged by any of the funds over one-, three-, five-, and 10-year periods. These examples assume a 5% return and that the contract is surrendered at the end of the relevant period. Additional examples are required that assume the investor does not surrender the contract if a sales load or other fee is charged upon surrender. This format shows the effect of any surrender charge.

The NAIC Annuity Disclosure Model Regulation requires that consumers be provided an NAIC-approved Annuity Buyer's Guide,[3] which provides general information about annuities, as well as an additional disclosure document containing specific and detailed information about the particular annuity being recommended to the consumer. The disclosure document must include specific dollar amount or percentage charges and fees and an explanation of how they apply, as well as a description of the contract and its benefits, including:

(a) the guaranteed and non-guaranteed elements of the contract, and their limitations;

(b) an explanation of the initial crediting rate;

(c) periodic income options both on a guaranteed and non-guaranteed basis;

(d) any value reductions caused by withdrawals from or surrender of the contract;

(e) how values in the contract can be accessed;

(f) the death benefit, if available and how it will be calculated;

[2] Available at http://www.naic.org/store/free/MDL-245.pdf.

[3] Available at http://www.naic.org/documents/prod_serv_consumer_anb_la.pdf.

(g) a summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and

(h) the impact of any rider, including, but not limited to, a guaranteed living benefit or long-term care rider.

Nearly 30 states have adopted this Model, and IRI and its members support adoption in all states. IRI member companies have already built the systems necessary to comply with the requirements of this Model, and typically need less than six months to implement those systems when a new state adopts the Model.

Allowing advisers and firms to utilize these existing disclosures to meet their obligations with respect to annuities would still ensure that consumers receive the information they need in order to understand what they are paying and to compare the costs of different products, both across and within different product classes, while significantly reducing market disruption that would result from the costly and time-consuming implementation of the disclosure regime included in the Proposed BIC Exemption.

Accordingly, IRI respectfully submits that the Department should revise Section III of the Proposed BIC Exemption to read as follows:

<u>Section III--Disclosure Requirements</u>

(a) <u>Prior to the execution of the purchase of an Asset by a Retirement Investor, and periodically thereafter (as applicable under the option selected) for as long as this exemption applies, the Adviser furnishes:</u>

<u>(1)</u> <u>To Retirement Investors who are participants or beneficiaries of a Plan, disclosures required by 29 CFR 2550.404a-5(d); and</u>

<u>(2)</u> <u>To Retirement Investors who are IRA owners:</u>

i. <u>For Assets that are registered as securities under the Securities Act of 1933, as amended, fee information and comparative chart(s) required for purposes of Securities and Exchange Commission Form N-1A (open-end management investment companies) or Form N-3 or N-4 (separate accounts offering variable annuity contracts), combined with a website as described in 29 CFR 2550.404a-5(d);</u>

ii. <u>For Assets that are annuities not subject to subparagraph (i) above, a disclosure document that meets the requirements of the National Association of Insurance Commissioners (NAIC) Annuity Disclosure Model Regulation, combined with a website as described in 29 CFR 2550.404a-5(d); and</u>

iii. For Assets not subject to subparagraph (i) or (ii) above, disclosures required by 29 CFR 2550.404a-5(d) with respect to the investments actually selected or recommended by the Adviser.

The Department raised questions during the hearing as to whether industry's concerns would be resolved by simply replacing the disclosure requirements currently included in the Proposed BIC Exemption with disclosures meeting the requirements of the Department's 408b-2 and 404a-5 regulations. While we do not believe the time, costs and burdens associated with extending these disclosure regimes to the IRA market would outweigh the benefits to IRA owners, it would technically be feasible. However, we note that these regulations were designed specifically for employer-sponsored plans and participants and primarily for use with mutual funds. If the Department decides to require that similar disclosures be provided to IRA owners, certain modifications or additional guidance and an extended implementation period will be needed. IRA providers who do not also service the 401(k) market will have to build the necessary infrastructure from scratch. Service providers who have already built the necessary infrastructure for use with employer-sponsored retirement plans will have to adapt that infrastructure to the IRA market, which will be extremely burdensome, particularly for providers who use different systems for their workplace retirement plan and IRA lines of business. Based on the industry's experience with 408b-2 and 404a-5, a three-year implementation period would be necessary and appropriate.

Data Retention Requirements

With respect to data retention, we respectfully urge the Department to delete Section IX(d) and (e) of the Proposed BIC Exemption. Compiling investor-level return information as contemplated by section IX(d) would be an enormously expensive and resource-intensive task, particularly for annuity products that feature guaranteed values as well as cash values, while public disclosure of this information under section IX(e) would be unhelpful at best and misleading at worst for plan participants and IRA owners. Moreover, we are concerned that Section IX could potentially be interpreted as applying to all of the Financial Institution's accounts. We do not believe this was the Department's intention, and therefore respectfully request that the Department insert the following at the end of the introductory paragraph to Section IX: "with respect to accounts to which this exemption applied at any time during such period."

B. Using Alternative to "Without Regard To" Language in Definition of "Best Interest"

As noted in Section III.A.3 of our July letter (see pp. 39-41), IRI and its members fully support a "best interest" standard when an adviser provides advice or recommendations to plans, plan participants and beneficiaries, and IRA owners. However, the formulation of the "best interest" standard in the Proposed BIC exemption (and in the Proposed Amendments to PTE 84-24) as requiring advisers to act "without regard to the financial or other interests of the Adviser, Financial Institution or an Affiliate, Related Entity or other party" is impossible to satisfy. As explained in our previous submission and in our testimony during the hearing, this language appears to require that any advice provided wholly ignore the business and economic reality that advisers and financial institutions have to generate enough revenue to cover their costs and earn a reasonable profit in order to stay in business. We appreciate the Department's comments during the hearing that this formulation of the "best interest" standard was not intended to differ from the existing prudent man standard under Section 404(a) of ERISA, but inconsistent interpretation of this provision by the courts is highly likely. Unless the Department revises this provision to make its intent clear, the only way firms and advisers can ensure they do not run afoul of this standard would be through fee-leveling. This outcome would be inconsistent with the statements by Department officials at the hearing about its intent to preserve commission-based compensation models (as discussed in greater detail below). Accordingly, we urge the Department to revise the standard in the manner requested in our July letter:

> ...the "Best Interest" of the Plan or IRA is when the fiduciary acts 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 plan or IRA, <u>and that subordinates the financial or other interests of the fiduciary and its affiliates to those of the plan or IRA. [or, "and that places the interests of the plan or IRA ahead of the financial or other interests of the fiduciary and its affiliates."]</u>

We believe this clear, plain English language would be the most effective way to ensure the "best interest" standard is consistently interpreted in the manner intended by the Department. However, the Department could instead resolve the issues created by the "without regard to" language by replacing the definition of "best interest" with either the language included in Section 404(a) of ERISA or a cross-reference to that Section.

In addition, to avoid any inference that the "best interest" standard requires only recommendations of the "best product," which would be an impossible standard, we respectfully request that the Department add the following to the end of the definition of "best interest" (regardless of how the Department decides to make change the definition):

> <u>For purposes of clarity, nothing in this standard shall require a determination of the single best recommendation, Asset or Product, either generally or with respect to a particular Retirement Investor.</u>

C. Making it Completely Clear that Selling Proprietary or a Limited Range of Products is Permissible

As noted in Section III.B. of our July letter (see pp. 43-45), IRI and its members believe proprietary annuity distribution models have an important place in the overall annuity marketplace, as they provide consumers with access to advisers who have chosen to focus their practices on a limited range of products and therefore have a level of expertise regarding those products that advisers offering a wider variety of investment options simply cannot match. Seemingly in recognition of the valuable role of proprietary products in the marketplace, Mr. Hauser and other Department officials made numerous statements throughout the hearing suggesting that the Proposal is not intended to prohibit proprietary business models. Unfortunately, Section II(e)(3) and Section IV of the Proposed BIC Exemption currently impose extra layers of requirements on sales of proprietary or a limited range of products that would significantly impair the viability of this business model. Advisers offering proprietary or a limited range of products would already be required to comply with all of the other elements of the Proposed BIC Exemption, including adherence to the "best interest" and "reasonable compensation" standards and provision of the required disclosures. For these reasons (which are more fully explained in our July letter), IRI does not believe these additional conditions provide any meaningful consumer benefit, but would negatively impact consumer access to these products, and therefore be removed.

Moreover, to provide certainty as to the availability of the Proposed BIC Exemption for sales of proprietary or a limited range of products, IRI respectfully requests that the Department add the following as an unnumbered paragraph at the end of Section 2(c) of the Proposed BIC Exemption:

> <u>A Financial Institution or Adviser may limit the Assets available for purchase, sale or holding based on whether some or all of the Assets are Proprietary Products (including insurance or annuity contracts issued by an insurance company) or for other reasons and still rely on the exemption, provided that the Adviser satisfies the requirements of the best interest standard. The ability to sell only Proprietary Products or a limited range of products shall not be considered a violation of the Impartial Conduct Standards.</u>

D. Preserving Ability to Receive Commissions

As noted in our previous submissions, IRI and its members believe the Proposal should be business-model neutral, and should provide a clear and viable path to allow advisers and firms to utilize commission-based compensation models. The Department appears to share this view, as Department officials noted throughout the hearing that the Proposed BIC Exemption is not intended to prohibit commissions. The rule effectively provides a safe harbor for compensation practices that meet the conditions of the Proposed BIC Exemption, but does not expressly state that commissions are permissible or provide any clarity as to the circumstances under which advisers may receive commissions. In the absence of a clear statement to the contrary in the rule, companies have no assurance that the courts will not interpret the language in the Proposed BIC Exemption in a manner that would have the practical effect of banning commissions. To avoid this outcome, IRI respectfully requests that the Department expressly indicate in the rule that commissions are permissible under the Impartial Conduct Standards by revising Section II(c)(2) of the Proposed BIC Exemption as follows:

> (2) When providing investment advice to the Retirement Investor regarding the Asset, the Adviser and Financial Institution will not recommend an Asset if the total amount of compensation anticipated to be received by the Adviser, Financial Institution, Affiliates and Related Entities in connection with the purchase, sale or holding of the Asset by the Plan, participant or beneficiary account, or IRA, will exceed reasonable compensation in relation to the total services (and, if applicable, products) they provide to the Retirement Investor; provided that the receipt of commission-based compensation and other standard and customary compensation practices shall not be considered a violation of the Impartial Conduct Standards (including, but not limited to, standard forms of revenue-sharing based on either sales or assets under management; deferred compensation or subsidized health or pension benefit arrangements for career agents or other similarly situated individuals; reimbursement for reasonable and necessary marketing, education and professional development expenses);

E. Defining "Reasonable Compensation" for Annuities Based on Value of Services Provided and Value of Benefits and Features of Product Being Sold

As noted in Section III.A.5 of our July letter (see pp. 41-42), IRI and its members believe the definition of "reasonable compensation" contained in the Proposed BIC exemption, as applied to annuities, should be conformed to the corresponding provision in Section III(c) of the Proposed Amendment to PTE 84-24. Under PTE 84-24, amounts paid for the provision of services to a plan or an IRA, together with amounts paid in connection with the purchase of the annuity contract itself, may not exceed reasonable limits. This formulation would be more appropriate given that much of the value provided by annuities (and to which many of the costs of annuities are attributable) pertains to their guaranteed features, and given that the amount and nature of the benefits and features provided by different annuities vary across the marketplace.

Based on the foregoing, we urge the Department to add the following to the Impartial Conduct Standards, at the end of Section II(c)(2) of the Proposed BIC Exemption (as revised above) to make this point explicitly clear:

> For example, when providing advice to the Retirement Investor regarding an Asset that is an annuity contract, the Adviser and Financial Institution will not recommend the Asset if the combined total of all fees, Insurance Commissions (as defined in PTE 84-24), and other direct or indirect compensation (as determined for purposes of 29 CFR 2550.408b2(c)(1)(iv)(C)) received by the insurance agent or broker, pension consultant, or insurance company, including forms of such compensation customarily payable in connection with similar products, will exceed reasonable compensation in relation to:
>
> (i) the value of the services provided to the Plan, participant or beneficiary account, or IRA, and
>
> (ii) the value of the insurance guarantees or other benefits provided by, or features of, the Asset.

In addition, IRI requests that the Department revise Section VI(b)(2) of the Proposed BIC Exemption to read as follows:

> (2) The combined total of all fees, Insurance Commissions (as defined in PTE 84-24), and other consideration ~~and compensation~~ received by the insurance agent or broker, pension consultant, or insurance company ~~and any Affiliate~~:
>
> (a) for the provision of services to the plan or IRA; and
>
> (b) in connection with the purchase of insurance or annuity contracts or securities issued by an investment company
>
> is not in excess of "reasonable compensation" within the contemplation of Section II(c)(2) of this Exemption ~~under the circumstances~~;

F. No Incentives for Sales Force to Act Contrary to Best Interest Standard

IRI and its members believe the protections provided by the best interest standard are sufficient to ensure that Advisers do not make recommendations that are not in the best interest of their customers without the need for the explicit prohibitions on the use of various incentives under Section II(d)(4) of the Proposed BIC Exemption. Moreover, the language included in this warranty could be interpreted by the courts as a prohibition on commissions, which, as noted in paragraph II.F above, would be contrary to the Department's intention to preserve commission-based compensation models. In fact, as noted in Section III.A.4 of our July letter (see p. 41), IRI and its members believe Section II(d) of the Proposed BIC Exemption should be deleted in its entirety. The warranties required under that Section would expose Advisers and Financial Institutions to risks of frivolous and costly litigation but would provide no meaningful consumer benefit beyond the protections already afforded by the best interest standard. In particular, we believe many firms will simply stop selling annuity products out of concern that the higher commissions paid for the annuity products as compared to the commissions for mutual funds will be found in litigation to have “tended to encourage” recommendations not in the customer’s best interest.

If the Department nevertheless determines that incentives need to be expressly addressed in the Proposed BIC Exemption, we respectfully request that the Department revise Section II(d)(4) as follows and moving it to a new subsection within the Impartial Conduct Standards in Section II(c):

> Subject to the provisions of paragraph (1) above, if ~~Neither~~ the Financial Institution or, ~~nor (~~to the best of its knowledge~~)~~, any Affiliate or Related Entity uses quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation (whether in type or amount; and, including, but not limited to, commissions and/or ongoing asset-based compensation) or other actions or incentives ~~to the extent they would tend to encourage individual Advisers to make recommendations that are not in the Best Interest of the Retirement Investor. Notwithstanding the foregoing, the contractual warranty set forth in this Section II(d)(4) does not prevent the Financial Institution or its Affiliates and Related Entities from providing Advisers with differential compensation~~ based on investments by Plans, participant or beneficiary accounts, or IRAs, the Financial Institution shall maintain practices and procedures reasonably designed to ensure ~~to the extent~~ such compensation would not encourage advice that runs counter to the Best Interest of the Retirement Investor (e.g., differential compensation would be permissible if based on ~~such neutral factors as~~ (a) the difference in time and analysis necessary to provide prudent advice with respect to different types of investments, (b) the value of insurance guarantees or other benefits provided by or features of the product being recommended, (c) the total production of the individual Adviser, without favoring any one Asset (i.e., credit received for similar Assets are equally weighted) or (d) similar neutral factors~~would be permissible~~).

We believe these requested changes would preserve legitimate uses of alternative compensation practices while helping to align advisors’ interests with those of their clients.

G. Additional Changes Needed in Proposed BIC Exemption

In addition to the changes identified in Mr. Hauser's question to Mr. Covington during the hearing, a number of additional changes are needed to make the Proposed BIC Exemption workable for IRI members and their customers, and to avoid harmful disruption in the annuity marketplace, including the following:

- Timing and Parties to Contract

    (a) Eliminate the requirement that the advice recipient sign the contract (see pp. 35-38 of our July letter for more details);

    (b) Require execution of the contract prior to the transaction, not prior to the recommendation (see p. 38 of our July letter for more details);[4] and

    (c) In recognition of the fact that multiple entities could be considered the "Financial Institution" with respect to a particular Covered Transaction, and to simplify the process of providing the best interest contract and permit companies to determine which entity will serve as the signatory to the contract, insert the following at the end of the definition of "Financial Institution" in Section VIII(e):

    > If this definition applies to more than one entity with respect to a Covered Transaction, the requirements of this exemption may be satisfied by either the entity with supervisory authority for the adviser and/or any other entity or entities to which this definition applies.

- Consequences of Violating Impartial Conduct Standards. Clarify that violations of the Impartial Conduct Standards would give rise to a contractual claim by the advice recipient but would not result in loss of the exemption (see pp. 42-43 of our July letter for more details).

- Grandfathering. Provide meaningful grandfathering to permit Advisers to:

    (a) make "sell" or "hold" recommendations with respect to existing annuity contracts issued under the current regulatory regime[5] (see pp. 50-51 of our July letter for more details);

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[4] If the Department makes this change, corresponding changes should also be made in any other sections where specified actions are required before the Adviser makes a recommendation, including, for example, Section IV(b)(3) of the Proposed BIC Exemption (unless, as we have requested, the Department agrees to delete Section IV in its entirety).

[5] The requested grandfathering for "sell" recommendations would not apply to any related recommendations to purchase different assets using the proceeds from the sale. This request is intended to ensure that Advisers are able to continue providing services to existing clients after the effective date of the Proposal. Given that advisers

(b) execute transactions after the effective date of the proposal based on recommendations made prior to such effective date;

(c) continue to fulfill systematic or other automatic deposit or withdrawal requests, whether or not related to a contractual living benefit;

(d) execute any unsolicited deposit to an existing account and/or unsolicited client reallocation request; and

(e) execute any election on or after the effective date, to retain a contract purchased prior to the effective date, upon the occurrence of an event otherwise provided for in the contract, including but not limited to: a statutory or contractual free look period; a change in the line-up of investment options available under the contract; the expiration, renewal or declaration of an interest crediting or other contractual benefit or feature; the initial or continuing availability of distributions under a contractual living benefit; a default allocation made under the terms of the contract or account in the absence of affirmative direction.

- Applicability of BIC Exemption to One-Time and Ongoing Advice. Consistent with the Department's stated intention to apply fiduciary status to both one-time advice and ongoing advice, revise Section II(e)(1) as follows to avoid an implicit expectation that a BIC will always involve ongoing obligations:

    Identify and disclose the scope of the fiduciary advice (e.g., one time or ongoing, and the nature and extent of continuing duties) and any Material Conflicts of Interest;

H. Provide Mechanism for Correction of Inadvertent Failures to Comply with Conditions to Proposed BIC Exemption

As the Department has recognized in other regulations adopted under ERISA (including, for example, the 408b-2 regulations), it is not uncommon for fiduciaries acting in good faith to comply with the terms of a regulation or exemption may inadvertently fail to fully satisfy a particular requirement or condition. Rather than strictly imposing penalties for inadvertent violations, we believe it is appropriate to allow fiduciaries a reasonable opportunity to take

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do not receive compensation with respect to "sell" recommendations, there is no potential conflict between the interests of the adviser and the client. However, without grandfathering protection for "sell" recommendations, advisers may be unable to provide appropriate advice to an existing client even when selling an asset is in the client's best interest.

corrective action. As such, we respectfully request that the Department insert the following as a new section at the end of the Proposed BIC Exemption:

> Notwithstanding any other provision to the contrary, the failure to comply with any term, condition or requirement of this exemption will not result in the loss of the exemption if the failure to comply was inadvertent and a good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements; provided that the Adviser or Financial Institution, as the case may be, takes appropriate measures to cure any such failure as soon as reasonably practicable.

I. Consolidation of All Conditions Applicable to Variable Annuities in Separate Section of Proposed BIC Exemption

In light of the extensive changes needed to make the Proposed BIC Exemption workable for variable annuities, we respectfully request that the Department create a separate subsection within the Proposed BIC Exemption to include all of the conditions that must be satisfied with respect to a sale of a variable annuity to an IRA owner. We believe this streamlined approach would be the most effective and efficient way to avoid any confusion as to the applicable rules for variable annuities under the Proposed BIC Exemption.

III. <u>Supplemental Comments Regarding Proposed Regulation</u>

Throughout the hearing, Department officials and witnesses engaged in an extensive dialogue about a number of issues related to the Proposed Regulation. The following comments reflect our reactions to those discussions, and are intended to supplement our views on these issues as presented in our previous submissions.

A. Need for Clarification of Definition of "Recommendation"

Mr. Hauser noted throughout the hearing that the Department might consider using the FINRA definition of "recommendation" as the trigger for the imposition of fiduciary status. As noted in FINRA's July 17 comment letter on the Proposal:

> The meaning of "recommendation" for purposes of the [FINRA] suitability rule has been developed over decades of guidance and enforcement. The question of whether a recommendation exists in a particular situation depends upon the facts and circumstances, but FINRA has articulated several guiding principles that are relevant to the determination. For instance, a communication's content, context and manner of presentation are important aspects of the inquiry. An important factor in this regard is whether – given its content, context and presentation – a particular communication reasonably would be viewed as a "call

to action" (i.e., a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy).

Consistent with the feedback and requested changes provided in our July letter (see pp. 18-19), we would fully support revising the definition of "recommendation" in paragraph (f)(1) of the Proposed Regulation to conform to FINRA's definition of "recommendation." However, we continue to believe additional changes are needed in paragraph (a)(2) to ensure the Proposed Regulation does not cause non-fiduciary activities to inappropriately and inadvertently give rise to fiduciary status, including removal of the "specifically directed to" language and modification of the "individualized to the advice recipient" and "for consideration" elements. See pp. 15-20 in our July letter for more details on our requested revisions to the definition of fiduciary in the Proposed Regulation.

B. Request for Manufacturer's Carve-Out

Following the hearing, we have become increasingly concerned that the Proposed Regulation could be interpreted to apply fiduciary status to a product manufacturer (i.e., companies that issue annuities, insurance or investment products) in the ordinary course of its business even if the company and its employees do not render investment advice for a fee or compensation or represent or acknowledge that they are acting as a fiduciary. We do not believe the Department intended to impose fiduciary status under these conditions, but the mechanics of state insurance law could lead some courts to interpret the Proposed Regulation in this manner. Specifically, under state insurance law, insurance products can only be sold by state licensed producers (agents) that are appointed (authorized) as agents by each insurance company whose product the agent sells. The appointment ties the insurance company to the acts of the agent when selling that company's products under state insurance law.

To ensure uniform and clear interpretation of the Proposed Regulation with respect to the treatment of insurance companies that do not directly render personalized investment advice or make individualized recommendations, we respectfully request that the Department add the following new carve-out for product manufacturers:

<u>Manufacturer/Issuer of Insurance or Investment Products.</u>

(1) <u>An Insurance Company, including its Affiliates, when solely performing the role of manufacturer/issuer or (when applicable) underwriter and distributor of investment products, shall not be deemed to be a Fiduciary within the meaning of section 3(21)(A) of the Act or section 4975(e)(3)(B) of the Code, with respect to an employee benefit plan or IRA solely because such Insurance Company or other manufacturer/issuer of investment products issues annuity or other insurance or investment products to such plan or IRA</u>

in the ordinary course of its business if the Insurance Company or other manufacturer/issuer of investment products, or their employees, do not:

(A) Render investment advice (as defined in paragraph (a) of this section) for a fee or other compensation related to such advice with respect to such insurance or investment products (as opposed to compensation for the product itself or services related thereto).

(B) Represent or acknowledge that it is acting as a fiduciary within the meaning of the Act with respect to the advice described in paragraph (a)(1) of this section.

(C) Render advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to annuities, insurance or other investment products it manufactures.

(2) For purposes of this section, an Insurance Company in its capacity as a product manufacturer/issuer is not considered a Fiduciary, Affiliate or a Financial Institution merely because a state insurance licensed and appointed agent, agency or their representatives, and state and federal securities licensed advisers or firms, who may or may not be a Fiduciary pursuant to this section, are required by state insurance laws to be appointed or otherwise authorized to sell the Insurance Company's products.

C. Need for Clarification and Expansion of Carve-outs

The carve-outs to the definition of fiduciary included in the Proposed Regulation were discussed extensively throughout the hearing, with numerous witnesses urging the Department to make changes similar to the revisions we requested in our July letter. We continue to urge the Department to modify the carve-outs as follows:

- Provide a new carve-out for recommendations where there can be no reasonable expectation on the part of the advice recipient that the advice provider is undertaking to provide unbiased and impartial advice" (see pp. 20-21);
- Broaden the counterparty carve-out to make it available for recommendations made to plans of all sizes, as well as individual plan participants, beneficiaries and IRA owners (see pp. 21-23);
- Clarify that the platform provider carve-out applies to IRAs and annuities (see pp. 23-25); and

- Permit the identification of specific investment options in connection with asset allocation models under the investment education carve-out (seep. 25-28).

D. Need for Three-Year Implementation Period

As noted in Section IV of our July letter (see pp. 51-52) and the attached operational impact study conducted for us by Deloitte & Touche, the Proposal's eight-month implementation period is overly aggressive and unrealistic in light of the extensive systems and process changes that will be required to comply with the Proposal. For the reasons identified in our previous submissions, we respectfully request that the Department provide an implementation period of at least three years to avoid unnecessary and harmful market disruptions.

E. Need for Updated Regulatory Impact Analysis Including Impact on Consumer Access to Annuities, and Impact on Capital Markets

While the Proposal was accompanied by a lengthy regulatory impact analysis ("RIA"), numerous commenters have identified serious flaws and raised serious questions about the RIA. IRI shares many of those concerns, but believes the RIA was particularly deficient in two key areas.

The first relates to the lack of any consideration in the RIA of the value of annuities and the impact of the Proposal on consumer access to annuities. While the proposal expressly applies to annuities, the RIA fails to consider either the cost to consumers of losing access to annuities and advice about how to use annuities to plan for a financially secure retirement, or the cost to financial institutions and advisers to develop and implement the systems needed to comply with the proposal's extensive conditions and requirements. Before DOL moves forward with the rule, it must carefully study and consider these consumer impacts and costs, and determine that the benefits afforded by the rule would outweigh those costs.

Second, the DOL did not adequately consider the impact of the Proposal on the capital markets and the potential systemic risk to the national economy. Many commenters, including IRI, believe the Proposal would ultimately drive the majority of retirement savers to put their money in passively managed indexed funds. The DOL even suggested there should be a simplified exemption (a "free pass") for passive index funds, which traditionally have lower fees than actively managed funds.[6]

As the Proposal's bias causes passive investments to gain market share, retirement savers could bear indirect costs due to the fact that sophisticated investors are able to trade ahead of, or front run, index funds. Stock additions and deletions to indexes are announced days prior to actual inclusion, enabling active arbitragers to front-run passive index funds by buying stocks in

[6] *See, e.g.,* http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2015/05/08/ the-hidden-provision-in-the-department-of-labors-proposed-fiduciary-rule

advance of their being added and selling them prior to their removal. Passive investments are more exposed to the costs of front running than active investments because many passive investments seek to minimize tracking error from their benchmark even at the expense of higher returns, meaning that they will still buy stock of new index members at the arbitrager-inflated prices (and vice versa). By contrast, active investments typically wield greater discretion on the timing and selection of security purchases and sales to avoid the ill-effects of the front-running.[7]

A study by Winton Capital Management notes that the effect of front-running "is well-known within the quantitative investment community,"[8] and – even more troubling in light of the Proposed Rule's bias towards such investments – that the "rising popularity of tracking an index such as the S&P 500 makes it a worse investment."[9] The costs associated with this perfectly legal practice – in the form of the higher prices paid by a fund once a stock is added to the index, and the lower cost received when a stock is removed – are not borne by the fund but rather by investors in those funds. As a result, the expense of owning an S&P 500 index fund is estimated to be as much as 0.28 percentage points higher than it otherwise would be, an increase that is almost three times the 0.11 percentage point management fee for the Vanguard 500 Index Fund – precisely the type of low-cost, passively managed mutual fund towards which the Proposed Rule is biased.

In fact, total lost income for investors in funds tracking the S&P 500 index in 2014 was estimated to be approximately $4.3 billion – and that number will only increase if the Proposed Rule is implemented because according to these studies, as passive indexes capture market share, the performance drag is expected to increase.[10]

DOL and other regulators with responsibility for oversight of the American economy (such as FSOC, Treasury and the SEC) should first conduct a full study to consider whether an excessive concentration of assets in passive investments would adversely impact capital formation, market liquidity, and the overall functioning of the equity markets. The study should focus on

[7] "The index premium and its hidden costs for index funds," by Antii Petajisto. Journal of Empirical Finance 18 (2011) 271-288 (Petajisto).

[8] Furthermore, industry participants engage in index front-running in their trading desks or hedge funds; the existence of these programs (e.g., Equity Index Arbitrage Trading) across the industry – including investment banks and high frequency trading desks – underscores that this practice is both common and well-known.

[9] "Hidden costs in index tracking," by Christophe Bernard, PhD, accessed via https://www.wintoncapital.com/assets/Documents/WWP_HiddenCosts_final_revised.pdf?1405926282 (Bernard)

[10] Id. See also "The Hugely Profitable, Wholly Legal Way to Game the Stock Market", by Yuji Nakamura, Bloomberg Business July 7, 2015. Accessed via http://www.bloomberg.com/news/articles/2015-07-07/the-hugelyprofitable-wholly-legal-way-to-game-the-stock-market

several potentially destabilizing trends which may reasonably be expected to result from the Proposal, including:

- overconcentration in passive index funds;
- overconcentration by target-date options in indexed funds; and
- robo-advisers directing clients into a limited selection of alternatives in accordance with a pre-determined model.

These trends will result in over-concentration in the market that could cause widespread instability under adverse market conditions.

F. Need for Re-Proposal

While we hope the Department will sufficiently address all of the legitimate concerns raised with respect to the Proposal in written comments and at the hearing, we agree with the numerous witnesses at the hearing who expressed the view that an additional notice and comment period is necessary and appropriate to ensure any changes developed by the Department effectively address those issues. As such, we respectfully urge the Department to give stakeholders an opportunity to review and comment on the next iteration of the Proposal before issuing a final regulation.

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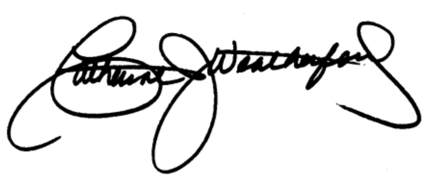
If you have any questions about any of the comments or requested changes included in this letter or any of our previous submissions on the Proposal, or if we can be of any further assistance as the Department works to improve the Proposal, please feel free to contact me or Lee Covington, IRI's Senior Vice President and General Counsel.

Sincerely,



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