Consumer Federation of America

September 24, 2015

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

Re: Conflict of Interest Rule, RIN 1210-AB32
Proposed Best Interest Contract Exemption, ZRIN: 1210-ZA25
Proposed Class Exemption for Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, ZRIN 1210-ZA25

Ladies and Gentlemen:

We are writing on behalf of the Consumer Federation of America (CFA)[1] to expand on our earlier comment letter in support of the proposed conflict of interest rule and best interest contract and principal transaction exemptions. A primary purpose of this second letter is to respond to some of the suggested revisions to the proposed rule that were submitted by industry rule opponents in the first round of comments and that, if adopted, would fatally undermine its core investor protections. These include a variety of proposals to inappropriately narrow the definition of fiduciary investment advice and to weaken the best interest standard, particularly with regard to mitigation of conflicts. In addition, this letter looks more closely at the types of policies and procedures that could be adopted to mitigate conflicts. We reexamine required disclosures to identify which are likely to be of greatest benefit to retirement savers. And finally, we examine some of the "studies" and other comments submitted by industry groups to impugn the Department's extensive and rigorous Regulatory Impact Analysis.

I. The Department Must Not Give In to Industry Pressure to Compromise the Core Principles Behind the Rule Proposal.

We recognize that there are areas where the rule can and should be adjusted before it is finalized. Certain provisions can be clarified and implementation of others can be streamlined without threatening the core principles embodied in the rule. As we noted in our earlier comment, for example, we believe implementation of the best interest contract can be simplified without undermining the investor protection benefits associated with the contract. Similarly, we

[1] The Consumer Federation of America is a non-profit association of nearly 300 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

believe it is possible to clarify that firms are free to market their services without opening new and unjustified gaps in the definition of fiduciary investment advice. And we believe an accommodation can be reached to preserve retirement savers' access to asset allocation tools that help them to identify investment options available to achieve the desired allocation.

On the other hand, if the rule is to achieve its intended purpose of strengthening protections for retirement savers, it must:

- eliminate loopholes in the definition of fiduciary investment advice that expose retirement savers to self-interested recommendations from conflicted advisers;
- ensure that rollover recommendations are included in the definition of investment advice; and
- include a strong best interest standard that balances the rule's loosened restrictions on the forms of compensation advisers can receive with stringent requirements to mitigate conflicts of interest wherever possible.

Unfortunately, many of the revisions proposed by financial firms and their lobbyists attack precisely those provisions that are crucial to the rule's effectiveness. We urge you to resist any and all such suggestions to recreate, using different words, precisely those problems the rule is intended to correct.

A. The Department Should Reject Suggestions to Inappropriately Narrow the Definition of Investment Advice.

As we noted in our previous comment letter, many financial professionals are able to exploit loopholes in the current definition of fiduciary investment advice in order to escape application of ERISA's fiduciary duty even as they "render investment advice" to retirement plans and retirement investors "for a fee or other compensation." The proposed rule is designed to close those loopholes by replacing the five-part test in the current definition with a functional definition that turns on whether the financial professional has made a recommendation that is individualized, or specifically directed to, the retirement investor for consideration in making investment decisions. In contrast to the current definition, the revised definition appears to capture the full range of services retirement investors reasonably rely on as fiduciary advice. It also better reflects the statutory language and more closely resembles the definition of investment advice under securities laws.

Many industry commenters have suggested revisions to the definition of fiduciary investment advice that would have the effect of significantly narrowing its reach, either by retaining existing loopholes or by crafting expansive new loopholes that would achieve the same result through different means. The most commonly suggested revisions to narrow the definition include: reintroducing a requirement for mutual agreement and/or reliance into the definition of fiduciary investment advice, allowing the scope and terms of the relationship (including whether recommendations constitute fiduciary investment advice) to be defined by contract, excluding rollover recommendations from the definition, and extending the seller's carve-out to the retail and small plan market. While each takes a slightly different approach, all would leave retirement savers vulnerable to the same sorts of deceptive practices financial firms commonly engage in today to escape their fiduciary obligations when offering retirement investment advice.

<u>Mutuality/Reliance</u>: A number of industry commenters have suggested revising the definition of fiduciary investment advice to require a mutual understanding between the adviser

and advice recipient that the advice is fiduciary investment advice and that the investor will rely on that advice in making investment decisions. So, for example, SIFMA suggests that the provision of individualized advice should be covered by a best interest standard only when both the financial professional and the client agree that a fiduciary account is what they both expect.[2] Financial Services Roundtable suggests that, for the fiduciary duty to apply, there should be a mutual understanding between the client and the financial professional or institution that the recommendations will play a significant role in the client's decision-making. A number of others have made similar suggestions, all of which would simply recreate the existing "mutual agreement" loophole that the rule is intended to close.

Others appear to go a step further, suggesting changes that would arguably expand the existing loophole. In its proposed rewrite of the definition, ACLI suggests that a fiduciary duty should only apply when the investor "requests" fiduciary investment advice. Such an approach would ensure that only the most sophisticated individuals – those who know enough to request fiduciary advice – would be protected.[3] Meanwhile, ICI argues that it is the expectations of the adviser, rather than the expectation or understanding of the investor, which should carry weight in determining whether a fiduciary relationship exists. It states: "Only under circumstances where the adviser believes that he or she is providing advice should there be a fiduciary relationship." ICI offers no explanation of why the adviser's belief should carry more weight than the understanding of the advice recipient, except to assert that the adviser needs certainty. Nor does it explain how regulators would be expected to enforce a standard based on the beliefs of the adviser. But investors also need certainty – in this case the certainty that the recommendations they get from their "financial advisor" are actually best interest advice and not just a sales pitch dressed up as advice. Any definition that turns on the belief or mutual agreement of the adviser will deny them that certainty.

In its proposed "new best interest paradigm," Fidelity Investments suggests a variation on this approach. Specifically, Fidelity proposes that the Department limit fiduciary protections to situations in which the advice recipient has "a reasonable expectation" that he or she can rely on the advice as "unbiased and in the recipient's best interests." Toward this end, it suggests that the Department modify the definition of fiduciary investment advice "to require that, based on the content, context, and presentation of such advice, it is reasonable for the advice recipient to rely on such advice as being unbiased and in the recipient's best interest with respect to such recipient's investment or management decisions." Fidelity fails to explain under what circumstances it would be reasonable to expect that advice from a conflicted adviser would be "unbiased and in the recipient's best interests" and in what circumstances it would not. Since a key difference between a sales pitch and advice is that advice is designed to serve the best interests of the customer while a sales pitch is not, in our view any time it is reasonable based on the content, context, and presentation to rely on the recommendation as advice it is also

[2] As we noted in our previous comment letter, when commenting on possible rulemaking by the Securities and Exchange Commission (SEC), SIFMA has supported a definition of investment advice that would seem to include all personalized recommendations. And, of course, the securities law definition of investment advice does not require either a mutual agreement or reliance to trigger a fiduciary duty. SIFMA fails to explain why, even as it is arguing for a harmonized regulatory approach between the DOL and SEC, it is advocating for a definition of investment advice under ERISA that would be inconsistent with the securities law definition.

[3] It is reasonable to assume that those who know enough to ask for fiduciary advice already receive such advice through a fee-based investment adviser.

reasonable to expect that the advice will be unbiased and in the best interests of the investor. However, we doubt that is the interpretation Fidelity intends.

Indeed, Fidelity proposes to create a mechanism that would enable firms to contract out of any such expectation.[4] This second feature of Fidelity's proposed approach would permit firms to dictate the scope and terms of the customer relationship through a pre-engagement contract negotiated outside the fiduciary standard. As described by Fidelity, nothing in its proposal would preclude firms from drafting the contract specifically to avoid any reasonable assumption that the advice is unbiased or designed to serve the customer's best interests. If this approach were adopted, firms could simply dictate as part of the contract that the advice is not unbiased to evade their fiduciary duty, much as they use legal disclaimers today stating the advice is educational or not designed to serve as the primary basis for the investment decision to achieve the same result. If this approach were adopted, the most vulnerable investors, those who fail to understand what rights they are signing away, would be most at risk of abuse.

We need not resort to speculation to conclude what the effect would be if DOL were to adopt any of these proposals for reincorporating a mutual agreement or reliance requirement in the definition. We need look no further than common industry practice under current rules. Today, the practice of using fine print disclaimers to avoid application of a fiduciary duty in circumstances where the adviser knows, or reasonably should know, that the investor is relying on their recommendations as the primary basis for their investment decisions is ubiquitous. In fact, Fidelity is itself a prime culprit in using such disclaimers in its current retirement materials. These disclaimers are often buried in the smallest, most inconspicuous font on a pamphlet or webpage.[5] This practice tells us all we need to know about how a new mutual understanding or reliance requirement would be abused by financial firms eager to evade their fiduciary obligations. In short, it is the financial firms' rampant abuse of the existing loopholes that renders inclusion of a mutual agreement or reliance requirement unacceptable as part of any revised definition of fiduciary investment advice.

<u>Rollover Recommendations</u>: One of the most important improvements in the proposed rule – the inclusion of rollover and benefit withdrawal recommendations in the definition of fiduciary investment advice – has also come under industry attack. This is hardly surprising given the billions in profits financial firms are able to reap recommending rollovers without regard to the financial interests of workers and retirees. SIFMA, for one, flatly denies in its comment letter that distribution recommendations are investment advice. It cites the lack of any mention in the statutory language or legislative history to justify its position. But rollover and benefit withdrawal recommendations clearly constitute recommendations regarding the investment or management of plan assets and thus fall naturally within the definition of fiduciary investment advice under ERISA. Moreover, SIFMA's reference to the lack of legislative history to justify its position is nonsensical. The fact that rollovers aren't specifically mentioned in either the statute or the legislative history should hardly come as a surprise, since at the time the statute was drafted IRAs were just being created and 401(k) plans did not yet exist. Indeed, the rise of

[4] Ironically, Fidelity, which has vociferously opposed the Department's best interest contract exemption as unworkable, foresees no such difficulty in getting its own contract in place.

[5] The language that Fidelity uses is specifically designed to evade the firm's fiduciary obligations under ERISA: "Guidance provided by Fidelity is educational in nature, is not individualized and is not intended to serve as the primary or sole basis for your investment or tax-planning decisions." *See, e.g.,* Fidelity Retirement Planning Overview, http://bit.ly/1JS7cCC.

the 401(k) plan, and the attendant rise of rollovers, is one of the most significant market changes that has occurred since ERISA was enacted and that demands an updating of the rules.

A number of others, including Fidelity, suggest that rollover recommendations should be treated as fiduciary investment advice only when they include specific recommendations regarding how to invest the proceeds. For retirement savers, the question of whether to withdraw funds from a pension or 401(k) plan is often at least as important as the question of how to invest the proceeds. If Fidelity's approach were adopted, however, advisers could make the initial recommendation regarding whether to conduct a rollover outside the protections of the fiduciary duty as long as they didn't also include specific investment recommendations. Once the money was withdrawn, the recommendation regarding how to invest the proceeds would be considered fiduciary investment advice. There is little mystery regarding why financial firms would prefer this approach, since their ability to syphon money out of 401(k) plans and into IRAs could continue unabated. This has been a major source of profits for financial firms in recent years, though far less beneficial for retirement savers who are too often moved into higher cost or otherwise inferior investments.

Fidelity argues that this bifurcated approach is necessary because the best interest contract exemption does not appear to apply to such recommendations. We disagree with their interpretation of the rule's application to rollover recommendations. Even if their interpretation is correct, however, their proposed solution is completely inappropriate. First, an adviser could rarely if ever know whether a recommendation to pull money out of a pension or 401(k) plan was in the best interests of the investor if they didn't have some idea about how they were going to invest the money. Thus, these sorts of generic rollover recommendations strike us as inherently suspect, driven by the adviser's desire to gather assets rather than the best interests of the retirement saver. Second, the proposed approach would make it altogether too easy for financial firms to game the rules in order to continue their current practice of recommending rollovers based on their own financial interests rather than those of the customer. If, as Fidelity and some others have suggested, there is some ambiguity about whether the best interest contract exemption applies to rollover and benefit withdrawal recommendations, the Department should simply clarify that it does.

<u>Seller's Carve-out</u>: Many industry commenters also argue that the seller's carve-out, which is available for advice to large plans, should be extended to both the retail and small plan markets.[6] ICI states, for example, that "simply selling an investment product or service cannot be a fiduciary act." The Financial Services Roundtable suggests that the seller's carve-out should apply when the advice recipient "should have no reasonable expectation that the party providing such advice is acting in the Retirement Investors' interest," but doesn't explain when it is

[6] In our original comment letter, we provided extensive evidence that many retail investors and small plans lack the financial sophistication to independently assess investment options and rely on sales recommendations as if they were objective investment advice. The fact that our comments here focus on retail investors should not be interpreted to indicate that our views regarding the small plan market have changed. In fact, new research from the Center for Retirement Research at Boston College reinforces the need to protect small plans and their participants. Mutual fund companies often help sponsors manage their plans and set the menu of investment options. According to the Center's research, it is in this role that mutual fund companies tend to influence 401(k) menus in ways that favor their own funds, especially their poor-quality funds. This has potentially adverse effects on the retirement savings of plan participants. Veronika K. Pool, Clemens Sialm, and Irina Stefanescu, *Are 401(k) Investment Menus Set Solely for Plan Participants?*, Center for Retirement Research at Boston College, August 2015, http://bit.ly/1Fhyu97.

unreasonable to expect that "advice" would be designed to serve the customer's interests. ACLI goes a step further and argues that any offering of investments or services should be treated as sales or marketing not covered by the definition of fiduciary investment advice unless there is a mutual understanding or agreement that products or services are being offered or marketed in a fiduciary capacity.

Without offering any evidence to support their claims, proponents of providing a seller's carve-out in the retail market suggest that retirement savers are perfectly capable of distinguishing sales recommendations from fiduciary advice. In its letter, for example, ACLI states their belief that "such confusion has not been an issue of any measurable degree and that this requirement should be eliminated." And ICI argues that "it does not require a high level of financial sophistication to understand that a discussion is a sales discussion." Similarly, SIFMA states that it "simply does not agree that participants cannot distinguish a sales call from trusted advice." To "support" its position, SIFMA cites research which tells us nothing about individuals' ability to distinguish sales recommendations from advice. Instead, the study in question simply shows that individuals with more trusting natures are more likely to follow advice and that few people, regardless of their propensity to trust, follow unsolicited advice.[7]

Arguments in favor of extending the seller's carve-out to the retail market are undercut by proponents' inability to describe with any clarity the difference between a sales recommendation and investment advice. Indeed, most seem to be incapable of describing this sales activity without actually describing it as investment advice. A perfect example can be found in FSI's comment letter, where a paragraph outlining their objections to the narrowing the of the seller's carve-out uses the term "advice" or "investment advice" eleven times and the term "sales" not at all. And, having described this sales-based advice as investment advice, these proponents of the expanded seller's carve-out fail to explain why it shouldn't then be treated as *fiduciary* investment advice. It seems reasonable to assume that if those arguing that there is a clear distinction between sales recommendations and investment advice can't describe that distinction and, moreover, routinely describe sales recommendations as investment advice, unsophisticated retail investors are likely to see these services as indistinguishable. It is therefore appropriate to hold all such advice to a fiduciary duty to put the customers' interests first.

In arguing that sales recommendations are easy to distinguish from fiduciary investment advice, proponents of an expanded seller's carve-out fail to acknowledge the great lengths that financial services firms have gone to over the years to obscure that distinction. Most firms call their sales representatives Financial Advisors or other similar titles. They typically describe their services as retirement planning not investment sales. And they market those services with messages the clear intent of which is to convince the retirement saver that their adviser will be looking out for their interests. As we discussed in our previous letter, this industry effort has "succeeded," leaving the majority of investors unable to determine whether their own financial professional is a salesperson or an adviser and whether the service being offered constitutes "simply selling" or fiduciary investment advice. It is simply not reasonable to suggest that, in the face of all that sophisticated messaging to the contrary, a simple disclosure will be enough to

[7] Jeremy Burke and Angela A. Hung. Trust and Financial Advice. Santa Monica, CA: RAND Corporation, 2015. http://bit.ly/1MrSRjA.

put retirement savers on their guard that they are dealing with someone who should not be relied on to provide objective advice.[8]

In short, in their eagerness to attract customers and increase sales by portraying themselves as trusted advisers, financial firms have destroyed the clear functional distinctions that might otherwise have served as the basis for a seller's carve-out. For a seller's carve-out to work, the seller would have to be clearly identified as a seller; titles such as Financial Advisor would have to be impermissible. The sales services would have to be clearly labeled as sales and not advice or planning. And clear disclosures would have to be provided regarding the limitations of the services and the lack of any obligation to act in the customer's best interests. And this would have to apply across the board and not just in the context of the retirement account. After all, the industry itself argues that retirement savers are unlikely to draw a clear distinction between the standards that apply to retirement and non-retirement accounts. To achieve that transformation in industry practices would require the cooperation of securities and insurance regulators who have, to date, been all too willing to allow brokers and insurance companies to rebrand their sales activities as advice. In the absence of any such clear distinctions, a seller's carve-out is simply unworkable in the retail market.

Sophisticated Investor: Some industry groups commenting on the rule proposal have advocated extending the seller's carve-out to "sophisticated" retail investors. In advocating this approach, they typically point to the securities law "accredited investor" definition as the appropriate vehicle for achieving their policy goal. But the accredited investor definition, as currently drafted, cannot reasonably be relied on to identify a population of financially sophisticated individuals capable of independently assessing the recommendations they receive from financial professionals. To our knowledge, no other widely accepted measure of financial sophistication exists that could be used in its place. In the absence of a reliable measure of financial sophistication, such an approach is simply not workable.

The accredited investor definition is used to identify individuals to whom private securities can be sold on the presumption that individuals who meet the definition are capable of "fending for themselves" without the protections afforded in the public securities markets. The determination of whether an individual investor can "fend for himself" has traditionally hinged on three factors: whether the individual has the financial sophistication and knowledge to independently evaluate the potential risks and benefits of an investment; whether they have the ability to negotiate access to information needed to make an informed decision; and whether they have the financial wherewithal to withstand potential losses associated with often risky and illiquid private investments. Over time, however, the Securities and Exchange Commission (SEC) has come to rely on income and net worth as proxies for financial sophistication and access to information. Thus, under the definition, an individual is deemed to be an accredited investor if he or she has annual income of $200,000 or more for two successive years ($300,000 per household) or a net worth of $1 million not including the value of the primary residence.

[8] In our original comment letter, we cited extensive evidence that conflict disclosures are ineffective at best, harmful at worst. Since then, new research has been published which shows that including a clear statement that the disclosures are legally required can help to put recipients on their guard, it is still not sufficient to counteract the strong tendency individuals have to rely on recommendations from a financial professional. Ahmed E. Taha and John V. Petrocelli, Disclosures About Disclosures: Can Conflict of Interest Warnings Be Made More Effective? (June 2015). *Journal of Empirical Legal Studies*, Vol. 12, Issue 2, pp. 236-251, 2015. Available at SSRN: http://ssrn.com/abstract=2600722 or http://dx.doi.org/10.1111/jels.12071.

There is no evidence, however, that financial thresholds of this kind serve as an effective proxy for financial sophistication. New research that looks specifically at the financial sophistication of older accredited investors shows that, while accredited investors typically demonstrate higher levels of financial literacy than non-accredited investors within particular age groups, significant numbers of accredited investors, particularly among the oldest age groups, do not appear to be financially sophisticated.[9] In a recent recommendation to the SEC to adjust the accredited investor definition, the SEC's Investor Advisory Committee expressed the view that the current definition does not effectively serve its intended function in all instances.[10] "Indeed, the limited data that exists suggests that though there is a correlation between income and financial literacy, a significant percentage of even the wealthiest investors score poorly on tests of basic financial literacy. Such tests don't begin to measure the type or level of financial sophistication needed to evaluate the potential risks and benefits of private offerings," the group wrote. The same could be said of these investors' ability to independently assess the recommendations regarding retirement investments that they receive from financial advisers. The relatively poor scores of older investors is particularly troubling in this regard.

Nor are the financial thresholds in the accredited investor definition sufficient to ensure that investors can bear the risk of loss. While $1 million is a considerable sum, it may not provide a sufficient cushion against risk, especially if the money is tied up in an illiquid asset, such as a family farm or closely held family business, or, as is particularly relevant in this context, if it consists of a retirement nest egg needed to provide a steady and reliable stream of income over many years. It would be contrary to the goals of this rulemaking if retirement savers who had diligently saved their entire careers were suddenly denied the protections of the proposed rule once their nest egg reached the $1 million mark. Moreover, the financial thresholds in the definition are likely to become steadily less protective over time. Investor advocates have argued for years that the thresholds, first set in 1982, should be adjusted to reflect inflation, but industry groups have successfully stymied those efforts.

It is worth noting, moreover, that there is no accredited investor carve-out from the protections of the fiduciary duty that applies to investment advisers under securities laws. On the contrary, investment advisers are considered fiduciaries with regard to all their clients, including institutional investors. There is even less justification for creating such a carve-out in the context of advice to those who are investing through tax-advantaged retirement accounts. The proposal's advocates appear to be motivated in large part by a desire to continue to be able to sell hedge funds and other private investments to wealthy IRA investors. But the effect of the proposal would be much broader, affecting all retirement investment advice to such investors. And it simply isn't justified, given the ability of these investors to continue to make such investments either through self-directed retirement accounts, based on advice from financial professionals who do not receive conflicted compensation, or outside retirement accounts.

While it would theoretically be possible to develop a carve-out that is based on actual financial sophistication, a reliable measure is difficult to develop and has so far not been attempted in the United States. It is certainly beyond the scope of this rulemaking for the DOL to attempt to develop such a definition. In the absence of a definition that effectively measures a

[9] Tao Guo, et al., "The Unsophisticated Sophisticated: Old Age and the Accredited Investor Definition," July 22, 2015, http://bit.ly/1KDLFhs.
[10] Recommendation of the Investor Advisory Committee: Accredited Investor Definition, October 9, 2014. http://1.usa.gov/1Vh6OVD

high level of financial sophistication, the proposed carve-out is unworkable. It would expose retirement savers to unacceptable risks, and those enhanced risks to retirement savers are simply not justified to achieve the policy goals of the proposal's advocates.

Marketing of Services: One area where industry's complaints about the broad sweep of the definition appear to be at least somewhat justified involves its effect on their ability to market their services. But that concern demands a targeted solution, not the broad new seller's carve-out or other loopholes industry has suggested to deal with the issue. Fidelity provides an excellent explanation in its letter of why a seller's carve-out does not provide an appropriate solution to this problem, since as Fidelity explains it creates an "all or nothing" approach. "Because the best interest standard does not apply to the actual investment recommendation when the carve-out applies, the carve-out defeats the purpose of the rule," Fidelity writes. "Thus the Department's proposal either imposes a fiduciary duty on the sale of an advisor's own services (where it does not belong) or removes a fiduciary standard with respect to an investment recommendation (where it does belong)." Unfortunately, the solution offered by Fidelity -- allowing the entire scope of the relationship to be negotiated outside the protections of the fiduciary standard -- could easily be exploited to define the relationship in a way that is designed to escape the application of a fiduciary standard when it reasonably should apply.

The main source of the problem related to marketing of services, according to Fidelity and others, is the inclusion of recommendations of an investment adviser or manager in the definition of fiduciary investment advice. If this language were revised to clarify that this refers to recommendations of third-party advisers or managers, and not to the marketing of the firm's own services, that would seem to address the concern without opening up broad new loopholes in the definition. Investment advisers who are fiduciaries under the securities laws remain free to market their services even though the SEC has interpreted the securities law definition of investment advice to include recommendations of investment advisers. We see no reason why a similar approach couldn't work here.

If the Department chooses to adopt this approach, it is important that the rules make clear that any such "marketing" cannot include specific investment recommendations and still qualify as non-fiduciary advice. The most obvious example being that a recommendation to withdraw money from a retirement plan in order to hire the financial professional to manage that money is not simply "marketing;" it is investment advice and, as such, should be subject to a fiduciary standard. Such an approach would avoid the more obvious pitfalls of either a broad, new seller's carve-out or Fidelity's proposed contract approach, which would give firms too much scope to define the entire customer relationship without regard to the best interests of the investor.[11]

B. The Department Should Resist Industry Pressure to Water Down the Best Interest Standard.

In addition to seeking to reopen loopholes that would allow them to evade fiduciary responsibility entirely, many industry opponents of the proposed rule have suggested changes that, if adopted, would result in a fiduciary standard for conflicted advice under the best interest contract exemption (BICE or BIC exemption) that is weak and ineffective. Industry commenters

[11] It is worth noting, in this regard, that the SEC and FINRA have held that broker-dealers have an obligation to base recommendations of account types (e.g., fee versus commission accounts) based on which are most appropriate for the customer. This is inconsistent with the approach advocated by Fidelity, in which all such decisions would be negotiated outside the protections of the fiduciary standard.

have adopted two main strategies to achieve this goal. The first is to make the standard unenforceable. The second is to remove any requirements that would force firms to abandon practices that exacerbate conflicts and undermine compliance. We urge the Department to reject any such changes. A rule that cannot be enforced or that gives lip service to a best interest standard while continuing to permit firms to compensate and reward advisers for recommendations that are not in the best interest of the customer would be unlikely to result in the meaningful changes in harmful industry practices that retirement savers need and deserve.

Commenters seeking to water down the best interest standard conveniently ignore the scope of the conflicts that pervade the broker-dealer and insurance business models. Yet it is crucial to understand the scope of the problem in order to understand why tough restrictions are needed to ensure a best interest standard provides meaningful benefits to retirement savers. In recent testimony before the House Financial Services Committee, University of Mississippi School of Law Professor Mercer Bullard described a "wide variety of compensation structures" developed by broker-dealers to "incentivize financial advisers to make recommendations that pay them the highest compensation" rather than those that are best for the investor.[12] The testimony does an excellent job of describing a sampling of common broker-dealer practices that create conflicts and the "mind-boggling" magnitude of the conflicts that can result.

To illustrate the problem, Bullard's testimony describes a series of typical scenarios to demonstrate the influence of a variety of common factors on the compensation to the broker. These include the higher commissions paid by certain types of mutual funds (in this scenario stock funds versus bond funds) and by certain fund complexes, the level of the gross dealer concession (GDC) paid to the firm and the individual adviser, and whether the purchase qualifies for a reduced commission rate known as "breakpoints." Bullard sums up this particular portion of the analysis, which is focused on differential compensation, this way:

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

Bullard notes, moreover, that, "Differential commissions represent only one way that financial advisers' recommendations are improperly conflicted. Financial advisers may also receive different levels of 12b-1 fees depending on the fund complex selected. They receive different financial benefits as a result of choosing fund complexes that pay higher revenue

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[12] Testimony of Mercer E. Bullard President and Founder, Fund Democracy, Inc. and MDLA Distinguished Lecturer and Professor of Law University of Mississippi School of Law before the Subcommittees on Capital Markets and Government Sponsored Enterprises and Oversight and Investigations, Committee on Financial Services, United States House of Representatives, *Preserving Retirement Security and Investment Choices for All Americans*, September 10, 2015, http://1.usa.gov/1V0ySje.

sharing than other complexes. The potential doubling of compensation described above grows larger as one type of improper financial incentive is stacked on another." In other words, the potential differences in compensation are substantial and are entirely unrelated to the services provided. And, while this analysis is focused on recommendations of mutual funds, there is every reason to believe that similar conflicts exist in the sale of insurance products, where the commissions paid to the broker are often even higher.

Even more egregious conflicts are associated with an industry compensation structure known as a "ratcheted payout grid," according to Bullard. Under these compensation schemes, advisers' payout ratios ratchet up as their GDC production goes up, with increased payouts applied not just to future sales, but also retroactively to their previous sales over the 12-month period. Again, using an example based on a real world payout grid, Bullard illustrates how an adviser nearing a threshold that would increase his payout ratio by 10 percentage points, and contemplating how to allocate a $20,000 investment, could face a choice between earning $120 for a recommendation of a short-term bond fund or $30,180 for a recommendation of a stock fund. It is simply not credible to suggest that such differences in compensation will not affect brokers' recommendations.

What's remarkable here, Bullard notes, is not just that firms that claim to have their customers' interests at heart create such egregious conflicts for their advisers, but that the SEC and FINRA tolerate them. We agree. It exposes the fallacy behind statements by rule opponents suggesting that the existing regulatory scheme adequately protects retirement savers, that compliance with existing standards should satisfy the BIC compliance requirements, or that the Department should follow securities regulators' lead in addressing these issues.

If such practices are to be reined in, and we believe they must be, the best interest standard imposed by the rule must be enforceable. Moreover, its enforcement cannot be left to regulators who have stood by and allowed such practices to proliferate. And the best interest standard itself must be backed by meaningful restrictions on the practices that exacerbate conflicts associated with sales-based payments. The fact that some firms have taken steps voluntarily to mitigate such conflicts provides all the proof that is needed that such a requirement is "workable."

<u>Enforceability</u>: One of the true investor protection benefits of the contract approach at the heart of the BIC exemption is its creation of an effective enforcement mechanism for the best interest standard. This is particularly important in the IRA market, where the Internal Revenue Service lacks resources for enforcement, where the SEC has a record of notably weak enforcement of the fiduciary standard under the Investment Advisers Act,[13] and where recent remarks by FINRA's CEO have raised questions about that organization's willingness and ability to enforce the standard for its broker-dealer members.[14] The availability of a remedy under state

[13] While the fiduciary duty under the Investment Advisers Act theoretically requires investment advisers to avoid avoidable conflicts, the SEC almost always accepts disclosure as an acceptable remedy even where conflicts are clearly "avoidable."

[14] In a May 27, 2015 speech by FINRA Chairman and CEO Richard Ketchum and in the comment letter it submitted to the Department, FINRA has sent an unambiguous message: 1) that broker-dealers cannot reasonably be expected to comply with the Department's new rules, specifically the "best interest without regard to" standard, and 2) that "judicial arbiters" (i.e., FINRA arbitrators) cannot reasonably be expected to evaluate compliance with the standard. This suggests reluctance on FINRA's part to enforce the standard for its members. Moreover, because those

contract law helps to ensure that financial firms and advisers can be held accountable for acting in their customers' best interests and for adopting the kinds of structural reforms to their business and compensation practices necessary to achieve that goal.

What investor advocates see as creating a much needed incentive for compliance and mechanism for enforcement, however, industry opponents characterize as creating an unwarranted liability risk for firms and advisers. ICI and FSR argue that the contractual warranties requirement should be eliminated entirely. According to ICI, "all it does is increase liability exposure without increasing investor protection." FSI states that "the BICE private right of action displaces SEC and FINRA authority over brokerage industry enforcement, and resolution of investor disputes" and that "the new state law contract right of action will prompt the plaintiffs' bar to encourage investors to forgo FINRA's complaint processes in favor of proceeding directly to court and the potential for lucrative damage awards." But SEC and FINRA have never had primary enforcement authority under ERISA, which applies more broadly than simply to broker-dealer conduct. And the BICE private right of action does nothing to interfere with the SEC and FINRA authority where it does apply. It supplements, rather than supplants, their authority in this area. And, although ICI claims there is no investor protection benefit to justify the liability risk, others have long acknowledged that liability exposure can provide an important supplement to regulatory enforcement and, particularly where regulatory resources or will are limited, play a vital role in creating an incentive for compliance that might otherwise be lacking.

The liability risk associated with the contract requirement is not disproportionate. ICI's claim that it will result in firms' being drawn into lawsuits "whenever there is an inevitable downturn in the financial markets" is a gross exaggeration. There is no evidence that investment advisers are sued whenever the market drops, though as fiduciaries under securities laws they could be held liable through state common law fiduciary claims. And, as we noted in our previous letter, the barriers to bringing a private action are considerable and the rule's standard does not support claims based on second-guessing the outcome of an investment recommendation. Moreover, as has been noted elsewhere, compliance with the ERISA fiduciary duty generally turns on whether an appropriate process has been followed and whether an informed and reasoned decision has been made.[15] Nothing about the rule proposal changes that. It simply clarifies that, in making an informed and reasoned decision, the fiduciary must set aside his or her own financial interests.

This is not to suggest that we would oppose any and all changes to the rule's contract requirements. As we indicated in our previous letter, we agree that changes can be made to ease implementation of the contract requirement without threatening its effectiveness. The litmus test must be whether the approach that is ultimately adopted ensures that financial professionals who receive conflicted compensation when providing retirement investment advice are subject to a legally binding and enforceable obligation to set aside their own financial interests and act in the best interests of their customers.

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statements are likely to be cited by defense attorneys whose clients face such claims, FINRA has poisoned FINRA arbitration as an impartial adjudicator of investors' legal rights under the Department's rulemaking.

[15] *See, e.g.,* "What It Means to Be Prudent Under ERISA," *Journal of Pension Benefits,* April 2005. http://bit.ly/1iw8LQf

Maintaining the Status Quo: Other changes to the best interest standard suggested by industry target those provisions of the rule that would force firms to mitigate conflicts. What becomes clear from the comments submitted on this topic by rule opponents is that firms want to be able to say their advisers act in customers' best interest, but they don't want to have to change compensation and other business practices that create incentives for financial advisers to do otherwise. They seek to achieve their goal of minimal regulatory impact by eliminating the "without regard to" language from the best interest standard and by eliminating, or watering down, the requirement that firms adopt policies and procedures to mitigate conflicts.

"Without Regard To": Industry attacks on the best interest standard are premised on a fundamental mischaracterization of the standard imposed under the BICE and its relation to the traditional interpretation of the ERISA fiduciary duty. A particular focus of industry concern is the portion of the standard that requires financial advisers to act "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party." ICI, for example, refers to the standard as a new fiduciary-plus standard, and says "there is a concern that the language could be construed by a court to establish a different and more stringent standard than ERISA's existing fiduciary duties." ICI adds that the language "has been read by some to require a complete prohibition of any financial interest by an adviser acting in a transaction." Similarly, ACLI claims in its letter that this provision "could easily be interpreted to imply that if an adviser has any financial interest in a retirement plan or IRA the transaction at all, he or she has violated the Best Interest standard. This includes having an interest in receiving any commission in any amount." Of course, just the opposite is true. The "best interest, without regard to" language effectively substitutes for the tougher ERISA standard that would otherwise prohibit conflicted compensation.

What industry ignores in making this argument is that there are two central components to the ERISA fiduciary duty:[16] a duty of prudence, which requires the fiduciary to "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims," and a duty of loyalty, which requires the fiduciary to discharge their duties "solely in the interest" of the plan participants and beneficiaries.[17] The duty of prudence is incorporated in the BICE fiduciary standard, but the traditional duty of loyalty is missing. Instead, the BICE substitutes a less rigorous "best interest" standard for the traditional "solely in the interest" standard. The "without regard to" language that is included as part of that best interest standard is designed to ensure that, although conflicted payments are permitted, they are not allowed to influence recommendations made to the retirement investor. In short, the "best interests, without regard to" formulation of the BICE standard represents an accommodation designed to permit the receipt of otherwise prohibited conflicted compensation while ensuring that investors are protected from the potentially harmful impact of those conflicts.

Despite that fact, a number of industry commenters have urged the Department to remove the "without regard to" language. For example, none of the alternatives from industry trade groups or firms (e.g., SIFMA, FSR, FSI, and Fidelity) that we've reviewed include this language in their "alternative" best interest standards. Ironically, this argument comes from groups like

[16] We recognize that there are additional fiduciary duties under ERISA, but these two central components are those most relevant to this discussion.
[17] David C. Kaleda, "A Matter of Trust: Standards of Conduct Under ERISA, the Exchange Act and the Advisers Act: Part 2 of 2," *The Investment Lawyer.* Vol. 20, No. 4, April 2013. http://bit.ly/1YgVmeZ

SIFMA and FINRA, which have long touted their support for SEC rulemaking under Section 913 of Dodd-Frank, from which this language was lifted.

The concerns expressed to justify this position are obviously exaggerated. SIFMA, for example, makes the patently absurd statement that "providing advice without regard to what one might earn requires that the financial professional not know what he could be paid." It also states that "the requirement that advice be 'without regard' for the financial interests of the adviser sets up a standard that an adviser will fail any time a plaintiff can prove that the adviser did not recommend the investment that paid him the least." But the burden of proof in any legal claim would be on the retirement investor to show that the compensation consideration was the basis for the recommendation. If the adviser has followed an appropriate process and can document that it has a reasonable basis for its recommendation, the investor would be hard pressed to make such a claim stick. Firms that have adopted strong policies and procedures to minimize conflicts in advisers' compensation will be further immunized against such claims.

FINRA, meanwhile, bases its opposition to the standard on the grounds that it "has not been developed under ERISA or the federal securities laws and financial institutions, their advisers and their compliance officers and counsel will be forced to anticipate its intended meaning." But that argument could be used to oppose any new standard proposed by any regulator, including FINRA, to respond to changing market conditions. It is an equally valid (which is to say invalid) argument against the adjustments FINRA recently made to its suitability standard, applying that standard to certain hold recommendations and interpreting the standard to require brokers to consider the best interests of the customer in making recommendations. It is, moreover, a prescription for regulatory paralysis that the Department can and should ignore.

SIFMA and others urge the Department to instead adopt the approach taken by FINRA, requiring that the adviser "put his client's interest before his own." Ironically, given the importance that SIFMA has placed on harmonization across regulatory regimes, their proposed approach would result in inconsistent standards if the SEC were to follow through on its pledge to adopt a uniform standard for brokers and advisers in reliance on its Dodd-Frank authority. Nor is the requirement inherently any clearer than the "without regard to" standard. What we do know is that it has not been enforced to require meaningful mitigation of conflicts. Instead, as we discussed at some length in our previous letter, this and the best interest component of the FINRA suitability standard have to date been enforced at a level that provides few if any investor protection benefits beyond those imposed by the anti-fraud standard. What seems clear, then, is that firms, in arguing for this standard to be adopted, are arguing to maintain the status quo.

Policies and Procedures: In addition to attacking the "without regard to language," industry rule opponents intent on maintaining the status quo also seek to eliminate or water down the required warranties related to mitigation of conflicts. They argue that the requirement with regard to policies and procedures – and particularly the prohibition on practices that "would tend to encourage individual Advisers to make recommendations that are not in the Best Interest of the Retirement Investor" – is not consistent with existing business practices. And they cite that disconnect between the rule requirements and current industry practices as proof that the rule does not live up to its promise to provide a "principles-based" approach that "will broadly permit firms to continue to rely on common fee practices."

In making this argument, industry rule opponents seem to be missing two crucial points. The first is that permitting advisers to receive a wide variety of types of compensation –

including commissions, 12b-1 fees, and revenue sharing payments – does not mean that every practice associated with those compensation arrangements must also be permitted. The second is that the purpose of the rule is to change conduct. When FINRA's CEO suggests that the rules "don't really describe a broker-dealer model that I'm aware of," or when SIFMA suggests that compliance would require "a substantial – if not complete – overhaul of broker compensation arrangements," their comments do not describe a problem with the rule. Rather, they illustrate the extent of the conflicts inherent in common industry compensation practices and the ineffectiveness of existing regulatory standards in addressing those conflicts.

There is a similar flaw in ICI's argument that even the requirement that a firm have written policies and procedures "reasonably designed to mitigate the impact of Material Conflicts of Interest and ensure that its individual Advisers adhere to the Impartial Conduct Standards" presents "unattainable compliance hurdles for advice providers." If this were true, it would argue not for a weakening of the warranty requirements, but rather for a return to a standard that doesn't tolerate material conflicts at all. After all, if firms cannot reasonably be expected to adopt procedures sufficient to mitigate the potentially harmful impact of conflicts, they can't provide any reasonable assurance that their advisers will ignore those conflicts and offer recommendations that serve the best interests of the customer. Surely, it is not ICI's intention to suggest that firms that receive conflicted compensation are categorically incapable of preventing the harmful impact of those conflicts and providing best interest advice, but that is what their comment letter appears to imply.

In seeking to eliminate or water down these requirements, industry rule opponents take slightly different approaches. Some, like ICI and FSR, suggest that these warranties should be eliminated entirely. They suggest that the best interest obligation that is incorporated in the impartial conduct standards (and which they have separately sought to water down) is sufficient to protect investors without the warranties. But if, as ICI also suggests, firms can't reasonably be expected to develop written policies and procedures to mitigate conflicts, there would seem to be no basis for their confidence. Others, like SIFMA and ACLI, focus primarily on eliminating the requirement that firms warrant that they do not engage in practices that "would tend to encourage individual Advisers to make recommendations that are not in the Best Interest of the Retirement Investor."

Short of a complete elimination of the warranty requirement, many industry commenters make suggestions that would water down the requirement to the point of meaninglessness. Here again, the argument that industry opponents make is based on a misrepresentation of the rule's impact. Citing the fact that examples provided by the Department are based on fee leveling, ICI and others argue that the rule would require fee leveling at the firm level or between different product types. But the Department has made clear that its examples are not intended to describe the only acceptable compliance approaches, and it has specifically requested suggestions for additional approaches that could be adopted to satisfy these requirements.

Similarly, none of the industry proposals offered as alternatives to the Department's rule proposal includes a robust requirement to mitigate conflicts.

- Fidelity's "new best interest paradigm" would rely exclusively on disclosures to address conflicts. Fidelity suggests that, "as a practical matter," advisers would have to meet the requirements in the warranties, but there is nothing in their proposal as drafted that would support that assertion.

- SIFMA's alternative includes a vaguely worded requirement that firms "[av]oid, or otherwise appropriately manage, disclose, and obtain consents to, material conflicts of interest, and otherwise ensure that the recommendation is not materially compromised by such material conflicts." SIFMA further states that the adviser should avoid material conflicts, "where practicable," but its strongly worded opposition to the proposed requirement to eliminate practices that exacerbate conflicts suggests that it doesn't envision much in the way of conflict mitigation as "practicable."
- Similarly, FINRA states its support for requiring firms to avoid avoidable conflicts and to have policies and procedures in place to mitigate and manage unavoidable conflicts. But it specifically classifies differential compensation as an unavoidable conflict, even though many if not most of the conflicts associated with differential compensation are eminently avoidable.
- FSR includes an even vaguer requirement that firms have policies and procedures in place to manage or mitigate conflicts, with no clarification of what those policies or procedures might look like.

Indeed, among the leading industry opponents who submitted alternative proposals, FSI stands out for having at least providing concrete suggestions to require mitigation of conflicts. While we believe their suggestions, which are based on FINRA "best practices," fall short of what is needed (as discussed further below), they represent a good faith effort to advance the discussion.

This stands in sharp contrast to the suggestion from ICI that "compliance training and monitoring designed to manage and mitigate conflicts," should be deemed "sufficient for compliance with the written policies and procedures condition of the BIC exemption" or that the Department "should provide examples of safe harbor policies and procedures based on existing FINRA or SEC guidance." As we discuss above, existing SEC and FINRA policies have allowed for the existence of massive conflicts of interest, including compensation that bears no reasonable relationship to the services rendered. Compliance with these weak standards should not substitute for real mitigation of conflicts. And, while training and monitoring might provide meaningful protection against the harmful impact of conflicts where firms also take meaningful steps to minimize those conflicts, it is not in and of itself a replacement for reform of the kind of industry practices that reward and encourage recommendations that are not in the customer's best interests. This is not a comprehensive solution.

We urge the Department not to give in to industry pressure to weaken this key component of the rule. It is no coincidence that industry has focused so much of its opposition on this provision. After all, if the goal of industry rule opponents is to minimize the impact of the regulation – and we believe their comments make clear that it is – then eliminating any requirement that they take meaningful steps to mitigate conflicts is central to that goal. The inevitable result would resemble what we have seen in enforcement of the securities law fiduciary duty: lip service to a best interest standard that is rarely enforced and tolerance for even the most egregious of conflicts.

C. The Department Should Provide Additional Guidance on Policies and Procedures that Would Satisfy the Warranty Requirement.

As discussed above, the Department has rightly recognized that for a best interest standard to be effective, it must be backed by meaningful restraints on industry practices that encourage advisers to work against their clients' best interest. In response to industry demands that any fiduciary rule be principles-based so as to flexibly accommodate a variety of business models, the Department has proposed a requirement that firms contractually warrant that they have adopted policies and procedures that are reasonably designed to mitigate the harmful impact of conflicts of interest and to ensure that individual advisers adhere to the impartial conduct standards. Importantly, the Department did not mandate the specific content of the policies and procedures that firms should adopt. According to the Department's release, the reason for providing such flexibility was to allow firms to develop policies and procedures that are effective for their particular business models, within the constraints of their fiduciary obligations and the impartial conduct standards.

In short, the Department proposed precisely the approach that industry demanded. Moreover, the Department sought comments on all aspects of its discussion of the sorts of policies and procedures that would satisfy the required contractual warranties. In particular, the Department requested comments on whether the exemption should be more prescriptive about the terms of policies and procedures or provide more detailed examples of acceptable policies and procedures. That has not stopped industry rule opponents from claiming, often simultaneously, that the proposed requirement is both not sufficiently principles-based and not specific enough in its requirements. For the most part, however, industry commenters have thus far ignored the Department's request for constructive feedback on this aspect of the rule. In particular, they have failed to provide comments on the types of policies and procedures that would satisfy the requirement, preferring to argue for approaches that would eliminate or dramatically weaken the requirement.

While we do not believe the Department can or should incorporate detailed requirements in the text of the rule, we do believe it would be beneficial for the Department to provide additional compliance guidance in this area. Since it remains to be seen whether industry commenters will take seriously the request for constructive feedback on this aspect of the proposal or continue to focus their efforts on eliminating this portion of the rule, we've suggested below the types of policies and procedures that we believe would help to mitigate the harmful impact of conflicts that encourage advisers to make investment recommendations that are not in their clients' best interest.

In developing these suggestions, we recognize that it is not possible to eliminate all conflicts, particularly at the firm level. Our goal has been to identify approaches that minimize conflicts at the adviser level, including practices that are likely to cause firm level conflicts to flow through to the adviser. In this regard, we applaud the Department for recognizing that it is not simply compensation alone that can create hard-to-resist incentives to make recommendations that do not serve the customers' interest. Restrictions on use of bonuses and personnel decisions and non-cash rewards must be included. Moreover, past experience has shown that, for this to be effective, management of conflicts at the branch manager level is also critically important. Better still would be practices that reward best interest recommendations. Consistent with the Department's proposed warranty requirement, the first step toward development of appropriate policies and procedures must be the identification of material conflicts of interest, elimination of those that are avoidable, and appropriate management of those that are not.[18]

[18] In this regard, we would note, for example, that differential compensation may not be avoidable at the firm level, but it clearly is avoidable at adviser and branch manager level.

- Levelizing compensation and any other rewards to advisers and branch managers for transactions in the same types of investments.

As discussed above, advisers can earn dramatically different levels of compensation for recommending investments of the same type based on such factors as the commission and gross dealer concession paid by the product sponsor and often shared, on a percentage basis, with the adviser. This creates an incentive for the adviser to recommend investments that pay higher commissioners or offer higher GDCs. Yet, any difference in time and analysis necessary to provide prudent advice with respect to the same types of investments should be deemed de minimis and thus not justified based on a neutral factors analysis. To be clear, this policy would not require compensation to be level at the firm level. Instead, any broker-dealer concession in excess of the level fee paid to the adviser would accrue to the firm, unless it were rebated to the investor. Nor would it require an investor's expenses to be level. An adviser could recommend a product that costs the investor more if it were the best fit for the investor. However, the adviser would not receive any additional benefit for recommending that investment. Under this policy, an adviser and his or her branch manager could not receive higher total compensation as a result of recommending:

- certain mutual fund complexes over others;
- proprietary vs. non-proprietary platform funds;[19] [20]
- certain asset and sub-asset classes (equity vs. fixed-income, or domestic vs. international, or growth vs. value);
- a certain share class over another;
- certain variable annuities over others, or certain fixed annuities over others.

Differential compensation among different types of investments would still be permitted to the extent that it could be justified on neutral factors related to the time and expertise necessary to research and develop an appropriate recommendation.

- Prohibiting advisers from making recommendations that seek to manipulate breakpoint discounts.

Advisers have an incentive to allocate investors' money across a variety of fund complexes in order to avoid triggering breakpoints that would lower the commission and, with it, the adviser's compensation. Securities regulators have taken enforcement actions based on egregious violations, but more can be done to discourage such practices. An effective means would be to cap the compensation paid to the adviser based on the entire investment amount and at the lowest sales charge tier among the fund complexes recommended. For example, if an

[19] According to FINRA's Conflict of Interest Report, several firms already have such a policy. *See* Report on Conflicts of Interest, FINRA, at 30, http://bit.ly/1Kxdp9z. ("An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.")

[20] Firms that make non-proprietary funds available on their platform should be able to recover the added costs of doing so and accept reasonable compensation for providing shelf space on the platform, but the individual advisers should not be paid to preference either the proprietary funds or funds that make such payments. Some have suggested that firms might respond by dropping nonproprietary funds from their platform, but we believe the competitive benefits associated with offering a broad and diverse array of funds and the ability to make a reasonable profit would be sufficient to discourage such a response.

investor has $50,000 to invest, that amount would typically qualify for a breakpoint discount on the front-end load (potentially lowering the commission from 5.75 percent to 3.75 percent, for example). However, if the adviser were to recommend splitting the $50,000 between three fund complexes (for example $20,000, $20,000, and $10,000) the investor would not qualify for breakpoints and would have to pay the full 5.75 percent load, maximizing the adviser's compensation. Under our suggested approach, an adviser's compensation would be calculated based on the $50,000 investment and whichever of the three fund complex's breakpoint schedule is most favorable to the investor. While it wouldn't entirely eliminate incentives to avoid fund complexes with low breakpoint levels, such an approach would significantly reduce the financial incentive to manipulate breakpoints in ways that are harmful to clients.

- Prohibiting exponential or "ratcheted" payout grids that disproportionately increase advisers' payouts based on incremental increases in sales.[21]

As described in the previous section of this letter, ratcheted payout grids have the potential to expose financial advisers to truly mammoth conflicts as they approach sales thresholds that qualify them for an increase in their payout percentage. We believe such practices, which increase payouts retroactively as well as on future sales, create unacceptable conflicts and should be banned outright. According to FINRA's Conflict of Interest Report, several firms already have adopted such a policy. In fact, the FINRA report states that "Several firms with which FINRA met do not use a grid structure based on production. Some of these firms base payout percentages on a registered representative's years of service." However, even those who prefer to maintain a more sales-focused compensation regime could create progressive, non-ratcheted payout grids that do not disproportionately increase advisers' payouts based on incremental increases in sales and do not apply any such increases retroactively. Even if such an approach were adopted, firms would need to provide additional monitoring of recommendations made at or near payment thresholds.

- There must be meaningful constraints on firms' ability to justify differential compensation to advisers for different product types based on "neutral factors" analyses.

We recognize the appropriateness of allowing advisers to receive differential compensation based on neutral factors, but we are concerned that it could present opportunities for abuse. The Department should seek to ensure that this provision isn't used to evade the separate requirement that adviser compensation must bear a rational relationship and must be proportional to the additional time and analysis advisers spend in order to make recommendations.

To illustrate the potential problem based on the bullets above relating to breakpoints and "ratcheted" compensation: annuities don't typically provide breakpoint discounts that reduce concessions paid to the broker, whereas mutual funds often do. And commissions on certain types of annuities are often significantly higher than those on mutual funds. This means an adviser can often make significantly more on the sale of an annuity than on a mutual fund sale of

[21] FINRA Conflict of Interest Report at 29 ("A conflict is created, however, if a representative's desire to move to a higher payout level influences the number or type of recommendations he makes to customers. This conflict may be heightened when there is a relatively large increase in the percentage payout between revenue tranches; when there is a high probability that a few, incremental sales will move a registered representative to a new payout level; or where increased payout percentages are applied retroactively once a threshold is satisfied.").

comparable size, particularly when dealing with the relatively large sums involved in a rollover recommendation. On a $500,000 rollover, for example, a recommendation to invest in an annuity could result in a six percent concession, whereas a recommendation to invest in a mutual fund with breakpoint discounts could result in a two percent concession. The difference in broker concessions on these recommendations would be $20,000 ($30,000 for the annuity vs. $10,000 for the mutual fund). Assuming an adviser receives a 40 percent payout, the adviser would make $8,000 more on this transaction for recommending the annuity.

While there may be differences in the time needed to research and analyze the recommendation, such a significant differential in compensation for what may only be several extra hours of the adviser's time is unjustifiable. We are not advocating requiring a neutral compensation grid for different products, as we believe it is justifiable to pay advisers for the services they provide, including any meaningful (i.e. not de minimis) additional time, research, and analysis that is required for advisers to understand, explain, and recommend more complex products such as annuities. However, advisers' compensation must bear a rational relationship to the services provided and must be proportional to the additional time and analysis advisers spend in order to make recommendations.

- Restricting the tying of non-cash compensation and cash bonuses for advisers and branch managers to sales.

Financial firms offer a variety of often lavish rewards based on an adviser's success in meeting sales goals. That can include vacations, attendance at conferences, entertainment, education and training, promotions, participation in recognition clubs, such as president's clubs, and inheriting another adviser's book of business. The more lavish the reward, the greater incentive it can create to make recommendations based on the desire to win the reward, rather than the customer's interests. The cleanest approach to dealing with this issue would be to prohibit entirely the tying of cash bonuses and non-cash rewards to sales. This would include prohibiting the indirect tying of compensation to revenue sharing that is paid to the firm as a result of the adviser's or branch manager's sales performance. At the very least, firms should be prohibited from tying any such rewards to the sale of particular investment products or product lines. Development of reward programs based on factors that align with customer interests would be better still.

- Requiring advisers to document the basis for their investment recommendations.

Whether a particular recommendation satisfies the prudence standard under ERISA turns in large part on whether the adviser followed an appropriate process and made a reasoned decision. Documentation of the basis for the recommendation is crucial to determine compliance, including whether the decision appears to have been made without regard to the adviser's own interests. Documentation should explain the basis on which the adviser concluded the recommendation was in the client's best interest, as outlined in the impartial conduct standards, and why the adviser dismissed reasonably available alternatives as inferior options. This requirement will help to ensure that advisers undertake a procedural and substantive best interest analysis based on each investor's unique circumstances when making investment recommendations, rather than simply recommending the investment that is most profitable for them. On the other hand, compliance with this requirement should not provide a safe harbor, whereby fully documenting the basis for the recommendation satisfies the adviser's best interest obligation.

In addition to documenting the fundamental question of why a particular investment recommendation is in the client's best interest, the adviser should assess how the recommended investment measures up against the criteria upon which the BICE's list of accepted assets is based. In our previous letter, we provided a number of such factors in addition to the three (transparency, liquidity, and the availability of a ready market price) listed in the proposing release, including: having transparent product features and not being excessively complex in structure; having a sufficient track-record to demonstrate the investment's utility; and not being excessively leveraged. At the very least, advisers would need to be able to answer the following questions when documenting the basis for their recommendations:

- If another product is reasonably available (for example on the firm's platform) that would achieve the same or a similar objective and costs less, what is the justification for recommending the higher cost option?
- If the adviser recommends a product that pays a higher gross dealer concession, 12b-1 fee concession, revenue sharing payment, or any other concession to the adviser's firm than a reasonably available alternative that achieves the same or a similar objective, what is the justification for recommending the higher paying product?
- If the adviser recommends one share class over another, what is the reason behind that decision?
- If the adviser recommends a tax-preferred product inside a tax-preferred account, what is the justification for the recommendation and why does that justification override the tax redundancy?

While this is not an exhaustive list of the policies and procedures firms could adopt to mitigate conflicts, we offer these suggestions as a starting point. The fact that, in many cases, some firms have already adopted these practices provides conclusive proof that they are "workable." Alternatively, firms could seek to develop compensation and bonus structures that reward advisers who do well for their clients, recommending investments that match their goals and risk tolerance and meeting appropriate performance benchmarks. In addition, as discussed further below, we believe that if firms have to clearly and publicly disclose the conflicts of interest in their business model, and what steps they take to mitigate those conflicts, they may be more likely to avoid practices that would appear unseemly to the public eye. Finally, by providing additional guidance with release of the final rule and during implementation, the Department can help smooth the transition for financial firms and advisers.

D. The Department Should Resist Industry Pressure to Water Down the Reasonable Compensation Standard.

Although this issue has gotten less attention than industry efforts to water down the best interest standard, several industry commenters have argued for changes to the reasonable compensation requirement that would render it essentially meaningless. Both ICI and the Financial Services Roundtable, for example, have argued that market forces should determine what constitutes reasonable compensation. ACLI suggests that the standard should reflect compensation that is "reasonable and customary." What these approaches have in common is a desire simply to rubberstamp existing compensation practices some of which are, in our view, far from reasonable.

The common theme of these suggestions is that market competition is adequate to discipline compensation and ensure that it is reasonable. ICI states, for example, that "It is crucial that a highly competitive marketplace for investment products determine reasonable compensation." There are several fallacies behind this argument. The first is that a competitive market for investment products can ensure reasonable compensation for investment advice. In fact, in a market where investment products compete to be sold not bought, market forces are more likely to drive compensation up not down, particularly for those investment products that cannot compete based on quality and cost. Thus, a "reasonable compensation" requirement is needed to discipline the potentially harmful impact of these sorts of market forces.

Second, the reasonable compensation requirement at issue here relates specifically to third-party payments and other forms of compensation over which investors typically have little control. For investors to impose some form of market discipline on these costs, they would first have to know what they are paying, they would have to understand how that compares to other alternatives, and they would have to have some ability to affect those payments. Research by Cerulli Associates found, however, that 31 percent of investors aren't sure how they are paying for investment advice, and another 29 percent believe the advice is being provided for free. That already appallingly high number doesn't take into account those who know how they are paying, but don't have a clue what the total cost is for the advice they receive.

Understanding the cost of the advice is relatively straightforward compared with the complexities that often govern the actual compensation to the adviser. Investors who don't know what or how they are paying for advice are even less likely to understand the details of how their adviser is compensated. Among other things, they are unlikely to know how significant the compensation differences can be for different products, how much compensation could be riding on a single recommendation under certain types of payout grids, or what the implications are for the recommendations they receive. Moreover, as discussed in the previous section of this letter, the differences in compensation for essentially identical services can be enormous and often bear no relationship to the services provided.

Finally, under the sales-based business models governed by the BIC exemption, the adviser's compensation isn't typically negotiated between the investor and the adviser. Instead, product sponsors and financial firms set the conditions of that compensation. As a result, investors have even less control over these payments to advisers than they do over the total costs of the advice. Under the circumstances, it is absurd to suggest that market forces can be relied on to keep compensation reasonable. Nor are existing regulations adequate to ensure that compensation is reasonable, as the above discussed examples should make all too clear. Thus, the Department should also reject suggestions that it simply accept as inherently reasonable any compensation that doesn't violate existing regulatory requirements imposed by securities and insurance regulators.

Instead, the rule's reasonable compensation requirement should work in tandem with the warranties related to differential compensation to ensure that any differences in compensation are based on neutral factors and are reasonable in relation to the services provided. To do so, the Department should retain in the final rule a requirement that fees be reasonable, and not simply customary, and that they be reasonable in relationship to the services provided.

E. The Department Should Use Disclosures to Reinforce the Rule's Core Features.

Wading into an area that insurance and securities regulators have badly neglected, the Department has attempted to develop a disclosure regime that would give investors timely and detailed information about the price they pay for retirement investment advice and investment products and the conflicts of interest that can encourage financial firms and their advisers to steer customers into products that do not serve their best interests. Financial firms and their trade associations have strenuously resisted the Department's proposed disclosures, arguing that they are too burdensome and costly and cannot reasonably be complied with. That firms claim they couldn't possibly provide clear and timely disclosures regarding costs and compensation is a sad commentary both on the unnecessarily complex and Byzantine systems industry has erected and, even more so, on the insurance and securities regulators who have failed to take effective action either to rein in conflicts of interest or to require clear and timely disclosures of material costs and conflicts. It is frankly appalling that, despite over a decade of entreaties from investor advocates, these regulators have failed to require brokers and insurance agents to provide clear dollar amount disclosures of the costs of the investments they recommend and the costs of the services of the broker or agent in recommending those investments. Their regulatory failure makes it doubly challenging for the Department to develop a workable disclosure regime that cuts across different investment products and business models.

While we support the Department's efforts to bring clarity to this mare's nest, we do not view the rule's disclosure requirements as core elements of the rule where no concessions can or should be made to accommodate industry concerns. Should the Department consider streamlining the rule's disclosure requirements,[22] we would urge you to retain those elements that are most likely to support retirement investors' ability to make an informed choice among financial professionals and bring market forces to bear on industry practices that increase costs and conflicts. As we discussed in our previous letter, research indicates that investors do not typically make good use of information on conflicts of interest. Once they have chosen a financial professional, they are strongly disposed to rely on that individual's recommendations, and disclosures regarding conflicts do little to change that. Pre-engagement disclosures that alert retirement investors to potential conflicts and limitations on services before they commit to the relationship are, in our view, likely to be more effective in helping these individuals to avoid business relationships that are likely to put their interests at risk.

Several industry commenters have expressed support for a form of up-front disclosure that could be adapted to fulfill this function. FSI, in particular, has proposed an up-front disclosure that includes much of the information that we believe would be appropriate in such a document. Specifically, FSI calls for a creation of a short-form disclosure document, provided as part of the account opening process, that would include the following elements:

- "A statement of the best interest standard of care owed by the Financial Institution to the client;

[22] Should the Department decide to streamline the BICE disclosure requirements, it should reconsider including non-securities annuities under the BICE, rather than providing relief exclusively under Exemption 84-24. It is our understanding that they were excluded from the BICE because of their inability to comply with the exemption's proposed disclosures. This would reduce the rule's inconsistencies across product types, would simplify compliance, and would make those annuities eligible for compensation, such as revenue sharing payments, not permitted under 84-24.

- The nature and scope of the business relationship between the parties, the services to be provided, and the duration of the engagement;
- A general description of the nature and scope of compensation to be received by the Financial Institution and financial advisor;
- A general description of any material conflicts of interest that may exist between the Financial Institution, financial advisor and investor;
- An explanation of the investor's obligation to provide the Financial Institution with information regarding the investor's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other relevant information the customer may choose to disclose, as well as an explanation of the investor's obligation to inform the Financial Institution of any material changes in this information;
- A statement explaining that customers may research the Financial Institution and its financial advisors through FINRA's BrokerCheck database or the IARD;
- A phone number and/or e-mail address the investor can use to contact the Financial Institution regarding any concerns about the advice or service they have received; and
- A description of the means by which a customer can obtain more detailed information regarding these issues, free of charge, including a link to the section of the Financial Institution's website featuring the second tier disclosure."

While there are adjustments we would make to this list, FSI has done a good job of identifying the essentials. The following are key areas where we believe their model can and should be improved.

- The statement regarding the best interest obligation should cover the financial adviser as well as the financial institution.
- The disclosure should include a description of the services provided by the firm and the adviser, including any significant limitations on those services (such as the sale of only proprietary products).
- The disclosures regarding conflicts of interest should make clear that the firm is legally required to make these disclosures, as recent research suggests that this increases the likelihood that investors will take the disclosures seriously. Moreover, the disclosures should not be meaningless boilerplate about conflicts the firm or adviser "may" have. Instead, they should be firm-, adviser-, and product-specific and convey the nature and extent of any material conflicts.
- The document should clearly describe how the retirement investor will pay for the services. Where the retirement investor pays for advice through commissions or other forms of transaction-based payments, that should be made clear.
- The statement regarding the ability to research the financial institution and its advisers should make clear that these databases include information on the adviser's disciplinary record and whether the adviser is appropriately registered. We are not aware of a similar database for non-securities professionals, but any such information should be included if it is available.

Developing such a disclosure, and including the best interest obligations of the adviser, could be particularly important if the Department provides greater flexibility around the timing of the execution of the best interest contract. If the disclosure is provided in a timely fashion, it could promote better informed decision-making regarding the selection of financial professionals. Toward that end, we would settle for less specificity around certain engagement-related issues – e.g., the exact nature and scope of the relationship – in return for earlier delivery of the document. To the degree possible, we'd prefer to see such disclosures provided at the first point of contact, rather than at the point at which the decision has been made and the relationship is being sealed.

A second priority should be requiring disclosures that will help to bring market forces to bear to rein in excessive costs and conflicts. As we discussed in our previous letter, even those investors who are not cost- or conflict-sensitive can benefit indirectly from such disclosures. The public website disclosures proposed by the Department represent the best mechanism for achieving this goal. While we appreciate the Department's desire to make those disclosures as granular as possible, we recognize that the level of detail in the Department's proposal drives much of industry's complaints that the disclosures are unworkable or excessively burdensome. While some of industry's complaints may be hyperbolic, we do believe it is possible to derive much of the benefit, at significantly less cost, through a somewhat less detailed approach.

The primary purpose of the website disclosures would be to provide more complete and detailed information about the nature and extent of conflicts related to the delivery of retirement investment advice by the financial institution and the financial adviser. That would start with an expanded discussion of the firm's business model(s) and the material conflicts of interest associated with that business model. The discussion should be product-, adviser-, and compensation-practice-specific. If, for example, a firm receives revenue-sharing payments, it should provide information that is sufficiently detailed to identify the sources, amounts, and uses of those payments. The same would be true for any other concessions paid by or to the firm, including GDCs and 12b-1 fees, for example. The firm should also be required to describe its compensation practices, including details on payout grids as well as any non-cash compensation or rewards. This would not necessarily require the detailed, dollar-amount breakouts of compensation sources and amounts by adviser anticipated under the proposal. A similar approach could be taken to the presentation of cost information for various investment products and services. Again, it might not be necessary to break out every detail of those costs to provide value from the disclosures.

It is worth noting, moreover, that to the degree that firms take seriously their obligation to mitigate conflicts, any such disclosures should be considerably easier to provide. In the previous section, we have described practices that firms could adopt to dramatically reduce compensation-related conflicts of interest. Not only would these practices bring firms into compliance with the requirement to eliminate practices that undermine the best interest standard, they could significantly reduce any costs or burdens associated with conflict disclosure. If, for example, a firm adopted a policy of level compensation within product categories (for all mutual funds, for example), its disclosures related to compensation and conflicts would be comparably simplified, and presumably the cost to maintain those disclosures would be reduced.

Our hope is that third-party information processors would be able to analyze and digest these website disclosures and present the information in a user-friendly format, comparing costs and conflicts against benchmarks and norms, for example. If this were to occur, investors could use that third-party information to make better, more informed decisions when selecting retirement investment advisers. That, in turn, could encourage financial institutions to respond by competing to reduce costs and conflicts, which would bring indirect benefits even to those retirement savers who are not cost- and conflict-conscious shoppers. Regulators could also benefit from the increased clarity that would be provided around practices that would benefit from additional scrutiny and oversight. While disclosures cannot substitute for a strong best interest standard and real mitigation of conflicts, measures such as these could serve as a useful supplement to the rule's core provisions.

II. The Department Must Not Give Undue Weight to Industry Economic "Studies" That Purport to Discredit the Department's Regulatory Impact Analysis.

Industry groups have developed a finely honed strategy in recent years for killing regulations they oppose by challenging them in court. As part of that strategy, firms and their trade associations attempt to create a Catch 22 for regulators, first demanding that they justify their rules based on an extensive cost-benefit analysis, then refusing to provide the data to support that economic analysis, and finally challenging the regulation in court based at least in part on the claim that the economic analysis conducted by the regulator was insufficient. That strategy is very much on display both in industry rule opponents' comments on the Department's Regulatory Impact Analysis and in the "studies" they have submitted challenging the RIA's conclusions.

For years industry rule opponents have been arguing that there is no evidence of harm to retirement investors that necessitates a modernization of the rules that apply to retirement investment advice. As part of their campaign to get the Department to withdraw its 2010 rule proposal, they demanded that it conduct a more extensive economic analysis to justify the rule. When the Department requested data from industry trade groups that could help the Department evaluate the impact of retirement investment advisers' conflicts of interest, they refused to provide any relevant data. Moreover, the Department is not alone in having unsuccessfully requested that the industry provide data for it to analyze. Academics have made the same request, to no avail. According to Boston College Professor Jonathan Reuter's hearing testimony, "So getting account-level data on broker clients is tough, and if you ask firms, they'll typically say no." Reuter said that the lack of academic papers analyzing account-level data is not for a lack of trying. "The lack of academic papers studying the behavior of broker clients and broker-sold mutual funds in the United States reflects the inability of academics to obtain account-level data rather than the lack of interest by academics."

So, when industry claims, as they do here, that the Department has not cited sufficient evidence to justify its rule, it is important to remember that industry itself is directly responsible for any lack of data. But it is equally important to recognize that industry is basing its criticism on a legally flawed analysis of what the Department is required to demonstrate through its economic analysis in order to justify its proposed regulatory approach. As a careful reading of Executive Orders 12866 and 13563 makes clear, the Department is not required to put a precise dollar figure on the potential costs or benefits of the rule. It does not have to provide data, as SIFMA suggests, that directly compares "the performance of accounts with a financial advisor who is a fiduciary to the performance of accounts with a broker or other financial advisor who is not a fiduciary" in order to justify is regulatory approach. And, contrary to ICI's assertion, it is not required to "clearly justify *any restrictions* on future access to guidance, products, and services resulting from the Department's rule." [Emphasis added.] Instead, as both executive orders make clear, the Department is required to reach "a reasoned determination" that the benefits of the rule justify its costs and that the regulatory approach it has proposed maximizes "net benefits."

In reaching that determination, according to the executive orders, the Department must use "the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible." In doing so, however, it should also "recogniz[e] that some costs and benefits are difficult to quantify." Difficult to quantify costs and benefits are not to be simply ignored. Rather, as the Executive Order 12866 provides and Executive Order 13563 reaffirms, "[c]osts and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider." Finally, the analysis must be based on "the best *reasonably obtainable* scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation." [Emphasis added.] Executive Order 13563 further emphasizes that agencies must "ensure the objectivity of any scientific and technological information and processes used to support the agency's regulatory actions."

In other words, the Department must do its best, using the best, most objective data available, to analyze the potential costs and benefits of the rule and, recognizing that any such analysis will be inherently limited and imprecise, reach a reasoned conclusion that the benefits justify the costs. In contrast to the industry "studies" and "analyses" discussed below, the Department has more than met that standard. It has clearly described the problem its rule is intended to address, citing to independent, peer-reviewed research to support its conclusions about the nature and scope of that problem. It has clearly explained how its proposed regulatory approach is intended to address the problem and requested comments on this and potential alternative approaches, including comment on the relative costs and benefits of those alternatives. We have no doubt that, before finalizing the rule, the Department will give full and careful consideration to credible commentary regarding the rule's potential costs and benefits.

But, as we discuss in more detail below, the Department cannot and should not give undue weight to industry funded advocacy pieces dressed up as economic analysis. Unless the studies are based on data that is publicly available, using a clearly described methodology based on reasonable assumptions, they cannot reasonably be deemed to meet the objectivity standard that governs the technical information the Department is permitted to rely on in assessing the likely economic impact of its rule. Like other comment submitted in support and opposition to the rule, they can inform an assessment of the rule's benefits and costs, but they cannot reasonably be relied on to estimate those costs.

ICI

ICI has taken the lead among industry rule opponents in challenging the Department's economic analysis. It centers its attack on the RIA on three basic arguments: 1) that the academic studies cited by the Department either are not relevant or are not sound and do not support the RIA's "sweeping" claims; 2) that investors' actual experience with broker-sold funds contradicts the RIA's claims; and 3) that the Department's analysis fails to account for some costs, including the economic impact of moving investors to fee-based accounts and the societal harm of investors' losing access to advice and guidance. Upon closer examination, however, none of these criticisms holds water.

1) Contrary to ICI's assertion, the academic research cited by the Department is both relevant and sound and the Department's reliance on that research in the RIA is appropriate.

ICI criticizes much of the academic research relied on by the Department on the grounds that it does not capture the current state of the market for mutual funds sold with front-end loads. They base their argument on the fact that in 2000, only about half of funds with a front-end load share class also had a no-load share class, but by 2010, about 90 percent of funds with a front-end load share class also had a no-load share class. However, by focusing on the number of share classes instead of the amount of money in the various share classes, ICI creates a misleading impression that the market is less segmented than it actually is. According to ICI's own data, the amount of money in front-end load share classes has grown from approximately $1.7 trillion in 2005 to approximately $2.1 trillion in 2014. And while the amount of money in retail no-load funds has grown at a faster pace than front-end load funds, the amount of investor dollars in front-end load funds still represents a significant portion (approximately 29 percent) of the retail market. While this is a decrease from 2005, when that figure stood at approximately 36 percent, it is not sufficient to justify ICI's conclusion regarding the relevance of academic research.

In its effort to discredit the academic research relied on by the Department, ICI has focused particular attention on an analysis of the effect of incentives on fund flows and performance by Susan Christoffersen, Richard Evans, and David K. Musto (CEM). Their paper, "What do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives," is cited extensively by the Department in support of its conclusion that financial incentives influence adviser conduct and do so in ways that are often harmful to investors. ICI makes several erroneous claims in its critique of that research. We understand that Christoffersen and Evans have provided a response showing why ICI's claims don't withstand scrutiny. The following is a brief explanation of some of the chief flaws in ICI's critique.

ICI's first erroneous claim is that CEM mistakenly interpret the relationship between loads paid to brokers and fund flows. They say that the researchers "assume that a fund can increase the amount that it pays to the broker without increasing the loads that it collects from the investor." ICI then claims that "to increase the amount that funds pay to brokers, most funds would be required to increase the load that they collect from investors....Accounting for the effect of paying out higher front-end loads amounts to brokers, which must be recaptured by charging higher front-end loads, would lead to a drop in sales--not an increase in sales." ICI appears to intentionally ignore the fact that different fund complexes pay different percentages of the load to the broker in the form of GDC payments, creating different incentives even among funds that charge the same front load. Moreover, as discussed above, the percentage of the GDC paid to individual advisers can vary greatly, not only from firm to firm among brokers but also within firms, where payout percentages may increase as the financial advisor meets certain sales quotas. Thus, particularly at the individual adviser level, the financial incentive to recommend a particular fund can vary dramatically without any change in the load charged by the fund.

More to the point, ICI's critique identifies as a weakness one of the key strengths of the research, that it isolates the effect of the incentive payment to the broker. In essence, ICI is criticizing CEM for holding loads constant so as to isolate the effect of the incentive payment to the broker, and is arguing that the correct approach is to compare different load funds to determine brokers' incentives. In other words, where CEM have taken great care to compare apples to apples, ICI urges comparing apples to oranges. For example, where CEM have purposely compared funds with a 4 percent front load to other funds with a 4 percent front load to isolate the incentive associated with the percentage of load paid to broker, ICI is arguing that CEM should be comparing funds with a 4 percent load to those with a 3 percent load. However, doing what ICI recommends would introduce different variables into the analysis, including the effect of consumer preference for lower cost funds. Such an approach would make it impossible to isolate brokers' incentives. According to CEM's findings, when loads are fixed but the actual incentive to the broker is greater in one instance than in the other, paying the broker a higher share of the load increases the fund flows to that fund compared with the fund that pays a lower share of the load to the broker. In other words, financial incentives matter, just as anyone who believes in the power of market forces would expect.

ICI's second erroneous claim is that CEM "improperly apply the relationship between the 'excess load' paid and the underperformance of the fund....When they attempt to measure the economic significance for the investor, they incorrectly multiply the coefficient on the 'excess load' variable by the average load paid, and argue that the typical fund underperforms by 1.13 percent annually. But the regression relating fund performance and loads was not using the actual load, but using the 'excess load.' The residuals of their first regression measuring the 'excess load' should have a mean of zero. Taking the results from their analysis literally, they should conclude that on average broker-sold funds neither underperform nor outperform their Morningstar category average."

So, where CEM used 2.3 percent, the average load paid to an unaffiliated broker, as the multiplier for its analysis, ICI is claiming CEM should have used zero as the multiplier. Its justification for this approach is that the average excess load necessarily would be zero, since funds with positive excess loads and funds with negative excess loads effectively would cancel each other out. However, structuring the analysis this way would mean brokers don't receive any compensation, which makes no sense. Furthermore, as any reasonably smart third grader knows, by using zero as the "correct" multiplier, ICI has ensured that any coefficient that is multiplied by zero will equal zero. The crux of the problem with this approach is that they are saying that, if the broker is paid no extra money to sell the fund, then this creates no incentive problems. While this is true, this is not the point of the economic analysis or at the heart of the debate. If it were, then we would all agree that one way to stop incentive problems is to stop paying brokers to sell products, but that would be a ridiculous position to take.

More generally, ICI argues that the academic research cited by the Department does not directly address the core question raised by the Department's proposal – whether investors would be better off using an adviser who is a fiduciary. But, as discussed in the introduction to this section above, this imposes an inappropriate standard for the conduct of economic analysis. The academic analyses routinely relied on by regulators are necessarily tailored to the intellectual curiosities of the investigators, the limitations of their data sets, and innumerable other variables. Here, as is common, there is no set of studies that is perfectly on-point. As noted above, this is in no small part the result of industry's refusal to provide the account level data either to the Department or to academic researchers that would support such an analysis.

However, this limitation does not foreclose the rulemaking. To the contrary, since the adoption of Executive Order 12866, the Department and other agencies have continued to adopt hundreds of rules and regulations—all without directly dispositive academic support. To the extent that relevant academic work is "reasonably obtainable," meets the objectivity standard for technical information relied on in economic analysis, and helps to support a reasoned assessment of the likely benefits and costs of the rule, it can and should be relied upon by the Department in conducting its regulatory impact assessment. Moreover, while ICI is critical of the peer-reviewed research relied upon by the Department in its analysis, the ICI Letter offers no meaningful replacement. The ICI Letter does not cite to any line of academic studies or research omitted by the Department in its analysis. Instead, the ICI offers selected conclusions tailored from its own data to support its advocacy position.

2) ICI's analysis of investors' experience with broker-sold funds is misdirected and incomplete.

ICI also attacks the RIA finding, based on academic research, that broker-sold funds underperform. ICI argues that, in order to determine whether such funds actually underperform, annual returns for front-end load share classes and retail no-load share classes should be compared to Morningstar Category Returns. And it offers its finding that investors who own front-end load funds have concentrated their assets in funds that outperform the Morningstar category average as proof that there is "no compelling need" for "significant regulatory action." However, comparing fund performance with Morningstar averages is a meaningless exercise. Furthermore, such a comparison says nothing about how adviser conflicts do or don't impact performance or whether flows that are influenced by conflicts of interest perform better or worse than those flows that are not influenced by conflicts of interest.

ICI's approach of comparing within Morningstar categories also falls short because it doesn't control for risk between categories. As Professor Bullard illustrated in his House testimony, different types of funds pay often dramatically different compensation to advisers, with stock funds, for example, paying considerably more than bond funds. This creates a financial incentive for advisers to steer clients to higher-risk funds that pay the adviser more, even if a lower-risk fund would be in the client's best interest. A comparison based on fund categories fails to offer relevant data regarding this pervasive conflict.

Even with everything ICI does to massage the numbers, its analysis of fund performance still supports a finding that front-load funds underperform direct-sold funds, just by less than the underperformance found in the Department's analysis of the academic research. According to ICI's analysis, front-end load funds underperformed direct-sold no-load funds by 43 basis points between 2007 and 2013. If, as ICI suggests, you remove 12b-1 fees from the calculations, that underperformance drops to 21 basis points. ICI's argument that the Department should just ignore 12b-1 fees entirely is highly questionable. It justifies this approach on the grounds that 12b-1 fees are used to compensate brokers and their firms "for the services that they provide to their clients." First, it's not clear what those services are when the investor has already fairly compensated the broker via a front-load commission. Second, it's worth noting these 12b-1 fees are charged for the life of the investment, even when the investor receives only one-time transactional advice. Moreover, the payment of those fees may still create an incentive for advisers to recommend funds which provide that compensation over funds that do not.

Finally, and most importantly, even if you accept ICI's conclusion that a hypothetical investor who holds a weighted average portfolio is not being systematically harmed after subtracting all of the costs that create conflicts that can lead to harm, it doesn't follow that widespread harm isn't occurring or that the harm isn't extensive. ICI does not provide the data that would allow the Department to see the extent to which investors are being harmed outside the hypothetical average weighted portfolio. While asset weighting does take into account what is happening in the tails, ICI presents the data in a way that is not fully transparent and does not sufficiently allow for analysis of performance differentials in the tails. Even more problematic, ICI's analysis of performance differentials between broker-sold front-load funds and no-load funds ignores the most relevant ways, including inappropriate rollovers, in which retirement savers can be harmed as a result of conflicted advice.

ICI's analysis of fund costs is similarly disconnected from real world experience. Where ICI compares costs between funds, it does so only between front-end load funds and retail no-load funds and ignores share classes sold through plans. Given the debate over whether rollover recommendations should be included in the definition of fiduciary investment advice, however, a comparison between 401(k) funds' costs and performance and retail load funds' costs and performance would be particularly relevant. ICI's own data suggests that fees on funds held in 401(k) plans are lower overall than fees on funds held in IRAs. This suggests that many investors are being advised to move into higher cost funds through rollovers, and that their subsequent performance is likely to suffer. Relevant questions include the following: When financial advisers recommend a rollover, do costs to the investor typically increase, decrease, or stay the same? If costs typically increase, by how much do they increase? How does performance of the recommended funds compare with performance of the funds held in the 401(k)? Yet ICI chooses to ignore this issue, perhaps because it doesn't support its advocacy on behalf of maintaining the rollover loophole in the definition.

Given its membership, ICI naturally focuses its analysis on mutual funds. The Department has also focused much of its analysis on mutual funds, because that is where the best quality data and peer reviewed research is available. But an analysis that focuses exclusively on mutual funds will inevitably understate the harm to investors from conflicted advice. Outside the fund context, the potential for investor harm is arguably much worse. A retirement investor could receive a recommendation to roll out of her 401(k) and into a variable or equity indexed annuity or non-traded REITs.[23] In these examples, the costs that the investor would pay would be considerably higher and their performance would often be lower than had they stayed in the plan. These costs are particularly difficult to quantify because the data is so sparse. But it is imperative that the Department remain cognizant of this non-quantifiable cost to investors in conducting its analysis, even if it cannot place a precise number of the scope of that harm.

3) The ICI offers no support for its cost estimates based on unfounded claims about the rule's likely impact.

ICI asserts, without offering any supporting data that is "reasonably obtainable," that "the BIC Exemption is unworkable and prohibitively costly." It is on this unsupported assumption that ICI bases its claim that the RIA fails to account for the societal harm of investors' being forced into fee accounts and losing access to advice and guidance. As we have noted elsewhere, industry's claim that firms will stop serving middle income retirement investors if forced to comply with the fiduciary standard and BIC exemption simply isn't credible. Yet, in its effort to prove that the rule would harm investors, ICI engages in sky-is-falling predictions about a loss of advice and a shift to fee-based accounts similar to those made by other industry trade groups. ICI's claims are based on assumptions that ICI does not disclose and that appear to have no factual support.

[23] *See, e.g.*, Craig McCann, Fiduciary Duty and Non-Traded REITs, Securities Litigation and Consulting Group, June 10, 2010, http://bit.ly/1YBQYaQ.

For example, ICI claims that fee-based accounts won't be available to investors with under $100,000 and as a result, "this segment will get no advice at all." First, this claim assumes that not one company will continue to charge transaction-based compensation and use the BIC exemption. While this is a popular industry talking point, it is not one that ICI supports with any data. Second, the claim assumes that not one company will provide advice pursuant to non-transaction-based compensation – including fee-based, hourly-based, or by engagement compensation – to retirement savers with under $100,000 in assets. ICI offers no explanation for its assumption that $100,000 is the magical cut-off for the availability of advice, nor for its assumption that every firm, regardless of its unique business model, will coincidentally make the same economic determination not to provide advice for those consumers with under $100,000 to invest. This is simply not logical. It is also belied by the facts. After all, there are many fee-based accounts that are available currently for well under $100,000, including one that is administered by one of ICI's largest members, Vanguard.

In short, to believe ICI's claims, one has to believe their assumptions that everyone who is providing transaction-based advice will suddenly stop providing transaction-based advice to retirement investors, all of the firms already providing non-transaction based advice to the under $100,000 market will mysteriously stop providing non-transaction based advice, and no one will fill their shoes by providing either transaction-based or non-transaction based advice. These predictions can't be supported, are not credible, and are belied by existing market conditions. The Department should not accept them.

In sum, ICI has provided a critique of the RIA with the veneer of economic analysis, but that doesn't hold up to scrutiny. The Department should not give it undue consideration in evaluating the potential costs and benefits of its rule proposal.

SIFMA-NERA

In a report commissioned by SIFMA, NERA collected account-level data from a number of firms to determine how the proposal would affect existing holders of commission-based accounts. It's worth noting that the industry has refused academics' and regulators' requests for account-level data based on the claim that producing such data would be too burdensome and costly. Yet somehow firms were able to overcome those insurmountable barriers when an industry consultant was hired to use firms' data to advance their advocacy efforts. This suggests that it is not the production of account-level data, but the potential for independent analysis of that data, that firms object to.

With respect to the report's content, NERA states that it "collected account-level data from a number of financial institutions in order to construct a representative sample of retirement accounts." However, NERA does not provide any of the report's underlying data or methodology so that it can be independently analyzed by the Department and other third parties to test whether the data analyzed are in fact representative of the market. Here are just a few of the specific points of information NERA fails to provide:

- NERA does not say how many financial institutions provided data;
- NERA does not say who those institutions were;
- NERA does not say what the basis was for choosing those financial institutions;
- NERA does not say how the customer accounts were chosen;
- NERA does not say what the characteristics of the customer accounts are;

- NERA does not say what types of investments the customer accounts are holding;
- NERA does not say how it determined whether the investments in the accounts at the financial institutions are in fact representative of the retirement market.

As we discuss above, the Department cannot reasonably rely on analysis that is based on data that is not readily available for independent analysis. Unless and until SIFMA and NERA are prepared to answer these questions and provide the underlying data, the report simply has no legitimacy.

Even on its face, there appear to be significant shortcomings in the paper. First, NERA excludes certain costs that brokerage investors pay to arrive at its conclusion that fee-based accounts are more expensive than commission-based accounts. According to the paper, "Fees include all proceeds paid by the account-holder directly to the firm, such as management fees and trading commissions. They exclude, however, fees paid to third-parties such as mutual fund managers." In a footnote, it makes clear that, "Fees exclude revenue that the firm may receive indirectly from the account-holder, such as markup/markdown revenue or 12b-1 fees." Leaving out these costs ensures that the cost results for brokerage customers will appear significantly lower than they actually are. For example, excluding 12b-1 fees from a front-end load share would discount the brokerage client's annual cost by 0.25 percent, which would make a material difference when comparing that client's costs with a client paying a 1 percent advisory fee. If, as it appears, the analysis also excludes 12b-1 fees paid for a level-load share, that would skew the numbers even further by excluding one of the primary methods through which brokers are compensated.[24] This would discount the brokerage client's annual cost by 1 percent. Of course, 12b-1 fees and markups/markdowns are precisely the types of indirect, hidden costs that investors pay, and that create conflicts of interest to recommend certain products over others, that the rule is intended to address.

NERA attempts to explain away this deficiency by stating, "Recognizing that such indirect revenues are not included in our fee data, we construct returns which are net of *all* fees, both direct and indirect." However, it's not clear that the return results that they provide fully capture what's happening throughout the market. This is because they provide only median differences in returns. In other words, if we understand NERA's approach, after considering over 63,000 IRA accounts (for which NERA provides no concrete evidence that they actually comprise a representative sample), NERA decided that only the median accounts should be used for a performance comparison and all the other accounts should be ignored. By focusing only on the median, NERA has completely ignored everything that has happened outside the median. So, for example, if 49 percent of commission investors were paying exorbitant fees, this would be invisible at the median. Thus, the median tells us nothing about either the range of practices that exist in the market or the distribution of results along that range. But this information is crucial to an understanding of the effect of conflicts on adviser conduct.

In sum, SIFMA and NERA don't provide the data they use for their analysis, don't explain their methodology, and the analysis that they do conduct appears either doctored, misleading, or incomplete. For these reasons, the Department should not give it undue consideration in evaluating the economic basis for its rule proposal.

[24] It is impossible to determine for certain whether such costs are included because of the report's lack of transparency with regard to the underlying data.

SIFMA-Deloitte

In further efforts to create the appearance that credible and independent third parties have provided economic analysis that contradicts the Department's RIA, SIFMA "engaged" Deloitte to "facilitate a study" on the anticipated operational impacts of the rule. However, the report makes clear that Deloitte's role was extremely limited to an administrative capacity. According to the report, "The findings represent the views expressed by the SIFMA Working Group as communicated to Deloitte through facilitated discussions and surveys. Deloitte has aggregated and summarized these views, but was not asked to and did not independently verify, validate or audit the information presented by the SIFMA Working Group." Thus, SIFMA hired Deloitte to merely play scribe to SIFMA members as they aired their complaints. It is nothing more than a SIFMA lobbying piece dressed up as an independent report.

Regarding the report's content, the SIFMA members interviewed here appear to have arrived at pretty detailed total cost estimates to broker-dealers for the rule. However, they don't break down the costs or present their underlying assumptions. Without this information, the report has no credibility, particularly in light of the gross misrepresentation of the rule included in SIFMA's comment letters. Moreover, it is difficult to square these detailed cost estimates with the report's claim that the proposed rule is so ambiguous and broad in certain areas that it poses challenges to operationalization. Either firms have a reasonable understanding of what the rule will require them to do and can estimate the costs of those actions, or they don't know with any certainty what the rule would require, rendering cost estimates unfounded. The contradiction between their claims about the ambiguity of the rule and their certainty about costs further delegitimizes this report.

FSI-Oxford Economics

In yet another industry survey, FSI engaged Oxford Economics to conduct a study of the economic consequences of the proposed rule, focusing on the perspective of independent broker-dealers. The approach taken here is quite similar to the approach taken by the SIFMA-Deloitte report, discussed above, in that Oxford collected industry data, but did not independently analyze that data to ensure it was accurate and reliable. In fact, it based its cost estimates in part on the SIFMA-Deloitte report in addition to FSI member firms' interview responses. Like other industry surveys discussed here, the report doesn't provide any of its underlying data or methodology. Among other things, it fails to describe:

- what member firms were interviewed, why it chose to interview those firms, and the extent to which they are or are not representative of the independent broker-dealer community;
- who the executives from those member firms were who were interviewed and why they were selected to be interviewed;
- why twelve firms were initially interviewed but follow-up interviews to obtain more detailed responses were only conducted with a portion of those firms;[25]
- which clearing firms were interviewed and why.

[25] It's not even clear how many firms were followed up with, as there is an internal contradiction in the report. The introduction says follow-up interviews were conducted with six firms, but the cost estimates on page 28 mention seven.

Ultimately, the extremely small sample size raises serious questions about whether the findings are even remotely representative of the effect of the rule on either independent broker-dealers or the broader market. It appears that detailed cost estimates were collected from only six or seven firms' executives. According to the basic methodology discussed on page 28, this includes three large FSI firms, three small FSI firms, and one medium FSI firm out of more than 100 total FSI member firms. Oxford uses these small subsets of firms to extrapolate costs for the entire independent BD market. This is simply indefensible. Moreover, the experience of independent contractors is particularly relevant under the independent broker-dealer business model, but Oxford apparently interviewed only about 36 executives in total from the 12 firms.[26]

In fairness to Oxford, it does discount its methodology and findings in several instances. It says, for example, "We do not wish to over-emphasize the precise figures presented here. First, as we've noted throughout, there is a great deal of uncertainty among respondents both about what the practical substantive requirements of the new rules will be, and what the costs of these will be. Second, our sample size is small and only consists of independent BDs (although as we noted above, there are reasons to believe startup costs for independent BDs will be low relative to others). Thus, it's possible these estimates are too high; it's also possible they are too low." For the same reasons, the Department should not give undue weight to these highly speculative findings in assessing the potential impact of its rule.

Litan-Singer

Another economic paper, authored by Robert Litan and Hal Singer, has received considerable attention. This paper was funded by the Capital Group, which owns American Funds, one of the largest broker-sold fund complexes and a strong opponent of the proposal. Despite its authors' economist credentials, it reads like an advocacy piece, and not a particularly well informed one, rather than an independent economic analysis. In this regard, it would be instructive to know the financial interests of the report authors and whether, and to what extent, Capital Group provided editorial feedback in the drafting process. Ironically, in a report that examines the influence of conflicts of interest, that information is conveniently missing.

The paper first seeks to exalt the benefits of the brokerage model. But the benefits of the brokerage model that Litan and Singer mention are irrelevant to the question of whether brokers engage in conflicted recommendations based on their economic incentives. Litan and Singer refuse to engage in a frank discussion about brokers' conflicts of interest, which are of course the central subject of the rulemaking. Predictably, the paper next asserts that brokers will leave the small-saver segment if the rule is adopted, and as a result, small savers will be "deprived of multiple benefits that brokers now provide to them." Litan and Singer provide none of their own economic analysis to independently assess what the impact of the rule will be on brokers. Rather, they regurgitate other industry paid-for "studies," several of whose flaws have been exposed, to conclude that the requirements of the BICE "are so restrictive and potentially costly that few, if any brokers, are likely to adhere to them…" Litan and Singer merely accept industry claims as gospel and don't seem interested or willing to hold those claims to any degree of economic rigor.

The lack of foundation for Litan and Singer's claim that brokers will leave the market calls into question all their subsequent findings. Based on that unfounded claim, Litan and Singer produce an estimate that "if brokers leave the small-saver segment…--their clients would

[26] This represents just 0.0002 percent of FSI's approximately 167,000 member advisors.

be deprived of multiple benefits that brokers now provide to them. Cumulatively, just these two of broker-provided benefits--coaching to stay invested through market downturns, and assistance in portfolio rebalancing--conservatively total 44.5 basis points annually." The point of these estimates is to show that the costs of the rule don't outweigh the benefits. However, the data that they rely on to make these estimates doesn't actually prove their point. In fact, if it proves anything, it proves the exact opposite point--that investors can receive what Litan and Singer refer to as "broker-provided benefits" without relying on conflicted advice from brokers.

The paper they rely on in making their estimates, which was published by Vanguard, seeks to assess the value of advice. But Vanguard didn't actually consider advisers' (or brokers' for that matter) influence. Instead, on the first question of "coaching to stay invested through market downturns," Vanguard used target date funds as a proxy for advisers. Target date funds represent one of several market innovations that have provided investors with access to professional management and investment selection without having to rely on an individual adviser. And the funds are managed under a fiduciary standard of care. It's not clear that the target date fund example tells us anything meaningful about any comparable benefits that brokers might provide. Vanguard's data does suggest, however, that in the unlikely event that brokers actually did abandon the small-saver segment, a claim for which they provided no evidence, target date fund investors would still have access to the benefit Litan and Singer attribute to brokers.

On the second question of "assistance in portfolio rebalancing," Vanguard compared historical returns and risks based on different portfolio constructions, ones that drifted with ones that did not. As Vanguard acknowledges in its paper, "rebalancing is not necessarily free: There are costs associated with any rebalancing strategy, including...time and labor on the part of advisors." Rebalancing often requires constant monitoring of an account to determine when it has drifted too far from the investor's preferred asset allocation, but brokers don't get paid to constantly monitor and manage accounts. In fact, this lack of ongoing account management is one of the main reasons the industry claims the brokerage model is less expensive than the advisory model. And industry trade groups have strenuously resisted any obligation, under a fiduciary duty, to provide that ongoing monitoring and account management. So, Litan and Singer have ascribed a benefit to brokers -- assistance in portfolio rebalancing -- but they've provided no concrete evidence that they actually provide that benefit. There's no legitimate basis for Litan and Singer's citing to the Vanguard study to support their proposition that brokers provide assistance in portfolio rebalancing. So returning to Litan and Singer's claim, if brokers were to leave the small-saver segment, small investors would in fact not be deprived of the supposed benefits that Litan and Singer claim brokers provide. As a result, their claimed investor loss of 44.5 basis points annually has no basis in logic or fact.

The Litan and Singer paper also appears to express a visceral and unjustified disgust for robo-advisers. In several places, they deride robo-advice in ways that suggest they don't understand these new advice providers and have an inherent bias and distrust toward technological innovation and cost reduction. For example, without offering any data to support their conclusions, they state that, "In fact, the decision to stay invested (or not) during times of market stress swamps the impact of all other investment factors affecting long-term retirement savings...Robo-advice...cannot effectively perform this critical role. (An email or text message in the fall of 2008, for example, would not have sufficed to keep millions of panicked savers from selling, with devastating consequences for their nest eggs.)" Elsewhere, they claim that "emails and tweets from a robot will not prevent an investor from selling in a panic, and the value of that human interaction during periods of market stress will swamp anything else a small saver does with respect to outcomes and retirement security."

First, the entire market was panicking in 2008 and Litan and Singer have provided no evidence that brokers kept millions of panicked savers from selling. In fact, there is academic research that shows brokers fail to prevent investors from behavioral quirks, and if anything, make them worse.[27] There's also evidence that brokerage (load) investors display significantly poorer market timing than no-load investors, which suggests that brokers may not be as effective at talking investors out of rash decisions as Litan and Singer suggest.[28]

Second, Litan and Singer's comments about robo-advisers reflect a lack of understanding about how these firms work. Robo-advisers do not merely send emails, text messages, and tweets to investors. They actually use very sophisticated software that is rooted in behavioral economics principles to reinforce good behavior and restrain bad behavior.[29] When considering actual data and not just Litan and Singer's opinions, we see that in recent times of market unrest, robo-advisers' clients do not appear to have engaged in panicked selling.[30] For example, during the recent market volatility, Betterment did not see any increase in withdrawals and, in fact, investors contributed more, according to the firm's director of finance, Dan Egan.[31]

While Litan and Singer are certainly entitled to their opinions, those opinions do not constitute economic analysis. The Department should not give their views undue weight in assessing the likely impact of its proposed rule.

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Economic analysis is, at best, an imperfect process. While it can inform rulemaking, it cannot be relied on to precisely predict the costs and benefits of a proposed rule. The best that can be hoped is that the analysis can help to elucidate the problem the regulation is intended to address, explain the reasoning behind the proposed regulatory approach to address that problem, and support a reasoned conclusion that the potential benefits of the rule justify its costs. As we discussed in the introduction to this section of our letter, the Department is required to base its analysis of the rule's likely impact on the best available information, and it has a specific obligation to ensure that any technical information relied on is objective.

This latter point is particularly relevant in assessing the "analyses" and "studies," discussed above, that have been submitted by and on behalf of industry in an effort to show that investors don't suffer as a result of conflicted advice or would be harmed if the DOL rule were adopted. None is based on peer-reviewed research. They fail to acknowledge, let alone assess, the impact of conflicts of interest, which is the focus of the rule. Without exception, their cost

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[27] *See, e.g.,* Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar. The Market for Financial Advice: an Audit Study. NBER Working Paper 17929, 2012, http://bit.ly/1PwIviU.

[28] *See, e.g.,* Mercer Bullard, Geoffrey C Friesen, and Travis Sapp. "Investor Timing and Fund Distribution Channels." Social Science Research Network. 2008. http://ssrn.com/abstract=1070545.

[29] *See, e.g.,* Anand Rao, *The Rise of the Robo-Advisers?*, INSURANCETHOUGHTLEADERSHIP.COM, June 5, 2015, http://bit.ly/1WkJWoR.

[30] *See, e.g.,* Daisy Maxey, *Market Turmoil Tests 'RoboAdvisers'*, WALL STREET JOURNAL, August 24, 2015, http://on.wsj.com/1KIt4QF; Mason Braswell, *Robo-advisers put to the test in their first significant market correction*, CRAIN'S WEALTH, August 25, 2015, http://bit.ly/1Ow4vgo.

[31] *Id*.

estimates are based on unsupported claims about the likely effect of the rule. Several are based on self-selected surveys that simply regurgitate rather than analyze industry criticisms of the rule. Moreover, most fail to clearly describe either the methodology they used or the assumptions they made to reach their conclusions. Most importantly, they fail to make their data available to independent parties, including the Department, academics, market analysts, or the rest of the public, so that the conclusions they reach can be scrutinized and tested. As such, the Department can and should consider these views just as they would any other comment, but they cannot rely on these studies as objective analysis in assessing the likely impact of the rule.

III. The Department Should Dismiss the Industry's Chronic Misrepresentations of the U.K. Experience.

Many in the industry who oppose Department action have improperly analogized recent reforms in the U.K. market to those that the Department has proposed. First, these industry opponents have drawn straight comparisons between these regulatory efforts, ignoring the fact the Department has proposed an entirely different approach from the approach adopted in the U.K. The U.K's Retail Distribution Review (RDR) banned financial advisers from receiving commissions in return for selling or recommending their investment products; the rule proposed by the Department does not ban commissions. Rather, it allows financial advisers and their firms to continue to receive commissions so long as they are willing to comply with the reasonable requirements of the BICE, including the impartial conduct standards, warranties, and disclosures. Furthermore, the RDR required advisers to comply with extensive and rigorous professional certification standards, which are not included in the Department's proposal.

Second, these industry opponents have misrepresented the effects of the U.K. reforms ostensibly to create a misimpression that similar effects will occur in the United States if the Department's rule is finalized and implemented. For example, they have cherry-picked certain data points, offering them without any relevant context, to serve their claim that investors have lost access to advice. They have also omitted other recent empirical data showing that the RDR has resulted in many benefits to consumers.

One claim industry opponents have made, for example, is that "the cost of advice increased and the number of investment advisors decreased in the United Kingdom following the implementation advisers in the U.K" and "the same unintended consequences and resulting 'advice gap' would occur if the Department's proposed rule were implemented.[32] They cite to a June 2013 report by Cass Consulting[33] to support their contentions but conveniently ignore material findings in that report that undercut their claims related to the RDR's compensation reforms. For example, they point to statistics showing the numbers of advisers fell from 40,000 at the end of 2011 to 31,000 by the start of 2013. However, they ignore Cass's findings that "even without RDR, the landscape for the advisory sector would have begun to change. Technological advances have been making the creation and delivery of investment products more accessible and cheaper to a wider audience, whether guided by an advisor or not," and that indeed, "the industry was already shrinking pre-RDR." But even with regard to the RDR's impacts on the industry, industry opponents ignore the main reason for the timing of the recent decrease in the number of advisers. According to the Cass Report survey, "survey participants

[32] *See, e.g.*, Lincoln Financial Network comment at 10, http://1.usa.gov/1Kx2JrE.
[33] Cass Consulting, *The impact of the RDR on the UK's market for financial advice: Challenge and opportunity*, June 2013, http://bit.ly/1L8bjjY.

said that an inability to meet the minimum standard for professionalism, the QCF Level 4 qualification, would be the main reason why advisers might choose to leave the industry…. It seems that some advisers had found it difficult to complete the exams while simultaneously running their business."

Opponents of the Department's proposal also point to the RDR as evidence for the proposition that middle-class investors will lose access to advice. However, the Financial Conduct Authority (FCA) conducted a post-implementation review of the Retail Distribution Review in December 2014 that found no conclusive evidence to support this conclusion.[34] FCA commissioned the external consultants Europe Economics to consider whether the RDR is on course to deliver its original aims and flag any immediate issues. As part of its report on the impacts of the RDR, Europe Economics considered evidence from a wide variety of sources, including additional research papers the FCA commissioned from two other consultants, NMG and Towers Watson.

The NMG report, 'Impact of the Retail Distribution Review on consumer interaction with the retail investments market,'[35] is a quantitative study based on consumer surveys and analysis. Contrary to industry's claims, it found that:

> "The RDR has had little impact on consumers' desire to use advice. Among consumers it appears that the RDR and specifically the introduction of Adviser Charging has not had a direct impact on likelihood to use advice. The post RDR requirement to pay a fee for advice is only mentioned by a minority of respondents as a reason for not undertaking any activity, not actually taking out a product or choosing a non-advised channel. When all respondents who gave a reason relating to the adviser charge (e.g. 'the adviser's fee was too high', 'I did not want to pay an adviser fee') are combined, this reflects just 5% of the total base. We cannot conclude that these consumers have been 'forced' into their decision to go down a non-advised route because they cannot access affordable advice. Many (64%) agree that they are comfortable making their own investment decisions and may simply feel that they should not have to pay for advice."

The Towers Watson report, 'Advice Gap Analysis: Report to the FCA,'[36] estimates whether there is a gap between demand for investment advice and capacity available to meet that demand. It concludes that:

> "The results do not point to an obvious or substantial gap in advisory provision, when considering demand for 'full' regulated financial advice. The central view of our analysis indicates demand for around 25,000 individual advisers, compared with estimates of around 30,000 financial advisers currently active in the market. These results therefore indicate excess capacity (or a negative advice gap) based on the productivity and time allocation assumptions used, of around 17% of the adviser base, or about 5,000 advisers. Over time, any such excess capacity may be absorbed if demand for ongoing advice increases and if demand for pre-, at- and in-retirement financial planning increases."

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[34] Financial Conduct Authority, United Kingdom, *Post-implementation review of the Retail Distribution Review – Phase 1*, Dec. 2014, http://bit.ly/1jdUM1H.
[35] David Burns and Georgina Clarke, *Impact of the Retail Distribution Review on consumer interaction with the retail investments market,* NMG Consulting, September 2014, http://bit.ly/1iyctsb.
[36] Towers Watson, *Advice Gap Analysis: Report to FCA*, December 5, 2014, http://bit.ly/1MKMFWJ.

Based on these findings and other evidence Europe Economics' report found that the regulations had increased professionalism, reduced product bias, lowered prices for investment products, and improved the quality of advice. The following are among the report's key findings, conveniently overlooked by industry opponents of the DOL rule proposal:

- "The vast majority of advisers are now qualified to the new minimum standards and there has been an increase in the number of advisers going beyond these minimum standards. The increase in qualifications, along with greater focus on provision of ongoing advice services, indicate positive moves towards increasing professionalism in the advice market."
- "The removal of commission paid by providers to advisers and platforms has reduced product bias from adviser recommendations reflected in a decline in the sale of products which paid higher commissions pre-RDR."
- "Charges for retail investment products have been falling post-RDR. Product prices have fallen by at least the amounts paid in commission pre-RDR, and there is evidence some product prices may have fallen even further. This is due in part to the introduction of simpler products and funds which have a lower charge and advisers and platforms exerting more competitive pressure on providers, with platforms increasingly able to negotiate lower product costs. The removal of commission also means that providers who sold lower or no commission products pre-RDR are now competing on a more equal basis."
- While the report does say that there is evidence that the cost of advice has increased, it qualifies the statement by saying that, "In relation to total cost of investment — or indeed the benefit to consumers from the advice received — the evidence does not yet enable us to draw firm conclusions as to whether this has changed post-RDR."
- "Those consumers who are receiving full advice now are more likely to be receiving better quality advice due to advisers being better qualified and the reduction in product bias."
- "Overall firms appear slightly better placed to deliver on their long-term commitments, with both average revenues and profitability of advisory firms having increased. The costs to firms of complying with the RDR have been in line with or lower than expectations, with ongoing costs largely successfully absorbed into business as usual costs by the industry."
- "Those consumers who are receiving full advice now are more likely to be receiving better quality advice due to advisers being better qualified and the reduction in product bias.
- "There is little evidence that the availability of advice has reduced significantly as a result of the RDR, with the majority of advisers still willing and able to take on more clients. However by revealing the true cost of advice, the RDR has led some consumers to consider the extent to which the advice they receive represents value for money, and in some cases conclude it does not. This group includes consumers who would be likely to pay for a cheaper form of advice, for example that which may be provided by a simplified advice model."

In short, industry opponents have mischaracterized both the nature of the review being conducted, implying that it is based on concern over the rule's unintended consequences, and the central findings of that review. Far from raising concerns about the Department's proposed regulatory approach, the review findings suggest that the Department should be bold in seeking to rein in conflicts, as the benefits to consumers are manifest and substantial.

IV. Conclusion

Nothing that we've seen in the comment record supports a radical revision to the Department's proposed regulatory approach or invalidates the RIA. On the contrary, while limited changes can be made to streamline the rule's requirements or ease compliance, the Department should resist any efforts to water down the rule's central provisions. Together, the rule's best interest standard, requirements to mitigate conflicts, and reasonable compensation provision have the potential to bring about a dramatic improvement in the quality of retirement investment advice to American workers and retirees and enhance their ability to afford a secure and independent retirement. We applaud the Department for its persistence in pursuing this much needed regulatory reform and we urge you to move forward expeditiously to finalize the rule.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

Micah Hauptman

Micah Hauptman
Financial Services Counsel