July 21, 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 comment 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, 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 BIC exemption and related proposals.[2] As to the Department's proposal regarding

[1] I am the founder and president of Fund Democracy, a non-profit organization

[2] 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

its interpretation of term "fiduciary" under ERISA, I hereby submit as an attachment to this letter my prior comments provided to the Office of Management and Budget.[3] The comments in this letter address a number of important aspects of the Department's proposed exemption, and I expect to supplement them during the course of the Department's staggered comment period. Part I begins with a discussion of the history of Class B shares and related recommendations. Part II illustrates how some conflicted fee arrangements may affect financial advisers' recommendations to their clients. I evaluate the enforcement of the Best Interest Contract in private claims in Part III and make related recommendations. Part IV provides five general recommendations regarding the overall structure of the BIC exemption. In Part V, I discuss specific provisions of the BIC exemption and make related recommendations. For convenience, I have provided a table of contents below.

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.

[3] *See* Letter from Fund Democracy, Consumer Federation of America, Public Citizen's Congress Watch, AARP and Americans for Financial Reform to Sylvia Burwell, Director, Department of Management and Budget (Oct. 18, 2013).

I. Class B Shares and the Efficacy of Enforcement

It is helpful to begin with a bit of history and context. The financial industry claims that the Department's proposal will cause substantial damage to its compensation practices and to investors. In considering this claim, the Department may wish to review the history of the sale of mutual fund Class B shares. Class B shares generally are no longer sold because, as described further below, securities regulators' enforcement divisions have used settled enforcement actions to banish Class B shares from the marketplace. Without any public comment, rulemaking process or specific regulatory guidance, enforcement staff have effectively eliminated a conflicted compensation structure.

Class B shares impose a deferred sales charge that declines over time and, typically, a 1.00% 12b-1 fee. The fund distributor usually pays the selling broker-dealer a fixed concession that equals a percentage of the purchase amount, and the broker-dealer, in turn, pays the selling financial adviser a percentage of that amount. One fund complex, for example, pays a 4.00% concession.[4] If an investor purchased

[4] This letter uses actual funds and disclosures but does not identify the entities in order to focus attention on what are industry-wide practices. To the extent the practices or disclosures of particular entities reflect negatively on them, it should be noted that these practices and disclosures are common in the industry and, in most cases, legally permissible.

$100,000 in Class B shares, the broker-dealer would be paid $4,000 and the adviser about $1,600 assuming a typical 40% payout rate (payout rates can be lower and significantly higher). In contrast, if the investor purchased Class A shares, discounts on the commission paid would result in a lower concession. For example, the same fund that pays the Class B 4.00% concession pays only a 3.00% concession on a $100,000 investment, which would reduce the broker-dealer's compensation by $1,000 and the adviser's by $400.

Not surprisingly, some advisers recommended large purchases of Class B shares solely because the adviser was paid higher compensation than if Class A shares were recommended. Some broker-dealers' sales were predominantly Class B shares, which indicated a firm-wide culture of maximizing compensation to the detriment of investors. Disclosure of the amount of the differential payments received by advisers on account of Class B shares has never been required or proposed to be required by the SEC or FINRA. Nor have such compensation structures ever been prohibited or proposed to be prohibited by either agency.

However, the SEC's and FINRA's enforcement staff saw an established compensation structure that amounted to a kind of fraud on investors, and they took action. They sued firms and entered into a series of non-litigated settlements that raised the cost of selling Class B shares. Initially, broker-dealers developed procedures that prevented very large purchases of Class B shares. The enforcement actions continued, however, and many, if not most industry participants ultimately decided against selling Class B shares.

Yet SEC and FINRA rules continue to permit the sale of Class B shares, which are with mathematical certainty almost never the best option for an investor.[5] The regulators also permit a variety of differential compensation structures, as discussed below, that are similar to the Class B compensation structure. The SEC and FINRA also continue to permit conflicted fee structures without disclosure by the funds or broker-dealers of amount of the differential compensation. To their credit, the agencies' enforcement divisions continue to bring enforcement actions on the basis of various differential compensation arrangements.

In some cases, these enforcement actions have, as with Class B shares, made *de facto* regulatory policy. As a result of these enforcement actions, the SEC is able to claim that broker-dealers "must" "disclosure information about revenue sharing

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[5] *See* Edward S. O'Neal, *Mutual Fund Share Classes and Conflicts of Interest between Brokers and Investors*, 10 PIABA Bar Journal 63, 67 – 68 (Spring 2003); John Rekenthaler and David McClellan, *Mutual Fund Share Class Limits and Share Class Suitability*, Morningstar, Inc., at 11 – 12 (May 15, 2006) *available at* http://corporate.morningstar.com/US/documents/MethodologyDocuments/MethodologyPapers/ShareClassLimitsandSuitability.pdf.

arrangements for the sale of mutual funds."[6] It cites no rule or regulatory guidance to that effect, but only a series of enforcement actions.[7] There is no specific rule that requires revenue sharing disclosure or any specific guidelines as to what it must include, but prudent broker-dealers generally provide online disclosure of information about certain conflicted fee practices in order to mitigate their public enforcement risk and, in the retirement plan context, to mitigate private liability risk (differential compensation and private liability risk are discussed in Part III, *infra*).

The history of Class B shares and the apparent SEC/FINRA policy of largely regulating differential compensation structures through enforcement are instructive. The history of Class B shares is relevant here for a number of reasons:

- It provides a recent example of regulators directly causing the kind of dramatic changes in conflicted compensation practices that the Department should seek to achieve for similarly conflicted practices.

- It shows that a major change in compensation structures recently occurred without any outcry that the industry or investors were harmed materially, if at all.

- This change occurred without any objections that small investors would be harmed, notwithstanding that the elimination of Class B shares has reduced compensation for small investors who would have been sold Class B shares (although not disproportionately, because the Class B differential depends on the purchase amount exceeding Class A commission breakpoints).

- It shows the SEC and FINRA, which the industry claims to prefer as regulators of differential compensation, choosing to ban conflicted compensation practices through enforcement actions rather than seeking to regulate them through rulemaking subject to public comment.

- Finally, the history of Class B share militates for more aggressive enforcement action by the Department.

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[6] Certain Broker-Dealers Deemed Not to Be Investment Advisers, Rel. No 34-51523, 70 F.R. 20433 at note 93 (Apr. 19, 2005). It is no coincidence that the most accurate, complete disclosure of differential compensation by a fund complex is provided by a firm that has been sued by both the California Attorney General and FINRA in connection with its revenue disclosure practices.

[7] *Id.*

In my view, the Department should, in conjunction with its rulemaking, identify and bring enforcement actions against advisers who oversee commission-based, discretionary IRAs (*i.e.*, fiduciaries under ERISA) that are invested with the fund complexes that make the largest differential payments. These are prohibited transactions, yet they are rarely subject to an enforcement action. To be frank, while the industry views penalties under ERISA as severe, it does not view the Department as posing a relatively significant enforcement threat. The Department has been remiss in not more vigorously enforcing existing law as a means of mitigating conflicted fee arrangements and providing a stronger record on which to conduct the present rulemaking. This must change if the Department wishes to accomplish its overall policy goals.

II. Conflicted Fee Arrangements

This part of my comments describes various differential compensation arrangements in the mutual fund context. As a general rule, the conflicts these arrangements create are significantly milder than those created by compensation arrangements for sales of variable annuities and fixed index annuities, and, at the extreme end of the conflicted fee spectrum, non-traded REITs, non-traded business development companies, and tenant-in-common investments.[8] Nonetheless, there is no doubt that conflicted fees in the mutual fund industry are significant enough to affect and do affect financial advisers' recommendations to their clients. The Department does not describe the detailed characteristics of these conflicted fee arrangements or state exactly what abusive practices would be inconsistent with BIC exemption. This reflects, in part, the principles-based approach that the industry claims to prefer, but it is an approach that the industry is also using to undermine the Department's initiative, and it ultimately may undermine the efficacy of its proposal.

If the Department's rulemaking is to be effective, it is my view that it must provide detailed examples of how current financial incentives work and explain why these arrangements are not consistent with the BIC exemption. This is not so much to inform firms how to be in compliance as it is to prevent firms from claiming that the

[8] *See generally* Dan Jamieson, Broker-Dealers Derive Big Income From Revenue-Sharing Deals (May 11, 2015) (discussing direct-participation programs such as non-traded REITs and business development companies) *available at* www.fa-mag.com/news/broker-dealers-derive-big-income-from-revenue-sharing-deals-21717.html; Tim Husson, Craig McCann and Carmen Taveras, *A Primer on Non-Traded REITs and other Alternative Real Estate Investments*, Securities Litigation and Consulting Group (2012) (as much as 20% of an initial investment in a non-traded REIT is paid in fees, and additional fees are generated by buying, selling, developing, or managing properties); Tim Husson, Craig McCann, Edward O'Neal and Carmen Taveras, *Large Sample Valuations of Tenancies-in-Common*, Securities Litigation and Consulting Group (2013) *available at* http://ssrn.com/abstract=2398958.

Department's purportedly "inadequate" and "unrealistic" guidance excuses their noncompliance. The Chairman and CEO of broker-dealers' primary regulator has opined that neither firms nor arbitrators could know what the Department's rule requires, thereby creating an independently significant hurdle for private and public enforcement of broker-dealers' fiduciary duty.[9] This charge must be countered with concrete examples of abusive compensation arrangements and how they are affected by the BIC exemption.

The following discussion uses a specific investment scenario to illustrate how differential compensation works in practice. It assumes a small investor who seeks a recommendation for a lump sum investment. The investor is a 65-year-old, financially unsophisticated, recently widowed retiree whose only current and prospective income is $18,000 each year in social security payments. He has received a $100,000 payout on his wife's life insurance policy. This investor is an example of the small investor whom the brokerage industry claims will be harmed by the Department's proposal. He is also an example of the kind of investor who is most vulnerable to sales abuses. He hopes to use the life insurance proceeds to generate a small amount of additional income for his remaining days while leaving some money to his children and looks to a financial adviser to make a recommendation on how to invest it. How might a financial adviser respond?

A. Transaction Fees

The adviser could recommend that he invest in a fairly recent investment option often referred as a managed payout fund. Using an actual no-load version of such a fund, the adviser could enter the $100,000 investment amount in the fund company's online income estimator for the fund, which will show an estimated monthly income of $296, or $3,552 annually. The fund's expense ratio is 0.42%, which means that he would pay approximately $2,000 in fees over a five-year period (the estimated monthly income is net of these expenses). This recommendation provides an effective one-stop solution that would require little ongoing advice, provide liquidity and hold out the possibility that the client could leave an inheritance for surviving family members. Each of these would be a typical common concern for such a client.

However, the typical financial adviser normally would not recommend such an investment, nor should the financial adviser be expected to. The financial adviser could not make a living based on such advice. The managed payout fund would be treated by the broker-dealer as a "transaction fee fund." This means that the broker-dealer would charge a one-time $50 fee for making the investment. Some part of that may be paid to the financial adviser (at least one broker-dealer does not pay any part of the transaction fee to the adviser), but there is no publicly available information on what that payment would be. Whatever the payment was, it would

[9] *See infra* discussion at footnote 27.

not provide a feasible compensation model for a financial adviser. A financial adviser might hear out the client on his situation and generously agree to put him into a managed payout fund, possibly spending less than an hour on the transaction. But this kind of a transaction does not reflect a viable overall business model for a broker-dealer.

The broker-dealer would receive additional compensation in connection with the transaction, but publicly available information suggests that the financial adviser would not benefit in any way as a result. The addition compensation would be what are known as sub-accounting fees that all funds pay to broker-dealers for maintaining shareholder accounts.[10] Broker-dealers invest their clients' assets in mutual funds through a single omnibus account, and manage each client's account with the fund at the broker-dealer level. These are payments are discussed further in Part II. At this point in the analysis, these fees are relevant because it may be that a broker-dealer, between the transaction fees and sub-accounting fees, could profitably operate such a no-load business.

The financial adviser could generate additional revenue with a more traditional recommendation to invest equal amounts in a U.S. equity fund, bond fund and cash fund. This would be a reasonable recommendation. This allocation may hold out the potential for greater long-term growth than the managed payout fund, which would benefit a client who may live another 40 years. The three transactions would generate $150 in transaction fees, and may push the adviser's compensation to over $100. However, this allocation would require a fair amount of ongoing oversight to help the client manage both the allocation among the three funds and the rate of withdrawals from the cash account. This alternative provides higher compensation, but it may actually be less economically viable for the adviser because of the additional investment of time required.

The point of this discussion, and reason for using this client, is to illustrate how difficult it may be for someone in this situation to get good advice. The client's situation is actually relatively simple, but there is generally no service model, other than a *pro bono* or special client part of a financial practice, that can accommodate this client other than broker-dealer load-fund model. This example provides useful insight into what the Department should be sure to *permit* as part of its rulemaking, that is, the servicing of this kind of client.

On one level, banishing conflicted fees would require that broker-dealers offer only no-load funds such as the funds discussed above. This could mean that the client went without any advice. A less pure approach might be to require broker-dealers to pay the same compensation to financial advisers with respect to all products sold by the broker-dealer. This would prevent the financial adviser from offering the no-

[10] A broker-dealer typically charges an approximate fee of either $18 per account or 0.18% of fund complex assets held at the broker-dealer.

load options discussed above. Rules should not *prevent* broker-dealers from selling lower cost products to the extent they can do so profitably. Good public policy also should allow for higher payments when services that require more time or more complex analysis. Otherwise, the client will likely receive the lowest quality advice.

Accepting these positions suggests certain guidelines for regulating broker-dealers' conflicted compensation. One guideline is that there can be good reasons to allow financial advisers' recommendations to be able to affect their compensation. Allowing differential compensation allows broker-dealers to provide a higher of lower level of service depending on the client's needs. It also allows the broker-dealer the ability to offer a category of products, such as no-load funds, that produce less compensation, while also offering products that pay higher compensation.

However, financial advisers should not be permitted, to the extent practicable, to make personalized recommendations of a specific mutual fund from a broker-dealer's selection of preferred funds where the adviser's compensation depends on the particular fund recommended. In that scenario, the laws of economics will result in more shares of funds that pay higher compensation being sold than would be sold if compensation had not been differential, but without any factors such as the time invested or analysis conducted to justify the differential compensation. As discussed below, the cost to investors is substantial.

B. Front-End Loads & 12b-1 Fees

For the reasons discussed above, this discussion assumes that the financial adviser will recommend one or more load funds, and will recommend the purchase of Class A shares. As a general rule, Class A shares would provide the most cost-effective option for a long-term investor such as the client and, with the elimination of Class B shares, there is a high likelihood that a financial adviser will recommend Class A shares.[11]

Class A shares typically charge a front-end load, or FEL, that is deducted from the initial investment, and a 12b-1 fee, which is deducted on an ongoing basis. The FEL can vary greatly, while the 12b-1 fee as a rule does not exceed 0.25% of assets and typically is exactly or close to that amount. These charges are prominently disclosed in the fee table near the front of the mutual fund prospectus as a percentage, but not as a dollar amount. Nor does the fee table disclose the amount paid to the broker-dealer. Near the end of the prospectus, the fund discloses amount paid to the broker-dealer out of the FEL, which is often called the "concession," "gross dealer concession" ("GDC") or "dealer re-allowance," and represents most of the total FEL

[11] The adviser might recommend Class C shares, which might pay higher compensation to the broker-dealer and the adviser, which probably (but not necessarily) would be inappropriate for this client. This problematic conflict is beyond the scope of the analysis in this letter.

(the fund's distributor, usually an affiliate of the fund company, retains the difference).

Funds also pay part of the 12b-1 fee to the broker-dealer, but this information is not required to be and generally is not disclosed. Nor is there much publicly available information on the amount paid. Based on a review of available information sources, it appears that, as a rule, a 12b-1 fee concession is paid to the broker-dealer, and this concession represents all or substantially all of the 0.25% fee.[12] This fee pays for ongoing shareholder services provided by the broker-dealer.

Broker-dealers pay part of the FEL concession to the financial adviser who is responsible for the sale. The amount is usually a percentage of the adviser's total concessions for the preceding 12 months according to a "payout grid." The specific dynamics of the payout grid are discussed in Part II.E. What is relevant here is that, as a rule, the primary source of compensation – and potential conflict – is the FEL. Although most broker-dealers publicly disclose information about the mutual fund compensation and payments to their advisers, they do not disclose the amount of their concessions, but refer to the mutual fund prospectus for that information. Nor do they disclose the amount they pay their advisers or, more importantly, the differential in payments that may result from the recommendation that the adviser makes.

It appears that most broker-dealers also pay part of the 12b-1 fee concession to financial advisers and the amount is based on same payout grid. However, some broker-dealers appear not to pay their advisers part of the 12b-1 fee. For purposes of this analysis, I have assumed that the broker-dealer's 12b-1 fee concession is 0.25%, and the adviser's payout percentage is 40%.

The financial adviser would be very likely to recommend a load fund from the broker-dealers list of preferred funds. Preferred funds are load funds managed by fund companies that make sales-based payments out of their fees to broker-dealers in addition to FEL and 12b-1 fee concessions paid by the funds. These payments are known as "revenue sharing" and are discussed in Part II.C. Financial advisers

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[12] In 1999, the ICI surveyed funds regarding the use of 12b-1 fees and found that 63% were used for compensating broker-dealers and 32% for administrative services provided by third parties. *See Use of Rule 12b-1 Fees by Mutual Funds in 1999*, 9 Fundamentals (April 2000) *available at* https://www.ici.org/pdf/fm-v9n1.pdf. An SEC economist, Lori Walsh, has stated that brokers are typically paid "a small (typically 0.25%) annual commission paid for by a 12b-1 plan," but it is not entirely clear that she intended by this statement to identify the precise amount of the broker's concession. See Lori Walsh, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns*, at n.14 (undated) *available at* https://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf.

generally sell only preferred funds. As one broker-dealer has disclosed: "Virtually all of [broker-dealer's] transactions relating to mutual funds (outside of advisory programs), 529 plans and insurance products involve product partners that pay revenue sharing to [broker-dealer]."

Returning to the client and his $100,000 investment, the financial adviser may recommend a managed payout fund, or a 2015 target date fund or retirement income fund, which generally serve the same purpose. One 2015 target date fund offered by a large fund complex charges a 5.75% FEL, a 0.24% 12b-1 fee, and has a waived expense ratio of 0.71%. (Where a fund waives certain fees, this analysis assumes the full amount of stated 12b-1 fees unless the waiver applies specifically to the 12b-1 fee.)

The broker-dealer's FEL concession, which is disclosed near the end of the prospectus, is 5.00%, respectively. However, breakpoints (commission reductions) are available at investments of $25,000, $50,000 and $100,000. For simplicity, in this analysis I have applied breakpoints up to but not including $100,000 in order to be able to apply breakpoints while also using round numbers in illustrating compensation differentials (*i.e.*, I could use a $99,999 investment and produce virtually identical results, but the data would be more difficult to work with).

Broker-dealers have an economic incentive *not* to apply breakpoint discounts because their compensation is reduced. They also have an incentive not to apply other standard discounts, which generally are available for assets invested in the same complex, re-invested dividends, re-investment of redemptions in the same fund complex, across the investor's family members, and pursuant to an installment investment program. As a result of this conflict of interest, the evidence shows that brokers and financial advisers routinely deny investors the breakpoints to which they are entitled. In 2003, the SEC, NASD and NYSE reported findings on overcharges on mutual fund purchases.[13] The agencies found that in almost *one-third* of transactions that were eligible for discounts, the broker did not provide the discount.[14] Three firms withheld the discount in *every single eligible transaction*.[15]

Little seems to have changed in the last decade. Just two weeks ago, three large brokers paid more than $30 million to settle claims for overbilling investors for fund

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[13] *See Joint SEC/NASD/NYSE REPORT of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds*, SEC, NASD and NYSE (March 2003) *available at* https://www.finra.org/sites/default/files/Industry/p006438.pdf.

[14] *Id*. at 15 (investors were overcharged in 32% of eligible transactions).

[15] *Id*. at 2.

purchases.[16] No fines were imposed. The firms were not required to admit any violations. While FINRA's enforcement chief applauded the brokers for their "extraordinary cooperation"[17] and claimed that they would make "full restitution," his agency required restitution only for transactions since January 1, 2015, despite its finding that overbilling had occurred at least since July 2009.[18] No individuals have been held responsible. In 2014, another large broker paid almost $90 million in restitution and fines for overcharging investors in mutual fund transactions.[19] Not only does overbilling continue to be commonplace, securities regulators appear to be quite forgiving of this practice. In light of broker-dealers' routine withholding of commission discounts, the Department should state explicitly that this practice will render the BIC exemption unavailable.

Assuming that breakpoints are applied to the client's investment, the FEL and FEL concession would be 4.50% and 3.75%, respectively. The broker-dealer would receive a one-time $3,750 payment and annual payments of $229, for a total of $4,896 over five years.[20] Under a 40% payout, the financial adviser would receive a one-time $1,500 payment and $92 annually, or $1,958 over five years. The client's expenses over five years (on his post-FEL, $95,500 investment), assuming the fund's waived expense ratio of 0.71%, would be $3,390. The client's annual income from the fund would depend on the fund's performance. It is statistically more likely than not that the client's income would be less,[21] but not substantially less, than the

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[16] *See FINRA Orders Wells Fargo, Raymond James, and LPL Financial to Pay More Than $30 Million in Restitution to Retirement Accounts and Charities Overcharged for Mutual Funds*, FINRA News Release (July 6, 2015) *available at* http://www.finra.org/newsroom/2015/finra-sanctions-wells-fargo-raymond-james-and-lpl-30-million.

[17] *Wells Fargo, Raymond James, LPL to Repay Investors More Than $30 Million for Mutual Fund Overcharges*, Investment News (July 6, 2015) *available at* http://www.investmentnews.com/article/20150706/FREE/150709950/wells-fargo-raymond-james-lpl-to-repay-investors-more-than-30.

[18] FINRA News Release, *supra* note 16.

[19] *See FINRA Fines Merrill Lynch $8 Million; Over $89 Million Repaid to Retirement Accounts and Charities Overcharged for Mutual Funds*, FINRA News Release (June 16, 2014) *available at* https://www.finra.org/newsroom/2014/finra-fines-merrill-lynch-8-million-over-89-million-repaid-retirement-accounts-and.

[20] The FEL concession is applied to the $100,000 purchase amount; asset-based fees are applied to the actual, post-FEL investment amount of $95,500. Here and elsewhere in this letter, totals may not total precisely because of rounding.

[21] In this context, I use the term "statistically" in the probabilistic sense. Importantly, this ignores reasonable judgments about whether a particular fund

payout from the no-load fund because the expense ratio is higher and the amount invested is lower. It could be materially higher or materially lower.

The Department's proposal generally does not address whether this is a reasonable outcome for this client, or whether the expenses are too high, or whether the broker-dealer or adviser are overpaid, although the BIC exemption's "reasonable" fee requirement is arguably implicated here (and clearly would not violated if measured according to market rates). What the Department seeks to address is how the adviser's recommendation may be influenced by conflicted compensation arrangements.

In this situation, the adviser may have recommended the target date fund because it paid higher compensation. Another preferred fund, a retirement income fund offered by a different large fund complex, imposes a 5.00% FEL and a 0.30% 12b-1 fee. It has a breakpoint at $50,000. This particular fund discloses concessions only in the SAI, a document that is not delivered to investors except upon request. The fund's SAI states that the FEL concession is 4.01%. The $50,000 breakpoint FEL is 4.50%, and the concession is 3.51%. The SAI also discloses that the 12b-1 fee concession is 0.25%, which allows the total concessions to be precisely calculated for the client's purchase. The broker-dealer would receive a one-time $3,510 payment and annual payments of $239, for a total of $4,704 over five years. Under a 40% payout, the financial adviser would receive a one-time $1,404 payment and $95 annually, or $1,881 over five years. The client's expenses over five years, assuming the fund's waived expense ratio of 1.03%, would be $4,918. It is statistically more likely than not that the client's income would be less, but not substantially less, than the payout from the no-load managed payout fund and the load 2015 target date fund because the expense ratio is higher. It could be materially higher or materially lower.

By recommending the 2015 target date fund rather than the retirement income fund, the adviser appears to have received an additional $77 over five years. The broker-dealer has received an additional $192. Coincidentally, the client is statistically likely to receive higher income payments from the fund that appears to pay higher compensation to the adviser. Thus, at this point in the analysis the broker-dealer, adviser and client are better off, although there is no way to know whether the adviser recommended the higher paying fund because it was a better option for the client or simply because it paid higher compensation.

There are many alternative recommendations that would substantially increase the broker-dealer's and adviser's compensation. For example, the adviser could recommend that the client invest in a diversified group of equity, bond and cash funds in different fund complexes. This would be a reasonable allocation for the

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manager, management style or asset allocation may generate superior performance for the client.

client, and the adviser could reasonably claim that the best fund in each asset class happened to be offered by a different complex. The adviser's true purpose, however, might be to generate higher commissions by evading breakpoints. By investing in four or five funds in different complexes, the adviser could increase the applicable FEL concession in some funds from 3.75% to 5.00%, and thereby increase adviser's immediate commission by hundreds of dollars.

An adviser could also generate higher commissions by recommending investments in riskier asset classes. Funds' FEL commissions typically range from 1.00% for short-term bond funds to 3.00% for bond funds to 5.00% for equity funds. The adviser would claim that a riskier portfolio was needed to generate higher long-term growth and mitigate the effects of inflation – the client may live for another 40 years -- but the adviser's true motivation may be solely to double their compensation. As these examples illustrate, key factors that should have no effect on an adviser's recommendation – the selection of the fund complex and specific fund, the number of funds, and the allocation among asset classes – can have a substantial effect on the size of the adviser's payout.

Importantly, none of these recommendations would provide the basis of a successful claim against the broker-dealer or adviser. Neither the Department nor the client would be able to show that any of these recommendations "ran counter" to the Best Interest of the client (or, under securities law, that it was unsuitable or a violation of a fiduciary duty). The adviser could justify each recommendation as reflecting generally accepted investment theory and reasonable opinions about the qualities of each recommended fund. Without a smoking gun admission, the adviser's actual intent would be irrelevant.

The foregoing illustrations actually understate the problem of conflicted fees. Concessions paid to broker-dealers are fairly transparent and easy to calculate in comparison with other forms of differential compensation paid to broker-dealers by fund companies. These less visible conflicted fees make it even more difficult to evaluate the adviser's financial incentives. In fact, the fund that appears to pay the adviser higher compensation may actually be far less remunerative overall once other conflicted fees are taken into account. This is the problem of revenue sharing.

C. Revenue Sharing

Mutual funds are permitted to pay for distribution activities only pursuant to SEC Rule 12b-1 under a 12b-1 plan through fees identified as "distribution" fees in the mutual fund fee table. Yet a fund may pay substantially more for distribution services through the "management" fee than it pays in "distribution" fees. The SEC permits fund companies to use their management fees to pay for fund distribution on the fiction that the payments are made from the fund companies' "legitimate" profits and not out of fund assets. Some fund companies appear to make distribution payments that represent more than half of the so-called "management" fee.

The SEC does not require fund companies to tell shareholders how much of the fee that shareholders pay the companies to *manage a fund* is actually used to *promote its shares*. The SEC requires that the fund prospectus include the following disclosure (usually repeated verbatim), which reveals little useful information:

> If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

This disclosure appears in a section of the prospectus called "General Description of the Registrant" (the "Registrant" is the fund), many pages removed from the description of revenue sharing arrangements that generally appears near the end of the prospectus (to the extent that such a description is provided). This description is not required by the instructions in the mutual fund registration statement, Form N-1A. In fact, the phrase "revenue sharing," which is a ubiquitous term of art in the fund industry, appears nowhere in the 51-page instructions to Form N-1A. Rather, the description of revenue sharing that appears in fund prospectuses and SAIs has developed as a prudent industry response to the threat of enforcement action, not because the SEC or FINRA has articulated a specific rule requiring it.

The description therefore follows no standard format and varies greatly in the amount of detail provided. The description generally acknowledges that the fund company makes payments for distribution to broker-dealers in addition to FEL and 12b-1 concessions. It also states that it covers expenses for education and training events for broker-dealers, which are usually characterized as serving purpose of selling fund shares. The description generally acknowledges that these payments create or may create a conflict of interest for the investor's financial adviser. As a general rule, these descriptions do not attempt to sugarcoat the existence of this conflict, much less deny it, in contrast with broker-dealer disclosure that often misrepresents the financial incentives that these payments create and the resulting conflict of interest.

Beyond this basic disclosure, funds may also disclose the specific terms of their revenue sharing arrangements. The target date and retirement income funds discussed above provide such disclosure. The fund company for the target date fund generally makes a one-time payment of up to 0.10% of the purchase amount plus an ongoing payment of up to 0.02% of assets held at the broker-dealer.[22] The

[22] The fund company has some discretion to pay less than this amount. The aggregate revenue sharing payments for the fund complex in 2013 were less than

fund company makes additional payments for training and education, but does not disclose the amount. Over five years, these payments would increase the broker-dealer's compensation on a $95,500 investment by approximately $191, bringing the total including the FEL and 12b-1 fee concessions to $5,087.

The fund company for the retirement income fund pays revenue sharing of up to 0.25%, which appears to be a combination of a one-time percentage of the purchase amount and an ongoing payment of a percentage of assets held with the broker-dealer (the one-time and ongoing payment combination is most common revenue sharing model in the industry). I assume that these payments are 0.15% and 0.10%, respectively, which based on my research should be about average. The fund company makes additional payments for training and education, but does not disclose the amount. Over five years, these payments would increase the broker-dealer's compensation by $621, bringing the total including the FEL and 12b-1 fee concessions to $5,324.

The additional revenue sharing changes broker-dealer's financial incentive. The target date fund pays $192 more based on FEL and 12b-1 fee concessions, but the retirement income pays more -- $237 more – once revenue sharing is taken into account. This gaps would widen the longer the investor holds the fund and as the fund appreciates in value (the expense calculation in the prospectus assumes a 5% annual appreciation). Over ten years, an investment in the retirement income fund would pay $667 more than if the investment had been made in the target date fund. The retirement income fund would pay more unless the fund were sold (ignoring the broker-dealer's compensation for the re-investment of the proceeds) in about two years or less.

Some fund companies make revenue sharing payments that are more than twice the rate charged by the fund company that sponsors the retirement income fund. If the revenue sharing one-time and ongoing payments were 0.30% and 0.20% rather than 0.15% and 0.10%, the retirement income fund investment would generate $1,760 more in payments over five years than the target date fund investment. The target date fund's total five-year revenue sharing payments would be $191, in comparison with the retirement income fund's total revenue sharing payments of $621, or 69% higher.

If one extrapolates this analysis to $1 billion in purchases, it is easy to see how recommendations driven by the financial incentives created by differential compensation could increase a broker-dealer's revenues by tens of millions of dollars. Recommending the retirement income fund would increase the broker-dealer's 69%, *i.e.*, 69% of the revenue sharing payment would be attributable to the payment differential. Broker-dealers generally do not disclose their total revenue

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0.02% of assets (it is not clear, however, whether this includes assets not held at a broker-dealer).

sharing receipts, but two fairly large broker-dealers have disclosed recent annual mutual fund revenue sharing totals of $210.1 million and $152.3 million. If the same percentage of each firm's revenue were attributable to differential payments, the conflict of interest would account for $145.0 million and $105.1 million of their revenue sharing receipts, respectively. We know this is not the case. Disclosures show that the latter firm sells far more shares of the target date's target date fund complex than any other complex, which reflects well on the majority of its advisers. However, in my view it is very likely that part of the firm's $152.3 million in revenue sharing is attributable to the purely self-interested minority of its 1,000+ financial advisers.

A statistical analysis could show clearly the extent to which differential payments affected advisers' recommendations, and such an analysis based on publicly available data might be feasible, with sufficient resources, for a limited number of firms. Broker-dealers could easily do such an analysis, which would go directly to the heart of the Department's proposal, but they have not. Rather, they have generated a constant stream of quantitative conclusions that do not address the central policy question underlying the Department's proposal and are not provided with the underlying data with which the data's accuracy could be confirmed. If differential payments do not directly affect advisers' recommendations, it would be a simple task for the industry to prove it.

This discussion has not yet addressed the effect of revenue sharing payments on *financial advisers'* incentives. Broker-dealers generally state that revenue sharing does not "directly" affect financial advisers' compensation. This likely means that, at a minimum, payout grids generally are not applied to revenue sharing. However, when a lawyer uses the term "directly," it usually means that applying this qualifier is legally necessary. In other words, broker-dealers do not state simply that revenue sharing does not affect advisers' compensation, that are only able to state that it does not "directly" affect their compensation.

It is very likely that differential revenue sharing has an *indirect* effect on advisers' compensation, and the effect may be substantial. The structure of advisers' compensation, as discussed further in Part II incorporates numerous factors, many of which are undecipherable to the uninitiated. These factors may partly or substantially incorporate revenue sharing differentials. Fund complexes that pay higher revenue sharing may provide enhanced travel and entertainment benefits to advisers. Revenue sharing affects both the broker-dealer's overall profitability and the branch's profitability, which may affect the adviser's income. Branch managers may receive compensation that is directly tied to revenue sharing, and they have many means of influencing advisers' recommendations, including through their control over the allocation of inherited accounts (left by departing advisers) and the size of adviser's expense accounts.[23] Branch managers evaluate each adviser in the

[23] *See* Trevor Hunnicutt, *In 2014, Carrot and Stick for Advisers at Wells Fargo*, Investment News (Dec. 19, 2013) ("[broker-dealer] also recently increased the extra

adviser's role as an employee and in their role a regulatory supervisee. Branch managers influence their advisers in all of the ways that daily, personal, intra-office contact provides opportunities for bosses to influence employees ("Sam, I know you like the target date fund, but the retirement income fund will do just as good job for your client and help out the firm at the same time. Let's be a team player here!").

In my view, there is a very high likelihood that differential revenue sharing affects financial advisers' compensation. This means that it is also likely that many broker-dealers are misrepresenting their advisers' conflicts of interest. Broker-dealers routinely attempt to create the impression that revenue sharing differentials have no effect on advisers' financial incentives. For example, one broker-dealers states:

> It is important to understand that none of the revenue sharing payments received by Commonwealth is paid or directed to any advisor who sells these funds. Commonwealth advisors do not receive a greater or lesser commission for sales of mutual funds for which Commonwealth receives revenue sharing payments. Because Commonwealth's advisors receive no direct increase or change in compensation from selling shares of one fund over another, we do not believe that they are subject to a conflict of interest based on the amount of compensation each advisor receives when recommending one fund's shares over another's.

Note that each sentence is carefully crafted to apply only to direct payments of revenue sharing. This firm's advisers could *indirectly* receive higher compensation or enhanced benefits in every one of the ways described in the preceding paragraph, yet this firm's lawyers would claim that this disclosure is technically accurate. The firm also admits that certain funds pick up the $15 transaction fee that would otherwise be paid by the adviser. Rather than also conceding such a direct subsidy gives the adviser a financial incentive to prefer those funds (advisers have frequently made exactly this point in the financial press), the firm states that "[w]e

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money added to advisers' expense accounts for drawing up financial plans for customers by 10 percentage points. [Broker-dealer] said it is also adding funds to its high-performing advisers' expense accounts. The base rate for those accounts will be $500, but advisers who meet performance goals or earn higher revenue can receive more. For instance, an adviser who earns $500,000 but meets one of six performance goals will receive $1,500. Any adviser who earns $850,000 in fees and commissions will receive $10,000, and advisers who produce $1.5 million or more will receive $15,000."); Trevor Hunnicutt, *3 Wirehouses Raise Stakes to Court Rich*, Investment News (Dec. 8, 2013) (describing broker-dealer increasing expense accounts based on a financial adviser's productivity) *available at* http://www.investmentnews.com/article/20131208/REG/312089988.

believe that this offset does not compromise the advice your advisor gives you."[24] In my view, the SEC's and FINRA's tolerance for this kind of disclosure is inexplicable. Such disclosure may violate the BIC exemption's Section II(c)(3) condition that broker-dealer statements "not be misleading," and the Department should say as much when it next provides guidance on the exemption.

One reason that it is highly likely that broker-dealers indirectly pay advisers more to recommend higher revenue sharing funds is that entities that exist primarily to maximize profits for their shareholders have a strong tendency structure their employee's compensation so as to increase profits. It is unrealistic to believe that broker-dealers' that can increase their profits by selling higher revenue sharing funds will not use the indirect incentive mechanisms described above. Their primary regulators do not prohibit these incentive mechanisms. Foregoing these mechanisms may put them at a competitive disadvantage.

Perhaps the adviser's compensation in the example above is in no way affected by revenue differentials, in which case the adviser would recommend the "better" fund because it pays him or her the most compensation based on FEL and 12b-1 fee concessions, rather than the fund that pays the broker-dealer the most overall compensation when revenue sharing is included. But simply framing the issue in this way illustrates why differentials that are not based on any difference in the services provided are patently improper. The impossibility of answering this question also illustrates the failure of securities regulators to require meaningful disclosure of advisers' financial incentives, and why disclosure along the lines required in the Department's proposal is necessary. There is no way to know, between the two funds described above, what the adviser's ultimate financial incentives are.

D. Education and Training (aka Travel and Entertainment)

Part of broker-dealers' standard fund compensation comprises payments from fund managers that are generally characterized as reimbursement for the cost of education and training events. These fund managers are generally the same fund managers who enter into the revenue sharing arrangements described above, but in their disclosure documents broker-dealers treat payments for education and training separately from revenue sharing.

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[24] Ironically, the same firm's disclosure regarding the direct conflict of interest that travel and entertainment benefits create is unusually candid: "The marketing and educational activities paid for with revenue sharing, however, could lead our advisors to focus more on those funds that make revenue sharing payments to [broker-dealer] — as opposed to funds that do not make such payments — when recommending mutual fund investments to their clients."

Unlike revenue sharing, the amount of payments for education and training as a rule is not disclosed. One broker-dealer that provides such disclosure states that each of the highest level preferred fund companies pays an annual minimum of $750,000 (the next tier pays $350,000). Assuming $1 billion in assets, a $700,000 payment would equal an annual rate of 0.07% of assets. This particular broker-dealer probably holds far more than $1 billion in assets for a number of fund companies, but the fund companies that pay the $750,000 fee are not among the 12 fund companies with the largest amount of assets with the broker-dealer, and many are far down that list. Some of them may have less than $1 billion in fund assets held at the broker-dealer. Thus, there is a reasonable likelihood that one or more fund companies pays more than 0.07% annually, and a high likelihood that some pay less than 0.01%.

In their fee disclosure documents, broker-dealers consistently employ the same tactics to make education and training events seem to have no effect the firm's or the adviser's financial incentives. These "events" typically take the form of an all-expenses paid trip to an urban center or tourist destination where advisers are feted by revenue sharing fund companies. These are the same fund companies whose revenue sharing payments, as described above, broker-dealers claim have no "direct" effect on advisers' financial incentives. Broker-dealer disclosure as a rule includes no mention of the travel and entertainment aspect of these events and often no admission that these benefits may create a conflict of interest for advisers. Yet there is no disputing that these travel and entertainment benefits are benefits provided to advisers in connection with the sale of fund shares.

Broker-dealers also consistently attempt to make education and training events seem to be nothing more than reimbursement of out-of-pocket expenses that the broker-dealer would not otherwise have incurred. Some broker-dealers attempt to create the impression that the payments provide no benefits to advisers at all. For example, the following comprises one broker-dealer's entire discussion of these benefits:

> We focus on a select group of mutual fund families providing them greater access to our financial advisors to provide training, educational presentations and product information. In return for these increased services, these sponsors compensate the firm in the form of revenue sharing payments and ticket charge subsidies.

This description is typical. It is the fund families that provide the training an education, *i.e.*, provide the services, but the description states that the fund families pay the broker-dealer "in return" for the services that the fund families provide. The actual quid pro quo is that these fund companies are paying the broker-dealers for marketing opportunities and the chance to promote sales of their funds' shares with financial advisers. The disclosure contrasts sharply with another firm's candid disclosure that "marketing and educational activities paid for with revenue sharing . . . could lead our advisors to focus more on those funds that make revenue sharing

payments to [broker-dealer] — as opposed to funds that do not make such payments — when recommending mutual fund investments to their clients." That is well said.

The intent of broker-dealers' typical disclosure about education and training events is to create the impression that these are the equivalent of out-of-pocket expenses that otherwise would not be incurred, which would mean they provided no benefit to the broker-dealer or the adviser. They make these events seem almost like a burden to advisers, when in fact broker-dealers require advisers to *earn* the right to attend. Consider the prospectus for the retirement income fund discussed above, which specifically notes:

> Although an intermediary may seek revenue-sharing payments ***to offset costs*** incurred by the firm in servicing its clients who have invested in the fund, the intermediary may ***earn a profit*** on these payments.

(emphasis added). This statement expressly warns the reader against interpreting "reimbursement of expenses" to mean that broker-dealers and advisers do not benefit from these "reimbursements." The fund even goes so far as to state explicitly that they may "profit" from the arrangements. Most broker-dealer disclosure attempts to create precisely the opposite impression. It may very well be misleading broker-dealer disclosure that the fund is seeking to counter.

The broker-dealer's brief, obtuse description of how its "training and education program" provides "greater access" to financial advisers starkly contrasts with the way it describes the same program to its advisers:

> [Broker-dealer] respects the effort and dedication it takes to achieve at the highest level, and we ***reward your success*** when you make it happen. We do so in many ways, including enhanced payouts, recognition at national conferences and in our corporate materials, and inclusion in special events.
>
> One such event is our annual meeting for top advisors and branch managers. This exclusive event presents the opportunity to socialize and network with top [#1 Level Producer] executives and top-producing peers from across the country, in a relaxed environment.
>
> We also recognize top performers with ***additional rewards***, including invitations to our annual [Mutual Fund] National Conference and direct access to our Top Producer Customer Service Desk. When you are among our top-three levels of producers, you will also enjoy [#1 Level Producer], [#2 Level Producer] or [#3 Level Producer]

> recognition, which acknowledges your status as one of "the best of the best," and affords you access to ***unique benefits and rewards***.

(emphasis added). The broker-dealer's recent National Conferences have taken place in Las Vegas and Nashville, and have included speakers such as Condoleeza Rice and David McCullough. This fall's conference in San Antonio will feature Malcolm Gladwell. Advisers who qualify for #1 Level Producer or #2 Level Producer status (those who are among the broker-dealer's "top-three levels of producers") receive free airfare, four nights free at the hotel of their choice, and a free program at the Knibbe Ranch for two. Based on the firm's public disclosures, one pictures the adviser attending one of these education and training events as Shakespeare's "whining schoolboy . . . creeping like snail unwillingly to school." The firm's internal description of the Las Vegas event paints a very different picture, where top producers received round-trip airfare, five nights at the Venetian, dinner at the Bellagio Resort and two tickets to the Cirque de Soleil show "O."

The sponsors of the 2015 event will include half of the mutual fund companies that are listed as participating in the broker-dealer's revenue sharing program, under which the fund manager pays the broker-dealer up to 0.25% of the purchase price, up to 0.45% of assets on an ongoing basis, and $10 ticket charge (purchase fee) subsidy.

Broker-dealers often say nothing about the conflict of interest that travel and entertainment benefits create for advisers. Some deny that there is any conflict at all. For example, the broker-dealer referenced immediately above concludes its mutual fund revenue sharing disclosure as follows:

> Financial advisors of [broker-dealer] do not receive additional compensation in connection with sales of the certain mutual funds compared to other mutual funds [sic].[25]

The statement is misleading because, as the disclosure concedes elsewhere, the advisers have an incentive to sell funds that pay higher sales loads and 12b-1 fees. The only way that this statement could be true would be to interpret "certain mutual funds" to mean, literally, individual funds, in the sense that for every single ("certain") fund there is another fund for which the adviser would receive the same compensation if that fund were sold instead.

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[25] At least one other broker-dealer makes exactly the same misleading representation that its financial advisors "do not receive additional compensation in connection with sales of the certain mutual funds compared to other mutual funds [sic]."

The statement is also misleading because the travel and entertainment provided to top producers as described above is paid with revenue sharing payments, and part of the top producers' production is generated by selling those funds. The statement may be technically correct in the sense that no sale of a specific fund paid directly for the trips, but the sentence implies that advisers have no financial incentives favor revenue sharing funds. In fact, the reason that the fund companies pay for advisers' travel and entertainment is that the fund companies believe that this will result in more sales of their funds' shares. This is exactly what they say in their prospectuses.

The broker-dealer's disclosure is also misleading because the clearest information about travel and entertainment benefits does not appear until the eighth and final page of the document, whereas the disclosure discussed above ends on page 3. The investor could not reasonably be expected to understand the disclosure at the end of the document to elaborate on the disclosure provided earlier. On page 8, the broker-dealer reveals, under the ambiguous heading "PRODUCT EXPENSE REIMBURSEMENTS" that:

> [Broker-dealer] and your financial advisor may be reimbursed by sponsors of mutual funds, variable annuities, variable universal life, asset managers, and direct investment sponsors for expenses incurred for various promotional activities including but not limited to sales meetings, conferences and seminars held in the ordinary course of business.
>
> Although product sponsors make an independent determination of what they will spend on such items, some sponsors may allocate their promotional budgets based on prior sales and asset levels.

The disclosure again does not acknowledge that these programs are a form of reward for advisers, but at least it acknowledges that financial advisors are reimbursed for expenses (again, as if a "reimbursement" were not a kind of payment). It also states that sponsors "may allocate their promotional budgets based on prior sales and asset levels." Yet there is still no acknowledgment, much less accounting of financial advisers' financial incentives to sell revenue sharing funds, in the form of five nights at the Venetian and dinner at the Bellagio followed by Cirque de Soleil.

E. Exponential Payout Grids

Financial advisers' compensation generally is based mainly on a payout grid that provides for the adviser to be paid higher amounts as their production increases. "Production" means the gross dealer concessions ("GDCs") earned by the broker-dealer on the adviser's sales. In the mutual fund context, the broker-dealer might be paid a 5.00% concession on a 5.75% front-end load, and the adviser would receive a percentage of that concession ranging from 20% to 100%. The percentage paid on

the preceding 12 months' GDCs typically rises as the adviser's total production rises, which creates a ratcheting effect on the adviser's compensation.

For example, a financial adviser who generates $399,999 in gross dealer concessions in a 12-month period may be entitled to be paid 40% of that total, or about $160,000. If just before the end of the 12-month period the adviser reaches the $400,000 breakpoint, the adviser's percentage payout will increase not only for the immediate transaction, but also for all prior transactions in the 12-month period. If the sale that crossed the breakpoint was a $20,000 purchase of a fund that paid a typical 5.00% concession on a 5.75% commission, the adviser's GDCs would reach $400,999. If the payout grid provided that at $400,000 in production the payout rises to 42%, the adviser would be paid, as the result of that transaction, a total of $8,420: $420 for the $20,000 purchase and an additional $8,000 commission (2 percentage points on the prior $399,999 in GDCs). A financial incentive that pays an adviser an $8,420 commission on a $20,000 purchase – the functional equivalent of a *42.1% commission* – should not permitted. There are no neutral factors that justify such huge exponential differential compensation.

The exponential effect of payout grids can create even more distorted incentives. For example, in 2012 a broker-dealer posted a payout grid (the most recent available grid for the broker-dealer on the Internet) that provided for a breakpoint increase at $400,000 in GDCs from 32% to 42%. Applying the same facts described above, the adviser would be paid $40,420 in commissions: a $420 commission on the $20,000 purchase and an additional $40,000 commission on the prior $399,999 in GDCs. The payment would be the functional equivalent of a *202% commission*. It is per se inconsistent with a fiduciary duty for an adviser to be able to earn a $40,420 commission on a $20,000 purchase.

The incentives under this scenario generally would exist only when an adviser was about to separate from the firm because otherwise a sale at the end of any 12-month period will only affect only compensation from the first month. In other words, compensation for months 2, 3 and so on will depend, respectively, on production in month 12 *and* months 13, 14, and so on – *i.e.*, not just month 12, as the example assumes. Put another way, each month's sales presents the last opportunity for the adviser to affect commissions earned from purchases 11 months before. If the $400,999 in GDCs were spread evenly over the 12 months, the additional commission generated for the first month's sales that is attributable to the final $20,000 purchase would be approximately 1/12 of the $40,000 total for the entire 12-month period, or $3,333. Under this assumption, the total payment to the adviser would be $3,753, or 18.8% of the purchase amount – *almost nine times more than adviser's regular $420 commission*.

Such absurdly distorted incentives should not be permitted for any securities transactions, much less when advisers make recommendations about how their clients should invest their retirement assets. Yet these payout grids are legally permissible and widely used. This is this kind of compensation structure that

clearly encourages recommendations that are made without regard to the investor's best interest.

The Department should consider expressly stating that ratcheted payout grids, or large incremental payout increases may be inconsistent with procedures that are reasonably designed to mitigate conflicts of interest. Broker-dealers do not describe payout grids in their mutual fund fee disclosure documents, which suggests that neither they nor securities regulators view the grids as raising any issues that require disclosure, much less substantive regulation. However, payout grids can create financial incentives that create a high risk that advisers will make recommendations without any regard to the investor's best interest.

III. Private Litigation and the Enforceability of the Best Interest Contract

The Department's proposal places heavy emphasis on the private enforceability of broker-dealers' fiduciary duties under the Best Interest Contract. As the Department recognizes, a right without a remedy is no right at all. Investors must be able to enforce their rights under the BIC for the Department's rulemaking to work. Yet investors who hold IRAs have no private right of action under ERISA's prohibited transaction rules. The Department's correction of its interpretation of "fiduciary" under ERISA will materially strengthen investors' claims in arbitration. However, in my view it will be extremely difficult for investors to enforce the Best Interest Contract in arbitration.

Before turning to that issue, one must consider why investors contract claims will be litigated in arbitration rather than in court. Virtually all broker-dealers' customer account agreements include mandatory arbitration provisions. These provisions prevent investors from bringing individual claims in court. They must submit disputes to arbitration, and the arbitration forum must be FINRA arbitration.

FINRA takes the position that, mandatory arbitration clauses notwithstanding, investors have the right to bring class actions in court. However, investor claims against broker-dealers are not likely to satisfy the legal requirement that class members demonstrate commonality. Many of the facts supporting a contract breach claim will be specific to individual clients, which will likely defeat a class action based because of the class's inability to establish sufficient commonality. For example, the investor would have to show that the financial adviser provided advice that established fiduciary status under the Department's revised definition of "fiduciary," which normally would require proof of individualized interactions and communications between the investor and both the financial adviser (one scenario in which commonality may be proved is a claim based on call center scripts). As a practical matter, private enforcement will occur exclusively in FINRA arbitration proceedings.

A. Fiduciary Claims in Arbitration

Fiduciary claims are the most common claim brought in arbitration proceedings against broker-dealers. To succeed, the investor must prove that the broker-dealer was a fiduciary and violated its fiduciary duty. Notwithstanding broker-dealers' public claims that they support a fiduciary duty, they expressly deny owing a fiduciary duty in virtually every case in which a fiduciary relationship is alleged for a nondiscretionary account.[26] Investors must devote part of their case to proving the existence of the kind of common law relationship of trust and confidence that establishes common law fiduciary status.

The Department's correcting of the definition of fiduciary to include, essentially, all personalized recommendations regarding ERISA assets should settle the question of whether the broker-dealer was a fiduciary as to those assets. Investors fill find it much easier to prove the broker-dealer was acting as a fiduciary. Investors therefore should be materially more likely to prevail in arbitration.

This is an admittedly subjective assessment. There is no empirically useful data on how and why arbitrators make decisions because FINRA does not require that they publish opinions explaining their judgments. Nonetheless, arbitration lawyers generally believe that a fiduciary claim, once fiduciary status is proved, is more likely to result in an award to an investor. If the broker-dealer was not acting as a fiduciary, the investor generally must show that the recommendation was unsuitable or fraudulent. In court, both claims require proof of both the broker-dealer's intent (extreme recklessness will suffice) and the investor's reliance. Many lawyers believe arbitrators apply the same distinction between fiduciary claims on the one hand, and suitability and fraud claims on the other, although it may be that they do not necessarily apply the specific legal concepts of intent and reliance. The Department's facilitating proof of fiduciary status should materially improve investors' changes of obtaining an award of damages in arbitration. This alone may be the single most important element of the Department's rulemaking.

B. BIC Enforceability

However, providing fiduciary status is separate from proving a breach of the Best Interest Contract. In my opinion, there is a significant risk that plaintiffs counsel will be disinclined to bring BIC breach claims and arbitrators will be disinclined to enforce the terms of the BIC. Introducing ERISA – a complex law that is based on

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[26] *See* Joseph C. Peiffer and Christine Lazaro, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty*, Public Investors Arbitration Bar Report (Mar. 25, 2015) (citing numerous examples of broker-dealers' contradictory public and litigation positions) *available at* https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf.

different principles from those that guide securities regulation – into arbitration poses risks for investors. Arbitrators are not likely to have much, if any experience with ERISA's prohibited transaction rules, prohibited transaction exemptions, or heightened fiduciary standard. FINRA does not require that arbitrators be attorneys or have any real legal training (although panel's chair is normally an attorney). Nor does FINRA provide arbitrator with guidance regarding the substantive law to be applied. Experienced lawyers have difficulty applying ERISA; this will be particularly challenging for arbitrators.

Once fiduciary status is established, the investor is halfway to making a common law fiduciary duty case. It is not clear that adding a contract breach claim to the mix would improve the likelihood of recovery. An arbitration is a court of equity. Arbitrators develop a feel for the fairness of competing positions based on the coherence of the story presented by each side in the course of a hearing. Although counsel will present SEC and FINRA rules and guidance regarding conduct that violates these rules, they will try not to rely too heavily on legal nuances and close reading of rules or statutes. In any case, these sources of law generally reflect intuitive standards of fair and honest commercial conduct.

These factors may disadvantage BIC claims, which will require more technical legal analysis than the standard mix of fiduciary, suitability, fraud and supervisory claims that are typically core elements of an arbitration complaint. Contract claims are less intuitive because contracts, by their nature, often seek to alter the default rules of standard commercial practice. Deeply conflicted fees are standard commercial practice in the financial services industry and will be viewed that way by experienced arbitrators.

A BIC claim also may be less susceptible to arbitration's heightened emphasis on oral advocacy. As a general rule, arbitrations are largely won and lost based on what happens in the hearing, not on pre- and post-hearing analysis of contracts, briefs and other documents. More than one arbitrator has reminded counsel, while emphasizing the importance of proceeding slowly and deliberately, that arbitrators are not paid for time spent outside of the hearing. In view of these factors, an investors' overall claim may be weakened by adding a complicated contract claim to the mix that requires additional legal arguments that depend heavily on arbitrators doing more work outside of the hearing.

Thus, in my view plaintiffs counsel will face a close call when considering whether a BIC claim – even if the breach is clear – is worth the additional investment of resources and risk of diluting or confusing the investor's common law fiduciary case. Establishing a breach of contract will likely depend heavily on proof of a financial adviser's financial incentives and the broker-dealer's procedures for mitigating the conflicts that they create. This line of proof is not central to a common law fiduciary duty violation, where the substance and suitability of the recommendations are far more important than conflicted compensation. More expansive discovery will be necessary to prove a contract breach claim, which will

require a greater investment of time and resources, both for plaintiffs counsel in preparing their case and for the arbitration panel in hearing it.

Moreover, a finding that a recommendation was unsuitable generally involves an investment that lost an identifiable monetary sum, which provides an intuitive link between liability and damages. In contrast, the specific damages that would arise from BIC breach are not intuitive. Courts have consistently had difficulty with claims that the remedy for a recommendation tainted by a fiduciary's conflict of interest is necessarily recovery of investment losses unless the plaintiff can show that an *unconflicted* recommendation would have avoided the investment losses. Thus, arguing for an award based on conflicted fees may confuse the intuitively stronger argument for an award based on unsuitable advice. Whereas courts are adept as maintaining the independent standing of each claim and producing findings on individual counts, no such discipline applies in the arbitration context. A weak BIC claim could actually drag down a strong common law fiduciary claim.

There is also a risk that FINRA arbitrators may be influenced by FINRA's opposition to the Department's rulemaking. In recent remarks that were widely reported in the financial press, FINRA's chairman and CEO delivered a harsh critique of the Department's proposal. He suggested that FINRA arbitrators could not fairly conclude that a broker-dealer breached the fiduciary contract due the impracticability of compliance and the inadequacy of the Department's guidance.[27] He stated that "the current Labor proposal is not the appropriate way" to achieve the goal of establishing a fiduciary standard and that in the proposal "there is insufficient workable guidance provided either to the firm or the judicial arbiter on how to manage conflicts in most firms' present business models." He also specifically questioned whether a "judicial arbiter" could "evaluate which compensation practices 'tend to encourage'" a breach of the fiduciary contract and faulted the Department for the "shortage of useful guidance" and the "shortage of realistic guidance."

These comments may adversely affect investors' contract breach claim. Diligent defense counsel will contend that it is not clear that their client's conduct was a breach of the BIC and use FINRA's concurrence that Department's guidance is "insufficient," not "useful" and not "realistic" to support their position. Counsel will present FINRA's questioning whether a "judicial arbiter" would have the ability to evaluate compliance with the fiduciary contract as a direct message to arbitrators that they should not hold broker-dealers to its terms. These statements will be a prominent exception to FINRA's longstanding position that it will not direct arbitrators as to what substantive law to follow, and arbitrators will take note.

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[27] *See* Remarks of FINRA Chairman and CEO Richard G. Ketchum before the 2015 FINRA Annual Conference, Washington, DC (May 27, 2015) *available at* https://www.finra.org/newsroom/speeches/052715-remarks-2015-finra-annual-conference.

In a FINRA proceeding operated by FINRA arbitrators in which plaintiffs counsel rely heavily on FINRA rules and guidance, the provenance of statements by the FINRA chairman and CEO are likely to be afforded heightened deference. These statements will be effective litigation tools even if the Department's final guidance is crystal clear. The only way these statements may be mitigated is an express statement by FINRA (or possibly the SEC) disavowing them.

Such an about face is unlikely, as FINRA's institutional hostility to the Department's proposal has deep roots. Many of FINRA's members view the proposal as an attack on their core business model, and their rhetoric reflects deep ideological and cultural opposition to it, as well as a rejection of the Department's competence to regulate in this area. The FINRA policymaking staff is fully aware of the fact that the Department's proposal, to be frank, is an implicit indictment of decades of SEC and FINRA policymaking. Broker-dealers' conflicts of interest and financial incentives have been a significant focus for securities regulators since the Tully Report in the late 1990s, and securities genuinely believe that they have made steady progress in this area. In fact, they have not. They have instead allowed the creation and growth of a deeply conflicted compensation model that threatens Americans' retirement security.

In summary, although I do not share the common view among investor advocates that mandatory arbitration should be abolished, it is my view that mandatory arbitration probably will not offer an effective forum for private enforcement of the BIC. The Department should consider certain steps to address this problem. First, the Department should consider, apart of the present rulemaking, whether mandatory arbitration, or at least FINRA arbitration, is consistent with the goals of providing the heightened protection of investors that ERISA mandates. In my view, it is not. Investors should be entitled to bring claims involving IRA assets. However, courts have demonstrated a strong bias against permitting individual consumers to assert their rights in court. It is not clear that the Department's exercise of its administrative authority would survive the strong judicial preference for arbitration.

Second, the Department should consider shifting inspection and enforcement resources to the identification and prosecution of prohibited transactions that arise from breach of the BIC. A portfolio of well-reasoned judgments in enforcement proceedings would provide the kind of record that would make BIC enforcement in arbitration significantly more viable. A separate benefit is that enforcement actions are both more likely to succeed and result in meaningful monetary damages than private claims in arbitration. Public enforcement actions would provide legal counsel and compliance professionals with significant motivation and leverage to push their broker-dealer clients to minimize conflicts of interest. A major, immediate inspection and enforcement effort commencing on effective date of the new fiduciary standard may be critical to the long-term efficacy of the Department's rulemaking.

Third, the enforceability of the BIC will be constrained if the Department does not soften its principles-based approach. This approach is, of course, what the industry claims to prefer. One reason is that the industry knows that it will be very difficult to persuade a FINRA arbitration panel that conflicted compensation practices that have been used for decades without objection by the SEC or FINRA (their enforcement divisions excepted) violate a broker-dealer's fiduciary duty. If the Department intends that the fiduciary contract be enforceable in arbitration, it must expressly identify the required characteristics of differential compensation, and provide explicit examples of conduct that constitutes a breach of the BIC.

IV. Differential Compensation Standards

The Department provides various tests for evaluating differential compensation, and those tests may apply differently to the broker-dealer, affiliates and financial advisers. In my view, these tests should be substantially reformulated as discussed below. The following recommendations should be viewed as a package, *i.e.*, the following pragmatic concessions to broker-dealers' business model are contingent on strengthening the Department's proposal in certain respects.

A. Permit Broker-Dealer-Level Differential Payments

In my view, the Department should make it clear that a broker-dealer could comply with the BIC exemption without making any material changes to the terms under which it receives compensation. The most costly way to comply with the BIC would be to ensure that the adviser's recommendation has no effect on the broker-dealer's compensation. It is at this level that compensation arrangements are most deeply embedded and most dependent on integrated systems and compliance structures, and require the most interparty coordination, and policy and procedure changes require negotiations between independent entities. Internal fee leveling would be for less costly.

At least some broker-dealers believe that fee leveling at the broker-dealer level, to a greater or lesser extent, is required. This may be the Department's intent. However, in my view it would be sufficient for a broker-dealer to make a contractual commitment that its advisers have no financial incentive to make a recommendation that generated any greater benefit for the broker-dealer or adviser than another recommendation. Admittedly, profit-making entities have a strong incentive to find ways to cause their employees to maximize the entity's profits. No matter what rules the Department finally adopts, conflicted recommendations by advisers will always be with us. But as a practical matter, to mandate fee leveling at the broker-dealer level would be make the perfect the enemy of the good – and achieving fee leveling inside the broker-dealer would be much than good.

B. Permit Differential Compensation between Categories of Investments

It is also my opinion that the Department should take the position that differential compensation between categories of investments is permitted under the BIC exemption. What would distinguish one "category" from another is the time invested and quality and nature of analysis conducted by the financial adviser and the firm – what the Department calls neutral factors. Broker-dealers have claimed that the proposal prohibits conflicted fee differentials between mutual funds and variable annuities, and variable annuities and fixed index annuities. It is my understanding that these differentials *are permitted* under the BIC exemption.[28] These categories involve differences in the time invested and analysis conducted by the adviser. Paying differential (higher) compensation would be consistent with recommending a category of investment that required more time and analysis.

Admittedly, this distinction does nothing to mitigate the conflict created, for example, by paying financial advisers more for selling variable annuities than for selling mutual funds. Variable annuities are the most frequently abused product in the securities industry, and the abuse is greater in the IRA context where the investor already enjoys tax deferral. Under this recommended approach, variable annuities in IRAs will be recommended primarily because of the additional compensation they pay. But it is not clear, as a practical matter, how honest broker-dealers can be prevented from being paid more for providing more, different, or higher quality services. And eliminating differentials that serve no purpose other than to create incentives to act contrary to investors' interests should be the Department's primary focus. The Department should adopt this policy and identify examples of categories of investments between which differentials would be permitted under the BIC exemption.

C. Prohibit Non-Neutral Differential Compensation within Investment Categories

Taking a very different tack, the Department should state expressly that differential compensation that does not reflect neutral factors (*e.g.*, a greater investment of time, or higher quality or more complex analysis) is not consistent with the BIC exemption. It should go without saying that financial advisers should not be in the position of deciding between recommending one or two U.S. equity funds where one will result in a substantially higher payout. This is simply indefensible. This kind of conflicted fee arrangement makes a mockery of FINRA's requirement that its members "observe high standards of commercial honor and just and equitable principles of trade."

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[28] *See* Example 4, 80 F.R. 21791 (higher compensation for advice regarding annuities than advice regarding mutual funds would be permissible).

In my view, under the current proposal broker-dealers could continue to provide financial advisers with financial incentives to make recommendations solely on the basis of the adviser's compensation. As discussed further in Part V, the BIC exemption's tests of fiduciary compliance will permit broker-dealers and their financial advisers to continue to receive differential compensation that serves no economic purpose other than encouraging recommendations based solely on the firms' and advisers' financial best interest. In short, the Department's principles-based approach goes too far and will allow broker-dealers to satisfy the key tests of compliance with the BIC exemption without materially changing the scope and intensity of their conflicted fee arrangements.

Provided that differential compensation is permitted at the broker-dealer level and between investment categories, the long-term cost of industry compliance with a prohibiting non-neutral differential compensation under the BIC exemption would be a fraction of the benefits to America's retirees. Notwithstanding industry claims, these benefits will inure to small investors as conflicted advice is suppressed.

The limited data on conflicted fee arrangements shows why small investors will benefit. One large broker-dealer that discloses both the rate and amount of revenue sharing payments by fund company shows that the majority of its sales are of funds in the fund complex that produces the *least revenue per dollar invested*. The second *lowest* revenue sharing fund complex represents the second *highest* volume of sales. If non-neutral differential compensation is prohibited under the BIC exemption, there is no doubt that sales of funds in higher revenue sharing fund complexes will decline, but only because the sales of these funds that currently occur solely as a result of differential compensation will decline. Sales of those funds that reflect investors' best interests will be unaffected because the rulemaking will change only the differential that advisers are paid for selling these funds. Fund complexes that rely heavily on differential compensation may fail. But this will not be the result of regulatory overreaching. It will be the painful but wealth-creating effect of allowing free market forces to cull the herd.

The broker-dealer industry claims that the rulemaking will force small investors into unaffordably expensive fee-based programs. Yet broker-dealers are already putting the lie to that claim. One major broker-dealer that is a tiny fund manager recently sold proprietary fund assets that placed it *fourth* among all fund complexes for the calendar year.[29] This extraordinary achievement was apparently

[29] *See* Trevor Hunnicut, *Edward Jones' Proprietary Funds Are Outselling Nearly All Active Managers*, Investment News (July 16, 2015) (broker-dealer charging 1.50% wrap program fee plus investment expenses of 0.30%) *available at* http://www.investmentnews.com/article/20150716/FREE/150719935/edward-jones-proprietary-funds-are-outselling-nearly-all-active. The firm stated that it "has been migrating funds in its mutual-fund advisory program, the industry's second largest, in an effort to simplify trading and lower costs." *Id.* A substantial part of the program's assets are managed by the same fund company that manages the majority

accomplished by substantially undercutting the 2.00%-and-higher asset-based fee that is common among broker-dealers' fee-based programs. The operative pricing innovation appears to be the use of a bare bones fund management fee that actually pays for portfolio management rather than revenue sharing.

This kind of market upheaval shows a broker-dealer that, while publicly decrying the purportedly industry-destroying, small-investor-crushing effect of the Department's rulemaking, has adopted a fee structure that better serves the interests of small investors and is putting the firm's competition in its rearview mirror. While other broker-dealers appear paralyzed, held in a trance by the shrill, mindless war cries of lobbyists and industry groups, this broker-dealer is already conquering the post-rulemaking world. This example illustrates how the Department's rulemaking will tip the competitive balance toward fund companies and broker-dealers that use fees to provide superior services to shareholders and clients rather than solely to create conflicted financial incentives for financial advisers.

D. Prohibit Non-Neutral "Reimbursed" Travel and Entertainment Expenses

As discussed above, broker-dealers generally attempt to characterize the so-called "reimbursement" of expenses for education and training as not creating a conflict of interest for advisers. In fact, these travel and entertainment benefits do create a conflict of interest, as expressly recognized by some broker-dealers.[30] Fund prospectuses often expressly state that these payments are intended to promote the sale of shares.

In my view, the Department should directly address the conflict of interest that these travel and entertainment benefits create. FINRA has crafted a finely tuned noncash compensation rule that prohibits some abuses but ultimately has the effect of insulating these practices from liability under the securities laws. It is therefore incumbent upon the Department to dispel the rule's implication of regulatory approval. Travel and entertainment benefits should be specifically identified as creating an impermissible conflict of interest to the extent that the benefits do not reflect neutral factors.

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of non-proprietary funds sold by the firm. In other words, the program essentially keeps the same portfolio manager but internalizes the distribution expense structure in a way that will make it easier to pay level fees to its advisers.

[30] *See* footnote 24, *supra*.

E. Treat Branch Managers as Financial Advisers

I strongly recommend that the Department expressly extend to branch managers the same basic requirements that apply to financial advisers. The Department generally applies its proposals according to three categories: the broker-dealer, broker-dealer affiliates, and financial advisers. The category of affiliates, rather than financial advisers, appears to cover branch managers. Although branch managers generally will not be fiduciaries under the proposal, they should be treated as such under the BIC exemption because they will influence, often decisively, recommendations made by their financial advisers, and they directly benefit from exercising that influence.

Branch managers routinely have direct contact with advisers' clients. They meet and interact with them in their offices. They comment on the services provided by their advisers, including investment recommendations. Even if they are not located in the same office with the adviser, the branch manager will have direct contact with clients. Compliance with FINRA's supervisory rules will alone trigger direct communications with clients. Branch managers oversee all client transactions in their branch to ensure suitability, among other things, and they often are required to provide direct, prior approval of individual transactions.

Branch managers also directly influence their advisers' recommendations. In some cases they do so as a matter of proper training and oversight. In other cases, they do so, unfortunately, to promote the branch manager's financial interests. Broker-dealers have a long history of evading rules designed to mitigate advisers' conflicts of interest by incentivizing branch managers to maximize the broker-dealer's revenues. For example, broker-dealers may directly compensate branch managers based on the amount of revenue sharing payments their branch generates. Alternatively, they may calculate a branch's profitability based in part on revenue sharing payments, or increase the branch's expense account based on the amount of revenue sharing generated.

Branch managers have many ways to incentivize their advisers to make recommendations that increase the manager's compensation, including through the allocation of accounts inherited from a financial adviser who has left the firm. The branch manager may control the size of the adviser's expense account and whether the adviser is eligible to attend conferences hosted by revenue sharing fund companies. Advisers are at the mercy of their branch managers with respect their employment evaluations. Branch managers also evaluate advisers' legal compliance as their regulatory supervisor. Finally, most employees intuitively understand the benefits of keeping the boss happy. The influence of branch managers is one reason that broker-dealers can claim only that revenue sharing does not "directly" affect advisers' compensation. Branch managers' actions are one way revenue sharing differentials may *indirectly* affect advisers' compensation.

The Department should view financial advisers and their branch managers as a *de facto* unit for purposes of advisers' recommendations to clients. The branch manager's financial incentives should be viewed as the financial adviser's incentives for purposes of evaluating the effect of differential compensation arrangements. The current proposal does not adequately prevent broker-dealers from being in compliance with the BIC exemption while using differential compensation structures to the branch manager level to promote conflicted advice.

V. Best Interest Contract Exemption Terms

The BIC exemption incorporates a number of tests for compliance with the Best Interest Contract. As discussed below, in certain respects the drafting of these tests may undermine effectiveness of the BIC exemption and the enforceability of the Best Interest Contract.

A. Reasonableness Requirement

It is a condition of BIC exemption that a recommendation not be expected to result in compensation to the adviser, broker-dealer or certain affiliates that exceeds "reasonable compensation in relation to the total services" provided. As applied, this test would require that the compensation not be unreasonable in the usually accepted commercial sense. In the common law, an unreasonable fee generally must be proved to be a fee that "shocks the conscience," "could not have been negotiated at arms-length," or "bears no rational relationship to the services provided." It will be a fee that is substantially higher than the highest routinely charged fee in the context and strongly suggests the exploitation of an unsophisticated, vulnerable investor. It will not turn on differential comparisons, *i.e.*, on the fact that an adviser may be paid two or three time as much for recommending one fund over another.

A fee will be deemed *per se* reasonable if it does not exceed express or implied legal limits and appears to be consistent with securities regulators' express or tacit approval. For example, an FEL it will not be unreasonable, as a matter of law, if it complies with limits imposed by FINRA Rule 2830. Nor can a 12b-1 fee be unreasonable that complies with these limits. The terms of revenue sharing arrangements are similarly protected by the implied regulatory approval. They are widely disclosed, yet neither the SEC nor FINRA has expressed any disapproval of the amounts involved. Discussion of the level of revenue sharing fees has been notably absent from SEC and FINRA enforcement actions involving revenue sharing. FINRA guidance makes it clear that the travel and entertainment benefits described above are permissible. These fees and benefits, and the significant conflicts that they create, are deemed by FINRA to be consistent with just and equitable principles under FINRA Rule 2010. It is extremely unlikely that a FINRA arbitration panel would contradict the considered views of securities regulators that the highest levels of fees currently charged are, in fact, legally impermissible.

In my view, the BIC exemption's reasonableness requirement will have no effect on the current range of compensation levels paid to financial advisers, broker-dealers, or their affiliates. Based on disclosed arrangements, a broker-dealer may receive ongoing asset-based 12b-1 and revenue sharing fees that *alone* exceed four or five times the total expense ratio of some mutual funds. The reasonableness requirement will only affect fees, if any, that are substantially higher than such existing fee arrangements. The Department should not view the success of fee-based class actions in the retirement plan context as being applicable here. They are not. It would be extraordinary for an attorney to encounter a "reasonable fees" breach in the IRA context that was worth litigating.

This is not to say that the reasonableness standard can be modified to address the Department's primary concerns regarding fee differentials. In my view, it cannot. It is not suited to serve the purpose of addressing conflicted fee arrangements. Nor can it be modified in a workable manner to serve this purpose (and the Department may have no intent that it serve this purpose). There is no harm in including the reasonableness requirement, but it will not materially advance the Department's goals.

B. Mitigating the Impact of Material Conflicts of Interest

The broker-dealer and adviser must warrant, in the Best Interest Contract, that the broker-dealer has adopted procedures that are reasonably designed to "mitigate the impact of Material Conflicts of Interest." As discussed below, the Department should consider certain revisions to this formulation. The Department also should keep in mind that, because breach of the warranty does not vitiate the availability of the BIC exemption, this warranty will be enforceable only in arbitration, where proving that a certain set of procedures is not "reasonably designed" to accomplish some purpose will be, to be frank, extremely difficult. As discussed above in Part III, arbitration may already be an inhospitable venue for enforcement of the Best Interest Contract. In my view, the "reasonably designed procedures" requirement will be practicably enforceable only if made a *condition* of the BIC the breach of which removes the protection of the exemption.

i. Materiality Standard

In my view, the BIC exemption should not, for a number of reasons, use the term "material." The Department's proposal states that a "material conflict of interest" exists when an adviser or financial institution "has a financial interest that could affect the exercise of its best judgment as a fiduciary in rendering advice." The lay meaning and securities law meaning of "material" are inconsistent with the "could affect" standard. Requiring procedures only for "material" conflicts may eviscerate the exemption.

The use of the lay term "material" seems to contemplate a markedly narrower category of financial incentives than the category of incentives that "could affect" the

adviser's judgment. The term "material" implies a set of financial incentives that would be both *more likely* to affect an adviser's advice and have a *greater effect* on an adviser's advice than financial incentives that "could" affect the adviser's judgment. The conflicts of interest, *i.e.*, differential compensation, that the procedures address should not be limited by a broker-dealer's subjective judgment about which differential compensation arrangements rise to the level of being material. The laws of economics tell us that when rational actors are compensated more highly for one recommendation than another, especially where there is no difference in the services provided, there will be more of the first recommendation.

Regardless of whether the lay meaning of "material" is consistent with the "could affect" definition, the securities law meaning of "material" clearly is not. Under the federal securities laws, the category of information that would be material would be *substantially* smaller that the category of information that could affect a person's conduct. Securities law provides that information is material when there is a "substantial likelihood" that it would be considered "important" to a reasonable investor.[31] The set of financial incentives that "could affect" an adviser's judgment is much larger than the set of financial incentives that would create a "substantial likelihood" of being "important" in the adviser's exercise judgment.

It is the securities law meaning of "material" that will likely apply in arbitration proceedings. There are few terms of art under the securities laws that are as firmly and deeply embedded as the term "material." Whether something is material is frequently a dispositive issue in private securities litigation. Although it generally is not a core issue in arbitration, arbitrators will be familiar with the meaning of the term in the securities context and will tend to assume that meaning in applying the BIC exemption.

In my view, the materiality standard is not appropriate in the conflicted compensation context. In a quintessential securities law claim, there is nothing about an asserted misrepresentation or omission that makes it more or less likely to be material. A statement or omission is inherently neutral until placed in context. The plaintiff therefore must prove materiality. In contrast, differential compensation is differential precisely for the purpose of selling shares. Most mutual fund prospectuses use these words to explain why they make revenue sharing payments and pay for advisers' travel and entertainment. The fund companies intend that higher compensation result in increased sales by creating financial incentives for advisers that have no relationship to the time invested or nature of analysis conducted by the adviser. Non-neutral differential compensation *always* could affect an adviser's advice because that is *always* the only reason for non-neutral differentials. If an investor can show that a financial adviser is paid more for selling one fund than another, there should be a presumption that the differential payment could adversely affect the financial adviser's judgment that shifts the

[31] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

burden to the broker-dealer and adviser to make a *prima facie* showing (without necessarily proving) that there are neutral, time and analysis factors that explain the differential.

In my view, the Department therefore should remove the term "material" from the BIC exemption, including from Section III(c)(1)(A), which requires disclosure of "material" compensation. *All* direct and indirect adviser compensation should be disclosed. Adviser compensation depends on an extremely complex, finely tuned set of performance measurements that to a lay person or arbitrator will seem not only immaterial, but trivial. They will ask: How could *one-hundredth of a basis point* affect a person's behavior? Without a doubt, it will. That is why this differential exists. The very existence of seemingly infinitesimal compensation increments represents the expert and universal view of broker-dealers that incremental benefits that appear to be trivial will have a desired effect on advisers' conduct. Why would a broker-dealer invest a great deal of time and effort in crafting and constantly revising minute, incremental benefits for advisers if it believed that this would have no effect? They would not and do not. It is a cliché that most self-made millionaires become millionaires by watching every penny. So do broker-dealers, as they should. Courts have stated that revenue sharing payments are too small to influence broker-dealers' and advisers' conduct, yet revenue sharing is paid *for precisely the purpose of influencing their conduct*. Either these courts are very wrong or the financial industry is deeply misguided. In my view, the market knows better than the judiciary what motivates salespeople. If non-neutral differential compensation did not affect advisers' conduct, there would be no non-neutral differential compensation.

It may not be sufficient merely to remove "materiality" descriptors from the proposal. The Department should consider expressly stating that the differences in compensation do *not* need to be material to require procedures that are reasonably designed to mitigate their impact. As noted, the presumption should be that differential payments tend to influence an advisers' judgment. Otherwise, broker-dealers and financial advisers will successfully argue in arbitration that the differential compensation must be substantially likely to be important in the adviser's exercise of judgment. Arbitrators who have applied securities law standards for decades may reflexively accept that argument. The standard should be the "could affect" standard, and broker-dealers' procedures should be required to be reasonably designed to prevent conflicts of interest defined as compensation that could affect the adviser's judgment taking into account neutral factor justifications for the differential.

ii. "Mitigate the Impact"

Another difficulty with the "reasonably designed procedures" requirement is the use of the "mitigate the impact" qualifier. As a general rule, "reasonably designed procedures" requirements are most effective when they are unqualified. In other words, the requirement should be to develop and implement procedures that are reasonably designed

to prevent any occurrence of the misconduct or practice. Adding additional qualifiers such as "mitigate" (rather than prevent) and "impact" to the already qualifier of "reasonably" designed weakens the effectiveness of a procedures requirement. Soft procedures requirements weaken compliance, make litigation more likely, and disadvantage firms that are truly committed to compliance relative to firms that are not.

To illustrate, the use of the term "mitigate the impact" rather than simply "mitigate" suggests that, once a conflict of interest is identified, the broker-dealer must determine the impact, for it is only the *impact*, not the *conflict of interest*, that must be "mitigated." As a matter of textual construction, the use of the term "impact" suggests a further winnowing of the conflicts of interest category. It also suggests that there must be evidence of an effect, that is, of advisers' recommendations actually being influenced by conflicted fees. A broker-dealer could conduct a legally sufficient statistical analysis that concluded that there was no "impact" from conflicted fees even when there was, or define "impact" so narrowly as to permit substantial room for abuse. This is not the intent of the procedures requirement. I strongly recommend that the Department delete the term "impact." The procedures should be reasonably designed to mitigate conflicts of interest, not to mitigate their "impact."

The term "mitigate" may also be problematic because it requires only procedures that are reasonably designed to *lessen in force or intensity, or reduce* conflicts of interest. This standard would undermine the procedures requirement because it presupposes that procedures may be designed to allow known conflicts of interest to exist even when there are no neutral factors that justify them. The standard also would be difficult to enforce because it allows the broker-dealer to exercise too much discretion in determining when it is appropriate to pay differential compensation that could affect an adviser's best judgment.

As many of the foregoing comments suggest, the Department should adopt a standard that requires procedures that reasonably designed both to mitigate conflicts of interest *and to prevent conflicts of interest that are not justified by neutral factors*. While the Department includes the neutral factors standard in the BIC exemption, they are used only to illustrate a non-exclusive way to comply with the exemption.[32] ***Instead, differential payments (other than at the broker-dealer level and across investment categories) should be per se inconsistent with the BIC exemption unless there are neutral factors that could reasonably justify them.***

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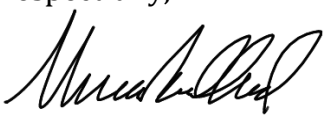
As noted above, these comments do not address many issues on which I expect to comment over the course of Department's extended comment period. Although in my view the Department's should be improved in certain respects, the core proposal is sound and holds out the potential to create substantial benefits for investors. Americans' retirement security has become increasingly fragile over the last few

[32] *See* Example 4, 80 F.R. 21791; BIC Exemption Section II(d)(4).

decades, in no small part due to a permissive regulatory culture that has allowed abusive compensation structures to flourish. As the amount of retirement assets in IRAs has grown, these compensation structures have increasingly undermined Americans' retirement security. The Department must act to address conflicted compensation practices that cost investors billions of dollars every year.

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,



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Attachment: as

Fund Democracy
Consumer Federation of America
Public Citizen's Congress Watch
AARP
Americans for Financial Reform

October 18, 2013

The Honorable Sylvia Matthews Burwell
Director
Department of Management and Budget
725 17th Street, NW
Washington, D.C. 20503

Dear Director Burwell,

We are writing on behalf of Fund Democracy, Consumer Federation of America, Public Citizen's Congress Watch, AARP and Americans for Financial Reform to respond to and comment on certain statements made in a letter from members of Congress to the Office of Management and Budget dated August 2, 2013 ("Congressional Letter"). The Congressional Letter relates to the Department of Labor's intent to amend its interpretation of "investment advice" under ERISA in order to ensure that Americans are adequately protected when provided advice about their retirement accounts. We strongly support this long overdue initiative and encourage the OMB to expedite its review when it receives the Department's proposal.

In contrast, the Congressional Letter asks that OMB *delay* the Department's initiative pending fiduciary rulemaking by the SEC. It justifies this proposed action based on the unfounded argument that "uncoordinated efforts undertaken by the agencies could work at cross-purposes in a way that could limit investor access to education and increase costs for investors, most notably Main Street investors" who invest through Individual Retirement Accounts (IRAs). The Congressional Letter ignores assurances that the Department has provided that it will address legitimate industry concerns with regard to the rule's potential impact on retail accounts. Moreover, while the Letter bases its argument on the alleged impact of Department rulemaking on IRAs, its proposed "solution" would deprive all retirement accounts as well as traditional pension plans of the important benefits the Department's rulemaking will create. The Letter is suggesting nothing less than that the Department's ability to exercise its authority under ERISA should be bounded by the standards that the SEC may eventually adopt under securities laws. Its proposal must therefore be judged in this light.

The Congressional Letter's request to the contrary, there is no reasonable basis for delaying the Department's rulemaking until the SEC rulemaking is

complete.[1] Such a delay would harm investors and further undermine Americans' already shaky retirement security. As discussed below, ERISA establishes different, higher standards for retirement accounts than those that apply under the federal securities laws. It would be inconsistent with the spirit and letter of ERISA to limit its standards based on standards established by the SEC.

We are most concerned regarding the Congressional Letter's implication that the fiduciary duties that apply under ERISA should be lowered to a securities law standard that is appropriate for general retail investment advice but not for advice regarding retirement assets. This proposition directly contradicts ERISA, which expressly, intentionally and appropriately imposes and has always imposed a higher fiduciary standard on providers of services to Americans with respect to the accounts on which they are relying for their retirement security. The SEC's ongoing initiative under the federal securities laws seeks to remedy a deficiency in the regulation of broker-dealers. We are dismayed by the suggestion that this purpose should be turned, instead, to compromising the protections that apply to retirement accounts.

ERISA's Higher Fiduciary Standard

We are particularly dismayed by the Congressional Letter's assertion that:

> Congress clearly intended that a single standard should apply to retail accounts, including retirement accounts, based on specific guidelines enumerated in Section 913 [of the Dodd-Frank Act].

We find no evidence to support this claim. Section 913, by its express terms, addresses only the legal standards that apply to broker-dealers and investment advisers under the securities laws. The purpose of Section 913 was to require the SEC to evaluate the regulation of broker-dealers and investment advisers under the securities laws and to authorize rulemaking on that subject. Section 913 was prompted by the anomaly that broker-dealers provide the same personalized investment advice to clients as investment advisers provide, but broker-dealers are subject to a lower suitability standard. There is nothing in the text of Section 913 or its legislative history that supports the view that it was intended to address fiduciary standards under ERISA.

Congress has, in fact, clearly and appropriately imposed a higher legal standard with respect to the accounts on which Americans rely for their retirement security than the standard that is imposed under the federal securities laws. An

[1] *See generally* Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (May 23, 2013) (testimony of Mercer Bullard).

ERISA fiduciary is required to act solely in the best interests of the ERISA client,[2] whereas a fiduciary under the securities laws is required only to act in the best interests of the client. The Supreme Court has specifically stated that "ERISA imposes higher-than-marketplace quality standards . . . , requiring a plan administrator to 'discharge [its] duties' in respect to discretionary claims processing 'solely in the interests of the [plan's] participants and beneficiaries.'"[3]

Under ERISA, fiduciaries are also explicitly prohibited from engaging in a wide range of transactions that are permitted, with adequate disclosure, for fiduciaries under the securities laws.[4] For example, ERISA fiduciaries are generally prohibited from engaging in principal transactions with their clients, whereas under securities law fiduciaries may do so with appropriate disclosure. These ERISA prohibitions establish a demonstrably higher standard than the standard imposed under the securities laws. Insurance agents, broker-dealers and investment advisers who are currently ERISA fiduciaries have been able to comply with these higher standards for years, including with respect to services provided to IRAs. The Congressional Letter asserts that the Department's original proposal would have "eliminated access to meaningful investment services for millions of IRA holders," but this assertion is contradicted by the fact that all types of financial professionals have ***for decades*** been complying with precisely the same rules that the Department's rulemaking would impose on new ERISA fiduciaries to IRAs.[5]

There is No ERISA "Conflict" with Securities Law

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[2] ERISA Section 404(a) requires, for example, that an ERISA fiduciary discharge its duties "solely in the interests of the participants and beneficiaries . . . with []care, skill, prudence, and diligence." Section 404(a) does not apply to most individual retirements accounts ("IRAs") because they are not employee benefit plans and therefore would not apply to IRAs under the Department's proposal.

[3] *Metropolitan Life Ins. Co. v. Glenn*, 554 U.S. 105, 106 (2008). *See* Lorraine Schmall, *Defined Contribution Plans after Enron*, 41 Brandeis L.J. 891 (2003) ("ERISA fiduciaries are held to a higher standard than are ordinary trustees") (quoting Susan J. Stabile, *Breach of ERISA Fiduciary Responsibilities: Who's Liable Anyway?* 5 Empl. Rts. and Employ. Pol'y J. 135 (2001)).

[4] Pension benefit plans are subject to the prohibited transaction rules in ERISA Section 406, unless exempt under Section 408 or one of the many exemptions granted by the Department. IRAs are subject to the prohibited transaction rules in I.R.C. Section 4975(c), which generally mirror the rules in ERISA Section 406.

[5] Some have criticized the Department's rulemaking on the ground that it "extends" ERISA's prohibited transaction rules to IRAs and thereby encroaches on the SEC's jurisdiction. In fact, there is no question that Section 4975(c) *already* applies to IRAs and those who currently qualify as fiduciaries with respect to IRAs. That includes many insurance agents and broker-dealers that are currently ERISA fiduciaries and are managing to serve their ERISA clients with IRAs in compliance with ERISA. The change that the Department proposes to make would expand the category of IRA fiduciaries that are subject to Section 4975(c).

It is also incorrect to imply that any Department proposal under ERISA would "conflict" with the securities laws. The original proposal included no conflict with the federal securities laws. Nor has any spokesperson for the Department made any statement that even suggests any such conflict. Nor has any commentator, to our knowledge, identified any possible conflict that the fiduciary rulemaking might create. The most recent *potential* conflict between a DOL rule and the rule of another agency (the CFTC) was quickly resolved before the CFTC rule became final.

Critics of the Department have adopted the term "conflict" to describe what is not a conflict at all, but rather a standard under ERISA that Congress decided should be higher than the parallel standard under the federal securities laws. The Department should, ***indeed must***, hold fiduciaries under ERISA to a higher standard than applies under the federal securities laws. This does not create a conflict in any meaningful sense, but simply reflects the higher standard the Congress decided to impose when investment assets are specifically intended for retirement and, not incidentally, subsidized through deferred tax collections.

Securities law and ERISA are different regulatory schemes because they should be different. The public interest in tax-subsidized employee benefit plans and IRAs is far greater than for securities investments 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. The Department's application of ERISA's fiduciary duty therefore should not be expected to conform to securities regulation, just as the SEC's application of the fiduciary duty under the securities laws should not be expected to conform ERISA's requirements. Each standard is appropriately designed to fit the context.

Retirement Accounts *Should* be Provided Greater Legal Protection

Indeed, it is difficult to understand how one could reasonably disagree with the proposition that services provided as to Americans' retirement assets should be held to a higher legal standard. Social Security is facing an actuarial shortfall, billions of dollars of municipal retirement obligations are unfunded, and Americans are living longer and not saving enough for retirement. At the same time, Americans are being encouraged to invest their retirement savings in high-risk hedge funds[6] and franchises.[7] The Department is doing what it should have done long ago; it is

[6] *See, e.g.*, Arleen Jacobius, *Carlyle brass: It's 'Unfair' to Deprive DC Investors of Private Equity Investments*, Pension & Investments (Sep. 26, 2013) *available at* http://www.pionline.com/article/20130926/DAILYREG/130929900/carlyle-brass-its-unfair-to-deprive-dc-investors-of-private-equity-investments?newsletter=daily&issue=20130926#utm_source=Newsletters&utm_medium=email&utm_campaign=P%26I%20Daily%20Plan%20Sponsor.

[7] *See, e.g.*, Rodney Brooks, *Using Your 401(k) or IRA to Start That Dream Business*, USA Today (Sep. 23, 2013) *available at*

repealing its own, extralegal narrowing of the meaning of investment advice to ensure that ERISA's fiduciary provision can do its job of protecting Americans' retirement security.

The Congressional Letter's implication that retirement assets should receive no more protection that any investment is striking in light of the most recent research on investment fraud. Earlier this month, FINRA released a study showing that 84 percent of Americans had been solicited with one of 11 types of blatantly fraudulent offers, with 11 percent losing a significant amount of money after engaging with an offer.[8] Forty-two percent of respondents found "claims of achieving 'typical' returns of 110% per year" appealing. Forty-three percent found claims of "fully guaranteed" investments to be appealing. In view of the stunning susceptibility of Americans to the most obvious forms of fraud, one can only imagine how likely they are to follow the advice of non-fiduciary investment professionals when investing for their retirement.

A GAO study released earlier this year documented fraud and abuse in precisely the kinds of transactions to which ERISA's fiduciary duty should apply.[9] The GAO found that call center representatives – employees of the most vocal opponents of the DOL proposal – "encouraged rolling 401(k) plan savings into an IRA even with only minimal knowledge of a caller's financial situation." Excerpts from GAO calls to representatives reveal a pattern of misconduct. Representatives claimed that 401(k) plans had extra fees and that their IRAs "had no fees,"[10] or argued that IRAs were always less expensive, notwithstanding that the opposite is

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http://www.usatoday.com/story/money/columnist/brooks/2013/09/23/retirement-entrepreneur-401k-pension/2833897/.

[8] Financial Fraud and Fraud Susceptibility in the United States, Applied Research and Consulting for FINRA Investor Education Foundation (Sep. 2013) *available at* http://www.finra.org/web/groups/sai/@sai/documents/sai_original_content/p337731.pdf. *See also* Investor Fraud Study Report, NASD Investor Education Foundation (May 12, 2006) *available at* http://www.sec.gov/news/press/extra/seniors/nasdfraudstudy051206.pdf.

[9] Labor and IRS Could Improve the Rollover Process for Participants, Government Accountability Office, GAO-13-30 (March 2013) ("GAO Report") *available at* http://www.gao.gov/assets/660/653506.txt. *See also* Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans, Government Accountability Office, GAO–09–503T (Mar. 24, 2009) *available at* http://www.gao.gov/new.items/d09503t.pdf.

[10] "Finally, misleading statements also make it difficult to understand IRA fees. Calls made by our investigator to 401(k) plan service providers, most of which offer IRA products, found that 7 of 30 call center representatives (representing firms administering at least 34 percent of IRA assets at the end of the 1st quarter in 2011) said that their IRAs were 'free' or had no fees with a minimum balance, without clearly explaining that investment, transaction, and other fees could still apply, depending on investment decisions. In our review of 10 IRA websites, we found 5 providers that made similar claims, often with certain conditions such as a $50,000 minimum balance or consent to receive electronic statements explained separately in footnotes." GAO Report, *supra* (footnotes omitted).

generally true: IRAs are *more* expensive for investors, on average, than 401(k) plans. Broker-dealers routinely hold themselves out as fiduciaries – the same standard that their employers do not want to have to meet in practice. The GAO study showed that providers of 401(k) plans undercut *their own plans* in order to push their higher-cost IRA options on unsuspecting investors. These studies suggest that, rather than seeking to undermine legal protections for Americans' retirement accounts, Congress should be seeking to strengthen them.

Investors' vulnerability to fraud is most acute, and the need for fiduciary protection is greatest, in the context of retail accounts, such as IRAs, that are subject to ERISA. One reason is that retail accounts are provided less protection than employee benefit plans under ERISA because they are not subject to section 404's heightened fiduciary standard[11] (and would continue to be exempt under the Department's proposal). Another reason is that retail retirement accounts lack the buffer provided by the employer in an employee benefit plan. Unlike salespersons, employers generally do not have the substantial conflicts of interest and economic stake in fees paid in connection with employees' investments (with the exception of employer stock). A committee of fiduciaries selected by the employer chooses the plan's investment options and generally negotiates lower fees than those charged in IRAs. In contrast, as the GAO has confirmed, some broker-dealers advise retirees to rollover their 401(k) plan assets into higher cost IRAs that directly benefit the broker-dealer. The broker-dealers that would be subject to a fiduciary duty under the Department's proposal have significant conflicts of interest and economic incentives to act in their own best interests rather than their clients'. Retail accounts therefore are in *greater* need of protection under the corrected interpretation of "investment advice" that the Department expects to propose.

We recognize that the prohibited transaction rules of ERISA, especially as applied to small, retail accounts, raise legitimate concerns for financial services professionals. However, this has been true for many years in a wide range of circumstances that the Department has successfully addressed by granting appropriate exemptions. The Department has a long history of appropriately accommodating business practices, consistent with the protection of Americans' retirement accounts, through carefully tailored prohibited transaction exemptions, known as "PTEs." Assistant Secretary Borzi has specifically noted that such exemptions require a finding that they are in the best interests of investors and stated unambiguously that "[w]e think that there are types of compensation that would otherwise be prohibited under a flat prohibition that we will be able to make that finding for."[12] She has repeatedly made it clear that there will be PTEs in the

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[11] *See supra* note 2.

[12] Diana Britton, *Borzi Hints at Exemptions to DOL Fiduciary Rule*, WealthManagement.com (Apr. 29, 2013) *available at* http://wealthmanagement.com/imca-2013-annual-conference/borzi-hints-exemptions-dol-fiduciary-rule/.

proposal that will be designed to accommodate existing business practices.[13] We agree that the proposal should include appropriately designed PTEs. However, without knowing the content of these exemptions – that is, without waiting until the proposed rules has actually been proposed – the Congressional Letter's concerns regarding the proposal's effect on current business practices are premature; we urge that OMB not similarly prejudge the Department's proposal.

There is No Limiting Effect on Investor Education

The Congressional Letter contends that the Department's proposal "could limit investor access to education." We agree that the Department should not impede investors' access to education, but the proposal would have no such effect. The concern that investment advice could be deemed to include investor education has long been addressed by an exclusion from the definition of investment advice under a longstanding Department position.[14] Investment advice does not include descriptions of investment options or information regarding asset allocations, asset class returns, diversification, risk and return, or risk tolerance. It does not include asset allocation models based on generally accepted investment theories that provide advice regarding asset classes' historical returns and volatility and their appropriateness for investors with different characteristics. Nor does investment advice include interactive worksheets that allow investors to estimate future income needs and test different asset allocation strategies.

The Department's original proposal expressly adopted the existing exclusion for investor education from the definition of investment advice. This means that this exclusion would apply to new fiduciaries under its proposal. Providers of IRAs, for example, would be able to provide all of the educational information to investors that current fiduciaries have found sufficient for years. We are not aware of any examples of investor education having been "limited" under the existing interpretation and are confident that if there were problems, the Department would ensure that such education did not trigger fiduciary status.

DOL's Overly Narrow Interpretation of "Investment Advice"

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[13] *See Borzi: DOL Fiduciary Rule Won't 'Outlaw' Commissions*, Financial Advisor (Sep. 10, 2013) (proposal will include new PTEs) *available at* http://www.fa-mag.com/news/borzi--dol-fiduciary-rule-won-t--outlaw--commissions-15408.html*;* Darla Mercado, *DOL's Borzi Says Fiduciary Rule Will Be Simple: Clients Come First*, Investment News (June 19, 2013) (Assistant Secretary Borzi stating that the proposal will include new PTEs) *available at http://www.investmentnews.com/article/20130619/FREE/130619875#;* Karl Thunemann, *Exemptions from Conflict of Interest Will Be Part of New Fiduciary Proposal*, RIABiz (May 7, 2013) (statement of ERISA attorney Fred Reish: "Phyllis Borzi has been saying — for over a year — that there would be exemptions with the new proposal") *available at* http://www.riabiz.com/a/22106168/borzi-exemptions-from-conflict-of-interest-will-be-part-of-new-fiduciary-proposal.

[14] 29 C.F.R. § 2509.96-1 (1996).

If there is a comparison to be made between ERISA and the federal securities laws, it should focus on the significant flaw in the Department's longstanding interpretation of the term "investment advice." The Department has narrowly interpreted the term not to apply to advice provided in connection with a one-time transaction or to advice that is not the "primary basis" for the client's investment decisions. Under the federal securities laws, there is no question that the term "investment advice" includes providing advice as to a single transaction. This is so clear that Congress created an exemption for broker-dealers from the definition of "investment adviser" in the Investment Advisers Act precisely because investment advice so clearly includes one-time advice for which a broker-dealer is paid a commission. Under the Advisers Act, "investment advice" also includes advice that is not the "primary basis" for a client's transaction.

Logic would dictate that the Department interpret "investment advice" under ERISA similarly to cover such obvious cases – if not interpret it *more broadly* for the protection of America's retirees. But the Department has interpreted that term in a way that is inconsistent with the statute.[15] There is no reasonable basis for the Department's narrowing the plain meaning of "investment advice;" this error should have been corrected long ago. Congress's concern should be the Department's delay in correcting its interpretation of the meaning of investment advice, which directly conflicts with the ERISA, rather than the possibility that broker-dealers will actually be subject to the ERISA standards that Congress has always intended to apply to Americans' retirement accounts. We anticipate that these short-comings will be addressed in the revised rule proposal.

The SEC Timetable

The Congressional Letter's suggestion that the Department delay its long overdue rulemaking pending SEC action is also troubling in view of the SEC's record on related rulemaking initiatives. The Commission has been promising rulemaking to establish a fiduciary duty for broker-dealers for years, yet no proposal has ever been issued. More than three years after Dodd-Frank Section 913 became law, the Commission has only just asked for information on the effects of a fiduciary rulemaking. If past practice is any indication, there is no guarantee that any rule proposals will be forthcoming. The SEC's initiatives regarding revenue sharing payment disclosure and 12b-1 fees – two of the primary practices that the Department is expected to address – have been languishing for, respectively, nine and thirteen years.[16] In contrast, the SEC did not hesitate to adopt a "temporary"

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[15] Definition of the Term "Fiduciary," Employee Benefits Security Administration, 75 F.R. 65263, 65264 (Oct. 22, 2010) (Department's interpretation of "investment advice" significantly narrows the plain language of section 3(21)(A)(ii)").

[16] *See* 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, Securities Act Rel. No. 8358 (Jan. 29, 2004)

rule that lowers standards applicable to broker-dealers' principal trades with their advisory clients. This so-called "temporary" rule has been extended, in clear violation of the Administrative Procedures Act, three times for a total of six years[17] without ever responding to public comments on its deficiencies.[18] On each occasion, the SEC has imposed a "sunset" date, but this is clearly a temporary rule on which the sun may never set. Given the SEC's record of delay and inaction, requiring the Department to wait on the Commission to conduct fiduciary rulemaking is the practical equivalent of prohibiting the Department's rulemaking altogether.

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We urge the OMB to base its ultimate review of the Department's reproposal on the facts, rather than the myriad of myths and falsehoods that have characterized much of the debate regarding the original proposal. We recognize that there were problems with the original proposal,[19] but that proposal has been withdrawn. We see no reason not to accept the Department's acknowledgment of the problems with the original proposal and its intent to address those problems in any reproposal. Secretary Perez has promised the Senate that he will carefully review any reproposal and ensure that it fully reflects industry and investor concerns. We see no reason for OMB to undermine the specialized expertise that the Department brings to bear on regulatory issues affecting Americans' retirement security. Finally, we have no doubt regarding the continued vitality and appropriateness of Congress's undisputed policy of applying higher standards when financial services professionals advise Americans regarding their retirement assets.

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available at http://www.sec.gov/rules/proposed/33-8358.htm. The SEC has been promising 12b-1 fee reform since February 2000, when it conceded that current rules fail to require disclosure of payments received by brokers for recommending fund shares and stated that it had directed its staff to make recommendations on how to fix this problem. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, in Donald Press v. Quick & Reilly, Inc. (2d Cir.)(Feb. 2000). The SEC proposed 12b-1 reforms more than three years ago, but has not taken any further action. *See* Mutual Fund Distribution Fees; Confirmations, Investment Company Act Rel. No. 29367 (July 21, 2010) *available at* http://www.sec.gov/rules/proposed/2010/33-9128.pdf.

[17] The "temporary" rule was originally "adopted" in 2007. *See Advisers Act Rule 206(3)-3T (Temporary Rule Regarding Principal Trades with Certain Advisory Clients)* (Dec. 21, 2012) *available at* http://www.sec.gov/info/smallbus/secg/206-3-3-t-secg.htm. The "temporary" rule was extended to Dec. 31, 2010 in 2009, to Dec. 31, 2012 in 2010, and to Dec. 31, 2014 in 2012. *See id.*

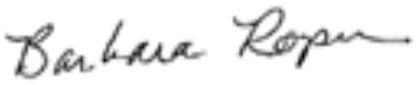
[18] *See, e.g.*, Letter from Mercer Bullard, Fund Democracy, and Barbara Roper, Consumer Federation of America to Nancy Morris, Secretary, SEC (Nov. 30, 2007)(commenting on adoption of temporary rule regarding principal trading restrictions) *available at* http://www.sec.gov/comments/s7-23-07/s72307-18.pdf

[19] Mercer Bullard, *DOL's Fiduciary Proposal Misses the Mark*, Morningstar.com (June 14, 2011) *available at* http://news.morningstar.com/articlenet/article.aspx?id=384065.

Thank you for your consideration of our comments. We would appreciate an opportunity to meet with you, at your convenience, to discuss them further. Please feel free to contact Mercer Bullard (662-915-6835) or Barbara Roper (719-543-9468) if you have any questions regarding this letter or would like to arrange a meeting, or if we can otherwise be of assistance.

Respectfully yours,

Mercer Bullard
Founder and President
Fund Democracy



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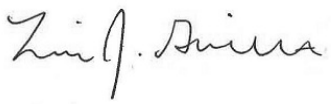

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