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**VIA ELECTRONIC MAIL**

April 12, 2011

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, NW, Room N-5655
Washington, DC 20210

Re: Proposed Definition of the Term "Fiduciary"

Ladies and Gentlemen:

Thank you for the opportunity to submit our February 3, 2011 comment letter on this very significant rulemaking, and for the opportunity to testify at the March 1-2, 2011 hearing. This letter supplements our prior commentary in light of the testimony and discussion at the hearing.

Consequences for ERISA Plans and Participants

In our prior commentary, we discussed at length the Department's largely successful effort since 1974 to fit independent broker-dealers into the regulatory structure of ERISA.[1] Because independent broker-dealers are most fundamentally selling firms compensated on a commission basis, regulatory solutions have been necessary for broker-dealers to continue to provide their essential services to ERISA plans and IRAs. The regulatory structure carefully constructed by the Department over the last 35 years, particularly under ERISA section 406, makes provision for the many instances in which financial services firms limit their activities to nonfiduciary services (e.g., the exemptions in PTE 75-1 for principal and agency transactions) and the more limited instances in which financial services firms take on the function of investment advice fiduciary (e.g., PTE 84-24 and PTE 86-128).

During our testimony, representatives of the Department discussed with us whether any of the typical services independent broker-dealers currently provide to ERISA plans and IRAs pursuant to this existing regulatory structure would become legally impermissible if they were in the ordinary course fiduciaries rather than service providers. Our discussion at the hearing primarily focused on gaps in existing prohibited transaction relief where broker-dealers have fiduciary status, on which we elaborate below.

Section 406 is not, however, the only consideration if independent broker-dealers routinely are made to be fiduciaries. The ERISA section 404(a) general fiduciary standards would of course also be applicable, with their rigorous "exclusive purpose" and other requirements. While the Department can provide relief from the section 406 prohibited transaction rules, it may not provide relief from section 404(a). If any new regulation causes them to become fiduciaries, our members are as or more concerned about how they would need to restructure their operations to comply with section 404(a) as section 406. In the absence of a legally reliable path for section

[1] Employee Retirement Income Security Act of 1974, as amended.

404(a) compliance, some broker-dealers will find it prudent to withdraw certain services from the market, to the extent section 404(a) exposure does not drive them from the market altogether.[2]

With respect to section 406, the activities of independent broker-dealers for retirement plans primarily relate to (i) packaged products like mutual funds and variable annuities, and (ii) investment advisory or management services, for which our members act as solicitors.[3] Broker-dealers may also assist ERISA plans and IRAs with transactions in individual securities, and with their selection of retirement platforms and other investment-related services. Typically, broker-dealers have been compensated on a commission basis for all the foregoing activities. Finally, broker-dealers may provide a number of services ancillary to these principal activities – cash management sweep services, for example, or settlement accommodations in the event purchase and sale transactions do not clear on the same schedule. The existing relief provided for these services if a broker-dealer is a fiduciary is neither comprehensive nor, when provided, always functional in the marketplace, as summarized in the following chart:

| **Broker-dealer activity** | **Existing prohibited transaction relief for broker-dealers that are §3(21)(A)(ii) fiduciaries** |
|---|---|
| Investment transactions | |
| Proprietary life/annuity products | PTE 84-24. |
| Nonproprietary life/annuity products | |
| Proprietary mutual funds | PTE 84-24 or PTE 77-4. |
| Nonproprietary mutual funds | PTE 75-1 mutual fund exemption. |
| Commissioned agency transactions | PTE 86-128, although this exemption is not widely embraced (outside of plans covering no common-law employees and IRAs) because of its incremental compliance costs. |
| Commissioned agency cross-transactions | |
| Proprietary hedge fund, private equity fund, ETF (if not registered as a mutual fund) or closed end fund | **None.** |
| Nonproprietary hedge fund, private equity fund, ETF (if not registered as a mutual fund) or closed end fund | PTE 86-128, but see the comment above. |
| Futures trades | **None**, unless provided by PTE 86-128. |
| Foreign exchange transactions | **None.** (Neither PTE 94-20, PTE 98-54 nor §408(b)(18) provides the necessary relief when the broker-dealer is an investment advice fiduciary with respect to the transaction.) |
| Other principal transactions – e.g., securities, currency, unlisted options, repurchases, reverse repurchases, forward contracts | Limited to (i) PTE 75-1 exemptions for an underwriting syndicate member who is not a syndicate manager, and for a market maker, and (ii) PTE 91-55 exemption for American Eagle gold and silver bullion coins.<br>**Otherwise, none.** |

[2] At the hearing, we reported on a substantial member firm which has concluded that it is already subject to all the risk it prudently can bear given its capital structure and that, if subjected to the incremental risks of ERISA fiduciary status, it will withdraw from the IRA and micro- to small-plan markets in which it currently provides services.

[3] See pages 8-9 of our February 3, 2011 comment letter.

| Broker-dealer activity | Existing prohibited transaction relief for broker-dealers that are §3(21)(A)(ii) fiduciaries |
|---|---|
| Commissioned sales of services (proprietary or nonproprietary) | |
| Investment advice arrangements (solicitation) | **None.** |
| Retirement plan platform | **None**, except to the extent provided by PTE 84-24. |
| Activities related to trading | |
| Bank deposit sweep programs | **None**, at least if the bank is unaffiliated with the broker-dealer. |
| Securities lending | PTE 2006-16. |
| Other extension or receipt of credit – e.g., short sales, margin loans, free credit balance, securities loans, overdrafts, settlement accommodations | Limited to (i) PTE 75-1 exemption for an extension of credit to the plan directly in connection with the purchase of specific securities and if no interest is charged the plan and (ii) PTE 80-26 but only for an unsecured interest-free loan to the plan for purposes incidental to its ordinary operation, e.g., overdraft protection to pay for securities or crediting of interest/dividends in advance of receipt.<br>Because they require interest-free extensions of credit, the foregoing exemptions are not widely utilized.<br>**Otherwise, none.** |
| Relationship brokerage | PTE 97-11. |

Moreover, there are longstanding interpretive issues under some of these exemptions – whether an intended (as distinguished from an inadvertent) investment advice fiduciary can rely on PTE 84-24, for example, or whether the form and recipient of all the compensation associated with an exempted transaction is within the scope of the exemption – that currently clouds the utility of the relief provided.

Thus, to the extent broker-dealers are in the ordinary course converted into fiduciaries by any new regulation, they would at a minimum be obliged to discontinue a number of their typical services for plans and IRAs (absent additional relief), and may choose to discontinue other services for which exemptive relief is unclear (absent clarifying guidance) or too costly to implement or cannot reliably be squared with section 404(a).

The "Seller" Exception

As we observed in our February 3 comment letter, there is nothing in the preamble to or justifications offered for the proposed regulation, nor otherwise in the enforcement history of ERISA, to suggest that broker-dealers have systemically abused plans and IRAs in a manner that demands a fiduciary "cure." Nothing at the hearing altered the empirical record in this respect.

Accordingly, we continue to believe it is imperative that the Department provide in any final regulation a reliable means for independent broker-dealers to continue to provide their services in the ordinary course other than as fiduciaries. Under the 1975 regulation, the five-part test provided a means for plans and broker-dealers to arrange their relationship, as fiduciary or non-fiduciary, with substantial confidence. If the Department persists in eliminating the five-part test and otherwise restructuring this definition as proposed, a different approach will be required.

In the course of the hearings, representatives of the Department variously suggested that the "seller" exception (Prop. Reg. §2510.3-21(c)(2)(i)) might be reformulated to serve this purpose, and specifically asked us for suggested language to accomplish that. From the vantage point of financial services activities, an effective seller exception would do the following:

- The exception must reach not only the sale of "securities or other property," but also the sale of the "management of securities or other property," if that remains an element of the "fiduciary" definition.
- The exception must clearly be available for agency transactions, as well as principal transactions.
- To the extent the excepted party continues to have a "selling" relationship with the plan after the initial point of sale – e.g., with respect to the plan's retention of an investment asset or management service – the exception must continue to apply.
- Where it is self-evident in a "selling" setting within the potential scope of the "investment advice" definition that a party necessarily is acting for its own interest rather than as a disinterested fiduciary for the plan – i.e., the counterparty to a plan's purchase or sale of an investment asset, or a provider of investment management services with respect to its initial or ongoing engagement by the plan – those parties and their representatives unconditionally should not be fiduciaries.
- Where investment intermediaries are acting in a sales capacity and compensated on a commission or other transactional basis, they cannot act as ERISA fiduciaries and should be excepted if they are not undertaking to act as such. (A formulation framed in terms of that ultimate conclusion is more constructive and certain than the "adversity of interest" formulation in the proposal.) As a representative of the Department suggested at the hearing, this might be established if the plan is provided[4] a written disclosure that the intermediary is not undertaking to act as an ERISA fiduciary. A safe-harbor disclosure approach would avoid the problems of uncertainty and proof embedded in the proposed exception, could be objectively and reliably implemented in practice and readily verified by the Department in its enforcement activities, but would not preclude the possibility of other approaches where the broker-dealer requires neither a written service agreement[5] nor a section 408(b)(2) disclosure[6] to provide the requested services to a plan or IRA.
- We agree with the Department that the exception should not be available to persons who are acknowledged fiduciaries, specifically with respect to the plan's decision for which the putative "advice" is provided. For example, a portfolio manager may be an acknowledged fiduciary with respect to its investment management activities, but it should be able to rely on the "seller" exception in promoting itself to the plan so long as it is not also an acknowledged fiduciary with respect to the plan's engagement of investment managers.

[4] For operational convenience, it should not be necessary for the disclosure to be provided directly by the intermediary to the plan.

[5] Broker-dealers sometimes provide recommendations or execution services without a written agreement.

[6] A section 408(b)(2) disclosure would not be required (i) in connection with an ERISA plan, if the firm is acting in a broker-dealer rather than investment adviser capacity, is not intending to act as an ERISA fiduciary, is not providing brokerage services including a designated investment option to a participant-directed individual account plan, and is not receiving indirect compensation, or (ii) generally in respect of IRAs.

Accordingly, we suggest that that the Department consider a "seller" exception to the effect of the following:

> (2) Limitations. For purposes of this paragraph (c): (i) Advice, recommendations or valuations shall not be treated as described in paragraph (c)(i)(A) if the person providing the advice, recommendation or valuation
>
> (A) is not described in paragraph (c)(1)(ii)(A) with respect to the decision for which the advice, recommendation or valuation is provided, and
>
> (B) as applicable,
>
> (*1*) is or has been compensated on a sales commission or other transactional basis and does not undertake to act as a fiduciary within the meaning of section 3(21) in providing the advice, recommendation or valuation. A person is deemed not to undertake to act as a fiduciary for purposes of this paragraph if so stated in a document provided to an independent plan fiduciary or the recipient of the advice, recommendation or valuation; or
> (*2*) is a counterparty to the plan in a transaction involving securities or other property, including an agent or appraiser for such a counterparty; or
> (*3*) is a provider of management of securities or other property, including an agent for such a provider.

<u>Individual Retirement Accounts</u>
In both our February 3 letter and our testimony, we joined a number of other commentators in urging that the proposed rulemaking provides an opportunity to develop a more sensible form of "fiduciary" definition for IRAs. Given the structural differences between employee benefit plans and the IRA's, a more limited "fiduciary" definition for IRAs – perhaps limited to IRA owners and acknowledged fiduciaries – may be appropriate. In its March 30, 2011 fact sheet on the proposal, the Department suggested a different perspective:

With the increase in the amount of assets held in IRAs, IRA holders shoulder a greater amount of investment responsibility, like 401(k) plan participants. But, unlike 401(k) plan participants, IRA holders are more vulnerable since no other plan fiduciary protects the IRA investments.

We respectfully disagree with the premise of this statement. The retirement security of plan participants, and their individual opportunity to influence that security, is subject to the choices and determinations made by the persons authorized to act for the plan; this dependent relationship is a classic setting for the law to impose fiduciary responsibilities. IRA owners, who have unfettered choice among all the IRA offerings in the market and the ability to "vote with their feet" or seek direct legal recourse against their IRA provider as they determine, are structurally in a far less vulnerable position. There may be IRA owners who find that the assistance of an adviser operating within the constraints of Internal Revenue Code section 4975, with its attendant limitations and incremental costs, is beneficial. The experience of our members, however, is that makes no sense to many IRA owners, who:

- Participate in and understand the IRA market as a retail market,
- Cannot fathom why otherwise permissible products and services available to them for their retail accounts should be unavailable for their IRA accounts by reason of section 4975, and

- Are satisfied (at least implicitly) with the protections afforded retail investors, i.e., with the standards imposed by the SEC, FINRA, state insurance and other applicable regulators. These are substantial protections that, unlike section 4975, provide private remedies directly for IRA owners and all other retail investors.

So long as IRA owners remain "fiduciaries," we see no tax policy reasons for a fiduciary definition under section 4975 as broad as the section 3(21) definition. Accordingly, we continue to urge the Department to consider, in consultation with the Treasury Department, a different "fiduciary" definition for IRAs.

Next Steps

This rulemaking proposes to remake one of the most significant elements in the ERISA regulation of plan management – the definition of "investment advice fiduciary." As such, this project is both a substantial undertaking for the Department and of enormous consequence to the regulated community – plan sponsors and participants, IRA owners, and service providers alike. It is unsurprising that, in a rulemaking of this magnitude:

- The Department indicated in the preamble that in a number of respects it was unsure of the effect of the proposed regulation; and
- At the hearing, the Department acknowledged that there were imperfections in the drafting of the proposal that would require further attention.

The Department has received over 200 written comments on the regulation and two days of hearing testimony, much of which included responsible, substantial criticism of the proposal. Accordingly, there is meaningful work yet to be done on the proposal itself.

The proposal also creates the potential need for additional prohibited transaction relief if essential investment services for plans and IRAs are not to be interrupted. The consequences of the "fiduciary" redefinition the Department ultimately concludes to adopt will need to be tested against the complex of statutory and class exemptions that currently accommodate investment services, and additional relief developed and adopted as appropriate. This cannot be reliably done in advance; the scope and content of existing relief can be reviewed, as above, but the need for and terms of additional relief cannot be truly evaluated without knowing the shape and contours of the "fiduciary" definition the Department concludes to adopt. Moreover, this additional exemptive relief will not be successful unless:

- It is issued contemporaneously with the final regulation defining "fiduciary." Any other approach risks recharacterizing financial services firms as fiduciaries before the relief necessary for the continuation of their essential services is fully in place. Neither the retirement system nor the credibility of the ERISA regulatory regime will be well served if broker-dealers are compelled by the "fiduciary" redefinition to even temporarily discontinue providing any investment products and services to which plans are accustomed and on which participants' retirement security depends; and
- It takes the form of a single, comprehensive class exemption. Piecemeal refinements to existing exemptions would needlessly (i) be laborious and time-consuming for both the Department and the regulated community, (ii) risk disruption of the extensive practices and procedures put in place over the last 35 years to comply with the existing relief, and (iii) create the possibility of an inadvertent gap in the exemptive framework for investment services. Also, we do not see how it is feasible for the Department to provide relief contemporaneous with the "fiduciary" regulation other than in a single, comprehensive exemption.

For all these reasons, the Department's next step in this project should be to (i) repropose the "fiduciary" definition taking into account the Department's own consideration of this rulemaking since the October 22 proposal and the extensive commentary it has received, and (ii) simultaneously propose the comprehensive class exemption suggested above.

Effective Date

The existing definition of investment advice fiduciary in Reg. §2510.3-21(c) has informed 35 years of practice for the financial services industry. Plans and service providers alike have come to rely on that definition in providing for the retirement security of millions of participants and beneficiaries. Many of the essential services plans receive from financial services firms were adapted to and depend on this definition. After reflecting on the proposal, the comment letters and the testimony provided at the hearing, our members believe that a minimum of twelve months after publication would be necessary to analyze any final regulation and restructure their business operations and contractual obligations in accordance with that regulation.

Conclusion

We remain committed to constructive engagement in this regulatory process and, therefore, welcome the opportunity to work with you on this important regulation.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 379-0943.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO