W O O D A R D

Don Woodard, CLU
Blake Woodard, CLU

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Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue NW
Suite 400
Washington, DC 20210

Submitted by e-mail:
e-ori@dol.gov
e-oed@dol.gov

Re: RIN 1210-AB82
Review of Definition of Fiduciary; Conflict of Interest Rule for Retirement Investment Advice
Review of Best Interest Contract Exemption

Ladies and Gentlemen:

As Secretary Acosta can testify as a long-time Florida resident, termites quickly can destroy what for many Americans is their largest investment. While Texas subterranean termites might be more laid-back than their Florida above-ground tropical cousins, sadly I can testify that they still can consume a home in months.

As a Texas resident who has suffered heavy termite damage on a residence, I long have maintained a service agreement with a national pest control company, whereby they not only will provide services to prevent termites from gaining a foothold on my home, but also they will repair any damages that occurred on their watch. There are many local, reputable pest control companies I could use. While these local firms might provide more responsive service, be more knowledgeable, or even be a little cheaper, I choose to do business with the national company because of their repair guarantee. Some of the local pest control companies choose not to offer a guarantee against termite damage, not because they are incompetent or dishonest, but because they do not want to bear that cost of doing business. I might be better served by these local companies, if they can prevent the agony of termite damage with their more watchful eye.

In a free market economy, I get to choose the termite control arrangement I want to purchase, and pest control companies get to choose whether to offer guarantees against termite damage. The government doesn't say, "Every pest control company must pay all cost to repair termite damage on its watch, and every homeowner who purchases termite mitigation services must purchase a warranty to repair such damage." It doesn't work that way in the United States.

Suite 600
University Centre I
1300 South University Drive
Fort Worth, Texas 76107
(817) 877-4405
(817) 877-1100 FAX

In this metaphor, the national termite firm is acting as my home's fiduciary, while the local pest control company is merely acting as a service provider, who will strive to protect my home. I guess that makes the termites the excessive investment fees.

Some might say that investments, particularly IRAs, are different than houses and require a more sophisticated service provider and top-down regulatory structure. To the contrary, one's home and one's investments have much in common. For many Americans, their home is their largest investment, and the purpose of their financial investments is to sustain that home for the rest of their lives. Their financial investments, IRA or otherwise, are a means to the home, which is the end. I can tell you that I have lost much more sleep and spent much more time dealing with termite damage than I have with investment losses. I want to know that my pest control company is looking out for my interests.

I am an investment representative of a broker-dealer and have served individual investors for 20 years. I also provide non-fiduciary compliance and consulting services to 401(k) plans and their sponsors. My plan-level 401(k) consulting work is done for an hourly rate. By design, my model is a non-fiduciary model.

Thank you for opening up the fiduciary definition rule ("Rule") for further comment. I request that the Rule be rescinded in its entirety. I don't think any degree of modification can repair its flaws. Ironically, this rule, which the Department has alternately labeled the "Conflict of Interest Rule," has been pushed on the American public by a segment of the investment industry that is highly conflicted, as they believe forcing all IRAs to be served by fiduciaries will channel hundreds of billions of dollars of assets in their direction. This conflicted fiduciary side of our industry has provided most of the fuel behind the Rule.

As I describe below, I have witnessed more out-of-control conflicts of interest on the fiduciary side of the investment industry than the suitability side. The Rule doesn't address these fiduciary conflicts of interest (except for its treating IRA rollovers as a fiduciary act) and grossly overstates the economic cost of conflicts on the suitability side.

As I explain in more detail below, the Rule makes a mockery of the word fiduciary. The Department's belief that every person who provides investment services to an IRA, no matter how small the IRA or how small the person's compensation, should bear the burden of a fiduciary (which is the case since June 9) shows a glaring misunderstanding of what a fiduciary is. Centuries of common, trust, and ERISA law are redefined with a regulation. Poof! You're a fiduciary!

The Rule has two fatal flaws that will harm investors, along with other non-fatal flaws.

Economic Analysis. Before I address the fatal flaws, let me address the Department's economic analysis that serves as the foundation for the Rule. The economic analysis is a set of nested assumptions, none of which is based on independently-verifiable facts. The oft-quoted $17 billion in losses attributed to bad or malicious investment advice is fake news. Ironically, as I explain in Fatal Flaw #1, the Rule's solution to reduce the $17 billion in losses may increase investor losses by reducing the robust oversight present in today's broker-dealer biosphere.

In her famous "Villas, Castles, and Vacations" white paper, Sen. Elizabeth Warren presents a number of examples of insurance company incentives that create potential conflicts for sellers of annuities. Sen. Warren's white paper makes some valid points, and some of the examples she cites have offended me for years. However, Sen. Warren's white paper covers a small subset of the investment advice conflict of interest universe, a subset that could be dealt with easily by simple, black and white levelized compensation rules. In addition, Sen. Warren's white paper covers a small subset of the qualified plan and IRA investment universe, as most qualified plan and IRA investors do not put their money in annuities.

Not only is the annuity world a small part of the qualified plan and IRA world, but also it is folly to create a spreadsheet to estimate the losses to investors from the actual conflicted advice. First, you would have to calculate the percentage of annuity sales affected by conflicted advice, and second you would have to measure the loss to investors from the conflicted advice. Some annuity purchases may turn out well for investors, even if the salesperson's advice was biased or malicious. For those investors whose conflict-tainted annuity purchases were harmful, how would you measure the loss? Once you have calculated the percentage of annuity sales affected by conflicted advice and the loss to investors from such conflicted advice, you only would have calculated the losses arising from a tiny portion of the conflict of interest universe. There are far larger and more insidious conflicts of interest threatening investors than an insurance company convention in Maui. But such conflicts do not a colorful white paper make. Sadly, as I explain below, the Rule may be leading investors directly into one of those conflicts.

The Department's economic analysis attempts to quantify many immeasurable factors and is an example of complex spreadsheets' creating their own legitimacy. Like the cunning young man who stole the king's entire fleet of wheelbarrows by filling them with sand so that the king's guards focused on the sand instead of the wheelbarrows, the Department's economic analysis, by its complexity, distracts the observer from the analysis' lack of substance.

Fatal flaw #1. The Rule may be leading investors away from the triple-layer protection offered by the Broker-Dealer world to the thin single-layer protection offered by the RIA (registered investment advisor) world. In response to question 3 in the Department's RFI, the Rule may be increasing conflicts of interest and decreasing consumer product

choices. Registered representatives of broker-dealers are not fiduciaries, while registered investment advisors are fiduciaries. The Rule has turned the Broker-Dealer universe upside down, as Broker-Dealers attempt to convert their large investment representative force from non-fiduciary to fiduciary status. Consequently, it is likely that as a result of the Rule, many investors will move their accounts from the Broker-Dealer world to the RIA world. It is no surprise that the RIA world has lobbied heavily for the Rule. Ironically, some RIAs may be conflicted in advocating for the Conflict of Interest Rule, as they may be advocating for a complex regulation that will steer more business in their direction.

The Rule makes a baseless assumption that a fiduciary standard is the only acceptable standard for providing investment assistance to IRA owners. A fiduciary standard is an extremely high standard and therefore a prohibitively costly standard, especially for small accounts. Many persons promoting the fiduciary standard simply do not understand what a fiduciary is. They throw around the F word very lightly.

Even when advisors adopt a fiduciary standard, it provides no assurance to the investor. Bernie Madoff was a fiduciary. I have seen registered investment advisers in Texas (who are fiduciaries, although not in the same meaning as in the Rule) engage in egregious, aggressive behavior that would get a registered representative disciplined. One Texas RIA exchanged one of my client's commission-based variable annuities for a fee-based annuity, unwittingly costing her thousands of dollars in surrender penalties. At her request, I stepped in and persuaded both insurers to reverse the transactions. Amazingly, the RIA – a fiduciary – then convinced the client to pursue the exchange of the larger of the two annuities, telling her he would reimburse her for the surrender penalty. This behavior would never happen in the registered representative world, but the Rule is pushing all consumers towards unsupervised RIAs.

A commission-based registered rep simply could have been named the representative on the annuities and managed them for the client while letting the surrender penalties expire, but because this RIA did not have a securities license, his only option to get paid was to exchange the annuity for a fee-based annuity. Then he had the nerve to tell her that the fee-based annuity's expenses were lower than the commission-based annuity's expenses, ignoring the fact that he was adding his fee separately. Was this level-fee fiduciary serving his client's best interest? The Rule assumes that level fees eliminate or reduce conflicts and therefore does not subject level-fee arrangements to the BICE. Conflicts are everywhere, but sometimes the worst conflicts don't make interesting Senatorial white papers.

This is the real world that registered representatives work in. We know that wrapping yourself in the fiduciary blanket or the level-fee blanket does not provide the investor with any more protection. The registered representative side of the securities industry, which ironically is the side disfavored by the Rule, is the side with a robust supervisory structure of broker-dealers to give the investor two extras layer of protection.

The Broker-Dealer world has three layers of protection:

1. The broker-dealer supervises the registered representative.
2. FINRA supervises the broker-dealer.
3. The SEC oversees FINRA.

By contrast, the RIA world has only one layer of protection. Whereas every transaction a non-fiduciary registered representative engages in is scrutinized by her broker-dealer, the RIA only occasionally is audited by either the SEC or, for smaller RIAs, the RIA's state securities board. Many investment professionals surrender their securities license and become RIAs to avoid the constant scrutiny the Broker-Dealer world imposes.

Mandating a fiduciary standard on small IRA investors not only provides an illusion of protection but also adds a great deal of expense. These small IRA owners may be relegated to automated "Roboadviser" accounts. Because of the Rule, small investors already are losing the services of their long-time registered reps. A significant percentage of most registered reps' clients are small legacy accounts. As registered reps, we have served these families for many years and are honored to keep helping them as they spend down their assets in their senior years. Our regulatory burden already is high, and these accounts already do not generate sufficient revenue to cover the compliance costs. Who wins when we no longer can serve these senior citizens due to the increased expense and liability of the fiduciary definition?

Fatal Flaw #2. While the Fiduciary Definition's first fatal flaw is steering investors away from the robust triple-layer of oversight of the Broker-Dealer world to the single layer of oversight of the RIA world, the second fatal flaw is even greater: The use of the word "best." Words matter. "Best" is a powerful word whose danger cannot be mitigated by artful writing. "Best" has no place in any regulation, because it is an unattainable standard, an unreachable limit on a hyperbolic curve. No one ever does his or her best. There always is room for improvement, and nowhere is this truer than with managing money. You always can do more research, spend more time, find a better, cheaper fund, and follow up more frequently.

It would be one thing to have a "Retirement Investors Interest Contract Exemption" or a "Retirement Investors Interest First Contract Exemption," but to use the word "best" is to guarantee litigation. Not only will the advisor never serve the best interest of the investor, but the investor will not even know what her best interest is. Ask an investor in 2007 whether they are more interested in growth or principal preservation, and they likely would have told you "growth." The same investor in 2009 likely would have told you "preservation." Investing is a complex process, as Section II(c)(1) of the BIC exemption recognizes in its unsuccessful attempt to define what is meant by "Best Interest." "Best" is a toxic word that has no place in the Rule. As the greater of the two fatal flaws in the Rule, it improves the retirement only of litigators who shall feast on it.

One of the non-fatal flaws is the Rule's impact on the quantity of investment professionals available to serve small IRA investors. Many investment professionals are leaving the industry, or redirecting their time to non-IRA investments. I have stopped taking on new IRA clients. Like the local pest control company, I provide knowledgeable, hands-on service for medium-size IRA owners. People ask me frequently to assist them with their IRAs, but I choose not to bear the burden of a fiduciary. That doesn't mean I'm dishonest or less capable; it means that, unlike the Rule, I understand what a fiduciary is.

Please call me if I can provide more detailed information on these concerns.

Sincerely,

Blake Woodard