

Sep. 24, 2015

BY EMAIL

Office of Exemption Determinations
Employee Benefits Security Administration
United States Department of Labor
122 C St. NW, Ste. 400
Washington, D.C. 20001

Office of Regulations and Interpretations
Employee Benefits Security Administration
United States Department of Labor
200 Constitution Ave. NW
Washington, D.C. 220210

RE: Docket ID EBSA-2014-0016; RIN 1210-AB32

Attn: Conflict of Interest Rule, Room N-5655; D-11712

Dear Sir or Madam:

Fund Democracy greatly appreciates the opportunity to submit additional comments on the Department's proposed Best Interest Contract Exemption ("BIC exemption").¹ During the last two decades, the conflicted structure of broker-dealer compensation has deteriorated to the point where it is an annual, multi-billion dollar drain on our economy. Securities regulators have repeatedly floated proposals to address these concerns but have in every case failed to follow-through,² leaving the Department, with its unique mandate to protect Americans' retirement security and to apply the heightened legal duties that ERISA requires, no choice but to take decisive action. I applaud the Department for its untiring diligence through a long rulemaking process and unwavering stand against an unprecedented onslaught by paid lobbyists and self-interested firms.

This letter reflects more than two decades of experience, covering a wide range of professional perspectives, with the issues addressed by the Department's proposed

¹ I am the founder and president of Fund Democracy, a non-profit organization formed in 2000 to advocate on behalf of investors. I do not receive and have never received any payments from Fund Democracy other than reimbursement of out-of-pocket expenses. I am currently a law professor at the University of Mississippi School of Law and a vice president of a St. Louis-based financial planning firm.

² See Attachment at 5 - 8.

BIC exemption and related proposals.³ Since submitting my first comments, I have submitted a written statement to the Department pursuant to its public hearings in August and written testimony to the House Financial Services Committee's Subcommittees on Capital Markets and Government Sponsored Enterprises, and Oversight and Investigations. My testimony, which is most relevant here with respect to its discussion of three alternative proposals floated by industry participants and lobbyists, is attached to this letter and hereby incorporated by reference.

This letter addresses the Department's proposal to excuse non-security annuities ("fixed annuities") from compliance with the contract requirement in the BIC exemption. In short, excusing fixed annuities from the BIC requirement is ill-advised in light of both the frequency of sales abuses in the sale of fixed annuities, specifically, indexed annuities,⁴ and the exempt status of indexed annuities under the federal securities laws. As noted by the North American Securities Administrators Association,

Equity-indexed annuities are extremely complex investment products that have often been used as instruments of fraud and abuse. For years, they have taken an especially heavy toll on our nation's most vulnerable investors, our senior citizens for whom they are clearly unsuitable.⁵

³ I have worked on these issues in many capacities over the last 25 years, including testifying before Congress, submitting comment letters, publishing commentaries, delivering presentations, providing consulting services, acting as an expert witness in private litigation and public enforcement matters (including revenue sharing cases brought by the California Attorney General and Massachusetts Secretary of States' Securities Division), developing policy as an Assistant Chief Counsel at the SEC, advising broker-dealers in private practice on compliance matters, teaching law classes and in working for a St. Louis-based financial planner. I am not being compensated in any way for these comments, and I believe my comments reflect an objective view of the best interests of investors. I have a conflict of interest, however, in that the Department's proposal may require substantial changes in the practices of the registered investment adviser that employs me. The Department should assume that the same principles that I recommend be applied to broker-dealers should be applied equally to investment advisers. My comments are focused only on broker-dealer issues due to time constraints and because that is where the Department's proposal will have the greatest effect.

⁴ See generally Investor Alerts: Equity-Indexed Annuities – A Complex Choice, FINRA (2015)(equity-indexed annuities ("EIAs") "are anything but easy to understand. . . investors will find it difficult to compare one EIA to another) *available at* https://www.finra.org/investors/alerts/equity-indexed-annuities_a-complex-choice; Indexed Annuities, FINRA (2015) ("A sales representative may describe an indexed annuity as a simple and easy-to-understand product.") *available at* <https://www.finra.org/investors/indexed-annuities>. Notice to Members: Equity-Indexed Annuities, FINRA (August 2005) (FINRA "is concerned about the manner in which associated persons are marketing and selling unregistered EIAs;" providing examples of misleading adviser claims regarding indexed annuities) *available at* <https://www.finra.org/sites/default/files/NoticeDocument/p014821.pdf>.

⁵ NASAA Statement on SEC Equity-Indexed Annuity Rule (Dec. 17, 2008) *available at* <http://www.nasaa.org/5611/nasaa-statement-on-sec-equity-indexed-annuity-rule/>. See also *Tricks of*

Excusing indexed annuities from the BIC requirements would further weaken regulation where regulation is already weak and the need for enhanced investor protection is heightened. I strongly encourage the Department to apply the same rules to indexed annuities as it proposes to apply to other types of assets.

Background

The Department has created an exemption, the BIC exemption, that requires that firms that rely on the exemption enter into a contract with investors that provides that, *inter alia*:

(2) The Financial Institution has adopted written policies and procedures reasonably designed to mitigate the impact of Material Conflicts of Interest and ensure that its individual Advisers adhere to the Impartial Conduct Standards set forth in Section II(c);

(3) In formulating its policies and procedures, the Financial Institution has specifically identified Material Conflicts of Interest and adopted measures to prevent the Material Conflicts of Interest from causing violations of the Impartial Conduct Standards set forth in Section II(c); and

(4) Neither the Financial Institution 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 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, to the extent such compensation would not encourage advice that runs counter to the Best Interest of the Retirement Investor (*e.g.*, differential compensation based on such neutral factors as the difference in time and analysis necessary to provide prudent advice with respect to different types of investments would be permissible).

the Trade, Dateline NBC (Apr. 13, 2008) (hidden camera documentation of indexed annuity sales abuses) available at http://www.nbcnews.com/id/24095230/ns/dateline_nbc/t/tricks-trade/#.VgRxlGRViko.

The Department proposes to exempt fixed annuities from these requirements as well as the requirement that firms enter into a Best Interest Contract with investors. The Department's rationale for that proposal is, in part, the perceived:

uncertainty as to whether the disclosure requirements proposed herein are readily applicable to insurance and annuity contracts that are not securities, and whether the distribution methods and channels of insurance products that are not securities fit within this exemption's framework.

However, the Department provides no further explanation of why it believes such uncertainty exists.

Indexed and Variable Annuities Raise Similar Conflicted Compensation Issues

In my view, there is no material distinction between conflicted compensation practices as they relate to variable and indexed annuities. Financial advisers are typically paid a commission for each product, with additional compensation being paid if features in addition the product's core features are sold. For example, a rider that guaranteed a minimum return over the life of a variable annuity that would generate additional revenues for the issuer would result in the adviser being paid more than if the variable annuity were sold without the rider. An indexed annuity will necessarily have fewer variations than a variable annuity at least because the former does not entail an investment in a portfolio of underlying assets. My understanding is that indexed annuities typically offer few add-ons than variable annuities, but this does not affect the issue of whether, if additional compensation is paid for such add-ons, this compensation structure creates an improper conflict. In addition, the compensation paid to advisers for selling indexed annuities may vary from and is typically higher than the compensation received for sales of other products, which means that advisers may have an incentive to recommend them solely on the basis of the relative compensation received. Indexed annuity compensation differentials should be subject to the same requirement that the firm have some rational basis for paying higher selling compensation other than simply to promote sales. In my view, the Department has not provided a reasonable basis for excusing indexed annuities from the BIC requirement.

Applying the BIC Exemption to Indexed Annuities Would Be Eminently Workable

As noted by the Department, the BIC exemption "does not mandate the specific content" of a firm's policies and procedures, but rather "allow[s] Financial Institutions to develop policies and procedures that are effective for their particular business models, within the constraints of their fiduciary obligations and the Impartial Conduct Standards." Requiring appropriate policies and procedures for sales of indexed annuities would similarly allow firms to develop policies and

procedures that were tailored to their particular business models and the characteristics of the product.

Similarly, the BIC exemption would prohibit compensation practices that “tend to encourage” recommendations that are not in the client’s best interest. Like the policies and procedures requirement, this principles-based approach will allow firms to tailor their compensation structures to their particular business models and the products they sell. The “tend to encourage” standard would allow sellers of indexed annuities to adopt policies and procedures that reflect the particular characteristics of these products.

The Department observes that paying higher compensation for variable annuities can be justified on the basis of the financial advisers’ additional investment time and analysis. This position is equally applicable to sales of indexed annuities. The Department provides four examples of compliant practices, each of which could easily be applied in the indexed annuity context. The Department identifies six examples of procedures that would mitigate or eliminate abusive conflicts, each of which is no less appropriate in the context of indexed annuities. There is simply no basis for concluding that entering into the Best Interest Contract would be materially more onerous for indexed annuities, or that IRA investors are entitled to less protection from conflicted sales of indexed annuities than conflicted sales of other products.

Indexed Annuity Sales Practices call for *More* Investor Protection, Not *Less*

In fact, IRA investors are in need of *greater* protection in the context of indexed annuities. As discussed below, a number of factors militate for imposing higher standards of conduct with respect to sales of indexed annuities because these products are: (1) subject to less non-ERISA regulation, (2) more susceptible to abusive sales practices, and (3) more likely to be sold by financial advisers whose primary concern is their own compensation rather than their clients’ best interest.

For example, indexed annuities are not subject to FINRA’s compliance requirements or suitability standard. The policies and procedures required by the BIC reflect FINRA’s requirement that broker-dealers adopt policies and procedures that are designed to mitigate conflicts of interest.⁶ However, FINRA’s policies and procedures requirements do not apply to sales of non-securities such as indexed annuities. Thus, the Department proposes to exempt the same category of IRA assets from the BIC’s policies and procedures requirements that are already exempt from FINRA compliance requirements. While mutual fund and variable annuity sales are subject to two layers of policies and procedures requirements, indexed annuities are subject to neither. The need for effective policies and procedures to

⁶ See generally Report on Conflicts of Interest, FINRA (October 2013) (“Report on Conflicts of Interest”) available at <http://www.finra.org/sites/default/files/Industry/p359971.pdf>.

mitigate conflicts in the sale of indexed annuities is greater than for other products, yet the Department proposes to subject these sales to lower rather than higher standards.

In its most recent interpretation of the suitability standard, FINRA made it clear that a suitability violation can be based on excessive or conflicted fees, which is consistent with the BIC's prohibition against providing compensation that "tends to encourage" advice that is not in the client's best interest. Both standards will apply to mutual fund and variable annuity sales because those products are securities, but neither standard will apply to indexed annuity sales. Again, the Department proposes to excuse indexed annuities from BIC requirements where the absence of securities regulation calls for heightened regulation.

There is no material difference between the conflicted compensation issues that arise in the context of variable annuities and indexed annuities. Variable annuities often include an array of riders and other special benefits that trigger higher compensation for financial advisers. For variable annuities, financial advisers will have to make determinations regarding when higher compensation is justified based on the time and analysis they have invested in the recommendation. The same kind of evaluation should be required for indexed annuities. In my view, there is no reasonable basis for distinguishing variable annuities and indexed annuities in terms of the structure of financial advisers' selling compensation or the procedures that would be required to comply with the BIC exemption.

Excusing indexed annuities from the BIC requirements will grossly distort financial advisers' selling incentives and harm investors. Indexed annuities, like variable annuities, already represent a disproportionate share of abusive sales practices. They pay higher compensation to financial advisers than other products and therefore attract financial advisers who are more inclined to sell on the basis of compensation than the client's best interest. They are often unsuitable investments, particularly when placed in a tax-deferred wrapper such as an IRA, a factor that the Department should specifically address.⁷ Securities regulators have become increasingly permissive with respect to unsuitable sales of annuities, which has contributed to skyrocketing unsuitable sales of these products in IRAs. From 2000 to 2012, sales of variable annuities and indexed annuities rose from 41% to 62%

⁷ The Department proposes to ban municipal securities from IRAs because they are virtually never appropriate investments in a tax-deferred wrapper, but it does not anywhere address the same issue for annuities. I note that this is actually a more significant problem in the retirement plan context, where assets are often invested in variable annuities in which the only non-investment feature is the guaranteed annuity rate at termination. The Department should address the question of how merely offering retirees the right to annuitize can rationally justify the higher fees paid by plan participants for these products, when participants could annuitize their plan balance just as easily (and as often as not more cheaply) after rolling over their accounts into an IRA or by choosing a fixed income annuity offered by the plan.

and 49% to 61%, respectively.⁸ These data are consistent with advisers increasingly advising investors to roll over their 401(k) assets into variable and indexed annuities, yet the Department would excuse indexed annuities from BIC requirements.

The indexed annuity exemption problem is exacerbated because financial advisers seeking to evade investor protection requirements have an additional incentive to sell indexed annuities because their abusive sales practices will not be subject to securities regulation. These are precisely the advisers who are most likely to engage sales abuses and be attracted to sales of higher compensation products solely on the basis of compensation. These are likely the same advisers who are primarily responsible for abusive sales practices in the non-traded REIT market. The Department has correctly concluded that sales abuses with respect to non-traded REITs have been so prevalent that these products cannot be permitted to be sold in IRAs. Yet the advisers who sell these products are likely to shift their non-traded REIT book of business to high-compensation indexed annuities, and the Department's exemption would give them an additional incentive to do so.

Finally, the Department's indexed annuity exemption will exacerbate sales practices abuses by driving more IRA assets into the hands of advisers who are not subject to any securities regulation. At least advisers employed by broker-dealers will continue to be subject to their firms' securities-law-based regulatory structures, even if their specific sales of fixed annuities are not specifically subject to securities regulation. In contrast, insurance agents that are not dually registered are not reached by securities regulation in any way. This makes a significant difference in the fixed indexed annuity market because that market is dominated by independent insurance agents. Whereas independent insurance agents account for only 1% of sales of variable deferred annuities, they account for 82% of sales of indexed deferred annuities.⁹ The Department's indexed annuities exemption therefore will have the effect of pushing IRA investors into the hands of less regulated insurance agents whose sales standards are even lower than FINRA's suitability standard.

* * * * *

In summary, the Department proposes to create an exemption and weaken investor protections where it should impose additional requirements and strengthen investor protection. The Department's excusing indexed annuities from the BIC requirements takes an approach that is the direct opposite of the approach it should take to what are probably, with the sole exception of non-traded REITs, the IRA assets that are most frequently associated with abusive sales practices and

⁸ See Joseph Montminy, *The Changing Individual Annuity Market* at 10, LIMRA (2013) available at https://s3.amazonaws.com/presspublisher-do/upload/567/2013_RIC_Session_2.1_-_Annuity_Market_Trends_-_Montminy.pdf (last visited Sep. 24, 2015).

⁹ *Id.* at 8.

unsuitable recommendations. The exemption will have the effect of increasing sales of less-regulated indexed annuities, which the most compensation-sensitive financial advisers will be incentivized to sell instead of better regulated mutual funds and variable annuities and to-be-banned non-traded REITs.

In my view, the Department's core proposal is sound and holds out the potential to create substantial benefits for investors, but the Department's indexed annuity exemption may simply make a bad situation worse. I strongly encourage the Department to remove the indexed annuity exemption or at least to incorporate the BIC's policies and procedures and "tend to encourage" warranties in PTE 84-24.

Thank you again for the opportunity to comment on the Department's proposal. I would be pleased to discuss these comments or related issues with the Department staff and may be contacted at 662-915-6835 or mbullard9@gmail.com.

Respectfully,

A handwritten signature in black ink, appearing to read "Mercer Bullard". The signature is fluid and cursive, with the first name "Mercer" being more prominent than the last name "Bullard".

Mercer Bullard

Attachment: as

Testimony of Mercer E. Bullard
President and Founder, Fund Democracy, Inc.
and
MDLA Distinguished Lecturer and Professor of Law
University of Mississippi School of Law

before the

Subcommittees on
Capital Markets and Government Sponsored Enterprises,
and Oversight and Investigations

Committee on Financial Services

United States House of Representatives

*Preserving Retirement Security and Investment Choices
for All Americans*

September 10, 2015

Chairman Garrett, Ranking Member Maloney, Chairman Duffy, Ranking Member Green, members of the Subcommittee, it is an honor and a privilege to appear before the Subcommittee today. Thank you for this opportunity. I am the Founder and President of Fund Democracy, a nonprofit advocacy group for investors, and a Professor of Law at the University of Mississippi School of Law. This testimony discusses H.R. 1090 in Part I and the Department of Labor's proposed exemption from prohibited transaction rules for Individual Retirement Accounts ("IRAs") in Parts II - IV.

In summary, I do not support H.R. 1090. As discussed in Part I.A, Section 2 would prevent the Department from completing its long overdue rulemaking by making that rulemaking contingent on prior, unrelated rulemaking by the Securities and Exchange Commission ("SEC" or "Commission") under Section 913 of the Dodd-Frank Act. Investors would continue to experience losses resulting from financial advisers' incentives to make recommendations that are not in investors' best interest, with no guarantee that the Commission would *ever* adopt rules under Section 913. As explained in Part IB, it is unreasonable to make any rulemaking contingent on SEC action in view of the SEC's longstanding rulemaking paralysis. Section 3 of H.R. 1090 would require unnecessary, redundant and burdensome reports and analysis by the Commission and would be inconsistent with APA principles of notice and comment, as I discuss in Part I.C.

I strongly support the Department's proposal and urge Congress to take proactive steps to help the Department finalize its rulemaking. The Department's proposal to treat financial advisers who make investment recommendations to investors as fiduciaries will help protect investors from abusive sales practices and conflicted compensation arrangements. Fiduciary status will cause broker-dealers and financial advisers to violate certain prohibited transaction rules as a result of conflicted compensation arrangements that make the amount of an adviser's compensation depend on the recommendation made by the adviser. However, the Department has proposed exemptions from the prohibited transaction rules that are both workable for the industry and effective in protecting investors.

The adverse effect of conflicted compensation arrangements is indisputable. Just as it is a fundamental law of economics that if you tax an activity you will get less of it, it is a fundamental law of economics that if you pay for more certain recommendations, you will get more of them. For example, if you pay your financial advisers more for selling stock funds than short-term funds, which is standard industry practice, more stock funds will be sold than if advisers' compensation was the same for both funds. I discuss the pervasive effect of conflicted compensation arrangements in Part II.

The financial services industry claims that the Department's proposal cannot work. In fact, the proposal is eminently workable. Industry claims are based on erroneous assumptions regarding how the proposal would operate in practice. Part III of this testimony corrects the most common misperceptions regarding the proposal. Industry claims are also belied by the fact that some broker-dealers have been able to implement workable compensation practices that comply with or even exceed the requirements of the Department's proposal. For example, some broker-dealers have already mitigated conflicted compensation arrangements by: (1) eliminating financial advisers' differential compensation for platform and proprietary funds, (2) capping commission compensation for financial advisers, (3) adopting product-neutral commissions and payout grids, (4) abjuring production-based payout grids altogether, and (5) limiting payout increases to prospective sales rather than also applying them retroactively. These and other current practices are both workable for broker-dealers and beneficial for investors. In Part IV, this testimony discusses certain alternatives to the Department's proposals that have been offered by industry members.

I. H.R. 1090

A. Section 2 of H.R. 1090

Section 2 of H.R. 1090 prohibits the Department from completing its rulemaking until at least 60 days after the Commission has issued a final rule pursuant to Section 913 of the Dodd-Frank Act. I do not support Section 2 for a number of reasons.

- Conduct standards under the securities laws are lower than under ERISA. In ERISA, Congress expressly decided to impose higher standards of care and loyalty with respect to retirement assets than it imposed under the federal securities laws. Section 2 therefore conflicts with ERISA because it prevents the Department from imposing the higher standards that ERISA requires in deference to an agency that does not have the authority to impose such standards.
- The securities laws regulate only securities, whereas ERISA covers all types of retirement assets. In ERISA, Congress expressly decided to regulate assets that are not securities and therefore not subject to the federal securities laws. Section 2 therefore conflicts with ERISA because it prevents the Department from regulating non-securities in deference to an agency that does not have the authority to regulate non-securities.
- In ERISA, Congress specifically granted the Department authority over the regulation of retirement assets, including non-securities assets. The Commission does not have authority over the regulation of non-securities or authority over many types of retirement plans. Section 2 prevents the Department from exercising the authority Congress specifically required it to exercise in deference to an agency that does not have this authority.
- The Department has not adopted any rules, it has only proposed rules. The Department has made it clear that it will make changes to its proposal. Congress should not prevent the Department from adopting rules when it does not know what rules the Department may adopt. Section 2 broadly threatens the functioning of regulatory agencies and the principle of notice and comment by judging, in effect, final rules without knowing what the final rules will be. It undermines the rule of law by interfering with the very process of administrative rulemaking.

If Congress disagrees with the positions taken by the Department in its proposals, there are reasonable means for it to do so. It could, once there is actually a rule with which it can disagree, amend ERISA to change the legal standards that apply to retirement assets or narrow the scope of those legal standards.

Section 2 is also inappropriate because it requires the Department to wait for an agency to adopt rules when the agency clearly will not do so. As discussed further below, the Commission has repeatedly acknowledged the problems that the Department's proposal addresses but chosen not to address them. Indeed, with respect to discretionary rulemaking the Commission has exhibited regulatory paralysis for more than a decade. It is unreasonable to condition the Department's rulemaking on other rulemaking that will

not happen in the foreseeable future. In this case, rulemaking delayed would be rulemaking denied.

B. Commission's Rulemaking Paralysis

The Commission has proposed a number of rules, none of which it has been able to finalize, that address issues that provide much of the impetus for the Department's rulemaking. In doing so, the Commission has demonstrated that it cannot be relied to take action under Section 913 of the Dodd-Frank Act or otherwise adopt rules to require adequate disclosure of conflicted compensation arrangements or to require procedures designed to eliminate or mitigate the adverse effect of these arrangements.

i. Revenue Sharing Payments

Since the 1990s, mutual fund companies have made distribution payments out of their management fees, yet there are no Commission rules that require disclosure of these payments, much less rules that address the conflicts of interest that differential revenue sharing payments create. Revenue sharing payments generally comprise a percentage of the transaction amount and an ongoing percentage of fund assets held at the broker-dealer. Industry participants have been sued by private parties, state securities regulators and the Commission itself regarding inadequate disclosure of revenue sharing arrangements, yet the Commission has been unable to set of clear standards for revenue sharing disclosure.

The Commission proposed rules to address this issue in 2004 that would have mandated disclosure to investors at the time of the transaction ("point of sale").¹ It was unable to finalize this rulemaking. In 2010, the Department put the Commission on notice that it intended to regulate revenue sharing with respect to retirement assets. Also in 2010, the Dodd-Frank Act amended the Exchange Act to require the Commission to:

¹ Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Rel. No. IC-26341 (Jan. 29, 2004). *See also* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Rel. No. IC-26778 (Feb. 28, 2005) (requesting additional comments).

examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers.²

Despite such patent invitations for the Commission to take action, the Commission has failed to promulgate rules. More than a decade after its point-of-sale proposal, the Commission has been unable to take final action on that rulemaking. It continues to regulate revenue sharing primarily through its enforcement program.

ii. 12b-1 Fees

The Commission has conceded for more than 15 years that Rule 12b-1 was in dire need of reform. For example, the mutual fund confirmation shows the amount of the commission charged, but it does not show the 12b-1 fees that investors pay on an ongoing basis. This misleading omission has been exacerbated by the broker-dealer industry's shift, over the last two decades, from commissions to asset-based fees. Commissions on mutual funds have steadily declined, while 12b-1 fees have increased and become the functional equivalent of a deferred or installment commission.

In 2008, SEC Chairman Christopher Cox promised that,

in coming days, you can look for the SEC to open up the hood of this old jalopy and start cleaning out the gunk. When the overhaul is done, I predict there won't be a 12b-1 in there anymore.³

The “coming days” became months, which became years. In 2010, the Commission finally proposed substantial reforms to 12b-1 fees,⁴ yet it has unable to take final action

² Dodd-Frank Act Section 913(g) (adding new subparagraph (l) to Exchange Act Section 15).

³ Comments by Christopher Cox, Chairman, U.S. Securities and Exchange Commission, at the Investment Company Institute 4th Annual Mutual Fund Leadership Dinner, Washington, D.C. (Apr. 30, 2008) (“Chairman Cox Comments”) *available at* <http://www.sec.gov/news/speech/2008/spch043008cc.htm>.

⁴ *See* Mutual Fund Distribution Fees; Confirmations, Rel. No. IC-29367 at 15 – 16 (July 21, 2010) (“12b-1 Fee Proposal”).

on that rulemaking. Seven years after Chairman Cox’s promise, and five years after proposing reforms, the SEC’s “pending repeal or reform of rule 12b-1”⁵ is still pending.

iii. Mutual Fund Fixed Pricing

Section 22(d) of the Investment Company Act requires that mutual funds sell their shares at the price stated in the prospectus. The effect of this requirement is to fix the commissions charged for purchasing shares of a given mutual fund, regardless of whether the broker-dealer responsible for the transaction would charge less for its services. Thus, one reason that broker-dealers are paid differential commissions is that they cannot choose the commission level at which they wish to provide their services.

As the Commission has noted, Section 22(d) “effectively prohibits competition in sales loads on mutual fund shares at the retail level;” such anticompetitive price fixing “would normally be a violation of the antitrust laws.”⁶ In 2010, the Commission proposed to allow funds to sell shares for which broker-dealers determined the commission.⁷ However, as has been the case with a number of initiatives, the Commission has been unable to close the deal.

iv. Fiduciary Duty

Section 913 of the Dodd-Frank Act specifically authorizes the Commission to adopt rules that apply a fiduciary duty when broker-dealers provide personalized investment advice. Congress provided specific guidance regarding its intention that such rulemaking not prevent commission-based compensation or the sale of proprietary products while also expressing specific concern regarding:

the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers,

⁵ Chairman Cox Comments, *supra*.

⁶ 12b-1 Fee Proposal, *supra*, at 87 & n.266 (citing *U.S. v. National Ass’n of Sec. Dealers, Inc.*, 422 U.S. 694, 701 (1975) (antitrust immunity is afforded to sales made pursuant to Section 22(d))).

⁷ *Id.*, *passim*.

including any material conflicts of interest.⁸

The SEC Chairman had promised to engage in such a fiduciary rulemaking even before the Section 913 was enacted, but more than five years after Section 913 became law no action has been taken.

v. Conclusion

These examples reflect a pattern of acknowledging the problems that the Department now seeks to address but failing to take action to address them, as well as a broader regulatory paralysis exhibited by the Commission over last fifteen years. For example, when the Commission exempted certain broker-dealers from registration under the Advisers Act, it was unable to adopt a final rule until forced to do so by litigation years later. In the 1990s, after the Commission permitted exchange-traded funds (“ETFs”) on the condition that they fully disclose their portfolios, and after issuing a concept release on actively managed ETFs in 2001,⁹ it took 14 years to permit the offering of a managed ETF that did not disclose its portfolio.

In 2003, the Commission proposed a rule that codified the terms of hundreds of multi-manager exemptions, but no final action has been taken.¹⁰ Nor has the Commission adopted proposed Rule 6c-11, which was proposed seven years ago and would codify ETF exemptions.¹¹ Both multi-manager fund and ETF sponsors therefore still must obtain individual exemptions. Giving new meaning to the word “temporary,” the Commission adopted a “temporary” exemption from principal trading provision of the

⁸ Dodd-Frank Act Section 913(g) (adding new subparagraph (l) to Exchange Act Section 15).

⁹ See *Actively Managed Exchange Traded Funds*, Rel. No. IC-25258 (Nov. 8, 2001). In 2015, the Commission requested comment on ETFs and other exchange-traded products. See *Request for Comment on Exchange-Traded Products*, Rel. No. 34-75165 (June 12, 2015).

¹⁰ See *Exemption from Shareholder Approval for Certain Subadvisory Contracts*, Rel. No. IC-26230 (Oct. 23, 2003) available at <https://www.sec.gov/rules/proposed/33-8312.htm>.

¹¹ See *Exchange-Traded Funds*, Rel. No. IC-28193 (Mar. 11, 2008).

Advisers Act in 2007 with an expiration date of Dec. 31, 2009,¹² which it has extended in violation of the APA in 2009, 2010, 2012 and 2014.¹³

In the 1990s, the Commission became aware of widespread market timing based on stale mutual fund prices, but it did nothing to stop such abuses until forced to do so, in effect, by the New York Attorney General. Similarly, the Commission sat by while analysts' conflicts corrupted the investment banking industry until the New York Attorney General stepped in and forced major reforms. In 2007 and the first half of 2008, the growing short-term credit crisis provided obvious signals that money market funds ("MMFs") were at risk. Requests for no-action relief to bail out funds had reached an all-time high, and funds that were structurally similar to MMFs failed or experienced runs.¹⁴ In January 2008, my advocacy group submitted a rulemaking petition with other advocacy organizations asking the Commission to reconsider its *ad hoc* no-action process and to require MMFs to file electronically their portfolios with the Commission to enable the systematic review of MMF pricing accuracy.¹⁵ The Commission took no action, and the Primary Reserve Fund failed in September 2008.

¹² See Advisers Act Rule 206(3)-3T; Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Rel. No. IA-2653 (Sep. 24, 2007).

¹³ See Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Rel. Nos. IA-3948 (Dec. 17, 2014) (Dec. 31, 2016 expiration date), IA-3522 (Dec. 20, 2012) (Dec. 31, 2014 expiration date), IA-3128 (Dec. 28, 2010) (Dec. 31, 2012 expiration date) & IA-2965 (Dec. 23, 2009) (Dec. 31, 2010 expiration date).

¹⁴ Financial Crisis Inquiry Report, National Commission on the Causes of the Financial Economic Crisis in the United States at 254 – 255 (January 2011)(at least 44 fund companies bought securities from their MMFs' portfolios in late 2007) available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>. A \$5 billion cash fund that was operated by GE similar to an MMF failed in late 2007, and a \$27 billion state-run cash fund experienced a run in which \$8 billion in assets were redeemed over a two week period. See *id.* at 255.

¹⁵ See generally Letter from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-CIO, Financial Planning Association, and National Association of Personal Financial Advisors to Nancy Morris, Secretary, U.S. Securities and Exchange Commission (Jan. 16, 2008) available at <http://www.sec.gov/rules/petitions/2008/petn4-554.pdf>.

In 2013, the Commission proposed investor protections in conjunction with adopting rules that permit issuers to advertise private offerings publicly.¹⁶ When the Commission issued the proposal, Chair Mary Jo White stated that she was:

firmly committed to keeping consideration of this proposal on track so that the Commission is able to make an appropriate and timely regulatory response to the operation of the new rule permitting general solicitation.¹⁷

Nonetheless, more than two years later the proposal is still pending.

In conclusion, it is *per se* unreasonable to make any regulatory action contingent on prior action by the Commission. Time and time again, the Commission has proposed rules and promised reforms but been unable to get the job done.

C. Section 3 of H.R. 1090

Section 3 of H.R. 1090 requires that, prior to promulgating a rule under Section 2, the Commission conduct a study of broker-dealer and investment adviser regulation. It requires that, “alongside” the promulgation of such a rule the Commission publish certain findings regarding harm to and confusion among investors. It also requires the Commission, in *proposing* such a rule, to consider the differences in the regulation of broker-dealers and investment advisers. In principle, I generally agree that the Commission should consider the factors identified in Section 3 pursuant to any fiduciary rulemaking. However, I am opposed to this provision for a number of reasons.

Section 3 is redundant because the Commission has previously committed to complying with Executive Order 13563, which would require the reviews and consider the factors that Section 3 mandates.¹⁸ That Order requires that agencies:

¹⁶ Amendments to Regulation D, Form D and Rule 156, Rel. No. 33-9416 (July 10, 2013). The Commission also stated that it would “monitor and study the development of private fund advertising and undertake a review to determine whether any further action is necessary.” Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Rel. No. 33-9415 at 51 – 52 (July 10, 2013).

¹⁷ Statement of Mary Jo White, Chair, U.S. Securities and Exchange Commission (July 10, 2013) *available at* <http://www.sec.gov/news/statement/2013-07-10-open-meeting-statement-mjw.html>.

¹⁸ *See Improving Regulation and Regulatory Review*, Executive Order 13563 (Jan. 18, 2001).

(1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify);

(2) tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;

(3) select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity);

(4) to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and

(5) identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public.¹⁹

Section 3 will complicate the administrative process and increase regulatory burdens and costs without providing any benefits. I also oppose H.R. 1090 for the following reasons.

- The Commission has already conducted an exhaustive study of the broker-dealer and investment adviser regulatory regimes. The provisions of Section 913 already provide clear guidance and limits on the Commission's rulemaking authority regarding a fiduciary duty for broker-dealers, such as the requirement that rulemaking not impede commission-based arrangements or the sale of proprietary products. The Commission already has indicated in its prior report that it intends to extend any fiduciary rulemaking to reconsideration of broker-dealer and investment adviser examination requirements.
- Section 3 requires that the Commission satisfy certain requirements before it even issues a proposal, which means that critics may be able to challenge a proposal before it has become final. This requirement undermines the notice and comment process and the foundation of administrative law. If this provision is adopted, it should clarify that the APA does not apply.
- Section 3 exacerbates the problems created by Section 2 because it places additional, improper impediments to the Department's carrying out its statutory

¹⁹ *See id.*

duties by delaying further the Department’s rulemaking. In other words, it requires that a different agency make certain findings that may not even be relevant to a Department rulemaking, yet the Department rulemaking could not occur unless such irrelevant findings are made.

- Section 3 improperly emphasizes investor “confusion.” Whether investors have a clear understanding of the legal duties owed to them by financial advisers is not the issue that a fiduciary duty addresses. A fiduciary duty comprises a standard of care and a standard of loyalty. Broker-dealers routinely hold themselves out and provide investment advice as financial advisers, and the law has for centuries held such professionals to a fiduciary duty, regardless and independent of their clients’ understanding of that duty.
- Section 3 would prevent the Commission from adopting rules unless it found that they reduce either “confusion or harm to investors . . . due to different standards of conduct” (the term “either” should be inserted in the provision for clarity). Harm to investors is not caused by different standards as such, it is caused by one or more standards being inadequate to protect investors. If a finding is required, it should be that the rule promulgated reduces harm or confusion.

II. Conflicted Compensation Arrangements

Over the last few decades, broker-dealers have developed a wide variety of compensation structures that incentivize financial advisers to make recommendations that pay them the highest compensation. The kinds and effects of conflicted compensation are truly mind-boggling. Differences in compensation often bear no relationship to the services provided. Instead, they seem to exist only to generate higher revenues for the minority of financial advisers who choose to serve investors by choosing to serve only themselves.

Broker-dealers are paid part of the commission paid on a mutual fund purchase, part of which is paid to the financial adviser. For example, on a \$10,000 purchase of the American Mutual Fund, an investor would pay a 5.75% commission (\$575), of which the funds’ distributor would pay 5.00% (\$500) to the selling broker-dealer (the “gross dealer concession,” or “GDC”), which would generally pay its financial adviser from 20% (\$100) to 100% (\$500) of that amount. The payment to the financial adviser is typically based on a “payout grid” that pays the adviser a percentage of the GDC. A typical payout would be 40% (\$200). I have assumed a 40% payout in the examples provided below.

If the investor were a 70-year-old retiree, it usually would not be appropriate to invest 100% of her \$10,000 in a stock fund. However, the adviser would be paid less if part of the investment were placed in a bond fund or short-term bond fund. For example, if \$5,000 of the \$10,000 investment were invested in The Bond Fund of America, the commission would be only 3.75% (\$187.50), the GDC only 3.00% (\$150), and the financial adviser’s payment only \$60. If \$5,000 were invested The Short-Term Bond Fund of America, the commission, GDC and adviser’s payout would be, respectively, 2.50% (\$125), 2.00% (\$100) and \$40. In other words, the financial adviser would be paid 40% less (\$60) for selling the bond fund and 60% less (\$40) for selling the Short-term bond fund.

These compensation differentials create a substantial economic incentive for a financial adviser to recommend more aggressive asset allocations to the 70-year-old retiree and other clients. The following table shows the commission/GDC/adviser payout for four different allocations. From the

most to the least aggressive, the financial adviser’s total compensation declines 35%. Extrapolating to an annual salary, the adviser must choose between

| | 100%/0%/0% Allocation | 80%/20%/0% Allocation | 50%/30%/20% Allocation | 30%/35%/35% Allocation |
|-------------------------|-----------------------|-----------------------|------------------------|------------------------|
| Commission | \$575 | \$530 | \$443 | \$383 |
| Gross Dealer Commission | \$500 | \$460 | \$380 | \$325 |
| Adviser Payout | \$200 | \$184 | \$152 | \$130 |

income of \$100,000 or \$65,000, or an income of \$200,000 or \$130,000. These distorted incentives are understated, however, because the combined effect of other types of compensation differentials can be far more extreme.

To illustrate, consider the same investor making an investment of \$35,000 instead of \$10,000. Now the adviser has an additional conflict because some complexes offer discounts on commission at certain investment levels, known as “breakpoints.” For example, The American Fund provides a breakpoint at \$25,000, at which point the commission on the entire investment drops from 5.75% to 5.00%, which would mean less compensation for the broker-dealer and the financial adviser. The financial adviser therefore has an incentive either to spread the investment among different complexes so as to fall under the \$25,000 breakpoint, or simply to avoid funds with \$25,000

breakpoints. This would not be difficult. Breakpoints at \$50,000 are quite common; they can be as high as \$500,000.

The financial adviser also has an incentive to recommend funds that pay higher commissions. The American Fund's 5.75% commission is typical, but many stock funds charge a 5.00% commission or less.²⁰ The Cavanal U.S. Large Cap Equity Fund charges a 3.50% commission and pays a 3.25% GDC. Simply choosing The American Fund over the Cavanal Fund for a \$10,000 investment would *alone* increase the financial adviser's compensation by 54% (from \$130 to \$200).

The financial adviser also has an incentive to recommend funds that pay a higher GDC. For example, the DWS Capital Growth Fund charges a typical 5.75% commission, but shares 5.20% with broker-dealers rather than the more common 5.00%. On a \$10,000 investment, the extra 0.20% would generate \$20 more for the broker-dealer and \$8 more for the financial adviser. This might not seem like much, but DWS believes that this additional payment will help increase sales. Over billions of dollars in annual fund sales, these incentives add up.

In summary, financial advisers can more than double their compensation by opting for a more aggressive allocation to stock funds that have high commissions, high GDCs, and low breakpoints. The financial adviser's compensation varies substantially where the time invested and level of analysis provided does not vary at all. The financial adviser's time and effort spent on choosing an asset allocation and fund complex is the same regardless of what allocation or complex is ultimately recommended. It is economically irrational for the adviser to be paid more to recommend an aggressive asset allocation over a conservative one, or for recommending one fund complex over another. The industry complains that the Department's proposal will adversely affect small investors. In fact, the industry's conflicted compensation causes the greatest harm to small investors

²⁰ The average commissions for stock and bond funds are 5.4% and 3.8%, respectively. See ICI 2015 Investment Company Fact Book at Figure 5.8. Cf. Robert Litan and Hal Singer, *Obama's Big Idea for Small Savers: 'Robo' Financial Advice*, Wall. St. J. (July 21, 2015) (claiming that "small savers [pay] **something like a 2% sales charge** (or commission) up front when buying mutual funds." (emphasis added)).

because they are most likely to purchase the shares that create the greatest conflicts. Small investors will benefit from the proposal more than other investors.

The financial industry claims that removing such conflicted compensation structures would not be workable. However, some broker-dealers have *already* done so. For example, some have introduced “fee capping” whereby they limit the maximum commission that a financial adviser can receive on the sale, for example, of an emerging markets equity fund at 4%.²¹ In other words, we know that eliminating incentives to provide bad advice is workable because it is already working. The Department’s proposal is intended to bring about precisely this kind of reform.

Differential commissions represent only one way that financial advisers’ recommendations are improperly conflicted. Financial advisers may also receive different levels of 12b-1 fees depending on the fund complex selected. They receive different financial benefits as a result of choosing fund complexes that pay higher revenue sharing than other complexes. The potential doubling of compensation described above grows larger as one type of improper financial incentive is stacked on another.

One of the most egregious forms of compensation incentives is the ratcheted payout grid. As financial advisers generate more GDCs, their payout percentage rises. For example, at \$300,000 of GDCs over the preceding 12 months, an adviser’s payout percentage might increase from 32% to 42% of GDCs, as is the case, for example, for a Janney Montgomery Scott payout grid.²² However, this increase does not apply only to the

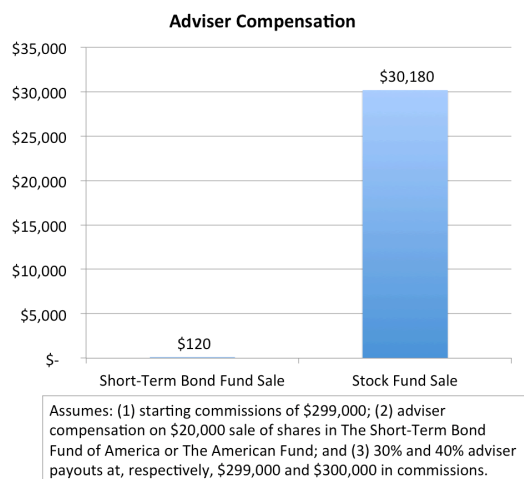
²¹ See Report on Conflicts of Interest, FINRA at 30 (October 2013) (“Report on Conflicts of Interest”) (“In the context of mutual fund and variable annuity sales, an effective practice FINRA observed is firms’ use of “fee-capping” to reduce incentives for a registered representative to favor one product family over another for comparable products. In a fee-capping arrangement, a firm caps the GDC that can be credited to a registered representative’s grid. Any GDC in excess of the cap accrues to the firm. For example, a firm may cap at 4 percent the GDC for emerging market equity funds. This would eliminate incentives for a registered representative to favor a mutual fund that paid a higher GDC than the 4 percent. It would not, however, eliminate the potential incentive for the registered representative to recommend a fund with a 4 percent as opposed to a 2.5 percent GDC.”) *available at* <http://www.finra.org/sites/default/files/Industry/p359971.pdf>.

²² The Janney Montgomery Scott payout grid appears at page 7 of my written submission to the Department at <http://www.dol.gov/ebsa/pdf/1210-AB32-2-WrittenTestimony28.pdf>. For a general discussion of the structure of payout grids, *see* Report on Conflicts of Interest, *supra*, at 27 – 28.

GDCs at \$300,000 and above. Rather, the 10 percentage point increase in the payout *also* applies to the previous \$299,000 in GDCs. This ratcheted compensation structure means that a financial adviser has an additional incentive of \$29,000 (10% of the first \$299,000 in GDCs) to recommend that his next sale generate enough commissions to get to \$300,000 for the preceding 12 months. In other words, how the adviser recommends that a \$20,000 investment be allocated will determine whether the adviser is paid an additional \$29,000. ***As shown in the chart below, an effective commission of 2.00% for the financial adviser (40% of the 5.00% GDC)***

on a \$20,000 investment in a stock fund is turned into an effective commission in excess of 150% of the amount invested. Will the adviser sell the short-term bond fund and be paid \$120? Or will he sell the stock fund and be paid \$30,180? It is truly remarkable that the

Commission and FINRA allow broker-dealers to offer such financial incentives for their financial advisers.²³



Indeed, this example illustrates where the Department’s position is far too tame. The Department suggests that, under its proposal, broker-dealers consider “effective policies and procedures relating to an Adviser’s compensation for broker-dealers,” including “[a]voiding creating compensation thresholds that enable an Adviser to increase his or her compensation disproportionately through an incremental increase in sales.”

Ratcheted payout grids such as the one applied by Janney Montgomery Scott should be

²³ While FINRA has noted such extreme incentives, but it has not prohibited them or, to my knowledge, taken any enforcement action regarding them. See Report on Conflicts of Interest, *supra*, at 28 - 29 (“Some firms apply a broker’s payout percentage on a retroactive basis. . . . In the context of compensation grids, paying a registered representative a higher percentage of gross revenue may legitimately reward effective and hard workers and encourage higher productivity. A conflict is created, however, if a representative’s desire to move to a higher payout level influences the number or type of recommendations he makes to customers. This conflict may be heightened when there is a relatively large increase in the percentage payout between revenue tranches; when there is a high probability that a few, incremental sales will move a registered representative to a new payout level; or where increased payout percentages are applied retroactively once a threshold is satisfied.”). Nor were these extreme financial incentives mentioned in FINRA’s most recent 2015 Regulatory and Examination Priorities Letter dated January 1, 2015. Available at <http://www.finra.org/industry/2015-exam-priorities-letter#1>.

per se prohibited. While that firm and others would likely complain that eliminating such structures would not be “workable,” this claim would beg the question as to how some broker-dealers find it workable to use payout grids *that are not based on production at all*.²⁴

III. The Department’s Proposals are Eminently Workable and Already Working

The Department’s has proposed rules that are, notwithstanding claims by industry, eminently workable. Industry sophists claim that they cannot comply with the rules while also receiving commissions and that they will be forced, as a result, to require investors to enter into asset-based fee arrangements. However, these claims are not supported by the facts or the actual terms of the Department’s proposal.

The industry is correct that, under the Department’s proposal, a financial adviser’s investment recommendation made to a retail investor regarding retirement assets will trigger fiduciary status, as it should, which would render a subsequent transaction a violation of the prohibited transaction rules if the financial adviser could receive differential compensation in connection with the recommendation (*e.g.*, higher compensation for a transaction in one available product than another). There is nothing unusual about fiduciary status triggering prohibited transaction rules. There are many instances in which common business practices run afoul of ERISA’s prohibited transaction rules, but the Department has adopted exemptions from these rules, subject to certain conditions, that have been quite workable and made ERISA a workable statute.

For example, a retirement plan administrator that is a plan fiduciary cannot be paid fees by the plan and also receive 12b-1 fees from mutual funds that are investments options in the plan. However, the Department has taken the position investments in 12b-1 fee funds are permitted provided that the plan fiduciary offsets the fee it receives from the plan by

²⁴ See Report on Conflicts of Interest, *supra*, at 28 (“Several firms with which FINRA met do not use a grid structure based on production. Some of these firms base payout percentages on a registered representative’s years of service.”).

the amount of the 12b-1 fees it receives from the funds.²⁵ This exemption is relevant here because it involves precisely the kind of fee leveling that firms that service plans have found workable for years, yet these same firms now claim that fee leveling in the retail context cannot work.

Rather than explain exactly how complying with the Department's proposal would actually affect their business practices, industry participants have generally adopted a strategy of insisting that the Department's proposal would put them out of business. The industry makes generalized assertions that the Department's standards are impossible to understand or comply with, when in fact their operation is self-evident and compliance requirements are clear. What is truly not "workable" *for investors* is paying financial advisers more for recommending one transaction than another when there is no reason to receive higher compensation other than to receive higher compensation. This is economically irrational and, as a policy matter, indefensible. The effect is an annual net social cost in the billions, a huge, wasteful transfer of wealth from uninformed, unsophisticated investors to deeply conflicted financial advisers.

Rather than acknowledging the blatant compensation conflicts discussed above and proposing *effective* alternatives to eliminating or mitigating them, the financial services industry has generally followed a public strategy of misrepresenting the operation and effect of the Department's proposal. Many of the same practices that the industry claims are not "workable" have been adopted (and made workable) by broker-dealers. The following discussion identifies and rebuts many of the baseless claims that have been made regarding the Department's proposal and provides examples of practices deemed not "workable" that some broker-dealers have nonetheless already adopted.

- ***Broker-dealers could receive compensation only if the compensation is level for all possible recommended transactions.*** The Department's proposal would require fee leveling only for fees paid to the financial adviser, and even then in limited circumstances. It would not require any change in compensation received

²⁵ See PTE 77-4 (April 8, 1977); DOL Advisory Opinion 93-13A (April 27, 1993); PTE 98-25 (June 9, 1998). See also EBSA Press Release (Aug. 23, 2012) (settling charges against ERISA fiduciary adviser for receiving 12b-1 fees and revenue sharing payments) *available at* <http://www.dol.gov/opa/media/press/ebsa/EBSA20121753.htm>.

at the firm level. Nor would it require any change in compensation paid at the branch manager level if the branch manager does not make recommendations to clients.

- ***Broker-dealers and financial advisers would be required to sell the lowest cost product and would be prohibited from selling the highest cost product.*** The relative cost of different products is irrelevant to the Department’s proposal, which goes to financial advisers’ financial incentives to sell products and the compensation they receive, not the cost of products to investors.
- ***Broker-dealers’ and financial advisers’ compensation would be required to be identical for all products.*** As noted, broker-dealers’ compensation is unaffected by the proposal. The Department has stated explicitly that financial advisers are permitted to be paid more for selling products based on neutral factors, *e.g.*, products that require more time or analysis, and for platform products (see below).
- ***Broker-dealers and financial advisers could not be paid higher compensation for selling variable annuities.*** The Department’s proposal would permit higher fees to be charged for selling variable annuities. The proposal explicitly states that higher fees paid for selling variable annuities would be justified by the additional time and analysis required when selling more complex products. Even if product-neutral compensation *were* required, there are broker-dealers that have demonstrated this approach is workable.²⁶
- ***Broker-dealers and financial advisers could not be paid higher fees for “platform” funds that pay up for shelf space.*** The Department’s proposal expressly permits broker-dealers and financial advisers to be paid higher compensation for selling platform funds. Even if higher compensation for selling platform funds *were* prohibited, there are broker-dealers that have demonstrated that not favoring platform funds is workable.²⁷

²⁶ See Report on Conflicts of Interest, *supra*, at 29 (“An effective practice FINRA observed was firms using ‘product neutral’ compensation grids to reduce incentives for registered representatives to prefer one type of product over another.”).

²⁷ See *id.* at 30 (“An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.”).

- ***Broker-dealers and financial advisers could not be paid higher fees for selling proprietary funds.*** The Department’s proposal specifically authorizes the sale of proprietary fund under broker-dealers’ existing business models, even if the funds offered are limited to proprietary funds. The proposal would not prohibit offering only proprietary funds, but some broker-dealers have demonstrated that this would be a workable approach.²⁸
- ***The requirement for financial advisers to provide advice “without regard” to their own financial interests would be impossible to apply in practice because it would prevent an adviser from negotiating its own fees and/or would otherwise be unworkable.*** The Department’s proposal has no effect on a fiduciary ability to charge a fee, or to charge a higher fee than its competitors, just as ERISA fiduciaries have been permitted to negotiate higher fees for decades. It is self-evident that the “without regard” requirement would only prevent a financial adviser from being paid more for making one recommendation than another, and then only if the differential does not reflect neutral criteria *and* is significant enough to prevent a recommendation from being made without regard to the differential. This means, for example, that a financial adviser could not be paid more for recommending one domestic large cap fund over another if the fund recommended generates higher compensation for the adviser. The “without regard” standard is identical to the “without regard” standard in Section 913 in Dodd-Frank Act, under which the industry now urges the Commission to enact rules while arguing that the same “without regard” standard as promulgated by the Department could not work.
- ***The prohibition against providing incentives to financial advisers that “tend to encourage” advice that is not in the client’s best interest would not be workable and/or is not sufficiently clear.*** As with the “without regard” standard, the “tend to encourage” standard clearly applies only to financial incentives that have no purpose other than to encourage sales of products that generate higher revenues for the financial adviser and broker-dealer. Compliance is simple. Broker-dealers need only level compensation paid to financial advisers where there are no neutral factors that explain the compensation differential on some basis other than incentivizing sale of a higher compensation product. When the only basis for differential compensation is to incentivize the sale of the higher compensation product, a firm may run afoul of the proposed rules, as it should.
- ***Broker-dealers and financial advisers could not comply with the “reasonable compensation” requirement.*** The prohibited transaction exemption on which broker-dealers currently rely in conducting transactions subject to ERISA, PTE 86-128, already imposes a reasonableness condition.²⁹ The industry has

²⁸ See *id.*

²⁹ See Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers, Prohibited Transaction Exemption 86-128 (exemption for reasonable compensation received by fiduciary for effecting or executing agency cross transaction).

considered this reasonableness requirement to be “workable” for years.³⁰ Moreover, the requirement that compensation be “reasonable” means only that it be within range of fees typically charged for similar products and services. This is exactly how the Commission has applied the “reasonable” commissions requirement under the Investment Company Act for decades,³¹ and the financial services industry has found this standard to be “workable.” Even the Securities Industry and Financial Markets Association (“SIFMA”) has proposed a “reasonable fee” requirement.³²

- ***Broker-dealers and financial advisers would be forced to move small investors into accounts that charge asset-based fees because commissions could not be charged.*** As explained above, the Department’s proposal would not prohibit commission-based compensation. Investors therefore would not be forced to move to other compensation models. They would only be forced to receive less conflicted advice that was not in their best interest.
- ***The U.K. adopted similar reforms and those reforms have had an adverse effect on investors.*** Both of these claims are false. The U.K. reforms are not similar to the Department’s proposed reforms. For example, the U.K. banned product-based commissions.³³ As is clear in the Department’s proposal and as explained above, the Department has not proposed to ban commissions. Broker-dealers will continue to be permitted to charge commissions. There is also strong evidence that the U.K. reforms have had a positive net effect on investors.³⁴

In summary, the industry’s principal complaints regarding the Department’s rulemaking are unfounded. In many instances, broker-dealers have adopted fee leveling and other

³⁰ Ameriprise Comment Letter at 6 (June 20, 2015) (describing PTE 86-128 as a “workable” exemption) available at <http://www.dol.gov/ebsa/pdf/1210-AB32-2-00560.pdf>.

³¹ The Investment Company Act prohibits fund affiliates from acting as brokers for a mutual fund if the remuneration paid “exceeds (1) the usual and customary broker’s commission if the sale is effected on a securities exchange.” ICA § 17(e)(2)(A). In Rule 17e-1, the Commission has interpreted “usual and customary” to mean “reasonable and fair compared to the commission, fee or other remuneration received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on a securities exchange during a comparable period of time.” ICA Rule 17e-1(a).

³² SIFMA’s proposal (“SIFMA Proposal”) can be downloaded at: <http://www.sifma.org/issues/item.aspx?id=8589954937> (last visited Sep. 5, 2015).

³³ See *Distribution of Retail Investments: Delivering the RDR - Feedback to CP09/18 and Final Rules*, U.K. Financial Services Authority at 4 (March 2010) (“Once the rules come into effect, **adviser firms will no longer be able to receive commissions set by product providers** in return for recommending their products, but will have to operate their own charging tariffs in accordance with our new rules.”) (emphasis added). In the United States, fund commissions are, by law, fixed by fund companies.

³⁴ See Sean Forbes, *U.K., Others Provide View of Fiduciary Rule Impact*, Pension & Benefits Daily (Aug. 31, 2015) (citing studies).

conflict-neutralizing practices that go further than would be required by the Department, yet industry lobbyists claim that these practices would be impossible to implement. These practices include: (1) eliminating financial advisers' differential compensation for platform and proprietary funds, (2) capping commission compensation for financial advisers, (3) adopting product-neutral commissions and payout grids, (4) abjuring production-based payout grids altogether, and (5) limiting payout increases to prospective sales rather than also applying them retroactively.

IV. Alternative Proposals

A number of alternatives to the Department's proposals have floated by industry members and special interest groups. I discuss some of them below. One feature they generally lack is a fiduciary duty for financial advisers who provide retail investment advice. A fiduciary duty applies to an adviser's compensation. The Fidelity proposal specifically exempts an adviser's compensation from being subject to a fiduciary duty. A fiduciary duty incorporates a duty of loyalty. Neither SIFMA's nor the Financial Services Roundtable's proposal imposes a duty of loyalty. The following proposals are not workable alternatives to the Department's proposals for addressing conflicted compensation arrangements.

A. Fidelity Proposed Alternative

Fidelity's principal objection to the Department's proposal is as follows:

the rule proposal makes an advisor a fiduciary with respect to establishment of its own services and compensation. This is both unprecedented in fiduciary law and not commercially viable, potentially requiring an advisor to recommend its competitors over itself even if its own services are wholly appropriate for the investor.³⁵

While Fidelity is correct as to the effect of the proposal, it is not correct that subjecting an

³⁵ Fidelity Comment Letter (July 21, 2015), *available at* <http://www.dol.gov/ebsa/pdf/1210-ZA25-00157.pdf>.

adviser's or other person's fees or services is unprecedented or not commercially viable. Trustees, under trust law, have been subject to a fiduciary duty with respect to their fees and services for centuries. Investment advisers, under the Investment Advisers Act, have been subject to a fiduciary duty with respect to their fees and services for decades. And fiduciaries under ERISA, including Fidelity, have been subject to a fiduciary duty with respect to their fees and services for decades, although the Department has granted many exemptions to make firms' obligations workable under ERISA. In each case, trustees, investment advisers and ERISA fiduciaries have found compliance with their duties to be commercially viable, and they have never had to recommend a competitor over themselves.

In fact, for decades financial advisers who act in a discretionary capacity or have a relationship of trust and confidence with their clients, including Fidelity financial advisers, have been subject to a fiduciary duty.³⁶ The most common claim made in arbitration against financial advisers is breach of a fiduciary duty.³⁷ Thus, Fidelity's recommendation that advisers not be subject to a fiduciary duty with respect to their fees flatly contradicts current law and reflects a standard that is *lower* than the current legal standard as applied to advisers under securities law.

³⁶ See, e.g., *United States v. Wolfson*, 642 F.3d 293 (2d Cir. 2011) (“Although we have long held that there “is no general fiduciary duty inherent in an ordinary broker/customer relationship,” we have also recognized that “a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.” ... [A] discretionary account is not the sole means by which a fiduciary duty may be created in the context of a broker-customer relationship; we have “recognized that particular factual circumstances may serve to create a fiduciary duty between a broker and his customer even in the absence of a discretionary account.” ... Put otherwise, it is well settled in this Circuit that the presence of a discretionary account automatically implies a general fiduciary duty between a broker and customer, but the absence of a discretionary account does not mean that no fiduciary duty exists.”).

³⁷ Fiduciary duty breach claims have been the most common every year at least from 2008 through 2014. See Dispute Resolution Statistics, Fin. Indus. Regulatory Auth., available at <http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/> (last visited Sep. 5, 2015); Mercer Bullard, *The Fiduciary Standard: It's Not What It Is, But How It's Made, Measured and Decided*, 87 St. John's L. Rev. 337, 369 – 78 (2013) (discussing arbitration). Arbitration panels are not required to explain the basis of their decisions, so it is unknown how often they find a breach of a fiduciary duty. However, on occasion a panel will reveal its findings. See, e.g., *Billings v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, FINRA Arbitration No. 11-01948 (Oct. 12, 2012) (finding respondent violated fiduciary duty to claimants and awarding monetary relief) available at <http://finraawardsonline.finra.org/viewDocument.aspx?DocNb=59344>.

What Fidelity may mean is that it disagrees with the effects of being a fiduciary under ERISA, which are certainly different from the effects of being a fiduciary in other contexts. But its blanket statement that it is “unprecedented” to subject an adviser to a fiduciary duty with respect to their fees and services is simply incorrect. It is not unprecedented. It is quite common.

Fidelity’s proposal is to separate the adviser’s fees and services from its recommendations. The financial adviser’s recommendations would be subject to a best interest standard, but conflicted compensation would not. Thus, Fidelity’s proposal does not create a fiduciary duty with respect to conflicted compensation that tends to encourage the sale of higher cost products. The conflicted compensation arrangements that Fidelity’s proposal would exempt from being subject to a fiduciary duty are precisely the conflicts that are the *raison d’etre* of the Department’s rulemaking.

Fidelity equates the situation where a “person who is already providing investment advice to a plan ‘persuades’ a plan fiduciary to extend his contract at a higher fee” to financial advisers’ compensation, arguing that “[t]here is no reason why this concept should not apply where the advisor’s compensation varies based on the transactions and services recommended.” Actually, there is a very good reason. Conflicted compensation is not about paying more or less for a given set of services or negotiating a higher fee. It is about compensation for a given set services – investment recommendations – *that varies based on the recommendation made by the adviser*. A doctor, lawyer or priest can negotiate a higher fee or salary consistent with their fiduciary duties. However, a doctor should not be paid more for an office visit for recommending one drug over another. A lawyer should not be paid more for interpreting the law one way rather than another. A priest should not be paid more for giving one kind of spiritual advice over another. Fidelity’s comparison to negotiating a higher fee misses the point.

Fidelity’s second primary objection to the proposal is that it is “unworkable.” As discussed above, the proposal is eminently workable. Although Fidelity has provided a number of constructive comments and recommendations regarding how to improve the

proposal in its comment letter, its suggested alternative approach is inadequate because it simply does not regulate conflicted compensation practices.

B. SIFMA Proposed Alternative

The Securities Industry and Market Association (“SIFMA”) has proposed as an alternative to the Department’s rulemaking that comprises only a set of amendments to FINRA rules.³⁸ In other words, SIFMA is opposed to broker-dealers being ERISA fiduciaries. Its proposal does not address non-securities, over which FINRA has no jurisdiction. Its proposal rejects the foundational premise of ERISA that retirement assets are deserving of more protection than other assets. Its proposal does not provide a reasonable alternative.

SIFMA claims that the Department’s proposal creates an “additional standard of care.” That is incorrect. The Department has stated that a recommendation that may trigger fiduciary status is a recommendation as determined under FINRA rules. FINRA rules

already impose a suitability standard. As the table on the right illustrates, the Department has essentially adopted FINRA’s suitability duty of care standard. The table makes it clear that the Department has not proposed an “additional” standard of care.”

| DOL Duty of Care BIC PTE II(c)(1) | FINRA Suitability Duty of Care Rule 2111(a) |
|--|---|
| When providing investment advice to the Retirement Investor regarding the Asset, the Adviser and Financial Institution will provide investment advice that is in the Best Interest of the Retirement Investor (<i>i.e.</i> , advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor | A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. |

SIFMA’s proposal would have no effect on conflicted compensation arrangements. It would require that these arrangements be “managed” and that steps be taken to ensure

³⁸ See SIFMA Proposal, *supra*.

that recommendations are not “materially” compromised by “material” conflicts of interest. However, FINRA has made it clear that it does not object to blatant conflicts of interest that violate current FINRA rules. SIFMA prefers that federal securities regulators tacit approval of conflicted compensation arrangements set the bar. As the above description of conflicted compensation arrangements demonstrates, the status quo is unacceptable.

SIFMA contends that there should be a uniform fiduciary duty for all retail brokerage accounts, that it should “serve as a benchmark for, be consistent with, and integrate seamlessly into, the SEC uniform fiduciary standard that ultimately emerges under Dodd-Frank § 913,” and that it should “follow the traditional securities regulatory approach.” Congress could satisfy SIFMA’s wishes in this respect, but the Department cannot. Congress specifically decided in enacting ERISA to impose a higher duty with respect to retirement assets than to other accounts subject only to securities regulation, and to impose that standard to non-securities (a distinction that SIFMA ignores). Congress specifically included IRAs as covered retirement assets. SIFMA’s wishes do not run contrary to the Department’s proposal. They run contrary to the statute that the Department is required to apply.³⁹ SIFMA, like FINRA, disagrees with the fundamental premise on which ERISA is based, that Americans’ retirement security deserved heightened protection.⁴⁰

SIFMA’s proposed amendments to FINRA rules do not impose a fiduciary duty on financial advisers and, in many respects, weaken existing standards applied by FINRA. Nor does SIFMA’s alternative provide for private enforceability, much less for a binding contractual commitment. For example, SIFMA proposes that investors be permitted to

³⁹ SIFMA notes that “FINRA CEO Ketchum, in his remarks at the FINRA Annual Conference on May 27, 2015, reinforced many of these same points. ‘It is not optimal,’ he stated, ‘to apply a different legal standard to IRAs and 401(k)s than to the rest of an investor’s assets.’” The same statements were made in FINRA’s comment letter to the Department. Subcommittee members should pay close attention to these statements. In both cases, FINRA not only has rejected a regulatory structure that has existed for decades, but also has cast doubt on its understanding of and willingness to enforce existing law. FINRA’s comments reflect the interests of private industry (its members), not the investors it is statutorily required to protect.

⁴⁰ *See id.*

“waive” or “consent to material conflicts” of interest, which defeats the investor protection purpose of a fiduciary duty. The centuries-old purpose of a fiduciary duty is to protect investors who are vulnerable or at informational disadvantage, which impairs their appreciation of waiving their rights. SIFMA would require disclosure of material conflicts of interest without any requirement to disclose conflicted compensation, much less the amount of or differences in such compensation, which comprises less disclosure than is currently provided by most broker-dealers. SIFMA would deem all existing customers to have consented to “material conflicts of interest” based solely on such inadequate disclosure, thereby assuming consent where the investor has not actually consented.

C. FSR Proposed Alternative

FSR has proposed an alternative to the Department’s BIC exemption.⁴¹ However, although FSR claims to support a “best interest” standard and that its proposed PTE “codifies a best interest standard,” its alternative PTE does not apply a best interest standard. FSR would require that a financial adviser’s recommendation to a client:

(i) reflects the care, skill, prudence, and diligence under the circumstances then-prevailing that a prudent person would exercise; and (ii) provides the Retirement Investor with an opportunity for an appropriate return, risk exposure, or benefit taking into account the Retirement Investor’s unique needs as disclosed by the Retirement Investor to the Adviser and/or Financial Institution.

A fiduciary duty comprises a duty of care *and* a duty of loyalty. The FSR’s standard reflects a duty of care; it does not include a duty of loyalty. FSR’s PTE nowhere references a financial adviser’s duty of loyalty. The primary purpose of the Department’s proposal is not to establish a higher standard of care. It is to create a higher duty of loyalty, and to apply a kind of loyalty standard to compensation that improperly incentivizes financial advisers to sell higher compensation products. However, nothing in the FSR’s PTE would prohibit financial advisers from making recommendations based

⁴¹ FSR’s Simple Investment Management Principles and Expectations Prohibited Transaction Exemption begins on page 101 of FSR’s written submission to the Department in connection with its testimony on August 10, which can be accessed at: <http://www.dol.gov/ebsa/pdf/1210-AB32-2-WrittenTestimony6.pdf>.

solely on their own financial interests so long as such recommendations could be defended as being within the range of what is prudent.

FSR's proposal requires that firms adopt procedures to mitigate material conflicts of interest, but it defines "material conflict of interest" in a way that would expressly exclude conflicted compensation even it was *likely* to affect a financial adviser's recommendation. FSR defines a "material conflict of interest" as a financial interest that creates a "substantial likelihood that a reasonable Retirement Investor would attach importance" to that interest in deciding whether to take or refrain from taking a particular action. This standard misses the point. The issue is not what is important to an investor. The question is not whether the investor would consider something important. The investor is not making an investment decision. The investor has decided to place his or her trust and confidence in the financial adviser. The issue, as even the SIFMA proposal expressly recognizes,⁴² is the likelihood that conflicts of interest will adversely affect *financial adviser's recommendations*.

Nor is FSR's "substantial likelihood" standard appropriate. If a conflicted compensation is "likely" – but not "substantially likely" – to affect a financial adviser's recommendation, there is no question that the compensation should not be permitted. FSR's position is that conflicted compensation that is "likely" to affect a financial adviser's should be permitted. This position is indefensible.

FSR defines "recommendation" as comprising only an "explicit suggestion" that the investor engage in or refrain from engaging in a "specific transaction or transactions." Financial advisers could easily frame their recommendations so as not to be "explicit" or "specific" so as *never* to trigger any of the PTE's requirements. This definition conflicts with the meaning of "recommendation" under FINRA rules.

Section V of FSR's proposal would provide a blanket exemption for all compensation received in connection with the purchase of an investment prior to the PTE's effective

⁴² See SIFMA Proposal, *supra* (requiring that recommendations "[a]void, or otherwise appropriately manage, disclose, and obtain consents to, material conflicts of interest, and otherwise ensure that the *recommendation is not materially compromised by such material conflicts.*") (emphasis added).

date. In other words, financial advisers could continue to advise a client, for example, to retain an investment that paid higher compensation even if it would be in the client's best interest to switch to a lower cost investment. This standard is lower than FINRA's current suitability standard, which applies to recommendations to hold investments, and, like many aspects of FSR's proposal, ignores existing broker-dealer regulation.

Finally, FSR's alternative does not create a contractually binding commitment for the paltry standards that it imposes. In arbitration proceedings, FSR's proposal would give defendants a basis for arguing for a standard under the FSR PTE that is lower than the current standard under FINRA rules. In summary, the FSR standard would be worse than no standard at all.