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SUBMITTED ELECTRONICALLY

July 21, 2015

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
Attention: Conflict of Interest Rule, Room N-5655
200 Constitution Avenue, NW
Washington, D.C. 20210

Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
Attention: D-11712 and D-11713
200 Constitution Avenue, NW
Suite 400
Washington, D.C. 20210

Re: *Definition of the Term Fiduciary: Conflict of Interest Rule (RIN 1210-AB32); Proposed Best Interest Contract Exemption and Principal Transactions in Debt Securities Exemption (ZRIN: 1210-ZA25)*

Ladies and Gentlemen:

Fidelity Investments[1] ("Fidelity") appreciates the opportunity to comment on the proposed rule ("Proposed Regulation") published by the Department of Labor ("Department") relating to the definition of investment advice under section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 ("ERISA") and section 4975(e)(3)(B) of the Internal Revenue Code ("Code"). The Proposed Regulation is accompanied by a proposed class exemption that would be based in part on a best interest contract commitment ("BIC Exemption"), a proposed class exemption regarding principal transactions involving certain debt securities ("Principal Transactions Exemption") [2] and amendments to several existing class exemptions. Taken together, the Proposed Regulation and the proposed exemptions would create a new regulatory structure for assisting retirement plans, participants and IRA owners with investment decisions.

[1] Fidelity was founded in 1946 and is one of the world's largest providers of financial services.
[2] *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Proposed Rule* 80 FR 21928 (April 20, 2015); *Proposed Best Interest Contract Exemption; Proposed Rule* 80 FR 21960 (April 20, 2015); *Proposed Class Exemption for Principal Transactions in Certain Debt Securities between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs* 80 FR 21989 (April 20, 2015). Capitalized terms not otherwise defined have the meaning ascribed to them in the Proposed Regulation or proposed exemptions.

As one of the nation's leading retirement services providers, Fidelity has a deep and long-standing commitment to working with the Department on its rulemaking in the area of investment education and advice. Fidelity provides recordkeeping, investment management, brokerage and custodial/trustee services to thousands of Code section 401(k), 403(b) and other retirement plans covering approximately 25 million participants and beneficiaries. Fidelity is the nation's largest provider of services to individual retirement accounts ("IRA") with more than 7 million accounts under administration. Fidelity also provides brokerage, operational and administrative support to approximately 5,000 third-party, unaffiliated financial services firms (including investment advisors, broker-dealers, banks, insurance companies and third party administrators) that may in turn provide investment advice to plans, participants and IRA owners. Since the Department's investment advice proposal would make fundamental changes in the way investment advice is regulated, it could dramatically affect the services Fidelity and its financial services clients provide to a significant portion of the nation's retirement investors.

Rule as Proposed is Unworkable

The new regulatory structure proposed by the Department would greatly expand the range of activities that constitute fiduciary-level investment advice subject to both a best interest standard and, more significantly, the prohibited transaction rules of ERISA and the Code. To address the prohibited transaction issue, the Department purports to create broad, principles-based exemptions for regulated financial services firms that comply with the best interest standard.

We support an appropriate expansion of the range of advice activities subject to a best interest standard so long as it is accompanied by broad prohibited transaction relief. Fidelity believes that it acts in the best interest of its customers and is willing to be legally accountable to that standard when it provides investment advice. Unfortunately, the proposal fails to meet its objectives through an overly broad definition of advice accompanied by exemptive relief that is unnecessarily narrowed through complex limitations and conditions. As a result, the rule is unworkable and will prevent firms like Fidelity from providing investment assistance that plans, participants and IRA owners need to invest successfully for retirement.

We believe that the activities of firms like Fidelity are more appropriately regulated through the primary financial services regulators and that the Department's effort to create an entirely new regulatory framework for investment advice services under ERISA is misguided. However, since the Department seems committed to regulatory action in this area, we believe there is a workable alternative that would better accomplish the Department's objectives. In the body of this letter, we outline a new best interest paradigm and highlight the significant problems with the proposal that it addresses. Since understanding both our proposed paradigm and the problems with the proposal requires analysis of the interaction between the proposed definition of investment advice and the exemptions, we are submitting this letter to both the Office of Regulations and Interpretations (which has responsibility for the rule itself) and the Office of

Exemption Determinations (which has responsibility for the prohibited transaction exemptions). More detailed comments are set forth in three attachments to this letter – Attachment A outlines in more detail our new best interest paradigm (including suggested language for the rule and exemption), Attachment B comments on the Proposed Regulation and Attachment C comments on the proposed exemptions.

A New Best Interest Paradigm

Assuming the Department intends to move forward with rulemaking in this area, there is a workable way to ensure that advice is provided in the investor's best interest while preserving existing business models that provide valuable assistance to retirement investors. Our proposed best interest paradigm addresses the two foundational problems with the proposal – the overly broad definition of investment advice under the Proposed Regulation and the limitations and conditions of the BIC Exemption which make it ineffective in addressing the prohibited transaction problems created by the overly broad advice definition.

The fundamental problem with the overly broad definition of investment advice under the Proposed Regulation is that it conflates two separate acts – an investor's engagement of an advisor[3] to provide advice and the advisor's recommendation of investment products and services pursuant to such engagement – and treats both as a single "recommendation" subject to fiduciary conduct standards. By so doing, the rule proposal makes an advisor a fiduciary with respect to establishment of its own services and compensation. This is both unprecedented in fiduciary law and not commercially viable, potentially requiring an advisor to recommend its competitors over itself even if its own services are wholly appropriate for the investor.

The Proposed Regulation attempts to deal with this problem in part through a limited seller's carve-out for large plans. While we believe the carve-out approach makes sense for true sales activity and should be applied to all investors in that context, the carve-out is an "all or nothing" approach. When it applies under the Proposed Regulation, neither the advisor's sales of its own services nor the advisor's actual investment recommendations would be held to a fiduciary standard. Because the best interest standard does not apply to the actual investment recommendation when the carve-out applies, the carve-out defeats the purpose of the rule. Thus, the Department's proposal either imposes a fiduciary duty on the sale of an advisor's own services (where it does not belong) or removes a fiduciary standard with respect to an investment recommendation (where it does). We refer to this as the "sales dilemma" that is created by the proposal. Notably, the proposal creates this dilemma not only with respect to advisors with transaction-based compensation but also for advisors selling fee-based advisory services.

This dilemma can be avoided by separating the advisor's establishment of its own services and compensation – that is, the otherwise conflicted components of the relationship –

[3] We generally use the term "advisor" to refer to both the regulated financial institution and/or its individual representative, but provide greater specificity where the context requires.

from the actual recommendations about investment products and services. These are inherently distinct activities subject to fundamentally different duties. Following appropriate disclosure, an investor would agree to the scope of the advice to be provided, the amount of compensation payable to the advisor in connection with an investment recommendation or over a range of recommendations, restrictions on the advice (such as limitations to proprietary products or products that generate revenue sharing), and other terms and conditions of the engagement. The investor's agreement with respect to the service and compensation terms would be established at arm's length outside of the fiduciary relationship, as it historically has been in every comparable fiduciary context. Once the terms of the engagement are established, all investment recommendations within that framework must be in the investor's best interest.

It is important to note that this approach of separating the terms of the engagement from the actual investment recommendation does not apply solely at the initiation of the advisory relationship. The terms of the engagement can later be renegotiated by the parties, or indeed can be established on a transaction-by-transaction basis.

This approach of separating the terms of the engagement from the actual investment advice is conceptually identical to a long-standing regulation of the Department addressing application of the prohibited transaction exemption under ERISA section 408(b)(2) for payment of service providers. This regulation provides that if a person who is already providing investment advice to a plan "persuades" a plan fiduciary to extend his contract at a higher fee, the advisor has not engaged in a prohibited transaction because the advisor has not used any of the authority, control or responsibility which makes it a fiduciary to cause the plan to pay an additional fee. There is no reason why this concept should not apply where the advisor's compensation varies based on the transactions and services recommended by the advisor, or to other limitations and conditions on the scope of the advisor's services.

The second foundational problem with the proposal is that its proposed exemption structure is laden with complex limitations and conditions which narrow both the scope and practicality of the exemptions and make them unworkable. Most of this problem can be solved by implementing what the Department said it was going to do – create a broad, principles-based approach to exemptions for regulated financial institutions that act in the investor's best interest. Notably, although the Department did not stay true to this commitment in proposing the BIC Exemption, it does follow this approach through the "Standards of Impartial Conduct" that are proposed as amendments to several existing exemptions in other parts of the rule proposal. For example, the Department has proposed this approach in the amendments to PTE 77-4 which allows a discretionary manager to invest in its own proprietary mutual funds – often cited as one of the most conflicted transactions for an advisor. If this simple, straightforward approach is sufficiently protective of the interests of plans, participants and IRA owners in the context of a discretionary investment manager, it is certainly sufficient in the context of nondiscretionary advice.

Accordingly, our new best interest paradigm would apply this approach to the BIC Exemption by modifying it to create a broad exemption that would reflect each of the three key Standards of Impartial Conduct for regulated financial services firms:

- a legally enforceable commitment to act in the best interest of the investor;
- a requirement that compensation be reasonable in light of the services provided; and
- disclosure of material conflicts, including compensation payable to the financial institution.

No further limitations or conditions on the exemption are needed.

Problems with the Proposal that Must Be Addressed

Adopting the new best interest paradigm set forth above and in Attachment A will address most of the key problems with the proposal and preserve access to investment advice. These key problems include:

1. <u>Do Not Treat the Advisor's Own Engagement as Fiduciary Advice</u>.

The tension in the proposal between permitting routine sales activity and subjecting investment recommendations to a best interest standard is evident throughout the rule. As proposed, the rule attempts to address this sales dilemma through several disparate avenues, including the creation of a limited seller's carve-out, a platform provider carve-out that would be of limited use and an extremely confusing provision in the BIC Exemption that permits investment advice to be provided only with respect to a "limited range of investment options". None of these avenues alone or together solves the problem. As described above and in Attachment A, the dilemma can be resolved through a new paradigm that clearly separates compensation and other conflicted aspects of establishing the investor-advisor relationship from the actual investment recommendation. That way the investor can agree to the framework through which advice will be provided outside the fiduciary context and receive advice subject to a best interest standard within that agreed-upon framework. This paradigm is consistent with the historical treatment of the fiduciary relationship in other fields of law, and would avoid the complex problems created by the proposal's current approach.

2. <u>Eliminate the Written Contract Requirement</u>.

The ultimate objective of the regulatory effort is to ensure that investment advice is provided in the best interest of the investor. Fiduciary status under ERISA creates an enforceable best interest standard by operation of law. However, in the case of IRAs not subject to ERISA, no substantive standard of conduct applies under the Code. To hold all fiduciaries accountable to the best interest standard, both the BIC Exemption and the Principal Transactions

Exemption would require a written contract between the individual Adviser, the Financial Institution and the Retirement Investor.

This written contract requirement is extremely burdensome, costly and in some cases unworkable. It requires separate written contracts between thousands of different individual representatives with millions of plan participants and IRA owners, along with recordkeeping systems accessible to representatives in all channels to determine whether a written contract was signed. Contracts would need to be signed at the initiation of any interaction where investments or distributions are discussed, including discussions with prospects who are merely inquiring about services that may be offered. It also introduces a written contract between plan service providers and participants where there is otherwise no contractual relationship.

A best interest standard is legally imposed and enforceable under Title I of ERISA so that a contract is unnecessary for plans and participants in any event. With respect to IRAs, we believe that an enforceable best interest standard can be established by much less onerous means – a unilateral contract offer by the financial services firm, reflecting the scope of the advisory relationship and the fees to be charged, which would be enforceable as a contract or through the doctrine of promissory estoppel. There is no need to require a signed, written document nor must the individual representatives be involved. Attachment C provides a more detailed legal analysis of this approach. In short, the class exemption should require legal enforceability, but allow reasonable flexibility with respect to the manner in which the commitment is documented.

3. Simplify and Improve Disclosure.

A key component of the exemptions is full and meaningful disclosure of all material conflicts of interest, including compensation payable to the advisor. The BIC Exemption contemplates a three-tiered approach involving a point-of-sale disclosure of the projected cost of recommended investments, an annual statement summarizing in dollar amounts the compensation actually paid to the advisor during the preceding year and a publicly available website listing every investment the advisor might recommend and the compensation associated with each. In addition, the contract includes warranties requiring disclosure of material conflicts, including fees payable to the financial institution. While we fully support meaningful disclosure of cost, compensation and material conflicts, the manner in which they are disclosed is critically important to both the usefulness of the information to the investor and workability from the perspective of the financial services firm.

We believe a simpler two-tiered approach would make the disclosure regime both workable and more meaningful to investors. The first tier would be a "static" disclosure that would explain the scope of the financial institution's services, describe its conflicts of interest (including potentially different compensation based on the investments recommended and selected by the investor), and include a link to a website. This website is the second tier and would enable the investor to obtain more detailed information about the cost and compensation associated with all products and services offered. The website could also allow the investor to estimate costs and compensation over time based on assumptions input by the investor about the amount to be invested, projected returns, etc. Under this two-tiered approach, the critical information required by the BIC Exemption is provided but in a format that is more meaningful for the investor and more workable for the financial institution.

In the context of our new best interest paradigm, this disclosure would be made in establishing or changing the terms and conditions of the advice relationship. It could also accompany, or be a component of, a unilateral contract that includes a commitment by the advisor to act in the investor's best interest and constitute agreement to the reasonable compensation to be paid to the advisor, thus meeting the best interest contract requirement contemplated by the BIC Exemption.

4. Give Small Plan Sponsors Access to Advice.

The proposal leaves the vast majority of small plans with no access to advice services when the advisor's compensation depends in any way on the plan's investments. The seller's carve-out is only available to plans with more than 100 participants or $100 million in assets, and the BIC Exemption does not apply to participant-directed plans of any size. The platform provider carve-out is simply insufficient to provide meaningful assistance on its own. Failing to permit investment advice by the financial services firms that are involved in providing investment and recordkeeping services to these plans will stifle plan formation in the very market segment where the lack of plan coverage is the biggest impediment to retirement savings for millions of American workers. The new best interest paradigm outlined above avoids this problem by creating a single exemption that would cover advice to plans of any size as well as individuals.

5. Preserve the Ability to Identify Investment Funds as Education.

The carve-out for investment education under the Proposed Regulation would be a significant step back from current law under Interpretive Bulletin 96-1 ("Bulletin") because it makes the identification of specific investment alternatives in connection with a model asset allocation fiduciary-level investment advice. We believe that without identifying investment alternatives, the asset allocation discussion permitted under the education carve-out is largely an exercise in investment theory and it is not concrete enough to be useful for most individuals.

When the Bulletin was adopted, the Department understood the potential conflict of interest that could arise in identifying investment alternatives but felt that participants' need for this information (with certain disclosures) outweighed the potential conflict. We do not believe that almost twenty years of experience under the Bulletin suggests any reason to change the balance struck between protecting against conflicts and meeting participants' needs for more specific information. This is particularly true in the plan context where the plan sponsor or another independent fiduciary has usually selected the available investment funds.

We recommend preserving the ability to identify specific investment funds within the education carve-out. To the extent the Department has identified abuses under IB 96-1, those could be addressed by requiring identification of several funds, if available, rather than a single fund.

6. Extend the Effective Date.

The eight month "applicability date" is grossly insufficient to implement a regulatory change of this magnitude. The time required will obviously depend on the complexity of the final rule. If finalized as proposed, we believe that a minimum of three years would be necessary to implement the rule.

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We would be pleased to respond to any questions or comments regarding this submission, including the points covered in the Attachments.

Sincerely,

Ralph C. Derbyshire

cc: **United States Securities and Exchange Commission**
The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

Financial Industry Regulatory Authority
Mr. Richard Ketchum, Chairman and Chief Executive Officer, FINRA
Mr. Robert Colby, Chief Legal Officer, FINRA

Treasury Department
J. Mark Iwry, Deputy Assistant Secretary for Retirement and Health Policy

National Economic Council
Jeffrey Zients, Director
Elizabeth A. Kelly, Senior Policy Advisor

Attachment A
A New Best Interest Paradigm

Much of the length and complexity of the proposal derives from the overly broad definition of investment advice and the limitations and conditions of the exemptions. Since the new best interest paradigm suggested in the body of this letter directly addresses these two foundational problems, it would greatly simplify both the Proposed Regulation and the proposed exemptions. This Attachment A outlines the paradigm in more detail and suggests language for the Proposed Regulation and BIC Exemption that could be used to implement this new paradigm.[4]

Narrowing the Definition of Advice

The broad definition of investment advice under the Proposed Regulation does not distinguish between an advisor's discussion and sale of its own services and the advisor's actual recommendation of investment products and services. The rule therefore treats the advisor as a fiduciary with respect to its own services and compensation, in some cases before a fiduciary relationship even exists. This would be the case both for advisors with transaction-based compensation and advisors selling fee-based advisory services. That approach is both unprecedented in fiduciary law and not commercially viable, potentially requiring an advisor to recommend its competitors over itself even if its own services are wholly appropriate for the investor.

The Proposed Regulation deals with this problem in part through a limited seller's carve-out for "expert plan investors".[5] We fully support the notion of a seller's carve-out for true sales activity and suggest that it should be applied to all investors (see comments in Attachment B). However, the seller's carve-out does not address the problem of a fiduciary advisor selling its own products and services because it is an "all or nothing" approach. When it applies under the Proposed Regulation, neither the advisor's negotiation and sale of its own services and compensation, nor the advisor's actual investment recommendations would be held to a fiduciary standard. Because the best interest standard does not apply to the actual investment recommendation when the carve-out applies, the carve-out defeats the purpose of the rule. Thus, the Department's proposal either imposes a fiduciary duty on the sale of an advisor's own services (where it does not belong) or removes a fiduciary standard with respect to an investment recommendation (where it does). We refer to this as the "sales dilemma" that is created by the proposal.

The sales dilemma is not limited to transaction-based compensation like that typically payable to a broker-dealer. The Proposed Regulation broadly defines fiduciary investment

[4] Note that with respect to the provisions of the Proposed Regulation and proposed exemptions that are not covered in this Attachment A, the Department should make the modifications/clarifications recommended in Attachments B and C.

[5] In addition to the seller's carve-out, the Proposed Regulation also includes a platform provider carve-out that is essentially a seller's carve-out with respect to a specific type of investment offering for employee benefit plans.

advice to include a recommendation of an investment advisor or manager.[6] Under the Department's historical view, the compensation received by the advisor or manager for its services is treated as being in exchange for the recommendation. At the point of the recommendation, all such compensation – even if it were formulated as a fixed dollar amount that does not vary based upon the advice or investment management services to be provided – would vary based on the recommendation to hire the advice provider or investment manager, since the compensation would be paid only if the recommendation was adopted and the advisor or manager was hired. ERISA prohibits a fiduciary from using its authority or control as a fiduciary to cause itself to be paid an additional fee or other compensation. Accordingly, under the Department's proposal, all investment advisors and managers in the process of selling their own services would be engaging in a prohibited self-dealing transaction. It is hard to believe that the Department intended this result.

A conceptually simple and straightforward solution to the sales dilemma is to separate the terms of engagement of the advisor – that is, the otherwise conflicted components of the transaction – from the underlying investment recommendation. The framework for engaging the advisor is agreed to by the investor after full disclosure which permits that framework to be established outside of the fiduciary relationship. However, once that fiduciary relationship is established, all recommendations within the framework must be in the investor's best interest.

An advisor's engagement has two main components: (i) the scope and nature of the advisor's services, and (ii) the advisor's compensation. The first component could include agreement about the scope of the advice to be provided (such as one-time recommendations versus continuous advice over time), restrictions on the investments taken into account when providing advice (such as limitations to proprietary products, products that generate revenue sharing, or investments that are available in a plan's fund lineup), and other terms and conditions of the engagement, including the potential disclosure of, and the client's consent to, the existence of any potential conflicts of interest in the advisor's business model. The second component would include the amount of compensation payable to the advisor in connection with an investment recommendation or range of recommendations. As is common in the investment advisor sphere today, these terms of the engagement would be established at the initiation of the advisory relationship, and could be amended with consent of the client from time to time throughout the relationship, including on a transaction-by-transaction basis.

The BIC Exemption hints at this solution in the "Limited Range of Investment Options" provision in Section IV(b) of the BIC Exemption. The specific limitations contemplated by Section IV(b) of the BIC Exemption include the ability to restrict recommendations to proprietary products or products that generate revenue sharing. Section IV(b) also includes the requirement that the financial institution make a written finding that these limitations will not prevent it from acting in the best interest of the investor. However, that best interest standard requires that the advice be rendered *without regard* to the financial interests of the advisor. How can that requirement be met when the very limitation is based on the advisor's financial

[6] The preamble to the Proposed Regulation characterizes this as a clarification of existing law, but the current regulatory definition in effect only refers to recommendations with respect to securities or other assets. It is important that the Department correct the preamble characterization to avoid any possibility of retroactive fiduciary or prohibited transaction exposure for activity that is non-fiduciary in nature under current law.

interests? The only way to make sense of this provision is to assume that the structuring of the limitation itself is not subject to the best interest standard. While Section IV(b) applies this concept only with respect to the range of Assets that may be recommended, there is no reason this concept should not extend to other aspects of the relationship that can give rise to potential conflicts.

This engagement concept is also analogous to a long-standing regulation of the Department (adopted in 1977) addressing application of the exemption under ERISA section 408(b)(2) for payment of service providers. An example from this regulation is instructive:

> E, an employer whose employees are covered by plan P, is a fiduciary with respect to P. A, who is not a party in interest with respect to P, persuades E that the plan needs the services of a professional investment adviser and that A should be hired to provide the investment advice. Accordingly, E causes P to hire A to provide investment advice of the type which makes A a fiduciary under § 2510.3-21(c)(1)(ii)(B). Prior to the expiration of A's first contract with P, A persuades E to cause P to renew A's contract with P to provide the same services for additional fees in view of the increased costs in providing such services. During the period of A's second contract, A provides additional investment advice services for which no additional charge is made. Prior to the expiration of A's second contract, A persuades E to cause P to renew his contract for additional fees in view of the additional services A is providing. A has not engaged in an act described in section 406(b)(1) of the Act, because A has not used any of the authority, control or responsibility which makes A a fiduciary (the provision of investment advice) to cause the plan to pay additional fees for A's services.[7]

In this example, the advisor is not just informing the plan fiduciary about these terms but *persuades* the fiduciary to extend the contract at a higher fee. So clearly the advisor is selling investment advice services at a point in time when the advisor is in fact already a fiduciary with respect to investment recommendations. However, there is no prohibited transaction because the advisor is not *causing* the plan to pay an additional fee. This can only be true if the terms of the engagement of the advisor are outside the scope of the fiduciary relationship.

This paradigm is also consistent with the determination of “independent control” under the Department’s regulation under ERISA section 404(c). Section 404(c) relieves a plan fiduciary from responsibility and liability for a participant’s investment decisions so long as the participant has sufficient information and is offered sufficient breadth of investment options to exercise independent control over his or her investments. The regulation provides that a participant’s exercise of control is not independent if the participant is subjected to “improper influence” by a plan fiduciary, or if the fiduciary has concealed material non-public facts regarding the investment or accepts instructions from the participant knowing him or her to be legally incompetent. The preamble makes clear that disclosure of material terms, including any material conflicts of the fiduciary, will avoid improper influence and concealment and, together

[7] DOL Reg. § 2550.408b-2(f), *Example 4*.

with fair and reasonable transaction terms, will result in the participant exercising independent control.[8]

The concept of separating the terms of engagement from the actual investment recommendation is entirely consistent with how many advisers, including fee-based investment advisors, negotiate their compensation today; the terms and fees associated with the relationship, along with any potential conflicts of interest embedded in those arrangements, are fully disclosed at the outset of the relationship with the client. At this point, the client has the opportunity to evaluate that fee structure and associated conflicts *before* deciding to enter into a fiduciary relationship with the adviser. Indeed, the seminal case articulating the scope of an investment adviser's fiduciary duty, *SEC v. Capital Gains Research Bureau*[9], makes clear that a potential client could agree to enter into a fiduciary relationship with an adviser whose business model included certain potential conflicts, so long as those conflicts were fairly and adequately disclosed to the client before the client agreed to engage the adviser as a fiduciary. Once so established, the advisor provides fiduciary advice within the agreed-upon framework.

There is no principled reason why this concept should not also apply in situations where the advisor's compensation varies based on the transactions and services recommended by the advisor. Whether its compensation is transaction-based or fee-based, the advisor should be free to determine the terms of its engagement and, accompanied by appropriate disclosure, persuade the investor that it should enter into an advice relationship under those terms and conditions. That activity is simply not fiduciary in nature.

Once the terms and conditions of the fiduciary relationship are established, recommendations by the advisor must be in the investor's best interest within the framework. The definition of "Best Interest" could remain as proposed by the Department, including the requirement that advice be provided "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party." This would not impinge on the parties' ability to agree to the advisor's compensation or other terms of engagement that would affect the advisor's compensation because establishing the framework for engaging the advisor is not itself fiduciary conduct subject to the best interest standard. For example, following full and fair disclosure, the advisor and investor could agree that its investment advice will be limited to proprietary funds. As this would be a term and condition of

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[8] Preamble to Final Regulation Regarding Participant Directed Individual Account Plans (ERISA 404(c) plans), footnote 25, quoting the Restatement (Second) of Trusts section 216 (1959):

> "(1) Except as stated in Subsections (2) and (3), a beneficiary cannot hold the trustee liable for omission of the trustee as a breach of trust if the beneficiary prior to or at the time of the act or omission consented to it.
> (2) The consent of the beneficiary does not preclude him from holding the trustee liable for a breach of trust, if – (a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or (b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee did not reasonably believe that the beneficiary knew; or (c) the consent of the beneficiary was induced by improper conduct of the trustee.
> (3) Where the trustee has an adverse interest in the transaction, the consent of the beneficiary does not preclude him from holding the trustee liable for a breach of trust not only under the circumstances stated in Subsection (2), but also if the transaction to which the beneficiary consented involved a bargain which was not fair and reasonable."

[9] 375 U.S. 180 (1963).

the agreed-upon advice relationship, the advisor's subsequent recommendation of a proprietary fund on that basis (assuming the recommended fund is otherwise in the investor's best interest) would not violate the best interest requirement that the advice be "without regard to" the advisor's compensation or other financial interests.

At the same time, the general obligations of a fiduciary would still prevent a recommendation by the advisor of an investment within the framework that is not appropriate for the investor. The notion of establishing the framework for the relationship outside of the fiduciary context is similar to the trust law notion that has historically permitted beneficiaries to waive conflicts of interest and permit a trustee to engage in acts of self-dealing. However, it is well-settled that "no matter how broad the provisions of a trust may be in conferring power to engage in self-dealing or other transactions involving a conflict of fiduciary and personal interests, a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly."[10] Similarly, a trustee is not exonerated "for a breach of trust committed in bad faith or with indifference to the fiduciary duties of the trustee, the terms or purposes of the trust, or the interests of the beneficiaries."[11] The framework allows the investor to waive the inherent conflict where the fiduciary structures the terms and conditions of its engagement without providing the fiduciary free license to recommend products and services that are clearly inappropriate.[12]

This concept of a baseline fairness test for investors runs throughout the laws otherwise applicable to regulated financial services providers, which laws themselves form an important additional layer of protection for investors – often in circumstances where there is no explicit fiduciary relationship. With respect to broker-dealers, the Securities and Exchange Commission ("SEC") states:

> Under the antifraud provisions of the federal securities laws and SRO [self-regulatory organization] rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers. While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, Commission and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent."[13]

In fact, these rules go far beyond the general trust standard of bad faith or unfairness. For example, FINRA Rule 2010 requires: "A member, in the conduct of its business, shall observe

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[10] Restatement (Third) of Trusts § 78 cmt. c(2) (2007).

[11] Restatement (Third) of Trusts § 96(1)(a) (2007).

[12] *See* Sitkoff, *An Economic Theory of Fiduciary Law* (2014) at 10-12 (discussing the concept of *mandatory rules* in fiduciary law that cannot be overridden by agreement) (published in Gold and Miller, *Philisophical Foundations of Fiduciary Law* (2014) at 197 and available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Sitkoff_769.pdf).

[13] *Study on Investment Advisers and Broker-Dealers, as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, a study by the Staff of the U.S. Securities and Exchange Commission, January 2011, at iv.

high standards of commercial honor and just and equitable principles of trade."[14] Similar principles apply under the Investment Advisers Act,[15] under insurance solicitation regulations,[16] and under regulatory guidance applicable to banks advising retail customers in a non-broker-dealer capacity.[17] The framework we propose thus would allow the advisor and investor to structure the terms of the advisor's engagement but would not allow the advisor to recommend products and services that are inappropriate for the investor.

Our proposed paradigm solves the sales dilemma because, within the terms of the engagement, the actual investment recommendation must still be in the investor's best interest. However, the overall framework for the engagement, including compensation payable to the advisor, can be freely negotiated. This approach accomplishes the objectives of the Department's proposal, including preserving freedom of choice.

Moreover, the fact that all advisors must disclose and obtain consent of the investor to the terms and conditions of engagement as a condition of excluding those terms and conditions from the scope of their fiduciary responsibility should result in much better understanding by investors about the nature of the advice they receive. Under this new paradigm, all advisors must be clear about their business model, compensation and potential conflicts as a condition of excluding other products and services from the scope of their best interest obligation. Every investor will better understand the scope and context of the advice received and an advisor may provide only investment recommendations that are in the investor's best interest within that framework notwithstanding the fact that the advisor may receive variable compensation in connection with those recommendations.

> *<u>Modification to Proposed Regulation</u>: Our new best interest paradigm would provide that the establishment of the terms of engagement between the advisor and investor is non-fiduciary in nature by modifying section 2510.3-21(c) of the Proposed Regulation as follows:*
>
> *(c) Scope of fiduciary duty—investment advice.*
>
> *(1) A person who is a fiduciary with respect to an employee benefit plan or IRA by reason of rendering investment advice (as defined in paragraph (a) of this section) for a fee or other compensation, direct or indirect, with respect to any securities or other property of such plan, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary with respect to :*
>
> *(i) the terms and conditions of engagement of the person, including the scope of the obligation to provide advice, the products or services with*

[14] FINRA Manual, Rule 2010. Standards of Commercial Honor and Principles of Trade.
[15] *See generally* Investment Advisors Act Release No. 1406 (March 16, 1994).
[16] *See generally* National Association of Insurance Commissions (NAIC) Annuities/Variable Contracts Suitability in Annuity Transactions Model Regulation and NAIC Annuities/Variable Contracts Disclosure Model Regulation, applying suitability rules to transactions involving IRAs.
[17] *See generally* OCC Bulletin 2015-2, Revised Comptroller's Handbook Booklet and Rescissions on "Retail Nondeposit Investment Products".

respect to which advice is provided and the compensation payable to the person, provided the plan fiduciary, participant or beneficiary, or IRA owner has consented to the terms and conditions of the engagement after disclosure of all material aspects of such terms and conditions, including potential conflicts of interest; or

(ii) any assets of the plan or IRA with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (a)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice.

(2) Nothing in this paragraph shall be deemed to:

(i) exempt such person from the provisions of section 405(a) of the Act concerning liability for fiduciary breaches by other fiduciaries with respect to any assets of the plan; or

(ii) exclude such person from the definition of the term "party in interest" (as set forth in section 3(14)(B) of the Act or "disqualified person" as set forth in section 4975(e)(2) of the Code) with respect to a plan.

Broadening the Exemptions

To the extent that an advisor's compensation varies with the investments it recommends within the terms and conditions of the engagement, exemptive relief is necessary because a potential prohibited transaction arises. The Department's proposal includes two new exemptions – the BIC Exemption and the Principal Transactions Exemption – and amendments to numerous existing exemptions. The problem with this approach is that the new exemptions are laden with complex limitations and conditions which narrow both their scope and practicality and make them unworkable. This is contrary to the stated intent of the Department:

> The Department has also sought to preserve beneficial business models for delivery of investment advice by separately proposing new exemptions from ERISA's prohibited transaction rules that would broadly permit firms to continue common fee and compensation practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers. [18]

[18] 80 FR 21929 (April 20, 2015). The Department also notes that the BIC Exemption "was developed to promote the provision of investment advice that is in the best interest of retail investors such as plan participants and beneficiaries, IRA owners, and small plans" and "[r]ather than create a set of highly prescriptive transaction-specific exemptions, which has generally been the regulatory approach to date, the proposed exemption would flexibly accommodate a wide range of current business practices, while minimizing the harmful impact of conflicts of interest on the quality of advice." 80 FR 21960 (April 20, 2015).

Most of these problems can be solved by adhering to the Department's stated intention to take a broad, principles-based approach to exemptions for regulated financial institutions that act in the investor's best interest.

We therefore propose a single exemption containing the three key requirements:

- a legally enforceable commitment to act in the best interest of the investor;
- a requirement that compensation be reasonable in light of the services provided; and
- disclosure of material conflicts, including compensation payable to the financial institution.

No further limitations or conditions on the exemption are needed to accomplish the Department's goals.

Indeed, the Department follows precisely this approach through the "Standards of Impartial Conduct" that are proposed as amendments to several existing exemptions in other parts of the rule proposal. For example, the Department proposed this straightforward approach in the amendments to PTE 77-4 which allows a discretionary manager to invest in its own proprietary mutual funds – often cited as one of the most conflicted transactions for an advisor. If this simple approach is sufficiently protective of the interests of plans, participants and IRA owners in the context of a discretionary investment manager, it is certainly sufficient in the context of nondiscretionary advice.

We believe that the first requirement – a legally enforceable commitment – would be satisfied through the unilateral best interest contract described in the main body of our letter and in Attachment C. The remaining two requirements would be satisfied through simple, two-tiered disclosure that would be both workable for firms and more useful for investors. The first tier would be a "static" disclosure provided at the time recommendations are made. This disclosure would explain the scope of the financial institution's services, describe its potential conflicts of interest, including that it may receive different compensation based on the investments recommended and selected by the investor, and include a link to a website where more detailed information about the cost and compensation associated with the products and services is available. This website would act as the second tier of disclosure, and would enable the investor to obtain specific information about the cost and compensation associated with all products and services offered at the firm in a format that will allow the investor to make comparisons across investments. The website could also allow the investor to estimate costs and compensation over time for specific products based on assumptions input by the investor about the amount to be invested, projected returns, etc. All of this information could also be made available in writing upon request.[19]

[19] The Department has repeatedly cited so-called "robo-advisers" as a means of providing advice to plan sponsors, participants and IRA owners in a manner that meets the Department's objectives. If a computer-based approach can satisfy the Department's goals with respect to an entire advice transaction, it should be reasonable and appropriate for an advisor to disclose its potential conflicts of interest electronically.

<u>Modifications to the BIC Exemption</u>: Our new best interest paradigm would simplify the BIC Exemption to be consistent with the Standards of Impartial Conduct approach proposed by the Department with respect to PTE 77-4 and other existing exemptions by making the following modifications:

- *Section I would be modified to cover all transactions and related compensation, including principal transactions and purchases of insurance contracts.*
- *Section II would be modified to read as follows:*

    Section II—Standards of Impartial Conduct.

    If the fiduciary is a fiduciary within the meaning of ERISA section 3(21)(A)(i) or (ii), or Code section 4975(e)(3)(A), or (B), with respect to the assets of a plan or IRA involved in the transaction, the fiduciary must comply with the following conditions with respect to the transaction:

        (a) The fiduciary is subject to a legally binding commitment to provide advice that is in the best interest of the plan or IRA.

        (b) All compensation received by the fiduciary and its Affiliates in connection with the transaction is reasonable in relation to the total services the fiduciary and its affiliates provide to the plan or IRA.

        (c) The fiduciary's statements about recommended investments, fees, Material Conflicts of Interest, and any other matters relevant to a plan's or IRA owner's investment decisions, are not misleading.

- *Advisors as a practical matter would have to meet the requirements of Section II(d) and (e) as proposed but those requirements should not be independent conditions of the prohibited transaction exemption. Section II(f) could be preserved as a limitation on the legally binding commitment set forth in (a) above.*
- *Section III would be replaced with the two-tier disclosure approach described above.*
- *Section IV relating to the "Range of Investment Options" would be unnecessary because every advisor would need to establish this through the terms and conditions of its engagement in order to define the scope of its fiduciary responsibility under the definition of advice. Alternatively, the provisions of Article IV could be reframed as specific disclosures required to be made with respect to the advisor's engagement.*
- *Sections V and IX should be omitted for the reasons set forth in Attachment C.*
- *Section VI should be omitted as unnecessary.*

Summary

In practice, this new best interest paradigm would be workable for financial institutions and meaningful for and protective of plans, participants and IRA owners. Before it begins making investment recommendations, the advisor would provide the two-tiered disclosure described above to the investor. The two-tiered disclosure would explain the scope of the financial institution's services, describe its conflicts of interest (including that it may receive different compensation based on the investments recommended and selected by the investor), and include a link to a website where more detailed information about the cost and compensation associated with the products and services is available.

Accompanying the disclosure would be a unilateral contract pursuant to which the advisor would agree to recommend only investments within the agreed-upon advice relationship that are in the best interest of the investor. The unilateral contract could also incorporate the reasonable compensation of the financial institution and other terms and conditions of the advice relationship as disclosed through the two-tiered approach described above. The unilateral contract would bind the advisor and provide a private right of action for the investor without the need for a signed written contract by the parties, which would be unreasonably burdensome to obtain.

Once the above disclosures have been made and the unilateral contract established, all recommendations of the advisor within the agreed-upon advice relationship would be made in the best interest of the investor. Any prohibited transaction resulting from variations in compensation associated with the advisor's best interest recommendations would be within the modified BIC Exemption by reason of the foregoing disclosures and unilateral contract. If the parties' advice relationship evolves over time, any amendments to the terms of the engagement, including on a transaction-by-transaction basis, would be accomplished through the same disclosures and unilateral contracting process.

Attachment B
Comments on Proposed Regulation

The definition of investment advice under the Proposed Regulation encompasses virtually any communication "specifically directed to" the investor that could reasonably be viewed as a suggestion to take (or refrain from taking) a specific course of action in making investment decisions. It includes specific recommendations to buy, sell, hold or manage securities or other property, recommendations relating to rollovers and distributions, and recommendations to hire persons who will provide investment advice or management. The advice must be "in exchange for a fee or other compensation." However, the Department has made clear that it interprets this requirement so broadly that it is satisfied if the advisor or any of its affiliates receives any compensation from any source in connection with the advice transaction. The proposed definition requires no particular level of reliance by the investor, nor any meeting of the minds betwee n the advisor and the investor as to the fiduciary nature of the advice.

The expansive scope of activities encompassed under this definition goes beyond any previous definition of investment advice made subject to a fiduciary standard under federal or state law, and it will have significant negative consequences for both investors and financial services firms unless important modifications and clarifications are made. Fidelity believes that it acts in the best interest of its customers and is willing to be legally accountable to that standard when it provides investment advice. However, in order for that standard to work in practice it must be applied in a way that allows providers to offer the guidance that plan sponsors, participants and IRA investors need to save and invest for retirement. As currently structured, the Proposed Regulation is inappropriately expansive and, together with limitations and conditions under the proposed exemptions on which we comment in Attachment C, will greatly inhibit the provision of investment assistance and limit choice for retirement investors.

Accordingly, we urge the Department to adopt the new best interest paradigm described in the main body of this letter and in Attachment A. In addition, following are the key changes that we urge the Department to make to the Proposed Regulation many of which are inherent in the paradigm we propose:

1. <u>Require a Reasonable Level of Reliance by the Investor</u>.

The Proposed Regulation would subject investment assistance to a fiduciary standard even where there is no expectation of reliance on the advice or advisor by the investor and no understanding or expectation on the part of the investor that such assistance is unbiased and is in his or her best interest. Rather, there need only be an understanding that the advice "is specifically directed to the advice recipient for consideration in making investment or management decisions…." Nor does the Proposed Regulation provide any way for an advisor and an individual to avoid a fiduciary relationship, even if the parties were to enter into an express agreement to the contrary. For example, the Proposed Regulation would subject an explicit sales pitch by a broker-dealer to an IRA owner to fiduciary status, even if both the advisor and the IRA owner agreed that such communication was not intended to be unbiased advice in the IRA owner's best interest.

Such an all-encompassing definition goes beyond traditional and well-established principles of fiduciary law. Under common law, a fiduciary duty may arise when "either one of the parties, in entering [a] transaction, expressly reposes a trust and confidence in the other or because of the circumstances of the case, the nature of their dealings, or their position towards each other, such a trust and confidence is necessarily implied."[20] The Proposed Regulation would impose a fiduciary duty even where the investor does not expressly or impliedly place trust and confidence in the advisor by relying on the advice as being unbiased and in the investor's best interest.

The Department should align the Proposed Regulation with long-standing principles of fiduciary law by requiring a reasonable expectation of reliance by the advice recipient. The Department could accomplish this, for example, by modifying the definition of investment advice to require that, based on the content, context and presentation of such advice, it is reasonable for the advice recipient to rely on such advice as being unbiased and in the recipient's best interest with respect to such recipient's investment or management decisions. This requirement is already effectively included in the definition to the extent that the definition treats all investment advice as fiduciary in nature where the investment advice provider states that it is acting as a fiduciary within the meaning of ERISA. Such a statement would render it reasonable for an advice recipient to rely on the advice as being unbiased and in the recipient's best interest. But, as currently proposed, there is no corollary to this rule that would treat conduct as non-fiduciary in nature even where there is an express understanding that a fiduciary relationship is not intended.

2. <u>Expand the Seller's Carve-Out.</u>

If reliance is made a component of the definition of investment advice as described above, there is no need for a seller's carve-out because it would be clear from the context that there is no expectation that the seller is providing unbiased advice. However, if the Department does not introduce the component of reliance, it needs to rethink the approach taken to address the problem the Proposed Regulation creates for any advisor selling investment products or services. The problem is that statements made in the sales context will almost always constitute investment advice under the proposal's current formulation because they are directed to a person and intended to encourage the purchase of a particular product or service.

The Department recognizes this problem and creates a seller's carve-out so that the rule "appropriately distinguishes incidental advice as part of an arm's length transaction with no expectation of trust or acting in the customer's best interest, from those instances of advice where investors may be expecting unbiased investment advice that is in their best interest." However, the seller's carve-out does not apply to either small plans or individuals. Other aspects of the proposal attempt to address the seller's problem inherent in other contexts, including the carve-out for platform providers and the BIC Exemption provision that allows investment advice to be provided for a limited range of investment options such as proprietary-only products.

[20] See *United Jersey Bank v. Kensey,* 306 N.J.Super. 540, 551, 704 A.2d 38 (App.Div.1997), citing *Berman v. Gurwicz,* 189 N.J.Super. 89, 93, 458 A.2d 1311 (Ch.Div.1981)(internal ellipses omitted).

As an initial matter, we note there is ambiguity as to whether the proposed seller's carve-out covers certain services such as fee-based advisory and managed account services when sold to plan sponsors. The Department should clarify that the seller's carve-out is available for all investment products and services where a recommendation with respect to that product or service would otherwise constitute investment advice.

As proposed, the seller's carve-out only applies to certain arm's length transactions with an "expert plan investor." The Department has proposed to use the plan's size, either in terms of participants or assets, as a proxy for expert plan investor status. As a result, the proposed seller's carve-out is effectively available only with respect to transactions involving large plan sponsors. As the basis for this narrow approach, the Department states that "[r]esearch has shown that disclaimers are ineffective in alerting retail investors to the potential costs imposed by conflicts of interest, of the fact that advice is not necessarily in their best interest, and may even exacerbate these costs."

We disagree that the disclosures proposed by the Department – i.e., fairly informing the counterparty of either the existence and nature of the seller's financial interests in the transaction or that the seller is not undertaking to provide impartial investment advice or act as a fiduciary – would not be effective with respect to investors other than large plan sponsors. The conclusion that retail investors are incapable of understanding this disclosure is contradicted by the prominent role that disclosures play under the BIC Exemption which is largely intended for use in connection with transactions involving individuals. Nor are long-standing, well-settled principles of fiduciary law consistent with such an assumption, as they do not impose fiduciary status on a person unless there is express or implied trust and reliance on the person by the investor and they clearly recognize and permit the need for beneficiaries to waive fully and fairly disclosed self-dealing conflicts.[21] While financial products and services may be complex, understanding the dynamics of a sales transaction is fundamental to the commercial activity that is part of everyone's daily life and the ability to waive fully and fairly disclosed conflicts is essential to the establishment and proper functioning of fiduciary relationships.

In addition, the assumption that individuals cannot understand the difference between impartial advice and statements made in connection with sales is inconsistent with Congress' own determination on that issue in enacting ERISA section 404(c). Section 404(c) relieves a plan fiduciary from responsibility and liability for a participant's investment decisions so long as the participant has sufficient information and breadth of investment options to exercise control over his or her investments. Where a participant has maximum investment choice and the opportunity to obtain investment information from any source, such as in a brokerage window, the participant necessarily must make decisions about whether the investment information on which he or she bases investment decisions is educational, part of a sales communication, or provided as fiduciary advice. Congress must have contemplated in enacting section 404(c) that participants were capable of assessing those decisions or it would not have relieved the plan's fiduciary from liability when those decisions were being made by the participant. The Department, however, has essentially structured the Proposed Regulation to impose on the

[21] See discussion at FN 10-12 supra.

investment advisor the same fiduciary responsibility for these assessments that Congress determined not to impose on the plan fiduciary itself. Fixing the seller's carve-out or imposing a reliance requirement under the fiduciary definition would eliminate this inconsistency and align the rule with the judgment Congress made in enacting section 404(c). However, we believe the new best interest paradigm outlined in the main body of this letter and in Attachment A is the best manner in which to accomplish this alignment.

3. Preserve the Ability to Identify Investment Funds as Education.

The carve-out for investment education under the Proposed Regulation would be a significant step back from current law under Interpretive Bulletin 96-1[22] ("Bulletin") because it makes the identification of specific investment funds in connection with a model asset allocation fiduciary-level investment advice. We believe that without identifying investment funds, the asset allocation discussion permitted under the education carve-out is largely an exercise in investment theory and it is not concrete enough to be useful for most individuals. Further, in the plan context, participants and beneficiaries have received communications that describe the asset class of each investment option. For example, the comparative chart required under the participant disclosure regulations under ERISA section 404(a) must include the type or category of each investment option listed.[23] Requiring the participant to refer to these other communications to connect the dots is simply counterproductive.

In proposing this change, the Department appears to rely on "those commenters to the 2010 Proposed Regulation who argued that cautionary disclosures to participants, beneficiaries and IRA owners may have limited effectiveness in alerting them to the merit and wisdom of evaluating investment alternatives not used in the model." The Department also states in conclusory fashion that "[i]n practice, asset allocation models concerning hypothetical individuals, and interactive materials which arrive at specific investment products and plan alternatives, can be indistinguishable to the average retirement investor from individualized recommendations, regardless of caveats." Accordingly, this dramatic curtailment of the Bulletin appears to be based solely on the opinions of certain prior commenters and the Department. It does not appear to be based on empirical evidence or any record of abuse by retirement educators.

When the Bulletin was adopted, the Department understood the potential conflict of interest that could arise in identifying investment funds but felt that participants' need for this information (with certain disclosures) outweighed the potential conflict. We do not believe that almost twenty years of experience under the Bulletin suggests any reason to change the balance struck between protecting against conflicts and meeting participants' needs for more specific information. Therefore, we recommend preserving the ability to identify specific investment funds within the education carve-out. To the extent the Department has identified abuses under the Bulletin, those could perhaps be addressed by requiring identification of several funds within the asset allocation category, if available, rather than just a single fund.

[22] DOL reg. § 2509.96-1.
[23] DOL reg. § 2550.404a-5(d)(1)(i)(B).

We also request clarification of the application of the Proposed Regulation's revised education carve-out to any discussion about the suitability of an investment option for a specific purpose. Under the Proposed Regulation, informing eligible employees or participants of the benefit of a plan's qualified default investment alternative or other default could be viewed as a recommendation. To the extent that such investments have been selected by the plan's fiduciary as the investment alternative that will apply absent other participant direction, however, it does not seem appropriate that such information be treated as a recommendation by an advisor other than the plan's fiduciary. For this reason, the Proposed Regulation should be clarified to provide that reference to specific investment alternatives under these circumstances constitutes education and not fiduciary advice.

Finally, we note that the preamble to the Proposed Regulation states that its education carve-out "incorporates much of [the Bulletin's] operative text, but with … important [identified] exceptions". The Proposed Regulation appears to condition applicability of the education carve-out to plan information materials and communications on there being no "reference to … a particular participant or beneficiary or IRA owner…". However, the Bulletin itself does not contain this condition and it is not called out in the preamble as an important exception. Therefore, it is unclear whether this language is intended to impose a new requirement that advisors must meet in order for their plan information related communications to be treated as non-fiduciary education.

For example, one possible interpretation of this new condition could be as follows. A statement by an advisor to an employee eligible to participate in a 401(k) plan that "the plan allows for deferral of income and provides for a 6% employer matching contribution and all employees should contribute at least enough to receive the full match" is education. A statement by the advisor to the employee that "you [i.e., the employee] should enroll in the plan and contribute enough to receive the maximum matching contribution of 6%" is not education because it refers to a particular participant (i.e., the employee to whom the advisor is speaking).

Interpreting the Proposed Regulation in this manner would represent a significant change between the Proposed Regulation and the Bulletin. It would also obviously render educational communications about plan information much more generic and abstract and therefore less useful to an individual. The Department should therefore modify and/or clarify that the Proposed Regulation is not to be interpreted as suggested above but is to be applied consistent with the Bulletin to plan information communications and materials, regardless of whether such communications or materials refer to the particular person or persons to whom the communications or materials are being directed.

4. <u>Clarify the Rule's Application to Rollovers</u>.

The Proposed Regulation provides that a person renders investment advice if the person provides in exchange for a fee or other compensation "[a] recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including … a recommendation as to the investment of securities or other property to be rolled over … from the plan or IRA" and "a recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over … from the plan or IRA". In many cases, however, an advisor might discuss a rollover with a participant or IRA owner without recommending or even mentioning how amounts that are rolled over should be invested or managed. For example, the advisor may simply state to a plan participant that the participant should rollover his or her plan distribution to an IRA generically or to an IRA offered by the advisor or another specific IRA provider.

It is not clear whether the Proposed Regulation includes within the definition of fiduciary advice conversations that do not include any reference as to how rolled over securities or other property should be invested or managed. Clarity on this point is important in part because, if such a rollover communication were treated as fiduciary investment advice and it was not covered by the BIC Exemption, it would effectively be prohibited by the proposal. The most appropriate way to avoid this result is to clarify that rollover communications that do not refer to investments in specific securities or other property are not fiduciary investment advice. Such clarification would be consistent with the Proposed Regulation's general focus on recommendations with respect to investing in or managing "securities or other property." Likewise, the Proposed Regulation appears to acknowledge that recommendations regarding the factors to be considered in deciding whether to rollover a plan account balance do not constitute investment advice.[24]

Moreover, if the Department were to treat such communications as investment advice but then attempt to expand the scope of the BIC Exemption to cover such advice, it would lead to confusion and nonsensical results. The BIC Exemption is largely conditioned on an extensive array of disclosures. All of the disclosures, however, are centered on specific recommended investments, investments bought, sold or held by the investor, or specific investments offered by the advisor. None of these disclosures as proposed would have any applicability to a recommendation that by definition does not refer to any specific investment. Thus, the BIC Exemption is simply not an appropriate means to permit non-investment specific rollover communications.

Clarification is also needed on the Proposed Regulation's application to two other important transactions. First, the Proposed Regulation's applicability to conversions from a traditional IRA or plan to a Roth IRA and on Roth in-plan conversions is unclear. It appears that conversions from a traditional IRA or plan to a Roth IRA should be treated the same as a rollover from one IRA to another IRA or rollovers between a plan and traditional IRA. In-plan Roth conversions, on the other hand, while treated as a distribution and conversion for tax purposes, typically do not involve any change in the investments in which the participant is invested. Rather, an in-plan Roth conversion often merely changes the tax treatment of amounts held within the plan. Accordingly, conversations about in-plan Roth conversions and Roth

[24] On the other hand, the Proposed Regulation's education carve-out provides that information and materials that describe varying forms of distribution, including rollovers, do not constitute fiduciary investment advice only so long as such information and materials make no "reference to the appropriateness of … any individual benefit distribution option for the plan or IRA, or a particular participant or beneficiary or IRA owner." Thus, to the extent a conversation referenced a particular IRA or suggested that a rollover to a specific or generic IRA was appropriate for the advice recipient, the education carve-out would arguably be inapplicable.

conversions in the IRA context which do not refer to specific investments should not constitute fiduciary investment advice.

Second, the Proposed Regulation's applicability to non-reportable transfers from one IRA to another IRA, a so-called Transfer of Assets ("TOA"), should be clarified. Rollovers and TOAs are treated differently by the IRS in certain important respects. For example, a rollover must be reported on Form 1099-R, while a TOA is non-reportable. The IRS also recently issued guidance announcing that, beginning in 2015, an IRA owner can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs owned by the IRA owner.[25] The guidance makes clear that this limitation does not apply to TOAs.

TOAs also differ from rollovers insofar as the IRA owner never takes receipt of the IRA assets in connection with the TOA. Rather, assets are transferred directly from one IRA trustee or custodian to another IRA trustee or custodian. In that respect, TOAs differ from distributions as well as rollovers, both of which can involve the IRA owner taking ownership of the assets outside of the IRA or any other tax-deferred vehicle.

It is unclear whether the Proposed Regulation is intended to include recommendations about TOAs within the definition of fiduciary investment advice. We recommend that the Department clarify the Proposed Regulation such that recommendations about TOAs are treated similarly to our proposed treatment of rollovers. That is, the Proposed Regulation should be clarified to provide that fiduciary investment advice does not include recommendations about TOAs if they do not include any reference to how transferred securities or other property should be invested or managed. However, recommendations about how to invest assets once they have been transferred through a TOA to another IRA would be fiduciary investment advice, so long as such recommendations met the other requirements of the fiduciary definition.

5. <u>Clarify the Rule's Application to Distributions and Loans</u>.

The Proposed Regulation states that a recommendation to take a distribution from a plan or IRA is fiduciary investment advice but it is not clear whether that is the case if the recommendation does not refer to the sale or investment of any specific security or other property. For example, a recommendation to take (or not take) a distribution from a defined benefit plan is not an investment transaction from the participant's perspective. Another example of a transaction that does not have investment implications is a discussion about the relative merits of a participant loan over a hardship withdrawal.

The Bulletin provides that information and materials that inform a participant or beneficiary about the benefits of plan participation do not constitute the rendering of investment advice under ERISA. The rationale is that such information and materials "relate to the plan and plan participation, without reference to the appropriateness of any individual investment option for a particular participant or beneficiary under the plan." The same rationale applies with equal force as a participant or beneficiary considers whether to leave the plan (take a distribution). Just

[25] See Announcement 2014-15 and Announcement 2014-32.

as a decision to enroll in a plan does not dictate how to invest the resulting contributions, a decision to leave the plan does not by itself necessarily dictate any change in investments and thus should not be considered fiduciary investment advice. Accordingly, treating communications that make specific reference to a plan participant, beneficiary or IRA owner in connection with distribution discussions as investment advice would not be consistent with the scope and application of the current Bulletin. Thus, it is necessary to clarify the Proposed Regulation to provide that both (a) discussions about distributions, rollovers and loans that do not make reference to any specific investments are not investment advice, and (b) that communications do not fail to constitute education merely because they refer to a particular plan participant, beneficiary or IRA owner.

It is also not clear whether the Proposed Regulation is intended to treat participant loans as distributions. While participant loans are distinct from distributions, they are functionally similar insofar as they involve the transfer of amounts from the plan. Also, loan discussions, like distribution discussions, typically do not involve any reference to specific investments and typically the liquidation of investment options since that is usually dictated by plan rules. So, for the same reasons that distribution discussions without reference to investments should not be treated as fiduciary investment advice, the Proposed Regulation should be clarified to provide that participant loan discussions without reference to investments are not treated as fiduciary investment advice.

This clarification is essential to prevent significant disruption in the normal administration of many plans. It is not uncommon for participant loans to be subject to a loan fee payable to the recordkeeper. Recordkeepers also charge distribution fees in certain circumstances. Neither transaction appears to be covered by the BIC Exemption. Thus, if either a loan discussion or a distribution discussion on its own (i.e., without reference to investments) were considered to be fiduciary investment advice, recordkeepers would effectively be precluded from discussing loans or distributions with participants, except perhaps in the most generic and abstract way as would be permitted by the education carve-out as proposed.

6. <u>Expand the Platform Provider Carve-Out</u>.

The Proposed Regulation provides a carve-out for certain persons who merely market or make available platforms of investments from which plan fiduciaries may select or monitor investment alternatives for their plans, provided certain disclosure requirements are met. A similar carve-out is provided that would allow such persons to identify investment alternatives available through the platform that meet objective criteria specified by the plan fiduciary, or to provide objective financial data and comparisons with independent benchmarks to the plan fiduciary. These carve-outs are helpful, but as proposed they only apply with respect to communications to plan fiduciaries. They do not apply to communications to IRA owners or plan participants. The rule should extend these carve-outs to both IRA owners and plan participants.

Both IRA owners and plan participants also have in interest in knowing what investment alternatives may be available on a provider's platform, in identifying available investment alternatives that meet certain objective criteria, and in obtaining objective financial data and comparisons with independent benchmarks. IRA owners essentially stand in the same shoes as the plan fiduciary in this regard, and plan participants should be able to obtain such information with respect to the investments available in their plan as well as other available investment alternatives so that they might be able to request that they be added to their plan's investment lineup. To the extent the carve-out provides protective disclosures that safeguard a plan fiduciary, such disclosures should also be sufficient to safeguard an IRA owner or plan participant.

In addition, insofar as the platform provider carve-out permits the identification of funds meeting objective criteria or the provision of objective financial data and benchmark comparisons, it is not clear whether the carve-out is intended to permit purely reactive communications by platform providers or whether a platform provider may proactively communicate such information. Requiring that platform providers only communicate this information in response to questions by plan sponsors would be extremely limiting in practice and would greatly reduce the efficacy of the proposed carve-out. The Department should therefore clarify the Proposed Regulation to provide that platform providers may make these communications either proactively or reactively. At a minimum, the Department should clarify that the platform provider carve-out permits the offering of an investment screening tool, including a computerized tool, which enables the user to develop lists of specific investments available through a provider that meet certain criteria that may be identified through the tool.

Finally, it is unclear what is intended to constitute "objective financial data and comparisons with independent benchmarks." For example, is objective financial data different than the "general financial information" that may be provided under the education carve-out and, if so, how? Similarly, what comparisons may be made to independent benchmarks? For example, it is common to select investment alternatives based on criteria such as the tenure of the fund manager. Would such a selection criteria constitute objective financial data or may it be compared to the tenure of other fund managers in the absence of an independent benchmark? Clarity on these terms would be important to enable this carve-out to be used effectively.

7. <u>Clarify the Rule's Application to Self-Identified Fiduciaries</u>.

The Proposed Regulation provides that a person is a fiduciary if such person "directly or indirectly (e.g., through or together with any affiliate) … represents or acknowledges that it is acting as a fiduciary within the meaning of the Act." According to the preamble, "advisers who claim fiduciary status under ERISA or the Code in providing advice would be taken at their word". This is a sensible and fair condition. However, it is not clear how literally the Department intends to apply this component of the rule. It would be helpful for the Department to clarify whether this condition requires the person to use the word "fiduciary" or to refer to ERISA or the Code in describing his or her status, or whether it would apply to other characterizations which may imply fiduciary status, such as "trusted advisor". If the latter interpretation is intended, the Department should clarify what terms other than "fiduciary" would trigger application of this component. The purpose of such clarification is to enable advisors that wish to avoid fiduciary status (and to not mislead their clients into believing the advisor is acting as a fiduciary) to confidently describe their status and services without inadvertently becoming a fiduciary by using the wrong words.

Note that this provision of the Proposed Regulation is unnecessary if the Department accepts our recommendation to modify the definition of investment advice to require that, based on the content, context and presentation of advice, it should be reasonable for the advice recipient to rely on such advice as being unbiased and in the recipient's best interest with respect to such recipient's investment or management decisions. In that case, a representation of fiduciary status by an advice provider would create reasonable reliance on the part of the advice recipient that the advice would be unbiased and in the recipient's best interest and there would be no need to separately and additionally provide that such a representation automatically gives rise to fiduciary status.

8. Address Valuation Issues in a Separate Initiative.

The Proposed Regulation retains a portion of the 2010 Proposed Regulation regarding the valuation of securities or other property, but only valuations performed in connection with an investment transaction. However, the Proposed Regulation excludes appraisals regarding employer securities purchased by an employee stock ownership plan (ESOP). The preamble to the Proposed Regulation states that "the Department has concluded that its concerns with regard to ESOP valuations raise unique issues that are more appropriately addressed in a separate regulatory initiative." We strongly urge that all valuation issues be considered in the separate initiative, rather than deferring action only on the situation that may have the greatest impact on plan participants.

At a minimum, however, the Proposed Regulation should be clarified to provide that the calculation of the net asset value of a separately managed account or a collective investment trust or similar "pooled" investment in which only one plan invests (e.g. unitized company stock fund) does not constitute an appraisal or other valuation. Such calculations are ministerial in nature and do not involve making the judgments or other determinations typically required for an appraisal or valuation of property. Moreover, to transform such ministerial calculations into fiduciary investment advice would cause significant disruption to normal and widespread recordkeeping practices and create a significant disincentive for plans to hold such investments or for recordkeepers to support them. As such investments are often, among other things, less costly to investors than other investments, such disincentives would ultimately be detrimental to retirement savers.

Attachment C
Comments on Proposed Exemptions

Many of the problems with the proposal can be solved through a simplified approach to the prohibited transaction exemption that is consistent with the Department's stated intent of broad, principles-based relief for regulated financial institutions. We urge the Department to adopt the new best interest paradigm described in the main body of this letter and in Attachment A.

In addition, following are the key changes that we urge the Department to make to the exemptions, many of which are inherent in the paradigm we propose:

The BIC Exemption

1. <u>Expand the Exemption to Cover All Plans</u>.

The BIC Exemption only applies to investment advice provided to plan participants and beneficiaries, IRA owners, and sponsors of small plans (less than 100 participants) that are not participant-directed. As a result, the exemption would not be available for investment advice provided to sponsors of large plans of any type or to small participant-directed plans, which represent the great majority of small 401(k) and other individual account plans. This is particularly problematic for small plans because they are also not eligible for the seller's carve-out in the Proposed Regulation.

This limitation on the application of the exemption would prevent small plan sponsors from using consultants, advisors or recordkeepers for assistance in structuring fund line-ups where the service provider receives any compensation based on the investment funds selected. It also creates the odd dynamic in which the exemption may be used in cases where the small plan sponsor has complete investment authority over participant accounts but not where the plan sponsor has the more limited responsibility to construct the investment menu to be offered to participants.

We believe this will discourage small plan formation and may result in some sponsors terminating their plans. The BIC Exemption preamble solicited comments on this aspect of the proposal, and we strongly recommend that the BIC Exemption be extended to cover investment advice to small plan sponsors of participant-directed plans. In addition, while the seller's carve-out is available to permit discussions with large plan sponsors, we see no reason why the BIC Exemption should not be available in situations where the plan and the advisor want to engage in a fiduciary-level relationship.

The preamble commented that the fund lineup could be structured under the carve-out for platform providers. However, Fidelity offers thousands of funds on its recordkeeping platforms. Without the ability to provide assistance in selecting funds based on something more than simple objective criteria, we do not view the platform provider carve-out as a workable alternative.

2. Expand the Exemption to Cover Online Only Computer Model Advice.

The BIC Exemption would exclude online-only computer model interactions (designated in the preamble as "robo-advice") unless an individual advisor is involved in providing the information generated by the model to the investor. That is, online advice is covered so long as a human advisor reads the online results to the investor rather than the investor reading the online results himself or herself. There is no justification for excluding advice in an online format solely because a human being has not read it out to the investor. On that basis alone, the Department should simply expand the BIC Exemption to cover online advice outright.

Notwithstanding the foregoing, the BIC Exemption preamble purports to justify the exclusion of online advice provided directly to an investor by stating that the advisor may rely on the ERISA section 408(g) statutory exemption added by the Pension Protection Act of 2006 ("PPA") (or some other approach such as that described in the Sun America advisory opinion) in order to provide online advice as construed under the new definition. The Proposed Regulation preamble provides the following insight:

> While the Department believes that computer generated advice that is delivered in this manner may be very useful to Retirement Investors, relief will not be included in the proposal. As the marketplace for such advice is still evolving in ways that both appear to avoid conflicts of interest that would violate the prohibited transaction rules, and minimize cost, the Department believes the inclusion of such advice in this exemption would adversely modify the incentives currently shaping the market for robo-advice.

The exclusion of online-only advice is designed to favor one business model over another. This is contrary to the position expressed by Department officials in various public statements and in the Proposed Regulation and BIC Exemption preambles. Respectfully, we also believe it is outside the Department's authority to favor particular business models in this manner, and that doing so will stifle competition and inhibit innovation. There is no sound reason to deny use of the BIC Exemption to online-only advice which is by design consistent and easy to monitor for compliance with the exemption.

Using the PPA computer model rule is not an appropriate solution. Among other issues, this would force reliance on two separate exemptions in the extremely common situation where the advice recipient begins the interaction online but then calls to ask for personal assistance from a phone representative. The legislative history of ERISA section 408(g) evidenced the intent of Congress not to override regulatory guidance regarding alternative ways of structuring certain permissible advice arrangements. The exclusion of online-only advice from the BIC Exemption contradicts that approach.

3. Expand the BIC Exemption to Cover All Investment Products and Services.

The BIC Exemption applies only to "compensation for services provided in connection with the purchase, sale or holding of an Asset". The definition of an "Asset" only includes specific categories of investment products and not services. As a result, it would not cover recommendations or suggestions regarding investment services provided to the plan or IRA owner, including managed account and other discretionary investment management services. The exemption needs to cover these types of services in order to provide the broad relief needed for investment services providers. The exemption also needs to cover account fees and other compensation payable to the financial services firm that may not be directly connected with the purchase of an Asset.

The proposed definition of an "Asset" also omits plan separate accounts or plan-specific custom funds from the definition even though these investment options are relatively common in the large plan market and would warrant consideration by plan participants as an investment for their plan account. Although these investment options may be limited to a single plan or the master trust of two or more related plans, they are essentially equivalent to a pooled investment vehicle from the participant's perspective so should be within the scope of permitted investments. In addition, the proposal as written would treat interests in plan-specific insurer separate accounts as eligible Assets, and treating them differently compared with separate accounts isn't warranted.

All of these concerns could readily be addressed by a broad-based exemption as would be the case with our new best interest paradigm described in the main body of this letter and Attachment A.

4. Clarify the Exemption's Application to Distributions and Rollovers.

As discussed in Attachment B, there is considerable uncertainty regarding the inclusion of interactions regarding distributions and rollovers in the proposed definition of "investment advice". For example, if a suggestion regarding the benefits of rolling a plan distribution to an IRA maintained by an affiliate of the advisor, without any mention of a specific investment, is included in the definition, the BIC Exemption would not appear to apply to that situation. Similarly, a suggestion whether to take a distribution may also be included in the proposed definition, but it does not appear to be covered by the BIC Exemption.

Fidelity representatives provide assistance to many plan participants and IRA owners regarding a possible plan or IRA distribution, including the tax and financial considerations, and try to help the participant, beneficiary or IRA owner in his or her personal decision-making. The breadth of the Proposed Regulation would deem some of these interactions to constitute investment advice under ERISA and the Code. For the reasons explained in Attachment B, the Proposed Regulation should not include such non-investment specific interactions within the definition of fiduciary investment advice. If the Department nevertheless determines that such interactions are covered, then the Department must include such interactions within the scope of the BIC Exemption.

This will presumably require considerable modification of the BIC Exemption. The BIC Exemption is largely conditioned on an extensive array of disclosures. All of the disclosures, however, are centered on specific recommended investments, investments bought, sold or held by the investor, or specific investments offered by the advisor. None of these disclosures would have any applicability as proposed to a recommendation that by definition does not refer to any specific investment and would require special modifications with respect to non-investment-specific related recommendations.

5. Expand Exemption to Cover Participants Employed by Financial Institutions.

The BIC Exemption would not allow a financial institution to rely on the exemption to provide investment advice to participants in the plans that it maintains for its own employees. The proposal preamble opines that due to the "special nature" of the employment relationship, the financial institution should not be permitted to profit from the investments of employees because that would not be in the best interests of the plan participants.

This approach is inconsistent with the Department's historical treatment of financial institutions as plan sponsor. For example, the Department stated in the preamble to the ERISA section 404(c) regulation proposed in 1991:

> The Department is persuaded, however, that in the case of plans sponsored by certain financial institutions which have appropriate professional expertise in investment management, the designating fiduciary need not be independent. In enacting ERISA, Congress recognized the need to accommodate such plans by fashioning special rules. For example, section 408(b)(4) of ERISA permits a bank to invest the assets of an in-house plan in deposits of that bank and section 408(b)(5) permits an insurance company to issue contracts to a plan covering its own employees. The stated Congressional policy underlying these exemptions is that it would be "contrary to normal business practice" for a bank or insurer to purchase the products of another company of its own in-house plans. Moreover, the Department has recognized in certain administrative exemptions that it would be contrary to normal business practice for a company whose business is financial management to seek financial management services from a competitor, e.g., Prohibited Transaction Exemptions 77-3 and 82-63.[26]

There is no reason why these same considerations should not be reflected in the BIC Exemption to cover investment advice provided to employees of financial institutions. In many cases, for compliance reasons, those employees are required to maintain their financial assets with the firm itself. Denying those firms the ability to provide employees investment advice means they would have no access to advice whatsoever, unless a third party advice provider is hired at additional expense.

6. Replace the Written Contract Requirement with a Unilateral Contract Requirement.

The BIC Exemption would require the individual advisor and financial institution to enter into a signed written contract with every potential recipient of investment advice in advance of any investment recommendation subject to the new definition. The BIC Exemption preamble describes the contract requirement as the "cornerstone" of the proposed exemption, in part

[26] 56 FR 10724 (March 13, 1991).

because it creates a mechanism for alerting the investor to the advisor's obligations and providing the basis upon which the investor's rights can be enforced.

The contract as proposed must include a lengthy list of provisions:

- affirmation of the advisor's fiduciary status;
- a statement that any investment advice will be in the best interest of the investor;
- a statement that only reasonable compensation would be received by the advisor and affiliates;
- a commitment that there would be no misleading statements relevant to the investment matters covered by the exemption;
- a warranty that the advisor will comply with applicable laws;
- a warranty that the financial institution has adopted written policies and procedures reasonably designed to mitigate conflicts of interest, including the identification of material conflicts of interest and measures adopted to prevent violation of the impartial conduct standards;
- a warranty that the financial institution does not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other actions or incentives which would tend to encourage individual advisors to make recommendations that are not in the investor's best interest;
- disclosure of any material conflicts of interest;
- notice to the investor that he or she has the right to complete information about fees, including direct and indirect fees payable to the advisor or financial institution; and
- disclosure as to whether the advisor offers proprietary products or receives payments from third parties and the address of a public website that discloses all the compensation arrangements entered into by the advisor or financial institution.

It would be extremely burdensome to re-contract with millions of existing IRA owners, many of whom would undoubtedly question why they have to enter into a contract with an individual or institution with whom they already have an existing relationship. Our experience is that most individuals will not sign and return documentation until such time as they want or need services. Under a rule requiring a signed written contract, this would mean that the financial institution would have to create a costly new tracking system (as well as training on it) so that the firm could implement the contract when a customer first calls and asks for investment assistance. In addition, the financial institution would need to create a firm-wide data system to ensure that representatives know whether they can talk to a person who has called with an investment or distribution question.

Finally, the BIC Exemption seems to assume that an investor will always deal with the same individual advisor, but that is not the true in most of our service roles. Since Fidelity has thousands of phone representatives, a plan participant contacting us by phone will generally get a different representative each time that he or she calls to ask a question about his or her account or a new product or service recently added to the plan. Even at the financial institution level, different legal entities may be engaged in providing investment advice depending on the product or service involved. This dynamic would simply multiply the adverse impact of the proposed written contract requirement.

On the plan side, recordkeepers do not have contracts with participants so introducing a new “best interest contract” into the relationship will undoubtedly be confusing to plan sponsors and participants alike. In addition, it seems totally unnecessary for plans subject to ERISA because the fiduciary duty standard already applies as a matter of law. Otherwise it would be necessary to create a database and “gate” protocol so that phone representatives could check the system each time a participant calls with a question. Participants would generally talk to a different representative each time they call, so that each call would be subject to a checking process. Alternate payees and beneficiaries of deceased participants would have to go through the same protocol.

We believe that an enforceable best interest standard can be established by much less onerous means – a unilateral contract offer by the financial institution which would be enforceable as a contract as well as through the doctrine of promissory estoppel. There is no need to require a signed, written document nor must the individual Advisers be involved.

In a unilateral contract, only one of the contracting parties makes a promise; the other party manifests assent by performance.[27] Accordingly, “[t]he legal result is that the promisor is the only party who is under an enforceable legal duty. The other party to this contract is the one to whom the promise is made, and this promisee is the only one in whom the contract creates an enforceable legal right.”[28] Moreover, no signature is required for a unilateral contract to be enforceable. Rather, parties may become contractually bound by indicating their assent through a variety of other means, such as by accepting and acting upon the contract, ratifying the contract, or accepting the performance by the other.[29]

The unilateral contract is supported by the same consideration that would support a signed bilateral contract such as the best interest contract. That is, engagement of the financial services firm by the investor constitutes sufficient consideration to create a legally binding relationship.

The principles of the unilateral contract are perfectly-suited to the BIC Exemption, where the goal should be to hold a single party – the financial services firm – to an enforceable legal duty. This can be achieved by requiring firms wishing to use the exemption to post a statement on their website (or other accessible venue) that sets forth the best interest contract standards and

[27] *Corbin on Contracts* § 1.23 (3d ed. 2004); see also *United States ex rel. Modern Elec., Inc. v. Ideal Elec. Security Co.*, 81 F.3d 240, 241 (D.C. Cir. 1996) (citing the “well-recognized” principle that “in a unilateral contract, performance constitutes acceptance of an offer”).
[28] *Corbin on Contracts* § 1.23.
[29] 17A Am. Jur. Contracts § 173; see also *Words, Inc. v. Xerox Corp.*, 205 F.3d 1336, at *1 (4th Cir. 2000) (per curiam) (“If the party against whom the contract is being enforced has indicated through some unequivocal act or through performance that it intends to adopt the contract, then a signature by that party is not required for the contract to be binding.”); *In re JetBlue Airways Corp. Privacy Litig.*, 379 F. Supp. 2d 299, 325-26 (E.D.N.Y. 2005) (finding a contract where customers “made flight reservations in reliance on express promises contained in [defendant’s] privacy policy” posted online).

commits to act in accordance with those standards when providing covered investment services. The client would be advised of this promise, the standards, and where to review them at the time covered services were offered. This could be done orally, when the interaction is by telephone or in person, or in writing, when the interaction is computer-based. The client would accept the firm's offer by proceeding to use the firm's services, thereby forming an enforceable agreement under basic principles of contract law.[30]

These principles of contract law would be sufficient to bind financial services firms to the best interest standard without the unnecessarily cumbersome and costly difficulties associated with an actual signed written agreement. However, the doctrine of promissory estoppel would serve as an additional means to enforce the best interest standard. Under promissory estoppel, if a party changes its position substantially either by acting or forbearing from acting in reliance upon a clear and unambiguous promise, then that party can enforce the promise even though the essential elements of a contract are not present.[31]

In the context of the BIC Exemption, that doctrine would apply if a firm represented to an investor that it would abide by the best interest standards when providing services, and the investor accepted those services in reliance on that assurance. In these circumstances, even if a court were to determine that for some reason no enforceable contract exists, a customer could use the doctrine of promissory estoppel to enforce the firm's representations. And here again, the firm could be bound even more tightly by requiring, as a condition of the exemption, that it acknowledge on its website (or in some other publicly-accessible format) the enforceability of its best interest promise, and the client's reliance on that promise in engaging in the interaction.

For all of these reasons, there is no need for the Department to require a signed written contract for the BIC Exemption. The proposed exemption should be revised to permit financial services firms to become legally bound in the manner described above.

7. <u>Simplify and Improve Disclosure Requirements</u>.

A key component of the exemptions is full and meaningful disclosure of all material conflicts of interest, including compensation payable to the advisor. The BIC Exemption contemplates a three-tiered approach involving a point-of-sale[32] disclosure of the projected cost

[30] *See Corbin*, *supra*; *see also Coulier v. United Airlines, Inc.*, 2015 WL 2452393, at *5 (S.D. Tex. May 21, 2015) (the portion of defendant's website guaranteeing lower price for tickets purchased on the website was a "unilateral contract that the customer must accept by performance"); *Edquist v. Bidz.com, Inc.*, at *1 (D. Mass. Mar. 29, 2013) ("[A] person such as the plaintiff who accepts the terms offered by the defendant on its website by participating in an online auction governed by those terms has entered into a contractual relationship with the defendant.").

[31] Restatement (Second) of Contracts § 90; *see also* Williston on Contracts § 8:7 (4th ed. 2008) ("[B]oth versions of the Restatement recognize that in certain circumstances, a promise might be enforced despite the absence of consideration – and, according to some courts, despite the absence of other elements necessary to form a traditional contract – based on the promisee's foreseeable, reasonable, justified and detrimental reliance on the promise"); *Allen v. A.G. Edwards & Sons, Inc.*, 606 F.2d 84, 87 (5th Cir. 1979) (recognizing promissory estoppel where broker-dealer, "[h]aving benefitted from oral agreements transacted through local agents, [ ] cannot now be heard to complain of failure to observe formalities").

[32] The BIC Exemption provides for "Transaction Disclosure" which is to occur "prior to the execution of the purchase of the Asset by the Plan, participant or beneficiary account, or IRA." However, an advisor will often not

of recommended investments, an annual statement summarizing in dollar amounts the compensation actually paid to the advisor during the preceding year and a publicly available website outlining all investments the advisor might recommend and the compensation associated with each. While we have no objection in theory to disclosing this information, the manner in which it is disclosed is critically important to both the usefulness of the information to the investor and workability from the perspective of the financial services firm.

Point-of-sale disclosures in particular are problematic. If an advisor is recommending one specific investment product or service a particular customer, it is perhaps feasible to develop and produce a point-of-sale document for the recommended investment. However, most discussions with customers cover a wide range of potential products and services as the customer develops an investment strategy. In many cases, a customer leaves the discussion without making a decision which means the financial services firm would be required to produce a point-of-sale disclosure for every product or service discussed since the customer may later decide to implement the investment strategy without further discussion with a representative. More importantly, the proposed point-of-sale disclosure addresses only the cost of recommended investments and not the compensation payable to the advisor and therefore does not disclose the conflict of interest.

We do not believe the proposed annual disclosure will provide meaningful information to investors about the advisor's potential conflict of interest. An investor's account will typically include a mix of investments and reflect a range of transactions, some of which may have been the result of recommendations of the advisor and others of which were entered into by the investor on their own. As a practical matter, other than transactions entered into immediately following the recommendation, there is no practical way to distinguish between the two. As a result, the annual statement must necessarily reflect all transactions in the account so will not in fact represent compensation payable as a result of recommended investments. In addition, building a system to keep track of this information at an individual account level would be extremely costly.

Finally, the public website does not appear to be intended for use by investors and is not directly related to the investor's decision about the specific transactions being recommended. With respect to employee plans, the proposed website information would be less helpful than the information already furnished to participants and beneficiaries in the form of a plan-specific comparative chart of designated investment options, as required under DOL reg. §2550.404a-5. Another difference is that the website would provide those investment options in combination with information about thousands of options not included in a plan’s menu of designated investment options. In some cases, information may be subject to confidentiality agreements between the plan sponsor and manager. With respect to IRAs, the website would include hundreds or thousands of institutional investment options – particularly group trust portfolios, plan-specific separate accounts and group annuity products - that would not be available to the retail investor as investment choices. Nevertheless, much of the information provided would be

know if or when a recommended Asset may be purchased by a customer. This means, as a practical matter, such disclosure would likely be provided at the time the advisor provides the advice to the customer. Accordingly, it is probably more accurately referred to as a “point-of-recommendation” disclosure.

available under our new best interest paradigm. We believe the more simplified two-tiered approach included in that paradiam, as described in the body of our letter and in Attachment A, will make the disclosure regime both workable and more meaningful to investors.

The more simplified, two-tiered approach would also be far more practical for advisors who provide advice with respect to investments not held in custody by the advisor. Much of the information required to be disclosed under the BIC Exemption would not be available to an advisor who does not have custody of the investor's account. For example, the annual disclosure includes information about all investments held in the investor's account, not just assets purchased pursuant to the advisor's recommendation. But an advisor may not have knowledge of all the investments in an account held by a third-party custodian. Similarly, the website is required to include information about all investments offered through the advisor, but an advisor may not have the information required to provide such disclosure about all the investments available through the advisor on a third-party recordkeeping platform. As a result, the BIC Exemption's disclosure requirements could not be met by an advisor with respect to investments held by a third-party custodian, absent an information sharing arrangement between the advisor and the third-party custodian.[33] The two-tiered disclosure, on the other hand, would only require disclosure of information that an advisor would have at its disposal regardless of whether it held custody of recommended investments.

Finally, the BIC Exemption preamble asks whether a "cigarette warning" could be as effective and less costly. The sample language provided in the preamble discussion warns that the fees "may determine your adviser's take home pay", which seems directly at odds with the conditions of the BIC Exemption relating to advisor compensation, so presumably any "cigarette label" warning would take a different form. In any event, the two-tiered approach described above would more effectively inform the customer about the nature of an advisor's conflicts. The two-tiered approach is also similar to the Department regulation under the PPA investment advice exemption which includes model disclosure that would inform the investor of the fiduciary nature of the advice and that the compensation received by the advisor may vary (within a range) depending on the investment choices made by the investor. This squarely addresses the "conflict" issue without inundating the investor with too much information.

8. Eliminate Special Data Production Requirements.

The BIC Exemption would authorize the Department to require the production of six years of firm-wide aggregate data regarding purchases, sales and holding of each Asset for retirement investors on a quarterly basis, and in each case the revenue received by the financial institution for such Asset "disaggregated by source". The financial institution would also need to provide data regarding quarterly cash flows and account balances for each retirement investor.

[33] Note that creating such information sharing arrangements, which would involve extensive contracting and systems build-outs among thousands of advisors and third-party custodians or recordkeepers, would be extremely time-consuming and costly. The proposal does not appear to take any of these costs into account or to allow for the time necessary to create these information sharing arrangements.

The proposal preamble states that the required information concerns purchases, sales and holdings "made pursuant to advice provided by the advisor or financial institution relying on the exemption." As an editorial matter, the text of the proposed exemption does not include such "made pursuant" language. As an even more important practical matter, however, it is particularly unclear how a firm would be able to track whether each buy, sell or hold decision was the result of investment advice. For example, if an investor is provided with a model portfolio illustration that includes a $20,000 investment in fund X, and two months later buys $30,000 of fund X. how would the advisor know whether the purchase was the result of a recommendation and, even if it knew that, how much of the purchase should be reflected in the database as resulting from the advice?

The proposal preamble states that the receipt of such additional data will assist the Department in assessing the effectiveness of the BIC Exemption. It is difficult to understand, however, how the aggregate data will be useful in that regard. It seems to indicate a research agenda (as in the case of the public website) which is unrelated to the furnishing of prohibited transaction exemption relief.

As a compliance matter, the approach taken in the proposal would mean that a firm would not be sure that its recommendations in a given year are covered by the BIC Exemption for another five years, because of the possibility that the firm experiences problems in responding to the Department's request for data. This would be true even if the difficulty is with respect to transactions completed in a different year!

The Department is already authorized under section 504 of ERISA to request the production of information by a financial institution or other service provider in order to determine whether there has been a violation of ERISA. It appears that the proposed exemption information production requirement may be intended to expand Department inquiries into the IRA world, but the Department has no enforcement authority there pursuant to the Reorganization Plan No. 4 of 1978. Putting financial institutions at risk of incurring prohibited transaction penalties if the firm has difficulty producing information unrelated to the transaction(s) in question would be an inappropriate use of the exemption process.

The Principal Transactions Exemption

As an initial matter, we note that the new best interest paradigm set forth in the main body of this letter and Attachment A would render the Principal Transactions Exemption unnecessary. That paradigm would provide for a single, broad, principles-based exemption that would cover all advice transactions, including principal transactions. We urge the Department to adopt this paradigm. In the event that the Department does not do so, however, we offer the following comments with respect to the proposed Principal Transactions Exemption.

Fidelity supports efforts to enhance fixed income price transparency. Pricing transparency promotes robust competition among diverse market participants, which helps foster innovation and allows for greater investor choice. However, we do not support the Principal Transactions Exemption as currently drafted for the following reasons:

- the extensive restrictions and conditions in the exemption are not necessary if financial institutions and advisors are held to a fiduciary best interest standard with respect to the provision of investment advice – the BIC Exemption (modified as described above) should cover all transactions, including principal transactions;

- the exemption fails to acknowledge the extensive, existing legal framework for principal transactions promulgated by the primary regulators of financial institutions, applicable to both retirement and non-retirement accounts; and

- the extensive restrictions and conditions in the exemption are unnecessarily burdensome and unworkable for advisors and financial institutions.

As currently drafted, the Principal Transactions Exemption will result in less choice and higher costs for retirement investors and will impact liquidity in the already fragile fixed income markets. The Principal Transactions Exemption should be revised to permit advisors to engage in a wide spectrum of principal transactions, across security types, subject to a fiduciary best interest standard and compliance with applicable law. Each of these comments is discussed in more detail below.

In the preamble to the Principal Transactions Exemption, the Department recognizes that the ability to execute principal transactions is integral to the economically efficient distribution of fixed income securities but also notes its concern with issues associated with principal transactions involving liquidity, pricing, transparency and a fiduciary's possible incentive to "dump" unwanted assets. As a threshold matter, we wish to highlight the important role of principal trading in the capital markets. Dealers acting in a principal capacity engage in activities beneficial to the markets, such as market making, and provide liquidity to the markets. Regulatory obligations on market makers often require them to engage in transactions in their own account in order to maintain a fair and orderly market. Any rulemaking that impacts principal trading should be implemented in a way that does not inadvertently reduce liquidity, which could increase volatility and risk in the capital markets. Moreover, if significant disincentives to trading on a principal basis are imposed, fewer dealers may be willing to act as principal, reducing market liquidity to the detriment of all investors.

Assuming the financial institution commits to act in the best interest of the customer, the Principal Transactions Exemption's additional restrictions and conditions on principal trading are not necessary. Moreover, these restrictions and conditions may even inhibit the financial institution's ability to act in the best interest of a retirement investor, in contravention of the Department's goals. For example, the Principal Transactions Exemption does not reflect the role of a financial institution in providing facilitation trades when a retirement investor seeks to sell a security and cannot obtain a reasonable price from a third party or cannot obtain a ready buyer. The Proposed Regulation and Principal Transactions Exemption would thus create a situation in which a financial institution could offer advice in the best interest of the retirement investor to sell a particular security, but the financial institution could not facilitate the trade in the absence of a reasonable price from a third-party or in the absence of other buyers. At best, we believe this scenario will frustrate retirement investors, and at worst, work against their best interest.

Additionally, the Principal Transactions Exemption's regulation of principal trading with respect to the provision of advice is layered onto an already comprehensive existing legal framework. Under the Principal Transactions Exemption, only three types of financial institutions may engage in principal trading: (1) registered investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act") or under the laws of the state in which the adviser maintains its principal place of business; (2) a bank or similar financial institution supervised by the United States or state; and (3) a broker or dealer registered under the Securities Exchange Act of 1934. This limitation is based on the Department's understanding that these entities may commonly sell debt securities out of inventory.

Fidelity has both investment advisory and broker-dealer businesses and clients. We appreciate from our experiences that both registered investment advisers and broker-dealers are extensively regulated, supervised, and their compliance with applicable rules enforced by numerous federal and state financial regulators and self-regulatory organizations.[34] The legal framework established by these regulators, includes rules specific to principal transactions. Financial regulators have long recognized the potential for conflicts of interest with principal transactions and have constructed a comprehensive legal framework carefully designed to minimize those risks. For example:

> *Registered Investment Advisers*: The United States Supreme Court has construed Sections 206(1) and (2) of the Advisers Act as establishing a federal fiduciary standard governing the conduct of advisers.[35] Thus, registered investment advisers are already subject to a fiduciary standard to act in their client's best interest. Moreover, Section 206(3) of the Advisers Act makes it unlawful for a registered investment adviser, acting as principal for its own account, to knowingly buy any security from or sell any security to a client, without disclosing to such client, in writing, before the completion of each such transaction, the capacity in which she is acting, and obtaining the consent of the client to the transaction. Written disclosure must be provided and consent must be obtained separately for each transaction, *i.e.*, blanket consent for transactions is not sufficient. The Commission staff has also taken the position that the registered investment adviser must disclose not only the capacity in which the adviser is acting, but also any compensation that the adviser receives for its role in such transaction.[36]
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> *Broker-Dealers:* Under the federal securities laws and rules of self-regulatory organizations to which they belong, broker-dealers may engage in principal transactions

[34] Fidelity has not commented on existing regulations applicable to principal trading by banks because we do not have a bank that engages in principal trading within our corporate structure. We believe that this area should be further explored by those familiar with the subject.
[35] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963).
[36] *See Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987).

with customers, across all security types, subject to a number of requirements. Securities and Exchange Act ("Exchange Act") Rule 10b-10 requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities) to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal. Rule 10b-10 also requires broker-dealers to disclose on confirmations the price of the security that was bought or sold by the customer. The Municipal Securities Rulemaking Board's ("MSRB") Rule G-15 requires similar disclosures from municipal securities brokers and dealers. Working with the SEC, FINRA and the MSRB are both currently actively engaged in rulemaking that would require disclosure of mark-ups in certain principal transactions.[37] Additionally, broker-dealers must seek to obtain best execution for principal transactions when a broker-dealer accepts an order from a customer[38] and may only receive fair compensation in both agency and principal transactions.[39] The SEC has determined that when engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups, without disclosing the fact to the customer.[40]

We note that investors often maintain multiple types of accounts and relationships with financial institutions. The Principal Transactions Exemption will apply to some, but not all, fixed income transactions in some, but not all, customer accounts held at a financial institution. The narrow category of accounts and securities covered by the Principal Transactions Exemption will undoubtedly prompt customer questions and confusion in contravention of the Department's goals to increase investors' understanding, as well as complicate implementation efforts at financial institutions.

To help promote investor understanding, the Department should defer to, or at a minimum, consider, the extensive legal framework established for principal trading by the primary regulators of financial institutions, and work with these regulators to develop consistent, harmonized requirements and disclosures across both retirement and non-retirement accounts. This course of action would promote legal certainty, put retirement investors on a level playing field with other investors, reduce investor confusion, and seek to mitigate the Principal Transactions Exemption's potential impact to liquidity in the capital markets.

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[37] *See* FINRA Regulatory Notice 14-52; *Pricing Disclosure in the Fixed Income Markets* (November 2014). ("FINRA Proposal") and MSRB Regulatory Notice 2014-20; *Request for Comment on Draft Rule Amendments to Require Dealers to Provide Pricing Reference Information on Retail Customer Confirmations* (November 2014) ("MSRB Proposal"). We urge the Department to allow FINRA and the MSRB to take the lead in rulemaking on this topic as their rules will apply across retirement and non-retirement accounts.

[38] *See* FINRA Rule 5310 ("Best Execution and Interpositioning").

[39] *See* FINRA Rule 2121 ("Fair Prices and Commissions") and associated Supplemental Material.01 ("Mark-Up Policy"), and Supplemental Material .02 ("Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities").

[40] *See, e.g., Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189-90 (2d Cir. 1998) as discussed in *SEC Staff Study on Investment Advisers and Broker-Dealers as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011) at page 70.

Nevertheless, if the Department chooses to proceed with a third layer of regulation of principal transactions in connection with the provision of advice after (1) already requiring financial institutions and advisors to contractually commit to a "best interest" standard and warrant compliance with all applicable federal and state law regarding the rendering of advice and the purchase and sale of debt securities and (2) in recognition of the numerous rules and regulations of other federal regulators that already apply to principal trading by financial institutions, we offer the following specific comments on the Principal Transactions Exemption.

1. <u>Distinguish "Principal Transactions" Executed on a Riskless Principal Basis</u>.

The Principal Transactions Exemption does not distinguish, or even discuss, transactions executed by a financial institution on a "riskless principal" basis versus traditional "principal" transactions. There is an important distinction between these two types of transactions. As described in more detail below, riskless principal transactions are unlike traditional principal transactions because the broker-dealer does not execute the purchase or sale from the broker-dealer's own inventory; the "principal" nature of the transaction is purely technical. The interests of investors would be well protected if the Department permitted broker-dealers who provide ERISA investment advice to engage in riskless principal transactions, across a broad range of security types, subject to a fiduciary best interest standard and in compliance with applicable rules regarding the purchase and sales of securities.

Typically, financial institutions engage in riskless principal transactions as an alternative method of executing customer orders to buy or sell financial instruments on an agency basis. Assuming that traditional principal transactions create a possible incentive to "dump" unwanted assets, as the Department asserts in the preamble to the Principal Transactions Exemption, riskless principal transactions present no similar incentive. In a typical riskless principal transaction, a financial institution, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset the contemporaneous sale of the financial instrument to (purchase from) the customer. Because riskless principal transactions are customer-driven and dealer exposure to market risk is limited by the brief period of actual ownership, investors generally incur lower transaction costs as compared to pure principal transactions, similar in economic terms to agency transactions.

Benefits accrued to investors from riskless principal transactions are at risk if the Department's proposal is approved as drafted. For example, when a broker-dealer executes a fixed income transaction on a riskless principal basis, the investor has a better understanding of the true yield of the bond, because the broker-dealer's mark-up is factored into the yield. In contrast, when a broker-dealer executes a fixed income transaction on an agency basis, the yield quoted is not inclusive of the commission, which offers less insight into the "real" yield of the investment.

Moreover, systems at financial institutions are not typically designed to switch from agency to riskless principal to principal capacity based on a trade by trade determination. If the Department determines to treat riskless principal transactions similarly to other principal transactions under the Principal Transactions Exemption, broker-dealers may decide that it is more cost effective to re-design certain systems to execute these orders on an agency basis, than comply with the Principal Transactions Exemption's numerous restrictions and conditions for a limited number of retirement accounts. The cost of converting a financial institution's systems from a riskless principal model to a straight agency model may nevertheless be substantial, and financial institutions may decide to pass these costs along to investors, increasing their transactions costs, in addition to limiting their choice of execution.[41]

Concurrent with the Proposed Regulation and the Principal Transactions Exemption, the Department has proposed amendments to PTE 86-128 and has also proposed to revoke PTE 75-1 Part 2(II). Among other items, the proposed amendments to PTE 86–128 include language that is currently a component of PTE 75-1, to permit a broker-dealer fiduciary to use its authority to cause a plan or IRA to purchase shares of a mutual fund from the broker-dealer fiduciary, acting as principal, where the shares were acquired solely to cover the plan's (or IRA's) prior order, and for the receipt of a commission by such fiduciary in connection with the transaction. The proposed amendments to PTE 86-128 would not include relief for fiduciaries who provide investment advice to IRAs, however (such fiduciaries would need to use the BIC Exemption).

The Department's amendments to PTE 86-128 indicate an awareness of riskless principal transactions and the Department's view that the provisions of the BIC Exemption better protect the interests of investors with respect to investment advice regarding securities transactions. The interests of investors would be further advanced if the Department permitted broker-dealers who provide ERISA investment advice to engage in riskless principal transactions under a simplified BIC Exemption as proposed under our new best interest paradigm or, at a minimum, under the Principal Transactions Exemption, across a broad range of security types, without numerous restrictions and conditions, subject to a fiduciary best interest standard and compliance with the rules of the SEC, FINRA and MSRB on riskless principal trades. We urge the Department to consider these alternative approaches.

2. Expand Securities Types Covered by the Principal Transactions Exemption.

The Principal Transactions Exemption would permit a financial institution to engage in principal transactions in connection with the provision of investment advice for only a narrow category of debt securities. For purposes of the Principal Transactions Exemption, the term "Debt Security" means "a 'debt security' as defined in Rule 10b-10 (d)(4) of the Exchange Act that is: (1) U.S. dollar denominated, issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933 ('33 Act'); (2) An 'Agency Debt Security' a defined in FINRA Rule 6701(l) or its successor; or (3) a 'U.S. Treasury Security' as defined in FINRA Rule 6710(p) or its successor." Our comments and concerns with this proposed definition follow below.

[41] Moreover, given the costs and complexity involved in changing technology systems, firms are unlikely to eliminate riskless principal transactions only for a "retirement" registration type. That is, the Principal Transactions Exemption may prompt broker-dealers to stop executing orders on a riskless principal basis across all account types, retirement and non-retirement, potentially further impacting liquidity in the markets.

First, only corporate debt registered under the '33 Act would be permitted to be principally traded in connection with the offering of investment advice.[42] We understand that there are practical difficulties that will inhibit a dealer to systematically determine whether bonds trading in the secondary market were issued pursuant to a registration statement. For example, Section 3(a)(2) bank note offerings (which are generally rated investment grade notes issued by banks) are often not registered. These notes are commonly held in retirement accounts. We urge the Department to allow corporate debt to be principally traded in connection with investment advice regardless of whether it is registered under the '33 Act as long as it is offered in the best interest of the investor and in compliance with applicable rules regarding the purchase and sale of securities.

We also note that there are several additional categories of securities commonly held by investors and primarily sold in principal transactions that are not included in the Principal Transactions Exemption. The omission of these security types from the Principal Transactions Exemption means that financial institutions cannot trade these securities as principal in connection with the provision of investment advice to retirement accounts. Given the Proposed Regulation's extremely broad definition of "investment advice", we anticipate that virtually any communication regarding these securities would be considered "investment advice", prohibiting the normal purchase and sale processing of these securities. We discuss the specific characteristics of some of these securities, and proposed safeguards that would apply to an exemption permitting their sale in a principal transaction, below.

Brokered CDs. The Department has not included brokered certificates of deposit ("CDs") in the definition of "Debt Security" in the Principal Transactions Exemption. Brokered CDs are CDs issued by banks for the customers of brokerage firms. The CDs are usually issued in large denominations and the brokerage firm divides them into smaller denominations for resale to its customers. Because the deposits are obligations of the issuing bank, and not the brokerage firm, FDIC insurance applies. A brokered CD is similar to a bank CD in many ways. Both pay a set interest rate that is generally higher than a regular savings account. Both are debt obligations of an issuing bank and both replay principal with interest if they are held to maturity. More importantly, both are FDIC-insured up to $250,000 (per account owner, per institution). Unlike a bank CD, a brokered CD can be traded on the secondary market, meaning that investors don't necessarily have to hold them to maturity.

Brokered CDs are offered through two main venues – as new issue offerings and from the secondary market. They are most often sold on a principal basis and are commonly held in IRAs. We see no clear reason why brokered CDs should be excluded from the definition of Debt

[42] FINRA has proposed, and intends to pursue, a proposal that would require disclosure of mark-ups in certain principal transactions for corporate and agency securities. The FINRA Proposal defines "corporate debt security" as "a debt security that is United States (U.S.) dollar denominated and issued by a U.S. or foreign private issuer and, if a "restricted security" as defined in Securities Act Rule 144(a)(3), sold pursuant to Securities Act Rule 144A, but does not include a Money Market Instrument as defined in Rule 6710(o)." Given the overlapping obligations of the Principal Transactions Exemption and FINRA Proposal on Financial institutions, we urge the Department and FINRA to develop a consistent definition of corporate debt security for purposes of the Principal Transactions Exemption and FINRA Proposal.

Security under the Principal Transactions Exemption, particularly since CDs are considered "Assets" for purposes of the Department's BIC Exemption. We recommend the Department correct this oversight.

New Issue Offerings of Equity Securities. The Department has chosen to exclude equity securities from the Principal Transactions Exemption under the reasoning that "equity securities…are widely available through agency transactions that do not involve the particular conflicts of interest associated with principal transactions." We do not agree with this assertion, particularly with regard to new issue equity, which is typically traded on a principal basis.

Fidelity invites eligible retirement and non-retirement customers to participate in new issue offerings, including initial public offerings ("IPOs") as well as follow-on secondary offerings. We clearly communicate that customers should read the offering prospectus carefully, and make their own determination of whether an investment in the offering is consistent with their investment objectives, financial situation, and risk tolerance. Given the Proposed Regulation's extremely broad definition of "investment advice", we anticipate that virtually any announcement of the availability of these securities to retirement investors would be considered "investment advice". The Department's limitations on securities that may be principally traded will prevent retirement investors, who have chosen to seek out new issue offerings of equity securities for good investment reasons, from purchasing these products.

Ultimately, the interests of investors would be further advanced if the Department simply permitted financial institutions that provide fiduciary investment advice to engage in principal transactions, *across a broad range of security types*, subject to a fiduciary obligation to act in the best interest of their customer and compliance with applicable rules regarding the purchase and sale of securities. Moreover, limitations on types of securities that can be principally traded in retirement accounts, may work against retirement investors' best interests. We urge the Department to adopt this alternative approach.

Municipal Securities. The Department has similarly not included municipal securities in the definition of Debt Securities in the Principal Transactions Exemption. Municipal Securities are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects, such as the construction of schools, hospitals, highways, sewers, and universities. Municipal securities can be bought either as new issues that are sold by underwriters to investors or can be purchased in the secondary market where they are traded over-the-counter. Municipal securities are heavily regulated by the SEC, FINRA, IRS and the MSRB, which is charged under the Securities and Exchange Act to propose rules governing the municipal securities markets.[43]

[43] The MSRB protects investors, state and local governments and other municipal entities, and the public interest by promoting a fair and efficient municipal securities market. The MSRB fulfills this mission by regulating the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities. To further protect market participants, the MSRB provides market transparency through its Electronic Municipal Market Access (EMMA®) website, the official repository for information on all municipal bonds. The MSRB also serves as an objective resource on the municipal market, conducts extensive education and outreach to market stakeholders, and provides market leadership on key issues. The MSRB is a Congressionally-chartered, self-

The municipal bond market is a dealer-driven market. The bulk of the bonds offered for sale via any online bond search are typically owned by dealers. Since the dealers actually own the bonds, the entire market operates on a principal basis, meaning that dealers buy bonds at one price and offer them for sale at a higher price, also known as a "spread". The profit a bond dealer earns is the difference between what the dealer paid for the bonds and the price at which the dealer ultimately sells the bond.

Municipal securities can play an important role in retirement accounts, both on a taxable and non-taxable basis. Taxable municipal bonds, such as the Build America Bonds, are not exempt from federal, state or local taxes. Depending on a number of factors including, the interest rate environment, offered yield, potential need for diversification of credit, and individual tax situation, it may be in the investor's best interest to hold a taxable municipal bond in his or her IRA. We acknowledge that taxable municipal bonds are more typically purchased in retirement accounts as compared to tax-exempt bonds, which are exempt from federal, state or local taxes. However, on an absolute yield basis, tax-exempt municipal bonds may be appropriate for retirement investors during certain time periods in the market.

Given that municipal securities are typically principally traded, the Department's omission of municipal securities in the Principal Transactions Exemption can be viewed as a determination that municipal securities are *never* appropriate for *any* retirement investor. We respectfully believe that such a judgment is not an appropriate exercise of the Department's regulatory authority, and we recommend that rather than limit retirement investors' access to these securities, the determination of whether an investment in a municipal security is in a retirement investors' best interest should be left to financial institutions and advisors who have a better understanding of the individual needs of the retirement investors they serve. We recommend the Department include municipal securities in the definition of Debt Security in the Principal Transactions Exemption, subject to a fiduciary best interest standard and in compliance with applicable rules regarding the purchase and sale of securities.

3. <u>Replace the Written Contract Requirement with a Unilateral Contract Requirement</u>.

For all of the reasons set forth above with respect to the written contract requirement of the BIC Exemption, we recommend a flexible approach where the contractual commitment can be established through a unilateral contract offer by the financial services firm which would be enforceable as a contract or through the doctrine of promissory estoppel. There is no need to require a signed, written document nor must the individual advisors be involved.

In addition, as part of the proposed written contract, the financial institution must agree that it will not enter into a principal transaction if the price (including the mark-up/mark-down) is unreasonable under the circumstances. If this provision is retained, the Department should

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regulatory organization governed by a 21-member board of directors that has a majority of public members, in addition to representatives of regulated entities. The MSRB is subject to oversight by the Securities and Exchange Commission.

include its interpretation of circumstances in which a price of a Debt Security is unreasonable to avoid confusion following FINRA and MSRB guidance on this point.[44]

4. Eliminate or Clarify Requirements Regarding the Quality of Debt Securities.

Under the Principal Transactions Exemption, an adviser and financial institution may only recommend debt securities that possess no greater than moderate credit risk and are sufficiently liquid that the debt security could be sold at or near its fair market value within a reasonably short period of time. The Department notes that debt securities subject to moderate credit risk should possess at least average creditworthiness relative to other similar debt issues and that moderate credit risk would denote current low expectations of default risk, with an adequate capacity for payment of principal and interest. As reference, the Department notes that the SEC has established similar standards of creditworthiness applicable to debt securities under Rule 6a-5 of the Investment Company Act of 1940.[45]

We disagree that SEC Rule 6a-5 is similar to the Department's proposal. The SEC's amended Rule 6a–5 replaced a credit rating requirement (removed by Congress as part of the Dodd-Frank Act) applicable to debt securities in which certain business and industrial development companies (''BIDCOs'') relying on the Investment Company Act exemption in section 6(a)(5) may invest. Under amended Rule 6a–5, a BIDCO that relies on the exemption in section 6(a)(5) may invest in certain debt securities, provided that the BIDCO board determines, at the time of purchase, that the debt security is (1) of no greater than moderate credit risk and (2) is sufficiently liquid. The standard for liquidity under the rules is whether the security can be sold at or near its *carrying value* within a reasonably short period of time.

The Department has replaced the SEC's "carrying value" standard for liquidity with a "fair market value" standard. Fair market value is the price that can be obtained in the market. Given that the fair market value for a security cannot be ascertained until one attempts to buy or sell a security, it is difficult to understand how market participants can meet this condition. Moreover, in making credit quality determinations, the SEC's rule permits a BIDCO to consider credit quality reports prepared by outside sources, including ratings of a nationally recognized statistical rating organization that the board or board members conclude are credible and reliable for credit quality determinations. The Principal Transactions Exemption contains no such additional criteria. Given that the financial institution would already be subject to a best interest standard and applicable law on the purchase and sale of securities when engaging in a Principal Transaction, detailed requirements on the types of securities that may be principally traded is not necessary, particularly when the requirements are not workable.

If the Department proceeds with this requirement, the Department should clarify how a financial institution should determine and measure the degree to which a debt security is "sufficiently liquid" such that it could be sold at or near its fair market value within a reasonably

[44] *See* discussion of pricing information and a dealer's best execution obligations *infra*.
[45] *See* Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)].

short period of time. The Principal Transactions Exemption requires the advisor and financial institution, among other items, to obtain a pricing quote for the debt security offered by two ready and willing counterparties that are not affiliates. We recommend the Department take the position that if a financial institution or advisor can obtain two independent quotes for a particular debt security, that debt security is sufficiently liquid for purposes of the Principal Transactions Exemption.

Moreover, because the financial institution cannot predict the liquidity status of the debt security at a future point in time, the Department must clarify that any assessment of liquidity must be based only upon information that is readily available at the time the advice is offered. The regulatory environment of the past several years has had a significant impact on liquidity in the trading markets, particularly for debt securities. The Volcker Rule as well as liquidity and capital requirements included within the Dodd-Frank Act and Basel III have transformed the structure and functioning of the fixed income markets. These regulatory proposals have served to reduce risk in the markets, but have also reduced liquidity. Given the uncertainties of liquidity in future debt markets, we urge the Department to clarify that an assessment of liquidity status is made at the time the investment advice is offered.

5. Eliminate Pricing Information Requirements.

Section III of the Principal Transactions Exemption provides that the purchase or sale of the debt security (1) must be executed at a price that the financial institution reasonably believes is at least as favorable to the investor than the price available to the investor in a transaction that is not a principal transaction and (2) must be at least as favorable to the investor as the contemporaneous price for the debt security, or a similar security if a price is not available with respect to the same debt security, offered by two ready and willing counterparties that are not affiliates in agency transactions.

The Department notes that when evaluating the price offered by the counterparties, the financial institution may take into account the resulting price to the investor including commissions. The Department intends that the proposal should allow a comparison between the actual cost to the investor of the principal transaction (including the mark-up or mark-down) and the actual cost to the investor of a non-principal transaction (*e.g.,* an agency transaction) in the same or a similar debt security, including a commission.

We note several practical difficulties to the Department's proposed approach. First, the Principal Transactions Exemption requires that the financial institution obtain two quotes on the debt security or a similar security offered by two ready and willing counterparties that are not affiliates in agency transactions. The underlying assumption is that two prices can be obtained. We anticipate that obtaining two quotes for treasury and agency debt securities may be achievable; however obtaining two quotes for a corporate debt security may be more difficult. Currently, corporate debt securities are liquid, but could be less liquid at a future point in time depending on market conditions.

Second, the Principal Transactions Exemption requires financial institutions to determine the commission, including mark-up or mark-down, of a counterparty to compare quotes. From a practical standpoint, a counterparty may be unwilling to share this information and the financial institution has limited means to compel it.

Most importantly, the Principal Transactions Exemption may impair a broker-dealer's ability to exercise reasonable diligence under FINRA and MSRB rules by adding a significant hurdle for dealers to act in a principal capacity. FINRA's Best Execution rule[46] and MSRB's approved but not yet effective Best Execution rule[47] require that dealers exercise reasonable diligence to ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. FINRA and MSRB provide a list of factors that will be considered when determining whether a dealer exercised reasonable diligence. The duty of best execution applies whether a broker-dealer is acting as an agent or a principal and applies across retirement and non-retirement accounts. The Department's proposed pricing information requirements conflict with a dealer's best execution obligations, in that if a dealer has used reasonable diligence and determined that its own principal inventory is the best available market under prevailing market conditions, under FINRA and MSRB rules it must execute in that market.

Moreover, given the existing FINRA and MSRB obligations on broker-dealers to obtain favorable prices for customers, on which regulators regularly perform surveillance and examinations, and on which financial institutions would be required to warrant compliance, we question why additional requirements and conditions are necessary to help ensure investors receive a favorable price for a particular security.

6. <u>Eliminate the Pre-Transaction Disclosure</u>.

The Principal Transactions Exemption provides that the advisor or financial institution must provide a pre-transaction disclosure to the investor, either orally or in writing. The disclosure must notify the investor that the trade will be executed on a principal basis and provide the investor with any available pricing information regarding the debt security, including

[46] For example, FINRA Rule 5310 ("Best Execution and Interpositioning") which provides that in any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used "reasonable diligence" are: (A) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; (B) the size and type of transaction; (C) the number of markets checked; (D) accessibility of the quotation; and (E) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.
[47] Amendments to MSRB Rule G–18 will require municipal securities dealers to seek the most favorable terms reasonably available for their retail customers' transactions. These amendments are added to long-standing MSRB rules regarding unfair pricing practices and will take effect December 7, 2015.

the two quotes obtained from unaffiliated third parties. The disclosure would also include the mark-up or mark-down[48] to be charged in connection with the transaction.

From a practical standpoint, assuming that a financial institution can even obtain two independent quotes from counterparties to fulfil the pre-transaction disclosure requirements, the financial institution will then need to circle back to the investor to obtain his or her consent prior to proceeding with the transaction. Given potential delays in this process and the passage of time, there is a risk that the quoted price may no longer be available, and the entire process required to be started again, frustrating all parties involved. These types of disclosures will impede trading and result in timing and opportunity losses for smaller retirement accounts. We urge the Department to withdraw this portion of the pre-transaction disclosure requirements.

7. Coordinate Written Confirmation Requirements with Other Financial Regulators.

The Principal Transactions Exemption would further require the financial institution to provide a written confirmation of the principal transaction in accordance with Rule 10b-10 under the Securities Exchange Act of 1934 that also includes disclosure of the mark-up, mark-down or other payment to the advisor, financial institution or affiliate in connection with the transaction.

We note that Rule 10b-10 does not currently require disclosure of mark-ups in principal transactions; however disclosure of mark-ups in principal transactions is a current focus of several regulatory and legislative efforts. FINRA and the MSRB, at SEC direction, recently issued concurrent rule proposals concerning disclosure of mark-ups in riskless principal transactions[49] and Senator Mark Warner and Senator Ron Coburn introduced legislation[50] in 113th Congress that would require bond dealers to disclose to customer the difference between the dealer's price and the customer's price before completion of a riskless principal transaction.

Changes to disclosure that customers receive should be viewed in totality across regulatory agencies to help ensure that the sum of such disclosure is coordinated, consistent, helpful and appropriate. More disclosure does not always result in a more informed investor. The Principal Transactions Exemption uses different terminology and disclosures from the FINRA and MSRB Proposals to meet the same regulatory goal. Moreover the Department's proposal applies only to retirement accounts in which fiduciary investment advice has been offered, while the FINRA and MSRB Proposals that would apply across retirement and non-retirement accounts, regardless of whether advice was offered. We urge the Department to carefully consider retirement investors need for additional disclosure, specific to retirement

[48] The Department is considering defining mark-ups and mark-downs as amount in excess or deficit of the "prevailing market price" that a customer receives for the debt security. The Department is considering whether to define the "prevailing market price" by reference to FINRA Rule 2121 which sets forth a methodology for determining the prevailing market price. We encourage the Department use the definition of "prevailing market price" in FINRA Rule 2121. This approach will help promote legal certainty and reduce confusion over terms used by different rules in the same context.

[49] FINRA Proposal and MSRB Proposal as discussed *infra.*

[50] S.2114 - Bond Transparency Act of 2014; a bill "to amend the Securities Exchange Act of 1934 with respect to disclosures to investors in municipal and corporate debt securities, and for other purposes."

accounts, in light of the comprehensive disclosure proposals currently under consideration for the same transactions and to coordinate its effort with other financial regulators.

The post–transaction disclosure requirements in the Principal Transactions Exemption will be operationally challenging for market participants, particularly for clearing broker-dealers. The Principal Transactions Exemption would require financial institutions to build a significant new system, at considerable cost, to identify principal trades in retirement accounts executed pursuant to investment advice versus principal transactions executed at the request of self-directed investors.

The operational challenges of the proposals are especially significant for clearing broker-dealers that would likely be required to coordinate and rely on third parties for data necessary for compliance. Fully-disclosed clearing broker-dealers clear and settle millions of securities transactions each day for thousands of introducing broker-dealers.[51] Clearing broker-dealers do not sell securities to retail customers. Rather, a fully-disclosed clearing broker-dealer provides routine and ministerial "back office" processing services -- clearance and settlement and custody services -- to introducing broker-dealers. The relationship between the clearing broker-dealer and the introducing broker-dealer and the division of responsibilities between them is set forth in a fully disclosed clearing agreement, which is filed with and approved by FINRA before any clearing services may begin.

Among other back-office functions, clearing broker-dealers settle fixed income trades and print and mail end-customer confirmation statements for introducing broker-dealers. Under the Principal Transactions Exemption, an introducing broker-dealer would need to submit information on a particular principal trade made pursuant to the provision of investment advice in a retirement account to its clearing broker-dealer, after the introducing broker-dealer has marked this information itself. All of this work would need to be performed, without error or delay, before the established deadlines for passing files to the trade confirmation engine to allow the clearing broker-dealer to print and mail the statement to the end-customer within established regulatory timeframes. We anticipate this process to be challenging at best and in some cases unworkable.

8. Eliminate Duplicative Annual Disclosure Requirement.

In addition to pre-transaction disclosure and post-transaction disclosure confirming the transaction, the financial institution would further be required to provide the investor with an annual statement, within 45 days after the end of a calendar year, that lists the principal transactions engaged in during the year, provides the prevailing market price at which the debt security was purchased or sold and provides the applicable mark-up or mark-down or other payment for each debt security.

[51] Because many introducing broker-dealers (aka "correspondents") do not have the net capital, resources, technology, personnel or expertise to clear and settle their own trades, introducing broker-dealers often contract with a third-party clearing broker-dealers to carry their proprietary accounts (if any) and its end-customer accounts and perform back office functions on a fully-disclosed basis (*i.e.*, disclosed to the introducing firm's end customers).

The Principal Transactions Exemption's annual statement requirement is duplicative of the pre-and post-transaction disclosure requirements and as such does not appear to serve any practical or useful purpose. Moreover, it makes no distinction between principal transactions executed in a retirement account versus principal transactions executed in a retirement account pursuant to the provision of investment advice. We assume that this disclosure only pertains to those principal transactions executed in a retirement account pursuant to the provision of investment advice and if the Department determines to proceed with this requirement, we ask the Department to clarify this point.

Also, the 45 day time period to provide the annual statement is too short a period of time to provide this information to all of the financial institution's retirement investors. Given that retirement investors will have already received this information in pre-transaction disclosure and in post-transaction confirmation disclosure, we do not believe that a shorter period of time is necessary. If the Department determines to proceed with this requirement, we request a 90 day period to provide the annual statement.

High-Quality Low-Fee Streamlined Exemption Concept

The Department has requested comments on whether it should create a streamlined exemption for "high-quality low-fee" investment options. We strongly encourage the Department to adopt instead the new best interest paradigm described in the main body of this letter and in Attachment A which would provide for a single streamlined best interest contract exemption for all transactions associated with the Proposed Regulation. However, we are commenting on the specifics of the Department's proposed high-quality low-fee approach because we believe it would be extremely problematic and we urge the Department not to move forward with the concept.

As the Department recognizes, establishing objective criteria to determine what investments are "high-quality low-fee" would be very difficult, if not impossible. If the Department determines to proceed with a streamlined exemption approach where specific criteria are utilized to determine which investments meet the definition for purposes of an exemption, the Department should first issue a comprehensive Request for Information or proposed exemption for review and public comment. Given the extraordinary challenges of identifying such options, there simply is not sufficient time to provide comprehensive analysis for the Department to review as part of the BIC Exemption.

Following are specific comments outlining our concerns.

1. <u>Challenges in Identifying "Low-Fee" Investments</u>.

The Department is correct that mutual fund operating expenses are highly transparent. However, a fund's expense ratio does not always reflect the full cost that an investor may incur because of the various ways investors may purchase funds. Just as the Department asks how commissions associated with ETFs could be incorporated into a low-fee calculation, the

Department should recognize broker-dealers may assess a transaction fee—which is not reflected in a fund's expense ratio—for the purchase or sale of a fund. These transaction fees can apply to very low-cost mutual funds, which are less likely to fully compensate third-parties for the costs of servicing fund shareholders. Therefore, relying on a fund's disclosed expenses may not capture all investor costs.

Even if these external fees are ignored, determining whether a particular fund is "low-fee" still requires a standard against which to measure, yet fees vary significantly by asset class. Median total expense ratios in 2014 were 1.18% for value equity funds, 1.39% for world equity funds, 0.86% for bond funds, and 0.10% for money market funds.[52] Adopting a single fee threshold may discourage advisors from recommending a fully diversified portfolio, which would normally include relatively higher-cost asset classes for which low cost passive options are few or non-existent, such as high yield, for example.

Abandoning a single "low-fee" threshold and instead devising multiple thresholds that vary based on asset class, while better, would still present additional challenges. First, there is no standard methodology for categorizing mutual funds. Even independent mutual fund data providers such as Morningstar and Lipper categorize funds differently. Second, given the rapid pace of innovation and evolution in the industry, the number and types of fund categories and the classification of funds into categories changes frequently. The mutual fund industry has long wrestled with the challenges of selecting an appropriate fee benchmark for comparison, and that explains why there is wide variation in the practices that independent mutual fund boards follow to satisfy their duties with respect to annual renewal of mutual fund management fee contracts. There is no reason to believe that competitive fee comparisons for purposes of the streamlined exemption can be standardized and also remain meaningful.

This issue is magnified when other investment products such as ETFs are considered for inclusion. If ETFs are included, trading fees/commissions would need to be considered as part of the exemption which adds further complexity. For example, there would be a significant effective cost difference between a participant investing a large position for a long-term investment versus a participant making smaller incremental periodic investments in their retirement plan.

2. <u>Challenges in Identifying "High-Quality" Investments.</u>

While questions posed by the Department seek insight on what might be considered a "low-fee" investment, it does not similarly inquire into how "high-quality" would be determined. Fidelity believes that while the quality of a fund is as important a consideration as its cost, this term is even more murky and elusive than "low-fee". Clearly, any measure of "quality" would encompass far more than an investment's costs, potentially including such other factors as performance, consistency, portfolio management process, liquidity, risk management and oversight. Unless the Department were to empower a third-party rating agency to judge an investment's quality and thereby exert undue influence on the use of the

[52] According to the Investment Company Institute's 2015 Investment Company Fact Book, Figure 5.7.

streamlined exemption—which we do not recommend—it is hard to imagine how this can be put into practice. Removing "high-quality" from the criteria would result in fees being the only factor used to assess whether a fund qualifies for the exemption which would not result in the best range of choices available to consumers. Implementing an exemption that makes it easier to recommend a poorer range of options is not in the best interest of the investors that the overall rule is meant to serve.

As the Department has recognized, fees should not be the sole criteria for investment selection. The regulation under ERISA section 404(a) mandates that fiduciaries provide participants with various disclosures in a participant-directed plan, including a comparative chart of the plan's investment options. This regulation requires that a statement be included in the disclosure that indicates "fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions."[53]

3. Active vs. Passive Investments.

The Department's proposal correctly acknowledges that an exemption based on fees would strongly favor passively managed index funds and that there is no consensus in academic literature that an optimal investment strategy comprises only passively managed funds. Actively managed funds and passive index funds both offer value to consumers, and a customer-centered rule should not favor one over the other. In fact, Fidelity's own research reinforces the view that actively managed funds can benefit investors more than index funds as explained below.

It is often claimed that on average and in every market, active management after fees does not add value for investors. Occasionally, this point is extended to say that passive index funds outperform active funds, on average. The assertion is demonstrably incorrect. Our analysis of Morningstar data, including the returns of every registered active and passive fund for more than two decades (to eliminate survivorship bias), shows that in U.S. small-cap equity and international large-cap equity investing, the average actively managed fund outperformed its benchmark after fees by 1.11% and 0.86% respectively, while the average passive index fund underperformed after fees by 0.35% and 0.32% respectively. These results are before any type of filter for "high-quality" or "low-cost" is applied.

Passive index funds offer low-cost exposure to the return and risk characteristics of an underlying benchmark index, and as such, are not intended to outperform the index after fees. Judicious active management offers investors the opportunity to outperform both a benchmark index and the passive index funds matched to that benchmark. This active outperformance can aid investors in reaching their financial goals. In addition, there are several investment asset classes or approaches for which true passive index funds do not exist, such as in the fixed income asset class which we discuss in more detail below. An exemption that effectively allows only passive index funds could restrict the recommendation of a diversified portfolio or strategy that may be in the best interest of the investor. Consequently, we believe that any streamlined

[53] DOL reg. § 2550.404a-5(d)(1)(iv)(A)(4).

exemption designed to benefit investors should be structured to allow for active as well as passive funds.

Even if, in spite of these facts and the Department's limited regulatory mandate under ERISA and the Code, the Department wanted to afford special treatment to passively managed funds, variations in investment strategies can obfuscate the distinction between active and passive investment strategies. For example, some funds are designed to adhere closely to the index but with slight overweights and underweights. Other funds, so-called "strategic beta" or "smart beta" funds are passively managed to track an index that itself is actively constructed to emphasize specific factors (e.g., low volatility or high earnings quality). Many fixed-income index funds seek to track the performance of the Barclays U.S. Aggregate Index, which contains more than 8,000 securities, many of which are illiquid, making it impossible for funds to replicate the index. Instead, they adopt an active selection process to mirror the characteristics of the benchmark index.

4. Use of Streamlined Exemption in Defined Contribution Plans.

It is unclear whether a streamlined exemption would be useful in defined contribution plans where plan sponsors typically offer to plan participants only a discrete line-up of investment options. First, many financial advisors believe an investor's portfolio should diversify across a variety of asset classes, including large cap equities, small cap equities, developed international equities, emerging market equities, high yield bonds, investment grade bonds, short-term bonds or cash equivalents, and perhaps even extended asset classes such as real estate, commodities, inflation-protected securities, and floating rate loans. If the plan line-up does not include "high-quality low-fee" investment options for each of these asset classes, a financial advisor would have to choose between abandoning the streamlined exemption or limiting the scope of its advice. Alternatively, the advisor would need to seek to use another exemption (e.g., the BIC Exemption) to provide advice on the participant's entire account which would result in a confusing and suboptimal customer experience.

Furthermore, many plans offer collective investment trusts or separate accounts instead of mutual funds. The fees for these unregistered investment products are less transparent than comparable mutual funds because they are not subject to the same SEC disclosure rules. However, they are also often less expensive than comparable mutual funds for a variety of reasons. If these investments are excluded from the streamlined exemption, participants in such plans could be less likely to receive investment advice.

5. Application of Best Interest Standard in Streamlined Exemption.

The Department contemplates that the best interest standard would not "expressly" be included in the streamlined exemption. Presumably the Department believes that options that meet the "high-quality low-fee" criteria would always be in the best interest of an investor. As discussed above, there are significant challenges for determining what criteria could be used for such a determination. Even if conditions could be established and a streamlined exemption created, the advisor should still be required to act in the best interest of the investor when providing the recommendation. While an investment may be "high-quality low-fee", that does not mean it necessarily is in the best interest of a particular investor. For example, a recent college graduate at age 21 does not typically need to invest any portion of his or her newly established 401(k) account in a bond or money market fund. However, without imposing the best interest standard as a condition of the exemption, advisors could recommend such investments to a participant and not be held responsible for such advice, so long as they were considered to be high-quality and low-fee.

6. Additional Considerations in Developing a Streamlined Exemption.

The Department inquires as to what other conditions should be imposed in addition to low fees as part of the exemption. As discussed above, an assessment of "high-quality" should be included in addition to "low-fees". Regarding other potential conditions, the Department suggests that "broadly diversified" can mean different things in different contexts, and is no guarantee of minimizing risk for a targeted return. If the goal is to eliminate highly concentrated or highly specialized funds from a streamlined exemption, this will need to be approached carefully. A sector fund may be broadly diversified within its sector, but not as diversified as, for example, a general small-cap stock fund. However, holding that fund as an investor's only investment might not represent an optimally diversified portfolio. The implication of the question, however, is whether the exemption should include only multi-asset class funds (e.g. "target date," "lifecycle," "target risk" or "balanced" funds). Limiting an exemption to such funds could greatly circumscribe the ability of broker-dealers to recommend responsible and appropriate diversified portfolios for investors with particular needs and inclinations.

The Department asks whether only investments that meet the definition of a qualified default investment alternative ("QDIA") within the meaning of 2550.404c-5 be included in the streamlined exemption. Presumably, such a requirement would potentially address the concerns related to diversification if other investments were not available to allow for recommendations on a plan participant's entire account. Most plans use a target date fund series as their QDIA[54]. We believe target date funds are excellent solutions for many investors. However, with the Department's emphasis on low-fee and passive management, we believe there may be some confusion about the actual structure and implementation of these types of funds and note the following for consideration:

The "optimal investment strategy" the Department references is sometimes called "strategic asset allocation." It involves looking at market inputs (including the historical and projected return, risk, and correlations of assets) and evaluating the investor's risk tolerance, in order to create a portfolio of diversified assets that will maximize the expected investment return for the desired level of risk. Strategic asset allocation is inherently active – there is no passive "formula" for optimizing allocation for a given individual or group of individuals, because it depends on the return objectives and risk tolerance being assumed. Research has shown that for multi-asset class portfolios, the strategic asset allocation is the main driver of investor outcomes.

[54] As of March 2015, nearly 84% of the corporate defined contribution plans recordkept by Fidelity used a target date fund as the QDIA.

In other words, simply deciding on the right balance between stocks, bonds, and other asset classes for a given investor's needs is more significant than which particular stocks and bonds are selected.

The view of optimal strategy described in the language is, importantly, theoretical only; there is no such thing as an investable market portfolio that is a passive "diversified portfolio of assets calibrated to track the overall performance of financial markets." Target date funds, rather than optimizing for an individual investor at a single point in time, set up parameters for strategic asset allocation that are followed according to a schedule, usually connected to the investor's anticipated time until retirement. This schedule of investment allocations is called a "glide path." Glide paths vary widely among investment providers, in large part because each glide path is an active decision based on the manager's risk management approach, savings behavior/retirement age assumptions, and the performance expectations for various assets classes, among other factors. The construction and management of the asset allocation parameters and the glide path is an inherently active endeavor.

The strategic asset allocation can also be actively managed in response to market conditions, by tilting the weights of various asset classes in response to periods when they have become over- or undervalued relative to history or to expectations. This is called "tactical asset allocation," and is an inherently active approach.

In addition, the underlying investments in a target date fund or in a balanced fund can be either actively or passively managed funds. By selecting underlying investments with the potential to outperform comparable index funds after fees, actively managed multi-asset class funds can potentially earn more returns for investors.

There are several asset classes that are considered part of a diversified portfolio that do not have properly representative index fund options (e.g., emerging market equity and debt), or for which actively managed funds tend to outperform passive (e.g., U.S. small-cap equity). To optimize a portfolio and achieve the best investment results using these asset classes, many portfolio managers include actively managed funds in their target date funds.

7. Business Model Implications of a Streamlined Exemption.

The Department asks a series of questions regarding certain business models and how they would potentially react to a high-quality low-fee exemption. While it is impossible to predict how such an exemption would be utilized in practice, there are potential concerns based on an advisor's business model that could affect use of a streamlined exemption. For example, as stated above, a broker-dealer may charge an additional fee for a given fund that could be included in the exemption. Should that fee be considered in a determination of high-quality low-fee funds? That would prevent a "master" list of funds that fall within the exemption and create the need for advisors to develop a mechanism to screen and track funds. Further, fees for funds can change over time and thus funds that meet the exemption criteria could change and would therefore require frequent monitoring.