Whitaker, Chalk, Swindle & Sawyer, L.L.P.
Attorneys at Law

301 Commerce Street, Suite 3500
Fort Worth, Texas 76102-4186

(817) 878-0500
Metro (817) 429-6268
www.whitakerchalk.com

John R. Fahy
Direct Dial (817) 878-0547
99999-00002

jfahy@WhitakerChalk.com

January 11, 2011

Via e-mail to: e-ORI@DOL.GOV

Office of Regulations and Interpretations
Employee Benefit Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210
100 F Street, N.E.
Washington, DC 20549-1090

Re: Definition of Fiduciary Rule Proposal

Ladies and Gentlemen:

This letter is submitted in response to the request for comments by the Employee Benefit Security Administration ("EBSA") in Release No. RIN 1210-AB32 (the "Rule Proposal"). In the Rule Proposal, EBSA has proposed to revise 29 CFR §2510.3-21(c) relating to the definition of a fiduciary under the Employee Retirement Income Security Act ("ERISA") which expands the definition of "fiduciary" to persons, including securities broker-dealers who have not been designated as an ERISA "fiduciary" since the passage of ERISA more than 35 years ago.

Each of the undersigned is a member of the Securities Committee (the "Committee") of the Business Law Section (the "Section") of the State Bar of Texas. Mr. Waller is also the Chairman of the Securities Committee of the American Association of Attorney-Certified Public Accountants. Several of us advise securities brokers and dealers. Please note that the comments expressed in this letter represent the views of the undersigned only and do not represent the views of their colleagues, clients or law firms or the official position of the State Bar of Texas, the Committee, the Section, or of the American Association of Attorney-Certified Public Accountants. None of the undersigned are being compensated, directly or indirectly, for our work on this comment submission.

Background

The Rule Proposal, among other things, provides that a person is a fiduciary if that person makes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property for a fee or other compensation directly or indirectly to an employee benefit plan, plan fiduciary or plan participant or fiduciary and the recommendations are made pursuant to an agreement, arrangement or understanding, written or otherwise, between the person and the plan, plan fiduciary or plan participant or beneficiary in connection with making investment decisions or management decisions with respect to plan assets and will be individualized to the needs of the plan, plan fiduciary or plan participant or beneficiary. This broad definition appears to be intended to encompass routine broker-dealer transactions and provides a great amount of uncertainty as to what is covered and what is not covered. Further, it seems to be premised on a model of broker-dealer services that is different than the models we have experienced.

EBSA's rules currently have an exemption from the definition of ERISA fiduciary for SEC-licensed securities brokers and dealers solely in their capacity as the executor of instructions relating to securities transactions during the ordinary course of its business as a broker or dealer. This broker-dealer transaction exemption is limited to brokers and dealers who are neither the fiduciary nor an affiliate of the fiduciary and the instructions specify the security to be purchased or sold, the price range for the transaction, a time span not to exceed five days to execute the transaction, and the minimum and maximum amount of the securities to be purchased. 29 CFR §2510.3-21(d)(1). Note that this transactional exemption is not available if the broker or dealer is deemed to be a fiduciary due to a "recommended" securities transaction involving plan assets.

If named a fiduciary, the broker-dealer will have responsibilities under 29 USC §1104. Specifically, the broker-dealer will be required to discharge its duties:

> solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

Fiduciaries are also required to exercise:

> 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 like character and with like aims.

Fiduciaries are further required to diversify "the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." Finally, ERISA requires fiduciaries to act "in accordance with the documents and instruments governing the plan."

Fiduciaries are also required to not engage in prohibited transactions under 29 USC §1106. Those prohibited transactions include:

1) selling, leasing or exchange any property between the plan and a party in interest;
2) lending money or other extension of credit between the plan and a party in interest;

3) furnishing goods, services, or facilities between the plan and a party in interest;
4) transferring to or using for the benefit of any party interest any assets of the plan;
5) fiduciaries dealing with the assets of the plan in their own interest or for their own account;
6) fiduciaries transacting business with the plan on behalf of a party whose interests are adverse to the interests of the plan or its participants or beneficiaries; and
7) receiving consideration from any party dealing with the plan in connection with a transaction involving the assets of the plan.

One of the exemptions from the prohibited transactions standards involved traded securities. 29 USC §1108(b)(16) provides an exemption from prohibited transactions for securities trades executed through SEC or CFTC regulated trading systems subject to best execution regulatory requirements in which the trading systems do not take the identity of the parties into account and the price of the securities and the compensation for the trade are consistent with arms-length transactions. Because these trades must pass through a regulated trading system, the securities trades covered by this exemption are agency trades.[1]

There are also exemptions for certain large block trades (29 USC §1108(b)(15)) and cross trades for plans of $100 million or more in assets. (29 USC §1108(b)(17)) The cross-trade exemption does not allow the payment of commissions.

This ERISA prohibited transactions exemption only covers one very narrow aspect of a broker-dealers business with a customer – on-exchange agency trades. Many other services that broker-dealers routinely do for plan-related customers would be barred as a prohibited transaction. Those prohibited activities would include:

1) <u>Principal trades</u> - Unlike investment advisers, broker-dealers have no substantive restrictions on principal trades other than the disclosure requirements of SEC Rule 10b-10, the best execution requirements of NASD Rule 2320, the interpositioning limitations under NASD Rule 2111 and the markup limitations in NASD Rule 2440. Broker-dealers routinely engage in principal transactions and mark such trades as principal trades on the trade confirmation. But, a broker-dealer cast as an ERISA fiduciary would be barred from filling a trade order with an otherwise perfectly legal and disclosed principal trade settlement, even when such a settlement could be obtained at a better price than through the market.

2) <u>Margin Loans</u> – ERISA fiduciaries may not loan money to plans or their participants or beneficiaries, which would include a margin loan. The broker-

[1] Investment advisers are barred from acting as a principal on their own account in client trades under Section 206(3) of the Investment Advisers Act of 1940 (15 USC § 80b-6(3)) without the informed consent of the client except for agency cross-trades allowed under SEC Rule 206(3)-2. ERISA also allows certain cross-trades by investment managers. 29 USC §1108(b)(19); 29 CFR 2550.408b-19.

dealer trade exemption from prohibited transactions in 29 USC §1108(b)(16) makes no reference to margin loans.

3) Margin Accounts – ERISA fiduciaries may not provide credit facilities to plans or their participants or beneficiaries.

4) Short Sales – Short sales involve borrowing securities and thus require a margin account.

5) Option Trades –Under securities laws uncovered option trades require a margin account.

6) Overdraft Protection – While there is an exemption from prohibited transactions for banks under 29 USC §1108(b)(6), broker-dealers are not banks and may not fall within that exemption for quasi-bank like services such as check clearing and overdraft protection.

7) Stock Lending – Broker-dealer customers can make money by allowing their assets to be borrowed by broker-dealers for loans to short-sellers. This interest income can boost returns. But, plans lending assets to fiduciaries are prohibited transactions under ERISA.

8) Soft Dollars. Soft dollars are the research and data provided by broker-dealers designated as fiduciaries to investment advisers under soft dollar arrangements furnishing goods, services, or facilities by a fiduciary to an ERISA party in interest. The safe harbor from fiduciary duties in Section 28(e) of the Securities Exchange Act of 1934 applies to registered investment advisers but not to broker-dealers.

9) IPOs. IPOs are generally firmly underwritten, so plans would purchase IPO shares from the broker-dealer acting as underwriter rather than the issuer. This would be a prohibited transaction under ERISA. Since IPO transactions are almost always "recommended" transactions, Plans will be barred from having access to IPO allocations.

10) Secondary Public Offerings. Secondary offerings are firmly written offerings by issuers who have previously been involved in the public securities markets. Like IPOs these are generally firmly underwritten offerings. Plans would be prohibited from participating in these offerings under ERISA because secondary public offering transactions are almost always "recommended" transactions.

11) Trade Error Accounts. Error accounts take securities from busted trades into or out of an error account on the broker-dealers books. The trades may be busted for a variety of reasons, including previous trade execution errors. In

any event, the purchase or sale would be directly to or from the ERISA fiduciary and thus be a barred business transaction directly with the plan.

12) Issuer-Affiliated Broker Dealers. Some broker-dealers are established to sell affiliated products, such as a broker-dealer owned by a real estate syndicator or hedge fund. If the broker-dealer is deemed a fiduciary, then all sales of affiliated products would be barred as fiduciary-related party transactions.

13) Mutual Fund Trailers and SEC Rule 12b-1 fees. Under the interpretive bulletin at 29 CFR §2509.75-3 an investment by a plan in an investment company registered under the Investment Company Act of 1940 does not, by itself, cause the investment company, its investment adviser, or its principal underwriter to be deemed a fiduciary or a party in interest for the plan under ERISA unless the plan covers the employees of the investment adviser. But, this interpretive bulletin does not cover whether a broker who recommends a mutual fund transaction and receives trailers or SEC Rule 12b-1 fees corresponding to the amount of plan assets invested in the investment company is receiving consideration from any party dealing with the plan in connection with a transaction involving the assets of the plan.

These are just a few of the broker-dealer services and functions that would be unavailable to plans, their participants and their beneficiaries under the Rule Proposal. This list is not intended to be comprehensive and we are not suggesting that crafting an exemption for each of these items will resolve these issues. Indeed, the dramatic effect that the prohibited transactions list would have on broker-dealers calls into serious question whether Congress in 1974 intended that the definition of ERISA fiduciary and ‘investment advice” to include broker-dealers because Congress barred many of the services that broker-dealers provide. In 1974 broker-dealers provided principal trades, margin accounts, options and stock lending to ERISA-covered plans.

According to FINRA, the securities broker dealer industry has nearly 4,620 brokerage firms, 165,920 branch offices and 636,340 registered securities representatives. The Rule Proposal, as stated, would have a significant and deleterious effect on the industry by causing disruptions with millions of customer account relationships.

Further, as the Rule Proposal acknowledges in its “Costs” section that it is procedurally difficult to treat services provided for plans different from other services provided to customers. Consequently, the above prohibited transactions list may have substantial carryover into non-plan customer accounts. The Rule Proposal said:

> The Department believes that service providers will need to review their entire book of business, not each individual transaction or a plan-by-plan review, to determine whether they are fiduciaries, because service providers will enter into agreements with plans to provide similar types of services.

Thus, EBSA expects that the securities broker-dealer industry will need to apply some of the prohibited transaction restrictions to all its customers because of logistical problems in treating plans differently from other customers.

Designating a Securities Broker a Fiduciary for "Recommending" or "Advising" about a Securities Transaction Leads to Effects that Will have a Negative Effect on Plan Options

Consider, for example, a small business such as a flower shop that has a profit-sharing plan. The flower shop owner due to years of service has a majority in interest in the plan and serves as the plan administrator. The plan administrator becomes absolutely convinced that the price of gold is going to increase substantially in the near future and that other types of investments will be subject to steep declines because of the poor performance of the economy and vast deficits which devalue the US dollar. The broker does not share that opinion and tells the customer so. Nevertheless, the customer wants a presentation of options that would allow him to take a position that would capitalize on the anticipated increase in the price of gold. The broker then presents various options including gold-related futures contracts, gold mining stocks, and gold-related exchange traded funds and discusses the pros and cons such as comparative volatility, leverage, risk of capital calls, and other relevant considerations. After being fully informed the customer chooses one of the options and the broker makes the purchase on the customer's behalf with the trade marked as "solicited" on the trade blotter. The price of gold then declines and the ERISA-covered customer loses money. Under the Rule Proposal would the broker have acted as a fiduciary in such a transaction? If the customer sets the investment parameters and seeks options within those parameters is presenting those options a recommendation or advice? Is this the kind of recommendation or advice that EBSA is targeting under the expansion of the fiduciary standard? Is this the kind of activity that a broker should be liable for damages based on the market conditions outside of its control relating to the decline of the price of gold?

To bring this example one step forward, assume that the customer decided to purchase the gold mining stock.

1) Can the broker's broker-dealer execute the trade order on a principal basis? That would depend on whether the broker was an ERISA fiduciary or not, which is uncertain. ERISA fiduciaries are barred from engaging in self-dealing with plans and a broker-dealer selling a security out of its inventory, even if sold at prevailing market prices, would be self-dealing with the plan. So principal trades would be forbidden, even if the securities could be closed at better net prices than agency trades through a securities exchange.

2) Can the purchase be done with margined funds or in a margin account? That would also depend on the uncertain determination of whether a broker was providing advice or making a recommendation under the presented fact situation. Margins are loans against the securities assets held in the securities

broker-dealer accounts and loans from ERISA fiduciaries to serviced plans are prohibited transactions under ERISA.

3) Can the customer hedge the gold position with a countervailing short sale or put option? That also depends on the uncertain determination of whether the broker was determined to be a fiduciary under ERISA. Short sales and put options require margin accounts which are a credit facility to provide loans on demand against assets held in the customers account. Margin accounts and such credit facilities to or from ERISA fiduciaries to plans are prohibited transactions under ERISA. Further, the short sale or put option would be barred if the broker-dealer is the counter-party.

4) Is there a disclosure that can be provided under the Rule Proposal to clear this up?

a) No - The Rule Proposal has a disclosure safe harbor that relies upon the customer's subjective perception and understanding or what would be deemed the customer's reasonable subjective perception or understanding. If the broker provided a comprehensive disclosure of all relevant conflicts, it would still be required to prove that the customer understood it or reasonably should have understood which in practical terms is an unsustainable burden and highly divergent from the standard for a broker-dealers disclosure responsibilities under federal securities laws. Those disclosure requirements contain no provision relating to needing to prove the customer's subjective or reasonable understanding.

b) No – The Rule Proposal's disclosure safe harbor only applies when a broker is operating as the disclosed agent of the counterparty. There is no disclosure safe harbor when a customer has ordered the broker-dealer to go out and execute a specific trade on its behalf as an agent.

5) Is the flower shop's plan business the kind of business that a typical broker-dealer would support under the Rule Proposal? No, the broker-dealer's legal and compliance departments will likely determine that it cannot offer trading or margin services to such accounts given the uncertainty as to whether such a transaction would cause it to be an ERISA fiduciary to the Plan with attendant liability should the price of gold decline and that the uncertainly cannot be cured by the safe harbor disclosure because of the broker-dealer's agency position and because of the subjective understanding requirement in the safe harbor disclosure.

EBSA should seriously consider the scope and ancillary effects of the Rule Proposal and whether it really needs to apply to the broad scope of the securities broker-dealer industry given that the securities brokers and dealers are already heavily regulated by the SEC, by state securities regulators and by self-regulatory organizations, including FINRA under a regulatory scheme built up through 75 years of experience and experimentation. Seeking to regulate an already regulated industry requires a deep understanding of the business lines, standards and practices of that industry. We are concerned that the broad stroke of the Rule Proposal as to securities brokers and dealers imposes costs and liabilities in areas in which there will be no benefit. Finally, the application of ERISA fiduciary requirements to broker-dealers would mean that many of the services provided to ERISA-covered customers would be unavailable including margin accounts, short selling, principal trading, repurchase agreements, access to underwritten initial or secondary offerings, overdraft protection, revenue from securities lending and access to products affiliated with broker-dealers. The loss of these services would have a substantial net negative impact on the performance of plans.

The Rule Proposal also does not recognize the broad scope of broker-dealer requirements and types of broker-dealers. Section 15(a) of the Securities Exchange Act of 1934 mandates the registration of a broad scope of persons as brokers and dealers. It covers all those who "effect any transactions in, or . . . induce or attempt to induce the purchase or sale of . . . any security" in interstate commerce. Thus, besides the general retail broker-dealers activities referenced above, there are numerous specialized broker-dealers. For example some broker-dealers are set up to sell affiliated products, such as a broker-dealer owned by a real estate syndicator or hedge fund. If the broker-dealer is deemed a fiduciary, then all sales of affiliated products would be barred as a related party transaction. Perhaps in that case there may be some protection in the safe harbor disclosure because such brokers act as the agent for the counterparty issuer. But, as stated above, the subjective standard in the safe harbor makes the standard practically unworkable and the Rule Proposal will have the possible effect of shutting down many of these investment opportunities for plans and bring substantial harms to the syndicators and their broker-dealers. As a result, while Federal securities laws would require these proprietary syndicators to have a broker-dealer, but having a broker-dealer would effectively bar them from selling to ERISA-covered customers.

The Rule Proposal eliminates mutual understanding and regular basis requirements. Thus, a broker who provides any kind of client service may become a fiduciary, whether or not it is necessary for the scope of the fiduciary rule to apply to that type of client. Further, because mutual understanding is not required, if any investment loses money, the customer could always allege that there was no such understanding on its part thus causing the broker to be a fiduciary, regardless of disclosures or other information provided. While the rule has a disclosure safe harbor, it is an affirmative defense in which a defendant would have to demonstrate the state of a customer's subjective knowledge. So, in sum the disclosure safe harbor provides no effective safe harbor at all to such claims that a person is an ERISA fiduciary. When combined with the elimination of the mutual understanding requirement, these accounts become too risky to service at current commission levels. Substantially higher commissions for plan transactions should be expected due to the extra risk.

Because of the Rule Proposal's 20/20 hindsight approach, lack of requiring mutual understanding and customer's subjective knowledge requirement in the disclosure safe harbor, the Rule Proposal, broker-dealers compliance departments will assume that they will be treated as ERISA fiduciaries for any ERISA-covered account. Because broker-dealers practically cannot expect to be able to enforce a completely different set of written supervisory procedures depending on whether the customer or account is covered by ERISA or not, the procedures will apply to all accounts. For example, a broker-dealer may have an account for the floral shop small business. There may be an account relating to operating reserves that is not covered by ERISA and there may be a profit-sharing plan account that is covered by ERISA. Further, the floral shop owner may also have a personal account. If the broker during a routine conversation about the operating reserves account or the personal account receives a question from the customer about the profit-sharing account, the broker handling the account will not be able to switch hats in mid-conversation. Instead, the broker must stop, fax over an extensive detailed disclosure as to the customer's subjective understanding, ask the floral shop owner/plan administrator to sign it and fax it back, and then pick up the conversation later. Since broker-dealer compliance directors and general counsels do not really anticipate that this is a likely scenario, they will just need to apply ERISA-required procedures to the whole panoply of broker-dealer businesses and all related customer accounts in order to comply with the fiduciary standards under ERISA.

Disclosure Safe Harbor

The Rule Proposal's disclosure safe harbor will be of little help in allowing a broker-dealer to offer some of the above-referenced services. Instead of saying that a disclosure that the broker-dealer is not an ERISA fiduciary is sufficient, it focuses on the plan's, plan fiduciary's, or plan participant's or beneficiary's subjective knowledge. And if the plan, plan fiduciary, plan participant or plan beneficiary denies knowledge, the burden is on the broker-dealer to:

> demonstrate (that the plan, plan fiduciary, plan participant or plan beneficiary) knows, or under the circumstances, reasonably should know that the person providing the advice or recommendation in its capacity as a purchaser or seller of a security or other property, or as an agent of, or appraiser for, such purchaser of seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and the person is not undertaking to provide impartial investment advice.

Broker-dealer compliance departments and general counsel departments will not risk their business operations to draconian remedies for prohibited activities under ERISA based on being able to prove a customer's subjective understanding. Under the Rule Proposal, a standard disclosure accepted by the securities industry, such as a SEC Rule 10b-10 trade confirmation, would not be accepted as meeting the disclosure requirements. Instead the broker-dealer will need to demonstrate that the customer subjectively knew or reasonably should have known the information on the Rule 10b-10 trade confirmation.

And what would the result of not being able to prove that subjective element on a post facto basis? A broker-dealer that provides a margin loan may not be able to collect or to foreclose on the pledged collateral because such loans are barred between ERISA fiduciaries and plans. Plus, there are countless other broker-dealer business services that would have similar problems as described above. So, broker-dealers' default position will likely be to deny plans access to these services.

Further, this proposed disclosure does not provide any safe harbor for agency trades. So, any broker-dealer providing agency trade services will not be able to disclose away its fiduciary status. This causes problems because having a fiduciary status would bar principal trades. And if both principal trades and agency trades end up being effectively barred under the Rule Proposal because the broker-dealer is deemed to be a fiduciary if it undertakes agency trades and as a fiduciary is barred from undertaking principal trades, then there will be many broker-dealers that refuse to do business with such customers. The market offerings to ERISA-covered customer will become much more limited.

Consequently, we suggest that if EBSA considers a disclosure safe harbor that it use an objective standard rather than a subjective standard in order to provide certainty as to the effect of the disclosure to industry participants. We also suggest that the disclosure also be permitted for transactions in which the broker or dealer is not explicitly acting as an agent for the counterparty.

In other contexts the SEC has approved of objective disclosure requirements in the securities industry without requiring proof that the reader subjectively understood it. The entire premise of the securities registration process under the Securities Act of 1933 and the periodic reporting obligations under the Securities Exchange of 1934 is based on disclosure. Issuers do not need to be able to prove that the recipient actually read the disclosure. Indeed, the SEC has said that the broker-dealers are not required to deliver prospectus relating to previously reporting companies. *See* SEC Rule 174. (17 CFR §230.174). In another example, Congress provided as safe harbor for forward-looking statements under Section 27A of the Securities Act of 1933 (15 USC §77z-2) and Section 21E of the Securities Exchange Act of 1934 (15 USC §78u-5). In drafting a disclosure safe harbor, Congress did not require proof of subjective understanding by the recipient because it knew that such a requirement would make the disclosure safe harbor not really a safe harbor at all. Consequently, EBSA should consider removing all references in the Rule Proposal's disclosure safe harbor that require a broker-dealer to "demonstrate" that the customer:

> knows, or under the circumstances, reasonably should know that the person providing the advice or recommendation in its capacity as a purchase or seller of a security or other property, or as an agent of, or appraiser for, such purchaser of seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and the person is not undertaking to provide impartial investment advice.

Instead, a disclosure that the advice or recommendation is in the capacity as a purchase or seller of a security or other property or as an agent of a party other than the plan, the plan administrator, or the plan participants or beneficiaries.

Definition of "Recommendation"

The Rule Proposal has the fiduciary status determination pivot on whether a service provider makes a recommendation or not. While we realize that the word "recommend" is derived directly from the ERISA statutory language we view "recommend" is a very vague word with multiple meanings and an unclear meaning in the Rule Proposal.[2] The Rule Proposal should have a specific definition as to what it means. This is especially relevant to the Rule Proposal's use of "recommend" to determine whether a securities broker or dealer is a fiduciary because "recommend" is just not a term that is used with an accepted common meaning in the broker-dealer industry. Broker-dealers mark trade blotters with whether a trade is solicited or unsolicited. A solicited trade does not necessarily mean a recommended trade. Those are not the same thing. For example, it is common for a customer to state the parameters of the type of investment he or she would like to make. The broker then presents several options, thus soliciting the trade, and the customer then chooses the appropriate option based on its own parameters. Such conversations would typically include descriptions of the various investment options. It is a misunderstanding that every solicited trade is a broker calling up a customer saying that "You should buy this security."

Further, is it EBSA's intent to impose a fiduciary duty when a customer sets the investment parameters, including investment parameters that the broker may disagree with, is presented with a range of different opportunities within those parameters, and then chooses one? Should a broker be liable as an ERISA fiduciary if the value of the security subsequently declines? The use of the word "recommend" does not sufficiently describe the give and take that goes on in discussing a range of possible investments with brokers. And it relies on a model that differs from the broker acting as an agent to fulfill the investment decisions of the customer that the customer makes of its own volition.

Timing – Upcoming SEC Consideration of Fiduciary Standard for Brokers

As described above, under the Rule Proposal plans would lose access to numerous broker-dealer services due to ERISA's prohibitions. This shows that the Rule Proposal needs more consideration and is premature. Indeed, we suggest that EBSA seriously consider refraining from imposing a fiduciary duty on securities broker-dealers until it understands what

---

[2] According to Dictionary.com, "recommend" can mean any of the following:

1) to present as worthy of confidence, acceptance, use, etc.; commend; mention favorably;
2) to represent or urge as advisable or expedient;
3) to advise, as an alternative; suggest (a choice, course of action, etc.) as appropriate, beneficial, or the like; and
4) to make desirable or attractive.

the Securities and Exchange Commission will do in regards to fiduciary duties and broker dealers.

The Dodd-Frank Wall Street Reform and Consumer Protection Act passed in July 2010 included a provision in Section 913 of the Act that required the SEC to study whether to impose a fiduciary standard on securities brokers and dealers. Congress also provided explicit authority to the SEC to impose such a fiduciary duty by rule. The Act adds Section 15(k)(1) to the Securities Exchange Act of 1934 which now says:

> Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940. The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer. Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.

Note that Congress limited the possible fiduciary standard for broker dealers to retail customers. No such limitation was included in the Rule Proposal despite this clear indication of current Congressional intent.

The Act followed this provision with the new Section 15(k)(2) of the Securities Exchange Act of 1934 which now says:

> Where a broker or dealer sells only proprietary or other limited range of products, as determined by the Commission, the Commission may by rule require that such broker or dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer. The sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the standard set forth in paragraph (1)

This shows that Congress understood that syndicators who provide a limited scope of products are representing counterparties, should disclose that role, and that having a limited scope of products, even affiliated products, will not be a violation of any broker-dealer fiduciary duty standard.

The SEC promptly followed up the passage of the Dodd-Frank Act by seeking comments on duties of care by securities broker-dealers to retail customers. SEC Release No. 34-62577 (July 27, 2010) (http://www.sec.gov/rules/other/2010/34-62577.pdf). Comments were closed on

August 30, 2010. The comment request generated hundreds of comments (http://www.sec.gov/comments/4-606/4-606.shtml#comments) and the SEC is now considering a rulemaking proceeding relating to fiduciary duties for brokers.

Given the SEC's long experience supervising the broker-dealer industry in its various forms, the extensive comments on the scope of broker-dealer fiduciary duties, and the Congressional directive on securities brokers selling proprietary products, it is likely the that the SEC will provide more nuanced proposal as to what broker-dealer activities require a fiduciary standard and which do not and what the scope of that fiduciary standard should be. Because the Rule Proposal would materially disrupt the securities broker-dealer industry and its customer accounts, it may be beneficial for EBSA to gain the experience of the SEC's consideration of fiduciary standards for securities brokers. Issuing a broad-based rule of general application that would terminate long-standing industry practices and services before the industry's primary regulator has completed formally considering precisely the same issue would be unsound policy-making. Indeed, it is likely that the cost of implementing the cost of any ERISA fiduciary standard for broker-dealers would be substantially reduced if such standards made an attempt to parallel the SEC's ultimate decision on the same issue. Thus, we request that any new Rule Proposals or final rule issuances be deferred until the SEC has completed the process mandated by Section 913 of the Dodd-Frank Act.

Soft Dollars

In Section 28(e) of the Securities Exchange Act of 1934 Congress specifically stated that investment advisers, including investment advisers serving as ERISA fiduciaries who have investment discretion shall not be deemed to have violated their fiduciary duties under State or Federal Law solely by reason of his having caused the customer's account to have paid a commission to a broker or dealer in excess of the commission another broker or dealer may be offering in the transaction in light of its overall responsibilities with the account if it determines that the brokerage's brokerage and research services have reasonable value, provided that it discloses its broker allocation policies.

This provision protects investment advisers receiving soft dollar research and other brokerage services from being deemed to have violated their ERISA fiduciary duties. But, if a broker-dealer is deemed an ERISA fiduciary under the Rule Proposal and provides such services and research to the investment adviser acting as ERISA fiduciary or a party in interest in lieu of the lowest trade execution price, it may be deemed to have violated ERISA's fiduciary and prohibited transaction provisions. These types of soft dollar arrangements are specifically sanctioned by Congress. It would defeat the Congressional purpose in enacting protections for investment advisers receiving such soft dollar compensation from broker-dealers to create liability under ERISA in the same transaction for the broker-dealer paying the soft dollar compensation.

Consequently, we request that EBSA consider ensuring that the soft dollar practices sanctioned by Congressional action in passing Section 28(e) of the Securities Exchange Act of

1934 be explicitly sanctioned under any revised Rule Proposal or the promulgation of the final rule. For further information on soft dollar practices please refer to the SEC's interpretive guidance on this issue.[3]

Misstatement of Standard of Proof for Claims Against Non-Fiduciaries

The Rule Proposal claims that EBSA staff must prove that a service provider is a fiduciary to pursue claims against that service provider.[4] But, that is untrue. The fiduciary status determination is only relevant to the types of claims that EBSA and private litigants pursue and the required mental state. ERISA's statutory scheme provides that non-fiduciaries may be pursued for equitable remedies such as injunctions, turnovers, rescission, disgorgement and restitution if they are knowing participants in a fiduciary's breach of duty or if they are parties-in-interest under 29 U.S.C. 1106(a). 29 USC §§1132(a)(3), 1132(a)(5) and 1132(l); *Mertens v. Hewitt Associates*, 508 US 248 (1993); *Harris Trust and Savings Bank v. Salomon Smith Barney*, 530 U.S. 238, 120 S.Ct. 2180 (2000).

The *Harris Trust* case merits further review. In it the Supreme Court specifically upheld actions against non-fiduciaries authorized by 29 USC §§1132(a)(3) and 1132(a)(5) against parties in interest to prohibited transactions and for participating in knowing breaches of the fiduciary's duties. The Court stated:

> Section 502(l) contemplates civil penalty actions by EBSA against two classes of defendants, fiduciaries and "other persons." The latter class concerns us here. Paraphrasing, EBSA shall assess a civil penalty against an "other person" who "knowingly participates in" "any . . . violation of . . . part 4 . . . by a fiduciary." And the amount of such penalty is defined by reference to the amount "ordered by a court to be paid by such . . . other person to a plan or its participants and

---

[3] SEC Release No. 34-54165 (July 18, 2006)

[4] The Rule Proposal states:

> One of the most critical elements in bringing enforcement actions under the ESOP and CAP initiatives is establishing that a service provider is a fiduciary. In order to make this determination investigators must gather evidence to support a finding for each element of the five-part test. In all cases, the analysis requires extensive review of plan documents and contracts, client files, e-mails, investment documentation, accounting records, and interview statements to be obtained from service providers and their affiliates. Consequently EBSA investigators routinely devote disproportionate time and resources establishing all elements of the give-part test, rather than focusing on the precise misconduct at issue in a particular case . . .
>
> One of the most substantial impediments confronting CAP investigators when bringing enforcement actions under the CAP program is proving all elements of the current rule's five-part test are met. As stated earlier, CAP investigators spend an inordinate amount of time gathering evidence to satisfy all elements of the five-part test rather than focusing on the misconduct in a particular case.

> beneficiaries in a judicial proceeding instituted by EBSA under subsection (a)(2) or (a)(5)."
>
> The plain implication is that EBSA may bring a civil action under § 502(a)(5) against an "other person" who "knowingly participates" in a fiduciary's violation; otherwise, there could be no "applicable recovery amount" from which to determine the amount of the civil penalty to be imposed on the "other person." This § 502(a)(5) action is available notwithstanding the absence of any ERISA provision explicitly imposing a duty upon an "other person" not to engage in such "knowing participation." And if EBSA may bring suit against an "other person" under subsection (a)(5), it follows that a participant, beneficiary, or fiduciary may bring suit against an "other person" under the similarly worded subsection (a)(3). Section 502(*l*), therefore, refutes the notion that § 502(a)(3) (or (a)(5)) liability hinges on whether the particular defendant labors under a duty expressly imposed by the substantive provisions of ERISA Title I. *(cites omitted) Harris Associates* at 248-249.

The Rule Proposal appears to be an end-around ERISA's well-established statutory scheme requirement that participation in a fiduciary's breach of duty and a culpable mental state be proven against non-fiduciary service providers to state a claim under ERISA. The culpable mental state is in the statutory scheme. It should not be rendered null and void by recasting those persons as fiduciaries. If EBSA or private litigants pursue non-fiduciary service providers, they need to prove that these defendants acted knowingly. The Rule Proposal appears to be a transparent attempt to evade the culpable mental state mandated by Congress for service providers to fiduciaries, plans and plan participants.

The knowing participation requirement is similar to the requirements in other relevant regulatory schemes to require a culpable mental state to find liability for ancillary persons for the primary violation of another. For example, Section 20(e) of the Securities and Exchange Act of 1934 (15 USC 78t(e)) provides for aiding and abetting liability to those who provide substantial assistance to the primary violator provided that 1) the defendant acted knowingly; and 2) that the action was brought by the U.S. Securities and Exchange Commission, not a private party. Indeed, the Securities and Exchange Act of 1934 corollary is especially apt because the Supreme Court cited ERISA's knowing participant provisions and limitations on parties bringing matters in assessing the scope of aiding and abetting liability under the Exchange Act as it was stated in 1993. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 US 164, 175 (1993). The SEC routinely brings cases requiring culpable mental states against aider and abettors and against principal violators under SEC Rule 10b-5, which requires *scienter*. We see no reason why EBSA investigators should not meet the same threshold. This would require that a case be based on what was known at the time rather than 20/20 hindsight.

The ERISA statutory scheme as determined by Congress and 35 years of court precedent, including Supreme Court cases such as *Mertens* and *Harris Associates*, should not be overrun by just changing the definition of fiduciary to enable EBSA's investigators to avoid needing to prove a culpable mental state against non-fiduciary service providers.

Inadequate Regulatory Findings

The Rule Proposal has inadequate regulatory findings to justify the imposition of the rule against the broad segment of securities broker-dealer service providers it targets. It make findings relating to some service providers such as pension consultants and valuation consultants, and then seeks to use that foundation to persons not mentioned in such findings, especially the entire broker-dealer industry. It also provides no referenced foundation for many of its findings. And when it does cite some source material for a finding, the source material does not support the finding.

The Rule Proposal admits that this is a significant rule that will cost persons who would become subject to the fiduciary rule more than $100 million per year due to their "increased liability" but basically deems it a wash because that $100 million or some similar sum would theoretically go to plans instead. It also recognizes the costs of service providers needing to restructure transactions or modify business practices due to ERISA's prohibited transaction prohibitions. But, the rule says that this is all justified because the expansion of the fiduciary standard would:

1) discourage harmful conflicts of interest;
2) improve service value; and
3) enhance EBSA's ability to redress abuses and more effectively and efficiently allocate its enforcement resources.

Unfortunately, each of those vague findings as to securities broker-dealers is unsupported in the Rule Proposal. For these persons the Rule Proposal does not demonstrate any need for additional regulation over what are already highly regulated service providers. In analyzing the regulatory findings, it would be beneficial to determine what the Rule Proposal found.

Finding #1 - "Consultants" who "<u>in some cases</u>" receive "compensation from investment companies whose products they recommend to the plan, which <u>could</u> lead them to steer the plans toward products for which they receive additional compensation. These arrangements <u>can</u> be harmful to plan participants because the plan <u>may</u> pay excessive fees which <u>could</u> lower returns."

1) As shown by the operative limitations "<u>in some cases</u>," "<u>could</u>," "<u>can</u>" "<u>may</u>" and "<u>could</u>" (for a second time) this finding is unabashed speculation. The Rule Proposal cites no concrete data demonstrating any likelihood that expanding the fiduciary standard to such "consultants" would increase returns or prevent excessive fees – not a single academic or industry study. The Rule Proposal cites no statistical averages, no alternative scenarios, no regressions, and no econometric analysis on a micro or macro level for its speculative conclusion outside of a reference to broker-sold mutual funds in footnote 30 of the Rule Proposal.

2) The Rule Proposal seems deliberately vague when it refers to "Consultants." Is this a reference to securities brokers? Is the compensation received from "products" a reference to commissions and Rule 12(b)(1) fees? Is it a reference to other consultants not subject to regulation by another regulator? Given the transparent speculation as to the value of the rule, EBSA should explicitly say who it is referring to in its speculative findings. If EBSA believes that the receipt of 12(b)(1) fees by broker causes an undisclosed conflict of interest, it should specifically say so.

3) As to securities brokers and dealers, each relevant transaction is subject to the conflict disclosure requirements in SEC Rule 10b-10. The Rule Proposal's apparent finding of non-disclosure of conflicts should identify what shortcomings EBSA sees in Rule 10b-10's conflict disclosure requirements. If there are no additional conflict disclosures to be required, then this does not provide a reasonable ground to extend the fiduciary standard to brokers and dealers subject to the requirements of SEC Rule 10b-10. At the very least the Rule Proposal should have identified the conflict disclosure shortcomings in federal securities laws in order to provide for a foundation for using conflict of interest disclosure to expand the fiduciary definition to brokers. It did not do so. [5]

---

[5] SEC Rule 10b-10 requires a securities broker or dealer to disclose the following for each transaction:

a. The date and time of the transaction;
b. Whether the broker or dealer is acting as an agent for the customer, as agent for some other person, as agent for both the customer and some other person, or as a principal, whether as a market maker or as a block positioner.
    i. If the broker or dealer is acting as an agent for the customer, for another person, or both the customer and another person, it is required to disclose the following:
        1. The name of the person from whom the security was purchased or to whom it was sold;
        2. The amount of remuneration received or to be received by the broker from the customer;
        3. Whether the broker or dealer is receiving payment for order flow in such securities and the source and nature of the compensation;
        4. The source and amount of any other remuneration received to be received by the broker or dealer.
    ii. If the broker or dealer is acting as a principal in its own account it is required to disclose:
        1. If the broker or dealer is not a market maker in the equity security and after having received the customer order, the broker or dealer purchased or sold the equity security from another person to offset a contemporaneous purchase or sale to the customer, the broker or dealer is required to disclose the difference between the customer's price and the broker or dealer's contemporaneous price
        2. The difference if any between the reported trade price to the market and the customer's trade price.
c. Whether any odd-lot differential or equivalent fee was paid by the customer and the amount of the fee;
d. In transactions involving redeemable debt securities customers must be told that such debt security is redeemable before maturity;
e. The dollar price and yield to maturity in debt security transactions;
f. For debt security transactions effected on the basis of yield:

4) Federal securities law also requires conflict of interest disclosures in registration statements and mutual fund prospectuses. For example, Regulation S-K requires the disclosure in registration statements and, by reference, certain periodic filings of security ownership of certain beneficial owners and management (Item 403), Transactions with Related Persons, Promoters and Certain Control Persons (Item 404); the Code of Ethics (Item 406), Corporate Governance (Item 407), Interests of Named Experts and Counsel (Item 509), and Indemnification of Directors and Officers (Item 702). SEC Form N-1A requires that mutual funds disclose to investors brokerage allocation and other practices and numerous other conflict of interests disclosures.

Finding #2 - "Service Providers" to defined benefit plans have undisclosed conflicts of interest.

1) The only source cite is made to a 2005 SEC study of pension consultants that 13 out of 24 pension consultants or their affiliates had undisclosed conflicts of interests with the defined benefit plans serviced.

2) The SEC study relates only to pension consultants. It does not relate to brokers, dealers, appraisers, or other service providers other than pension consultants. Any findings relating to pension consultants have zero bearing on the activities of brokers, appraisers, and other service providers who would be deemed ERISA fiduciaries under the Rule Proposal. As to service providers other than pension consultants this finding is irrelevant.

3) The cited 2005 SEC study related to conflict disclosures pension consultants who were SEC-registered investment advisers, and thus were already ERISA fiduciaries. Consequently, EBSA is citing a source relating to undisclosed conflicts by fiduciaries to attempt to justify the expansion of the fiduciary definition to appraisers, brokers and other service providers who are not fiduciaries. That approach is improper.

---

i. The yield at which the transaction was effected, including the percentage amount of characterization (e.g. current yield, yield to maturity, or yield to call), and if effected at yield to call, the type of call, the call date and the call price;
ii. The dollar price calculated from the yield;
iii. If calculated on a basis of other than yield to maturity or if the yield to maturity is lower than the represented yield, then the yield to maturity must be disclosed along with the represented yield;

g. For asset-backed debt securities representing an interest in or secured by a pool of receivables or other financial assets subject to prepayment, a statement that the actual yield of such asset-backed securities may vary according to the rate at which the underlying receivables or other financial assets are prepaid and a disclosure of the factors that affect yield, including minimum estimated yield, weighted average life, and the prepayment assumptions underlying yield;
h. If a debt security has no rating, the fact of no rating must be disclosed unless the debt security is issued by a governmental entity; and
i. If the broker or dealer, (or the correspondent clearing firm) is not a SIPC (Security Investor Protection Corporation), then a disclosure that there is no SIPC coverage on the transaction or for the asset.

4) The Rule Proposal failed to disclose that the cited SEC report noted that in 2004 1,742 SEC-registered investment advisers who have fiduciary duties under the Investment Advisers Act of 1940 disclosed providing pension consulting services. *See U.S. Securities and Exchange* Commission*, Office of Compliance Inspections and Examinations, Staff Report Concerning Examination of Select Pension Consultants* (Washington, DC: May 16, 2005.) at footnote 2. Such registered investment advisers acting as pension consultants would be fiduciaries and already subject to the ERISA fiduciary responsibilities.

5) The Rule Proposal further omits to state the actual number of pension consultants in 2010 who are SEC-registered investment advisers and subject to fiduciary requirements. This number is likely substantially higher than 1,742 from 2004 due to the phase-in of SEC Rule 202a-2 relating to pension consultants.

Finding #3 – Consultants, Appraisers and Advisors have abused their relationships with plans by recommending investments in exchange for undisclosed kickbacks from investment providers.

1) This finding is unsourced in the Rule Proposal. Consequently, we cannot effectively determine what type of transaction this finding is intended to refer to.

2) To the extent that this refers to securities broker-dealer commissions, SEC Rule 12b-1 fees and mutual fund trailers, SEC Rule 10b-10 and other regulations require disclosure of this information to the customers.

3) As to securities broker-dealers this finding should denote the "undisclosed kickbacks" and the disclosure shortcomings in the SEC regulatory regime. Because it did not do so, this finding does not support extending the fiduciary exemption to securities broker-dealers.

Finding #4 – Consultants, Appraisers and Advisors have abused their relationships with plans by engaging in bid-rigging;

1) This finding is unsourced in the Rule Proposal. Consequently, we cannot effectively determine what type of transaction this finding is intended to refer to.

2) Successful "bid-rigging" requires a concentration of suppliers in that market segment. The securities broker-dealer industry is currently is highly diversified and deeply competitive. Before 1975 securities broker commissions were based on a fixed schedule set by the SEC and commissions levels had been fundamentally unchanged for many decades. But, on May 1, 1975 the SEC eliminated fixed commission rates and allowed for negotiated commissions. Commission rates immediately dropped substantially and have continued their downward migration as the industry has gained efficiency. Any attempts at "bid-rigging" among securities brokers would likely have no effect on the

marketplace due the level of competition. This finding is thus unsupportable as it relates to securities brokers and dealers.

Finding #5 – Consultants, Appraisers and Advisors have abused their relationships with plans by misleading plan fiduciaries about the nature and risk associated with the plans investments.

1) This finding is unsourced in the Rule Proposal. Consequently, we cannot effectively determine what violations by securities brokers and dealers this refers to.

2) Misleading plan fiduciaries about nature and risk of investments is actionable under the anti-fraud provisions state and federal securities laws. Indeed, under the FINRA suitability standard in NASD Rule 2310 there are added protections without having to prove fraud.[6] Further, new causes of action may arise from the SEC consideration of a fiduciary standard for broker and dealers. Nothing in the Rule Proposal demonstrates that current causes of action against securities brokers and dealers are inadequate and need additional remedies in light of the remarkable disruption of broker-dealer services that would ensue from imposing prohibited transaction standards on the broker-dealer industry.

Finding #6 – Appraisers have been providing biased valuation opinions.

1) The appraiser bias finding is sourced via footnote 25 of the Rule Proposal to a 2007 GAO report.[7] But, the report related to pension consultants, not appraisers. Using the GAO report to justify a bias finding against appraisers is improper.

2) Further, this finding has no relevance to expanding the fiduciary standard to brokers and dealers using this finding to justify such an expansion to these service providers would be improper.

---

[6] NASD Rule 2310 says:
(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
(1) the customer's financial status;
(2) the customer's tax status;
(3) the customer's investment objectives; and
(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

[7] GAO, Conflicts of Interests Involving High Risk of Terminated Plans Pose Enforcement Challenges, Defined Benefit Pension Report (June 2007).

Finding #7 - Pension Consultants have an "Implied Bias"

1) The pension consultant implied bias finding is found in footnote 25 of the Rule Proposal. The finding in the Rule Proposal that there is an "implied bias" that taints pension consultants' advice derives from a 2007 GAO Report. But, the Rule Proposal misrepresents the GAO Report's actual findings. In fact, the sentences in the GAO Report immediately following the referenced return information state:

> Because many factors can affect returns, and data and modeling limitations limit the ability to generalize and interpret the results, this finding, while suggestive, should not be considered as proof of causality between consultants and lower rates of return. Lack of data prevented a similar study of PBGC trusteed plans or high risk plans likely to terminate. Although SEC staff have reported that some of the consultants examined in its study have since taken some corrective action, this finding nevertheless illustrates the importance of detecting the presence of undisclosed conflicts of interest among ongoing plans, and likely among terminated plans. However, independent experts, EBSA and PBGC officials all concur that while analyzing rates of return is a useful first step, determining whether conflicts resulted in financial harm to individual plans and the magnitude of that harm is often extremely difficult without a detailed forensic audit. *GAO Report at pages 3-4.*

   In substance, the Rule Proposal morphs a GAO report which says that analyzing rates of return is inconclusive, "suggestive" and a "useful first step" to a definitive regulatory finding of "implied bias" that taints the entire pension consulting industry, and causes lower returns. As demonstrated by the GAO report the finding relied on, this "implied bias" regulatory finding misrepresents the finding of its source material and is improper.

   Although the EBSA Rule Proposal mentioned the SEC study, it failed to reference what the SEC did with the results of the study. It issued rules causing the pension consultants to fall within the requirements of the Investment Advisors Act of 1940 and made the pension consultants eligible to be registered as investment advisers under the Investment Advisers Act of 1940 if they consulted with plans having an aggregate value of $50 million or more. SEC Rule 203a-2. There is no reference to any study or finding that this is an inadequate regulatory regime. Plus, as previously stated, investment adviser registration imposes fiduciary duties on pension consultants.

2) Since this finding related only to pension consultants, it has no relevance to expanding the fiduciary standard to appraisers, brokers and dealers using this finding to justify such an expansion to these service providers would be arbitrary and capricious.

Finding #8 – Appraisers have been providing incompetent valuation opinions

1) This finding is unsourced in the Rule Proposal.

2) This finding does not relate to securities brokers and dealers.

Finding #9 – Appraisers have been providing unreliable valuation opinions.

1) This finding is unsourced in the Rule Proposal.

2) This finding does not relate to securities brokers and dealers.

In sum, none of these findings explicitly relates to the securities broker-dealer industry. None of these findings justifies the enormous costs to the securities broker-dealer industry and the complete restructuring of broker-dealer services required by the Rule Proposal.

Indeed, the following table clearly summarizes the above analysis.

Continue to Next Page

Finding No.	Finding Description	Finding Relevant to Securities Brokers and Dealers	Source Cited in Rule Proposal	Comment
1	Consultants, Appraisers and Advisors have abused their relationships with plans by recommending investments in exchange for undisclosed kickbacks from investment providers	Unclear	No	No reference to alleged shortcomings in securities broker-dealer's mandatory disclosures under securities law
2	"Service Providers" to defined benefit plans have undisclosed conflicts of interest	Unclear	Yes - 2005 SEC Study on Pension Consultants	Source material relates only to pension consultants, most of whom are already ERISA fiduciaries due to their SEC investment adviser registration. Nothing cited on broker-dealers. No reference made to any shortcomings in securities broker-dealer's mandatory disclosures under securities laws.
3	Consultants, Appraisers and Advisors have abused their relationships with plans by recommending investments in exchange for undisclosed kickbacks from investment providers	Unclear	No	No reference made to any shortcomings in securities broker-dealer's mandatory disclosures under securities laws. Unclear if this is a reference to mutual fund trailers and Rule 12(b)(1) fees
4	Consultants, Appraisers and Advisors have abused their relationships with plans by engaging in bid-rigging	Unclear	No	Bid-rigging requires a concentration of available suppliers. Securities broker-dealer industry is highly diverse and competitive. Fixed commissions have been illegal since 1975.

Finding No.	Finding Description	Finding Relevant to Securities Brokers and Dealers	Source Cited in Rule Proposal	Comment
5	Consultants, Appraisers and Advisors have abused their relationships with plans by misleading plan fiduciaries about the nature and risk associated with the plans investments	Unclear	No	No finding as to inadequacy of regulation and remedies under securities laws.
6	Appraisers have been providing biased valuation opinions	No	Yes - GAO Report	GAO Report is on pension consultants, not appraisers; pension consultants are already subject to ERISA fiduciary standards as investment advisers
7	Pension Consultants have an “Implied Bias”	No	Yes - GAO Report	Pension Consultants are already subject to ERISA fiduciary requirements as registered investment advisers; GAO Report does not support “Implied Bias” finding
8	Appraisers have been providing incompetent valuation opinions	No	No	
9	Appraisers have been providing unreliable valuation opinions	No	No	

Benefit Analysis

Based on the above unsupported findings of problems to be fixed in reference to the securities broker-dealer industry, EBSA found that the Rule Proposal will 1) discourage harmful conflicts; 2) improve service value; and 3) enhance the Department's ability to redress abuses and more effectively and efficiently allocate resources.

In support of these benefits, EBSA cites several times to the 2007 GAO report finding of an apparent correlation of 130 basis points. But, as stated above, this use of the GAO report misrepresents the findings of the GAO report. The GAO report cannot be used for the finding of regulatory benefits because, as the report stated, in 2007 EBSA represented to the GAO that: "while analyzing rates of return is a useful first step, determining whether conflicts resulted in financial harm to individual plans and the magnitude of that harm is often extremely difficult without a detailed forensic audit." Further the GAO Report also stated:

> Because many factors can affect returns, and data and modeling limitations limit the ability to generalize and interpret the results, this finding, while suggestive, should not be considered as proof of causality between consultants and lower rates of return

Thus, EBSA should not use the GAO report as the basis for a finding of regulatory benefits and its use of the report for that purpose in the Rule Proposal directly contradicts the evaluation of the data set that it made to the GAO in 2007. Moreover, the GAO report is, in fact, not relevant to the Rule Proposal because the GAO report focuses on pension consultants who are already ERISA fiduciaries as registered investment advisers. The GAO report makes no relevant findings as to the apparent intended targets of the Rule Proposal, appraisers and securities broker-dealers.

In its benefit analysis, EBSA also cites to the 2005 SEC report on pension consultants. But that report only had a sample size of 24 and the referenced pension consultants were already ERISA fiduciaries because they were registered investment advisers. That report adds nothing to justifying the Rule Proposal against appraisers and securities broker-dealers.

The Rule Proposal also referenced three studies on the value of brokers in the sale of mutual funds in footnote 30. While we have not canvassed the relevant academic literature due to time constraints, we note that these studies all apparently relate to one product and one service offered by the broker-dealer industry (broker-sold mutual funds) but the Rule Proposal is not so limited. It incorporates the whole panoply of products in the broker-dealer universe, including stocks, notes, bonds, structured notes, exchange-traded funds, IPOs, secondary offerings, real estate syndications, options, securities derivatives, security-based swaps, etc. If EBSA has issues with the broker-sold channel for mutual funds, it should specifically address those concerns rather than use it as a rationale for causing a complete restructuring of the broker-dealer industry's service models.

Further, we question the currency of the mutual fund studies in light of recent industry developments. In response to new fee disclosure requirements by plan sponsors the mutual fund industry has rolled out a new class of mutual fund shares – the "R" shares. These shares do not have Rule 12b-1 or shareholder services fees. American Funds launched an R6 share class in May 2009. Principal Financial Group offers R shares on Principal Trust Target Date Collective Investment Funds. In December 2010 J.P. Morgan Asset Management introduce an R6 share class for its mutual funds.[8] EBSA should anticipate that other mutual fund providers will be following suit.

Thus, the represented anticipated benefits relating to the securities broker-dealer do not withstand scrutiny. First, as to discouraging harmful conflicts nothing in the in the Rule Proposal demonstrates any shortcomings in the mandatory conflict disclosures required of securities broker-dealers under federal securities laws. As stated above federal securities law requires disclosure of material conflicts of interests and SEC Rule 10b-10 provides specific conflict disclosures that must be provided on every single securities transaction. As to securities broker-dealers the Rule Proposal had no mention of non-disclosure of "harmful conflicts." Thus, as to securities broker-dealers this cited benefit has no discernible basis. There is no basis to believe that additional conflict disclosures would be made beyond those already required of broker-dealers under federal securities laws.

Second, EBSA found that the Rule Proposal "will" improve service value. As to securities broker-dealers that is demonstrably untrue. Plans, their participants and the beneficiaries will lose access to margin accounts, the ability to use options and short sales as hedges, the ability to derive income from securities lending, access to IPO and secondary offering allocation, and the ability to resolve trade disputes through transfers to and from broker-dealer error accounts. All these limitations also reduce available revenue streams for broker-dealers, so plans, their participants and beneficiaries should expect substantial price increases for the remaining services that broker-dealers would be able to provide. Indeed, the Rule Proposal acknowledges this in Section 7 by saying that service providers "might charge higher fees to plan clients." So, while a non-plan account could expect to continue having low commission costs subsidized by other revenue streams, there is a substantial risk that such commission prices would no longer be available to plans, their participants and beneficiaries because of the increased compliance costs and lack of any other income streams from those accounts. In sum, the Rule Proposal will likely be a substantial net negative for plans receiving broker-dealer services in terms of both services provided and the costs of those services.

Third, EBSA finds a benefit in making it easier for it to "redress abuses" and allow it to better "allocate resources." As stated above, the Rule Proposal does not say that the U.S. Supreme Court held in *Harris Associates* that EBSA can seek remedies against current non-fiduciaries if it proves knowing participation and that the ERISA's statutory scheme requires proof of a culpable mental state in actions against non-fiduciaries. So, it appears that making it

[8] "JPM Launches R Class free of 12(b)-(1) fees" Investment News, December 13, 2010, page 3, found online at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20101212/REG/312129977

easier to "redress abuses" is, in other words, an attempt to avoid ERISA's statutory requirements that a culpable mental state should be proven when pursuing remedies under ERISA's statutory scheme against ancillary figures.

Regulatory Flexibility Act: Impact on Small Businesses

We believe that EBSA has taken insufficient steps to ensure compliance with the Regulatory Flexibility Act (5 USC 601 et seq.) in connection with extending the ERISA fiduciary standard to securities brokers and dealers. The sole foundation for the determination of the effect on small business was based on estimates extrapolated from payments of $5,000 or less to service providers as reported in the 2007 Form 5500. EBSA then concluded that this would amount to 5,170 service providers with revenues of less than $7 million, but that it believed that this number was overstated.

We object to EBSA's methodology in connection with the securities broker-dealer industry because it makes no reference the information available about the industry. First, FINRA reports on its website that there are 4,620 brokerage firms registered with FINRA which includes 165,920 branch offices and 636,340 registered securities representatives. Of those 4,620 FINRA-registered brokerage firms, FINRA classified 4,306 of them as small firms for the purposes of its Board of Directors election on August 12, 2010. It also classified 220 firms as mid-sized and 172 firms as large.

But, that does not tell the whole story. Many broker-dealers provide platforms for small business entities. The representatives run their own offices and are not employees. They generally have and advertise their own brand. The broker-dealer provides the platform for the independent representative and his or her small business entity to operate. Most of these independent representative firm branch offices will qualify as their own small business entities. Schedule A attached shows information derived from a list of independent representative firms posted on www.investmentnews.com.[9] The 88 independent representative firms on Schedule A show a total of 126,643 registered representatives, with 17,456 employees. Assuming that each employee is a registered person, then that would yield 109,187 independent representatives from those 88 firms. Assuming an average of three registered representatives per independent representative office, that would yield 36,396 small business entities affected by the Rule Proposal. This is a reasonable number given that FINRA has stated that there are 165,920 registered broker-dealer branch offices. When the number of small broker-dealers is added to that, the total number can surpass 40,000 small business entities, or approximately 8 times the number of small business entities referenced in the Rule Proposal.

This number of small businesses is not the complete number because this is just for the securities broker-dealer business. This does not include other small businesses that may be affected by the imposition of the Rule Proposal, especially in the appraisal industry.

---

[9] Investment News asks that questions on the data set be directed to: Kristen Hensley at khensley@investmentnews.com or 212-210-0451.

We also object because EBSA has apparently made no attempt to survey the above-referenced small business entities, instead relying only on Form 5500 reports from plan administrators servicing over 100 employees. It would not be difficult to survey the securities broker-dealer industry. The SEC posts a complete list of registered broker-dealers and addresses on its website in a spreadsheet format.[10] Online service providers could have compiled the survey results without imposing much of a burden on EBSA staff.

EBSA also claims in the Rule Proposal that it is unable to estimate the increased business costs if the small business entity and that such costs would include purchasing fiduciary liability insurance. We believe that EBSA could have surveyed insurers and determined a range of marginal additional costs per covered employee.

EBSA also estimated in the Rule Proposal that it would have an average impact of only $1,900 to review the services providers' contracts and operations to seek compliance with ERISA fiduciary status requirements. We don't know the source of that assessment. The Rule Proposal also states that compliance will take 19 hours of legal work at a billable rate of $119 per hour which amounts to $2,261. Regardless of the precise number, we believe that this assessment materially understates the true costs by several magnitudes. As explained above, the Rule Proposal would be incredibly disruptive to broker-dealers, require major changes to business operations, and require the review of each customer account to determine whether it is plan account, and if so, how the contracts would need to be revised. In our estimation the 19 hour estimation understates the reality of the task by several magnitudes. Further, most of the small broker-dealers and other businesses referenced above are too small to employ dedicated in-house legal counsel. Consequently, they will need to engage qualified outside securities counsel. And we can assure you that the going rate for qualified securities counsel substantially exceeds $119 per hour.

So, while EBSA has come out with an estimated undiscounted cost of legal and compliance review derived from the Rule Proposal of less than $18 million over ten years, we believe that the true legal review and compliance costs will be several times that amount.

We believe that EBSA likely could have obtained more complete and accurate cost numbers had it surveyed those it intends to place under the fiduciary standard. This information is simply not going to be available from a review of one year of Form 5500 reports.

Statutory Authority

Finally, we are concerned that EBSA lacks statutory authority for its proposed expansion of the definition of fiduciary in the securities broker-dealer context. We understand that EBSA has said in the Rule Proposal that the previous approach to fiduciary status is not "compelled by the statutory language" and apparently is not seeking comments on this issue. But, nonetheless

[10] http://www.sec.gov/foia/docs/bdfoia.htm

we do not think that securities broker-dealers were meant to be designated as fiduciaries under ERISA's statutory scheme.

In 1974 when ERISA passed there was a well-understood difference between investment advisers who had fiduciary duties under the Investment Adviser Act of 1940 and securities brokers and dealers who had no such duties and operated under the Securities Exchange Act of 1934. These types of service providers provide different types of services. We believe that Congress understood that securities brokers and dealers were not ERISA fiduciaries because it prohibited fiduciaries from engaging in so many of the activities and services that brokers and dealers had performed for decades for their customers. These activities and services included margin loans, margin accounts, uncovered options, short selling and securities lending. Moreover, Congress could have specifically referenced securities brokers and dealers but failed to do so. It is unlikely that Congress intended to incorporate an entire industry supervised by another federal regulator into the ERISA fiduciary standard by implied inference derived from statutory language.

This view is further reinforced when Congress revisited the fiduciary issue in 1975 a year after passing ERISA. In response to industry changes stemming from the end of fixed commissions in May 1975, Congress added Section 28(e) to the Securities and Exchange Act of 1934. It states that investment advisers, including investment advisers serving as ERISA fiduciaries, who have investment discretion shall not be deemed to have violated their fiduciary duties under State or Federal Law solely by reason of his having caused the customer's account to pay a commission to a broker or dealer in excess of the commission another broker or dealer may be offering in the transaction in light of its overall responsibilities with the account if it determines that the brokerage's brokerage and research services have reasonable value, provided that it discloses its broker allocation policies. Note that Congress provided this protection only to investment advisers, not securities brokers and dealers. It would have made no policy sense to exempt the recipient of the soft dollars from ERISA's fiduciary duties but to deem the payor of the soft dollars to have engaged in a prohibited transaction under ERISA (by paying a party in interest while recommending securities transactions) for the same transaction. This shows that in 1975, a year after Congress enacted ERISA, Congress did not view the activities of securities brokers and dealers, such soliciting trades, to bring them under the ERISA fiduciary standards. Otherwise brokers and dealers would have also received a soft dollar fiduciary exemption along with the investment advisers.

Finally, Congress revisited this issue again just last year in the Dodd Frank Act. Congress considered industry changes in the securities broker-dealer business to merit revisiting fiduciary standards for brokers. The Dodd-Frank Act added §15(k)(1) to the Securities Exchange Act of 1934 to provide the SEC with the statutory authority to impose such a standard by regulation. The clear inference is that Congress and the SEC deemed there to be serious questions about the SEC's statutory authority to engage in such rulemaking absent that explicitly authority.

Pointedly, Congress did not provide similar authority to EBSA in the Dodd-Frank Act. Since EBSA is promulgating the Rule Proposal under it general rulemaking authority rather than specific rulemaking authority relating to the securities broker-dealer industry, there should be serious questions as to why Congress did not specifically grant EBSA the same authority it granted the SEC and whether EBSA needs specific rulemaking authority relating to the securities broker-dealer industry to promulgate the proposed rule.

We look forward to EBSA's consideration of these important matters and hope that our comments will be of use.

Very truly yours,

John R. Fahy
Whitaker, Chalk, Swindle & Sawyer, L.L.P.
jfahy@whitakerchalk.com
Committee Vice-Chair, Securities
Committee of Business Law Section of the State
Bar of Texas
(Primary Author)

Carol Mattick
Carol Bavousett Mattick, P.C.
carol@cbmattick.com
Committee Chair, Securities Committee
of the Business Law Section of the
State Bar of Texas

Dan Waller
Secore & Waller, LLP
dan@secorewaller.com
Member, Securities Committee of the
Business Law Section, State Bar of Texas
Chairman, Securities Committee, American
Association of Attorney-Certified Public
Accountants

Schedule A

No.	Independent Representative Broker-Dealer	Number of Reps	Full-Time Employees	Estimated Net Independent Reps (Number of Reps minus Number of Full-Time Employees)
1	LPL Financial	11,214	2,200	9,014
2	NYLIfe Securities LLC	7,793	216	7,577
3	Lincoln Financial Network	7,682	895	6,787
4	Ameriprise Financial Services	7,658	2,400	5,258
5	Metlife Securities, Inc.	6,631	265	6,366
6	AXA Advisors, LLC	5,883	47	5,836
7	Northwestern Mutual	5,752	448	5,304
8	H.D. Vest Financial Services	5,175	280	4,895
9	Raymond James Financial Services, Inc.	3,278	2,338	940
10	Park Avenue Securities, LLC	2,988	107	2,881
11	Financial Network Investment Corp.	2,413	219	2,194
12	ING Financial Partners	2,389	62	2,327
13	Princor Financial Sercices Corp.	2,370	72	2,298
14	Waddell & Reed, Inc.	2,359	299	2,060
15	New England Securities, Inc.	2,318	265	2,053
16	Genworth Financial Securities	2,100	100	2,000
17	Securities America, Inc.,	1,933	412	1,521
18	John Hancock Fianncial Network	1,896	172	1,724
19	Ameritas Investment Corp	1,886	130	1,756
20	NFP Securities	1,750	170	1,580
21	Woodbury Financial Services	1,700	224	1,476
22	Cambridge Investment Research, Inc.	1,604	345	1,259
23	National Planning Corp.	1,593	173	1,420
24	SagePoint Financial, Inc.	1,554	242	1,312
25	Royal Alliance Associates, Inc.	1,549	207	1,342
26	Primevest Financial Services, Inc.	1,448	244	1,204
27	TransAmerica Financial Advisors, Inc.	1,432	135	1,297
28	Securian Financial Services, Inc.	1,394	113	1,281
29	Commonwealth Financial Network	1,314	435	879
30	Invest Financial Corp.	1,227	167	1,060
31	ProEquities, Inc.	1,210	101	1,109
32	FSC Securities Corpo.	1,064	157	907

No.	Independent Representative Broker-Dealer	Number of Reps	Full-Time Employees	Estimated Net Independent Reps (Number of Reps minus Number of Full-Time Employees)
33	Multi-Financial Securities Corp.	980	124	856
34	Next Financial Group, Inc.	1,027	138	889
35	Caderet Grant & Co., Inc.	990	112	878
36	The O.N. Equity Sales Co.	868	39	829
37	Capital Financial Group, Inc./H Beck, Inc.	836	77	759
38	Uvest	736	141	595
39	Wells Fargo Advisors Financial Network	745	76	669
40	Walnut Street Securities, Inc.	731	265	466
41	M Holdings Securities, Inc. (M Securities)	706	54	652
42	Equity Services, Inc.	670	45	625
43	First Allied Securities, Inc.	663	231	432
44	American Portfolio Financial Services, Inc.	647	72	575
45	Centaurus Financial, Inc.	644	50	594
46	Questar Capital Corp	614	74	540
47	Sigma Financial Corp	608	100	508
48	Investors Capital Corp	577	77	500
49	National Securities Corp	568	94	474
50	SII Investments Inc.	556	68	488
51	Sammons Securiites Co., LLC	526	118	408
52	Great American Advisors, Inc.	500	33	467
53	Hornor Townsend & Kent, Inc.	488	54	434
54	Tower Square Securities, Inc.	467	265	202
55	Investacorp, Inc.	460	65	395
56	Triad Advisors, Inc.	450	41	409
57	QA3 Financial Corp.	444	51	393
58	Lincoln Invesmtment Planning, Inc.	432	200	232
59	Secuirity Service Network, Inc.	425	55	370
60	WRP Investments, Inc.	375	25	350
61	PlanMember Seuritics Corp.	370	98	272
62	Investment Centers of America, Inc.	366	79	287
63	Berthel Fisher and Company Financial Services, Inc.	352	65	287

No.	Independent Representative Broker-Dealer	Number of Reps	Full-Time Employees	Estimated Net Independent Reps (Number of Reps minus Number of Full-Time Employees)
64	Summit Brokerage Services, Inc.	350	70	280
65	United Planners Financial Services	342	46	296
66	Independent Financial Group	315	28	287
67	Pacific West Financial Group	309	42	267
68	Geneos Wealth Management, Inc.	302	49	253
69	Crown Capital Securities, LP	302	25	277
70	LaSalle St Securities, Inc.	273	34	239
71	VSR Financial Sercices, Inc.	267	77	190
72	Kovack Securities, Inc.	259	41	218
73	J.W. Cole Financial, Inc.,	250	29	221
74	TFS Securities, Inc.	250	15	235
75	Sterne Agee Financial Services, Inc.	220	20	200
76	Girard Securities, Inc.	200	30	170
77	First Midwest Securities, Ic.	197	28	169
78	Harbour Investments, Inc.	194	19	175
79	CFD Investments, Inc.	185	43	142
80	Wall Street Financial Group, Inc.	163	17	146
81	vFinance Investments, Inc.	154	75	79
82	Ensemble Financial Services, Inc.	150	48	102
83	IMS Securities, Inc./IMS Financial Advisors, Inc.	135	15	120
84	Prospera Financial Services, Inc.	100	31	69
85	Coordinated Capital Securities, Inc.	86	7	79
86	GBS Financial Corp.	65	9	56
87	Synergy Investment Group	60	19	41
88	Spire Investment Partners, LLC	50	13	37
	Total:	**126,643**	**17,456**	**109,187**

Source: Investment News Databook 2010 – December 27-31, 2010