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July 20, 2015

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

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

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

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

Dear Madam or Sir:

I write in support of the DOL's proposed Conflict of Interest proposed rule and to suggest enhancements to the BIC exemption, and to further suggest a new exemption relating to IRA rollovers.

As a longtime researcher into fiduciary law as applied to financial and investment advisers, I currently serve as Asst. Professor of Finance at Western Kentucky University, Bowling Green, KY, where I Chair the undergraduate (B.S. Finance) Financial Planning Program with the Gordon Ford College of Business and teach classes in retirement planning and investments. I am also an investment adviser, having served as the Director of Research, Chair of the Investment Committee, and Chief Compliance Officer of an SEC-registered investment adviser firm, and I currently serve as the principal of my own registered investment adviser firm. I am also currently a Certified Financial Planner™, a member of the Steering Group for The Committee for the Fiduciary Standard, consultant to the Garrett Planning Network, and a member of both the Financial Planning Association (where I served on its "Fiduciary Task Force" and "Standards of Conduct Task Force") and the National Association of Personal Financial Advisors (where I served on its national Board of Directors, and where I currently serve on the South Region Board of Directors). In the past I served as a consultant to a large financial services firm on a program relating to retirement planning. I am also a member of The Florida Bar, and have advised clients on tax and estate planning issues. I have previously commented extensively on fiduciary rule proposals and often provide writings and presentations on the topic. These comments represent my personal views.[1]

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[1] *This comment letter reflects my personal views. These views are not necessarily representative of the views of any institution, organization, group or firm with whom I may be, or have been, associated.*

First, I desire to express my personal gratitude for the courage shown by the White House, the Secretary of the DOL, and Asst. Secretary Borzi and her dedicated staff, as they seek the necessary changes to better the retirement security of our fellow Americans. The tenacity shown to effect these much-needed updates to the standards of conduct applicable to the delivery of advice to retirement accounts are particularly noteworthy, given the flood of money and resources flowing from many Wall Street firms and their lobbying organizations into Washington, D.C. in an effort to delay or halt these important and long-overdue changes.

Second, I provide the rationale for the imposition of fiduciary standards upon providers of investment advice to ERISA-governed retirement accounts and individual retirement accounts (IRAs). This requires an understanding of the high rent extraction by most providers of financial products today, and the monumental adverse affect of this extraction of rents by Wall Street. These high rents not only hinder the retirement security of hundreds of millions of our fellow Americans, but also hinder the growth of the U.S. economy and the future economic prospects for all Americans.

Third, I provide a discussion of a bona fide fiduciary standard, and contrast the authentic "best interests" fiduciary standard of conduct with the wholly misleading and ineffective "best interests" standards of conduct now proposed by SIFMA and most recently by FINRA. I urge policy makers, such as those in Congress and in our regulatory agencies, to not be fooled by these 11th-hour attempts to deter the expansion of true fiduciary duties.

Fourth, I comment on the "Best Interests Contract Exemption," also known as the BIC exemption. I provide suggestions which will serve strengthen the exemption and lead to better personal financial outcomes for our fellow citizens, as (given the advocacy by SIFMA on its "best interests" proposal, and other attempts to re-define commonly used legal terms) there is a danger that the term "best interests" will be, in the future, interpreted incorrectly.

Fifth, I recommend the adoption of a new prohibited transaction exemption (PTE) for independent investment advisers who are bound by the "sole interests" standard of ERISA, regarding the conflict of interest all providers of personalized investment advice possess regarding the important decision of Americans as to whether to undertake a rollover of a qualified retirement plan (QRP) account into one or more individual retirement accounts (IRAs).

Sixth, I comment on the "Seller's Exemption." There has been a long history of "expert advisers" failing to provide excellent and non-conflicted advice to retirement plan sponsors. I propose some enhancements to this exemption.

Seventh, I observe that it is extremely easy to reconcile different standards of conduct advisers might practice under, under different regulatory regimes, despite the assertions by FINRA, broker-dealers and insurance companies to the contrary.

I also hereby incorporate by reference my previous comment letters regarding a previous version of the proposed rule.[2] These letters set forth additional legal authority for the propositions contained in this letter. I attempt to not duplicate these earlier submissions, except as necessary to address the specific issues raised by this important proposed rule and the new or modified PTEs associated therewith.

Thank you for your consideration. I would be pleased to discuss this proposal at your convenience with Department staff. By separate submission I have requested to testify at the DOL's August 2015 hearing on these matters.

Yours truly,
Ron A. Rhoades, JD, CFP®

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[2] My prior comment letters, dated April 11 and 12, 2011, can be found at https://www.dol.gov/ebsa/pdf/1210-AB32-PH026.pdf and https://www.dol.gov/ebsa/pdf/1210-AB32-PH029.pdf, respectively.

COMMON SENSE 2015:

ADDRESSED TO THE

INHABITANTS

OF

AMERICA,

on the following interesting

SUBJECTS.

Written by: R O N A . R H O A D E S .

"*The best security for the fidelity of men is to make interest coincide with duty.*"

– Alexander Hamilton

I. On the Failure of the Financial Services Industry to serve the Public Good.

A. An Illustration: The Compton's Expensive, Tax-Inefficient Portfolio.

Jake and Missy Compton Seek A Second Opinion. Jake and Missy Compton (not their real names, for reasons of confidentiality), husband and wife for the past 10 years, and both in their early 40's were doing relatively well financially. Jake was an executive at a multi-national company with a compensation package that was mid-six figures. Missy was attentive to the needs of home and her husband, diligently saving, paying bills, planning each modest vacation for maximum enjoyment, and ensuring no debt (other than their very-low-interest-rate mortgage) was incurred. After maximizing contributions to Jake's 401(k) plan and electing to defer as much income as possible in the company's nonqualified compensation plan, over the past several years the Comptons were still left with extra funds to invest. After several years of investing with the current wealth manager, Jake and Missy sought me out for a "second opinion."

Before beginning to invest with their existing wealth manager, several years before, Jake and Missy already had investments. In addition to their condominium (their home, in a major city), Missy owned two condominiums in another state. These rental properties were generating positive cash flows for Jake and Missy.

Several years before a friend had previously referred the Comptons to the wealth manager's firm. This "wealth management" firm's stated policy, per their web site (retrieved 2/22/15) was "to provide *independent* and *sound* investment advice whatever your financial situation … *trust* is important." (*Emphasis added.*) The firm also held out as "your *expert* partner in all things financial." (*Emphasis added.*) The wealth manager they were referred to, a founder of the firm, touted his ability to "compete based on knowledge, relationship and world class service." My review of the wealth manager's registrations revealed that he was a dual registrant (*i.e.,* possessing registration as both the registered representative of a broker-dealer firm and as the investment adviser representative of a registered investment adviser firm), and that he also possessed life insurance and annuity provider state licensure.

The wealth management firm suggested, for the Comptons, investments in many different types of accounts – traditional and Roth IRA, joint, and individual (taxable) accounts. Many different types of investments were undertaken. Variable universal life (VUL) insurance policies were also recommended and sold to both Jake and to Missy by the wealth manager. A nonqualified equity indexed annuity (EIA) was also recommended and sold to Jake.

After a few years, as Missy reviewed the many monthly and quarterly statements she received, she thought something might be amiss. She couldn't put her finger on it, but she suspected that things were "not right." Despite the tremendous increase in stock market values over the past few years, it appeared that the value of their investment portfolio was substantially lagging.

After reading an article I had written years before, Missy contacted me for a second opinion, to which I consented. (I call such second opinions or portfolio reviews "BearScans," as my students often refer to me as "Da' Bear" – perhaps due to my size or perhaps because I may growl at them.) I gathered detailed information from Jake and Missy Compton, including about their lifestyle, spending habits, past personal history, and goals, as well as monthly or quarterly statements of all of their investment accounts.

The Compton's Retirement Goals. Jake desired to retire in about 15 years, and he believed that he was well on his way to doing so. With no children and none expected, Jake and Missy were not anticipating any major expenses prior to retirement. Working for a multinational company, Jake felt his position was very secure. The Comptons desired to retire to a state that had no state income tax. Their accumulated deferred compensation was invested per the plan at a rate slightly exceeding the prime rate, with no interest rate risk present. Additional contributions to the deferred comp plan were likely.

Compton's Tax Return Reveals Unnecessary Tax Drag on Investment Returns. Even with the substantial deferred compensation arrangement, their recently prepared Form 1040 showed that their marginal tax rate was 28% for federal income tax purposes, and additional state income tax was paid. They possessed $9,000 of net capital loss carryforwards (NCLCF). Their tax return for the prior year indicated over $18,000 of ordinary dividend income and $4,000 of qualified dividend income. Three of their taxable investment accounts had generated realized net short capital gains exceeding $5,000, and five of their taxable investment accounts had generated realized net long-term capital gains exceeding $21,000. Due to a combination of deductions for state income taxes, the presence of qualified dividends, a small amount of tax-free interest income, and their long-term capital gains, the Comptons were subject to alternative minimum tax.

At first glance, the amount of nonqualified dividends seemed alarming, as were the realized capital gains from publicly traded investments. The continued realization of long-term capital gains would likely result in increases to their alternative minimum tax liability.

No Investment Policy for the Comptons. I then turned to Jake and Missy's investments, made on the advice of their current wealth manager. First, I inquired, had an "Investment Policy Statement" been prepared by their current wealth management firm? No, the clients responded, inquisitive as to what an Investment Policy Statement was all about. The Comptons indicated that they would be contacted by their wealth manager whenever they contributed cash to their accounts, and recommendations would then be undertaken and discussed verbally. But they did not recall any "asset allocation" target percentages being discussed.

The Compton's Oil & Gas Limited Partnership. The immediate question Jake and Missy posed to me was whether they should invest more into an oil and gas limited partnership, which recommendation they just received from their wealth manager just one week before they contacted me (in Nov. 2014). Of their total in the investment accounts with the wealth manager, nearly 20% had been invested in oil and gas limited partnerships with this same master general partner. A review of the investment revealed that outside investors in nearly all of the private placements arranged by the master limited partner either lost money or just about broke even. In fact, the limited partnerships were so poorly designed, so as to benefit the master limited partner over the limited partners, that a law firm had posted a notice stating that it was "interested in hearing from investors who have lost money investing in [the master limited partner's] oil and gas investments." With such red flags appearing, and with dramatically falling petroleum prices in the Fall of 2014, it was readily apparent that the risks of the investment outweighed the potential for returns, and I discouraged the Comptons from purchasing any more of these partnership interests.

While Jake and Missy extolled the tax credits they had received from these investments, and the current 6% dividend yield, I explained that the dividend was likely to fall in the months ahead as oil and gas revenues declined (which it subsequently did – quite dramatically). I also explained the "tax tail" should never wag the "prudent investor" dog. Tax credits would not offset the fact that their investments in these limited partnerships were highly unlikely to generate any reasonable rate of return. One does not invest to generate losses, but rather to generate gains. This fundamental truth seems have to been ignored by their wealth manager, at least with respect to these investments.

I also pointed out that the limited partnership interests were highly illiquid. In fact the value of these (non-liquid) investments had already likely fallen substantially. This was confirmed later when, seeking to sell one of their existing limited partnership interests, the best offer the Comptons received was for about 13% of the initial purchase price they paid for the units.

Why did their wealth manager recommend such a poor investment? Especially in November 2014, when despite rapidly falling oil prices the wealth manager recommended an even greater amount be invested? The answer appeared obvious. The sale of the limited partnership interests netted the "wealth management firm" commissions in the range of 10% to 15% - far in excess of the commissions which would have been charged had the Comptons purchased a mutual fund (especially when breakpoint discounts are applied).

Review of the Compton's Other Tax-Inefficient and Costly Investments. I then turned to other accounts Jake and Missy possessed.

First Taxable Account. I would have expected that tax-efficient investments would be utilized and that avoidance of realization of capital gains, especially of a short-term nature, would be sought. Yet, the stock mutual funds possessed in these accounts had relatively high turnover and were woefully tax-inefficient. Some of the mutual funds held in the account were municipal bond funds; yet, these funds held few bonds in the Compton's state of residence (leading to state income taxation of the otherwise "tax-free" interest income.) Another concern in this account was the layering of fees. In addition to investment advisory fees paid to their wealth management firm (which appeared to be about 1% a year, per the firm's Form ADV), another advisory firm ("separate account manager") was called upon to select the funds and was likely paid a fee of 0.6% to 1.0% according to its Form ADV. Then there were the fees and costs of the mutual funds themselves. A short review indicated annual expense ratios (AERs) as high as 1.91%, with most of the stock mutual funds possessing AERs exceeding 1%. Additional costs would be incurred within the stock funds – i.e., various transaction and opportunity costs due to the high amount of securities trading and sometimes relatively high cash holdings.

Second Taxable Account. Several stock and asset allocation funds were used in the account, all of which possessed relatively high portfolio turnover rates. The annual expense ratios of the mutual funds ranged from 0.89% to 1.25% for the three largest holdings in the account. Again, relatively high cost funds existed. With an allocation of 27% of the account to fixed income investments and most of the balance to stock mutual funds which generated substantial realized capital gains as well as taxable interest income, the account was not invested tax-efficiently.

Review of the Compton's Non-qualified Equity-Indexed Annuity. Jake was also sold a nonqualified equity-indexed annuity (EIA), the value of which was less than the value shown on their brokerage statement, as surrender fees still applied (which reduced its actual market value). When I explained the likely rates of return of the EIA's various investment options (given the crediting mechanisms and the caps), the tax restrictions on taking funds from the non-qualified annuity prior to age 59½, and the large commission paid to their wealth management firm upon the purchase of the EIA, Jake was not pleased. What struck me, as well, was that given the substantial qualified (401k) and nonqualified (deferred compensation) plans in which Jake was enrolled, there did not appear to be any good reason, from an overall tax planning perspective, to contribute to any non-qualified tax-deferred accounts.

The Compton's Non-Publicly Traded REITs. The Comptons had also been sold two REITs by the wealth management firm. Both were non-publicly traded. Given the Compton's other privately held real estate investments, any additional asset allocation to real estate was inappropriate. In addition, the REITs (which generate ordinary income, most of which must be distributed to the owners of the REITs) were held in taxable accounts. More alarming was the fact that the initial offering price of the REIT was still being utilized for purposes of valuing the shares on the statements, despite the fact that commissions of 8-10% and additional "marketing expenses reimbursements" were paid to the various brokerage firms that sold the REIT. A recent spreadsheet provided by their wealth manager indicated that this investment had "no fees" that year (perhaps accurate, but only in the sense that the large commission had already been paid and no investment advisory fees were paid on these investments). I explained to Jake and Missy that REITs pay their managers (or outside managers) fees to manage the properties, and other expenses exist within the REIT itself. I also explained that the value of the REIT was likely far below the value listed on the brokerage statement.

The Expensive Futures Ltd. Partnership. Jake and Missy also possessed a taxable (joint) account, invested in a non-publicly traded limited partnership that invested with other "Trading Advisors" who in turn invested primarily in futures contracts. One Trading Advisor's compensation was 2% and 20% of the "net new trading profits." Others had compensation of "0 and 30%" or "0.75% and 25%" or similar. In addition, the limited partnership charged an annual management fee of 1.5%, plus 7.5% of the new profits calculated monthly. Selling agent fees also were 2% annually. To the Comptons I explained the likely long-term returns of commodities, as an asset class, the historical returns of commodities, the tax implications of the fund, as well as the many layers of fees and costs. I also explained the lack of liquidity for this investment. Needless to say, the Comptons were again not pleased with their wealth manager's advice to invest in this investment product.

Roth IRA Investments – What the Hell? I then reviewed the Comptons' Roth IRA accounts, invested in a mix of U.S. and foreign stock funds as well as some bond funds. Of course, two things stood out immediately. First, foreign tax credits can result from international stock mutual funds, which flow though to U.S. owners of those funds when held in taxable accounts. These tax credits are lost when the international stock mutual funds are held in Roth IRA or tax-deferred accounts. Second, fixed income investments have no place in this Roth IRA account. Roth IRAs generally grow income tax-free, and these accounts will likely be the client's last source of withdrawals during retirement. Accordingly, allocation to the asset classes with the best expected long-term returns would be far more appropriate.

Very Expensive VUL Policies. Both Jake and Missy had variable universal life insurance (VUL) policies that which were sold to them by the wealth manager in 2010. Missy's death benefit was $381,000, and her accumulation value was $57,377. Jake's policy had a death benefit of $336,000 and an accumulation value of $54,000. The accumulation values remained far below the total premiums paid, given the high commissions paid to the wealth manager during the VUL policies' first few years.

I would never have recommended permanent life insurance for them. The only need for life insurance was to replace Jake's lost income, or cover possible expenses upon Missy's end of lifetime. I would have recommended term policies, with a far larger death benefit for Jake and far less of a death benefit for Missy (as she did not have earned income).

It should be noted that there was no need to secure liquidity to pay estate taxes. In fact, during the year the policies were sold to the Comptons (2010), the federal estate tax did not exist. In December 2010 the federal estate tax exemption was established at $5m for 2011 (with increases tied to inflation thereafter, and with spousal portability). There simply was no need for the clients to possess permanent life insurance. I surmised that the only plausible reason that the Comptons were sold these policies was due to the fat commissions paid to the wealth manager.

However, since the Comptons already possessed these policies, and had paid hefty commissions on the premiums paid and since the policies still possessed surrender fees, more analysis was needed to determine whether to continue with the policies and/or continue to pay premiums. In-force projections would have been ordered, using conservative rates of return and with minimal or no future premiums paid. Comparisons of mortality fees paid under the policy, to the insurance charges from new term insurance policies, would also need to be undertaken. Regardless of whether, following more analysis, the current policies will be surrendered or not, more term life insurance for Jake was likely needed, which will be handled through one or more new term life policies.

The Compton's Non-Managed 401(k). Jake also had a 401(k) with his company. Fortunately, this account was not managed by the wealth management firm. The Vanguard funds in the account had been selected by Jake. While the asset allocation was not favorable, from an overall portfolio standpoint, this could be easily fixed. I wondered, however, why the "wealth management" firm had not provided advice on the 401(k) investments, given the need to consider a client's overall asset allocation in order to ensure tax-efficiency and adherence to a sound investment policy; perhaps they had not been asked to do so. I explained to the Comptons that the best means to tax-efficiently an overall investment portfolio is to hold all of their desired asset allocation in tax-deferred accounts, such as this one (and the nonqualified retirement plans mentioned above), while holding tax-efficient stock funds in taxable accounts, all other things being equal.

In Summary - The Compton's Portfolio Fiasco. Upon reflection, I wondered what expertise, if any, had been applied to the construction and management of the investment portfolio. The overall portfolio did not seem to possess any overall investment strategy. Investments were recommended that appeared to pay either high commissions (REITs, oil and gas limited partnerships, VUL policies, EIA) or which incurred layer after layer of annual fees and costs. Most of the investment portfolio was structured tax-inefficiently, leading to a huge tax drag on investment returns. Several of the investments were quite illiquid and would likely take years to unwind.

From the facts available to me, I concluded that the wealth management firm had not, in my opinion, delivered upon their promise of "independent and sound investment advice." Multiple conflicts of interest existed. Little or no expertise was applied. Even in the investment advisory accounts (subject to the fiduciary duties imposed by the Advisers Act) it did not appear that due consideration was given to avoidance of high fees and costs. And, under state common law, at least in some states, fiduciary duties extend to the entirety of the relationship.

The Comptons, in their own words, "trusted" this "financial professional." *It was a trust betrayed.*

The Comptons became a client of my own investment advisor firm. Over the first year of our relationship, in which I am paid a reasonable flat fee, I have been undertaking a restructuring of their investment portfolio to become much more tax-efficient and to dramatically reduce the extraordinarily high fees extracted from many of their investments. In addition, as part of that fee, I have provided advice on their estate plan, advised on the impact of changes undertaken by Jake's company to the nonqualified profit-sharing plans the company offered to him, income tax planning, and much more. After this first year my annual flat fee will be cut in half, as much less professional services will be needed by Jake and Missy Compton, once I spend a year straightening out their current accounts (to the extent such corrective action is possible).

B. Wall Street's High Extraction of Rents from Our Fellow Americans

I wish I could say that the Compton's experience was rare. *But it is far from a rare event.* Rather, the experience of receiving non-expert, highly conflicted financial and investment advice results for most Americans today.

Jake and Missy Compton are both very highly educated. They asked many of the right questions. But, lacking knowledge of the complex array of financial products their wealth adviser presented to them, the Comptons were at a substantial disadvantage. They were unaware of the many conflicts of interest possessed by their wealth manager. And they were unaware of just how much their wealth manager had been able to extract from them by way of commissions and other fees.

I have seen similar situations, some less complex, some more complex, for clients who came to me with $1,000 accounts, and for clients who came to me with total accounts in the tens of millions of dollars. Regardless of the amount involved, and regardless of the educational level and "sophistication" of the client, nearly all of these clients were subject to payment of relatively high fees and costs – and payment to their "advisor" of fees (often hidden from view) – which were excessive in nature.

In my nearly 30 years as an estate planning and tax attorney, and in my nearly 15 years as a fiduciary investment adviser, I have possessed the opportunity to review hundreds of clients' investment portfolios. When the clients' investment portfolios were advised upon by either broker-dealer firms, by dual registrants (firms and individuals with both securities broker/dealer licensure and registered investment adviser licensure), or by insurance agents, the allure of high-fee investment and insurance products to the registered representative of the broker-dealer firm, or to the insurance agent, was nearly always too strong to resist. Over 95% of the time, in my reviews of hundreds of clients' portfolios, I discerned high-cost investments, tax-inefficient portfolios, or both.

Economic incentives matter, and they matter a great deal. When a salesperson has the opportunity to receive much higher compensation from the sale of one product, compared to another, the allure of the investment product with the higher compensation (and higher fees to the client) nearly always win.

These insidious conflicts of interest cause great harm to the financial and retirement security of our fellow Americans. The academic research in this area is compelling – higher-cost investments lead, on average, to lower returns. In fact, there is a strong negative correlation between the total fees and costs of an investment product and the returns of that product over the long term, relative to similar investments:

As stated in a 2011 paper by Michael Cooper et. al., using data on active and passive U.S. domestic equity funds (the sample included a total of 13,817 funds within the CRSP Mutual Fund Database) from 1963 to 2008, the authors observed:

> *Similar to others, we first show that fees are an important determinant of fund underperformance – that is, investors earn low returns on high fee funds, which indicates that investors are not rewarded through superior performance when purchasing 'expensive' funds.* We explore a number of hypotheses to explain the dispersion in fees and find that none adequately explain the data. Most importantly, there is very little evidence that funds change their fees over time. In fact the most important determinant of a fund's fee is the initial fee that it charges when it enters the market. There is little evidence that funds reduce their fees following entry by similar funds or that they raise their fees following large outflows as predicted by the strategic fee setting hypothesis. *We also do not find evidence that higher fees are associated with proxies for higher service levels provided to investors.*"[3] (*Emphasis added.*)
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> In a recent paper by Vidal et. al., they also found that high mutual fund fees predict lower returns. "[We confirm the negative relation between funds´ before fee performance and the fees they charge

[3] Michael Cooper, Michael Halling and Michael Lemmon, Fee dispersion and persistence in the mutual fund industry (March 2011).

> to investors. Second, we find that mutual fund fees are a significant return predictor for funds, fees are negatively associated with return predictability. These results are robust to several empirical models and alternative variables."[4]

> And, in another recent paper by Sheng-Ching Wu, it was noted that it is not just the disclosed fees (found in the commissions or redemption fees paid and the annual expense ratio), but also the transaction costs resulting from turnover of securities within the fund, that matter. "[F]unds with higher portfolio turnovers exhibit inferior performance compared with funds having lower turnovers. Moreover, funds with poor performance exhibit higher portfolio turnover. The findings support the assumptions that active trading erodes performance....[5]

America must act now to substantially reduce this excessive rent seeking by Wall Street via broker's sale of expensive investment products to unwitting consumers. And the best way to do this is to eliminate, or at least substantially reduce, the many conflicts of interest that drive the extraction of such high rents by brokers and insurance agents from the portfolios of our fellow citizens.

C. Wall Street's Excessive Fees and Costs Impair the U.S. Economy

The high costs of Wall Street's services and products not only engender the retirement security of individual Americans, but also impair the American economy. As the role of finance has grown ever larger, instead of providing the oil that ensures the American economic engine churns efficiently, the peddling of expensive investment products to Americans has led to a sludge that impairs the vitality and threatens the future of not only our fellow Americans, but of America itself.

The growth of the financial services industry has grown to an extraordinary proportion of the overall U.S. economy. As stated in a recent article by Gautam Mukunda appearing in the *Harvard Business Review*:

> In 1970 the finance and insurance industries accounted for 4.2% of U.S. GDP, up from 2.8% in 1950. By 2012 they represented 6.6%. The story with profits is similar: In 1970 the profits of the finance and insurance industries were equal to 24% of the profits of all other sectors combined. In 2013 that number had grown to 37%, despite the aftereffects of the financial crisis. These figures actually understate finance's true dominance, because many nonfinancial firms have important financial units. The assets of such units began to increase sharply in the early 1980s. By 2000 they were as large as or larger than nonfinancial corporations' tangible assets ....[6]

The result of this excessive rent extraction by Wall Street is a substantial impediment to the present and future growth of the growth of the U.S. economy. As Steve Denning recently noted:

> The excessive financialization of the U.S. economy reduces GDP growth by 2% every year, according to a new study by International Monetary Fund. That's a massive drag on the economy–some $320 billion per year. Wall Street has thus become, not just a moral problem with rampant illegality and outlandish compensation of executives and traders: Wall Street is a macro-economic problem of the first order ... Throughout history, periods of excessive financialization have coincided with periods of national economic setbacks, such as Spain in the 14th century, The Netherlands in the late 18th century and Britain in the late 19th and early 20th centuries. The focus by elites on "making money out of money" rather than making real goods and services has led to wealth for the few, and overall national economic decline. 'In a financialized economy, the financial tail is wagging the economic dog.'[7]

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[4] Marta Vidal, Javier Vidal-García, Hooi Hooi Lean, and Gazi Salah Uddin, The Relation between Fees and Return Predictability in the Mutual Fund Industry (Feb. 2015).

[5] Sheng-Ching Wu, Interaction between Mutual Fund Performance and Portfolio Turnover, Journal of Emerging Issues in Economics, Finance and Banking (JEIEFB) 2014 Vol: 3 Issue 4.

6 Gautam Mukunda, "The Price of Wall Street's Power," *Harvard Business Review* (June 2014), available at https://hbr.org/2014/06/the-price-of-wall-streets-power/ar/1.

[7] Steve Denning, "Wall Street Costs The Economy 2% Of GDP Each Year," Forbes (May 31, 2015), available at http://www.forbes.com/sites/stevedenning/2015/05/31/wall-street-costs-the-economy-2-of-gdp-each-year/

Wall Street's lack of legal and ethical constraints have been opined by many as the root cause of the financial crisis of 2008-9 and the resulting recession in the United States, from which we still have not fully recovered. In fact, the failure of the U.S. economy to recover may partly be due to the excessive rent seeking Wall Street undertakes.

As Jack Bogle, founder of Vanguard, observed: "Self-interest, unchecked, is a powerful force, but a force that, if it is to protect the interests of the community of all of our citizens, must ultimately be checked by society. The recent crisis—which has been called 'a crisis of ethic proportions' – makes it clear how serious that damage can become."[8]

II. The Unworkable Current State of Affairs: The Failure of "Suitability" and Disclosure Alone; SIFMA's and FINRA's "Best Interests" Proposals As Misleading and Weak

A. The Unworkable Current State of Affairs of Americans

Is America the greatest country? Not by many measures, when compared to other developed nations of the world. Yet, with the concerted effort of entrepreneurs, innovators, educators, and the providers of monetary and human capital, tempered properly by logical and efficient standards of conduct imposed by necessary government regulation so as to constrain excessive rent seeking and to deter improper conduct, I believe America can once again become the greatest country.

Essential to these efforts is the need to better ensure the future retirement security of all Americans. At the present time trust in our system of financial services remains at a historical low. Americans in need of financial advice are reluctant to seek out such advice, given the presence of so many conflicts of interest from purveyors of investment products.

While SIFMA, FSI and other representatives of many of the broker-dealer firms have referred to the DOL rule as "unworkable," the reality is that the current conflict-ridden product-sales business model of Wall Street does not desire to see its high extraction of rents from individual Americans terminated.

Yet, the delivery of investment advice to small business owners and large business owners (plan sponsors), and to individual Americans (whatever the size of their account), is currently undertaken under a fiduciary standard of conduct. In fact, independent registered investment advisory firms and their investment advisers representatives deliver fiduciary investment advice to millions of Americans at the present time, under a fiduciary business model.

The current sad state of affairs is untenable. If Americans are not aided by fiduciary advice, and if the continued high extraction of rents occurs by Wall Street from the hard-earned retirement savings of millions of Americans, then federal, state and local governments will be all called upon to provide increased support for individual Americans, especially those in retirement, who possess far too less in their investment portfolios in the future. This will further create a burden upon governments, resulting in pressure to raise taxes. This in turn would further constrain future U.S. economic growth.

Every effort should be undertaken to better arm our individual Americans with fiduciary investment advice. The DOL proposal to expand the application of fiduciary status is an outstanding part of the solution required to ensure a better future not just for our fellow Americans, but for America itself.

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[8] John Bogle, "The Fiduciary Principle," ETF.com (June 22, 2009), adopted from a speech given to the Columbia University School of Business, New York City, NY, April 1, 2009.

B. The Failure of the Suitability Doctrine to Protect Investors

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"I am a stock and bond broker. It is true that my family was somewhat disappointed in my choice of profession." – Binx Bolling, THE MOVIEGOER (1960)[9]

Generally, "suitability" refers to the obligation of a full service broker to recommend to a customer only those securities that match the customer's financial needs and goals. There are essentially two major dimensions of the suitability obligation: (1) "reasonable basis" or "know your security" suitability that focuses on the characteristics of the recommended security and requires a minimal degree of product due diligence prior to the sale of the security to any client; and (2) "customer-specific" or "know your customer" suitability, which focuses on ascertaining the financial objectives, needs, and other circumstances of the particular customer before recommending investment products to that customer. A third dimension of suitability guards against churning.

In simplistic terms, the "reasonable basis" aspect of suitability prohibits one from selling investments which are high explosives, as brokers cannot sell investments are "unsuitable" for *any* investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics. This might, for example, present a barrier to the sale of unregistered securities with no operations, assets or earnings. However, under "reasonable basis suitability" the sale of high-risk Roman candles and other firecrackers might be permitted as a portion of some investors' portfolios.

However, the "customer-specific" aspect of suitability prevents the sale of Roman candles and firecrackers to certain particular investors who might be unable to bear the risks of certain investments. It prevents brokers from selling by high-risk, illiquid, and/or complex securities to elderly, inexperienced or unsophisticated customers who do not understand the risks of such investments.

While the suitability obligation was for a time imposed directly[10] by the U.S. Securities and Exchange Commission (SEC) upon brokers who were not a member of a self-regulatory organization (SRO), the SEC's regulation was rescinded in 1983 when all broker-dealers were required to be a member of an SRO. Hence, the source for the suitability obligation is now found exclusively in the rules of the National Association of Securities Dealers (NASD), renamed as the Financial Services Regulatory Authority (FINRA), and in FINRA Rule 2111.[11]

The Exchange Act directs that FINRA's rules be "designed to prevent fraudulent and manipulative acts and practices." FINRA also imposes on its members the duty to "observe high standards of commercial honor and just and equitable principles of trade."[12] This duty has been interpreted by FINRA to he prohibit registered firms from making false, misleading, or exaggerated statements or claims or omitting material information in all advertisements and sales literature directed to the public.

At its core, when it applies to the provision of advice, the suitability doctrine actually lessens the duty of due care. In the context of advisory recommendations, suitability serves to confine the duties of broker-dealers and their registered representatives to their customers to below that of the broad common law duty of due care.

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[9] Walter Percy, THE MOVIEGOER (New York: Ivy Books, 1960), pg. 6.

[10] 1934 Act Rule 15b10-3.

[11] FINRA generally explains its current version of the suitability rule, FINRA Rule 2111, as follows: "FINRA Rule 2111 requires, in part, that a broker-dealer or associated person 'have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile.' In general, a customer's investment profile would include the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. The rule also explicitly covers recommended investment strategies involving securities, including recommendations to "hold" securities. The rule, moreover, identifies the three main suitability obligations: reasonable-basis, customer-specific, and quantitative suitability. https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq#sthash.LWz8PjDs.dpuf (retrieved June 10, 2015).

[12] FINRA Conduct Rule 2110: Standards of Commercial Honor and Principles of Trade.

By way of explanation, with the early 20th Century rise of the concept of the duty of due care, and the commencement of actions for breach of one's duty of due care (via the accelerated development during of the negligence doctrine during such time), broker-dealers sought a way to ensure they would not be held liable under the standard of negligence. After all, "[t]o the extent that investment transactions are about shifting risk to the investor, whether from the intermediary, an issuer, or a third party, the mere risk that a customer may lose all or part of its investment cannot, in and of itself, be sufficient justification for imposing liability on a financial intermediary."[13] This appears to be a valid view as to the duty of care that should be imposed upon a broker-dealer. However, this low duty of care is only appropriate if the broker-dealer is only providing only trade execution services to the customer.

In essence, the suitability standard was originally designed solely to protect brokers who provided trade execution services from breaches of the duty of due care applicable to all product sellers, given the inherent risks of investing in individual securities. Yet, as broker's services have expanded, the suitability standard has inappropriately been applied to broker's other services, including those services that are clearly of an advisory nature.

In contrast to the individual stocks and bonds for which brokers mostly executed transactions in the 1930's, currently brokers often recommend mutual funds and other pooled investment vehicles (including but not limited to unit investment trusts, ETFs, variable annuity subaccounts and equity indexed annuities). Indeed, mutual fund sales exploded a thousand-fold shortly following the SEC's abolition of all fixed commission rates effective May 1, 1975. But, along the way, no longer were broker-dealers just performing trade execution services, but they were, in fact, providing advice through their recommendation of investment managers. Yet, inexplicably, the SEC and FINRA permitted the suitability doctrine to be extended to incorporate broker-dealers' recommendations of the managers of pooled investment vehicles. As a result, brokers operate with a free hand today when providing advice on mutual fund selection. Brokers, as a result of the incorrect expansion of the application of the suitability doctrine, are unburdened by the duty of nearly every other person in the United States with respect to their advisory activities, which, at a minimum, for other providers of advice require adherence to the duty of due care of a reasonable person.

Suitability's abrogation of the duty of care means that suitability lacks teeth when investment advice is provided.

- Suitability does *not* generally impose upon broker-dealers any obligation to recommend a "good" product over a "bad" one.
- Suitability does *not* impose upon brokers and their registered representatives a duty to recommend a less expensive product over an expensive product, even where the product's composition and risk characteristics are almost identical, and even though substantial academic research concludes that higher-cost products return less to investors than similar lower-cost products over longer periods of time.
- Suitability does *not* require brokers and their registered representatives to recommend products that meet a client's objectives for tax-efficient and prudently structured investment portfolios.
- Suitability does *not* require brokers and their registered representatives to avoid conflicts of interest, nor to properly manage the unavoidable conflicts of interest that remain to keep the clients' best interests paramount at all times.

In summary, the suitability standard permits the conflict-ridden sale of highly expensive, tax-inefficient and risky investment products, leaving the customer with little or no redress.

Suitability remains a "nebulous and amorphous with respect to its content and parameters."[14] It essentially imposes upon broker-dealers only the responsibility to not permit their customers to "self-destruct."

In summary, the "suitability" standard was not originally designed to, nor should it be permitted to, apply to the provision of investment advice. Suitability abrogates the all-important duty of care required of nearly every other provider of services.

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[13] 60 Am. U.L. Rev. 1265, 1275.

[14] Lowenfels and Bromberg, *Suitability in Securities Transactions*, THE BUSINESS LAWYER (Aug. 1999) 1557.

In essence, suitability is a shield that protects brokers, not investors. It is such a low standard of conduct that, even when surrounded by a multitude of other rules and an enforcement regime, it is but a loud dog that lacks any teeth.

C. THE LIMITS OF DISCLOSURE AS A MEANS OF CONSUMER PROTECTION

In recent years various proposals have been advanced by Wall Street to merely enhance the suitability doctrine. These suggestions include adding certain mandated disclosures, usually of a casual nature (such as "our interests may not be aligned with yours"). Wall Street advances these proposals in hopes of defeating the imposition of fiduciary status on brokers who provide investment advice. Yet, as Wall Street is fully aware, disclosures are seldom read by consumers, and even when read they are rarely understood. While disclosure is said to be a key component of the federal securities laws, the Investment Advisers Act of 1940 and ERISA were enacted, subsequent to the regulations imposed under the '33 Securities Act and the '34 Securities Exchange Act (and the '37 Maloney Act amendments thereto), in order to impose fiduciary standards upon those who provide investment counsel to our fellow Americans. In essence, Congress recognized that disclosure was insufficient to safeguard the interests of investors, and hence public policy dictated that fiduciary obligations be imposed.

While federal and state securities laws and regulations have imposed certain disclosure obligations upon brokers, such disclosures are inherently ineffective as a consumer protection measure, for a variety of reasons. Indeed, the necessity for the rise of fiduciary standards of conduct throughout several centuries of the law reflects the realization, over the centuries, that disclosures possess limited impact as a means of consumer protection. If disclosures were a sufficient means of protection, then the common law would have never created the fiduciary standard.

Even in the 1930's, the perception existed that disclosures would prove to be inadequate as a means of investor protection. As stated early on by Professor Schwarcz:

> Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.[15]

Academic research exploring the nature of individual investors' behavioral biases, as a limitation on the efficacy of disclosure and consent, also strongly suggests that client waivers of fiduciary duties are not effectively made. In a paper exploring the limitations of disclosure on clients of stockbrokers, Professor Robert Prentice explained several behavioral biases which combine to render disclosures ineffective: (1) Bounded Rationality and Rational Ignorance; (2) Overoptimism and Overconfidence; (3) The False Consensus Effect; (4) Insensitivity to the Source of Information; (5) Oral Versus Written Communications; (6) Anchoring; and (7) Other Heuristics and Biases. Moreover, as Professor Prentice observed: "Securities professionals are well aware of this tendency of investors, even sophisticated investors, and take advantage of it."[16] Much other academic research into the behavioral biases faced by individual investors has been undertaken, in demonstrating the substantial challenges faced by individual investors in dealing with those providing financial advice in a conflict of interest situation.

Behavioral biases also negate the abilities of "do-it-yourself" investors. As shown in DALBAR, Inc.'s 2009 "Quantitative Analysis of Investor Behavior," most individual investors underperform benchmark indices by a wide margin, far exceeding the average total fees and costs of pooled investment vehicles. A growing body of academic research into the behavioral biases of investors reveals substantial obstacles individual investors must overcome in

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[15] Steven L. Schwarcz, Rethinking The Disclosure Paradigm In A World Of Complexity, Univ.Ill.L.R. Vol. 2004, p.1, 7 (2004), citing "Disclosure To Investors: A Reappraisal Of Federal Administrative Policies Under The '33 and '34 Acts (The Wheat Report)," 52 (1969); accord William O. Douglas, "Protecting the Investor," 23 YALE REV. 521, 524 (1934).

[16] Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future, 51 Duke L.J. 1397 (available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397#H2N5).

order to make informed investment decisions,[17] and reveal the inability of individual investors to contract for their own protections.[18]

Financial advisors also utilize clients' behavioral biases to their own advantage, if not restricted by appropriate rules of conduct. As stated by Professor Prentice, "instead of leading investors away from their behavioral biases, financial professionals may prey upon investors' behavioral quirks … Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments."[19] (as was the case with the Comptons, and as is the case with tens of millions of other Americans.)

Practice management consultants train financial and investment advisors to take advantage of the behavioral biases of consumers. In fact, I have been so trained. The instruction involves actions to build a relationship of trust and confidence with the client first, far before any discussion of the service to be provided or the fees for such services. It is well known among marketing consultants that once a relationship of trust and confidence is established, clients and customers will agree to most anything in reliance upon the bond of trust that has been formed.

The SEC's emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image a vast majority of investors who are unable, due to behavioral biases and lack of knowledge of our complicated financial markets, to undertake sound investment decision-making. As stated by Professor (and former SEC Commissioner) Troy A. Paredes:

> The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon's claim. Simon recognized that people have limited cognitive abilities to process information. As a result, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify complicated tasks. In Simon's terms, when faced with complicated tasks, people tend to 'satisfice' rather than 'optimize,' and might fail to search and process certain information.[20]

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[17] As stated by Professor Ripken: "[E]ven if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk. As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors. Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions. No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors to be distracted and miss the most important aspects of the disclosure … The bottom line is that there is 'doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases' … While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices." Ripken, Susanna Kim, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

[18] *See* Robert Prentice, Whither Securities Regulation Some Behavioral Observations Regarding Proposals for its Future, 51 Duke Law J. 1397 (March 2002). Professor Prentices summarizes: "Respected commentators have floated several proposals for startling reforms of America's seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of information, securities intermediaries such as stock exchanges and stockbrokers to appropriately consider the interests of investors, or investors to be able to bargain efficiently for fraud protection." Available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397.

[19] *Id. See also* Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

[20] Troy A. Parades, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 83 Wash.Univ.L.Q. 907, 931-2 (2003).

In reality, disclosures, while important, possess limited ability to protect investors, particularly in today's complex financial world. As Professor Daylian Cain has often remarked, "The saying that 'sunlight is the best disinfectant' is just not true."

The insufficiency of disclosure as a means of investor protection was highlighted at the Fiduciary Forum, held in September 2010 in D.C. and co-sponsored by the Committee for the Fiduciary Standard, CFP Board, NAPFA, FSI, and FPA. Two of the professors presenting at that conference also have written extensively regarding the inherent limits of disclosure as a means of consumer protection.

In a paper by Professors Daylian Cain, George Loewenstein, and Don Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," they challenged the belief of some that disclosure can be a reliable and effective remedy for the problems cause by conflicts of interest, and concluded:

> In sum, we have shown that disclosure cannot be assumed to protect advice recipients from the dangers posed by conflicts of interest. Disclosure can fail because it (1) gives advisors strategic reason and moral license to further exaggerate their advice, and (2) the disclosure may not lead to sufficient discounting to counteract this effect. The evidence presented here casts doubt on the effectiveness of disclosure as a solution to the problems created by conflicts of interest. When possible, the more lasting solution to these problems is to eliminate the conflicts of interest. As Surowiecki (2000) commented in an article in the *New Yorker* dealing specifically with conflicts of interest in finance, 'transparency is well and good, but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them.'[21]

In another paper co-authored by Professor Cain, he opined:

> Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. This means that while disclosure may [insufficiently] warn an audience to discount an expert-opinion, disclosure might also lead the expert to alter the opinion offered and alter it in such a way as to overcompensate for any discounting that might occur. As a result, disclosure may fail to solve the problems created by conflicts of interest and it may sometimes even make matters worse.[22]

The dimensions of the biases of advisors, when attempting to deal with non-avoided conflicts of interest, was revealed in a paper citing earlier research by Professor Cain and others, as Professor Antonia Argandoña observed:

> As a rule, we tend to assume that competent, independent, well trained and prudent professionals will be capable of making the right decision, even in conflict of interest situations, and therefore that the real problem is how to prevent conscious and voluntary decisions to allow one's own interests (or those of third parties) to prevail over the legitimate interests of the principal – usually by counterbalancing the incentives to act wrongly, as we assume that the agents are rational and make their decisions by comparing the costs and benefits of the various alternatives.
>
> Beyond that problem, however, there are clear, unconscious and unintended biases in the way agents gather, process and analyze information and reach decisions that make it particularly difficult for them to remain objective in these cases, because the biases are particularly difficult to avoid. It has been found that,
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> - The agents tend to see themselves as competent, moral individuals who deserve recognition.
> - They see themselves as being more honest, trustworthy, just and objective than others.

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[21] See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=480121

[22] Cain, Daylian M., Loewenstein, George F. and Moore, Don A., The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest (December 1, 2003). Available at SSRN: http://ssrn.com/abstract=480121

- Unconsciously, they shut out any information that could undermine the image they have of themselves – and they are unaware of doing so.
- Also unconsciously, they are influenced by the roles they assume, so that their preference for a particular outcome ratifies their sense of justice in the way they interpret situations.
- Often, their notion of justice is biased in their own favor. For example, in experiments in which two opposed parties' concept of fairness is questioned, both tend to consider precisely what favors them personally, even if disproportionately, to be the most fair.
- The agents are selective when it comes to assessing evidence; they are more likely to accept evidence that supports their desired conclusion, and tend to value it uncritically. If evidence contradicts their desired conclusion, they tend to ignore it or examine it much more critically.
- When they know that they are going to be judged by their decisions, they tend to try to adapt their behavior to what they think the audience expects or wants from them.
- The agents tend to attribute to others the biases that they refuse to see in themselves; for example, a researcher will tend to question the motives and integrity of another researcher who reaches conclusions that differ from her own.
- Generally speaking, the agents tend to give far more importance to other people's predispositions and circumstances than to their own.

> For all these reasons, agents, groups and organizations believe that they are capable of identifying and resisting the temptations arising from their own interests (or from their wish to promote the interests of others), when the evidence indicates that those capabilities are limited and tend to be unconsciously biased.[23]

In essence, disclosure – while important - has limited efficacy in the delivery of financial services to clients. Making disclosures "simpler" does not solve the problem of their effectiveness, either. As stated by Professor Ripken:

> [E]ven if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk. As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors. Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions. No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors to be distracted and miss the most important aspects of the disclosure … The bottom line is that there is 'doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases' … While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices.[24]

The inability of disclosures to overcome the substantial economic self-interest that brokers possess when selling products can also be understood through judicial prose. If disclosures were sufficient, there would be no need for the fiduciary obligation. But disclosure, being insufficient as a means of consumer protection, requires that individual investors seeking investment advice be served under a bona fide fiduciary standard. In *Bayer v. Beran*, 49 N.Y.S.2d 2, Mr. Justice Shientag observed:

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[23] Anonia Argandoña, Conflicts of Interest: The Ethical Viewpoint (2004).

[24] Ripken, Susanna Kim, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

> The fiduciary has two paramount obligations: responsibility and loyalty. * * * They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. * * * While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason.[25]

In summary, disclosures are not the answer. If disclosures were sufficient as a means of protecting consumers in a relationship of trust and confidence with another, then the fiduciary standard would have never arisen under English law, nor would it have been transported into American law. ERISA properly reflects the reality that disclosures are insufficient and that a strict fiduciary standard must be applied to protect individual investors and plan sponsors from transgressions by far more knowledgeable advisers.

At its very core, the fiduciary standard is a constraint upon greed. The fiduciary standard of conduct imposes important duties upon fiduciary advisors in order to protect the consumer of advice. As the U.S. Supreme Court has observed: "[T]he primary function of the fiduciary duty is to constrain the exercise of discretionary powers which are controlled by no other specific duty imposed by the trust instrument or the legal regime. If the fiduciary duty applied to nothing more than activities already controlled by other specific legal duties, it would serve no purpose."[26]

D. THE REQUIREMENTS OF THE FIDUCIARY DUTY OF LOYALTY

While suitability is a very low standard of conduct, the fiduciary standard of conduct is well known as the "highest standard under the law."

While there have been many judicial elicitations of the fiduciary standard, including Justice Benjamin Cardozo's lofty early 20th Century elaboration, a relatively recent and concise recitation of the fiduciary principle can be found in dictum within the 1998 English (U.K.) case of *Bristol and West Building Society v. Matthew*, in which Lord Millet undertook what has been described as a "masterful survey" of the fiduciary principle:

> A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of the fiduciary obligations. They are the defining characteristics of a fiduciary.[27]

In the U.S., the "triad" of fiduciary duties is most commonly referred to as the duties of due care, good faith and loyalty. But other fiduciary duties are said to exist, including but not limited to the "duty of obedience" and the "duty of confidentiality."

A further elicitation of fiduciary duties can be discerned from English law, from which the U.S. system of jurisprudence was initially derived. Under English law, it is reasonably well established that fiduciary status gives rise to five principal duties:

> (1) the "no conflict" principle preventing a fiduciary placing himself in a position where his own interests conflict or may conflict with those of his client or beneficiary;

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[25] *Bayer v. Beran,* 49 N.Y.S.2d 2 (N.Y.Sup.Ct. 1944).

[26] *Varity Corp. v. Howe,* 516 U.S. 489, 504, 116 S. Ct. 1065, 134 L. Ed. 2d 130, 1996 U.S. LEXIS 1954, 19 Employee Benefits Cas. (BNA) 2761 (1996).

[27] *Bristol and West Building Society v Mothew* [1998] EWCA Civ 533

(2) the "no profit" principle which requires a fiduciary not to profit from his position at the expense of his client or beneficiary;

(3) the "undivided loyalty" principle which requires undivided loyalty from a fiduciary to his client or beneficiary;

(4) the "duty of confidentiality" which prohibits the fiduciary from using information obtained in confidence from his client or beneficiary other than for the benefit of that client or beneficiary; and

(5) the "duty of due care," to act with reasonable diligence and with requisite knowledge, experience and attention.

When one is engaged as a fiduciary, the fiduciary steps into the shoes of the client, in order to act on the client's behalf. As Professor Arthur Laby observed: "What generally sets the fiduciary apart from other agents or service providers is a core duty, when acting on the principal's behalf, to adopt the objectives or ends of the principal as the fiduciary's own."[28]

In fiduciary relationships, a transfer of power occurs – if not the actual transfer of assets (as may occur in a trust or custody relationship), then the transfer of power through the taking, by the client, of the fiduciary's advice and counsel (as may occur in a lawyer-client or investment adviser-client relationship).

The client permits this close, confidential relationship to exist in recognition that the expertise of the fiduciary, brought to bear for the benefit of the client, can lead to much more positive outcomes.

But such expertise, if improperly applied, can be used to take advantage of the client. The fiduciary, as a expert, possess a much greater knowledge of investments, portfolio management, etc. Also, the client's guard is down; due to a variety of behavioral biases, client consent to action by the fiduciary is easily secured.

Hence, U.S. fiduciary law applicable to investment advisers guards against the abuse of the consumer through its "no conflict" rule. Reflective of English law's "no benefit" and "no conflict" principles, the Restatement (Third) of Agency (all agents are, to a degree, fiduciaries) dictates that the duty of loyalty is a duty to not obtain a benefit through actions taken for the principal (client) or to otherwise benefit through use of the fiduciary's position.[29]

The "no conflict" rule has nothing to do with good or bad motive. The U.S. Supreme Court, in discussing conflicts of interest, stated:

> The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative declaration that no man can serve two masters; and considering that human nature must be dealt with, the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them ....[30]

And, as the U.S. Supreme Court said a hundred years ago, the law "acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty."[31]

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[28] Arthur B. Laby, SE*C v. Capital Gains Research Bureau* and the Investment Advisers Act Of 1940, 91 Boston Univ. L.Rev. 1051, 1055 (2011).

[29] *See* RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt. a (2006) (explaining that under duty of loyalty, "an agent has a duty not to acquire material benefits in disconnection with transactions or other actions undertaken on the principal's behalf or through the agent's use of position").

[30] *Capital Gains,* 375 U.S. at 196 (*citing United States v. Mississippi Valley Generating Co.*, 364 U.S. 520 (1961)); id. at 196 n.50

[31] Michoud v. Girod, 45 U.S. 503 555 (1846). The U.S. Supreme Court also stated in that decision: "if persons having a confidential character were permitted to avail themselves of any knowledge acquired in that capacity, they might be induced to conceal their information and not to exercise it for the benefit of the persons relying upon their integrity. The characters are inconsistent. *Emptor emit quam minimo potest, venditor vendit quam maximo potest.*" *Id.* at 554.

And, in the seminal case addressing the fiduciary duties of investment advisers under the Investment Advisers Act of 1940, the U.S. Supreme Court observed:

> This Court, in discussing conflicts of interest, has said: 'The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative declaration that no man can serve two masters; and considering that human nature must be dealt with, the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them ....'[32]

Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine "has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'"[33]

E. The Non-Waiver of Core Fiduciary Obligations; Limits on Estoppel

The stark difference between arms-length and fiduciary relationships is also found in the treatment of the doctrines of waiver and estoppel. The DOL's proposed BIC exemption correctly notes this distinction by prohibiting disclaimer or waiver of the adviser's fiduciary obligations.

In arms-length relationship consent by a customer to proceed, when a conflict of interest is present, is generally permitted. Caveat emptor ("let the buyer beware") applies to such merchandiser-customer relationships. The customer is not represented by the merchandiser but is rather in an adverse relationship - that of seller and purchaser.

In such instances, it is a fundamental principle of the common law that *volenti non fit injuria* – to one who is willing, no wrong is done. Customer consent to the transaction generally gives rise to estoppel – i.e., the customer cannot later state that he or she can escape from the transaction because a conflict of interest was present, or because full awareness of the ramifications of the conflict of interest were absent. The customer, in such instances, bears the duty of negotiating a fair bargain. The law permits customers, in arms-length relationships, to enter into "dumb bargains." Generally, jurists will not set aside unfair bargains unless fraud, misrepresentation, mutual mistake of fact exists or unless the contract is so unjust and burdensome that it is deemed unconscionable.

But the fiduciary relationship is altogether different. The entrustor (client) and fiduciary actor have formed a relationship based upon trust and confidence. In such a form of relationship, the law guards against the fiduciary taking advantage of such trust. As a result, judicial scrutiny of aspects of the relationship occurs with a sharp eye toward any transgressions that might be committed by the fiduciary.

Hence, mere consent by a client in writing to a breach of the fiduciary obligation is not, in itself, sufficient to create waiver or estoppel. If this were the case, fiduciary obligations – even core obligations of the fiduciary – would be easily subject to waiver. Instead, to create an estoppel situation, preventing the client from later challenging the validity of the transaction that occurred, the fiduciary is required to undertake a series of steps:

> First, disclosure of all material facts to the client must occur. [For some commentators on the fiduciary obligations of investment advisers, this is all that is required. Often this erroneous conclusion is derived from misinterpretations of the landmark decision *of SEC v. Capital Gains Research Bureau*.][34]

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[32] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180; 84 S. Ct. 275; 11 L. Ed. 2d 237; 1963 U.S. LEXIS 2446 (1963). The principle is also found in early Christianity: "Christ said: 'No man can serve two masters, for either he will hate the one and love the other, or else he will hold to the one and despise the other. Ye cannot serve God and Mammon [money].'" *Beasley v. Swinton*, 46 S.C. 426; 24 S.E. 313; 1896 S.C. LEXIS 67 (S.C. 1896), *quoting* Matthew 6:24.

[33] *Tisdale v. Tisdale*, 2 Sneed 596 (Tenn. 1855).

[34] See my previous 2011 comment letter and its detailed discussion of Wall Street's wishful misinterpretation of *SEC vs. Capital Gains*.

> Second, the disclosure must be affirmatively made and timely undertaken. In a fiduciary relationship, the client's "duty of inquiry" and the client's "duty to read" are limited; the burden of ensuring disclosure is received is largely borne by the fiduciary. Disclosure must also occur in advance of the contemplated transaction. For example, receipt of a prospectus following a transaction is insufficient, as it does not constitute timely disclosure.
>
> Third, the disclosure must lead to the client's understanding. The fiduciary must be aware of the client's capacity to understand, and match the extent and form of the disclosure to the client's knowledge base and cognitive abilities.
>
> Fourth, the informed consent of the client must be affirmatively secured. Silence is not consent. Consent is not obtained through coercion nor sales pressure.
>
> Fifth, at all times, the transaction must be substantively fair to the client. If an alternative exists which would result in a more favorable outcome to the client, this would be a material fact which would be required to be disclosed, and a client who truly understands the situation would likely never gratuitously make a gift to the advisor where the client would be, in essence, harmed.[35]

These requirements of the common law – derived from judicial decisions over hundreds of years – have found their way into our statutes. For example, ERISA's exclusive benefit rule unyieldingly commands employee benefit plan fiduciaries to discharge their duties with respect to a plan solely in the interest of the plan's participants and for the exclusive purpose of providing benefits to them and their beneficiaries. And the Investment Advisers Act of 1940 was widely known to impose fiduciary duties upon investment advisers from its very inception, and it contains an important provision that prevents waiver by the client of the investment adviser's duties to that client.

As one examines the foregoing requirements, it is important to realize that disclosure is neither a fiduciary duty nor a cure (without much more) to the breach of one's fiduciary obligations. In other words, it must be understood that, quite frankly, there exists fiduciary duty of disclosure. While disclosure may be imposed by other law or regulation, or by contractual obligations created between the parties, disclosure is not, itself, a core fiduciary obligation found in the common law.

Rather, fiduciaries owe the obligation to their client to not be in a position where there is a substantial possibility of conflict between self-interest and duty. This is called the "no-conflict" rule, derived from English law. Fiduciaries also possess the obligation not to derive unauthorized profits from the fiduciary position. This is called the "no profit" rule, also derived from English law.

While there is no fiduciary duty of disclosure, questions of disclosure are often central in the jurisprudence discussing fiduciary law, as many cases involve claims for breach of the fiduciary duty due to the presence of a conflict of interest. In essence, a breach of fiduciary obligation – either the obligation not to be in a position of conflict of interest and the duty to not make unauthorized profits – may be averted or cured by the informed consent of the client (provided all material information is disclosed to the client, the adviser reasonably expects client understanding to result given all of the facts and circumstances, the informed consent of the client is affirmatively secured, and the transaction remains in all circumstances substantially fair to the client).

In essence, asking a client to consent to a conflict of interest by the fiduciary is requesting that the client waive the no conflict rule, the no profit rule, or both rules. Again, clients would only do so in circumstances where the client is not harmed. It would be difficult to believe that client is so gratuitous to his or her investment adviser that the client would incur a detriment, beyond reasonable compensation previously agreed to, in order to provide the adviser with more lucre or other benefits.

Hence, disclosure, alone, is not a cure. And disclosure is only one of the five important requirements, all of which must be met, for a client's waiver of a fiduciary obligation to be valid.

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[35] These steps, and legal authority for these requirements, are contained in my prior 2011 comment letters.

As the DOL and SEC further consider the imposition of fiduciary obligations upon those providing advice to retirement plan sponsors, retirement plan participants, IRA account holders, and more broadly to any American receiving personalized investment advice, let us first understand that the fiduciary's obligation includes, at its core, the obligation to not put herself or himself into a situation which is in conflict with the client. And, since some conflicts of interest are unavoidable, when such conflicts do occur this series of five important requirements must be met to properly manage the conflict.

The core of fiduciary law requires nothing less. Nor should the DOL and the SEC.

F. SIFMA'S AND FINRA'S "BEST INTERESTS" PROPOSALS: MISLEADING AND WHOLLY INEFFECTIVE

"Goldman's arguments in this respect are Orwellian. Words such as 'honesty,' 'integrity,' and 'fair dealing' apparently [in Goldman's eyes] do not mean what they say; [Goldman says] they do not set standards; they are mere shibboleths. If Goldman's claim of 'honesty' and 'integrity' are simply puffery, the world of finance may be in more trouble than we recognize." – Judge Paul Crotty, *Richman v. Goldman Sachs Group, Inc.*, 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

In just the past couple of months, SIFMA has advanced a "best interests" standard of conduct, as an amendment to FINRA's suitability obligation.[36] FINRA, in its July 17, 2015 comment letter to the U.S. Department of Labor regarding the Conflict of Interest rule proposal and the exemptions relating thereto, also proposes a "best interests" standard. Upon close examination it is apparent that the rhetoric emanating from SIFMA and broker-dealer firms regarding the "best interests" proposal, and the proposals themselves, are but eleventh-hour attempts to defeat the U.S. Department of Labor's proposed Conflict of Interest Rule. SIFMA and FINRA, by these proposals, seek to deny the imposition of fiduciary status upon those who provide investment advice to retirement plans and retirement accounts, and in so doing seek to preserve a product-sales-driven "caveat emptor" relationship which is inappropriate for the delivery of personal investment advice. It is also apparent that the term "best interests" should not be utilized by either SIFMA or FINRA at all, given its understanding for centuries in the context of delivery of trusted advice to mean adherence to the fiduciary duty of loyalty.

For example, Richard Ketchum, Chairman and CEO of FINRA, recently summarized the protections for customers of brokers, stating that these protections "show that depictions of the present environment as providing 'caveat emptor' freedom to broker-dealers to place investors in any investment that benefits the firm financially with no disclosure of their financial incentives or the risks of the product, are simply not true."[37] However, Mr. Ketchum's characterization of broker-dealer firms' customers as not being subject to the ancient principle of 'caveat emptor'[38] is largely incorrect; by his statement he obfuscates the sales origins and present reality of today's broker-customer relationships. Additionally, while certain disclosure obligations are imposed on broker-dealers, these disclosures are often casual in nature, do not require the adviser to ensure client understanding of the conflicts of interest and their ramifications, and do not require that any proposed transaction wherein a conflict of interest exist remain (even with disclosure and informed consent) substantively fair to the client.

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[36] SIFMA announced a "best interests" proposal in late May 2015, and then provided a "mark-up of existing FINRA Rules that outlines the broad contours of how a best interests standard for broker-dealers might be developed as part of the path forward on this most important investor protection issue." Retrieved from SIFMA web site, June 10, 2015.

[37] Richard G. Ketchum, Remarks From the 2015 FINRA Annual Conference, Washington, DC (May 27, 2015).

[38] BLACK'S LAW DICTIONARY 252 (9th ed. 2009) (defining "caveat emptor" as a Latin phrase meaning "let the buyer beware"); *see also* Matthew P. Allen, A Lesson from History, Roosevelt to Obama – The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty, 5 ENTREPRENEURIAL BUS. L.J. 1, 20 n.77 (2010) ("*Caveat emptor* is an old property law doctrine under which a buyer could not recover from the seller for defects in the property that rendered it unfit for ordinary purposes. The only exception was if the seller actively concealed latent defects.").

I would observe FINRA's recent support of a new "best interests" standard recently advanced by SIFMA,[39] the broker-dealer lobbying organization, grounded upon a weak suitability obligation accompanied by somewhat enhanced casual disclosures of additional information to investors, continues 75 years of FINRA's failure to advance standards to the highest levels, as envisioned by Senator Maloney and others, and fails to protect individual investors. FINRA's stated opposition to the Department of Labor's Conflict of Interest rule proposal is further evidence that FINRA serves only the interests of its broker-dealer members, and fails to adequately protect the investing public. Rather than embrace any changes to FINRA's suitability obligation by means of a misleading and wholly ineffective "best interests" standard, I would suggest that FINRA should be disbanded and its quasi-government oversight functions of the market conduct of broker-dealer firms and their registered representatives should be returned to federal and state agencies.

SIFMA has proposed that its "best interests" standard be adopted in lieu of the imposition of fiduciary standards of conduct upon brokers who provide investment advice. Yet, SIFMA's proposed "best interests" standard is also a far cry from the significantly enhanced protections afforded to consumers by a bona fide fiduciary standard of conduct, as proposed by the U.S. Department of Labor in its "Conflict of Interest" rule proposal (April 2015) and as found in existing common law applicable to those in relationships of trust and confidence with their clients. SIFMA's proposed "best interests" standard would – if enacted – deny consumers, in today's complex financial world, important protections by keeping individual investors in the situation where "caveat emptor" remains the rule for investors, even for those in relationships of trust and confidence with individuals and firms who provide personalized investment advice.

SIFMA's new "best interests" standard is also inherently misleading and deceptive, as the term "best interests" is commonly understood by consumers to mean that the advisor is acting on behalf of the consumer/investor, keeping the consumer's interests paramount at all times.[40]

FINRA's July 17, 2015 comment letter to the DOL also outlines its version of a "best interests" standard. This proposal demonstrates FINRA's continued inability to substantially raise the standards of conduct of brokers to the highest levels, as contemplated by Senator Maloney and others at the time of FINRA's inception (when it was called

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[39] SIFMA provided a "mark-up of existing FINRA Rules that outlines the broad contours of how a best interests standard for broker-dealers might be developed as part of the path forward on this most important investor protection issue." Retrieved from SIFMA web site, June 10, 2015.

[40] Legal commentators also continue to equate the term "best interests" with the requirement of the fiduciary duty of loyalty. *See, e.g.*:

- Edward J. Waitzer and Douglas Sarr, Fiduciary Society Unleashed: The Road Ahead for the Financial Sector, 69 Bus.Lawyer 1081, 1090 (Aug. 2014). ("these individuals need to *trust* that the specialists they rely upon will keep their best interests at heart ... Fiduciary law aims to promote this trust. It applies to relationships in which one party, the fiduciary, gains discretionary power over another party, the beneficiary, in circumstances where both parties would 'reasonably expect' that the fiduciary will exercise this power in the ***best interests*** of the beneficiary") (*Emphasis* in original; ***emphasis*** added.)
- Gold, Andrew S., The Loyalties of Fiduciary Law (December 20, 2013). Philosophical Foundations of Fiduciary Law, Andrew S. Gold & Paul B. Miller, eds., Oxford University Press, 2014, Forthcoming. Available at SSRN: http://ssrn.com/abstract=2370598 ("Another conception of fiduciary loyalty suggests that the fiduciary must act in the *best interests* of the beneficiary ... This conception can readily be linked to the first conception, given the possibility that the rules against conflicting interests are designed to increase the likelihood that a fiduciary will act in the beneficiary's *best interests*.") (*Emphasis* added.)

The influential Restatements of the Law also equate "best interests" or "placing the interests of the principle first" with the fidicuairy duty of loyalty:

- American Law Institute, Restatement of the Law of Trusts (Third) § 78. ("[A] trustee must refrain, whether in fiduciary or personal dealings with third parties, from transactions in which it is reasonably foreseeable that the trustee's future fiduciary conduct might be influenced by considerations other than the *best interests* of the beneficiaries.") (*Emphasis* added.)
- Restatement (Third) of Agency § 8.01 comment b. ("Although an agent's interests are often concurrent with those of the principal, the general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and *place the principal's interests first* as to matters connected with the agency relationship.") (*Emphasis* added.)

the NASD). FINRA's willingness to continue to protect brokers, under the shield of an inherently weak suitability standard (whether or not "enhanced" by its "best interests" proposal), also confirms the necessity of the U.S. Department of Labor moving forward to impose fiduciary status upon investment advisers to ERISA-governed retirement plans and to IRAs, as contemplated by the proposed rule.

In the table below I summarize the flaws in SIFMA's and FINRA's recent "best interests" proposals and demonstrate why SIFMA's proposed changes to FINRA's suitability rule do not come even close to the protections provided by the fiduciary standard:

A Concise Comparison: Bona Fide Fiduciary Standard vs. SIFMA's and FINRA's "Best Interests" Proposals

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA's "Best Interest" Proposal (as outlined in its June 2015 release)	FINRA'S "Best Interest" Proposal (as outlined in its July 17, 2015 comment letter)[41]
Who does the financial representative represent?	The client.	The brokerage firm, and, through the firm, various product manufacturers. The financial representative functions as a "seller's representative" with no substantial allegiance required to the purchaser (customer).	The brokerage firm, and, through the firm, various product manufacturers. The financial representative functions as a "seller's representative" with no substantial allegiance required to the purchaser (customer).

[41] FINRA states, in its comment letter of July 17, 2015 to the U.S. Department of Labor, that "any best interest standard for intermediaries should meet the following criteria:

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

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA's "Best Interest" Proposal (as outlined in its June 2015 release)	FINRA'S "Best Interest" Proposal (as outlined in its July 17, 2015 comment letter)[41]
Does a duty exist upon the representative to clearly and fully disclose all compensation received by the person providing advice, and by his/her firm?	Yes.	No. While annual disclosure occurs of "a good faith summary of the *investment-related fees*" associated with an investment, there is no requirement in SIFMA's proposal that the *compensation* of the broker-dealer or its registered representative be affirmatively quantified and then disclosed. As a result, customers will remain uninformed of the precise amount of the compensation of the broker and its registered representative. Hence, the client will not possess the means to assess the reasonableness of the compensation so provided, and the receipt of only "reasonable compensation" is a requirement for a fiduciary actor.	No. While annual disclosure occurs of a product's "fees and all related expenses," there is no requirement in FINRA's proposal that the *compensation* of the broker-dealer or its registered representative be affirmatively quantified and then disclosed. As a result, customers will remain uninformed of the precise amount of the compensation of the broker and its registered representative. Hence, the client will not possess the means to assess the reasonableness of the compensation so provided, and the receipt of only "reasonable compensation" is a requirement for a fiduciary actor. Why do broker-dealer firms resist the fiduciary requirement to fully disclosure a material fact – their compensation – to their customers? *Because a large proportion of these customers believe that their registered representative and brokerage firm is acting gratuitously,*[42] *given broker-dealers' ability to hide compensation from the customers.*[43]

[42] *See, e.g.*, Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Rel. No. IA-3058; File No. 4-606 (a.k.a. the "Rand Report" of 2008), in which over one-fourth of consumers surveyed related that they paid "$0" for the brokerage or advisory services they were provided. Since registered investment advisers are required to provide clients with periodic statements of the fees paid, under the requirements of the Investment Advisers Act of 1940 and regulations thereunder, and since the survey included a large number of clients of dual registrants (which fosters confusion among titles), it is likely that the survey understates the number of customers of broker-dealer firms who hold such firm. I have personally observed many, many customers of brokers who believed that their broker provided his or her services "for free" and "without compensation," and I have never met a customer of a full-service brokerage firm who understood *all* of the ways, or the high amounts, of the compensation received by the broker or the brokerage firm.

[43] Information regarding all of the compensation paid by product providers to the brokers is not provided by brokers to their customers, except piecemeal and in multiple lengthy documents, such as often 50+ page disclosure statements signed upon the opening of accounts, mutual fund prospectuses, and various web site disclosures. Even then, such disclosures are often ambiguous, such as "we may receive compensation from" a product provider or (in product provider documents, such as prospectuses) "we may compensate a broker." Indeed, even the author – who is trained in reading legal documents and who possesses a broad and deep knowledge of investment products, often cannot discern the sum total of compensation provided to a full-service broker resulting from many investments, given that the sum total includes not only commissions and 12b-1 fees, but also payment for shelf space, sponsoring of seminars for prospective customers, sponsorship of events at broker-dealer firm meetings, payment of brokerage commissions including soft dollar compensation, and other forms of revenue-sharing payments. The disguising of the total compensation paid to broker-dealer firms and their registered representatives appears to be a central concern of the broker-dealer community, since if full and complete disclosures were made of the compensation arrangements, the fact of differential compensation, and the amounts paid, most customers would likely choose not to be business with the brokerage firm. I have observed many a client, once I informed them of my estimate of what they had been paying to their broker-dealer firm over the past year, become very angry. Yet, a remedy for their grief is usually not available, as the "suitability" standard does not require that a broker-dealer firm receive only "reasonable compensation." In contrast, the fiduciary standard of conduct requires affirmative disclosure to the client of all material facts, which by necessity includes all compensation the fiduciary investment adviser receives, stated in terms that are clear, concise and understandable by the client. In addition, the fiduciary standard of conduct requires that compensation received be reasonable.

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA's "Best Interest" Proposal (as outlined in its June 2015 release)	FINRA'S "Best Interest" Proposal (as outlined in its July 17, 2015 comment letter)[41]
Is there a duty *upon the representative* to ensure client understanding of material facts, including material conflicts of interest?	Yes.	No. Under SIFMA's proposal disclosures must only be "*designed* to ensure client understanding." There is no requirement, as exists for a fiduciary, that client understanding of conflicts of interest, and their ramification, actually occur.	No. Under FINRA's proposal disclosures relating to products must only be provided to the customer. There is no requirement, as exists for a fiduciary, that client understanding of conflicts of interest, and their ramification, actually occur by means of affirmative obligations placed upon the registered representative.
Is *informed* consent of the client required prior to the client undertaking *each and every* recommended transaction?	Yes.	No. There is no requirement in SIFMA's proposal that the client's consent be "informed" – a key requirement of fiduciary law before client waiver of a conflict of interest can take place. Nor is there a requirement that the client provide informed consent prior to each and every transaction. Rather, SIFMA would only require: "Customer *consent* to material conflicts of interest or for other purposes as appropriate *may be provided at account opening*." Of course, consent "at client opening" often involves a customer briefly initialing a line, as one of many initials or signatures provided in account opening forms which are often dozens of pages long. The result of SIFMA's proposal is that clients can and will consent to be harmed – an outcome which cannot exist under a bona fide fiduciary standard. And such "consent" will hardly ever be "informed."	No. There is no requirement in FINRA's proposal that the client's consent be "informed" – a key requirement of fiduciary law before client waiver of a conflict of interest can take place. Nor is there a requirement that the client provide informed consent prior to each and every transaction. Rather, FINRA would only require brokers to "obtain client consent" to conflicts of interest. Such consent, often given with little or no understanding by the customer of the broker, creates an estoppel defense for the broker, who is in an arms-length relationship with the customer. As explained in this comment letter, the role of estoppel is very limited in fiduciary relationships, and much more than "simple consent" is required for the fiduciary to proceed when a conflict of interest is present.
Must the transaction remain, at all times, *substantively fair* to the client?	Yes.	No. There is only a requirement that the transaction be in accord with the client's "best interest" – a new SIFMA-proposed standard that is ill defined and which remains subject to much interpretation. Such interpretations will primarily occur through FINRA's much-maligned system of mandatory arbitration. In contrast, the fiduciary standard possesses centuries of interpretation and application. Under a bona fide fiduciary standard, clients are unable to waive core fiduciary duties; the role of estoppel is quite limited. This is enforced by the courts by requiring both *informed* consent of the client and that the transaction remain *substantively fair* to the client.	No. There is only a requirement that the transaction be in accord with the client's "best interest" – a new FINRA-proposed standard that is ill defined and which remains subject to much interpretation. Such interpretations will primarily occur through FINRA's much-maligned system of mandatory arbitration. In contrast, the fiduciary standard possesses centuries of interpretation and application. Under a bona fide fiduciary standard, clients are unable to waive core fiduciary duties; the role of estoppel is quite limited. This is enforced by the courts by requiring both *informed* consent of the client and that the transaction remain *substantively fair* to the client.

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA's "Best Interest" Proposal (as outlined in its June 2015 release)	FINRA'S "Best Interest" Proposal (as outlined in its July 17, 2015 comment letter)[41]
Does there exist a duty to *properly manage* investment-related fees and costs that the client will incur at all times?	Yes.	No. SIFMA expressly states: "Managing investment-related fees does not require recommending the least expensive alternative, nor should it interfere with making recommendations from among an array of services, securities and other investment products consistent with the customer's investment profile." These caveats leave the door wide open for the broker to recommend highly expensive products, including products which pay the broker more, in which the total fees and costs incurred by the customer will substantially lower the long-term returns of the investor.	No. FINRA does not appear to recognize that, under fiduciary law, there is an obligation imposed upon the fiduciary to ensure that any expenditures of the client's funds, through payment of product-related fees and costs, be undertaken with close scrutiny. FINRA appears to desire that high-cost products could still be recommended compared with lower-cost products that possess nearly the same risk and other characteristics. The fiduciary standard of due care requires that the client's expenses be controlled and that avoidable expenses be avoided. The fiduciary is permitted to obtain reasonable, professional-level compensation, through agreement with the client at the inception of the relationship, and with full disclosure of same.
Does there exist a duty to properly manage the design, implementation and management of the portfolio, in order to reduce the tax drag upon the customer's investment returns?	Yes.	No. There is no express duty under SIFMA's proposal to properly manage the tax consequences of investment decisions. Far too often under the suitability standard, and under this proposed "best interests" standard, customers of broker-dealers have and will possess substantial tax drag upon their investment returns that otherwise could have been avoided through expert advice.	No. Nothing in FINRA's proposal addresses portfolio management. FINRA is mired in the ancient practice of providing products under the suitability standard. Today's investors deserve expert advice from true fiduciaries, not the sale of products which generate high profits for the broker without proper consideration of how the product fits into the client's overall portfolio.

As seen, SIFMA's and FINRA's proposed "Best Interests" standards fall far short of the protections afforded by ERISA's fiduciary standard. The fact of the matter is that Wall Street wants to eat its cake and have it too. It wants to be perceived as acting in customer's "best interests," but enjoy the freedom to act in its own interests. Wall Street's new "Best Interests of the Consumer" proposal is, in reality, only "Wall Street's Self-Interest."

As alluded to in the chart above, by its "Best Interests" proposal SIFMA and FINRA do not turn brokers from sell-side merchandizers into buy-side purchaser's representatives and fiduciaries. Rather, SIFMA's and FINRA's proposal are nothing more than an attempt to obfuscate into some kind of obscene and confusing hybrid between the two. In fact, the enhancement to the inherently weak suitability standard under these proposals is extremely modest.

This begs the question – who does the broker under SIFMA's and FINRA's proposed "best interests" standards represent? This is a key question, for the following is well known in the law:

> The characters of buyer and seller are incompatible, and cannot safely be exercised by the same person. *Emptor emit quam minimo potest; venditor vendit quam maximo potest.* The disqualification rests ... on no other than that principle which dictates that a person cannot be both judge and party. No man can serve two masters. He that it interested with the interests of others, cannot be allowed to make the business an object of interest to himself; for, the frailty of our nature is such, that the power will too readily beget the inclination to serve our own interests at the expense of those who have trusted us.[41]

[41] Carter v. Harris, 25 Va. 199, 204 (1826); 1826 Va. LEXIS 26; 4 Rand. 199 (Va. 1826).

It is obvious that under SIFMA's and FINRA's proposed "best interest" standards the registered representative would continue to act as sellers of products, thereby representing the broker-dealer firm and product manufacturers. This is a far, far cry from acting as a fiduciary, and acting as the representative of the purchaser. And it fails to achieve a key objective that the U.S. Department of Labor alluded to in its release for the BIC exemption: "In the absence of fiduciary status, the providers of investment advice are neither subject to ERISA's fundamental fiduciary standards, nor accountable for imprudent, disloyal, or tainted advice under ERISA or the Code, no matter how egregious the misconduct or how substantial the losses."[45]

The U.S. Department of Labor should reject any proposal from SIFMA, FINRA, or broker-dealer firms, or insurance companies, which seeks to advance such a woefully inadequate rule. These are proposals that, like the suitability standard today, protect Wall Street, and utterly fail to protect consumers from Wall Street's greed.

Let us not permit Wall Street profess to act in the "best interests" of customers, when any sensible consumer would conclude that Wall Street's definition of "acting in your best interests" is wholly deceptive to consumers. Such fraud[46] has no place in government regulatory efforts, nor even in self-regulatory organization rulemaking activities. SIFMA's and FINRA's proposals should be loudly and firmly rejected by the DOL and other policymakers. And the recent embrace by FINRA of SIFMA's proposal should subject FINRA to further scrutiny over whether FINRA's market conduct regulation of brokers should be transferred back to federal and state governments for direct oversight,[47] especially when FINRA characterizes its proposal as a "fiduciary 'best interests'" proposal – when it clearly is not.

III. Of the Need for Government Intervention and Constraints on Greed.

Raised within the legacy of Adam Smith, as a lifelong student of economics and a professor of finance, I am a committed Capitalist. I believe in our Free Market Economy, its opportunities presented to all, and the immutable Spirits of Innovation and Entrepreneurship, and our personal drive to seize and profit from opportunity. America was founded in part upon these and other principles.

A. Even John Locke Embraced the Need for Government Regulation

John Locke, whose words so influenced our founding fathers that their majesty found way into our Declaration of Independence, espoused the natural rights of man and the right to retain of each of us to retain his or her income and property.

Locke conceived of the concept of government wherein citizens give over these rights (some wholly, others only partially) to government in trust, as a means of protecting the natural rights of man. In essence, those who we elect to represent us in our republican form of government are bound by fiduciary principles to use the power so entrusted to balance the competing needs of those in society, as we would ourselves.

John Locke is well known for the principle that each of us possess the rights to his or her own property. However, libertarians quoting John Locke often overlook Locke's spirit of compassion for his neighbors, and his belief in the role of charity. In his *Second Treatise Concerning Civil Government*, Locke observed this law of reason:

> Whatsoever then he removes out of the state that nature hath provided, and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property. It being by him

[45] BIC exemption release at pp. 21962-3.

[46] As Professors Angel and McCabe observed: "The relationship between a customer and the financial practitioner should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer's financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – *to give biased advice with the aura of advice in the customer's best interest – is fraud*. This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners." James J. Angel, Ph.D., CFA and Douglas McCabe Ph.D., *Ethical Standards for Stockbrokers: Fiduciary or Suitability?* (Sept. 30, 2010). (*Emphasis* added.)

[47] I have previously written about FINRA's seven-decades long failure to live up to the aspirations of the Maloney Act to raise the principles of broker-dealers firms to the highest level. *See* "Disband FINRA," available at http://scholarfp.blogspot.com/2013/07/disband-finra-unabridged-and-with.html.

> removed from the common state nature hath placed it in, it hath by this labour something annexed to it, that excludes the common right of other men: for this labour being the unquestionable property of the labourer, no man but he can have a right to what that is once joined to, *at least where there is enough, and as good, left in common for others* … Charity gives every Man a Title to so much out of another's Plenty, as will keep him from *extream want, where he has no means to subsist otherwise*. (*Emphasis added.*)

Many of us derive the basis of our own personal political and economic views from philosophers such as John Locke. Yet Locke and others recognize that opposing rights exist among the members of a society, and accordingly the rights of men and women must be balanced. As even John Locke alluded to, the right to generate profits from own labors has limits. In certain situations duties are imposed through government law and regulation to protect those susceptible to harm. Hence, government has a role to play to ensure that the rights of all of its citizens are balanced and respected.

B. Adam Smith's Recognition of the Need to Constrain Capitalism

Armed with the understanding that one father of libertarianism believes that government has a role to play in the regulation of the affairs of men, we now turn to the words of another father of libertarianism, Adam Smith, widely known as also the founder of Modern Economics. Perhaps all of us are aware of Adam Smith's *The Wealth of Nations*, published in 1776, in which he famously and correctly argued that economic behavior was motivated by self-interest, writing: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."

As Adam Smith pointed out, capitalism has its positive effects. Actions based upon self-interest often lead to positive forces that benefit others or society at large. As capital is formed into an enterprise, jobs are created. Innovation is spurred forward, often leading to greater efficiencies in our society and enhancement of standards of living. Indeed, a person in the pursuit of his own interest "frequently promotes that of the society more effectually than when he really intends to promote it."

Yet, while Smith espoused the principle of the free market, he also advocated the principle of constraint. While Adam Smith saw virtue in competition, he also recognized the dangers of the abuse of economic power in his warnings about combinations of merchants and large mercantilist corporations. In essence, Adam Smith balanced the "commercial society" with the judicious hand of a paternalistic state.

Adam Smith also recognized the necessity of professional standards of conduct, for he suggested qualifications "by instituting some sort of probation, even in the higher and more difficult sciences, to be undergone by every person before he was permitted to exercise any liberal profession, or before he could be received as a candidate for any honourable office or profit." In essence, long before many of the professions became separate, specialized callings, Smith advanced the concepts of high standards of conduct.

Unfettered capitalism results in greed. Unconstrained the excesses of capitalism become apparent, as evidenced by the misconduct which fostered financial crisis of 2008-8, the resulting Great Recession, and untold suffering imposed upon millions of our fellow Americans. The fiduciary standard, at its core, is a restraint upon greed.

Into the void of wholly free markets, efficient government regulation is altogether necessary. For, to quote the words of one of America's founding fathers, James Madison, "If men were angels, no government would be necessary."

Many believe in small, efficient government. But even the fathers of libertarisim, John Locke and Adam Smith, recognized the need for certain constraints to be imposed by government upon the conduct of men and women, lest greed run amuck and destroy our great country.

IV. On the Distinction Between Arms-Length and Fiduciary Relationships

In every commercial relationship misrepresentations in contract formation are outlawed and good faith in performance is required. In certain situations the purchaser is aided by disclosures of certain facts, mandated by law and regulation, as a means to evaluate whether to enter into the transaction. Even with mandated additional disclosures, however, the relationship between the parties is arms-length, and the consumer possesses the duty of personal due diligence under the doctrine of *caveat emptor* – "let the buyer beware."

Yet, in some forms of relationships much more is required than just the mere avoidance of actual fraud, performance of one's contractual obligations in good faith, and even the making of required disclosures. In these types of relationships fiduciary obligations are imposed upon the provider of goods and services. These fiduciary duties include the fiduciary duty of loyalty, which requires the fiduciary to step into the shoes of the entrustor (client) and act in the client's sole interests or best interests. The fiduciary duties also encompass due care, which requires the fiduciary to possess and exercise a high level of expertise.

The result of the imposition of fiduciary duties is a complete change in the role of the provider of goods or services. No longer does the advisor act as a merchandizer – representing the manufacturer or dealer of a product. Rather, the advisor is transformed, wholly and absolutely, into a representative of the purchaser of the good or service.

V. On the Necessity of Fiduciary Standards

Why does such a dramatic transformation in the form of the commercial relationship mandated in these instances? It is because trust is not an absolute, in that it either exists or does not exist. Rather, trust falls along a continuum. In many commercial relationships the purchaser is aware of the need to exercise his or her own due diligence prior to entering into, or consummating, the transaction; in such instances the need for trust is minimal. But, in this increased era of specialization in society, and vast disparities in knowledge and expertise when dealing with complex matters, a much higher degree of trust must be present in order to protect consumers who receive certain types of services, such as investment advice.

A. The Vast Disparity in Expertise

During the provision of specialized goods and services (including advice) that society treasures and where a vast imbalance of knowledge and expertise is present, the purchaser of goods or services is at such a disadvantage the purchaser's own due diligence cannot guard against the potential for abuse by the service provider. In these situations the law rightly and justly goes further and imposes *fiduciary status* upon the provider of such goods or services.

The consumer of investment products and services today is simply overwhelmed by information. Our fellow Americans are thrust into a highly complex financial environment in which a high degree of expertise is required to properly undertake portfolio design and management, and investment product selection. To prosper in today's modern financial world requires not just the ability to understand often-complex financial products, but also a knowledge of Modern Portfolio Theory (MPT), concepts intertwined with MPT (such as variance, correlation, and the benefits of diversification), strategic vs. tactical asset allocation, multi-factor models of risks and returns, tax and risk characteristics of various asset classes and particular investments, the extent of regulation (or non-regulation) of various types of investment managers, and much, much more.

Where such information disparity and complexity exists, "the traditional tools for supervising counterparties, available through the law of contract, cannot guarantee the effective delivery of specialized services. Individuals simply do not have the resources or the expertise to determine on their own whether these specialized services are actually serving their interests. Instead, these individuals need to *trust* that the specialists they rely upon will keep their best interests at heart."[48]

Accordingly, by necessity our consumers justly rely upon specialists. Just as they do in medicine, law, and other disciplines, consumers rely on financial and investment advisers to help them take advantage of the many advances in understanding of how the capital markets function and how the returns of the capital markets can be brought to bear to achieve the individual's lifetime financial goals.

As Professor Tamar Frankel, long the leading scholar in the area of fiduciary law as applied to securities regulation, once observed:

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[48] Edward J. Waitzer and Douglas Sarr, Fiduciary Society Unleashed: The Road Ahead for the Financial Sector, 69 Bus.Lawyer 1081, 1090 (Aug. 2014).

> [A] prosperous economy develops specialization. Specialization requires interdependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity.[49]

Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client that relate to the service, and encourage the client to utilize the service. Accordingly, the imposition of fiduciary status thereby furthers the public interest.

Some might opine that financial literacy efforts can fulfill this role. Yet, the body of academic research, and my own experience in dealing with thousands of clients, reveals that financial literacy efforts only significantly assist consumers with basic personal finance training, such as in expenditures budgeting and saving for future needs. However, the complexity of the financial markets, and the limits of time each consumer possesses to devote to training in finance, renders the vast majority of consumers unable to become investment experts or to understand the many terms and concepts required, even with the aid of a multitude of disclosures. We are just as likely to turn a consumer of financial services into a highly knowledgeable designer and manager of her or his investment portfolio as we are to turn a patient needing a brain operation into a neurosurgeon.

We must recognize that the combination of specialization and interdependence found today is essential to the progress of our society. This combination fosters both the development of new knowledge and expertise. It provides great benefits to consumers, provided the advice is delivered with a high degree of due care and in the consumers' best interests. It enables consumers to place the fruits of their hard-earned labor to work in the capital markets, with the expectation that the returns offered by the markets will be returned to the consumer, less only a reasonable amount for professional-level compensation to the specialist and the carefully scrutinized fees and costs of any investment product.

B. The Importance of Trust to Economic Growth

In this section, we must first ask, "What is 'trust'?" I submit that there exists "at least implicitly accepted a definition of trust as a belief, attitude, or expectation concerning the likelihood that the actions or outcomes of another individual, group or organization will be acceptable . . . or will serve the actor's interests."[50]

How important is trust to commerce, generally? Aristotle once observed that the doctrine of good faith is so fundamental to the making and performance of contracts that, "[i]f good faith has been taken away, all intercourse among men ceases to exist."

Trust itself is also crucial to a society's economic success. Nobel laureate economist Kenneth Arrow has stated that "[v]irtually every commercial transaction has within itself an element of trust," and that "much of the economic backwardness in the world can be explained by the lack of mutual confidence."[51]

Several studies have documented the positive relationship between trust in society and economic growth. Increased trust between actors in commercial transactions has a direct positive and significant effect on income per capita

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[49] Tamar Frankel, Trusting And Non-Trusting: Comparing Benefits, Cost And Risk, Working Paper 99-12, Boston University School of Law.

[50] Sim B. Sitkin & Nancy L. Roth, Explaining the Limited Effectiveness of Legalistic "Remedies" for Trust/Distrust, 4 ORG. SCI. 367, 368 (1993).

[51] Kenneth Arrow, Gifts and Exchanges, 1 Philosophy & Pub. Affairs 343, 357 (1972).

growth.[52]

Individuals need to trust that the specialists they rely upon will keep their best interests at heart. The imposition of broad fiduciary duties of due care, loyalty, and utmost good faith promotes this essential relationship of trust. It permits entry into the capital markets by those without the knowledge and skill to navigate their complex waters. As stated by Luhmann:

> Trust is necessary in order to face the unknown, whether that unknown is another human being, or simply the future and its contingent events. Seldom, if ever, can we obtain all the information we would need in order to take decisions in a completely rational manner. At a certain point in our 'intelligence-gathering' about the world we have to call a halt, say 'enough is enough' and take a decision based on what we know and the way we feel. That decision will inevitably partly be based on trust. Trust is thus a way of reducing uncertainty. It lies somewhere between hope and confidence, and involves an element of semi-calculated risk-taking. Trust, by the reduction of complexity, discloses possibilities for action which would have remained unattractive and improbable without trust - which would not, in other words, have been pursued.[53]

I have personally seen the trust of consumers betrayed, over and over again, by providers of financial and investment advice who act out of their own self-interest, not bound by a fiduciary standard. Immense personal harm results, involving the destruction of the hopes and dreams of the consumer.

For society the cost of abuse of trust in the provision of investment advice is even greater. I have personally seen consumers, burned and unwilling to trust any other financial or investment adviser, flee from the capital markets – likely for all time. Like most of the Greeks, such consumers resort to placement of their savings in commercial banks. As a result, the costs of capital increase, for the capital markets are deprived of direct funding and the provision of available equity capital, in particular, is diminished.

Investment advisory services rendered in a relationship of trust and confidence, as a fiduciary, encourage participation by investors in our capital markets system, which in turn promotes economic growth. The first and overriding responsibility any financial professional has is to all of the participants of the market. This primary obligation is required in order to maintain the perception[54] and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital market is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, will lead to the best operation of the U.S. and worldwide economy. Indeed, academic research has revealed that individual investors who are unable to trust their financial advisors are less likely to participate in the capital markets.[55]

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[52] *See, e.g.*, Tatsi, Eirini and Zafar, Tasneem, Social Capital and Economic Growth: Evidence from OECD Countries (May 1, 2011).

[53] Niklas Luhmann, Trust and Power (John Wiley & Sons; Chichester, 1979), p. 4.

[54] "Applying the Advisers Act and its fiduciary protections is essential to preserve the participation of individual investors in our capital markets. NAPFA members have personally observed individual investors who have withdrawn from investing in stocks and mutual funds due to bad experiences with registered representatives and insurance agents in which the customer inadvertently placed his or her trust into the arms-length relationship." Letter of National Association of Investment advisers (NAPFA) dated March 12, 2008 to David Blass, Assistant Director, Division of Investment Management, SEC re: Rand Study.

[55] "We find that trusting individuals are significantly more likely to buy stocks and risky assets and, conditional on investing in stock, they invest a larger share of their wealth in it. This effect is economically very important: trusting others increases the probability of buying stock by 50% of the average sample probability and raises the share invested in stock by 3.4 percentage points ... lack of trust can explain why individuals do not participate in the stock market even in the absence of any other friction ... [W]e also show that, in practice, differences in trust across individuals and countries help explain why some invest in stocks, while others do not. Our simulations also suggest that this problem can be sufficiently severe to explain the percentage of wealthy people who do not invest in the stock market in the United States and the wide variation in this percentage across countries." Guiso, Luigi, Sapienza, Paola and Zingales, Luigi. "Trusting the Stock Market" (May 2007); ECGI - Finance Working Paper No. 170/2007; CFS Working Paper No. 2005/27; CRSP Working Paper No. 602. Available at SSRN: http://ssrn.com/abstract=811545.

C. Other Compelling Reasons for Imposition of Fiduciary Status

The key to understanding fiduciary principles, and why and how they are applied, rests in discerning the foregoing public policy objectives the fiduciary standard of conduct is designed to meet, as well as the other public policy objectives set forth in this section.

Fiduciary Status Address "Overreaching" When Person-to-Person Advice is Provided

The Investment Advisers Act of 1940 "recognizes that, with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients ... The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."[56] "The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication[57] ... The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications...."[58]

Consumers' Lack of Desire to Expend Time and Resources on Monitoring

The inability of clients to protect themselves while receiving guidance from a fiduciary does not arise solely due to a significant knowledge gap or due to the inability to expend funds for monitoring of the fiduciary. Even highly knowledgeable and sophisticated clients (including many financial institutions) rely upon fiduciaries. While they may possess the financial resources to engage in stringent monitoring, and may even possess the requisite knowledge and skill to undertake monitoring themselves, the expenditure of time and money to undertake monitoring would deprive the investors of time to engage in other activities. Indeed, since sophisticated and wealthy investors have the ability to protect themselves, one might argue they might as well manage their investments themselves and save the fees. Yet, reliance upon fiduciaries is undertaken by wealthy and highly knowledgeable investors and without expenditures of time and money for monitoring of the fiduciary. In this manner, "fiduciary duties are linked to a social structure that values specialization of talents and functions."[59]

The Shifting of Monitoring Costs to Government

In service provider relationships which arise to the level of fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary's promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor's power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world, by enabling trust to be placed in the advisor by the client.

Fiduciary relationships are relationships in which the fiduciary provides to the client a service that public policy encourages. When such services are provided, the law recognizes that the client does not possess the ability, except at great cost, to monitor the exercise of the fiduciary's powers. Usually the client cannot afford the expense of engaging separate counsel or experts to monitor the conflicts of interest the person in the superior position will possess, as such costs might outweigh the benefits the client receives from the relationship with the fiduciary. Enforcement of the protections thereby afforded to the client by the presence of fiduciary duties is shifted to the courts and/or to regulatory bodies. Accordingly, a significant portion of the cost of enforcement of fiduciary duties is shifted from

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[56] *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985).

[57] *Id.* at 208.

[58] *Id.* at 210.

[59] Tamar Frankel, Ch. 12, United States Mutual Fund Investors, Their Managers and Distributors, in CONFLICTS OF INTEREST: CORPORATE GOVERNANCE AND FINANCIAL MARKETS (Kluwer Law International, The Netherlands, 2007), edited by Luc Thévenoz and Rashid Barhar.

individual clients to the taxpayers, although licensing and related fees, as well as fines, may shift monitoring costs back to all of the fiduciaries that are regulated.

Consumers' Difficulty in Tying Performance to Results

The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each incremental period over long periods of time – and in such instances the honesty of the investment adviser should be suspect.

Consumers' Difficulty in Identifying and Understanding Conflicts of Interest

Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest that can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available that are available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

Survey after survey (including the Rand Report) has concluded that consumers place a very high degree of trust and confidence in their investment adviser, stockbroker, or financial planner. These consumers deal with their advisors on unequal terms, and often are unable to identify the conflicts of interest their "financial consultants" possess.

Transparency is important, but even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns.[60] Nor will competition, even with transparency, serve to substantially lower costs due to the economic incentives advisers possess to sell higher-cost funds.[61]

For Fiduciaries, the Cost of Proving Trustworthiness is Quite High

How does one prove oneself to be "honest" and "loyal"? The cost to a fiduciary in proving that the advisor is trustworthy could be extremely high – so high as to exceed the compensation gained from the relationships with the advisors' clients.

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[60] In a 2005 study, Professors "Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 -- MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard. All participants were asked to make hypothetical investments of $10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. 'We chose the index funds because they are all tracking the same index, and there is no variation in the objective of the funds,' Madrian says ... 'Participants received the prospectuses that fund companies provide real investors ... the students 'overwhelmingly fail to minimize index fund fees,' the researchers write. 'When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund' ... [Said Professor Madrian,] 'What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long." Knowledge@Wharton, "Today's Research Question: Why Do Investors Choose High-fee Mutual Funds Despite the Lower Returns?" citing Choi, James J., Laibson, David I. and Madrian, Brigitte C., "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (March 6, 2008). Yale ICF Working Paper No. 08-14. Available at SSRN: http://ssrn.com/abstract=1125023.

[61] *See* Choi, James, David Laibson, and Brigitte Madrian. 2010. Why does the law of one price fail? An experiment on index mutual funds. Review of Financial Studies 23(4): 1405-1432. ["[Subjects overwhelmingly failed to minimize index fund fees. Instead, they placed heavy weight on irrelevant attributes such as funds' annualized returns since inception. Highlighting these misleading historical returns caused student subjects (in one of our randomized experimental treatments) to chase those returns even more intensely, despite the negative future return consequences such behavior had. Even subjects who claimed to prioritize fees in their portfolio decision showed minimal sensitivity to the fee information in the prospectus. Subjects apparently do not understand that S&P 500 index funds are commodities ... *In the real world, this problem is likely to be exacerbated by the financial advisors whose compensation is increasing in the fees of the mutual funds they sell to their clients. When consumers in a commodity market observe prices and quality with noise, a high degree of competition will not drive markups to zero ....*" [*Emphasis* added.]

In his influential article discussing the creation of the federal securities acts, and in particular their moral purpose, John Walsh (formerly of the SEC's OCIE) reviewed the legislative history underlying the creation of the Investment Advisers Act:

> As part of a congressionally mandated review of investment trusts the agency also studied investment advisers. The Advisers Act was based on that study. By the time it passed, it was a consensus measure having the support of virtually all advisers.
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> Investment advisers' professionalism, and particularly their professional ethics, dominated the SEC study and the legislative history of the Act. Industry spokespersons emphasized their professionalism. The "function of the profession of investment counsel," they said, "was to render to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments." In terms of their professionalism they compared themselves to physicians and lawyers. However, industry spokespersons indicated that their efforts to maintain professional standards had encountered a serious problem. The industry, they said, covered "the entire range from the fellow without competence and without conscience at one end of the scale, to the capable, well-trained, utterly unbiased man or firm, trying to render a purely professional service, at the other end." Recognizing this range, "a group of people in the forefront of the profession realized that if professional standards were to be maintained, there must be some kind of public formulation of a standard or a code of ethics." As a result, the Investment Counsel Association of America was organized and issued a Code of Ethics. Nonetheless, the problem remained that the Association could not police the conduct of those who were not members nor did it have any punitive power.
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> The SEC Study noted that it had been the unanimous opinion of all who had testified at its public examination, both members and nonmembers of the Association, that the industry's voluntary efforts could not cope with the "most elemental and fundamental problem of the investment counsel industry—the investment counsel 'fringe' which includes those incompetent and unethical individuals or organizations who represent themselves as bona fide investment counselors." Advisers of that type would not voluntarily submit to supervision or policing. Yet, all counselors suffered from the stigma placed on the activities of the individuals on the fringe. Thus, an agency was needed with compulsory and national power that could compel the fringe to conform to ethical standards.
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> As a result of the Commission's report to Congress, the Senate Committee on Banking and Currency determined that a solution to the problems of investment advisory services could not be affected without federal legislation. In addition, both the Senate and House Committees considering the legislation determined that it was needed not only to protect the public, but also to protect bona fide investment counselors from the stigma attached to the activities of unscrupulous tipsters and touts. During the debate in Congress, the special professional relationship between advisers and their clients was recognized. It is, said one representative, "somewhat [like that] of a physician to his patient." The same Congressman continued that members of the profession were "to be complimented for their desire to improve the status of their profession and to improve its quality."[62]

This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. A recent example of the problems faced by investment advisers was the "fee-based brokerage accounts" final rule adopted by the SEC in 2005, which would have permitted brokers to provide the same functional investment advisory services as investment advisers but without application of fiduciary standards of conduct. This would have negated to a large degree economic incentives[63] for persons to become investment advisers and be subject to the higher standard of

[62] John H. Walsh, "A Simple Code Of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra L.Rev. 1015, 1066-8 (2001), *citing* SEC, REPORT ON INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939).

[63] One might reasonably ask why "honest investment advisers" (to use the language of the U.S. Supreme Court in *SEC vs. Capital Gains*) had to be protected by the Advisers Act. Was it not enough to just protect consumers? The answer can be found in economic principles, as set forth in the classic thesis for which George Akerlof won a Nobel Prize:

> There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the

conduct. The SEC's fee-based accounts rule was overturned in *Financial Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir., 2007).

Monitoring and Reputational Threats are Largely Ineffective

The ability of "the market" to monitor and enforce a fiduciary's obligations, such as through the compulsion to preserve a firm's reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by fiduciaries can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by fiduciary firms are so strong and pervasive that they overwhelm the reported instances of breaches of fiduciary duties.

VI. On DOL's Expanded Definition of "Fiduciary" & Service to Small Investors

I fully support the DOL's expanded definition of "fiduciary." This definition is better in accord with the actual language of the statute. Additionally, the expanded definition encompasses most of the relationships of trust and confidence, for the provision of investment advice to retirement accounts, to which fiduciary status usually attaches under state common law, which common law serves to inform the development of federal law.

SIFMA, FSI and other broker-dealer lobbyists, and insurance company lobbyists, have proclaimed loud and clear that small investors cannot be served under the DOL's best interest proposal. The fallacy of this argument is evident in the fact that, for decades, fiduciary advisers have been serving both plan sponsors and individual clients, of all sizes, under a bona fide fiduciary standard of conduct, and doing so extremely well and with the clients paying far less in fees and costs than the compensation paid to registered representatives and to insurance agents.

Fiduciary Advice is Readily Available to Even Small Investors

For example, suppose an investor desires to invest $10,000 in an IRA account. Currently many such investors succumb to the marketing prowess of Wall Street and end up undergoing a brief conversation with a broker (i.e., a registered representative) and thereafter receive a singular investment recommendation.

Often that broker's recommendation is to invest IRA account cash into a Class A mutual fund shares, in which the broker charges a 5.75% upfront commission. In addition to the $575 up-front commission on a $10,000 account, ongoing 12(b)-1 fees are also typically paid to the brokerage firm, usually in the amount of 0.25% a year. These commissions and annual fees are in addition to the management and administrative fees charged by the fund itself.

And, far too often, a portion of the often-high mutual fund management fees is paid to the brokerage firm as "payment for shelf space" or via sponsorship of events at "educational gatherings" at brokerage firms.

Wall Street's large firms have often made threats to abandon smaller investors as regulators contemplate changes to rules governing their conduct. What if they make good on those threats? Should fiduciary obligations be imposed upon brokers who provide personalized investment advice? The Financial Services Institute complains loudly about the U.S. Department of Labor's proposed Conflicts of Interest Rule and its broadened imposition of fiduciary standards of conduct that "millions of hard-working Americans could find financial advice priced out of their reach."

> entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods and also in the size of the market.

George A. Akerloff, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics, Vol. 84, No. 3. (Aug., 1970), p.488.

George Akerloff demonstrated "how in situations of asymmetric information (where the seller has information about product quality unavailable to the buyer), 'dishonest dealings tend to drive honest dealings out of the market.' Beyond the unfairness of the dishonesty that can occur, this process results in less overall dealing and less efficient market transactions." Frank B. Cross and Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardoza L.Rev. 334, 366 (2006). As George Akerloff explained: "[T]he presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence." Akerloff at p. 495.

The other major broker-dealer lobbyist organization, SIFMA, argues that adoption of fiduciary standards of conduct for those who provide personalized investment advice to consumers "is likely to have a negative impact on consumers, particularly smaller investors."

Does Wall Street serve the small investor?

Before I proceed to rebut these fallacious arguments, I must point out that many of the larger broker-dealer firms mandate minimums for their registered representatives to receive compensation, which discourages such brokers from providing services to small investors. Often, individual brokers are not compensated until the account size grows to $100,000 or even $500,000.

As a result, these smaller investors are often directed to advisors located in "call centers," if they are served at all. Hence, to the extent Wall Street firms threaten to "abandon" small investors, it must first be realized that many of these brokerage firms have, in essence, already largely abandoned smaller investors.

Still, we must ask: do FSI's and SIFMA's claims hold merit? Will small investors not be served if brokers abandon the small IRA account-owner market? More specifically, we might inquire: "Where else can a small IRA investor receive investment advice on a $10,000 IRA account, for $575 or less?"

Let's examine the evidence, by looking at just a few of the offerings that currently exist to serve small IRA investors.

Garrett Planning Network: Fiduciary, hourly advice

One group has long existed to provide advice to investors both large and small. Its vision is succinctly explained on their website: "Everyone needs competent, objective financial advice from time to time. The Garrett Planning Network has a nationwide membership of over 300 independent, fee-only financial planners providing advice to people from all walks of life, without minimum account requirements, sales commissions, or long-term commitments. Our members proudly embrace their fiduciary duty, always placing their clients' best interests first."

When Sheryl Garrett founded the Garrett Planning Network (currently celebrating its 15th year), its groundbreaking philosophy was to provide fee-only, fiduciary advice under hourly fee arrangements. Since then, Sheryl's vision has substantially influenced the industry. Innovations have been adopted by many of its members in recent years, such as the "two-hour financial checkup" — often costing only about $300 to $500.

Not only might the consumer receive a recommended strategic asset allocation, as well as specific investment recommendations, but these recommendations are provided in context with financial planning recommendations around the key issues the client may face at that moment. Given the high quality of the truly objective financial and investment advice provided, the consumer gets far greater and better advice for fees that are lower. And, since all GPN's advisors eschew third-party payments such as 12(b)-1 fees, and nearly all favor very-low-cost, no-load mutual funds, clients incur far less total fees and costs over the long run.

In a recent e-mail exchange I had with Sheryl Garrett, she opined: "Demand for investment advisory services from our members is great and increasing exponentially. The marketplace has changed significantly, driven in part by public awareness of the benefits of working with a fiduciary advisor. Advisors also are attracted to the fiduciary space, as it puts them on the same side of the table as their clients. If brokerage firms stop serving small investors just because they will now be forced to do what is in a client's best interest, there are a lot of fiduciary advisors who are willing to take up the slack and take care of these investors' advisory needs."

No wonder President Obama chose to highlight Sheryl Garrett in her visit to the White House earlier this year, as he announced his support of the DOL's rulemaking efforts.

NAPFA: The largest network of fee-only advisors

More than 30 years ago a group of industry visionaries gathered and established a professional organization that has now grown to over 2,400 members, with members located in 49 of the 50 states. The nation's largest professional organization of fee-only personal financial advisors, the National Association of Personal Financial Advisors — NAPFA — has members ranging from solo practitioners to some of the largest registered investment advisory firms in the United States today, many of them serving thousands of individual investors.

While some NAPFA member firms have minimums, many others do not — even many of the larger NAPFA-member firms. For example, Abacus Wealth Partners, a fee-only firm with over $1 billion of assets under management, has six offices and serves clients in 40 different states. Abacus offers consumers a “Financial Checkup” involving a two-hour phone or in-person session with a 30-minute telephone follow-up. For a fixed fee of $600, small IRA investors and other clients can receive financial and investment advice.

“We’ve made it part of our mission to serve anyone who needs our help,” J.D. Bruce, president of Abacus Wealth Partners, conveyed to me via a recent e-mail. “We’ve eliminated our investment management minimum and we find a way to offer some level of financial planning, even if we have to do it for free through our pro-bono program. It’s not that we’re a charity, we still make a good profit, and our high net-worth prospects appreciate our mission and are more likely to hire us and refer us their friends.”

XY Planning Network: Monthly retainer, no asset minimums

A relatively newer but rapidly growing organization of fee-only, fiduciary advisors is the XY Planning Network. All of its advisors offer monthly retainer services and none of them require asset minimums. Many of the XY Planning Network’s members also offer consultations for hourly fees or fixed fees.

A typical example of XY Planning Network’s members is Ben Wacek, a fee-only, Certified Financial Planner who provides financial and investment advice online and through phone calls. In addition to a 30-minute free phone call “to get to know each other and see if I can help,” Ben provides hourly financial advice for only $80 an hour. He also offers ongoing financial and investment advice through a monthly retainer that starts at only $50 per month. With seven years experience, Ben says that he “loves working as a financial planner because of the opportunity that he has to make a difference in people’s lives.”

Robo-advisors: Badly named but there for the little guy

Several recently formed firms offer investment advisory services through a combination of automated services and/or human interactions. They build and manage low-cost portfolios at a fraction of what investors typically pay human advisors. These firms, incorrectly but commonly called “robo-advisors,” apply technology to bring efficiencies to the investment advisory process. Given that the Internet and technology in general has led to wholesale disintermediation in many different industries, it is no surprise that such firms have arisen in the online investment advisory space.

One of the largest of these new offerings is from nonprofit, low-cost mutual fund provider The Vanguard Group. However, its Vanguard Personal Advisor Services currently has a $50,000 minimum. Under this platform Vanguard now manages billions and billions of assets for individual investors.

Perhaps more representative of the new type of fee-only, fiduciary online advisory services is investment advisory online firm Wealthfront Inc. Wealthfront does not charge an advisory fee on the first $10,000 of assets under management. On amounts over $10,000, Wealthfront charges a monthly advisory fee based on an annual fee rate of 0.25%. Hence, the annual investment advisory fee on a $10,000 account is only $250. The only other direct cost clients incur is the very low fee embedded in the annual expense ratio of the exchange traded funds it recommends; Wealthfront states that these fees average only 0.12% a year. With over $2.4 billion in assets under management in just a relatively short period of time, Wealthfront stands ready to provide investment solutions to hundreds of thousands, if not millions, of potential small IRA customers. Other online investment advisory firms exist, with several more currently in the process of forming.

What do the Wall Street threats really mean?

Wall Street’s large firms have often made threats to abandon smaller investors as regulators contemplate changes to rules governing their conduct. For example, in 2005-2007, during the Financial Planning Association’s successful litigation in overturning the SEC’s ill-fated “fee-based accounts rule,” several firms stated that they would be unable to serve investors if they were forced to switch the fee-based brokerage accounts to investment advisory accounts. Of course, this was largely an empty threat, as the end of fee-based brokerage accounts saw many, if not most, of these fee-based brokerage accounts transformed into investment advisory accounts governed by the Advisers Act’s fiduciary standard.

If the Department of Labor's rules are finalized, then changes to the delivery of investment advice will occur for some IRA account owners. But these changes will be a great positive, as small IRA investors would then be provided investment advice by fiduciary advisors who possess a legal obligation to both control and account for investment fees and costs. In most instances, not only will the advice received by these small investors be lower-cost, but the advice will also be better, far more objective, and much more comprehensive.

This begs the question: Why do the members of SIFMA and FSI threaten to not serve small IRA account owners under the DOL's fiduciary standard?

One might conclude a more logical explanation exists. Simply put, without the free rein provided by FINRA's scandalously weak "suitability standard" to recommend high-cost, expensive investment products that pay broker-dealer firms and their registered representatives inordinately high fees (including many pay-to-play and similar back-door payments), what Wall Street really means is that it cannot afford to still serve such investors under its current business model if it cannot continue to reap inordinately high rents from unsuspecting consumers.

Time to stop feeding the beast

To Wall Street's empty threats I would reply as follows. Small IRA investors deserve trusted advice, from expert investment advisors, for reasonable fees. They don't deserve to be sold costly investment products that a huge body of academic research has concluded deprives individual investors of a significant portion of the returns the capital markets have to offer.

Nor do the regulators need to permit this abuse by Wall Street firms of individual investors to continue. Part of the duty of both the DOL and the SEC is to protect capital formation, which is highly dependent upon the trust placed in financial intermediaries by individual investors. The DOL and SEC also serve to protect investors, both large and small. Nothing in their charters requires either to preserve an archaic, abusive business model of Wall Street in which perhaps a hundred billion dollars (or more) are diverted each year from individual investors as a means to fuel Wall Street firm's extraordinary levels of compensation, bonuses, and profits.

The simple truth is that Wall Street's sell-side, high-expense model is not desired by knowledgeable small IRA investors. More importantly, a vast array of better alternatives exist to serve the small IRA investors. If Wall Street actually were to carry out its threat to abandon small IRA investors should the DOL finalize its proposed rules which largely prohibit most of the conflicts of interest Wall Street firms currently embrace, I say let these firms so depart the marketplace! There are many, many investment advisory firms willing to provide trusted advice for reasonable fees to these small IRA investors without the huge conflicts of interest that cause so much harm to investors.

As to Wall Street's conflict-ridden, enormously expensive (for consumers) business model in which excessive rents are extracted, what should occur? Wall Street's broker-dealer firms are dinosaurs, like the genetically modified monster in the recent *Jurassic World* movie. And, unwilling to adapt their standards of conduct for the benefit of our fellow Americans and America itself, Wall Street's firms dinosaurs that well deserves their own mass extinction event.

Let us embrace the U.S. Department of Labor's proposal to eliminate most of Wall Street's perverse conflicts of interest, as these rules when implemented will usher in a new era in which both small IRA and large IRA investors are able to save and accumulate far greater amounts for their own personal financial security.

VII. On the BIC Exemption, Generally.

> *"All other things being equal, the smaller a fund's expense ratio, the better the results obtained by its stockholders ... But the burden of proof may reasonably be placed on those who argue the traditional view –that the search for securities whose prices diverge from their intrinsic values is worth the expense required." - Sharpe, William F. 1966. "Mutual Fund Performance." Journal of Business, vol. 39, no. 1 (January):119–138.*

I am most appreciative of the U.S. Department of Labor's efforts to provide an exemption for brokers and insurance agents to permit the sale of products using commission-based compensation and other product-provided compensation. This represents a noble effort to accommodate a large (but ever-declining) segment of the industry that provides investment advice to plan sponsors and to individual clients.

However, I believe the current BIC exemption could be misconstrued, in several respects, so as to permit over time institutionalization of perverse economic incentives and conflicts of interest that continue to apply to many financial services providers today and which cause so much harm to individual investors. Hence, below I undertake recommendations for modifications to the BIC exemption that will strengthen the requirements of the exemption in order to better protect consumers.

It must be remembered that ERISA mandates a "sole interests" fiduciary standard of conduct, which is further augmented by prohibited transaction rules. The DOL possesses the authority to provide exemptive relief, provided it is the interests of consumers. The BIC exemption must be carefully constructed to ensure that the interests of individual investors are protected, and that it is not interpreted incorrectly.

A. On the Difficulties Presented by Differential Compensation.

The BIC exemption permits a wide variety of compensation methods, including but not limited to commissions, 12b-1 fees, payment for shelf space arrangements, and other forms of revenue sharing, at the brokerage firm level and/or insurance agency level. It is not necessarily the fact of how these payments are made, but the fact that such payments may be different depending upon the investment product (or insurance product) recommended, that creates the first significant hurdle for firms bound by the fiduciary standard of conduct, and the agents of those firms.

Why Level Compensation, for Both the Adviser and the Firm, is So Important to Adhering to a Fiduciary Standard.

Fixed compensation, agreed-to in advance with the client, is much preferred in fiduciary-client arrangements. As Professor Laby explained: "It can be difficult *ex post* to determine the wisdom of an investment recommendation at the time it was made. A decision to recommend one investment over another is based on many factors; one can seldom know if self-interest was a motivating force. The imposition of the fiduciary duty of loyalty and the regulation of conflicts are ways to control the risk that an investment recommendation will not be objective."[64]

As Professor Laby observed above, it must be recognized that it can take many years of investment manager performance to be able to test for a fund manager's skill. As recently observed by David Blake:

> Our final conclusion is that, while 'star' fund managers do exist, all the empirical evidence – including that presented here – indicates that they are incredibly hard to identify. Furthermore, it takes a very long time to do so: Blake and Timmermann (2002) showed that it takes 8 years of performance data for a test of a fund manager's skill to have 50% power and 22 years of data for the test to have 90% power. For most investors, our results show that it is simply not worth paying the vast majority of fund managers to actively manage their assets.[65]

The principle that Professor Arthur Laby summarized above has long been observed by the courts of our country. As Hallgring explained nearly a half-century ago:

> The courts have consistently held that this inflexibility is essential to its effective operation ... First, the courts have acknowledged that it is difficult, if not impossible for a person to act impartially in a matter in which he has an interest...Secondly, the courts have realized that fiduciary relationships lend themselves to exploitation ... Finally, the courts have made much of the fact that disloyal conduct is hard to detect.[66]

As Fred Reish and Joseph Faucher more recently expounded:

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[64] Arthur B. Laby, Fiduciary Obligations Of Broker-Dealers and Investment Advisers, 55 Villanova L.Rev. 701, 739 (2010).

[65] David Blake et. al., New Evidence on Mutual Fund Performance: A Comparison of Alternative Bootstrap Methods (2014) at p.19.

[66] Hallgring, R., The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility. 41 WASHINGTON LAW REVIEW 808–11 (1966).

> Conflicts of interest adversely affect the integrity of the private retirement system. At the least, the appearance of impropriety calls into question fiduciaries' loyalty to participants. At worst, a conflict of interest can have a direct adverse impact on the plan and its participants. For instance, a conflict of interest, gone unchecked, can result in the plan paying more than reasonable compensation to service providers or result in fiduciaries offering mediocre and overly expensive investment options when superior products are available at equal or less expense. Conflicts of interest, therefore, can adversely affect the benefits available to participants at retirement – the exclusive purpose for which retirement plans exist.[67]

The BIC exemption (and the Principal Transaction Exemption) addresses the problems posed by differential compensation by requiring that both financial institution and adviser affirmatively agree to provide investment advice that is in the best interest of the retirement investor "without regard to the financial or other interests" of the financial institution, adviser, or other party." While the intent of this language appears clear on its face, FINRA in its July 17, 2015 comment letter to the DOL on the proposals suggests three possible interpretations. FINRA's third (and correct) interpretation is that under the BIC exemption "investment advice may be deemed in the customer's best interest as long as, among other matters, the amount of compensation earned was not a factor in the recommendation." Yet, in the sentence thereafter, FINRA states: "It is unclear how a financial institution or adviser would demonstrate that the amount of compensation was not a factor in the recommendation."

The clarity FINRA seeks is provided by the DOL itself, in its issuing release for the BIC exemption:

> [B]oth ERISA section 404(a)(1)(A) and the trust-law duty of loyalty require fiduciaries to put the interests of trust beneficiaries first, without regard to the fiduciaries' own self-interest. Accordingly, the Department would expect the standard to be interpreted in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts ...
>
> Example 3: Fee offset. The Financial Institution establishes a fee schedule for its services. It accepts transaction-based payments directly from the plan, participant or beneficiary account, or IRA, and/or from third party investment providers. To the extent the payments from third party investment providers exceed the established fee for a particular service, such amounts are rebated to the plan, participant or beneficiary account, or IRA. To the extent third party payments do not satisfy the established fee, the plan, participant or beneficiary account, or IRA is charged directly for the remaining amount due

Other examples are provided by the U.S. Department of Labor. However, the "fee offset" example appears to provide the best mechanism for brokers and insurance companies to ensure adherence that the amount of compensation was not a factor in the recommendation. I hope this reminder serves to provide FINRA, which seems completely unable to understand what a true fiduciary standard requires (despite its acknowledgement, in the early 1940's, that brokers forming relationships of trust and confidence with their clients would possess such fiduciary duties), with the clarity FINRA seeks.

Higher Compensation = Higher Investment Product Costs = Lower Returns for the Client.

The impact of additional differential compensation on the individual investor should not be underestimated. The compensation arrangements permitted under the BIC exemption, paid by product providers, include commissions (front-end sales loads), deferred contingent sales charges (DCSC), 12b-1 fees (approximately 80% of which are paid by mutual funds to brokers), payment for shelf space (typically paid by a fund's investment adviser, out of a portion of the management fees charged to the fund, resulting in economic incentives to keep management fees high), brokerage commissions paid by funds to brokers (including the insidious payment of higher commissions as "soft dollar" compensation), and other forms of revenue-sharing arrangements.

These forms of compensation result in higher-cost investment products (as additional compensation paid by product providers to brokers and insurance agents must be recouped through higher-cost products). Yet, the academic research is compelling in support of the proposition that investment products with higher fees and costs result, in average, in lower returns for investors, especially over the long term.

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[67] C. Frederick Reish and Joseph C. Faucher, The Fiduciary Duty to Avoid Conflicts of Interest in Selecting Plan Service Providers (Feb. 2009).

1) The Market as a" Zero-Sum Game."

William F. Sharpe, in his Nobel laureate-winning paper, "The Arithmetic of Active Management," posited that the stock market was a "zero-sum game." Following is an extended excerpt form this important paper:

> If "active" and "passive" management styles are defined in sensible ways, it must be the case that
>
> > (1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and
> >
> > (2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar
>
> These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required.
>
> Of course, certain definitions of the key terms are necessary. First a *market* must be selected -- the stocks in the S&P 500, for example, or a set of "small" stocks. Then each investor who holds securities from the market must be classified as either active or passive.
>
> A passive investor always holds every security from the market, with each represented in the same manner as in the market. Thus if security X represents 3 per cent of the value of the securities in the market, a passive investor's portfolio will have 3 per cent of its value invested in X. Equivalently, a passive manager will hold the same percentage of the total outstanding amount of each security in the market.
>
> An active investor is one who is not passive. His or her portfolio will differ from that of the passive managers at some or all times. Because active managers usually act on perceptions of mispricing, and because such misperceptions change relatively frequently, such managers tend to trade fairly frequently -- hence the term "active."
>
> Over any specified time period, the *market return* will be a weighted average of the returns on the securities within the market, using beginning market values as weights3. Each passive manager will obtain precisely the market return, before costs4. From this, it follows (as the night from the day) that the return on the average actively managed dollar must equal the market return. Why? Because the market return must equal a weighted average of the returns on the passive and active segments of the market. If the first two returns are the same, the third must be also.
>
> This proves assertion number 1. Note that only simple principles of arithmetic were used in the process. To be sure, we have seriously belabored the obvious, but the ubiquity of statements such as those quoted earlier suggests that such labor is not in vain.
>
> To prove assertion number 2, we need only rely on the fact that the costs of actively managing a given number of dollars will exceed those of passive management. Active managers must pay for more research and must pay more for trading. Security analysis (e.g. the graduates of prestigious business schools) must eat, and so must brokers, traders, specialists and other market-makers.
>
> Because active and passive returns are equal before cost, and because active managers bear greater costs, it follows that the after-cost return from active management *must* be lower than that from passive management.
>
> This proves assertion number 2. Once again, the proof is embarrassingly simple and uses only the most rudimentary notions of simple arithmetic.[68]

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[68] William F. Sharpe, The Arithmetic of Active Management, *The Financial Analysts Journal* (January/February 1991) (Vol. 47, No.1, pages 7-9).

2) *The Race Horse Analogy.*

Another way of explaining the success of low-cost investment management is by focusing on the burden of fees and costs. Generally (but not always), passively managed funds have lower fees and costs than actively managed funds.

What is the consequence of high fees and costs? It requires outperformance simply to "break even," and even more outperformance to "pull ahead."

For example, imagine a racehorse in a race. In nearly all horse races the combined weight of the jockey, saddle and other tack is the same. Lower-weight jockeys must place weights in locations near the saddles to make it a fair race.

Now imagine that one racehorse is given an extra 25 pounds of weight, relative to all other race horses. Will that racehorse be unable to win in a relatively short race, lasting just 3/4ths of a mile? Not necessarily – that racehorse may have a favorable starting position, an excellent start, or indeed may have better performance. The likelihood that such racehorse will win is only marginally lower.

But now imagine that the races get longer, and longer. The added 25 pounds of weight begins to take its toll. It becomes harder and harder for the racehorse with the added weight to prevail in these longer races. Not impossible, but just much harder.

And so it is with the added fees and costs of active management. In such instance, the longer the race (i.e., the greater the number of years surveyed), the ongoing fees and costs take their toll, and the higher-fee stock mutual fund or ETF is unlikely to prevail, and often may struggle to even survive.

3) *The Academic Research Prior to 2012.*

Many investors are willing to pay higher fees with the hope of earning a higher return. However, the academic research prior to 2012 generally supports the conclusion that higher-fee, actively managed mutual funds are bested, on average, by low-cost passively managed funds:

- Sharpe (1966)[69] and Jensen (1968)[70] first showed that the average mutual fund underperformed relative to their indexes.
- "Eugene Fama, William Sharpe and Jack Treynor were some of the first researchers to note the apparent lack of skill by mutual fund managers. Economist Michael Jensen provided his view in 1967, that "mutual funds were on average not able to predict security prices well enough to outperform a buy-the-market-and-hold policy, but also that there is very little evidence that any individual fund was able to do significantly better than that which we expected from mere random chance."[71]
- Actively managed funds tend to underperform their benchmarks after adjusting for expenses, and the probability of earning a positive risk-adjusted return is inversely related to expense ratios. (Haslem et al., 2008).[72]
- Although a small number of early studies find that mutual funds having a common objective (e.g., growth) outperform passive benchmark portfolios, Elton, Gruber, and Blake (1996)[73] argue that most of these studies would reach the opposite conclusion if survivorship bias and/or adjustments for risk were properly taken into account.

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[69] Sharpe, William F. 1966. Mutual fund performance. Journal of Business 39, 119-138.

[70] Jensen, Michael C. 1968. The performance of mutual funds in the period 1945-1964. Journal of Finance 23, 389-416.

[71] Ferri, R.A., Benke, A.C., 2013. A Case for Index Fund Portfolios. Technical Report. Available at: http://www.rickferri.com/WhitePaper.pdf. (Last retrieved July 1, 2015.)

[72] Haslem, J.A., Baker, H.K., & Smith, D.M. (2008). Performance and characteristics of actively managed retail equity mutual funds with diverse expense ratios. Financial Services Review, 17, 49-68.

[73] Elton, Edwin J., Martin J. Gruber, and Christopher R. Blake (1995), 'Fundamental Economic Variables, Expected Returns, and Bond Fund Performance', Journal of Finance, 50, 1229-1256.

- Expense ratios and turnover are negatively correlated with return. (Carhart, 1997[74]; Dellva & Olson, 1998[75]; O'Neal, 2004).
- Loads are also negatively associated with fund performance (Carhart, 1997[76]; Dellva & Olson, 1998[77]).
- Load funds underperform no-load funds by an estimated 80 basis points (bps) per year (Carhart, 1997).[78]
- Transaction costs also decrease the potential benefit of active management (Carhart, 1997).[79]
- Opportunity costs exist due to cash holdings by funds. Hence, part of this underperformance is because actively managed mutual funds have higher liquidity needs for frequent purchases and redemptions. (O'Neal, 2004).
- Lower performing funds have higher fees, and high-quality funds do not charge comparatively higher fees. (Gil-Bazo & Ruiz-Verdu, 2008).[80]
- Mutual funds on average underperform benchmarks by approximately the amount of fees and expenses. (Fama and French, 2008).[81]
- After correcting for false discoveries in positive alpha, lucky mutual fund managers, most funds do not deliver positive alpha net expenses. Skilled managers are disappearing, finding skilled managers in 1996 but almost none by 2006. (Barras et. al., 2010).[82]
- Evidence collected over an extended period on the performance of (open-ended) mutual funds in the US (Jensen, 1968[83]; Malkiel, 1995[84]; Wermers et al., 2010)[85] and unit trusts and open-ended investment companies (OEICs) in the UK (Blake and Timmermann, 1998[86]; Lunde et al., 1999)[87] has found that on average a fund manager cannot outperform the market benchmark and that any outperformance is more likely to be due to luck rather than skill.

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[74] Carhart, M.M. (1997). On persistence in mutual fund performance. Journal of Finance, 52(1), 57-82.

[75] Dellva, W.L., & Olson, G.T. (1998). The relationship between mutual fund fees and expenses and their effects on performance. The Financial Review, 33, 85-104.

[76] Carhart, M.M. (1997). On persistence in mutual fund performance. Journal of Finance, 52(1), 57-82.

[77] Dellva, W.L., & Olson, G.T. (1998). The relationship between mutual fund fees and expenses and their effects on performance. The Financial Review, 33, 85-104.

[78] Carhart, M.M. (1997). On persistence in mutual fund performance. Journal of Finance, 52(1), 57-82.

[79] Carhart, M.M. (1997). On persistence in mutual fund performance. Journal of Finance, 52(1), 57-82.

[80] Gil-Bazo, J., & Ruiz-Verdu, P. (2008). When cheaper is better: Fee determination in the market for equity mutual funds. Journal of Economic Behavior & Organization, 67, 871-885.

[81] Fama, E.F., & French, K.R. (2008). Mutual fund performance.

[82] Barras, L., O. Scaillet, and R. Wermers. 2010. False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas. Journal of Finance 65:179-216.

[83] Jensen, M.C., 1968. The performance of mutual funds in the period 1945-1964. Journal of Finance 23, 389-416.

[84] Malkiel, B.G., 1995. Returns from investing in equity mutual funds 1971 to 1991. Journal of Finance 50, 549–72.

[85] Wermers, R., Barras, L., Scaillet, O., 2010. False discoveries in mutual fund peformance: measuring luck in estimated alphas. Journal of Finance 65, 179-216.

[86] Blake, D., Timmermann, A., 1998. Mutual fund performance: evidence from the UK. European Finance Review 2, 57-77.

[87] Lunde, A., Timmermann, A., Blake, D., 1999. The hazards of mutual fund underperformance: a Cox regression analysis. Journal of Empirical Finance 6, 121-52.

- As a result of lower expenses, broad index funds tend to outperform actively managed funds with equivalent risk. Therefore, the best way for most investors to improve performance is to have a broad index fund with minimal costs (Malkiel, 2003).[88]

- As stated in a 2011 paper, using data on active and passive US domestic equity funds (the sample included a total of 13817 funds while the CRSP Mutual Fund Database) from 1963 to 2008, the authors observed: "*Similar to others, we first show that fees are an important determinant of fund underperformance – that is, investors earn low returns on high fee funds, which indicates that investors are not rewarded through superior performance when purchasing 'expensive' funds.* We explore a number of hypotheses to explain the dispersion in fees and find that none adequately explain the data. Most importantly, there is very little evidence that funds change their fees over time. In fact the most important determinant of a fund's fee is the initial fee that it charges when it enters the market. There is little evidence that funds reduce their fees following entry by similar funds or that they raise their fees following large outflows as predicted by the strategic fee setting hypothesis. *We also do not find evidence that higher fees are associated with proxies for higher service levels provided to investors.* Overall, our findings provide little evidence that competitive pricing exists in the market for mutual funds."[89] (*Emphasis added.*)

- The finding that active mutual fund managers underperform their benchmark, net of fees, on average, is generally robust for other developed and emerging market equity managers (*e.g.,* Otten and Bams 2002[90], Standard & Poor's 2009[91]).

4) *More Recent Academic Research.*

- Vidal et. al., 2015: High Mutual Fund Fees Predict Lower Returns. "[We confirm the negative relation between funds´ before fee performance and the fees they charge to investors. Second, we find that mutual fund fees are a significant return predictor for funds, fees are negatively associated with return predictability. These results are robust to several empirical models and alternative variables." Marta Vidal, Javier Vidal-García, Hooi Hooi Lean, and Gazi Salah Uddin, The Relation between Fees and Return Predictability in the Mutual Fund Industry (Feb. 2015).

- Sheng-Ching Wu, 2014: High-Turnover Funds Have Inferior Performance. "[F]unds with higher portfolio turnovers exhibit inferior performance compared with funds having lower turnovers. Moreover, funds with poor performance exhibit higher portfolio turnover. The findings support the assumptions that active trading erodes performance….]"[92]

- Blake, 2014 (UK): Average Fund Manager in UK Unable to Deliver Outperformance Using Either Selection or Market Timing. "[U]sing a new dataset on equity mutual funds [returns from January 1998–September 2008] in the UK … [we] find that: the average equity mutual fund manager is unable to deliver outperformance from stock selection or market timing, once allowance is made for fund manager fees and for a set of common risk factors that are known to influence returns; 95% of fund managers on the basis of the first bootstrap and almost all fund managers on the basis of the second bootstrap fail to outperform the zero-skill distribution net of fees; and both bootstraps show that there are a small group of 'star' fund managers who are able to generate superior performance (in excess of operating and

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[88] Malkiel, B.G. (2003). The efficient market hypothesis and its critics. Journal of Economic Perspectives, 17(1), 59-82.

[89] Michael Cooper, Michael Halling and Michael Lemmon, Fee dispersion and persistence in the mutual fund industry (March 2011).

[90] Otten, Roger, and Dennis Bams. 2002. European Mutual Fund Performance. European Financial Management 8, no. 1: 75–101.

[91] Standard & Poor's. 2009. Standard & Poor's Indices versus Active Funds Scorecard, Midyear 2009.

[92] Sheng-Ching Wu, Interaction between Mutual Fund Performance and Portfolio Turnover, Journal of Emerging Issues in Economics, Finance and Banking (JEIEFB) 2014 Vol: 3 Issue 4.

trading costs), but they extract the whole of this superior performance for themselves via their fees, leaving nothing for investors."[93]

- Ferri and Benke (2012). Using the "CRSP Survivor-Bias-Free US Mutual Fund Database ... maintained by the Center for Research in Security Prices (CRSP®), an integral part of the University of Chicago Booth School of Business ... In all portfolio tests, there was some benefit to using low-cost actively managed funds, but not as much as we expected, given the reported impact that fees have on individual fund performance. The probability of outperformance by the all index fund portfolios remained above 70% in all scenarios ... We speculate that filtering actively managed funds may shift the probability curve closer to an all index fund portfolio as in the low-expense example, but we are not convinced that any filtering methodology will significantly alter the balance in favor of all actively managed funds. This may be an area for future research ... A diversified portfolio holding only index funds in all asset classes is difficult to beat in the short-term and becomes more difficult to beat over time. An investor increases their probability of meeting their investment goals with a diversified all index fund portfolio held for the long term."[94]

- SPIVA Scorecard (For Period Ending 12/31/2014). The S&P Dow Jones SPIVA® U.S. Scorecard is an extensive report that's published semiannually at mid-year and year-end. SPIVA divides mutual fund return data into category tables covering different asset classes, styles, and time periods. There's also a measure of survivorship bias and style drift for every category over each period. This accounts for funds that are no longer in existence or have had a change in investment style. The SPIVA® U.S. Scorecard Year-End 2014 has data going back 10 years. Excerpts from this report follow:
    - "It is commonly believed that active management works best in inefficient environments, such as small-cap or emerging markets. This argument is disputed by the findings of this SPIVA Scorecard. The majority of small-cap active managers have been consistently underperforming the benchmark over the full 10-year period as well as each rolling 5-year period, with data starting in 2002."
    - "Funds disappear at a meaningful rate. Over the past five years, nearly 24% of domestic equity funds, 24% of global and international equity funds, and 17% of fixed income funds have been merged or liquidated. This finding highlights the importance of addressing survivorship bias in mutual fund analysis."[95]

Hence, to the extent investment advisers believe, under the BIC exemption, that they can recommend higher-cost products that pay their firm more than substantially similar low-cost investments, with no harm to the client, these investment advisers are not acting as expert advisers with the due care required of a fiduciary. The academic evidence is compelling that higher-cost products possess a heavy burden which, on average, negatively affects returns.

Divided Allegiance and Loyalties = Inability to Instill a True Fiduciary Culture Within a Firm.

I would also observe that some commentators have been stating, publicly, that suitability is "97% of the way there" to the fiduciary standard of conduct. This could not be further from the truth. Even with the relaxation of the sole interests standard under the BIC exemption to the best interests standard, as proposed, there remains a key distinction – *i.e.,* whom does one represent? There is a huge gulf between representing a brokerage firm and/or product manufacturer, versus representing the client. The mindset of the adviser is completely different, as are the adviser's loyalties.

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[93] David Blake et. al., New Evidence on Mutual Fund Performance: A Comparison of Alternative Bootstrap Methods (2014).

[94] Ferri, R.A., Benke, A.C., 2013. A Case for Index Fund Portfolios. Technical Report. Available at http://www.rickferri.com/WhitePaper.pdf. Last retrieved July 1, 2015.

[95] SPIVA® U.S. Scorecard Year-End 2014, available at http://www.spindices.com/documents/spiva/spiva-us-year-end-2014.pdf.

Moreover, SIFMA's and FINRA's recent attempt to re-define "best interests" standard as a different version of suitability, discussed in a previous section of this comment letter, clouds the issues even further and risks further confusion for both individual advisers and their clients.

While the BIC exemption proposed by the U.S. Department of Labor seeks to levelize the compensation to the individual adviser, the brokerage firm or insurance company is still permitted to possess higher, differential compensation for the sale of some products relative to other similar products which might be available. Yet, under a fiduciary standard, both the investment adviser and the firm possess broad fiduciary duties toward the client.

While the fiduciary duty of loyalty also extends from the investment adviser to the firm, when the fiduciary duty of loyalty to the client also exists the duties are ordered. In other words, the interests of the client are paramount, and the duty of loyalty owed by the investment adviser to the firm are subordinate to the duty of loyalty owed to the firm. The client's best interest can, and should, remain paramount in the eyes of both the firm and the individual adviser.

Is it realistic to believe, as required under the BIC exemption, that firms will not seek to influence their advisers to sell investment products which result in higher compensation to the firm (but not to the adviser)? The long history of fines on various brokerage firms and other product providers who repeatedly push propriety products suggests that brokerage firms are unlikely to put forth pressure on advisors, whether explicit or by other means.[96] It is easy to surmise that some brokerage firms view such fines as a "cost of doing business" and are likely to continue to put pressure, directly or indirectly, on their sales representatives, especially given the substantial economic incentives for the firms resulting from the sale of higher-cost products.

Modifications to the BIC Exemption are Recommended in Order to Increase Consumer Protections.

Given the DOL's relaxation of the sole interests requirement and prohibited transaction rules under the BIC exemption, and the inherent difficulties in determining whether the fiduciary has been improperly motivated by his, her, or the firm's own economic self-interest in recommending a higher-cost product over a lower-cost product, I suggest several modifications which might be undertaken to the BIC exemption in order to strengthen same, in the sections that follow.

B. EXPRESSLY PLACE THE BURDEN OF PROOF, TO DEMONSTRATE COMPLIANCE WITH FIDUCIARY DUTIES, ON THE ADVISER AND HIS OR HER FIRM.

Given the extensive academic evidence in support of the proposition that higher-fee investment products result in lower-returns, and given the academic evidence in support of the proposition that the skill of an outperforming investment manager cannot be judged accurately until decades of performance history exist, the availability of the BIC exemption should be questioned, to the extent such exemption permits higher compensation for brokerage firms and insurance companies.

Differential compensation to the firm creates, as expressed above, a perverse economic incentive for the firm. While not a *per* se violation of a "best interests" fiduciary standard, given all of the academic evidence in support of the proposition that higher-fee investment products are highly likely to underperform lower-fee investment products with the same characteristics (e.g., the same asset class), the bar for receipt of higher compensation should be set high. Given the foregoing, the standard of due care should be expressly set forth, and the burden of proof for adherence to such standard should rest, in any legal (judicial or arbitration) proceedings, with the firm and the adviser.

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[96] See, e.g., Nathaniel Popper, "Wall Street Banks' Mutual Funds Can Lag on Returns," *New York Times* (April 12, 2015); *also see* Randall Smith, "Banks Face Tension Over Sales of In-House Products," *New York* Times (September 8, 2014); *also see* Jed Horowitz, "Ex-Fidelity brokers claim sales pressure," *InvestmentNews* (Apr 3, 2009).

It must be noted that an ERISA fiduciary is held to the standard that a prudent person "acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims", 29 U.S.C. §1104(a)(1)(B). As such, the investment adviser and his or her firm are effectively held to the standard of a "prudent expert." The U.S. Department of Labor should make it clear that this "prudent expert" standard is applicable under the BIC exemption.

Furthermore, I recommend that the U.S. Department of Labor adopt, under the BIC exemption, that for any proceedings brought against the adviser and/or the firm, that the adviser and firm bear the burden of proof that both procedural and substantive due diligence were followed in the selection of the investment products.

While broker-dealer firms and insurance companies may complain that such shifting of the burden of proof is unwarranted, I believe sufficient academic evidence, as well as logical principles, exists to warrant the conclusion that the burden of proof should be shifted whenever differential compensation arrangements for the adviser or his or her firm exist.

The U.S. Department of Labor may desire to restrict the application of this shifted burden of proof to cases where differential compensation exists. It is relatively easy for firms to adopt a level-compensation methodology, thereby eschewing the perverse economic incentives that result from differential compensation arrangements. For example, in the release of the proposed BIC Exemption, Example 3 illustrates fee offsets. Of course, other requirements must still be met, including the "best interests" requirement within the Standards of Impartial Conduct, as well as the requirement that the compensation be reasonable, as well as the other requirements set forth in the exemption.

C. ESTABLISH THE STANDARD FOR THE ADMISSIBILITY OF EVIDENCE

In addition, I recommend that U.S. Department of Labor expressly state that *Daubert* standard of reliability (for the admission of expert testimony) is applicable to all proceedings (including but not limited to arbitration) in which either party seeks to address whether or not the fiduciary duties of the firm and/or the adviser has been met.

In this regard, purely qualitative assessments of investment products are inherently speculative and would not meet the requirement of the adviser and firm to act as a prudent expert.

Rather, the selection of the investment product, when differential compensation arrangements exist, should be undertaken on the basis of either extensive back-testing, or commonly accepted academic evidence, or both, under the *Daubert* standard.

D. HIGHLIGHT THE REQUIREMENTS OF THE FIDUCIARY DUTY OF LOYALTY, WHEN A CONFLICT OF INTEREST IS PRESENT

The DOL should highlight what its "best interests" fiduciary standard requires when a conflict of interest is present. The receipt of additional compensation, beyond that which would be secured under the lowest-compensated available, where differential compensation is permitted, is perhaps the most egregious of the possible conflicts of interest. If, as the BIC Exemption permits, such differential compensation is to be permitted, then investment advisers and their firms should be cautioned, by the DOL, on the steps required to properly manage such a conflict of interest.

These steps include, when a conflict of interest is present:

> First, disclosure of all material facts, which by definition include disclosure of any and all conflicts of interest, and which also includes disclosure of the existence of alternative products that are available, either through the investment adviser or in the marketplace, which would result in lower compensation to the fiduciary;
>
> Second, that communication to the client must take place to ensure that the client understands the material facts, including the conflict of interest and its ramifications for the client, that such communication must be affirmative (not simply providing access to certain documents), and that the adviser has taken reasonable steps to ensure that the client has understood the material facts (including ramifications for the client);

Third, that the client must provide informed consent to any conflict of interest that are not avoided, recognizing the fundamental principal that no client would ever consent to be harmed (and, as a best practice, it is wise to secure the client's informed consent in writing);

Fourth, that even with informed consent, the proposed transaction must be and remain substantively fair to the client.

I further believe that the DOL should require that the foregoing methodology for properly managing conflicts of interest be included in each firm's Code of Ethics, and that *annual* training around this all-important methodology be required for any individual adviser who relies upon the BIC exemption.

E. The DOL Should Provide Examples of Unreasonable Compensation.

The issue of what constitutes "reasonable compensation" is a complex one. For example, over the past 15 years asset-based fees charged by brokers (under wrap accounts) and by registered investment advisers (when charging as a percentage of assets under management) have generally fallen. Further competition in the marketplace as more fiduciary advisers appear, as well as the continued application of technology and increased ease of receipt of investment advice through the internet, will likely continue to drive down asset-based fees. Hence, what is "reasonable" compensation in one era may not be "reasonable" in a future era.

Additionally, the scope of the services provided can be quite different. Many fiduciary investment advisors bundle a range of financial planning services, and even concierge services and tax return preparation, into asset-based fees charged for investment advisory services.

And, of course, the size of the account, in terms of dollar amounts, can affect the amount charged. It is quite common for larger accounts to not pay the same percentage fee as smaller accounts do, under asset-based compensation arrangements with fiduciary investment advisers, due to the economies of scale present.

Hence, while I do not believe that the U.S. Department of Labor should declare what constitutes "reasonable compensation," it would be proper for the DOL to provide examples of unreasonable compensation.

For example, suppose a qualified retirement plan participant seeks to rollover a $500,000 401(k) account into an IRA account. The fiduciary adviser, under the BIC exemption, seeks to charge a commission. If a single family of mutual funds were to be recommended, due to breakpoints on the commissions paid on "A" class shares, falls to 2% for a $500,000 investment.[97]

However, no breakpoint discounts are typically provided on sales of many variable annuity products, nor for nearly all equity indexed annuities and fixed annuities. This provides an economic incentive to a broker-dealer firm and/or insurance company to recommend these products over mutual funds. These economic incentives are powerful, as evidenced by the substantial sales of these products despite their often-high fees and costs or other unfavorable characteristics (see discussion below).

It would be easy for the U.S. Department of Labor to illustrate that a 5% commission on a $500,000 variable annuity sale, in conjunction with a rollover into an IRA account, amounting to $25,000, would be "unreasonable." (It should be noted that many variable annuities and other types of annuities pay much higher commissions than set forth in this example. I have encountered certain equity indexed annuities with surrender fees – an indication of the size of the commission paid – of 10% and higher, and even as high as 25% in one instance.)

While variable annuity products are complex, as discussed in a later section, the product-specific due diligence on investment products recommended by a firm and its advisers is often undertaken at the firm level, resulting in the

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[97] (Per Nov. 2014 prospectus, Growth Fund of America). See also Report of the Joint NASD/Industry Task Force on Breakpoints (07/22/03) at: http://www.finra.org/industry/mutual-fund-breakpoint-information-investors#sthash.8e9iAGG1.dpuf, stating: "sales loads on equity funds typically start anywhere from 4% to 5.75% for purchase amounts up to $49,999. Typically, the sales load percentage applied to purchase amounts between $50,000 and $99,999 may decline by 0.5% to 1.0%; similar discounts may exist for purchases at $100,000, $250,000 and $500,000. Generally, purchases of $1 million or more are not charged any sales load."

ability to spread out the costs of such due diligence over many, many clients. While time required to explain an variable annuity to a client in order to adhere to the obligation to ensure client understanding of material facts may involve several hours of more time for the investment adviser, this also would not justify an extraordinarily higher commission. Fiduciary advisors deserve to be compensated as expert professionals, and such professional-level compensation must be at all times reasonable.

As seen, one of the problems with commissions is that, when the amounts involved are large, the up-front compensation for the services provided can easily become unreasonable. For example, for the sale of a variable annuity product, in which product-specific and client-specific due diligence has been undertaken, the services might also include the preparation of an investment policy, the selection of funds within the annuity to meet the terms of that investment policy, and the completion of paperwork necessary to attend to the IRA rollover and the making of the investment. Yet, again, these services would clearly not justify the receipt of a $25,000 commission in the $500,000 IRA rollover example above.

Under a fiduciary standard, for compensation to be reasonable the timing for the receipt of such compensation should also be tied to when the professional services are rendered. Compensation should not be made for services to be rendered at some distant point in the future (such as years into the future, for continued rebalancing of the portfolio or other investment advice or services). This is because there is no assurance that the advisor-client relationship will continue, nor is there any assurance that a product once acquired will not be quickly disposed of by the client (due to changed circumstances of the client or other factors).

Hence, continuing the example above, a 5% commission paid upon the rollover of a $500,000 401(k) plan balance into an IRA variable annuity, or $25,000 commission, would result in unreasonable compensation. This is especially so since, in all likelihood, trailing fees are likely to be paid to the selling firm on an annual basis (typically from 0.05% to 0.80% annually), for at least several years, if not indefinitely.

Other examples can be provided by the DOL. I suggest that the DOL empanel an advisory board, consisting of fiduciary investment advisers, to develop further examples of unreasonable compensation. And, the caveat should be stated that just because the percentage amount of compensation provided under the BIC exemption does not arise to the level of the examples which are illustrated does not mean that the compensation is reasonable; each instance in which reasonableness of fees is challenged will require a fact-based analysis to compare the circumstances then existing, including the amount of services provided, to the compensation received.

It should also be noted that if the fiduciary investment adviser and/or his or her firm is receiving ongoing compensation, in the nature of 12b-1 fees or trails on annuity fees, then continued services should be provided. Otherwise, the receipt of additional compensation, without the provision of substantial advisory services, would result in unreasonable compensation.

For example, merely acting as custodian, and providing monthly statements as well as annual reports and semi-annual reports to the client, without more, would be insufficient to support a 0.25% annual compensation structure. There are fiduciary investment adviser firms that provide full investment management services, including portfolio rebalancing and tax loss harvesting, as well as ongoing due diligence of the investment products the clients hold (which ongoing due diligence is required of a fiduciary advisor through periodic re-examination of the products and competing products), for a 0.25% annual fee.[98]

Where the adviser-client relationship is terminated, but custodial services are still provided, it is far more reasonable in such instances for a flat annual account administration fee to be paid by the customer; any compensation received by the broker/custodian which exceeds a reasonable account administration flat fee should be rebated to the customer.

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[98] Because investment advisory fees are I.R.C. §212 expenses, a retirement account's ongoing investment advisory fee can be paid directly from the account without being treated as a taxable distribution, under Treasury Regulation 1.404(a)-3(d). *See also* PLR 201104061, addressing wrap account fees and investment advisory services in connection therewith.

Some broker-dealer firms and insurance companies might take the position that during the first year of a client engagement much higher compensation is allowed under the BIC exemption, if financial planning services (such as tax planning, estate planning recommendations, reviews of property and casualty insurance, etc.) are undertaken. Certainly more work is required in the first year to structure and implement the investment portfolio for the client and to explain the investment strategy and the characteristics of the investment products. However, it must be remembered that we are dealing with IRA accounts and qualified retirement accounts under the BIC exemption. While fees for investment advice can be deducted (directly by the investment adviser, or indirectly via the product provider) from such accounts, there is no provision in the law that permits fees to be paid from those accounts for other services such as financial planning.[99]

As seen above, the receipt of commissions by fiduciary investment advisers raise a number of issues relating to unreasonable compensation. However, fiduciary advisers can shop for products that pay lower commissions, or as many variable annuity contracts now provide utilize fee structures that provide an ongoing investment advisory fee to the firm and its investment adviser rather than an up-front sales load or commission.

F. Sunset the BIC Exemption After Five Years.

I believe that the DOL has made a good faith effort to ensure clients continue to receive advice, in an investment advisory industry where half or more of investment advice is delivered in association with the sale of investment products, rather than in an advisory context where no substantial third-party compensation is received by the investment adviser.

However, given the existence of non-level compensation arrangements under the BIC exemption, economic incentives exist that will result in non-adherence to all the requirements of the exemption. And efforts will likely be made, such as SIFMA's "best interests" proposal recently advanced, to re-define the scope of fiduciary duties as far lesser obligations.

In a July 14, 2015 article, "Fees vs. Commissions: Why An Old Debate Is New Again," appearing at *AdvisorPerspectives*, long-time and highly respected industry commentator Bob Veres observed:

> [Recent changes in the securities industry] are forcing us to revisit the ancient fees versus commissions debate. New data and new circumstances have changed the debate in powerful ways.
>
> How? Let's start with the middle market. Historically, defenders of commissions have persistently asserted that it's impossible to deliver investment advice, profitably, to middle-market consumers if you only charge fees for your services …
>
> If you sell a small [*e.g.,* approximately $5,000] annuity and pocket a $300 commission, how is that more efficient than receiving a $300 check from the client for your recommendation of comparable mutual funds or ETFs?
>
> Meanwhile, advisors all around the country have been refuting this argument for decades through their normal business practices. The Garrett Planning Network and Alliance of Comprehensive Advisors have been working with non-wealthy clients for years on a fee basis. More recently, the XY Planning Network of advisors has been charging subscription fees to younger Gen X/Y clients who have far more credit card debt than investible assets. This, at least, suggests that fee compensation is compatible with the middle market and even with those who have assets at all.

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[99] *See* Michael Kitces, "Deducting Financial Planning And Retainer Fees, And The (Tax) Problem With Bundled AUM Fees," *Nerd's Eye* View (blog), May 20, 2015, stating: "While IRAs are allowed to pay their own expenses – thus why an investment management fee for an IRA can be deducted directly from that IRA without a taxable event – and doing so effectively makes the management fee pre-tax (since it was deducted directly from a pre-tax account), an IRA should only pay for its own expenses. When an IRA's assets are used for other non-IRA expenses, it is deemed to be a distribution from the account. And when IRA assets are used in particular to pay personal expenses on behalf of a 'disqualified person' (including the IRA owner themselves), it may be treated as a prohibited transaction under IRC Section 408(e)(2) and IRC Section 4975, which causes the entire account to lose its tax-qualified status and be deemed as distributed at the beginning of the tax year. Thus, using IRA assets to pay the personal financial planning expenses of the IRA owner would be a deemed distribution of that dollar amount at best, and at worst a prohibited transaction triggering distribution of the entire account." Available at https://www.kitces.com/blog/deducting-financial-planning-and-retainer-fees-and-the-tax-problem-with-bundled-aum-fees/.

> But even granting the validity that sales is somehow more efficient than fee-compensated advice when both are delivered face-to-face, we now have a plethora of online advice platforms that are willing to deliver relatively sophisticated investment services to non-wealthy customers on an AUM- (that is, pure fee) basis. Middle market consumers can get investment services from Betterment, Wealthfront or one of the competitors that are sprouting up like mushrooms after a warm summer rain.
>
> This is a game-changer. You can no longer argue that someone has to charge commissions in order to provide services to the vast majority of Americans ...
>
> Today, it's possible to look back over 35 years and see that there has, indeed, been a visible migration among advisors and planners from commissions to fees ... The number of fee-only planners has grown from fewer than 100 during the tax-shelter limited-partnership days to roughly a fifth of all advisors registered with the SEC, according to the latest data compiled by Tiburon Associates.
>
> Many dually-registered reps are now primarily compensated by an AUM revenue model, and every independent broker-dealer has its own asset management platform to serve them. According to the various broker-dealer surveys in the industry magazines, fees represent the fastest-growing segment of broker-dealer revenues, virtually across the board ...
>
> The point here is that it is finally possible to identify a clear trend from commissions to fees in the profession. Before, those on the commission side of the debate might have challenged the idea that commissions are on the decline as a component of advisor compensation, and argued that fees are not the future of the profession. They can't make that argument any more ...
>
> [There still exist] advisors who are happily getting paid to recommend investment and insurance solutions that, if those products stopped paying commissions, they would never recommend as the optimal solution to their clients.
>
> That is the pernicious effect that sales commissions are having on our profession: the quality gap between what consumers are getting when they pay commissions, and what they would get if they pay for advice directly ...
>
> Can you name any other profession that routinely allows its practitioners to accept sales commissions for the sales of products?[100]

As Bob Veres alludes to, the provision of investment advice has been in a state of transition for several decades. In just the past decade the transition away from product sales to fiduciary relationships in which fees are paid directly by the client has accelerated dramatically. New deployments of technology have aided advisors serve the middle class, and the increased competition among fee-only investment advisers continues to drive down the level of compensation. All of these ARE is an extremely important, and powerful, developmentS that better secure the retirement security of Americans.

The DOL's new proposed definition of "fiduciary" will further accelerate the already rapid change away from commissions and other third-party compensation to client-paid, professional compensation arrangements.

However, the BIC exemption, which as stated above permits differential compensation and hence provides an economic incentive to maintain product sales, and the potential under pressure from the industry for re-definition of important terms utilized in the BIC exemptions' requirements, could slow down this evolutionary process.

While the BIC exemption is necessary at the present time in order to not disrupt the availability of advice to Americans, and while the BIC exemption is workable in its current form, the U.S. Department of Labor should not make the BIC exemption permanent. With sufficient advance notice, product providers can and will change the structures of their products in order to eliminate the many conflicts of interest that firms and their representatives might otherwise possess, and both firms and advisors can adjust to these changes.

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[100] Available at http://www.advisorperspectives.com/newsletters15/29-fees-vs-commissions-why-an-old-debate-is-new-again.php.

Additionally, certain product-based compensation arrangements, such as 12b-1 fees, possess troubling aspects. For one, such fees are often (if not nearly always) received for services which are advisory in nature; as a result 12b-1 fees are "investment adviser fees in drag" and are subject to legal challenge as non-permitted "special compensation" under the broker-dealer exception to the definition of investment adviser found in the Investment Advisers Act of 1940.

In addition, 12b-1 fees continue to apply even if the adviser-client relationship is terminated. Moreover, such fees are incapable of negotiation in many cases, and it could be argued that such fees act as an impermissible restraint of trade. FINRA's cap on 12b-1 fees could be seen as a *de facto* industry agreement on fees to be paid; in other fiduciary contexts, such as fees established by statute for certain legal services, such laws and/or regulations have been overturned as unreasonable restraints of trade.

Consumer confusion abounds with regard to 12b-1 fees. And, 12b-1 fees no longer serve their original purpose.

Hence, necessary evolution is required in the product manufacturing industry to eliminate 12b-1 fees. The SEC has recently stated that it is again studying the issue of 12b-1 fees.

In summary, many concerns exist that the BIC exemption will wind up being diminished by industry pressure to interpret terms, such as "best interests," in some new manner. In addition, the receipt of differential compensation leads to perverse economic incentives. *Accordingly, I STRONGLY recommend that the U.S. Department of Labor automatically sunset the BIC exemption, in order that ERISA's sole interests standard and prohibited transaction rules are then applied (barring the application of some other existing prohibited transaction exemption), on December 31st of a year which is 5-6 years following the effective date of any final rule.*

This 5-6 year period will permit an adequate period of time for both the investment product manufacturers, broker-dealer firms, and individual advisors to adjust their compensation arrangements in order that ERISA's sole interests requirement can be applied.

As stated above, the fiduciary standard acts as a restraint upon greed. There is no need for the government to permanently modify ERISA's "sole interests" fiduciary standard of conduct in order to fit the existing business models of broker-dealer firms and insurance companies. However, the BIC exemption can be justified as a temporary transitional standard for those advisers unable at the present time due to the numerous often-hidden flows of revenue from product providers to product sellers.

In no event, however, should the BIC exemption become permanent, as the economic incentives for differential compensation provided by the BIC exemption, even with the changes recommended above, will eventually lead to the BIC exemption becoming the rule, and not the exception. Hence, an automatic sunset of the BIC exemption is essential.

VIII. On the Sale of Variable Annuities Under the BIC Exemption.

As a professor teaching undergraduate classes in both insurance and investments, I have often reviewed variable annuity contracts with my students. Different contracts often use different terminology for the same concepts. The array of available riders and choices inside a variable annuity also contribute to their complexity. As a result, much time is spent analyzing different variable annuity contracts, in order to secure for the students an appropriate foundation for the analyses they will undertake in the future.

What I have also seen is the sale of variable annuities by many agents/registered representatives who fail to understand the product itself – its fees, costs, potential benefits, and limitations. For example, a common broker-sold variable annuity contract I encounter contains a guaranteed minimum withdrawal benefit rider. With this rider, the annual expenses of the annuity range from 3% to 4%, and perhaps higher. This is broken down as follows, for the series of the variable annuity that does ***not*** possess an up-front and substantial commission (paid via a deferred contingent sales charge, or DCSC). A product that lacks a DCSC is more appropriate for a fiduciary advisor, given the requirement of reasonable compensation):

1.80%	Annual mortality & expense charges (*decreases* to 1.3% after 9 years)
0.15%	Annual administration charge

1.10%	Annual expense percentage for the spousal highest daily lifetime income rider, a very popular feature when this annuity is sold. Since this charge is assessed on the greater of the actual account value or the "protected withdrawal value," when the actual account value falls below the protected withdrawal value the effective annual expense percentage would be greater than 1.1%. Additionally, the insurance company can raise this annual charge to as high as 2.0% a year.
0.79% to 1.59%	The annual expense ratios for the funds are: 0.79%, 0.85%, 0.87%, 0.88%, 0.92%, 0.91%, 0.92%, 0.94%, 0.94%, 0.95%, 0.99% 1.02%, 1.03%, 1.05%, 1.07%, 1.11%, 1.12%, 1.14%, 1.21%, 1.46%, and 1.59%. These fund annual expense ratios assume the spousal highest daily lifetime income rider is chosen, as noted above. When the rider is chosen, the fund selection is limited by the terms of the contract; 10% must be allocated to the fixed income account and the remaining 90% must be allocated to the insurance company's selected mutual funds, rather than the much larger universe of funds permitted under the annuity contract if no lifetime income rider is chosen. The interest rate on the fixed income account is determined by the insurance company each year, based upon several factors, including the returns of the insurance company's general account. Each optional living benefit also requires the contract owner's participation in a predetermined mathematical formula that may transfer the account value between the VA's permitted sub-accounts and a proprietary bond fund. It is assumed that the insurance company generates revenue for itself on its fixed income account equal to the lowest annual expense ratio of the available sub-accounts, for purposes of this analysis. Most of these funds are "funds of funds" and include balanced funds (with equity and fixed income allocations) or tactical asset allocation strategies.
0.2%	Each mutual fund (i.e., sub-account) pays brokerage commissions (for certain stock trades) and principal mark-ups and mark-downs for bond trades. In addition, stock trades incur other transaction costs in the form of bid-ask spreads, market impact, and opportunity costs due to delayed or cancelled trades. In addition, fees are paid to an affiliate of the fund out of a portion of any securities lending revenue. In addition, cash held by a fund results in a different kind of opportunity cost. There is no method to estimate the impact of these "hidden" fees and charges and costs, from publicly available information. However, it is likely that these fees and charges and costs vary from a low of perhaps 0.2% to a high of 1.0% (or even higher). For purposes of this analysis, it is assumed that these fees and charges amount to only 0.2%.
----	Some states and some municipalities charge premium taxes or similar taxes on annuities. The amount of tax will vary from jurisdiction to jurisdiction and is subject to change. The current highest charge (Nevada) is 3.5% of the premiums paid. Often this premium tax, if assessed, is deducted by the insurance company from the premium payment. However, for purposes of this analysis it is assumed that there is no premium tax assessed.

Given the limited asset allocation choices that are mandated by the insurance company if the spousal lifetime benefit rider is chosen, it is likely that the gross returns (before any fees and expenses) within the variable annuity would average 7.5% annually, over the very long term, based upon long-term historical average returns of the asset classes included in such funds. Yet, after deduction of fees of 4% (or greater) (decreased to 3.5% or greater after the first 9 years), the net return to the investor is likely to be only 3.5% over the long term, and perhaps even less. However, for the first ten years of the annuity contract, the annuity contract offers a "roll-up rate" of 5% (compounded) for the "protected value" – the value if annuitization takes place. However, this 5% roll-up rate is terminated if lifetime annuitization takes place during the first ten years.

While the annuity offers a "guarantee" in the sense that, if lifetime annuitization is elected at a future date, the highest daily value of the annuity will be used when applying the annuitization rate, it is obvious that, given the high fees and costs of this variable annuity it is highly unlikely that the variable annuity will reach a high principal value over the long term. There simply exist too much extraction of rents – fees and costs – for the sea encompassed within this variable annuity to ever reach a good "high water mark" in most long-term market environments. In fact, over a period of 20 years or longer, there is only a very small probability that the variable annuity value, against which lifetime annuitization is based, will exceed the rates of return on a balanced portfolio of low-cost stock and bond funds (even assuming investment advisory fees and fund fees for such a balanced portfolio totaling 1% a year). Hence, for longer-term investors, the "guarantee" is often illusory.

Additionally, the annuitization rate offered by the insurance company is quite low, compared to the rates for immediate fixed income annuities from insurance companies with excellent financial strength on the marketplace today. This is true even though annuitization rates offered today are quite low, relative to those historically offered, due to the low interest rate environment of today. Here's a comparison:

Age of Younger Spouse	The Annuity Reviewed Above: Spousal (100%) Lifetime Annuitization Rates (Per Prospectus Supplement dated July 15, 2015)	Comparable Single Premium Immediate Annuities: Spousal (100%) Lifetime Annuitization Rate (per January 2015 survey by www.annuityshopper.com)	ACGA Suggested Charitable Gift Annuity Rates – Spousal (100%) (as of April 2015)
60	3.4%	4.0% to 4.4%	3.9% to 4.2% (depending on age of older spouse)
65	4.4%	4.3% to 4.8%	4.2% to 4.5%
70	4.4%	5.0% to 5.4%	4.6% to 4.9%
75	4.4%	5.9% to 6.3%	5.0% to 5.6%

As seen in the table above, the client would typically be far better off shopping for a single premium immediate annuity in the marketplace. Even purchasing a charitable gift annuity, in which the American Council on Gift Annuities targets a residuum (the amount realized by the charity upon termination of an annuity) of 50% of the original contribution for the gift annuity, would usually be better. And, as noted above, if annuitization is to occur in the future, it is highly likely that today's extremely low interest rate environment would moderate, resulting in even higher annuitization rates at that time.

Given this substantial limitations of this variable annuity product, it is difficult to see how any fiduciary investment adviser who, after performing due diligence on variable annuities such as this one, would recommend it to a client with a long-term investment time horizon. Other investment strategies and solutions exist which are highly likely to generate outcomes much more favorable to the client over the client's lifetime.

Even more rare is the client who understands the variable annuity he or she has purchased. In fact, for broker-sold variable annuities, in all my years of practice I never met a client who, having already been sold a variable annuity with these or similar features, came close to fully understanding the features of the variable annuity, and the often-illusory nature of the "guarantee" provided. Most clients assume that the guaranteed value will be available if the full amount is withdrawn in full; hardly any clients realize that the variable annuity must be annuitized, over lifetime, at a relatively low annuitization rate. And none of the clients I met understood the high level of fees and charges assessed against the annuity account value (or, worse yet, the higher protected value, as to some of the percentage fees charged).

It is the obligation of the fiduciary investment adviser to understand the product he or she is selling, and to fully explain all material aspects of the contract to the client. Hence, I suggest that the U.S. Department of Labor, in its issuing release, remind investment advisers of their fiduciary obligation of due care when dealing with variable annuities. The investment adviser should be able to comprehend, and be able to effectively explain to the client in a manner which ensures client understanding, many concepts relating to variable annuity products, including *but not limited to* the following:

1) there is no tax advantage for holding a variable annuity in a traditional IRA, Roth IRA, 401(k), or other qualified retirement plan;
2) the client should normally not purchase a variable annuity with funds that the client will likely need for current (or near-term) expenses;
3) that withdrawals from the annuity before the client attains age 59-1/2 may be subject to a 10% federal penalty tax [and ways to avoid such penalty, such as 72(t) elections, rollovers to qualified retirement plans possessing age 55 withdrawal rights without penalty, etc.];
4) the computational methods utilized in determining any guaranteed amounts which might be available either upon the death of the annuitant(s) or upon annuitization, and the nature of each guarantee and any limitations on when the guaranteed amounts are secured;
5) the annuity's various fees and expenses, including but not limited to annual mortality and expense charges (and whether fees/costs vary), annual administration expenses, contingent deferred sales charges, expenses associated with any riders (enhanced death benefit, GMWB, etc.) provided under the contract, the annual expenses of the variable annuity's sub-accounts, and their composition, including management fees, administration fees, and 12b-1 fees; the brokerage commissions paid (due to transactions occurring within the funds) by any subaccounts recommended to the client, as a percentage of the average net asset value of the subaccount, and whether such brokerage commissions are paid to the insurance company or its affiliates and/or to any firm associated with the investment adviser or affiliates of such firm, and whether such brokerage commissions include any soft dollar compensation; securities lending revenue obtained by such subaccount and the extent to which the gross security lending revenue is shared with the investment adviser or any other service provider and whether such service providers are affiliated with the insurance company or the investment adviser's firm or any of their affiliates; additional transaction and opportunity costs resulting from securities trading within the fund, the subaccount's annual turnover rate (computed as the average of sales and purchases within the fund divided by average net asset value of the fund); the percentage of cash holdings of the subaccount over time and the likely resulting opportunity costs arising therefrom;
6) the financial strength of the insurance company and the importance of such financial strength, especially during a period of annuization;
7) the rate of return of the variable annuity's fixed account, the exposure of fixed account assets to the claims of the general creditors of an insurance company upon default; whether state guaranty funds likely protect against a default by the insurance company and if so to which extent; whether different annuities should be purchased – from different companies – to better protect against the risks of insurance company default; the likelihood of insurance company default on a historical basis given the starting financial strength of the company as measured by the various rating agencies; the Comdex score for the insurance company;
8) the impact of fees and costs of the variable annuity contract on the account value of the variable annuity, and the availability of and any limitations on the various guarantees offered by the insurance company either as a core of the policy or as a rider;
9) an estimate of the likely long-term rate of return of the variable annuity contract, as structured by the investment adviser, versus the likely long-term rate of return of alternative investment strategies and alternate products (including alternate variable annuity products), and an estimate of the likelihood that the protected value of the annuity will be higher than the returns of non-guaranteed products, over various time periods;
10) the annuitization rates offered under the annuity contract, whether those rates are guaranteed, how these rates may change over time, how these rates compare to similar single premium lifetime annuity rates in

the marketplace, and the negative or positive effective rate of return the client(s) will receive during the annuitization period assuming death of the client(s) occur at various ages.

11) any options existing for spousal lifetime annuitization and/or term certain, or any combination thereof, and how these options should be considered given the medical history of the clients and their family members;

12) whether, during annuitization, the client would be better served by annuitization of a portion of the client's portfolio, whether an annual inflation increase would better serve the client in terms of providing needed lifetime income, whether there exist optimal ages or times (from the date of purchase of the annuity contract) to consider undertaking annuitization, and whether a ladder of annuitized investments undertaken over time, at various ages, would better serve the client;

13) for nonqualified annuities: the taxation of withdrawals from the annuity contact, the lack of long-term capital gain treatment, the lack of stepped-up basis upon the death of the account holder(s), and the withdrawals mandated by heirs of the annuitant(s) and the combined estate tax / federal income tax / state income tax consequences of income in respect of a decedent; and how withdrawals from such nonqualified annuity contract might be undertaken to take advantage of any lower marginal income tax brackets (both during lifetime of the annuitants, and as to beneficiaries); and the impact of withdrawals on related income tax planning issues for a client including taxation of social security retirement benefits, the amount of Medicare premiums paid, and alternative minimum tax computations; and the taxation of principle and income upon annuitization of the nonqualified variable annuity contract; the lack of foreign tax credit availability to the client when foreign stock funds are utilized as subaccounts of the variable annuity;

14) the impact of any cash withdrawals upon any guarantees or features of the variable annuity contract;

15) the various risks attendant to the investments in any fixed income account or the subaccounts in the variable annuity; and

16) the understanding that higher cost investments nearly always result in lower returns for investors over the long term, relative to lower cost investments that are substantially similar in composition and risk exposures.

IX. On the Sale of Equity Indexed Annuities Under the BIC Exemption

I recommend that the prohibited transaction relief for the receipt of sales commissions has been available under Prohibited Transaction Exemption (PTE) 84-24 for sales by "fiduciary" insurance advisors of equity indexed annuities (EIAs) to ERISA plans and to IRAs be repealed, not modified. I further recommend that the BIC exemption apply to the sale of equity indexed annuities, but that the BIC exemption be modified to reflect that disclosure of the costs of the EIA cannot be undertaken with any accuracy, and instead that the compensation to the fiduciary investment adviser be disclosed with particularity. This recommendation is undertaken as a means of consolidating the regulatory regime and providing further guidance and instruction to insurance agents over time (as, no doubt, cases and notices will be published regarding the BIC exemption over time). Additionally, while the insurance industry will argue that equity indexed annuities are "insurance products" (in the sense that they are not regulated as securities), from the consumer perspective such equity indexed annuities are an "investment" – similar to the consumer perception that a bank-issued certificate of deposit is also an investment.

In addition, equity-indexed annuities (EIAs), also known as fixed indexed annuities, are another product that, in my experience, many investment advisers and the clients who purchase them do not fully comprehend.

The fiduciary investment adviser should be able to understand EIAs, and be able to effectively explain the many features of these products to the adviser's client. This includes, *but is not limited to*, the following:

We have observed that most purchasers of EIAs gain little understanding of many of the material facts surrounding these products. A fiduciary advisor must not only disclosure these material facts, but must also ensure client understanding of them. These include:

1) That the EIA imposes a penalty, similar to a surrender charge, for early withdrawals from the annuity, whether any portion of the funds can be withdrawn from the EIA each year without a penalty, the amount of the surrender charge and when it disappears, and that withdrawals from the EIA are best undertaken at particular points during each contract year.

2) That investments in an EIA are not meant for funds which are likely to be utilized by the client to address short-term financial needs.

3) That the dollar value of the annuity shown on the client's statement is not the "market value" of the annuity as it relates to the client, but rather the "surrender value" (unless these are separately stated and appropriately marked on each statement).

4) That the amount of the credit provided to the client during any period for index returns during each period does not include dividends which would have been received by an index fund tied to that index and which would otherwise have been be reinvested in that index; how the dividend rates for the index have fluctuated over time; the current dividend rate for the index; and if in the future dividend payout rates are higher due to changes in U.S. federal income tax policy, or due to other factors (such as shareholder demand for payment of dividends, versus retention thereof), the percentage of index total returns the client receives could be significantly impaired by the fact of the exclusion of dividends.

5) That the amount of the credit provided to the client during any period in which the client elects to tie returns to those of an index is further limited by a cap on the index returns; that this cap limits the amount of interest credited to the client's annuity contract; the current cap and the cap in recent years; whether the insurance company has lowered the cap since the inception of the annuity contract (for any purchaser thereof) and when; and that the insurance company reserves the right to lower such caps, which would negatively affect the client's returns;

6) That the amount of the credit provided to the client during any period in which the client elects to tie returns to those of an index is further limited by the participation rate; the current level of the participation rate; the past levels of the participation rate; and that the insurance company reserves the right to lower the participation rate, which would negatively affect the client's returns.

7) That the amount of the credit provided to the client during any period in which the client elects to tie returns to those of an index is further limited by is further limited by market value adjustments, which should be able to be described with particularity, and that such market value adjustments may negatively affect the client's returns;

8) That the amount of the credit provided to the client during any period in which the client elects to tie returns to those of an index is further limited by is further limited by the imposition (annually) of "administrative charges," whether the insurance company reserves the right to increase the administrative charges; whether such administrative returns are capped; the current level and historical level of the administrative charges, and that such administrative charges negatively impact the client's returns;

9) That the funds placed with the insurance company are part of the insurer's general account and subject to the general claims of the insurance company's creditors; unlike a mutual fund or variable annuity sub-account your annuity funds are not segregated and therefore the client's funds are <u>not</u> protected in the event of insolvency of the insurance company; the financial strength ratings of the insurance company including its Comdex score; whether any state guaranty funds exist to safeguard investors and the extent of such guarantees; whether such state guaranty funds would apply should the client's state of residence be changed; and the fact that state guaranty funds exist at this discretion of the states' legislatures.

10) The default rate, over the past 10, 20, 30, 40 and 50 years or more, of insurance companies, based upon their initial financial strength rating;

11) That various tax proposals exist which, if they were to be enacted, could adversely affect the commercial viability of many life insurance and annuity products, which in turn could significantly impair the ability of

many insurance companies to meet their obligations to their present insurance policy holders and annuity contract owners;

12) That for nonqualified EIAs any withdrawals from the annuity of gains within the annuity will be taxed at the client's ordinary income tax rates, that gains are distributed prior to the return of principal (unless annuitization occurs); that the client will not receive the more favorable long-term capital gain treatment that would have been available through a tax-efficient or tax-managed stock mutual fund; and that no stepped-up basis exists upon the death of the annuitant (and the consequences of same, to heirs);
13) That for EIAs held in IRA accounts, tax deferral is already provided by the IRA account possessed, and hence is not a benefit of this annuity contract; similarly, for EIAs held in Roth IRA accounts, tax-free growth of principal is a feature of the account and not of the annuity contract.

X. On the Sale of Fixed Annuities Under the BIC Exemption

Over 20 years ago I was approached by a client who had his entire qualified retirement plan balance (approximately $400,000) rolled over into a fixed tax-deferred IRA annuity. The client requested my opinion regarding the safety of the investment. After conducting an investigation into the financial strength of the insurance company that issued the fixed annuity, I determined that the fixed annuity was issued by a very low-rated insurance company, that state guarantees at the time were insufficient to protect the client's investment in the annuity contract, and that the client should withdraw a significant portion of the annuity (and incur a significant surrender fee, then 9% of the amount withdrawn) in order to better safeguard the client's hard-earned retirement savings.

Unfortunately, lower-rated insurance companies often offer higher commissions to insurance agents to sell their insurance products, including annuities. As a result, the insurance agent often possesses an economic incentive to recommend not among the best of the fixed annuity products available, but among the worst. The application of fiduciary duties, along with other measures I recommend herein, under the BIC exemption, should go a long way to counter these perverse economic incentives.

I recommend that the prohibited transaction relief for the receipt of sales commissions has been available under Prohibited Transaction Exemption (PTE) 84-24 for sales by "fiduciary" insurance advisors of fixed insurance products to ERISA plans and to IRAs be repealed, not modified. I further recommend that the BIC exemption apply to the sale of fixed annuities, but that the BIC exemption be modified to reflect that disclosure of the costs of the fixed annuity cannot be undertaken with any accuracy, and instead that the compensation to the fiduciary investment adviser be disclosed with particularity. This recommendation is undertaken as a means of consolidating the regulatory regime and providing further guidance and instruction to insurance agents over time (as, no doubt, cases and notices will be published regarding the BIC exemption over time). Additionally, while the insurance industry will argue that fixed annuities are merely "insurance products" (in the sense that they are not regulated as securities), from the consumer perspective such fixed annuities are an "investment" – similar to the consumer perception that a bank-issued certificate of deposit is also an investment.

Similar to EIAs above, the investment adviser should be aware of the risks of insurance company default, the financial strength ratings of the insurance company, the presence of state guaranty funds and the limits and effect of a client's change of residence, and more. In addition, the investment adviser should be able to compare the rate of return of the fixed annuity to other fixed income vehicles, weigh the varying risks and returns of different forms of fixed income vehicles, and determine whether diversification of fixed annuities among highly rated insurance companies as a best practice given the client's situation.

In addition, the fiduciary investment adviser should be able to examine, and to explain to the client: the benefits of a fixed annuity with an annual CPI increase during annuitization; the impact of inflation upon the client's purchasing power; whether laddering of annuities over time presents a valid strategy; the liquidity (or lack of liquidity) characteristics of the annuity either before or after annuitization; and the effective rate of return for the client of an product annuitized over one's lifetime given the client's attainment of certain ages.

XI. On the Regulation of IRA Rollovers by Independent Advisers

When undertaking a rollover from an ERISA plan to an IRA account, a great deal of care must be undertaken. This requires any fiduciary adviser to possess a great deal of knowledge of the many factors and tax rules which come into play, in order to ensure maximum benefits to the individual client. In addition, a rollover into an individual IRA account often involves a much higher level of service provided to the individual investor, during and following the rollover process; as a result of this differing level of service and the lack of economies of scale which are often present in the defined contribution space, the compensation for individual accounts is higher. Accordingly, this results in a potential prohibited transaction, even for fee-only independent registered investment advisers.

Any fiduciary adviser providing advice on an IRA rollover should fully understand, and be able to apply, the often-complex tax and other considerations that may affect the decision, including but not limited to:

(1) the availability under many qualified retirement plans (QRPs) to undertake distributions commencing at age 55, rather than the age 59½ requirement imposed upon IRAs;

(2) the existence and best methods for undertaking a series of substantially equal periodic payments from traditional IRA accounts using the 72(t) election;

(3) the 2-year-from-inception restriction on distributions from SIMPLE IRA accounts;

(4) the ability to distribute appreciated employer stock from certain QRPs and receive long-term capital gain treatment upon its later sale, under the technique commonly referred to as "net unrealized appreciation";

(5) the most tax-efficient manner to design, implement and manage a client's entire portfolio, which might consist of QRPs, traditional IRAs, Roth IRAs, nonqualified annuities, life insurance cash values, taxable accounts, 529 college savings plans accounts, HSA accounts, and other types of accounts, generally, in order to best secure for the client the likely attainment of the client's objectives;

(6) the ability to undertake due diligence on the investment options within a QRP account, including but not limited to the potential availability of guaranteed investment accounts (and the risks and characteristics of same, including the reduced exposure to interest rate risk which might be present);

(7) the restrictions which exist on the availability of foreign tax credits and/or deductions for foreign stock funds held in certain types of accounts;

(8) the best manner to minimize future potential income tax liability for both the clients and the client's potential heirs, including the role of stepped-up basis;

(9) the availability of tax-managed or tax-efficient stock mutual funds in taxable accounts;

(10) the marginal rates of tax (federal, state and local) which might be imposed upon ordinary income and long-term capital gain income, and qualified dividend income, both in the current year and in future years;

(11) the ways to avoid realization of short-term capital gains and long-term capital gains;

(12) the harvesting of losses in accounts and how such losses may offset either various types of capital gains or ordinary income (up to certain annual limits);

(13) whether Roth IRA conversions should be considered, and if so when and to what extent, whether separate Roth IRA accounts might be established during conversions for different investment assets, and whether re-characterizations might take place thereafter;

(14) whether distributions might be undertaken to generate additional ordinary income, in order to mitigate the effect in any year of the alternative minimum tax;

(15) the increased amount of premiums for Medicare Part A which might result should the client's/clients' modified adjusted gross income exceed certain limits;

(16) the effect of additional income resulting from QRP or IRA distributions, or from other investment-related income, on the taxation of social security retirement benefits;

(17) the interplay between the timing of taking social security retirement benefits, income tax itemized vs. standard deduction strategies, the receipt of various forms of income, and the taking of QRP or IRA distributions, given the various marginal income tax rates the client is likely to possess, then and in the future, for both federal and state tax purposes;

(18) the ability to take investment advisory fees from certain types of accounts, the best methods to allocate fees and pay them from various types of accounts, the potential for deductibility of fees when paid from certain types of accounts, and avoidance of prohibited transactions which might otherwise result if fees for non-investment advisory services are incorrectly paid from QRP or IRA accounts;

(19) the ability to delay QRP distributions past age 70½ in certain circumstances, for certain clients;

(20) the availability of lifetime annuitization options for a portion of any QRP or IRA, both inside the QRP and in a rollover IRA, including an evaluation of the single life, spousal (with and without reduced benefits to the survivor), term certain, and combinations of the foregoing, and including further an evaluation of the possible use of CPI adjustments in the annuity contract to keep pace with increased spending needs, and including further the possible use of a staggered approach to annuitization, and including further the available of deferred annuities with payouts commencing at later ages, and including further the risks and return characteristics of certain annuities, the costs and fees associated with same, the possible applicability of premium taxes, the various riders which might be employed and their costs and benefits and limitations; and

(21) the best method to ensure asset protection of the rollover IRA, such as by segregating it from contributory IRA accounts.

As to broker-dealers, dual registrants, and insurance agents, the DOL's requirements for the BIC exemption (with modifications, as suggested above) seem wholly appropriate. The DOL might seek, in its issuing release, to remind fiduciary advisers of the need for a high degree of competence when planning for IRA rollovers and the extensive knowledge required to provide advice on proper structuring of investment portfolios to best secure the client's retirement income needs over the long term or to meet other objectives of the client.

However, for independent registered investment advisers, who are not affiliated with any broker-dealer and who receive no third-party compensation (i.e., compensation from providers of investment products or insurance products), the requirements of the BIC exemption (especially as to the requirement of no discretion) seem inapplicable. These "fee-only" registered investment advisers already agree to adhere to the tough "sole interests" standard found under ERISA and the prohibited transaction rules when providing ongoing investment advice. The conflict of interest that occurs is only in whether to undertake a rollover to an IRA, where the fees paid by the client will be higher than those in the qualified retirement plan account, such higher fees reflective of a higher level of service provided.

Hence, I suggest that the DOL promulgate a new prohibited transaction exemption for advice provided with respect to rollovers from an ERISA-covered retirement plan to an IRA account. This prohibited transaction exemption would be applicable only to independent registered investment advisers who receive no cash payments from any broker-dealer or insurance company. Under this prohibited transaction exemption the following requirements would be imposed, over and above the fiduciary requirements already imposed under ERISA and the various requirements of the SEC and state securities administrators:

1) That the independent investment adviser fully disclose to the client the difference in the amount the client would pay in the estimated total fees and costs if client continued in the client's current qualified retirement plan account versus the recommended rollover IRA, expressed both as a percentage of the amount invested and as a dollar amount (estimated in good faith);

2) That the independent investment adviser fully disclose to the client that the client has other options, including self-managed IRA accounts, and that some options will possess lower fees and costs; and

3) That the independent investment adviser fully disclose to the client that the higher the total fees and costs associated with investments and the delivery of investment advice, the lower the return of the investor, on average, and that such lower returns can significantly affect the size of the investment portfolio over the long term.

Again, this exemption would be limited to independent fee-only registered investment advisers – *i.e.,* those who receive no payments from broker-dealer firms, insurance companies, or investment product manufacturers. Upon the sunset of the BIC exemption, as suggested above, it would be anticipated that all providers of rollover IRA advice would be able to adhere to the "sole interests" requirements of ERISA and its prohibited transaction rules, under this new proposed prohibited transaction exemption.

Since this would be a new PTE, and it is relatively straightforward, I believe that this PTE could be proposed and finalized under the normal timeline for agency rulemaking. There would be no need to delay the rulemaking process for the DOL's Conflicts of Interest Rule and for the BIC exemption and other exemptions the DOL has proposed, simply as a result of the promulgation of this new, simple and limited exemption.

XII. On the Seller's Exclusion for Large Retirement Plans.

The DOL has proposed an exemption for non-fiduciary investment providers from the definition of fiduciary for large retirement plans. In examining this proposed exclusion, attention should be given to the effectiveness of large retirement plans to embrace the best investment products.

As discussed earlier in this comment letter, there exists a compelling body of academic research that low-cost funds, such as passive investment vehicles (including but not limited to index funds and index ETFs), outperform higher-cost funds, on average. The longer the time horizon the greater the frequency, and amount, of the outperformance.

One would expect that large pension funds, armed with savvy investment advisers, would flock to passive investing. Yet, as reported in early 2015 by The *Wall Street Journal*:

> More individuals are pouring money into so-called passive investing or index funds, which aim to match the performance of the main stock and bond markets, but larger institutions like pension funds and endowments have been slower to follow suit, despite the potential for higher returns and lower fees.
>
> These bigger institutions still tend to rely on an army of asset managers and consultants who charge higher fees but promise better returns through so-called alternative investments like private equity and hedge funds. But many of these investments do no better — or even worse — than index funds, opponents say.[101]

How good are these consultants? Not very – they fail to add value. As reported by *The Economist* in March 2015:

> Many pension funds and endowments hire investment consultants to help them choose fund managers (one estimate is that 82% of US pension plans use such services, and consultants advise on $25 trillion of assets). The consultants employ highly-educated workforces, have decades of experience and charge hefty fees. But an academic paper, which was awarded the 2015 Commonfund prize, concluded:
>
> > *we find no evidence that these (the consultants') recommendations add value, suggesting that the search for winners, encouraged and guided by investment consultants, is fruitless*
>
> … The first point is how important these consultants are: the top 10 have an 82% market share worldwide and are seen by most fund managers as the gateway to clients. Despite this, there is very little data on how good the consultants are at their jobs. For people who demand a lot of numbers

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[101] Randall Smith, "Pension Funds Trail Individuals in Embracing Index Funds," *The Wall Street Journal* (March 3, 2015), retrieved July 3, 2015.

from the fund management profession, they release very little information themselves. However, Greenwich Associates have conducted a survey of the consultants' recommendations of American long-only equity funds from 1999 to 2011.The surveys contain an annual list of fund managers showing what proportion of consultants recommend each manager; it also asks the consultants why they do so.

Interestingly, the consultants do not merely chase past returns. This is not too surprising; they are smart people and know the limitations of the data. They look at soft factors such as investment style (is performance consistent with the stated philosophy? can the manager explain trading decisions?) or service provision. Despite all this, they conclude that

> *the portfolio of all products recommended by investment consultants delivered average returns net of management fees of 6.31% per year (7.13% before fees). These returns are, on average 1.12% lower than the returns obtained by other products available to plan sponsors, which are not recommended by consultants.*

... So if they can't pick winners, why do the consultants favour active managers at all? After all, fees are higher than on passive products and clients are more likely to switch managers on a regular basis, an activity that tends to reduce returns.

The authors suggest that

> *Consultants face a conflict of interest, as arguably they have a vested interest in complexity. Proposing an active US equity strategy, which involves more due diligence, complexity, monitoring, switching and therefore more consultancy work, drives up consulting revenues in comparison to simple cheap solutions.*[102]

As indicated, the view that larger ERISA retirement plan sponsors don't need the protection of the fiduciary standard of conduct, and its imposition of a duty of due care as well as, through the duty of loyalty, the avoidance of conflicts of interest, is highly suspect.

Indeed, an ERISA plan sponsor and/or its independent investment adviser would, if truly educated and informed, would require any provider of investment recommendations to be a fiduciary.

Simply because an investment adviser to a larger plan sponsor is "independent" does not, in and of itself, assure that the investment adviser possesses adequate expertise to advise upon the selection of investment options for the plan.

Accordingly, I recommend that this proposed exemption be dropped from consideration.

Alternatively, I recommend that educational requirements be established for the independent adviser to the plan, who will be engaged in the selection of investment products offered by non-fiduciary providers. Rather than specify a particular designation, I suggest that a minimum number of hours of education, acquired through either college-level (undergraduate or undergraduate) course work, or via certification programs or seminar attendance, be required. Specifically:

> An independent investment adviser should possess a minimum of 90 hours of education from college-level (or higher) course work, acquired through university, college, certification/designation training, or other seminars for which continuing education credit in the area of investments is provided by either the CFP Board of Standards, Inc., the AICPA, the IMCA, or the CFA Institute, in which the following subjects are covered: (1) discerning the fees and costs of investment products, including but not limited to the impact of sales loads, transaction costs relating to securities transactions occurring within a fund, and various opportunity costs which may be present; (2) Modern Portfolio Theory; (3) the Efficient Markets Hypothesis; (4) variable, equity-index and fixed deferred and immediate annuities, their fees and costs, and their benefits and limitations, and understanding the various guarantees and riders available; (5) the structure, characteristics, and fees and costs of publicly traded REITs; (6) multi-factor investment strategies, including but not limited to discussions of the value, small-cap, and profitability factors; (7) ERISA and regulations

[102] Buttonwood, Buttonwood's notebook (Financial markets), "Nobody knows anything," *The Economist* (March 3, 2015), retrieved March 10, 2015.

promulgated thereunder; and (8) the requirements of the fiduciary standard of conduct (of which a minimum of 10 hours of instruction in this area, out of the total hours, must be devoted).

XIII. On the Integration of DOL's Fiduciary Standard with Other Standards.

Various objections to the DOL's proposal have been raised in the public sphere that differing fiduciary standards may exist, between providing advice to accounts covered by the Conflicts of Interest Rule and other types of accounts, and that compliance with differing standards would prove too difficult. This is patently false and non-sensible. It has long been understood by providers of services under two different standards of conduct that the easiest path to ensure compliance is to simply apply the higher standard to the entirety of the relationship.

Indeed, the SEC staff in 2011, following in the footsteps of the Certified Financial Planner Board of Standards, Inc.'s professional rules of conduct, explained that the federal fiduciary standard applies to a fiduciary adviser's "entire relationship" with clients and prospective clients.[103] In this regard, it must be understood that "contract law concerns itself with transactions while fiduciary law concerns itself with relationships."[104]

While the DOL cannot, through its own regulations, mandate the fiduciary standard applicable to non-ERISA and non-IRA accounts, any "dilemmna" posed by the existence of differing standards is easily solved, as set forth above. The highest standards applicable to any account should govern the entirety of the relationship. This is likely the perception the client will possess, and this solution follows upon accepted common law that fiduciary status attaches to relationships, not accounts.

One must wonder why FINRA, in existence for over 75 years, has not incorporated into its conduct rules for brokers the requirements of a fiduciary standard, and acknowledge that under certain circumstances (*e.g.,* when a relationship of trust and confidence is formed, when *de facto* discretion exists, etc.) that brokers can (and have been, repeatedly) held to be fiduciaries under state common law. If FINRA is concerned about the "confusion" that might exist among brokers and their registered representatives about varying standards of conduct, the solution for FINRA's concern is very apparent: (1) simply copy into FINRA's conduct rules the fiduciary standards of conduct under DOL (or other) regulatory regimes; (2) specify when such fiduciary standards of conduct apply (easily discernible from the DOL's proposals, and guided by established law in other areas); and (3) instruct the broker and its registered representatives to simply apply the highest standard of conduct imposed upon any account or any aspect of the relationship to the entirety of the relationship.

Adherence to the highest standard imposed, when differing standards exist, isn't rocket science. FINRA's protests (and those of the broker-dealer industry associations such as SIFMA and FSI, and those of many broker-dealers themselves) should be dismissed as meritless and mere attempts to deny to Americans the important fiduciary protections they deserve.

XIV. In Conclusion

Again, I generally applaud the U.S. Department of Labor's effort to better secure for our fellow Americans their retirement security, and in so doing result in lesser burdens upon government in the future, which in turn will assist with future economic growth.

I hope that the suggestions included herein will aid the DOL as it seeks to finalize the Conflicts of Interest rule and the various new and modified PTEs associated therewith.

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[103] Securities and Exchange Commission Staff, Study on Investment Advisers and Broker-Dealers 22 (2011).

[104] Rafael Chodos, *Fiduciary Law: Why Now! Amending the Law School Curriculum*, 91 Boston U.L.R. 837, 845 (and further noting that "Betraying a relationship is more hurtful than merely abandoning a transaction.")

Should the U.S. Department of Labor, I am more than happy to discuss these recommendations in person, to further elaborate upon them, and/or to provide other assistance which may be desired as the DOL continues down the path to provide a better future for all Americans.

Yours truly,

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