



July 21, 2015

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U. S. Department of Labor
200 Constitution Avenue, N.W.
Washington D. C. 20210

ATTN: Conflict of Interest Rule; RIN1210-AB32

Dear Sir or Madam

Thank you for this opportunity for the Institute for the Fiduciary Standard to comment on EBSA's "Definition of the Term 'Fiduciary'; Conflict of Interest Rule – Retirement Investment Advice."

The Institute applauds the Department of Labor's historic effort to update ERISA after 40 years. The transformative changes in the markets, investing, and the employer – employee relationships since 1974 call out for major reform. The independent and credible research that quantifies the costs to investors in higher fees and lower quality investments, due to antiquated rules, is compelling. DOL's bold leadership in acknowledging and articulating the gravity of the problem, proposing bold rule-making, and listening to and then challenging opponents of the rule to get around the table and help improve the rule is to be applauded.

The Institute for the Fiduciary Standard comments on areas it feels need particular attention to ensure that the administration of the rule meets vital objective and the high aspirations of the rule. Our comments are limited to the historic nature of the Conflict of Interest (COI) Rule, generally, and particular points raised by the proposed "Best Interest Exemption."

The Historic Nature of the COI

ERISA has long signified the gold standard across professional advisory services. Its “sole interest” standard based on trust law is rightly viewed as separate from and more stringent than the SEC’s “best interest” standard.

The rationale for ERISA’s independent status often seems overlooked in policy discussions. There is solid reasoning why ERISA and securities law are separate and unequal. As University of Mississippi Law Professor, Mercer Bullard, put it in Congressional testimony, “Securities law and ERISA are different regulatory schemes because they should be different. The public interest in employee benefit plans is far greater than for securities investment in general. Investment regulation takes on greater importance in the context of retirement benefits, where losses resulting from misconduct have greater adverse individual and societal consequences than losses associated with securities investments generally.” ¹

Retirement savings is like apple pie. The fundamental importance of robust retirement savings to the nation’s economic health and social fabric is not in dispute and establishes the rationale for updating ERISA rules. The COI rule is intended to plug the gaps in the current law. Currently, many industry participants do not meet the current five part test and are not ERISA fiduciaries, despite their significant influence on plan and IRA investments.

These persons, DOL notes, “May operate with conflicts that they need not disclose and have limited liability under federal pension law from any harms resulting from the advice they provide. Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers financial interests; and act on conflicts of interests in ways that would be prohibited if the same persons were fiduciaries.” ²

The BICE changes the game. The proposed Best Interest Contract Exemption (BICE) seeks to address these circumstances in an unconventional way. The BICE lets firms continue using conflicted compensation arrangements if the firm and broker / adviser also contractually agree to adhere to the ERISA best interest standard. In other words, after decades of associating “conflicts” with “prohibited,” with the DOL now associates “conflicts” with “permitted.”

This strategy is counter intuitive and a significant departure from established thinking. It’s logic: strengthen fiduciary duties by permitting conflicted advice, if and only if, the conflicted advice is disclosed and is contractually warranted by the firm and broker – adviser to be in the best interest of the client.

Enforcement is the only thing. This strategy presents opportunities and risks. The main opportunity is potentially very significant i. e.: firms that are currently associated with opacity and conflicted advice will change their practices and meet the ERISA best interest standard. The main risk, however, is that these firms will agree to meet the best interest standard and hold themselves out as such; yet, they won't materially change their practices and, instead, make voluminous arguments why their current practices *are* best practices. They will essentially place a bet that their legal arguments prevail in any subsequent enforcement action or legal challenge. With apologies to former Green Bay Packer Coach Vince Lombardi, 'enforcement is the only thing.'

Proposed Best Interest Contract Exemption (BICE)

The BICE fundamentally re-engineers ERISA's foundation by allowing many previously prohibited compensation arrangements. As DOL states the BICE seeks to:

"Preserve beneficial business models by taking a standards-based approach that will broadly permit firms to continue to rely on common fee practices as long as they are willing to adhere to basic standards aimed at ensuring their advice is in the best interest of their customers." ³

BICE requirements. DOL sets out the standards' requirements. The firm and the broker / adviser must "contractually acknowledge fiduciary status, commit to adhering to basic standards of impartial conduct, adopt policies and procedures reasonably designed to minimize the harmful impacts of conflicts of interest, and disclose basic information on their conflicts of interest and the cost of their advice. Central to the exemption ... (is) to meet fundamental obligations of fair dealing and fiduciary conduct to give advice that is in the customer's best interest; avoid misleading statements; receive no more than reasonable compensation; and apply with applicable state and federal laws governing advice." ⁴

In other words, the firm and the broker / adviser are asked to do what most investors believe their broker / adviser already does -- or should do, today. Or, more significantly, what a broker / adviser implies doing in meeting a best interest standard. What are they asked to do?

To promise in writing to do what's right. Charge reasonable fees. Follow policies to manage conflicts, give impartial advice and tell the truth. Disclose conflicts and all fees the investor pays and the firm receives, and follow state / federal laws.

It's common sense: conflicts cause harms. In sum these practices seek to apply the fiduciary duty of loyalty and reflect the corollary enduring principle that is the very focus of the DOL proposed rule. This principle has been so completely woven into law and ethics and culture, and so often expounded on by jurists throughout history, that it is today considered a given, not needing explanation. It is simple common sense to investors and virtually irrefutable to academics and regulators. The principle: conflicts are inherently harmful.

One researcher terms conflicts, “A cancer on objectivity,”⁵ and a former SEC Senior staff official calls them, “Viruses that threaten the organization’s well-being ... and if not eliminated or neutralized even the simplest virus is a mortal threat to the body...”⁶

What is the Meaning of “Best Interest” in the BICE

“The best interest standard set forth in this exemption is based on long-standing concepts derived from ERISA and law of trusts. .. Accordingly, the Department would expect the standard to be interpreted in light of forty years of judicial experience with ERISA’s fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts. In general, courts focus on the process fiduciaries used to reach its determination or recommendation – whether the fiduciaries “at the time they engaged in the challenged transactions employed the proper procedures to investigate the merits of the investment....”

In addition ... “The obligation to pay no more than reasonable compensation to service providers is long recognized under ERISA. ...The reasonableness of the fees depends on the particular facts and circumstances.....

For further clarification the Department sets forth the following examples of broad approaches to compensation structures that could help satisfy the contractual warranty... (and include) Independently certified computer models, ...asset based compensation ... fee offset ... differential payments based on neutral factors, ... (and) alignment of interests”⁷

Three areas, in particular, stand out where the BICE needs strengthening and greater definition. They are disclosure, establishing the reasonableness of fees and reducing the conflicts in third party payments.

What is the Meaning of Effective “Disclosure”?

The BICE relies heavily on disclosure and the particular requirements of the disclosure appear open to broad interpretation. This is cause for concern. Allowing for broad interpretation will effectively permit meaningless – or even harmful -- disclosure. Industry participants have spelled out in regulatory commentary their view that disclosure protocols must be designed to be efficient for the firm. Whether disclosure is also effective for investors is not addressed in these commentaries. ⁸

The underlying problem with disclosure in addressing conflicts in an advisory relationship, generally, is noted by Bullard (cited above), when he discusses the “sellers exemption” in the prior 2010 DOL proposal. Bullard highlights a central fact that all too often is minimized – or entirely overlooked -- in discussions of conflicts of interest. This is the inherent contradiction – or illogic -- of significant reliance on mere disclosure alone (especially casual disclosure) to address conflicts in a fiduciary relationship. ⁹

“The basis for finding a fiduciary duty is a relationship of dependence, whether through trust, informational disadvantage, relative incapacity, or some combination thereof that results in potential overreliance on the fiduciary's advice. Simply knowing that a fiduciary has a conflict of interest changes none of the factors that make fiduciary standards necessary. It may even exacerbate the client's overreliance on the conflicted fiduciary's advice if the candid admission of the conflict engenders even greater, but still misplaced trust. The fiduciary duty is based on the likelihood that the client will misjudge the fiduciary's advice, including any conflicts about which the client may have been fully informed”

Disclosure in a “relationship of dependence” may be an inherently flawed tool. Bullard’s comment gives practical meaning and significance to the mounds of research which attest to investors’ “relationship of dependence.” The significance becomes clearer still when considering appropriate and reasonable steps to overcome this dependence.

Given this dilemma the overriding principle must be that conflicts are avoided if at all possible. The importance and rationale for doing so are clear. Any unavoidable conflicts must be assessed and managed to ensure their harms are neutralized or minimized. The following steps are recommended for managing conflicts in the Institute’s proposed Best Practices. ¹⁰

“A material conflict of interest is any factor “which might affect” a client’s decision regarding a recommendation. Managing material conflicts involves several steps. First, there must be clear, complete and timely disclosure. Second, fiduciaries must have a reasonable basis for believing that clients fully understand the implications of the conflict to the advisor and client. Implications may include the relative merits and risks of options not chosen by the advisor, and the additional fees earned by the advisor (whether paid out of client funds or not) and any

additional client paid expenses incurred. Third, the client must provide "informed, intelligent, and independent" consent before the transaction is completed. Finally, after receiving client consent, the advisor must also be able to demonstrate that the transaction remains reasonable and fair and consistent with the client's best interest."

What are "Reasonable" fees?

What are reasonable fees? The BICE emphasizes the longstanding duty under ERISA that retirement investors pay "no more than reasonable compensation" and that reasonableness depends on the "facts and circumstances." Particular circumstances that may or may not justify higher fees and expenses are not discussed, described or noted. This leaves enormous discretion left to the financial institution.

Variable compensation is OK; "incentive systems" are not. This discretion is evident in the discussion of what may be the cornerstone of BICE enforcement -- the requirement for written policies and procedures designed to mitigate material conflicts. The BICE states, "the proposal does not mandate the specific content of the policies and procedures. This flexibility is intended to allow the 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... (the policies and procedures) must not authorize compensation or incentive systems that would tend to encourage individual advisors to make recommendations that are not in (investors) best interest."

Further, the proposal points out that "there are no particular required compensation or employment structures. Certainly, one way for a financial institution to comply is to adopt a level-fee" structure, in which compensation for advisers does not vary based on the particular investment product recommended." ¹¹.

There is no clarity in what constitutes unreasonable, impermissible fees. The BICE permits broad discretion in determining "reasonable" fees and variable compensation structures that meet the best interest standard. Such discretion that variable commission are deemed OK while incentive systems that "tend to encourage" recommendations favoring the broker – adviser over the investor are not OK.

While DOL helpfully offers examples of "broad approaches to compensation structures," there is no discussion of particular factors that may be (or should be) considered in setting reasonable fees. Materially different fees for substantially similar products and service offerings appear to be plainly justifiable.

Closing Comments and Recommendations

DOL's strategy presents opportunities and risks. The main opportunity is that firms currently associated with opacity and conflicted advice may change their practices and meet the ERISA best interest standard. The main risk, however, is that firms will agree to meet the best interest standard and hold themselves out as such; yet, they won't materially change their practices and, instead, make voluminous legal arguments to explain why their current practices *are* best practices. This is no small risk.

DOL has addressed the fiduciary rule with conviction, persistence and humility all too rare in Washington today. The agency proposed and withdrew and then re-proposed a rule. DOL acknowledged shortcomings in its first proposal, seeks improvements in the current proposal and has repeatedly invited the industry to offer more suggestions.

Meanwhile, industry participants who have publicly engaged on fiduciary rulemaking, almost without exception, do not acknowledge the existence of any problem associated with the industry. Instead, industry participants turn logic upside down and argue that conflicted advice benefits investors and fiduciary duties harm investors. Industry "logic" is captured in its high-decibel angst over the commonsense – an agreement promising to do right, to tell the truth, to give impartial advice, charge reasonable fees and disclose conflicts, etc. – in the BICE. This type of "logic" has been called "Orwellian" by one (Republican-appointed) judge. ¹²

The Institute offers four recommendations to strengthen the BICE. First, DOL should continue listening to industry suggestions aimed at lowering firms' costs without weakening the BICE requirements. Second, DOL should provide greater specificity to the definition of "reasonable fees." Third, DOL should spell out the steps required of the broker-advisers to overcome and neutralize or mitigate a material conflict. Finally, DOL should underscore its conviction that conflicts are corrosive and reduce them. DOL should require a level fee compensation arrangement as a condition of the BICE.

Thank you for this opportunity to express our views on this historic rulemaking.

Sincerely,

Knut

Knut A. Rostad
Founder and President
www.thefiduciaryinstitute.org

Notes

1. <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-mbullard-20130523.pdf>
For a discussion of Bullard's testimony, see:
<http://www.thefiduciaryinstitute.org/2013/05/30/a-spade-a-spade-merc-mercer-bullard%E2%80%99s-dissection-of-proposed-fiduciary-legislation-offers-way-forward-for-fiduciary-rulemaking/>
2. Definition of the Term Fiduciary ... , page 4.
3. Proposed Best Interest Exemption, page 22.
4. Definition of the Term Fiduciary ... page 6.
5. Yale Management Professor, Daylian Cain, at the Institute for the Fiduciary Standard Fiduciary Forum, September 2011. <http://www.thefiduciaryinstitute.org/fiduciary-forum-2011/>
6. Carlos V. di Flora, SEC Director, Office of Compliance and Inspections, in October 2012, <http://www.sec.gov/News/Speech/Detail/Speech/1365171491600>
7. Proposed Best Interest Exemption, pages 37 -- 43.
8. SIFMA has expressed been particular concern that disclosure protocols are efficient for firms. See letter to the SEC from the Institute regarding SIFMA's framework for a standard, especially pages 8 -- 10. <http://www.thefiduciaryinstitute.org/wp-content/uploads/2012/04/Institute-for-the-Fiduciary-Standard-Letter-to-SEC.pdf>
9. From a Morningstar column June 14, 2011. <http://www.morningstar.com/advisor/t/45786630/dol-s-fiduciary-proposal-misses-the-mark.htm?&single=true>
10. Proposed Best Practices, June 23, 2015 Draft. <http://www.thefiduciaryinstitute.org/wp-content/uploads/2015/06/BestPracticesJune232015.pdf>
11. Proposed Best Interest Exemption, pages 39 -- 41.
12. Judge Paul A Crotty, appointed by Republican George W. Bush noted, in response to a legal argument that called a promise to put investors first as "puffery," in a footnote in *Richman v. Goldman Sachs Group*, June 21, 2012 (that ruled against the investment bank):

"Goldman's arguments in this respect are Orwellian. Words such as "honesty," "integrity," and "fair dealing" apparently do not mean what they say; they do not set standards; they are mere shibboleths. If Goldman's claim of "honesty" and "integrity" are simply puffery, the world of finance may be in more trouble than we recognize.