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July 20, 2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Regulation Best Interest, File Number S7-07-18, and
Proposed Disclosure Rules, File Number S7-08-18

Dear Mr. Fields:

On behalf of a group of firm clients, including brokerage firms, insurance companies, asset managers, mutual funds, and banks, we are writing today with respect to the Commission's proposed Regulation Best Interest and its proposed rule regarding "Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles."

## SUMMARY OF COMMENTS

I. **We urge expeditious finalization of the proposals.** We have long supported a workable best interest standard. To address both the confusion and the undermined investor confidence that are attributable to the recent public policy debate regarding the Department of Labor ("DOL") fiduciary rule, we urge the Commission to finalize the proposals as expeditiously as possible while still taking the time needed to achieve the most workable and effective set of rules.

II. **In Regulation Best Interest, we recommend replacing the preamble's prescriptive DOL-based language with principles-based rules.** The proposed regulatory requirement to mitigate or eliminate conflicts would work very effectively because it states a simple, principles-based rule.[1] ***The preamble to Regulation Best Interest, on the***

[1] *See* proposed rule § 240.15l-1(a)(2)(iii)(B) (providing that the best interest obligation shall be satisfied in part if the broker or dealer "establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations"). 83 Fed. Reg. 21682.

***other hand, explicitly rejects a principles-based approach in favor of a prescriptive approach based directly on a DOL rule that has been invalidated as overreaching.***

The preamble incorporates the prescriptive DOL rules with respect to conflict mitigation, including the rule indicating that any differential pay should be justified by "neutral factors." As discussed below, any compensation regime based on neutral factors is susceptible to disputes and significant potential liability. In fact, also as discussed below, potential liability resulting from the DOL rules that are effectively included in the Commission's proposal led to much of the documented harm caused by the DOL rule. For example, many companies sought to eliminate DOL-rule related sources of risk by ceasing to serve small customers or recommend certain important products. We believe the Commission should replace the DOL rule-based preamble provisions on mitigation and elimination of conflicts with a simple principles-based statement, such as:

> A broker-dealer shall establish, maintain, and enforce written policies and procedures reasonably designed to ensure that financial and other incentives do not result in recommendations that are not in the best interest of retail customers.

***This alternative approach also addresses a very troubling procedural aspect of the proposals, under which much of the "regulating" is done through the preambles, not the regulations themselves. The core of any regulatory structure should be in the regulation itself, not in a preamble. On the mitigation and elimination issues, Regulation Best Interest does the reverse***.

**III.** **<u>We recommend the Commission avoid creating impermissible new private rights of action.</u>** We believe the creation of a new contract-based private right of action based on the Commission's proposals would (1) be impermissible under the recent Fifth Circuit decision invalidating the DOL rule, and (2) have adverse effects similar to those created by the DOL rule. To avoid this result, the Commission should clarify that broker-dealers may include, in both their contracts and disclosures, disclaimers of contract liability based on the new Commission rules and required disclosures.

## <u>COMMENTS</u>

This letter is not intended to provide comprehensive comments on the two proposals. Instead, we will focus on the issues critical to the establishment of a workable and effective best interest standard, based on our experience with the DOL fiduciary rule. Through that experience, we saw firsthand the adverse effects of the DOL rule. We offer our comments to highlight potential pitfalls to be avoided.

## I. **Support for Expeditious Finalization of Commission Proposals**

We believe that the Commission's Regulation Best Interest and Form CRS proposals are a major step forward. We applaud the Commission for taking the lead on ensuring that all retail investors are protected by a best interest standard. It is our hope that these proposals can be moved expeditiously toward finalization. Certainly, we are not suggesting sacrificing clarity or workability for the sake of moving quickly. Whatever time is needed to achieve those goals is certainly time well spent. But within that framework, we recommend expeditious finalization for reasons discussed below.

We urge expeditious finalization of the proposals in part because there is a broader issue at stake than the precise contours of the new proposals. We are concerned about the adverse effects of the DOL fiduciary rule public policy debate of the last few years on retail investors. From the beginning of that debate almost 10 years ago, the bulk of the broker-dealer industry has been clear on one fundamental point: it supports a best interest standard for all retail investors. We have conveyed that point in countless letters to the agencies and we have testified explicitly on that point before Congress. Unfortunately, despite the clarity of our position, this point has often been left out of public reports on the policy debate, leaving the investing public confused about the priorities of the broker-dealer industry. This confusion is in no one's interest, as it undermines investor confidence and can lead to lower rates of saving.

The broker-dealer industry prides itself on seeking to serve its customers' best interest, which is why we have long championed the establishment of a regulatory best interest standard. We believe that the confusion of the last few years can be remedied by the Commission setting forth a clear and workable best interest standard for all broker-dealers.

## II. **Proposed Rules Regarding Mitigation or Elimination of Conflicts**

We firmly believe in the principle that conflicts should be mitigated or eliminated. However, we are concerned that, in proposing this rule, the Commission has proposed a rigid, prescriptive approach that is based directly on the approach that proved so unsuccessful in the context of the DOL rule.

It is certainly true, as discussed later in this letter, that the Commission, to its credit, did not create a new private right of action, unlike DOL. But with respect to the substance, much of the Commission's proposal is drawn directly from the DOL rule, which has been invalidated as overreaching.

Although the preamble to the proposed Regulation Best Interest suggests that the mitigation policies and procedures would offer a "principles-based approach" that "leave[s] broker-dealers with flexibility to develop and tailor reasonably designed policies and procedures . . . based on each firm's circumstances,"[2] the examples described in the preamble effectively create prescriptive standards for broker-dealer compensation models. ***In fact, the Commission's own economic analysis alludes to this prescriptive nature. For example, in reference to potential alternatives to the proposal, the economic analysis states, "the Commission preliminarily believes that a principles-based standard of conduct approach on its own, would be less effective from a retail customer protection standpoint than the proposed Regulation Best Interest."***[3]

**Principles-based rules work better than prescriptive rules.** A prescriptive approach, with its excessive line-drawing, will inevitably (1) disallow some behavior that is beneficial and should be allowed, and (2) allow some behavior that should not be allowed, but was carefully designed to avoid the reach of the prescriptive rules.

As noted, the DOL rule took a prescriptive approach. The DOL attempted to write mechanical rules to micro-manage detailed aspects of the broker-dealer/customer relationship, especially with respect to compensation. The result was counterproductive, as it left broker-dealers unable to efficiently serve small retail IRA accounts or advise retail investors on certain products (such as variable annuities). See Appendices A and B for a description of these adverse effects of the DOL rule.

**The problems with DOL's prescriptive rules.** To be more specific with respect to adverse elements of the DOL rule, the DOL's Best Interest Contract Exemption ("BICE") established a general rule prohibiting differential compensation or other incentives payable by broker-dealers to individual representatives providing advice.[4] But the BICE included an exception under which differential pay was permitted based on "neutral factors tied to the differences in the services delivered to the [investor] with respect to different types of investments."[5] The preamble to the BICE explains that the reference to neutral factors was a reference to "differences in the time and expertise necessary to recommend [different classes of investments]."[6]

In many ways, this is exactly the type of prescriptive rule-making that is most damaging to the system. It establishes a general, rigid rule that advisor fees must be level. Then it establishes an exception that would be difficult to comply with without running significant risks. These risks are attributable to the difficulties involved in measuring with any accuracy any of the following:

- **Extra time needed.** How does one measure how much extra time it takes to recommend, for example, a variable annuity compared to a mutual fund? No data exists on that issue,

[2] 83 Fed. Reg. 21620.
[3] 83 Fed. Reg. 21662.
[4] See 81 Fed. Reg. 21040 ("The Department agrees with the commenters that suggested that differential compensation based on non-neutral factors is likely to encourage advice that is not in Retirement Investors' Best Interest.").
[5] BICE Section II(d)(3).
[6] 81 Fed. Reg. 21035.

nor is there guidance on how to create such data. Would it be based on the average advisor, an experienced advisor, an inexperienced advisor, or some unknown combination of the three? Would it be based on a sophisticated investor, an unsophisticated investor, an average investor, or an unknown combination of the three?

- **<u>Extra expertise needed.</u>** How does one measure expertise? We are aware of no data or system for measuring expertise. Moreover, there is a wide range of knowledge regarding different products. How would one determine how much expertise is "needed" to recommend, for example, a variable annuity?
- **<u>How much differential pay is permitted based on any particular amount of needed time or expertise.</u>** Even if the needed time and expertise could be measured, how would a specified amount of time and expertise be translated into a precise amount of differential pay? We are not aware of any system that could be used to do this with any confidence.

In short, the BICE established a prescriptive compensation rule, which would be difficult to comply with, especially with confidence. Very predictably, this rule gave rise to adverse results. And yet the Commission's proposal follows the BICE in this regard very closely.

**<u>Evidence of harm caused by DOL's prescriptive rules.</u>** A key situation where differential pay is needed is with respect to variable annuities. These products clearly require more time and expertise to advise on, as compared to, for example, mutual funds. The effect of the BICE's upcoming "neutral factor" regime on variable annuities was very adverse. Even though the neutral factor regime never took effect, broker-dealers had to anticipate its application because of a lack of sufficient grandfather protection for prior investments. Hence, many of the adverse effects on variable annuities described in Appendix B flowed from the neutral factor test. There were certainly other elements of the BICE that contributed to the adverse effects, but the portions of the BICE incorporated into the Commission's preamble played a major role.

**<u>The mitigation and elimination language in the preamble to the Commission's proposed Regulation Best Interest is much closer to DOL's approach than to a principles-based approach.</u>** In contrast, the actual proposed language regarding mitigation or elimination of conflicts in the regulation itself provides in relevant part:

> The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

We support this language, which would help ensure that broker-dealers act in their clients' best interest. But the language in the preamble, which could be relied on by a court, establishes a more prescriptive approach, in many ways following the BICE approach. That language says:

[B]roker-dealers generally should consider incorporating the following non-exhaustive list of potential practices as relevant into their policies and procedures to promote compliance with (a)(2)(iv) of proposed Regulation Best Interest:[*]

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- ***minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis – for example, establishing differential compensation criteria based on neutral factors (e.g., the time and complexity of the work involved);***[7]
- ***eliminating compensation incentives within comparable product lines (e.g., one mutual fund over a comparable fund) by, for example, capping the credit that a registered representative may receive across comparable mutual funds or other comparable products across providers;***[8]
- implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction) or from one product class to another;
- adjusting compensation for registered representatives who fail to adequately manage conflicts of interest;[9] and
- limiting the types of retail customers to whom a product, transaction or strategy may be recommended (e.g., certain products with conflicts of interest associated with complex compensation structures).

In addition, we believe certain material conflicts of interest arising from financial incentives may be more difficult to mitigate, and may be more appropriately avoided in their entirety for retail customers or for certain categories of retail customers (e.g., less sophisticated retail customers). These practices may include the payment or receipt of, certain non-cash compensation that presents conflicts of interest for broker-dealers, for example, sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management. Broker-dealers that make

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[*]As noted above, while the Commission suggests that these practices, if incorporated into written policies and procedures, may reasonably mitigate conflicts of interest arising from financial incentives, whether a recommended securities transaction or investment strategy complies with the proposed Regulation Best Interest will turn on (1) the facts and circumstances of the particular recommendation and the particular retail customer, and (2) whether the broker-dealer has complied with the Disclosure Obligation and the Care Obligation.

[7] Compare with "Example 4" from the preamble to the BICE. 81 Fed. Reg. 21038.

[8] Compare with "Example 3" from the preamble to the BICE. 81 Fed. Reg. 21038.

[9] Compare with "Example 5" from the preamble to the BICE. 81 Fed. Reg. 21039.

> recommendations to retail customers that may involve such compensation practices should carefully assess the broker-dealer's ability to mitigate these financial incentives and whether they can satisfy their best interest obligation. 83 Fed. Reg. 21621 (footnotes not included, except as noted) (emphasis added).

**Mitigation issues.** The above preamble language largely follows the BICE in strongly pushing broker-dealers toward a regime where any differential in representative pay must be based on a neutral factor test. But such a test could not be used without taking material risks. It is true that the Commission does not mandate the use of such a regime, and thus the Commission's proposal is better than the BICE in this regard. ***But any broker-dealer seeking comfort that it is complying with the mitigation rules would find it hard not to try to satisfy the neutral factor test.*** As noted, it would be difficult to comply with the neutral factors test with any reasonable degree of confidence.

Without a way to comply with the mitigation rules with any reasonable degree of confidence, many broker-dealers likely would do what they did in reaction to the DOL rule: minimize their risk by eliminating (1) small accounts and/or services to small accounts, which are too small to justify the risk, and (2) products, such as variable annuities, due to the disproportionate risks for a broker-dealer in recommending them under a neutral factor regime. See Appendices A and B for evidence of these effects of the DOL rule.

**Elimination issues.** The preamble's approach to conflict elimination is also troubling in numerous respects. First, the preamble identifies specific practices that may need to be eliminated, again moving away from a principles-based rule to a prescriptive rule without any explanation. Second, the practices described as possibly in need of elimination seem almost arbitrary. What is concerning about incentives based on assets under management? Isn't that simply an incentive to advise well and grow customer assets and recruit additional customers based on such good results? Third, there is no guidance at all on where the line is between conflicts that can be mitigated and conflicts that must be eliminated. A set of prescriptive rules without a logical framework underlying them is very hard to comply with.

**Problematic process.** In addition, both the elimination and mitigation discussions in the preamble suffer from one core problem: they set forth critical rules that are "buried" in the preamble, not in the regulation. The apparent mistake in the preamble identified above regarding elimination of incentives based on assets under management might well not have happened if that provision had been in the regulation itself, and subject to the additional scrutiny that comes with that. Regulating critical issues in the preamble is not consistent with a sound regulatory structure.

**Jeopardizing the brokerage model**. Finally, the preamble to the Commission's rule says that the Commission "sought to preserve the ability of investors to pay for advice in the form of brokerage commissions" in recognition of the fact that certain investors "prefer a commission-based brokerage relationship over a fee-based account."[10] But the prescriptive standards described in the preamble to the Commission's rule seriously jeopardize that goal.

**The solution.** We believe the solution to the above issues is to eliminate the prescriptive examples in the preamble sections describing the mitigation and elimination approaches. We recommend simply articulating a core principle in the preamble, such as:

> A broker-dealer shall adopt policies and procedures reasonably designed to ensure that financial and other incentives do not result in recommendations that are not in the best interest of retail customers.

That simple statement is entirely consistent with the principles-based rule in the proposal itself.

The DOL introduced a demonstrably counterproductive approach based on rigid mechanical rules that were not workable. We urge the Commission to reject that approach and apply a principles-based approach that is much more workable and is espoused specifically in parts of the preamble.

## III. Avoid New Private Rights of Action That Create New Counterproductive Risks

In addition to its use of prescriptive rules, the other key problem with the DOL rule was its creation of broad new opportunities for massive class action lawsuits based on those prescriptive rules. For example, under the DOL rule, any attempt to use "neutral factors" to provide differential pay could be second-guessed on a national scale, creating the potential for multi-billion dollar class action lawsuits.

In fact, the DOL rule was designed specifically to outsource enforcement to plaintiffs' lawyers in light of the resource challenges faced by the DOL and the IRS in their enforcement efforts. The DOL created a new contract right of action with respect to IRAs under the BICE, which could be enforced through state law class actions. And in the ERISA space, where the potential for class actions already existed, the DOL massively expanded those opportunities by broadening the definition of a fiduciary to include both salespeople and almost any financial professional making a casual "suggestion" regarding an investment.

This expansion of potential liability directly contributed to the harmful effects described in the Appendices. Broker-dealers very naturally sought to eliminate sources of liability that were not justified by the benefits, such as small IRA accounts.

The Commission very appropriately is not seeking to create any new private rights of action through Regulation Best Interest.[11] But in order to ensure that new private rights are not created,

[10] 83 Fed. Reg. 21583-84.

we ask the Commission to clarify two things. First, the Form CRS and any other required disclosures should be permitted to contain disclaimers stating that the terms of the disclosure do not give rise to any contractual obligation based on the disclosure. Second, any broker's customer contract should be permitted to contain disclaimers stating that the new Commission rules are not part of the broker's contractual obligation.

**The new best interest standard and required disclosures should not trigger contract liability.** Generally, courts do not treat required disclosures and regulatory standards as giving rise to contractual liability in the absence of a contractual obligation to comply with those disclosures and standards.

It is unlikely that the proposed "best interest" standard of care would, by itself, create contractual liability for broker-dealers. This is because courts have generally been reluctant to infer standards of care imposed through federal securities law into the terms of the contracts between brokers and clients.[12] Contract actions are intended to enforce the terms of the agreement between contracting parties. Contract actions should not be permitted to enforce regulatory standards that do not provide their own private right of action.

There have been questions about whether the new disclosures, especially when presented contemporaneously with an account opening agreement, could be construed as contract terms, thereby triggering additional liability. It is certainly possible that such claims could be brought and it is possible that in some circumstances, and in some courts, such claims could be successful. But such arguments are not consistent with fundamental contract principles, as discussed below, and thus should not prevail.

The disclosures in the Commission's proposals do not require brokers to disclose information as new promises to their clients. They are informational in nature and are not intended to be contract terms.[13] For example, the mock-up Form CRS disclosures published by the Commission state, "We must act in your best interest." They do not say "we promise" or "we agree" to act in your best interest. This may seem like legal parsing, but the actual terms of the disclosures would be highly relevant to any dispute based on a contract claim. Contract liability can only arise out of one party's failure to abide by an actual agreement, and in the presence of an express written

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[11] *See* 83 Fed. Reg. 21584 ("Furthermore, we do not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result.").

[12] *See, e.g., Gurfein v. Ameritrade, Inc.*, 312 Fed. Appx. 410 (2d Cir. 2009); *Appert v. Morgan Stanley Dean Witter, Inc.*, 08-CV-7130, 2009 WL 3764120, at *2 (N.D. Ill. Nov. 6, 2009), aff'd, 673 F.3d 609 (7th Cir. 2012). Both of these cases concluded that a brokerage contract notifying clients that the firm was subject to FINRA rules and regulations did not impose contract obligations on the brokerage firm to comply with such rules and regulations. For example, in *Gurfein*, the brokerage agreement said: "All transactions under this Agreement are made subject to the constitution, rules, regulations, customs and usages of the various execution points and their clearinghouse, if any."

[13] "The mere expression of an intention to do something or a manifestation of willingness to do it without some promissory communication to the offeree is insufficient." 1 Williston on Contracts § 4:9.

agreement, courts will generally not impose contract liability through terms or representations that are beyond the scope of that agreement.[14]

**It is possible, however, for the new standards and disclosures to be incorporated into customer agreements, thereby triggering contract liability.** Whether this is true in any particular case will depend on each broker-dealer's customer agreement and the law of any relevant jurisdictions. For example, it could depend on whether a broker-dealer's agreement with its clients expressly or impliedly binds the broker-dealer to comply with the new standard of care or the new disclosure requirements included in the Commission's proposals. As another example, if a broker-dealer's customer agreement obligates the broker-dealer to operate in accordance with all applicable state and federal securities laws, a failure to satisfy the new "best interest" standard (e.g., by failing to disclose or mitigate financial incentives) or a failure to comply with the Form CRS's new disclosure requirements could trigger contract liability. A contract claim could be brought on a class basis, exposing the broker-dealer to large potential liabilities.[15]

**Disclaimers of contractual obligation to follow Commission rules.** Some or all broker-dealers will likely seek to use contracts that expressly exclude the new disclosures from their terms and/or expressly disclaim any contractual obligation based on such disclosures or the new best interest standard. Nothing in the Commission's proposals expressly prohibits a broker-dealer from disclaiming a contractual obligation based on any new disclosures or requirements.

For example, if a broker-dealer's account opening agreement expressly states that the terms of the customer agreement are limited exclusively to the terms of the written contract itself (and to the exclusion of any other materials or disclosures shared with clients or any applicable rules), a broker-dealer should be able to avoid any contract liability flowing from any Commission-mandated disclosures or rules.

**Need for confirmation regarding the permissibility of contract disclaimers.** Given how significant contract liability could be in light of the new disclosures and new best interest standard of care, we ask the Commission to expressly confirm that the new disclosures are not contractual obligations and that affected broker-dealers may disclaim any contractual liability that could otherwise result from the disclosures or requirements added by the Commission proposals. Certainly, broker-dealers should still be permitted to incorporate some documents by reference in their customer agreements, but the key is that broker-dealers should be permitted to disclaim any contractual obligation to comply with the new disclosures and Commission rules in the proposals.

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[14] "The law may recognize an implied contract in the absence of an express contract on the same subject matter, but not where there is an express contract." 1 Williston on Contracts § 1:5.
[15] The recent Supreme Court decision regarding class action waivers does not help in this regard, since FINRA has an explicit rule prohibiting waivers of the right to bring a class action. FINRA Rule 2268.

Please note that any such disclaimer is not a "hedge clause" in any way. Under a hedge clause, a party disclaims liability for noncompliance with a rule. We are not suggesting in any way that a broker-dealer could disclaim the obligation to comply with the new SEC rules. We are only asking that a broker-dealer should be permitted to avoid taking on new contract-based liabilities ***in addition to*** its duty to comply with the SEC rules. As long as that is made clear in the disclaimer, the concerns underlying the hedge clause rule are not implicated.

If disclaimers of such contractual obligations are not permitted and it turns out that the Commission's proposals may be used as the basis of a contractual cause of action, then the Commission's proposals would be subject to invalidation under the recent Fifth Circuit decision in Chamber of Commerce of the United States of America, et al. v. United States Department of Labor, et al., No. 17-10238 (March 15, 2018). In that case, the Court stated that:

> [T]he BICE provisions regarding lawsuits also violate the separation of powers . . . . Only Congress may create privately enforceable rights, and agencies are empowered only to enforce the rights Congress creates . . . . DOL may not create vehicles for private lawsuits indirectly through BICE contract provisions where it could not do so directly. . . .
>
> If the BICE-mandated provisions are intended to authorize new claims under the fifty states' different laws, they are no more than an end run around Congress's refusal to authorize private rights of action enforcing Title II fiduciary duties. Paraphrasing the Supreme Court, "[t]he absence of a private right to enforce [Title II fiduciary duties] would be rendered meaningless if [IRA owners] could overcome that obstacle by suing to enforce [DOL-imposed contractual] obligations instead. The statutory and contractual obligations, in short, are one and the same."

Thus, while implied rights of action have been recognized in the anti-fraud context of section 10(b) of the Exchange Act, no implied right is permitted for a breach of contract claim based on the Commission's proposals. Accordingly, clarification by the Commission that disclaimers of contractual obligations are permitted would simply ensure that, as intended, the proposals would not run afoul of judicial precedent.

## CONCLUSION

I. **We urge expeditious finalization of the proposals.** To address the confusion and the undermined investor confidence that are attributable to the recent public policy debate regarding the DOL fiduciary rule, we urge the Commission to finalize the proposals as expeditiously as possible while still taking the time needed to achieve the most workable and effective set of rules.

II. **We recommend replacing the preamble's prescriptive DOL-based language with principles-based rules .** The proposed regulatory requirement to mitigate or eliminate conflicts would work very effectively because it states a simple, principles-based rule.

The preamble to Regulation Best Interest, on the other hand, explicitly rejects a principles-based approach in favor of a DOL-based prescriptive approach. The Commission should replace the DOL-based preamble provisions on mitigation and elimination of conflicts with a simple principles-based statement, such as:

> A broker-dealer shall establish, maintain, and enforce written policies and procedures reasonably designed to ensure that financial and other incentives do not result in recommendations that are not in the best interest of retail customers.

**III.** **<u>We recommend the Commission avoid creating impermissible new private rights of action.</u>** The Commission should clarify that broker-dealers may include, in both their contracts and disclosures, disclaimers of contract liability based on the new Commission rules and required disclosures.

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We thank you for your consideration of our comments.

Sincerely,

Kent A. Mason

## APPENDIX A: GENERAL HARM CREATED BY THE FIDUCIARY RULE

1. **Deloitte & Touche Study (August 9, 2017), as described in SIFMA's August 9, 2017 comment letter (study attached to letter as Appendix I)**
   a. *Description: a study of a cross-section of SIFMA's members, consisting of 21 financial institutions that represent 43% of U.S. financial advisors and 27% of the retirement savings assets in the market.*
   b. "[A]s of the Rule's first applicability date on June 9th, 53% of study participants reported limiting or eliminating access to brokerage advice for retirement accounts, which the firms estimate impact 10.2 million accounts and $900 billion AUM."
   c. "Roughly 95% of study participants indicated that they have reduced access to or choices within the products offered to retirement savers because of efforts to comply with the Rule. Products affected include mutual funds, annuities, structured products, fixed income, private offerings, and more, impacting an estimated 28.1 million accounts. Examples of the reduction in mutual fund availability include: 1) the elimination of no-load funds from brokerage platforms; 2) the elimination of mutual funds held directly at the mutual fund company; 3) reduced product offerings; and 4) elimination of other share classes."
   d. "Across the industry, broker-dealers will have spent more than $4.7 billion in start-up costs relating to the Rule, much of which has already been spent."
   e. "The ongoing costs to comply are estimated at over $700 million annually…."

2. **Harper Polling (July 2017), as described in the Financial Services Roundtable's August 10, 2017 comment letter (report and survey slides attached to letter)**
   a. *Description: a national survey of 600 financial professionals conducted by phone and through online interviews from July 7-12, 2017 (July 17, 2017).*
   b. A majority of respondents reported the Rule is restricting them from serving their clients' best interests.
   c. "Only 12% of respondents report the Rule is helping them to serve their clients best interest and 33% report there has been no impact, yet those respondents still report more complicated paperwork and fewer small accounts." "For those who reported the Rule is helping or has had no impact on their ability to serve their clients best interests, many reported negative changes to client services by (i) servicing fewer small accounts, (ii) offering fewer investment options, (iii) including fewer mutual fund options, and (iv) higher compliance costs, including additional fees for Retirement Investors."
   d. "Only 10% of Certified Financial Planners (CFP) report that the Rule is helping them to serve their clients best interests, and 55% report the Rule is restricting them from serving their clients best interests. This runs counter to the claim by the CFP Board of Standards that the Rule is workable for their members."
   e. 75% of respondents whose "typical clients have starting assets under $25,000 report that they will take on fewer small accounts due to increased compliance costs and legal risks."
   f. 63% reported that "the fiduciary standard will definitely/probably/or has already limited investment options/products they can provide to clients."

g. 56% said "their firms would offer fewer mutual fund products to consumers."
h. "…68% reported that they or their institutions will take on fewer small accounts."

3. **<u>American Action Forum (AAF)</u> (March 16, 2017 comment letter)**
   a. *Description: AAF's comments are based on: (1) an AAF staff survey of the available literature in 2015 on the likely impact of the DOL rule, as discussed in an August 4, 2015 article; (2) a September 17, 2015 AAF article; and (3) AAF research as discussed in a February 22, 2017 article.*
   b. Found reported compliance costs of at least $106 million in 2016, representing up-front costs from just four companies.
   c. "[A]lmost all retail investors will see their costs increased by 73 to 196 percent due to a mass shift toward fee-based accounts."
   d. "[F]irms providing investment advice will see an average of $21.5 million in initial compliance costs and $5.1 million in annual maintenance costs."
   e. "[U]p to 7 million Individual Retirement Accounts (IRAs) would fail to qualify for an advisory account due to the balance too low to be sustainable for the advisor. In the shorter term, we found that the fiduciary rule, as written, will result in over $1500 of duplicative fees charged per household retirement account."
   f. "…the fiduciary rule would cost $31.5 billion in total costs and $2 billion in annual burdens, making it the most expensive rule of 2016 and the second most expensive non-EPA rule since 2005."

4. **<u>Meghan Milloy / American Action Forum (AAF) Research (April 2017)</u>, as stated on AAF's website**
   a. *Description: a research article by Meghan Milloy, Director of Financial Services Policy.*
   b. The Rule will result in additional charges to retirement investors of approximately $816 annually per account or over $46 billion in aggregate.
   c. "Although the rule has not yet become effective, AAF research has found that three major companies have left part of the brokerage business, and six more are drawing down their business or switching to a fee-based arrangement. From these companies alone, reported compliance costs have already topped $100 million, affecting 92,000 investment advisors, $190 billion in assets, and at least 2.3 million consumers."

5. **<u>Chamber of Commerce's Monitoring of Rule's Impact</u>, as described in the Chamber's August 16, 2017 comment letter**
   a. *Description: outreach conducted by the Chamber to 14 firms that collectively manage $10 trillion in assets.*
   b. "[N]early all of the institutions reported excluding some investment products from retirement investors in response to the rule, largely due to concerns about the pending 'level' fee requirements of the 'full' BIC Exemption."
   c. "Most of the institutions also reported using the 'grandfathering' provisions included in the final rule, meaning that a substantial number of investors would be prevented from receiving new investment advice going forward, unless they

decide to change the type of account they have (e.g. change from a transaction-based account to a fee-based account)."

6. **NAIFA Survey of 1,093 Members (April 2017)**
   a. Nearly 75% of financial professionals have experienced or expect to experience an increase in the minimum account balances for the clients they serve.
   b. Nearly 90% of advisors believe consumers will need to pay more for their financial advice services.
   c. More than 90% of financial professionals have already experienced or expect to experience restrictions of product offerings to their clients.
   d. 68% of NAIFA's members have been told that they cannot recommend certain mutual fund classes or types to clients, and almost 70% say they cannot recommend certain annuities.

7. **LIMRA Secure Retirement Institute's *Second Quarter 2017 U.S. Retail Annuity Sales Survey*, as described in an August 23, 2017 LIMRA press release**
   a. Total annuity sales for the first half of 2017 decreased 10% over the first half of 2016, the lowest first half sales since 2001.
   b. Q2 2017 is the:
      i. 5th consecutive quarter of decline in overall annuity sales.
      ii. 6th consecutive quarter in which fixed annuity sales have been greater than variable annuity sales, which "hasn't happened in almost 25 years."
   c. "A closer look at what's driving the drop in VA sales reveals qualified VA sales have experienced a more significant decline than non-qualified VAs…. VA qualified sales were down 16 percent in the second quarter, while nonqualified sales were actually up 5 percent. This could be in reaction to the DOL fiduciary rule," according to the director of annuity research.
   d. Variable annuity sales are forecast to drop 10-15% in 2017, returning to levels not seen since 1998.

8. **LIMRA Secure Retirement Institute's *First Quarter 2017 U.S. Retail Annuity Sales Survey*, as described in a May 18, 2017 LIMRA press release**
   a. Indexed annuity sales are forecast to decline 5-10% in 2017 and "another 15-20 percent in 2018 when the BICE goes into effect."

9. **LIMRA Secure Retirement Institute Study (2017), as described in NAIFA's August 4, 2017 comment letter**
   a. "LIMRA estimates that access to guaranteed income products will decline 29% under the Rule/PTEs."

10. **Morningstar Report (2017), as described in the Insured Retirement Institute's April 17, 2017 comment letter**
    a. Variable annuity sales declined nearly 22% from 2015 to 2016 despite a rising stock market.

11. **Survey of Insured Retirement Institute (IRI) Member Firms (July 2017), as described in IRI's August 7, 2017 comment letter**
    a. *Description: IRI surveyed a representative sampling of its insurance company and distributor members from July 18-31, 2017.*
    b. "More than 60 percent of the distribution firms that participated in the Survey have, are planning to, or are considering exiting or de-emphasizing target markets such as small IRA holders and small retirement plan sponsors."
    c. A number of distributors reported that "approximately 155,000 of their clients have already been 'orphaned,' and a number of our insurer members told us that both the adviser and the firm have dissociated from the accounts of hundreds of their annuity contract owners. Far more accounts are expected to be impacted as implementation of the Rule proceeds."

12. **CoreData Report, CoreData Research UK (2016), as described in comment letter and attachment submitted by Kent Mason (August 3, 2017)**
    a. *Description: a non-commissioned report based on an October 2016 survey of 552 U.S. financial advisors.*
    b. 71% of financial professionals will disengage from at least some retirement savers because of the Fiduciary Rule.
    c. 64% of financial professionals think the Fiduciary Rule will have a large negative impact on their mass-market clients (i.e., investors with less than $300,000 in net investable assets).
    d. On average, financial professionals estimate they will no longer work with 25% of their mass-market clients, creating an advice gap for low-balance investors.
    e. 39% of advisors believe the cost of personal financial advice will become too expensive for most investors.
    f. 32% of advisors believe that shifting away from certain products, such as annuities and non-traded REITs, is one of the biggest challenges posed by the fiduciary rule.
    g. 57% of advisors "believe increased paperwork stemming from reporting and disclosure requirements will be one of the top three challenges of the fiduciary rule."
    h. 18% of advisors "believe preparing for potential litigation will be one of the biggest challenges they must overcome."

13. **A.T. Kearney Study (October 2016), as described in comment letter and attachment submitted by Kent Mason (August 3, 2017)**
    a. *Description: a study of the effects of the Fiduciary Rule published in connection with a discussion of how the global management consultant can help financial institutions adjust to the rule.*
    b. Concludes that "[a]s firms move toward fee-based advisory, many low-balance accounts will no longer be served, shifting many assets to formats such as robo-advice and self-directed."
    c. Recommends that broker/dealers should "[a]ccelerate the transition to fee-based services and advisory, and evaluate account thresholds to continue serving (for example, accounts greater than $200,000)."

d. States that "[c]ertain high-cost investment products (such as variable annuities) will be phased out as the business model is no longer viable under the new rule…."
e. By 2020, broker-dealer firms will collectively stop serving the majority of the $400 billion currently held in low-balance retirement accounts.
f. Implementing the DOL's new fiduciary rule for retirement accounts will cost the brokerage industry $11 billion over the next four years.

**14. <u>Large Mutual Fund (2017 data)</u>, as described in the Chamber of Commerce's April 17, 2017 [comment letter]**

a. *Description: an interview the Chamber conducted with a large mutual fund provider.*
b. One mutual fund's number of orphaned accounts (i.e., accounts without an advisor) nearly doubled in the first three months of 2017, and the average account balance in these orphan accounts is just $21,000. The fund projects that "ultimately 16% of the accounts it services will be orphaned this year because of the Fiduciary Rule." "Extrapolating this prediction suggests that at least 1.6 million small retirement savers have already lost access to investment assistance since January 2017, and an additional 1.6 million are likely to lose access after the Rule becomes applicable."

**15. <u>Fidelity Clearing & Custody Solutions Poll (August 2016)</u>, as described in September 28, 2016 ThinkAdvisor [article]**

a. *Description: A blind online poll of 459 advisors conducted from August 18-26, 2016. Respondents consisted of 30% independent broker-dealer reps, 21% RIAs, 19% regional BD reps, 15% from wirehouse firms, 11% insurance BD reps, and 3% from banks.*
b. 10% of advisors responding to the survey reported they are planning to leave or retire from the field earlier than expected because of the rule, and another 18% said they are "reconsidering their careers as advisors."

**16. <u>2016 Global Survey of Financial Advisors commissioned by Natixis Global Asset Management</u>, as described on Natixis [website] and in survey [whitepaper]**

a. *Description: a survey of 2,550 advisors (including 300 in the U.S.) in 15 countries in Asia, Europe, the United Kingdom, and the Americas conducted in July 2016. The online quantitative survey was developed and hosted by CoreData Research.*
b. 38% of respondents said they will likely "disengage with smaller clients" as a result of new regulations.
c. Almost 80% of respondents are "concerned that more stringent regulations could limit access to financial advice for lower balance and mid-tier clients."
d. More than 75% of advisors surveyed "believe increased regulations could even lead to higher costs for clients."

**17. <u>The Cerulli Report – U.S. Broker/Dealer Marketplace 2016</u>, as described in Lincoln Financial Group's March 17, 2017 [comment letter]**

a. *Description: an "in-depth analysis of broker/dealers (B/Ds) with financial advisors serving retail investors." Available for purchase.*
b. 66% of advisors believe that small investors will have less access to professional financial advice as a result of the rule.

**18. NERA Economic Consulting's comment on the Department of Labor Proposal and Regulatory Impact Analysis (July 17, 2015)**

a. *Description: SIFMA retained NERA Economic Consulting to review and comment on the proposed fiduciary rule. To conduct its cost study of the proposal, NERA gathered account-level data from several financial institutions, representing tens of thousands of IRA accounts that were observed from 2012 through Q1 2015.*
b. "Using [a] conservative minimum account balance of $25,000, over 40% of commission-based accounts in our dataset would not be able to open fee-based accounts. Using a $50,000 threshold, over 57% of accounts would not meet minimum balance requirements for a fee-based account. If the effective threshold is $75,000, two-thirds of account holders would be left without any professional investment advice."

**19. Chamber of Commerce company interviews, as described in the Chamber's April 17, 2017 comment letter**

a. *Description: In-depth, structured interviews of two to five persons with about 10 investment-advisory companies, broker-dealers, insurance companies, and others affected directly or indirectly by the Fiduciary Rule.*
b. Interviewed companies "uniformly report that they have already restricted the choices of investment products available to retirement savers through their fee-based advisory channels, or they intend to do so when the Fiduciary Rule becomes applicable. The majority of companies interviewed have also either already raised the minimum account amounts to qualify for advisory services or have plans to do so upon applicability of the rule. Some firms have raised the minimum for advisory accounts to $100,000 or more, clearly excluding from their services small beginning savers."
c. "[E]ven when the financial institution itself has not increased account minimums, individual brokers may implicitly discourage enrollment of smaller accounts and ration their time to larger accounts to earn better pay and to reduce time spent on compliance associated with smaller, transaction-based accounts."
d. Insurance costs could exceed two to three times the cost estimated by the Department. Some respondents cited numbers as high as $10,000 per professional per year for Errors and Omissions coverage.
e. The Chamber is unaware of any "robo-advisor" that recommends annuity products to generate retirement income, despite the clear need for these products and the Department's reliance on robo-advisors to alleviate the potential loss of access to retirement advice for small savers.

20. **<u>SIFMA survey</u>, as described in document "New Data Shows DOL Fiduciary Rule Harming Small Retirement Savers" (available as attachment to Kent Mason's August 3, 2017 [comment letter])**
    a. *Description: a survey of 25 member financial firms impacted by the Fiduciary Rule.*
    b. "More than half the firms are considering moving IRA brokerage clients to call center services only."
    c. "44% of the respondents anticipate that more than half of their clients could see a change in services (e.g., limitation of product choice, shift to fee-based account, or shift to online only, etc.). More than 50% of responding firms anticipate offering only advisory services to a subset of their current IRA brokerage customers."
    d. "… more than 60% of the responding firms stated that they anticipate that some or all of the costs resulting from the potential increase in litigation and liability insurance may be passed on to clients."

21. **<u>Wall Street Journal Reports (February and April 2017)</u>, as described in the Financial Services Roundtable's April 17, 2017 [comment letter]**
    a. Firms have responded to the Rule by taking actions that include: (1) moving clients to fee-based accounts; (2) eliminating commission-based IRAs; (3) raising investment minimums for commission-based IRAs; (4) eliminating variable annuity products; and (5) excluding certain products from commission-based IRAs (e.g., annuities, mutual funds, and exchange-traded funds).

22. **<u>Jonathan Reuter updated analysis</u>, as described in the American Bankers Association's (ABA) March 15, 2017 [comment letter]**
    a. *Description: ABA recommendations of key developments that an updated DOL analysis of the Fiduciary Rule should account for.*
    b. The author of one of the academic studies cited by the Council of Economic Advisers (CEA), Jonathan Reuter, "issued an updated analysis that looked at more recent mutual fund performance (from 2003 to 2012) and concluded that broker-sold funds underperform no-load funds by an average of 18 basis points, significantly narrower than the 100-basis point difference cited by CEA."

## APPENDIX B: HARM TO THE ANNUITY MARKET FROM THE FIDUCIARY RULE

1. **LIMRA Secure Retirement Institute's *Second Quarter 2017 U.S. Retail Annuity Sales Survey*, as described in an August 23, 2017 LIMRA press release**
    a. Total annuity sales for the first half of 2017 decreased 10% over the first half of 2016, *the lowest first half sales since 2001*.
    b. Q2 2017 is the:
        i. 5th consecutive quarter of decline in overall annuity sales.
        ii. 6th consecutive quarter in which fixed annuity sales have been greater than variable annuity sales, which "hasn't happened in almost 25 years."
    c. "A closer look at what's driving the drop in VA sales reveals qualified VA sales have experienced a more significant decline than non-qualified VAs…. *VA qualified sales were down 16 percent in the second quarter, while nonqualified sales were actually up 5 percent. This could be in reaction to the DOL fiduciary rule*," (emphasis added) according to the director of annuity research.
    d. *Variable annuity sales are forecast to drop 10-15% in 2017, returning to levels not seen since 1998.*

2. **LIMRA Secure Retirement Institute's *First Quarter 2017 U.S. Retail Annuity Sales Survey*, as described in May 18, 2017 LIMRA press release**
    a. Indexed annuity sales are forecast to decline 5-10% in 2017 and "another 15-20 percent in 2018 when the BICE goes into effect," referring to the "Best Interest Contract Exemption" under the DOL fiduciary rule.

3. **LIMRA Secure Retirement Institute Study (2017), as described in NAIFA's August 4, 2017 comment letter**
    a. "LIMRA estimates that access to guaranteed income products will decline 29% under the [DOL Fiduciary] Rule/PTEs." (The reference to "PTEs" is to the exemptions from the application of the Fiduciary Rule, which substantially all qualified annuities must use.)

4. **Morningstar Report (2017), as described in the Insured Retirement Institute's April 17, 2017 comment letter**
    a. Variable annuity sales declined nearly 22% from 2015 to 2016 despite a rising stock market, which "has traditionally led to increased sales" of VAs.

5. **Insured Retirement Institute (IRI) member survey (July 2017), as described in IRI's August 7, 2017 comment letter**
    a. "Half of the participating insurance companies reported that some of their distribution partners have already dropped the insurer's products from their shelf as part of their efforts to implement the [Fiduciary] Rule."
    b. "Nearly 60 percent of the participating insurance companies expect that fee-based annuities manufactured in response to the [Fiduciary] Rule will result in higher overall fees to the consumer."
    c. "[A] number of our distributor members reported that approximately 155,000 of their clients have already been 'orphaned,' and a number of our insurer members

told us that both the adviser and the firm have dissociated from the accounts of hundreds of their annuity contract owners. Far more accounts are expected to be impacted as implementation of the Rule proceeds."

6. **Independent Insurance Agents & Brokers of America, Inc. (IIABA) Member Survey (July 2017), as described in IIABA's August 3, 2017 comment letter**
   a. "38%, or 315 respondents, answered that they personally and/or the insurance agency they work for had stopped selling or giving advice related to products impacted by the fiduciary rule, or planned to do so on or before January 1, 2018 when the [fiduciary] rule takes full effect."
   b. "[M]ore than one third of independent insurance agents who responded to the survey will exit the market on or before January 1, 2018; and for those that remain some will offer more limited services to clients."

7. **ACLI (August 7, 2017 comment letter)**
   a. "One ACLI member informed us that it has reduced its proprietary insurance product offerings by 54 percent and its non-proprietary variable annuity offerings available through its broker-dealers by 76 percent."
   b. Consequences of the Fiduciary Rule as reported by ACLI members:
      i. "Some banks are no longer offering access to fixed and indexed annuities, even when they are used outside the context of an employee benefit plan or IRA."
      ii. "Some broker-dealers are no longer offering variable annuities even to savers and retirees with non-qualified assets not subject to the Regulation."
      iii. "Some broker dealers are reducing the number of insurers and annuity products available on their platforms."
      iv. "Some firms are inquiring how quickly they can be removed as the broker dealer of record from existing annuity business."
   c. "[T]he Regulation has already resulted in a dramatic increase of 'orphaned' accounts. Several ACLI member companies have already been notified by distribution partners that they will resign as agent of record to IRA and ERISA plan annuity holders. For example, one ACLI member has informed us that, since the Regulation's June 9, 2017 applicability date, it has received 'disassociation' requests for 84 annuity contracts, and the reason provided for each action was the Regulation. By comparison, this member received only 3 disassociation notices during 2016, none of which included the Regulation as the basis for the disassociation."
   d. One member reported that it has "identified over 250 small retirement plans that have lost access to guidance and advice as a result of the Regulation."

8. **NAIFA Survey of 1,093 Members (April 2017)**
   a. 70% of NAIFA's members say they cannot recommend certain annuities.

9. **CoreData Report, CoreData Research UK (2016), as described in comment letter and attachment submitted by Kent Mason (August 3, 2017)**

a. *Description: a non-commissioned report based on an October 2016 survey of 552 U.S. financial advisors.*
b. 32% of advisors believe that shifting away from certain products, such as annuities and non-traded REITs, is one of the biggest challenges posed by the fiduciary rule.

**10. <u>A.T. Kearney Study (October 2016)</u>, as described in [comment letter and attachment]() submitted by Kent Mason (August 3, 2017)**

a. *Description: a study of the effects of the Fiduciary Rule published in connection with a discussion of how the global management consultant can help financial institutions adjust to the rule.*
b. States that "[c]ertain high-cost investment products (such as variable annuities) will be phased out as the business model is no longer viable under the new rule…."

**11. <u>Chamber of Commerce</u> (April 17, 2017 [comment letter)]()**

a. The Chamber is unaware of any "robo-advisor" that recommends annuity products to generate retirement income, despite the clear need for these products and the Department's reliance on robo-advisors to alleviate the potential loss of access to retirement advice for small savers.

**12. <u>Wall Street Journal Reports (February and April 2017)</u>, as described in the Financial Services Roundtable's April 17, 2017 [comment letter]()**

a. Firms have responded to the Rule by taking actions that include: (1) moving clients to fee-based accounts; (2) eliminating commission-based IRAs; (3) raising investment minimums for commission-based IRAs; (4) eliminating variable annuity products; and (5) excluding certain products from commission-based IRAs (e.g., annuities, mutual funds, and exchange-traded funds).

**13. <u>Cerulli Associates Research</u>, as reported in December 15, 2016 ThinkAdvisor [article]()**

a. "U.S. variable annuity and fixed indexed annuity sales are expected to decline by at least 10% through 2018 as the industry struggles to adapt to upcoming regulations put forth by the Department of Labor."
b. Cerulli views insurers' "biggest challenge for the foreseeable future" as being the Fiduciary Rule.

**14. <u>Insured Retirement Institute (IRI) First-Quarter 2017 Annuity Sales Report</u>, as described in June 6, 2017 [press release]()**

a. *Description: sales results based on data reported by Beacon Research and Morningstar, Inc.*
b. Industry-wide annuity sales declined 18% in the first quarter of 2017 as compared to the first quarter of 2016.
c. Fixed annuity sales during the first quarter of 2017 declined 13.9% as compared to the first quarter of 2016, and variable annuity sales declined 10.2% for the same period.

15. **Insured Retirement Institute (IRI), as reported in December 15, 2016 ThinkAdvisor article**
    a. IRI "found that industrywide annuity sales in the third quarter totaled $51.3 billion, an 8.2% drop from sales of $55.9 billion during the second quarter of 2016, and a 12.3% decline from $58.5 billion in the third quarter of 2015."