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

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

Re: Proposed Conflict of Interest Rule (RIN 1210-AB32) and Best Interest Contract Exemption (ZRIN 1210-ZA25)

Vanguard welcomes the opportunity to provide further comments on the Department of Labor's (the "Department") April 2015 proposed Conflict of Interest Rule defining fiduciary investment advice (the "Proposal") and the corresponding proposed Best Interest Contract Exemption ("BICE"). Vanguard appreciates the Department's consideration of the full spectrum of written comments and oral testimony it has received on the Proposal and the BICE to date. We encourage the Department to continue engaging with investors, the regulated community and other regulators as it works to finalize the rule and exemptions.

In addition to the comments included in the two letters we submitted on July 21, 2015, regarding the Proposal and the BICE, we ask the Department to consider this supplemental letter addressing two primary issues: the scope of the definition of investment advice in the Proposal and the conditions that should be included in a substantially simplified BICE. By making modifications suggested here in addition to the changes we proposed in our earlier comments, we believe the Department will foster continued availability of important investment education and advisory services in a way that both protects the rights of plan participants and IRA investors and also is administratively feasible.

1. **The Department should adopt FINRA's guidance on the definition of a "recommendation" as part of the Department's definition of fiduciary investment advice.**

As described in our initial comment letter on the general definition of fiduciary, Vanguard believes that the Department should narrow the definition of "recommendation" to match the expectations of plan sponsors, participants, and IRA investors (collectively, "Retirement

Investors") as to when they should reasonably believe that they are receiving impartial investment advice. We understand from the Department's comments and questions during the hearings that the Department remains interested in comments as to whether the "recommendation" element of the definition should be based on FINRA's "recommendation" guidance. As we noted in our prior letter, we agree that FINRA's guidance on what constitutes a recommendation under FINRA Rule 2111 provides a sound basis for the Department's regulation. Further, we believe that completely incorporating the FINRA standard would be comparable to implementing the totality of circumstances test that we proposed in our prior letter.

Complete adoption of the FINRA standard into the Department's regulation would provide a number of benefits to investors and simplify compliance for many industry members. First and foremost, participants and IRA investors would benefit from greater consistency in the standards that apply to their retirement and nonretirement investments. Industry members would also benefit significantly from a consistent approach. The FINRA standard is understood through a substantial body of interpretive guidance on the distinction between providing investment education on the one hand and making an investment recommendation on the other. In addition, many plan providers or their affiliates are already subject to FINRA's jurisdiction. We acknowledge the Department's position that it cannot practically achieve a fully coordinated definition of fiduciary with a possible future harmonized definition of fiduciary for broker-dealers and investment advisers under Securities and Exchange Commission ("SEC") rules at this time. Nevertheless, we believe harmonizing the definition of recommendation at the core of the Department's fiduciary definition with FINRA's standard would be a helpful start.

a. <u>The FINRA standard provides an appropriate measure for distinguishing between investment advice and other services.</u>

Under the FINRA standard, all facts and circumstances under which a communication occurs between an investor and a broker-dealer or its representative must be evaluated to determine whether a recommendation has been made. Important factors include, but are not limited to (1) whether the content, context, and presentation of the communication would be viewed by a reasonable person as a call to action with respect to the investment or investment strategy, and (2) consideration of the degree to which the communication has been individually tailored to the investor.

This standard is appropriate for the Department's regulation because it reflects a critical concept that must be encompassed in any definition of fiduciary investment advice under ERISA: the degree to which a financial professional has implicitly or explicitly induced the Retirement Investor to expect impartial advice. As outlined in greater detail in our prior comments, we believe that this is the core dividing line between true investment advice to which ERISA's fiduciary standards and prohibited transaction rules should attach and other services and activities that, like marketing and education, are clearly nonfiduciary.

For example, when discussing whether a participant should take or roll over a distribution, the extent to which the financial professional has called on the participant to take a particular course of action would drive the determination of fiduciary status. If the financial professional provides a highly tailored communication on whether or not to take the distribution or rollover, it is likely fiduciary investment advice. In contrast, if the financial professional merely describes the services he or she can provide outside the plan if the participant chooses to roll over without a call to action, that should be considered nonfiduciary communication.

This approach would also translate well to conversations investors may have with call center employees at financial institutions. For example, communications suggesting that a participant consider certain features of target date funds should be evaluated with respect to their content, context, and presentation to determine whether the communication is a recommendation rather than presentation of information about investment options.

b. Material changes to the FINRA standard are unlikely and should not disrupt plan services if appropriate carve-outs are in place.

One concern that many commenters have raised with regard to incorporating the FINRA standard into the ERISA definition of a fiduciary is the possibility that FINRA's standard, originally intended for a different purpose, might change over time in a way that narrows or expands the definition of a recommendation to a degree that would be inconsistent with the ERISA standard. In our view, these fears are overstated. First, the FINRA standard has existed in essentially its current form for decades and is unlikely to change materially absent a legislative directive or rulemaking from the SEC. Second, FINRA could not materially change FINRA Rule 2111 without going through its own rulemaking process, which includes SEC review and opportunity for public comment on the proposed rulemaking.[1] As a result, the Department and other interested parties would have an opportunity to raise any concerns through comment on the FINRA rulemaking. If concerns with a FINRA rule change persist after a new FINRA standard is adopted, the Department could use its own rulemaking authority to amend its fiduciary definition or provide further interpretive guidance in light of a new FINRA standard.

While we do not believe a significant and rapid change in the FINRA standard is likely, it is not an issue that should be ignored. The other mitigating factor in the event of a change in the FINRA standard is the Proposal's carve-outs from the fiduciary definition. These carve-outs cover a number of basic services and would allow the continuation of practices deemed nonfiduciary by the Department if unanticipated changes are made to the FINRA standard. As a result, it is important that the Department retain and expand the carve-outs as we recommended in prior comments, so that any significant change in the FINRA standard would not impact the practices of providers under the Department's definition of advice and would allow the Department to provide additional guidance if necessary.

[1] 15 U.S.C. § 78s(b)(1).

2. Description of services, presentation of service terms, and contract negotiations should not be considered fiduciary recommendations.

Some commenters noted the distinction the Department has recognized in other contexts between arm's length negotiations and a service provider's provision of services pursuant to an agreement or arrangement.[2] We agree that a service provider's service descriptions, presentation of service terms, and contract negotiations should not be considered fiduciary recommendations. Rather, to the extent those services constitute investment advisory services under the new regulation, fiduciary responsibility should attach after the client has entered an agreement or arrangement with an investment provider or advisor. This approach will address concern that the Proposal's coverage of investment advisor or manager recommendations as fiduciary services will sweep in standard "hire me" conversations and contractual negotiations. It will also, however, address the Department's concern that the seller's carve out in the counterparty exception can be too broad. Additionally, as noted below, the Impartial Conduct Standards of a revised BICE would require the terms of any arrangement to be reasonable under the circumstances. This separate condition would serve to protect Retirement Investors from unreasonable arrangements without forcing arm's length negotiations into an inapposite fiduciary framework.

Recognizing a service provider's own service terms, descriptions, and contract negotiations as nonfiduciary activity and provision of services under those arrangements as fiduciary activity will ensure that advisors have a fiduciary duty to act in a Retirement Investor's best interest within the scope of the advisory arrangement that the Retirement Investor has contracted to receive. In the contracting phase, advisors may agree with Retirement Investors to limit the scope of advisory services to certain categories of investment, such as investments available on a particular provider's platform, proprietary investments, or a particular investment mandate. Their discussions in setting the terms of the engagement would not be fiduciary, but the advisor's services within the scope of the engagement would be required to be in the Retirement Investor's best interest.

3. The Department should significantly simplify the conditions of the BICE to achieve an exemption that both protects Retirement Investors and is administratively feasible.

As we stated in earlier comments, the feasibility of a broader fiduciary standard depends on workable prohibited transaction exemptions. As commenters and the Department noted during last month's hearings, the Department can effectively address its concerns about conflicts of interest and foster broader availability of fiduciary advisory services by substantially simplifying the conditions of the BICE. Such an approach would reflect a better balance between the administrative feasibility of the exemption and protection of the rights and interests of Retirement Investors as required by ERISA section 408(a). To this end, as the Department articulated during the hearing, we agree that the BICE would be meaningfully simplified if the

[2] *See, e.g.*, 29 C.F.R. § 2550.408b-2(f), Example 4.

Department limited its requirements to an enforceable commitment to adhere to and actual compliance with the core components reflected in the Impartial Conduct Standards, as follows:[3]

- when providing investment advice to a Retirement Investor, the advisor must provide investment advice that is in the best interest of the Retirement Investor;
- the terms of the arrangement may not be unreasonable under the circumstances; and
- the advisor's statements about any matters relevant to a Retirement Investor's investment decision may not be misleading.

This simplified approach would better reflect the Department's stated objective of adopting a principles- or standards-based exemption.[4] Vanguard commends the Department for its flexibility in considering this approach and agrees that a standards-based approach can better adapt to new business models and advances in retirement products and services. Such an approach can avoid application of inconsistent standards that can create an uneven playing field for different services and investment products.

That said, regulated entities and Retirement Investors will trade some measure of certainty in the application of the BICE for the flexibility afforded by a principles-based approach. This uncertainty is troubling in light of the severe financial and reputational consequences that can result from an uncovered prohibited transaction. Accordingly, Vanguard urges the Department to pair a principles-based BICE with clear, up-front interpretive guidance, both at the BICE's inception and on an ongoing basis. A regime that allows for enforcement based on changes in the Department's view of an exemption's requirements, retroactively applied, will serve to restrict the availability of helpful products and services in the same way an overly complex, narrow and prescriptive set of conditions can. To that end, it is important that the Department's Office of Regulations and Interpretations and Office of Exemption Determinations work closely with its regional offices and the Office of Enforcement to ensure that the conditions of the BICE are consistently interpreted and enforced based on public and prospective guidance. The success of the BICE will depend on continued attention to this type of coordination by the Department.

a. <u>The best interest standard should not be based on a new, untested definition.</u>

We agree that advisors should be held to a best interest standard when providing investment advice to Retirement Investors. The definition of the investor's "best interest" should reflect the requirements financial institutions have satisfied as fiduciaries for decades. To that end, the Department stated that the best interest standard is intended to parallel the fiduciary standards

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[3] These Impartial Conduct Standards reflect the key protections the Department added to other exemptions as part of its overall proposed reforms. *See* 80 Fed Reg. 22035 (Apr. 20, 2015).

[4] *See* Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21928, 21966 (Apr. 20, 2015) (the Department "seeks to preserve beneficial business models by taking a standards-based approach that will broadly permit firms to continue to rely on common fee 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").

already applicable to plans subject to ERISA and extend them to IRAs.[5] However, the best interest definition included in the BICE does not follow the statutory language precisely and we are concerned that this variation may result in inconsistent standards. Specifically, the BICE definition provides that investment advice is in the best interest of a Retirement Investor if it

> reflects the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity or other party.

BICE section II(c)(1). We understand that commenters have encouraged the Department to adopt a standard for IRAs that is consistent with either ERISA or securities law fiduciary standards to create better harmonization with either the rules applicable to retirement plans or the rules applicable to retail accounts. While there are merits to either approach, in no event should the Department adopt a new, third standard that differs in any respect from both retirement and securities law. In our view, a new standard invites litigation in the absence of the decades of interpretive guidance developed under either ERISA or securities law. At a minimum, Vanguard encourages the Department to delete the requirement that advisors act "without regard to" the advisor's interest, which seems to paraphrase ERISA's exclusive purpose rule. To the extent the Department is concerned that such a change may fail to address an advisor's conflicts, it is our view that those concerns can be considered in the context of the firm's policies and procedures to mitigate conflicts, which we review below.

b. <u>Advisors' adherence to a best interest standard should be disclosed to Retirement Investors and enforced through the BICE.</u>

As we noted in our earlier comments, the Department should permit advisors to commit to fiduciary obligations through an enforceable acknowledgement or disclosure provided when the Retirement Investor engages the advisor rather than through a multi-party contract before conversations may begin.

Importantly, the practicality of this condition of the BICE does not turn on a question of timing. The Department will not resolve the tension created by its original proposed exemption by amending the contract condition of the BICE to delay execution of a written contract to the time recommended transactions are effected. As we noted in previous comments, advice and implementation can often be simultaneous. Further, advisors may not have the ability to determine whether or when an investor acts on the discussion. Indeed, an investor might not execute the recommended transactions with the financial institution that provided the advice but instead complete them through another financial institution.

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[5] 80 Fed. Reg. at 21970.

Retirement Investors will be provided the same level of protection if advisors are required to adhere to a best interest standard that is disclosed to Retirement Investors and enforced through the BICE. Such an approach could be compared to other policies financial institutions adopt and disclose to govern their conduct, such as privacy policies. A Retirement Investor would receive the same level of disclosure of the protections of the BICE whether or not that disclosure is accompanied by a signature (electronic or otherwise). Finally, whether an advisor or Retirement Investor executes a contract or not, an advisor's ability to rely on the BICE remains dependent on its satisfaction of the requirements of the BICE, including the best interest standard. Because the consequences of a nonexempt prohibited transaction are so severe, advisors and financial institutions will have significant incentives to comply with the BICE (or forego offering investment advice).

c. To the extent disclosure is a component of a reasonable arrangement under the Impartial Conduct Standards, the Department should build upon existing disclosure requirements.

Vanguard agrees that clear, complete disclosure of advisor and financial institution compensation is an important element of a reasonable arrangement. A clear description of the cost of products and services allows investors to compare providers on the basis of similar information and helps investors ensure they are obtaining the investment assistance they want for a price they can understand. In that regard, the BICE's conceptual focus on fee disclosure as an aspect of the contract or arrangement for advisory services makes sense.

As we observed in our prior comments, however, the Department did not leverage its extensive efforts to adopt regulations requiring fee disclosure to plan sponsors and plan participants.[6] Instead, the contractual and separate disclosure requirements of the BICE layered disclosure upon disclosure in a confusing set of point-of-sale and ongoing obligations to provide information in an individualized, dollar-amount format that has already been rejected as administratively unworkable in two sets of recent regulations. To the extent the Department requires separate fee disclosures as part of the BICE, we reiterate our view that the Department should amend the BICE so that financial institutions are required to provide only a simplified point-of-sale disclosure to the Retirement Investor orally or electronically. Additionally, to the extent that advisors are subject to the fee disclosure requirements of ERISA section 408(b)(2) as fiduciaries, we encourage the Department to confirm that compliance with those requirements with respect to services to plan sponsors will satisfy the requirements of the BICE.

[6] The Department has adopted three major regulations relating to fees in the last ten years, including the issuance of regulations under ERISA section 408(b)(2) relating to fee disclosure to plan sponsors, ERISA section 404(a) relating to fee disclosure to plan participants, and disclosure to the Department of additional fee information through annual Form 5500 Schedule C filings.

d. <u>The Department should provide illustrations of policies designed to mitigate, rather than eliminate, conflicts of interest to allow financial institutions to better evaluate their practices.</u>

As noted in prior comments and throughout this letter, the BICE can be substantially simplified by eliminating complex, costly conditions that do little to protect Retirement Investors. In Vanguard's view, a BICE that is limited to the Impartial Conduct Standards, including an enforceable commitment to comply, will provide an exemption that is administratively feasible while continuing to protect the interests of Retirement Investors as required by ERISA section 408(a).[7] Without these changes, Retirement Investors will not be protected in their advisory engagements simply because the exemption is not administratively feasible for advisors and financial institutions to implement, and it will not be used.

During the hearings the Department repeatedly questioned whether the BICE could be improved by limiting its requirements to compliance with the Impartial Conduct Standards and adherence to a system of policies and procedures that do not frustrate the Impartial Conduct Standards by encouraging individual advisers to make recommendations that are not in the best interest of Retirement Investors. To the extent the Department requires institutions to adopt policies and procedures that do not frustrate the Impartial Conduct Standards, we would encourage the Department to consider the following additional comments.

The Department recognized level-fee compensation arrangements as a particularly meaningful way to mitigate individual conflicts of interest. In our experience, this approach is effective. Vanguard does not pay its employees commissions or other forms of compensation that vary based on the investments they recommend to investors. This structure helps ensure that our employees are focused on the investment needs of our clients without consideration of potential personal gain. Congress and the Department have already recognized the value of a level-fee structure in investment advisory services through the exemption for eligible investment advice arrangements described in ERISA section 408(b)(14) and 408(g). In our view, the Department is right to recognize arrangements that pay level compensation to advisors as the primary way to mitigate conflicts of interest in the BICE as well.

While the Preamble provided multiple examples of practices that, in the Department's view, could be viewed as mitigating individual conflicts of interest in the context of differential compensation arrangements, those examples more frequently served to completely eliminate conflicts. For example, the Department suggested compensation models under

[7] As we noted in our earlier comments, the exemption should not require advisors to make additional warranties that are enforceable through costly class action suits in state court. We encourage the Department to build upon the uniform standards of a federal enforcement regime as part of any requirement that advisors provide an enforceable commitment to comply with the standards of the BICE.

arrangements that use third party computer models to generate advice[8] or completely offset variable compensation[9] as examples of ways institutions could address conflicts faced by the advisor or financial institution. By completely eliminating conflicts, however, these policies would also eliminate the need for a prohibited transaction exemption. These examples confuse the question of whether an institution or advisor following these practices outside the BICE should be required to adhere to the BICE. This confusion will not promote the continued access to important investment services that the Department intends to achieve.

Many investors value the services they can obtain from advisors who receive differential compensation. To protect Retirement Investors and provide the certainty these advisors and financial institutions need to continue delivering investment services, the Department should expand examples of practical means to mitigate, rather than eliminate, conflicts of interest in the context of differential compensation.

The Department recognized FINRA's efforts in this regard in the Preamble, citing FINRA's Report on Conflicts of Interest. In that report and in its comments on the Proposal and the BICE, FINRA noted that certain broker-dealers it regulates have adopted best practices designed to mitigate conflicts of interest that can result in the context of differential individual compensation practices. We respect FINRA's perspective on this issue and encourage the Department to consider incorporating FINRA's recommendations as specific examples of methods advisors and financial institutions may use to mitigate conflicts of interest in the context of differential compensation. We encourage the Department to continue to consult with FINRA as it develops more numerous and practical examples of these procedures.

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[8] *See* DOL Adv. Op. 2001-09A (Dec. 14, 2001) (use of a third party to develop investment decisions and recommendations did not involve applicant's exercise of authority, control or responsibility for purposes of ERISA section 406(b)).

[9] *See* DOL Adv. Op. 1997-15A (May 22, 1997) (where trustee provides investment advice, dollar-for-dollar offset of 12b-1 or subtransfer agent fees received due to plan investment in mutual fund against trustee and recordkeeping fees avoids prohibited transaction issues under ERISA section 406(b)), DOL Adv. Op. 2005-10A (May 11, 2005) (same analysis with respect to dollar-for-dollar offset of affiliated and unaffiliated fund revenue in connection with advice to IRAs).

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Vanguard appreciates the opportunity to submit these comments and would welcome the opportunity for further discussion with the Department. If there are aspects of our comments that you would like to explore in greater detail or if you have any questions, please do not hesitate to contact Ann Combs at 610-503-6305, John Schadl at 610-669-4011 or Scott Milne at 610-503-5833.

Sincerely,

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The Vanguard Group, Inc.