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BY EMAIL

Office of Exemption Determinations
Employee Benefits Security Administration
United States Department of Labor
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Washington, D.C. 20001

Office of Regulations and Interpretations
Employee Benefits Security Administration
United States Department of Labor
Room N-5655
200 Constitution Ave. NW
Washington, D.C. 220210

RE: RIN 1210-AB79

Attn: Fiduciary Rule Examination

Dear Sir/Madam,

Fund Democracy appreciates the opportunity to comment on the Department of Labor's evaluation of its fiduciary rulemaking. Fund Democracy concurs in the DOL's recent conclusion that there is general agreement that its interpretation of "fiduciary" under the Code is necessary to accurately reflect the commonly accepted meaning of that term.¹ The DOL's prior position was an unreasonable and impermissibly narrow interpretation² that the current rulemaking re-aligns with Congress's original intent. Fund Democracy is also in agreement that: (1) court decisions have essentially settled the issue of the propriety of the DOL's interpretation, (2) the DOL is bound by its prior findings

¹ Definition of the Term "Fiduciary," 82 F.R. 16902, 16905 (Apr. 7, 2017) ("Fiduciary Release") ("there is fairly widespread, although not universal, agreement about the basic Impartial Conduct Standards, which require advisers to make recommendations that are in the customer's best interest (i.e., advice that is prudent and loyal), avoid misleading statements, and charge no more than reasonable compensation for services (which is already an obligation under ERISA and the Code, irrespective of this rulemaking)").

² *Id.* at 16904 ("Commenters noted that the rulemaking had been upheld by three federal district courts to date, and that two of those courts had concluded that the previous regulatory definition of fiduciary investment advice *may be difficult to reconcile with the statutory text of ERISA's definition of fiduciary.*" (emphasis added)).

regarding the costs and benefits of the rulemaking,³ and (3) losses to investors caused by further delay would dwarf any speculative reduction in costs.⁴ Fund Democracy congratulates the DOL for forcefully reminding the industry that the long overdue overhaul and/or elimination of conflicted compensation structures must be completed by June 9 and compliant with the full BIC exemption by next year.⁵

Fund Democracy also believes that guidance regarding the rulemaking needs to be updated to reflect recent developments. As discussed further below, recent developments show that the DOL must more fully explain the broad reach of the Impartial Conduct Standards. Part I of the letter explains why the Impartial Conduct Standards must be clarified to reflect recent case law relating to fiduciary duties under ERISA. Part II discusses new empirical evidence of conflicted advice and misconduct in the financial services industry and of the substantial cost of advisers' conflicts. Part III demonstrates that, notwithstanding industry arguments to the contrary, the already workable fiduciary rulemaking has become even more workable as a result of recent DOL actions. Part IV explains how weakening the rulemaking will undermine the integrity and efficiency of DOL rulemaking and administrative rulemaking in general.

³ *Id.* at 16905 (“At the same time, however, the Department has concluded that it would be inappropriate to broadly delay application of the fiduciary definition and Impartial Conduct Standards for an extended period in disregard of its previous findings of ongoing injury to retirement investors. The Fiduciary Rule and PTEs followed an extensive public rulemaking process in which the Department evaluated a large body of academic and empirical work on conflicts of interest, and determined that conflicted advice was causing harm to retirement investors”).

⁴ *Id.* at 16906 (“In the absence of the Impartial Conduct Standards, retirement investors are likely to continue incurring new losses from advisory conflicts. Losses arising from a delay of longer than 60 days would quickly overshadow any additional compliance cost savings . . .” “much of the potential investor gains predicted in the Rule’s regulatory impact analysis published on April 8, 2016, will commence on June 9, 2017, and accrue prospectively while the Department performs the examination mandated by the President and considers potential changes to the Rule and PTEs.”).

⁵ *Id.* at 16910 (“even though the applicability date of the exemption conditions have been delayed during the transition period, it is nevertheless anticipated that firms that are fiduciaries will implement procedures to ensure that they are meeting their fiduciary obligations, such as changing their compensation structures and monitoring the sales practices of their advisers to ensure that conflicts in interest do not cause violations of the Impartial Conduct Standards, and maintaining sufficient records to corroborate that they are adhering to Impartial Conduct Standards”).

I. *Tibble v. Edison*: Fiduciary Standards Include Prudence as well as Loyalty

The most significant recent development arises from a Supreme Court ruling that ERISA’s fiduciary duty requires an ongoing duty to monitor retirement plan investment options. On remand in that case, the Ninth Circuit took the opportunity to clarify the standard by which ERISA fiduciaries must evaluate existing and potential investment options, a standard that applies equally to the standard applicable to recommendations by fiduciaries under ERISA and the Code. The Ninth Circuit’s guidance has important ramifications for the Impartial Conduct Standards.

In short, the Ninth Circuit’s recent decision in *Tibble v. Edison International* requires the DOL to substantially overhaul its overly lax approach to fiduciary duties as applied to the consideration of investment expenses.⁶ Applying the fiduciary duty standard under ERISA, the court looked to longstanding trust law principles in finding that:

a trustee is to “incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.” RESTATEMENT (THIRD) OF TRUSTS § 90(c)(3); *see also id.* § 88. The Restatement further instructs that “cost-conscious management is fundamental to prudence in the investment function,” and should be applied “not only in making investments but also in monitoring and reviewing investments.” *Id.* § 90, cmt. b; *see also id.* § 88, cmt. a (“Implicit in a trustee’s fiduciary duties is a duty to be cost-conscious.”); *Donahue v. Donahue*, 182 Cal.App.4th 259, 273, 105 Cal.Rptr.3d 723 (2010) (reversing and remanding an award for attorneys’ fees incurred by a trustee because the trial court did not consider whether the trustee fulfilled his duty to be cost-conscious in incurring the fees). As the Uniform Prudent Investor Act observes: “Wasting beneficiaries’ money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.” Unif. Prudent Investor Act § 7.⁷

The court summarized the significance of its findings for ERISA fiduciaries as follows:

Pursuant to the aforementioned trust law principles, a trustee cannot ignore the power the trust wields to obtain favorable investment products, particularly when those products are substantially

⁶ 843 F.3d 1187 (9th Cir. 2016).

⁷ *Id.* at 1197 – 98.

identical—other than their lower cost—to products the trustee has already selected.

The *Tibble* decision requires that the DOL expand its discussion of an adviser’s duty of prudence under the Code to address how *Tibble* affects their duties under the Impartial Conduct Standards when, for example, recommending 401(k) rollovers and investments to IRA owners.

An adviser’s fiduciary duty does not end with ensuring that conflicted compensation arrangements do not affect their advice; it includes an affirmative obligation not to “waste” their clients’ money on high cost investment products. The DOL’s position that paying advisers more for selling variable or fixed indexed annuities, for example, is permissible from a *conflicts* perspective is misleading and inconsistent with the fiduciary duty under the Code to the extent that it suggests that such sales therefore are generally permissible. Under the *Tibble* standard, many, if not most sales of variable and fixed indexed annuities would not satisfy an adviser’s duty of prudence. Such sales should not be eligible to rely on the BIC exemption or PTE 84-24 once the Impartial Conduct Standards become applicable on June 9.

As an industry lawyer has correctly suggested, the *Tibble* court’s description of an ERISA fiduciary’s duties regarding high cost products requires that, under the Code (and suitability obligations), advisers have a reasonable basis for recommending actively managed funds, especially when virtually identical passively managed funds are available at a fraction of the cost.⁸ The Restatement of Trust’s chapter on Investment of Trust Funds, on which the *Tibble* court based the positions cited above, states that:

the duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule. This is done to reflect the importance of market-efficiency concepts and differences in the degrees of efficiency and inefficiency in various markets. In addition, this emphasis reflects the availability and continuing emergence of modern investment products, not only with significantly varied characteristics but also with similar products being offered with significantly differing costs. The duty to be cost conscious requires attention to such matters as the cumulation of fiduciary commissions with agent fees or the purchase and management charges associated with mutual funds and other pooled-investment vehicles. In addition, active management strategies involve investigation expenses and other transaction costs (including capital-gains taxation) that must be considered,

⁸ See Marcia Wagner, *Advisers Should Heed Fiduciary Principles in Ongoing Tibble 401(k) Suit*, Investment News (Apr. 11, 2017).

realistically, in relation to the likelihood of increased return from such strategies.⁹

As this statement of modern principles of investment theory reflects, the DOL's interpretation of "fiduciary" for purposes of the Impartial Conduct Standards is antiquated and inconsistent with the Code and the protection of investors.

The DOL is obligated to expand its guidance on the Impartial Conduct Standards to reflect *fully* what the Code requires of fiduciaries. For example, when a high cost, actively managed U.S. stock fund's portfolio reveals that it is nothing more than a closet S&P 500 index fund, advisers generally cannot recommend an investment in the former consistent with their duty of prudence, regardless of whether their compensation is level or otherwise unconflicted. Under *Tibble* and the Restatement of Trusts, a Code fiduciary must consider the closet-index characteristics of recommended investments. For funds that are actually actively managed, a fiduciary must weigh active management risk in evaluating the appropriateness of the investment. The DOL's current guidance on the Impartial Conduct Standards does not adequately address these issues.

II. Recent Evidence of Sales Abuses

Since the rulemaking became final, evidence of abuses in the financial services industry has mounted, thereby making it more imperative that the DOL strengthen the BIC exemption and its guidance on the Impartial Conduct Standards.

A. Cross-Selling Abuses

The adverse effects of distorted compensation schemes have been amply demonstrated since the rulemaking concluded. Wells Fargo has admitted that its sales force created millions of fake accounts in order to meet sales quotas the design of which made sales abuses virtually inevitable.¹⁰ An internal report found that the "root cause of sales practice failures was the distortion of the Community Bank's sales culture and performance management system, which, when combined with aggressive sales management, created pressure on employees to sell unwanted or

⁹ Restatement Third of Trusts § 17, Intro. Note (2007); *see also id.* at cmt f(1) ("Trustees, like other prudent investors, prefer (and, as fiduciaries, ordinarily have a duty to seek) the lowest level of risk and cost for a particular level of expected return"); *Advisers Should Heed Fiduciary Principles in Ongoing Tibble 401(k) Suit, supra* (Section 90 of Restatement of Trusts reflects "arguments in favor of index funds").

¹⁰ *See Wells Fargo to Pay \$110 Million to Settle Fake Accounts Lawsuit*, NBC News (Mar. 28, 2017).

unnneeded products to customers and, in some cases, to open unauthorized accounts.”¹¹

The same kind of aggressive cross-selling compensation structures are used to incentivize advisers. For example, one of the largest U.S. broker-dealers recently settled charges that it used “a high-pressure sales contest among its financial advisers to encourage clients to borrow money against their brokerage accounts.”¹² The DOL rulemaking addresses this problem, and the industry’s opposition to the rulemaking reflects precisely the “deep-seated adherence to its sales model” that the Well Fargo report found was at the heart of abusive sales practices¹³ and that the rulemaking is designed to change.

B. Persistence and Pervasiveness of Adviser Misconduct

A study of advisers’ misconduct records completed in February 2016 illustrates the depth and breadth of misconduct in the financial services industry.¹⁴ The study found that almost half of advisers who lost their job after engaging in misconduct were rehired in the financial services industry within a year.¹⁵ It found that firms with advisers who engage in more misconduct were located in counties with low education, elderly populations and/or high incomes, thereby strongly suggesting that these advisers choose the most vulnerable investors on which to prey.¹⁶

The study analyzed the incidence of advisers with misconduct disclosures at firms with at least 1,000 advisers.¹⁷ The authors found that at one firm almost *one*

¹¹ Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report (Apr. 10, 2017).

¹² See Mark Schoeff, Jr., *Morgan Stanley Seaches \$1 Million Settlement with Massachusetts over High-Pressure Sales Contest*, Investment News (Apr. 12, 2017).

¹³ Sales Practices Investigation Report, *supra*, at 5.

¹⁴ See Mark Egan, Gregor Matvos, and Amit Seru, *The Market for Financial Adviser Misconduct* (Feb. 26, 2016).

¹⁵ *Id.* at 4.

¹⁶ *Id.* at 27 (“Our results suggest that misconduct is widespread in regions with relatively high incomes, low education, and elderly populations. These results suggest that firms that specialize in misconduct with several unscrupulous financial advisers are likely targeting vulnerable consumers, while other firms use their reputation to attract sophisticated consumers.”).

¹⁷ *Id.* at 36.

in five advisers (19.60 percent) had a misconduct disclosure. This statistic is stunning in light of the fact that the percentages for the ten firms with the lowest incidence of misconduct advisers were *all below 2.00 percent*.

The broker misconduct study also demonstrated the particularly high incidence of sales abuses with respect to insurance products. The study found that 13.81 percent of complaints related to insurance, and another 8.55 percent related to annuities, for a total of 22.36 percent. In contrast, complaints related to mutual funds, stocks, bonds and options *combined* totaled only 13.77 percent.¹⁸ As discussed above, *Tibble* and the Restatement require that the DOL strengthen prudence standards with respect to variable and fixed indexed annuities. Evidence of continuing sales abuses require that the DOL strengthen duty of loyalty obligations as to these products as well. This is particularly imperative for fixed indexed annuities, which, unlike variable annuities, are exempt from securities regulation.

C. Misrepresentations by Advisers

Misrepresentations by advisers continue to plague the financial services industry. The financial press has recently reported that many advisers have falsely held themselves out as “conflict free” – the kind of a blatant misrepresentation that will continue unabated unless the DOL strengthens its rulemaking.¹⁹ Remarkably, a representative of one firm – a *chief compliance officer* no less – defended its use of the term “conflict free” on the ground that it “is not intended to suggest that [the broker-dealer’s] advisers do not have conflicts.”²⁰ The DOL should state clearly that such misrepresentations violate the Impartial Conduct Standards and represent precisely the kind of breach for which investors have a contractual right to sue and obtain relief.

D. The Cost of Conflicts

The cost of conflicts is real and continues to be documented in empirical analyses. Most recently, a study found that if plan investment options were replaced with options that had superior performance and similar risk/return characteristics,

¹⁸ *Id.* at 34. The remaining 69.90 percent related to Other/Unidentified categories, none of which exceeded 2 percent.

¹⁹ See Jason Zweig, *Why Your Financial Adviser Can't Be Conflict Free*, Wall. St. J. (Apr. 7, 2017) (“I found hundreds of financial advisers’ websites that claim to be free of ethical dilemmas;” also finding dozens claiming to be “conflict-free”).

²⁰ Jason Zweig, *LPL Financial No Longer Claiming to Be ‘Conflict Free’*, Wall. St. J. (Apr. 11, 2017).

investors would realize a gain of 0.25% annually – a total of \$17 billion each year.²¹ One of the reasons for differences in fees is the abnormally wide variance in selling compensation that leads to investors buying higher cost funds where selling compensation is highest, such as for variable and fixed-indexed annuities. Another recent study demonstrated the extraordinarily high degree of price dispersion among mutual funds and observed that this dispersion is indicative of a highly inefficient marketplace,²² which is unsurprising in light of the distorted incentives that conflicted compensation structures create.

III. The DOL Has Made A Workable Rulemaking *More* Workable

It is remarkable that some commentators have suggested that the DOL rulemaking should be *weakened* in light of recent developments. They argue that somehow the rulemaking has become more costly and/or burdensome since it was adopted. In fact, recent developments have demonstrated precisely the opposite.

Since the rulemaking became final, the DOL has taken many steps to improve the rulemaking and lessen potential burdens on industry. The DOL has issued two sets of questions and answers, the vast majority of which illustrate situations when the industry has incorrectly perceived that burdens existed. It made corrections to the rulemaking to clarify that insurance companies could rely on the rule.²³ The DOL has bent over backwards to enable certain insurance intermediaries to rely on exemptions in the rulemaking, including a rule proposal that was published in January that would allow for relaxed compliance requirements until August 15, 2018.²⁴ Industry lawyers have admitted that the Best Interest Contract exemption

²¹ See Daniel Satchkov and Yon Perullo, *Significant Fee Waste in Retirement Plans*, RiXtrema (Apr. 11, 2017) (comparing actively managed funds and noting that including low cost, passively managed funds would substantially increase potential gains). See also Ian Ayres and Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and “Dominated Funds” in 401(k) Plans*, 124 Yale. L.J. 1476 (2015); Veronika Poole, Clemens Sialm and Irina Stefanescu, *It Pays to Set the Menu: Mutual Fund Investment Options in 401(k) Plans*, NBER Working Paper No. w18764 (Aug. 15, 2015; forthcoming J. Fin.) (finding that mutual fund company 401(k) plan service providers offered biased investment menus that reduce participants’ returns).

²² See Michael Cooper, Michael Halling and Wenhao Yang, *The Mutual Fund Fee Puzzle* (October 2016) available at ssrn.com/abstract=1456079.

²³ See Best Interest Contract Exemption; Correction, 81 F.R. 44773 (July 11, 2016).

²⁴ See Proposed Best Interest Contract Exemption for Insurance Intermediaries, 82 F.R. 7336 (Jan. 19, 2017).

may be *preferable* to existing exemptions, such as PTE 84-24, on which their clients rely.²⁵

Courts in Minnesota, Texas, Missouri and the District of Columbia have unanimously found that the rulemaking is well-supported by the DOL's cost-benefit analysis. Some have provided lengthy analysis of the overwhelming arguments in favor of the rulemaking, all of which are growing stronger with the delay of the implementation date. It would be remarkable for the DOL to find that all of these courts were wrong. As the DOL is aware, it is highly unlikely that arguments for weakening the rulemaking would be well-received by these and other courts.

IV. Integrity and Efficiency of Administrative Rulemaking

Any about-face after almost a decade of work on the rulemaking would undermine the DOL's credibility and the integrity of the administrative process. Its actions would create the appearance of having already decided that revision or repeal is necessary, regardless of the overwhelming evidence that the rulemaking is more necessary than ever to combat pernicious conflicts in industry compensation practices. The DOL should reject demands that it become part of the New York Times has called "The Regulatory Wrecking Ball."²⁶

The DOL provided for a long transition period to benefit the industry, but the DOL's using that period as an opportunity to undo years of work will make administrative agencies leery of ever providing for transition period that extends beyond the date that a new administration takes office. The DOL admits that the Presidential Directive has already caused firms to delay compliance with the Rulemaking and increased investor losses due to conflicted compensation practices;²⁷ the DOL-imposed delay is now causing firms to delay compliance even further, while every day advisers hold themselves out as *de facto* "conflict free" fiduciaries as they are paid compensation that belies the title.

Claims regarding the alleged burdens of the rulemaking have been directly and repeatedly contradicted by industry members. Lobbyists have claimed that

²⁵ See Greg Iacurci, *Some Firms Opting to Sell Fixed Annuities under Best-Interest Contract Exemption to Keep Trips, Bonuses Intact*, Investment News (Oct. 17, 2016) ("84-24 says the adviser or agent can only receive a commission, period. No trips, awards, bonuses, no nothing. Only a commission,' Mr. Reish said. 'BICE, if properly managed, allows additional compensation.'").

²⁶ Editorial Board, *The Regulatory Wrecking Ball*, N.Y. Times (Apr. 6, 2017).

²⁷ Fiduciary Release, *supra*, at 16905 ("The Department is also concerned that many firms may have reasonably assumed that the Department is likely to delay implementation as proposed and may, accordingly, have slowed their compliance efforts."). See also *JPMorgan Halts Action as DOL Weighs Fiduciary Rule*, Financial Advisor IQ (Apr. 13, 2017).

accounts would become less accessible to small investors, yet a number of firms have adapted to the rulemaking by making their services *more accessible to small investors*.²⁸ Lobbyists have claimed that firms would no longer be able to charge commissions, yet numerous firms have announced that they will *continue to offer commission-based accounts*.²⁹ Lobbyists have claimed that the leveling fees paid to advisers would be infeasible, yet firms have already adopted policies to *pay level fees*.³⁰ Lobbyists have complained that the rulemaking's reasonable fees requirement is unreasonable, yet the reasonable fee requirement has been in place and complied with for decades.³¹ Lobbyists have claimed the compliance would be all but impossible, yet many firms have announced that they are already *100% prepared to comply*.

At the same time that the rulemaking has hastened the demise of investment products that are virtually never appropriate for investors,³² it has hastened the development of new products that are designed to mitigate or eliminate conflicts of interest. As the DOL noted, its rulemaking has prompted the SEC to act on its long-neglected proposal to facilitate level fees by eliciting an interpretive position that allows for so-called "clean shares."³³ Mutual fund companies have begun to register clean shares that generally will allow broker-dealers to set the commission they are paid for sales of fund shares and thereby more easily level the compensation paid to their advisers.³⁴ It would be a travesty of administrative policy to reverse course

²⁸ See, e.g., Michael Wursthorn, *Brokerages Adapt to Pending Labor Rule*, Wall St. J. (Mar. 16, 2016) (citing firms that have reduced fees and account minimums in response to the DOL rulemaking).

²⁹ Greg Iacurci, *Wells Fargo to Keep Commission Retirement Accounts under DOL Fiduciary Rule*, Investment News (Dec. 2, 2016); Bruce Kelly, *Stifel Will Retain Commissions in Retirement Accounts under DOL Rule*, Investment News (Nov. 3, 2016); Bruce Kelly, *Cambridge, Cetera Will Continue to Pay Commissions on IRAs under DOL Fiduciary Rule*, Investment News (Nov. 1, 2016); Bruce Kelly, *Raymond James Will Continue to Allow Commissions for IRAs under DOL Fiduciary Rule*, Investment News (Oct. 27, 2016); Christine Idzelis, *Morgan Stanley to Keep Commission-Based IRA Business Despite DOL Rule in Contrast to Merrill Lynch*, Investment News (Oct. 26, 2016); Bruce Kelly, *Ameriprise Will Stick with IRA Commissions under DOL Fiduciary Rule*, Investment News (Oct. 26, 2016).

³⁰ See Greg Iacurci, *MassMutual to Level 401(k) Fees for Its Brokers*, Investment News (Mar. 30, 2017).

³¹ See PTE 84-24.

³² See Greg Iacurci, *DOL Fiduciary Rule Hastening Death of L-Share Variable Annuities*, Inv. News (Jan. 11, 2017).

³³ Fiduciary Release, *supra*, at 16911.

³⁴ *Id.*

when the fiduciary rulemaking has already created substantial benefits for investors and simplified compliance for the industry.

* * * * *

Since the DOL's rulemaking became final, a litany of developments has proved not only the appropriateness and necessity of the rulemaking, but also the DOL's unacceptably narrow guidance on the Impartial Conduct Standards. Critics of the rulemaking are correct that it needs to be improved, but recent evidence demonstrates that the rulemaking must be strengthened, not weakened. The DOL's guidance on the Impartial Conduct Standards is inadequate to address the cost of conflicts and imprudent recommendations in the financial services industry. Fund Democracy strongly recommends that the DOL further clarify the requirements of the Impartial Conduct Standards and strengthen the BIC exemption to address recent evidence of abuses in the financial services markets and developing legal standards under ERISA and the Code.

Again, on behalf of Fund Democracy I appreciate the opportunity to comment on the DOL's ongoing evaluation of the fiduciary rulemaking and would be happy to discuss this letter or any other issues with the staff. I can be reached at 662-915-6835 or mbullard9@gmail.com.

Sincerely,



Mercer Bullard
President and Founder
Fund Democracy, Inc.