July 17, 2015

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attention: Conflicts of Interest Rule
Room N-5655

Office of Exemption Determinations
Employee Benefits Security Administration
Attention: D-11712 and D-11713

United States Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

*RE: Proposed Conflict of Interest Rule and Related Proposals, RIN-1210-AB32*

Dear Sir or Madam:

The Financial Industry Regulatory Authority ("FINRA") welcomes the opportunity to comment on the Department's proposed amendments to the definition of "fiduciary" (the "Proposed Fiduciary Definition"),[1] the proposed Best Interest Contract Exemption (the "BICE"),[2] and the proposed Exemption for Principal Transactions in Certain Debt Securities (the "Principal Transaction Exemption")[3] (together, the "Proposal").

FINRA is the independent regulatory authority of the broker-dealer industry, established under the Securities Exchange Act of 1934 and subject to the oversight of the Securities and Exchange Commission ("SEC"). FINRA comprehensively regulates the broker-dealer industry by adopting investor protection rules, examining broker-dealers for compliance with the federal securities laws and rules of FINRA, the SEC and the Municipal Securities Rulemaking Board, and enforcing those rules.

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[1] *See* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice; Proposed Rule, 80 FR 21928 (April 20, 2015).

[2] *See* Proposed Best Interest Contract Exemption, 80 FR 21960 (April 20, 2015),

[3] *See* Proposed Class Exemption for Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 80 FR 21989 (April 20, 2015).



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In 2014 FINRA conducted 6,800 broker-dealer examinations and took 1,397 disciplinary actions that addressed a wide variety of misconduct. We barred 481 individuals from association with FINRA-regulated firms, suspended 705 individuals from such association, levied more than $132 million in fines, and ordered $32.3 million in restitution to customers.

## 1. Executive Summary

The Department of Labor has an important responsibility to protect retirement investors. FINRA applauds the Department for raising public awareness about the need to ensure that retirement investors can obtain financial advice without being subject to abusive or predatory sales practices. The Proposal reflects a sincere effort to respond to comments received on the Department's 2010 proposal. The Department is to be commended for its readiness to engage in a dialogue with regulators, investors, and other interested parties about these issues.

### *A. FINRA Supports a Best Interest Standard for Broker-Dealers*

FINRA has publicly advocated for a fiduciary duty for years and agrees with the Department that all financial intermediaries, including broker-dealers, should be subject to a fiduciary "best interest" standard. A best interest standard would align the interests of intermediaries with those of their customers; better protect investors by providing a more consistent set of obligations across financial service providers; help ensure that intermediaries eliminate or manage conflicts of interest; and help ensure that intermediaries establish an ethical culture throughout their firms.

### *B. Minimum Criteria for a Best Interest Standard*

At a minimum, any best interest standard for intermediaries should meet the following criteria:

- The standard should require financial institutions and their advisers[4] to:
  - act in their customers' best interest;
  - adopt procedures reasonably designed to detect potential conflicts;
  - eliminate those conflicts of interest whenever possible;
  - adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer's best interest;
  - obtain retail customer consent to any conflict of interest related to recommendations or services provided; and
  - provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses.

[4] The terms "financial institution" and "adviser" will have the same meaning in this letter as in the Proposal.

- A best interest standard should apply to both retirement and non-retirement accounts. Most investors consider their investment portfolio to include their assets in Individual Retirement Accounts, employer plan accounts, and non-retirement accounts. This perception is rational because an investment decision should reflect the assets in all of those accounts. Imposing disparate standards on different accounts would confuse investors because it would conflict with their own logical assumption that those accounts will be treated seamlessly within their total investment portfolio.

- FINRA respectfully urges that the federal securities laws serve as the foundation of the best interest standard that will apply to broker-dealers. To be successful, the standard must build upon existing principles under the federal securities laws rather than introducing precepts without precedent that will impede the good faith efforts of financial institutions and advisers to comply. The federal securities laws and FINRA rules comprehensively regulate all aspects of a broker-dealer's business. Among the many requirements imposed are the principles that broker-dealers deal fairly with customers, adhere to just and equitable principles of trade, and ensure that recommendations are suitable for customers. Broker-dealers also must establish rigorous systems of compliance and supervision, which are regularly examined by FINRA and the SEC.

  Using these existing requirements as the core structure of a best interest standard would reduce the costs of transitioning to a best interest requirement and provide assurance that the core structure will be enforced by the SEC and FINRA. We recognize that imposing a best interest standard requires rulemaking beyond what is presently in place for broker-dealers. We stand ready to work with the Department and the SEC to develop this additional rulemaking.

- Sufficient guidance must accompany the best interest standard to ensure that financial institutions and advisers will understand what is expected in order to comply with the best interest standard.

- The standard for different intermediaries, especially broker-dealers and investment advisers, must be harmonized. Approximately 87% of all investment adviser representatives are associated with a broker-dealer and many customers hold brokerage and advisory accounts with the same financial institution. The standards for the investment adviser and the broker-dealer businesses must be harmonized to provide consistent investor protection while reflecting the distinctive nature of each business model.

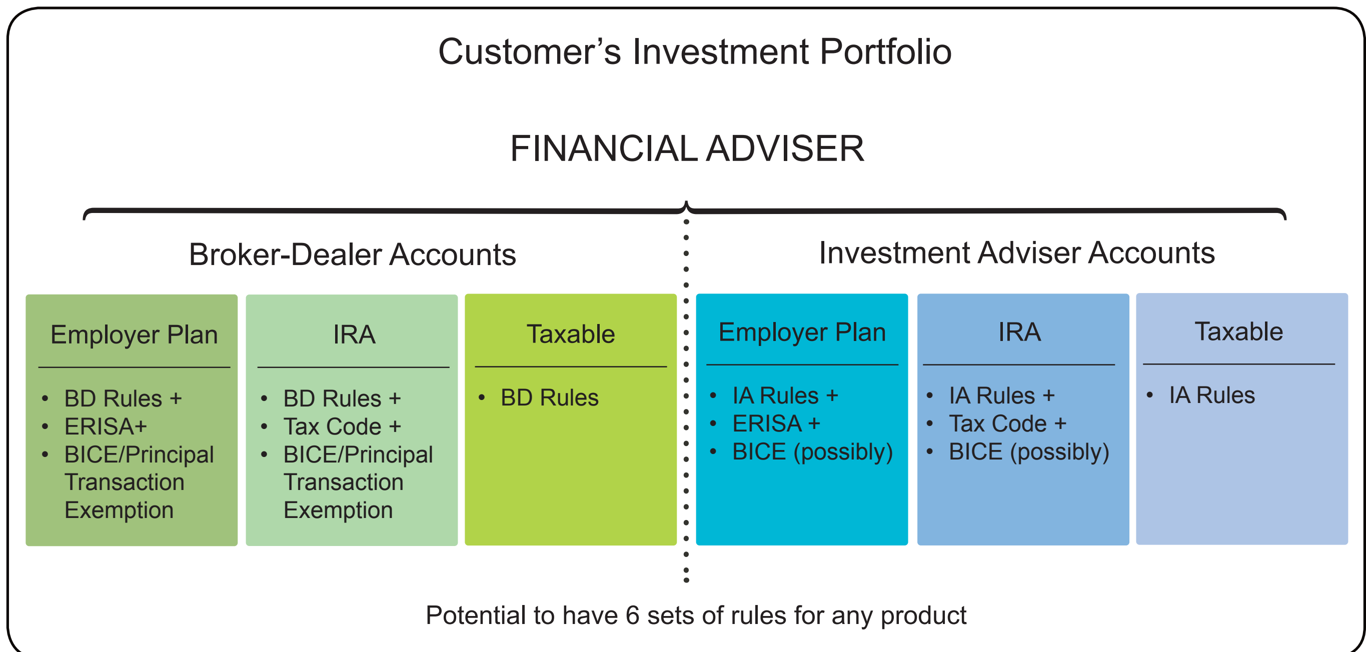
- Customers must have the ability to recover losses incurred as a result of a financial institution or adviser's violation of a best interest standard. The Proposal would permit customers to seek recovery of losses through the existing arbitration process or through actions in court.

*C. The Proposal Does Not Meet Some Minimum Criteria*

The Department should be commended for its efforts to establish a best interest standard. The Proposal, however, does not meet some of the minimum criteria for such a standard. The Proposal does not sufficiently build upon the existing regulatory system under the federal securities laws. The Preamble makes passing reference to the comprehensive, well-established system of regulation that the federal securities laws impose upon broker-dealers under the oversight of the SEC and FINRA. The Proposal does not incorporate existing regulation and introduces new concepts that are fraught with ambiguity. We urge the Department to consider that these ambiguities will frustrate the ability of a financial institution and advisers to comply with the Proposal. These ambiguities will necessitate interpretive guidance on a wide array of issues, which the Preamble does not provide. In some respects the Proposal even conflicts with existing FINRA rules and securities market trading practices.

The Proposal would impose a best interest standard on broker-dealers that differs significantly from the fiduciary standard applicable to investment advisers registered under the federal and state securities laws, and it would impose the best interest standard only on retirement accounts. This fractured approach will confuse retirement investors, financial institutions, and advisers. Below is a depiction of the panoply of regulatory regimes that will apply under the Proposal to different accounts served by the same financial adviser for a single customer.

Proposed DOL Requirements



The confusion illustrated by this graphic could be easily ameliorated if a harmonized best interest standard applied to all of the accounts, retirement and non-retirement, investment and advisory and broker-dealer. The customer and financial adviser could then properly consider the investment portfolio as a whole, subject to a single, harmonized standard.

### *D. FINRA Recommends Five Fundamental Improvements to the Proposal*

If the Department proceeds with the Proposal, FINRA recommends five fundamental improvements.

- First, the Proposal should be amended to clarify the scope and meaning of the best interest standard.

- Second, the Proposal's treatment of differential compensation should be simplified by offering financial institutions a choice: either adopt stringent procedures that address the conflicts of interest arising from differential compensation, or pay only neutral compensation to advisers.

- Third, the Proposal should be based on existing principles in the federal securities laws and FINRA rules. In doing so, the Department would help remove many of the ambiguities that will frustrate good faith attempts at compliance, would avoid conflict with existing rules, and would better ensure that the Proposal's objectives are achieved. FINRA stands ready to engage in additional rulemaking to enhance present requirements.

- Fourth, the Department should streamline the BICE and Principal Transaction Exemption (together, the "Prohibited Transaction Exemptions" or "PTEs") so that they only impose conditions that restrict conflicts of interest, and eliminate the ambiguous conditions that will not meaningfully address those conflicts.

- Finally, the Department should clarify the effects of non-compliance with the Prohibited Transaction Exemptions and the extent that remedies can be defined in the BICE contract.

We urge the Department, at a minimum, to adopt these five recommendations in order to ensure that highly-regulated broker-dealers can continue to serve small investors. According to a 2011 study, 98% of IRA accounts with less than $25,000 are commission-based brokerage accounts.[5] Many investors are buy-and-hold customers who pay lower fees -- commissions upon purchase – than would be paid as an annual percentage of their nest egg.

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[5] *See Assessment of the impact of the Department of Labor's proposed "fiduciary" definition rule on IRA consumers (Oliver Wyman) (April 2011)* at 2.

If the Proposal were adopted as is, many broker-dealers will abandon these small accounts, convert their larger accounts to advisory accounts, and charge them a potentially more lucrative asset-based fee. They will do so largely because of the BICE constraints on differential compensation, the ambiguities in the best interest standard, the lack of clarity concerning various conditions, the costs of compliance, and uncertainty about the consequences of minimal non-compliance.

The Department should not be sanguine about this result. Robo-advice may provide a valuable alternative for some classes of knowledgeable investors, but for many customers robo-advice is a poor substitute for a financial adviser who understands the customer's needs and guides the customer through market turbulence or life events. And private wealth clients who are converted to advisory accounts may still be subjected to conflicted advice, like the peddling of fee-based IRAs for their ERISA plan assets.

## 2. The Best Interest Standard Should be Clarified

The BICE and the Principal Transaction Exemption would require that a financial institution and adviser affirmatively agree to provide investment advice that is in the best interest of the retirement investor "without regard to the financial or other interests" of the financial institution, adviser, or other party.[6] This principle, borrowed from Section 913 of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[7] 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. One could interpret the principle to prohibit any investment advice that takes into account the compensation that the financial institution or adviser will earn for providing that advice. Since financial institutions and advisers are engaged in a business that will earn compensation for their services, they would not provide investment advice at all if the customer were unwilling to pay the fee. Surely this is not the Department's intent.

One could alternatively interpret the principle to prohibit the receipt of compensation that varies with an investment recommendation, but this should not be the meaning because the BICE is intended to permit this compensation. A third interpretation might be that the "without regard to" phrase merely elaborates the term "best interest." Under this interpretation, investment advice may be deemed in the customer's best interest as long as, among other matters, the amount of compensation earned was not a factor in the recommendation. It is unclear how a financial institution or adviser would demonstrate that the amount of compensation was *not* a factor in the recommendation.

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[6] *See* BICE Section II(c)(1), 80 FR at 21984, and Principal Transaction Exemption Section II(c)(1), 80 FR at 22002.

[7] *See* Section 913(g), Dodd-Frank Act (authorizing the SEC to require broker-dealers to "act in the best interest of the customer without regard to the financial or other interest of the broker [or] dealer … providing the advice").

The "best interest" standard also demands that the financial institution and adviser act prudently. The prudence standard might be interpreted to require the financial institution and adviser to provide ongoing advice to the customer, to alert the customer to market events or other circumstances that may affect the prudence of the customer's holdings, and to recommend changes to his investments. The BICE Preamble states that, "[t]he terms of the contract, along with other representations, agreements, or understandings between the Adviser, Financial Institution and Retirement Investors, will govern whether the nature of the relationship between the parties is ongoing or not."[8] Nevertheless, we understand that ERISA plan fiduciaries must comply with a prudence standard that requires ongoing monitoring of this nature. While some broker-dealers provide different levels of monitoring, most commission-based broker-dealers do not charge for ongoing monitoring of their customers' accounts. Moreover, the Dodd-Frank Act would not impose such a duty on broker-dealers.[9] Indeed, frequent suggestions to the customer that the portfolio be changed might expose a broker-dealer to allegations that it is churning the account.

Another question is whether "best interest" requires the financial institution and adviser to recommend the investment that is "best" for the customer. Recent remarks suggest that the Department believes that it may.[10] Fiduciaries must use their best judgment when they provide financial advice, and the question of which investment meets that standard in a particular case will depend upon many factors, including the customer's investment objectives and risk profile, the various components of a specific product, and its risk correlation to other assets in the customer's portfolio. Reasonable and qualified financial advisers may reach different conclusions about which factors are more significant and which product best meets the criteria that the financial adviser believes are most relevant. Fiduciaries generally are not required to discern or recommend the "best" product among all available for sale nationwide or worldwide. Investment advisers, for example, are required to recommend suitable investments, not the "best" investment available to the customer. A requirement to recommend the "best" product would impose unnecessary and untenable litigation risks on fiduciaries. Such a standard would conflict with the Proposal itself, which permits, and even requires, a

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[8] The Principal Transaction Exemption Preamble contains similar language. *See* BICE Preamble, 80 FR at 21969, and Principal Transaction Exemption Preamble, 80 FR at 21995-21996.

[9] *See* Section 913(g), Dodd-Frank Act ("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.").

[10] Secretary Perez has stated:

> If you're an adviser operating under a suitability standard, once you narrow the options down to those that are suitable, you can recommend the one that is most lucrative for you – even though that might mean a lower return for the client. Under a best interest standard, you would need to choose the one that is best for the client.

Remarks by U.S. Secretary of Labor Tom Perez at the Brookings Institution, The Hamilton Project, Forum on Promoting Financial Well-Being in Retirement (June 23, 2015).

financial institution and adviser only to offer a limited group of investments to their customers.[11]

At a minimum, in order to address the ambiguities of the best interest standard, we respectfully recommend that the Department (1) delete the "without regard to" phrase or provide clear guidance on its meaning under as many scenarios as possible, in each PTE, (2) clarify that the best interest standard does not require that a financial institution or adviser prove that they recommended the "best investment" , (3) clarify in the rule text that no ongoing duty exists under the prudence standard in the PTEs, and (4) add a new paragraph (g) to Section II of the proposed PTEs:

> (g) Monitoring. The contract describes whether or not the Adviser and Financial Institution will monitor the Retirement Investor's investments and alert the Retirement Investor to any recommended change to those investments and, if so, the frequency with which the monitoring will occur and the reasons for which the customer will be alerted.

This contractual language would indicate to the retirement investor whether the financial institution and adviser will monitor the account. We emphasize, however, that in addition to this suggested language for the contract, the Department should clarify that the "best interest" standard itself does not impose such an ongoing duty.

### 3. The Approach to Differential Compensation Should be Simplified

The BICE and the Principal Transaction Exemption would require an adviser and financial institution to warrant that they do not use forms of compensation, including "differential compensation," or other "actions or incentives" that "would tend to encourage individual Advisers to make recommendations that are not in the Best Interest of the Retirement Investor." Both PTEs seem to permit a financial institution to receive differential compensation subject to certain conditions. The BICE appears to permit the payment of differential compensation to advisers if it "would not encourage advice that runs counter to the Best Interest of the Retirement Investor (*e.g.*, differential compensation based on such neutral factors as the difference in time and analysis necessary to provide prudent advice with respect to different types of investments would be permissible)."[12] The Principal Transaction Exemption also appears to contemplate the payment of differential compensation to advisers, but uses language different than the BICE, which creates confusion.[13]

The BICE is made more perplexing by the statement in the Proposal that it contemplates compensation such as trail commissions, 12b-1 fees, and revenue

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[11] *See* BICE Section IV(b), 80 FR at 21985-21986 and BICE Section VIII(c), 80 FR at 21987.

[12] *See* BICE Section II(d)(4), 80 FR at 21984.

[13] *See* Principal Transaction Exemption Section II(d)(4), 80 FR at 22002.

sharing.[14] None of these forms of differential compensation are easily demonstrated to be based upon "neutral factors such as the difference in time and analysis necessary to provide prudent advice with respect to different types of investments." The treatment of differential compensation paid to advisers is thus complex and confusing.

We respectfully recommend a more straightforward treatment of differential compensation to advisers. The Department should offer financial institutions a choice: either implement stringent procedures to address conflicts of interest from the payment of differential compensation to advisers, in which case differential compensation may be paid to them, or pay advisers only "neutral" compensation without those procedures. The Department should offer this choice for principal and agency transactions, and should provide guidance on the types of stringent procedures that would permit the payment of differential compensation.

We therefore suggest that the Department replace Sections II(d)(2)-(4) in the BICE with the following language, and make conforming changes to the Principal Transaction Exemption (new text is underlined; deleted text is bracketed):

> (2) The Financial Institution has adopted written policies and procedures reasonably designed to identify and mitigate **[**the impact of**]** Material Conflicts of Interest and ensure that its individual Advisers adhere to the Impartial Conduct Standards set forth in Section II(c).
>
> (3) If the Financial Institution or (to the best of its knowledge) any Affiliate or Related Entity pays any form of compensation to Advisers that varies based on the Assets that they recommend, including payouts based upon commissions, trail commissions or 12b-1 fees, ticket charge discounts, awards, or product contests, and not solely on neutral factors such as the difference in time and analysis necessary to provide prudent advice, then the written policies and procedures described in paragraph (2) must be reasonably designed to ensure that such Advisers only make recommendations that are in the Best Interest of the Retirement Investor. These policies and procedures must include procedures to mitigate, to the extent practical, the effects of these forms of compensation on an Adviser's choice of Asset, to supervise the recommendations made by those Advisers, to promptly detect possible recommendations that may not be in the Best Interest of the Retirement Investor, and to take prompt and appropriate action concerning any recommendation that is found to have not been in the Best Interest of the Retirement Investor.

The procedures that the Department suggests might include those that some broker-dealers have adopted in order help ensure compliance with FINRA rules and the federal securities laws. The procedures suggested by the Department might, for example, require financial institutions to:

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[14] *See* BICE Preamble, 80 FR at 21967.

- Establish a committee to consider whether new products are appropriate for the firm's customers, especially new products that pay higher compensation.

- Establish a comprehensive system to supervise the recommendations by all advisers.

- Ensure that no adviser participates in any revenue sharing from a "preferred provider," nor earns more for the sale of a product issued by a "preferred provider" or a proprietary product than for other, comparable products, and that the adviser discloses to customers the payments that the financial institution and its affiliates have received from a preferred provider or for a proprietary product.

- Establish thresholds in the compensation structure that will require increased supervision of advisers that have approached the thresholds.

- Monitor an adviser's recommendations to determine whether products or services for which the adviser receives higher compensation are being sold improperly.

- Penalize advisers by reducing compensation, based on the receipt of customer complaints or indications that conflicts are not being carefully managed.

- Develop metrics for behavior (e.g., red flags), compare an adviser's behavior against those metrics, and base compensation in part on them.

The procedures also might include methods to reduce the disparity of compensation among different products -- without imposing a perfectly neutral compensation system:

- Some broker-dealers use "product neutral" compensation grids to reduce incentives for their financial advisers to prefer one type of product over another. Under this system, a financial adviser receives the same percentage of the gross dealer concession (GDC) no matter the product sold. The broker-dealer also may monitor recommendations of its financial advisers to determine whether any tend to be concentrated in high GDC products.

- In the context of mutual fund and variable annuity sales, some broker-dealers use "fee-capping" to reduce incentives for a financial adviser to favor one product family over another for comparable products. For example, a broker-dealer may cap at 4% the GDC for emerging market equity funds. This cap would eliminate incentives for a financial adviser to favor an emerging market equity fund that paid a higher GDC than the 4%.

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The Department also suggests policies and procedures that seek similar goals in the BICE Preamble.[15] We would be pleased to work with the Department to develop

[15] *See* BICE Preamble, 80 FR at 21971-21972.

guidance concerning other procedures or to develop FINRA rulemaking that would help the Department achieve these goals. By incorporating existing procedures and FINRA requirements the Department would better ensure that management of conflicts of interest are subject to FINRA examination and enforcement.

By providing financial institutions with a choice of either paying differential compensation to advisers subject to strict procedures, or paying them "neutral" compensation, the Proposal would better ensure that financial institutions may pay their advisers without exposing their customers to major risks from conflicts of interest that arise from differential compensation.

## 4. The Proposal Should Build Upon Existing Principles in the Federal Securities Laws and FINRA Rules

In our experience, financial institutions are best able to develop successful compliance procedures in response to new standards when regulatory expectations are clear and the standards are derived from existing requirements that they understand. Unfortunately, the Proposal establishes principles that employ imprecise terms with little precedent in the federal securities laws or, in many cases, ERISA. In some respects these principles even conflict with FINRA rules. In order to better ensure that financial institutions, their advisers, and their compliance officers and counsel understand the contours of the best interest standard, we respectfully recommend that the Department incorporate well-understood terms and established principles from the federal securities laws and FINRA rules or directly rely on federal securities laws and FINRA rules, whenever possible. We provide examples below, and we would be pleased to explore other ways in which these terms and principles can be incorporated into the Proposal.

### *A. Example: Definition of "Recommendation"*

The Proposed Fiduciary Definition would define investment advice to include a "recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property."[16] The Proposal defines "recommendation" as "a communication that, based on its content, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."[17] The Preamble requests comment on whether the Department should adopt FINRA's standards for "recommendation" under FINRA Rule 2111.[18]

Rule 2111 generally requires that a broker-dealer and a financial adviser "have a reasonable basis to believe that a recommended transaction or investment strategy

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[16] *See* Proposed Fiduciary Definition § 2510.3-21(a)(1)(i), 80 FR at 21957.

[17] *See* Proposed Fiduciary Definition § 2510.3-21(f)(1), 80 FR at 21960.

[18] *See* Proposed Fiduciary Definition, 80 FR at 21938.

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involving a security or securities is suitable for the customer." The meaning of "recommendation" for purposes of the suitability rule has been developed over decades of guidance and enforcement. The question of whether a recommendation exists in a particular situation depends upon the facts and circumstances, but FINRA has articulated several guiding principles that are relevant to the determination.[19] For instance, a communication's content, context and manner of presentation are important aspects of the inquiry. An important factor in this regard is whether – given its content, context and presentation – a particular communication reasonably would be viewed as a "call to action" (*i.e.*, a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy). In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It makes no difference whether the communication is initiated by a person or a computer software program. Through this guidance, together with myriad published decisions and practical experience with the rule for nearly 80 years, broker-dealers and their financial advisers, compliance officers and counsel generally understand the meaning of this term.

Reliance on these well-established concepts concerning the meaning of "recommendation" would remove the ambiguities that arise from the use of the term in the Proposal. It would better ensure that broker-dealers and their financial advisers, compliance officers and counsel correctly determine when they will be providing investment advice under the new fiduciary standard. Accordingly, FINRA respectfully recommends that the Department incorporate the meaning of "recommendation" from FINRA Rule 2111 into the Proposal.

The proposed amendments to the definition of "fiduciary" also define investment advice to include "a recommendation as to the management of securities or other property."[20] It is unclear from this language what activities the term "management" is meant to cover. The Preamble more clearly explains that the intent of this provision is to "include advice and recommendations as to the exercise of rights appurtenant to shares of stock (*e.g.,* voting proxies)."[21] We suggest revising this provision to more closely reflect the Department's intent.

Therefore, we respectfully recommend that the Department revise the definition of "recommendation" in proposed Rule 2510.3-21(f)(1) to read as follows (new text is underlined):

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[19] *See, e.g.*, FINRA Regulatory Notice 12-25 (May 2012); Regulatory Notice 11-02 (Jan 2011); Notice to Members 01-23 (April 2001).

[20] *See* Proposed Fiduciary Definition § 2510.3-21(a)(1)(ii), 80 FR at 21957.

[21] *See* Proposed Fiduciary Definition, 80 FR at 21939.

(1) (i) "Recommendation" means a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.

(ii) With respect to a Financial Institution or Adviser that recommends a transaction or investment strategy involving a security or securities, "recommendation" shall have the same meaning as in Financial Industry Regulatory Authority (FINRA) Rule 2111 (Suitability) or any successor rule, as interpreted by FINRA.

We also recommend amendments to proposed Rule 2510.3-21(a)(1)(ii) concerning the "management" of securities or other property, as follows (new text is underlined; deleted text is bracketed):

(ii) Advice or a recommendation as to the **[**management of**]** exercise of rights appurtenant to securities or other property, including [recommendations as to the management of] securities or other property to be rolled over or otherwise distributed from the plan or IRA;

*B. Example: Suitability Obligation*

A suitability standard is imbedded in the fiduciary duty of an investment adviser under the Investment Advisers Act of 1940[22] and the Proposal implies that it would be an element of the best interest standard. The PTEs thus state that financial institutions and advisers must provide advice that is based on the retirement investor's "investment objectives, risk tolerance, financial circumstances, and needs" – precisely the type of criteria that determine whether an investment adviser's recommendation is suitable under the Investment Advisers Act fiduciary duty and whether a broker-dealer's recommendation is suitable under FINRA Rule 2111.[23]

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[22] The SEC staff has stated:

> As fiduciaries, investment advisers owe their clients a duty to provide only suitable advice. This duty generally requires an investment adviser to determine that the investment advice it gives to a client is suitable for the client, taking into consideration the client's financial situation, investment experience, and investment objectives. Investment Advisers Act Release No. 1406 (March 16, 1994).

General Information on the Regulation of Investment Advisers, www.sec.gov (Division of Investment Management).

[23] *See* BICE Section II(c)(1), 80 FR at 21984, and Principal Transaction Exemption Section II(c)(1), 80 FR at 22002.

We recommend that the Department make explicit its incorporation of a suitability element into the best interest standard. This change would facilitate customer enforcement of the best interest standard in many cases. Often the best interest standard will be violated because the recommended product was illiquid, presented excessive risk, or otherwise was inconsistent with the retirement investor's financial needs or condition. Including a suitability standard would simplify the customer's complaint in these cases and would provide adjudicators with a specific, well established basis upon which to find that the financial institution or adviser violated the best interest standard. It also would better ensure that an important element of the best interest standard is subject to FINRA examination and enforcement. While the suitability standard would not be the exclusive set of principles with which a financial institution and adviser would have to comply, it would simplify the inquiry for retirement investors and adjudicators in many cases.

In order to clarify that the Impartial Conduct Standards includes a suitability obligation, we respectfully recommend that the Department revise Section II(c)(1) of the BICE (and make consistent changes to the Principal Transaction Exemption) as follows (new text is underlined):

> The Adviser and the Financial Institution affirmatively agree to, and comply with, the following:
>
> (1) When providing investment advice to the Retirement Investor regarding the Asset, the Adviser and Financial Institution will provide investment advice that is in the Best Interest of the Retirement Investor (*i.e.,* advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise <u>and that is otherwise suitable</u> based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party);

We also recommend conforming changes to the definitions of "Best Interest" in the Proposal.

*C. Example: Projections of Performance*

Section III(a)(1) of the BICE would require, prior to the execution of the purchase of a recommended Asset, that an Adviser furnish a chart that provides the total cost to the plan, participant or IRA holder, of investing in the Asset for one, five and ten-year periods expressed as a dollar amount, assuming an investment of the dollar amount recommended by the Adviser and "reasonable assumptions about investment performance, which must be disclosed." This requirement conflicts with FINRA Rule 2210, which generally prohibits broker-dealers from including projections of performance in communications with the public. Moreover, the meaning of a

"reasonable assumption" about investment performance is unclear. Without standardized methods of calculating the total cost, meaningful comparisons between alternative investments will be impossible.

We respectfully recommend that the Department eliminate the requirement to provide projections of performance as a basis for the estimation of future cost. We suggest that the Department substitute language based upon the instructions to Form N-1A, the SEC's form for mutual fund registration.[24] Item 3 requires a fee table in the registration statement, including an example that is meant to help investors compare the costs of investing in the registered fund with the cost of other funds. This example assumes a $10,000 original investment, a 5% annual return, and redemption of all shares at the end of one, three, five and ten year periods. The example must state that actual costs might be higher or lower.

The hypothetical nature of the example is apparent and the use of a 5% assumed rate of return should not mislead investors into believing that it is a projection of future returns. If the Department were to take a similar approach, then a retirement investor would have information concerning the cost of its investments in dollar amounts without being misled by projections that FINRA Rule 2210 is intended to prevent. Moreover, this approach would build upon existing regulatory requirements, reducing the likelihood of confusion concerning what is expected under this provision.

*D. Example: Two-Quote Requirement*

Sections III(d) and IV(a)(2) of the Principal Transaction Exemption would require that before each transaction, a retirement investor receive a statement that includes price quotes for the same or a similar debt security from two ready and willing counterparties that are not affiliates of the adviser, apparently in order to demonstrate that best execution was obtained. The market for debt securities can vary significantly depending on the specific fixed income product. For example, some fixed income securities may trade frequently, be highly liquid and have transparent, accessible and firm quotations available, while others do not have public quotations or frequent pricing information available, and may trade infrequently. Some fixed income securities that are less liquid also are highly fungible, meaning that they trade like other, similar securities, and the pricing in these similar securities can be used as a basis for determining prices in the original security.

Given this significant variation in trading characteristics across fixed income securities, FINRA is concerned that a strict application of a minimum quotation requirement is not practical. A specific debt security may not have been traded recently and expected interest rate movements, concerns about credit risk associated with the issuer, or other factors may have affected its value. A reference price for a "similar" debt security may be unavailable. Moreover, the requirement to obtain the two quotes may delay execution of the transaction and could affect the price that the retirement investor eventually pays.

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[24] *See* Form N-1A Part A: Information Required in a Prospectus, Item 3.

Rather than applying a minimum quote standard, we respectfully recommend that the Department replace the two quote requirement with a standard that would permit transactions that meet the requirements of FINRA's best execution rule (Rule 5310). This rule uses a "facts and circumstances" analysis by requiring that a firm dedicate reasonable diligence to ascertain the best market for the security and to buy or sell in such market so that the price to the customer is as favorable as possible under prevailing market conditions. A key determinant in assessing whether a firm has met this reasonable diligence standard is the character of the market for the security itself, which includes an analysis of price, volatility, and relative liquidity.

Rule 5310 also addresses instances in which there is limited quotation or pricing information available. The rule requires a broker-dealer to have written policies and procedures that address how the firm will determine the best inter-dealer market for such a security in the absence of pricing information or multiple quotations and to document its compliance with those policies and procedures. For example, a firm would be expected to analyze pricing information based on other data, such as previous trades in the security, to determine whether the price to the customer is as favorable as possible under prevailing market conditions. If pricing information related to that security is unavailable, a firm may also consider previous trades in a similar security, if that security and those previous trades constitute a reliable basis for comparison. Although a firm should generally seek out other sources of pricing information or potential liquidity when little or none is otherwise available, which may include obtaining quotations from other sources (e.g., other firms with which the broker-dealer previously has traded in the security), in other instances obtaining quotations from multiple sources could adversely affect execution quality due to delays in execution or other factors.

Accordingly, we suggest that Section III(d) be amended to add the following sentence to the end of this section:

> An Adviser or Financial Institution will not be required to obtain price quotes from two ready and willing counterparties that are not Affiliates provided that the purchase or sale of the Debt Security complies with the requirements of FINRA Rule 5310 (Best Execution and Interpositioning) or any successor rule, as interpreted by FINRA.

### *E. Example: Disclosure of Markups and Markdowns*

Section IV(a)(2) and Section IV(b) of the Principal Transaction Exemption would require pre-transaction and confirmation disclosure of the markup, markdown or other payment to the adviser, financial institution or affiliate in connection with the principal transaction. Broker-dealers already are subject to FINRA's markup policy under Rule 2121, which prohibits a broker-dealer from entering into a transaction with a customer "at any price not reasonably related to the current market price of the security."[25] Moreover, FINRA

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[25] In 1994 the SEC solicited comment on a proposal to require mark-up and mark-down disclosure on the customer confirmation for riskless principal transactions. The proposal was not adopted and the federal

recently solicited comment on a related initiative that would bring additional pricing transparency to customers through the customer confirmation.[26]

We respectfully recommend that the requirement for disclosure of markups and markdowns be deleted from Section IV(a)(2) and Section and IV(b) and that the following language be added to Section IV as a separate condition:

> Markups and Markdowns. The Adviser and Financial Institution comply with the markup policy of FINRA Rule 2121 or any successor rule and to any applicable FINRA rules concerning the disclosure of pricing information related to principal transactions, as interpreted by FINRA.

We also suggest addition of the following at the end of the first sentence in Section IV(a)(2):

> (if applicable).

### *F. Example: Definition of "Reasonable Compensation"*

The BICE would require the financial institution and adviser to affirmatively agree that it will not recommend an investment if the total amount of compensation anticipated to be received in connection with the purchase, sale or holding of the investment "will exceed reasonable compensation in relation to the total services" provided to the retirement investor.[27] The Principal Transaction Exemption would require that the purchase or sales price of debt securities not be "unreasonable under the circumstances."[28] The meaning of "reasonable" or "unreasonable" compensation for purposes of these provisions is unclear. For example, the Department has not stated whether a broker-dealer may consider the compensation that is normally charged in the broker-dealer industry for similar transactions in determining whether compensation is "reasonable." Even if such a comparison is permissible, the parameters of the comparison are undefined. Which products would provide the basis for comparison? The comparison may be particularly difficult when analyzing the reasonableness of compensation related to a "hold" recommendation.

We respectfully recommend that the Department incorporate existing FINRA rules that are familiar to broker-dealers, their advisers, and their compliance officers and counsel. NASD Rule 2830(d) imposes specific caps concerning investment company securities that broker-dealers may sell. Since mutual funds are commonly found in IRA accounts

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securities laws do not require that a confirmation statement include the amount of the markup or markdown, nor do they require pre-transaction disclosure.

[26] *See* FINRA Regulatory Notice 14-52 (November 17, 2014).

[27] *See* BICE Section II(c)(2), 80 FR at 21984.

[28] *See* Principal Transaction Exemption Section II(c)(2), 80 FR at 22002.

and employer plans, reliance on these caps would best ensure that the compensation received by financial institutions and advisers is reasonable. FINRA Rule 2121 requires broker-dealers to charge only fair prices and commissions. FINRA Rule 2122 requires broker-dealers to impose only reasonable charges for their services.

We respectfully recommend that the Department add the following language to the end of Section II(c)(2) of the BICE and the Principal Transaction Exemption:

> , provided that an Adviser or Financial Institution will be deemed to have complied with this condition if the recommendation complies with FINRA rules concerning the reasonableness, type and amount of compensation or fees, as interpreted by FINRA.

**5. The PTEs Should be Streamlined to Address Specific Conflicts**

FINRA respectfully recommends that the Department ensure that the conditions in the BICE and the Principal Transaction Exemption address the conflicts of interest presented by differential compensation and principal transactions, and that the Department eliminate those conditions that will not incrementally strengthen the PTEs by mitigating those conflicts in a meaningful way. The PTEs are designed to permit, subject to conditions, legitimate business activities that otherwise would constitute prohibited transactions under ERISA or the Internal Revenue Code. Some conditions would not incrementally mitigate the conflicts of interest given the other conditions in the PTEs. Moreover, these unnecessary conditions often employ terms with imprecise meanings that will be difficult for financial institutions, compliance officers and advisers to interpret without extensive guidance from the Department.

For example, the BICE would require a financial institution to maintain a public webpage that discloses material compensation “payable” to the financial institution, its advisers and affiliates for services in connection with each retirement asset, the source of compensation, and how it varies among assets. Much of this information would not be useful even to a customer of the financial institution, who will not hire most of the firm’s advisers and who may not purchase many of the assets that are listed. Disclosure of this nature would not meaningful reduce, mitigate or eliminate any of the conflicts that arise from the payment of differential compensation given the existing requirements of the BICE.

Similarly, the limitation of permitted assets seems unjustified for the full range of retirement investors. We agree that conflicts of interest can arise with respect to the differential compensation paid for the sale of some products. Nevertheless, these conflicts should be addressed through the policies and procedures and other conditions of the PTEs, not by limiting the choice of investments available to all retirement investors. As a final example, the BICE and the Principal Transaction Exemption would require a financial institution and adviser to affirmatively warrant that they and their affiliates “will comply with all applicable federal and state laws regarding the rendering of investment advice, the purchase, sale and holding of the Asset, and the payment of

compensation related to the purchase, sale and holding of the Asset."[29] Compliance with the law by a financial institution or adviser is a reasonable expectation, but it need not be related to the conflict of interest that arises from the receipt of differential compensation or from principal transactions.

While these conditions do not address the conflicts of interest, they do create ambiguity. The Department will be called upon to answer a host of interpretative questions. What types of compensation is "material" and "payable"? What types of laws are the subject of the warranty? When does a law regard the rendering of investment advice? Must the warranty to one customer cover violations of laws applicable to the investment advice provided to other customers?

FINRA respectfully recommends that the Department streamline the PTEs by eliminating those conditions that do not incrementally address the conflicts of interest at issue in a meaningful fashion. By way of example, we recommend that the Department eliminate Section II(d)(1) of the BICE and the Principal Transaction Exemption, Section III(c) of the BICE, and the limitation on permitted assets.[30] We would be pleased to discuss proposed changes concerning the other conditions that create ambiguity without meaningfully addressing the conflicts of interest.

## 6. The Effects of Non-Compliance and the Remedies Should be Clarified

Financial institutions and advisers may avoid relying on the PTEs if the effects of non-compliance, even for minor infractions, are ambiguous. Moreover, it is unclear whether the parties to the BICE contract may designate the remedies that will be available in the case of a breach.

### *A. Effects of Non-Compliance*

The consequences of non-compliance with the PTEs are unclear. The BICE Preamble, for example, states that "the exemption is not conditioned on compliance with" the warranties concerning compliance with law and adoption of policies and procedures.[31] We are uncertain, however, whether the BICE or the Principal Transaction Exemption

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[29] *See* BICE Section II(d)(1), 80 FR at 21984, and Principal Transaction Exemption Section II(d)(1), 80 FR at 22002.

[30] If the Department determines to retain Section II(d)(1), then at a minimum the Department should clarify that this warranty only covers compliance with applicable federal and state laws as they apply to the retirement investor that is a party to the contract, as follows:

> (1) The Adviser, Financial Institution and Affiliates will comply with all applicable federal and state laws regarding the rendering of investment advice <u>to the Retirement Investor,</u> the purchase, sales and holding of the <u>Retirement Investor's</u> Asset, and the payment of compensation related to the purchase, sale and holding of [the] <u>such</u> Asset;

Similar changes would have to be made to Section II(d)(1) of the Principal Transaction Exemption.

[31] *See* BICE Preamble, 80 FR at 21970.

are conditioned on the warranty concerning differential compensation and other arrangements that would tend to encourage recommendations that are not in the customer's best interest. The Preamble implies that this warranty is considered to be part of the "policies and procedures" warranty, in which case the exemption might not be conditioned on compliance with that warranty.[32] On the other hand, the warranty itself states that it "does not prevent" the financial institution from paying advisers differential compensation that is neutral.[33] This language implies that failure to comply with the terms of the warranty *would* "prevent" the financial institution from paying differential compensation, apparently because it would constitute a prohibited transaction under ERISA.

Moreover, it is possible that a financial institution or adviser operating in good faith that fails to meet a specific requirement would be deemed to have engaged in a prohibited transaction in violation of ERISA. We respectfully recommend that the Department clarify that the receipt of differential compensation by a financial institution or adviser or the execution of a principal transaction that failed to comply (1) with all aspects of the warranties or to provide all of the disclosures required by the BICE and the Principal Transaction Exemption or (2) in an insignificant way with a condition of a PTE, would not by itself constitute a prohibited transaction in violation of ERISA. For example, the Department could add a new provision to the BICE and the Principal Transaction Exemption that provides:

> Notwithstanding any other provision to the contrary, the availability of this exemption is not conditioned upon compliance with the warranties required by Section II(d) or providing the disclosures in Section II(e) and the failure to comply with any term, condition or requirement of this exemption will not result in the loss of the exemption if the failure to comply was insignificant and a good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements.

We also recommend that the Department provide guidance on the types of failures that would be considered insignificant. They might include the following (to the extent that the Department determines to adopt the relevant conditions):

- Minor errors in transaction or annual disclosure, including errors in calculating total costs;
- Inadvertent exclusion of an asset from the annual list required to be provided to each retirement investor; and
- Inadvertent problems with the required webpage disclosure, such as unavailability of the webpage for a period of time for technical reasons.

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[32] *See* BICE Preamble, 80 FR at 21970-21971.

[33] *See* BICE Section II(d)(4), 80 FR at 21984.

*B. Remedies*

The BICE would establish a private right of action for breach of contract, without indicating what remedies should be made available to the customer. Could the financial institution include a liquidated damages provision in the contract, limiting the amount of recovery available to the customer? Could the customer demand rescission rights for the securities that have been sold, in which case the contract would effectively constitute a "put" or a guarantee on all transactions that it covers? We respectfully recommend that the Department clarify how much latitude the financial institution and the customer have in drafting provisions in the contract related to the available remedies and damages for breach of contract. We suggest that financial institutions should not be permitted to include a provision for liquidated damages, but that they should be allowed to preclude a right of rescission. The Department could revise Section II(f)(2) of the BICE to read as follows (new text is underlined):

> (f) Prohibited Contractual Provisions. The written contract shall not contain the following:
>
> * * *
>
> > (2) A provision under which the Plan, IRA or Retirement Investor waives or qualifies its right to bring or participate in a class action or other representative action in court in a dispute with the Adviser or Financial Institution<u>, or agrees to an amount representing liquidated damages for breach of the contract; provided that the parties may agree to limit damages to an amount equal to the return an investor would have earned from an investment that met the best interest standard at the time of the recommendation and the return that the investor actually earned, and to preclude the right to rescind any transaction the rescission of which is not otherwise contemplated by federal law</u>.

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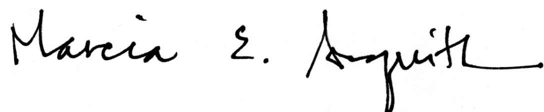
Thank you again for the opportunity to comment on the Proposal. FINRA would be pleased to discuss any of our comments in this letter or other issues related to the Proposal, at the convenience of the Department staff.

Sincerely,



Senior Vice President and Corporate Secretary

cc: The Honorable Thomas E. Perez, Secretary of Labor