E*TRADE FINANCIAL

October 4, 2017

EBSA.FiduciaryRuleExamination@DOL.gov

U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210
Re: RIN1210-AB82 & Related Requests for Comment
CC: Timothy D. Hauser, Lyssa Hall, and Joe Canary

Rule-Comments@SEC.gov

U.S. Securities and Exchange Commission
Division of Investment Management
Chairman Jay Clayton
Re: Investment Adviser and Broker Dealer Conduct Standards & Related Requests for Comment

RE: Joint Request for Digital Investment Advice Guidance in a Post Fiduciary Rule World

Ladies and Gentleman:

Both U.S. Department of Labor ("DOL") Secretary Acosta and U.S. Securities and Exchange Commission ("SEC") Chairman Clayton[1] have expressed the need for the DOL and the SEC to work together in regard to the DOL's Final Rule-Definition of the Term 'Fiduciary'; Conflicts of Interest Rule – Retirement Investment Advice ("Fiduciary Rule").[2]

As we pointed out in our original comment letter on the proposed Fiduciary Rule,[3] we are approaching this opportunity to comment from our unique vantage point serving retail investors ("Main Street Investors")[4] and our history of innovation in the digital space. In our view, one of the topics ripe for collaboration between the DOL and the SEC pertains to the investment advice provided via digital channels.[5] By working together, the two agencies can promote an industry standard that provides clarity and consistency. Currently,

1. Testimony by Chairman Clayton before U.S. Senate Appropriations Subcommittee on Financial Services June 27, 2017 and before U.S. Senate Banking, Housing, and Urban Affairs Committee September 26, 2017 and testimony by Secretary Acosta before U.S. Senate Subcommittee on Labor, Health and Human Services, Education and Related Agencies Committee on Appropriations June 27, 2017.
2. In referring to the Fiduciary Rule, this letter encompasses the final rule regarding the definition of "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice and the associated Best Interest Contract Exemption published in the Federal Register on April 8, 2016, as well as subsequent guidance issued in the form of questions and answers from the DOL.
3. Letter dated September 24, 2015 from E*TRADE Financial Corp. to Office of Regulations and Interpretations Employee Benefits Security Administration regarding RIN 1210-AB32, Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice and related Prohibited Transaction Exemptions ("2015 Letter").
4. As of August 31, 2017, we provide custodial and brokerage services to approximately 947,774 retirement accounts.
5. Some refer to this area as robo-advice, but it is broader than that spanning educational guidance as well as investment advice provided through the internet. The investment advice could be incidental, one-time investment advice, discretionary or non-discretionary ongoing investment advice.

the industry is not only struggling to comply with the Fiduciary Rule, but is also navigating mixed messages from regulators regarding digital advice, as well as trying to apply regulations or exemptions that predate, and in no way anticipate, the existence of the internet or omnichannel[6] investment advice. Issuance of further clarity and updating of guidance and regulations being applied by the industry in the digital space so as to comply with the Fiduciary Rule and existing securities regulations would benefit both the industry and investors.

The SEC and the DOL have lauded automated advice as having the potential to give retail investors more affordable access to professional assistance, minimizing conflicts of interest, and changing the landscape for the provision of investment advice.[7] With this in mind, we would like to raise in this letter a few areas where further clarity and updating would be particularly beneficial to E*TRADE[8] and its customers.

A. <u>The DOL Fiduciary Rule and Sections 408(b)(14) and (g) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")("Section 408(g)")</u>

1. Compliance Approaches for Digital Advice to Retirement Accounts Should not Differ from Advice Provided via Other Channels

The DOL Fiduciary Rule arguably replaced most existing prohibited transaction exemptions with the "Best Interest Contract" exemption ("BIC exemption" or "PTE 2016-01").[9] However, the DOL explicitly carved out advice provided digitally from the BIC exemption, stating the exemption would not be available for compensation received "as a result of investment advice to [an IRA] generated solely by an interactive Web site in which computer software-based models or applications provide investment advice based on personal information each investor supplies through the web site without any personal interaction or advice from an individual adviser."[10] The DOL noted that "A statutory prohibited transaction exemption at ERISA section 408(b)(14) covers computer-generated investment advice and is available for robo-advice involving prohibited transactions if its conditions are satisfied. See 29 CFR §2550.408g-1."[11] Thus, it would appear that the DOL contemplated Section 408(g) as the applicable compliance approach for investment advice provided digitally. Furthermore, it seems there are no options other than Section 408(g) for providing purely digital investment advice while receiving traditional brokerage commission-based or revenue-sharing compensation.[12]

Since the enactment of Section 408(g) in 2006, there has been little use of it due to the existence of other options (many of which were eliminated with the Fiduciary Rule) and other challenges. Those challenges remain and arguably are exacerbated in the digital channel. Given the importance of the digital channel and its recent and predicted astronomical growth, it is our view that (i) other compliance options for the Fiduciary Rule should be available in the digital channel such as the BIC Exemption; (ii) digital advice should not be

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6. http://omnichannel.me/what-is-omnichannel/
7. See IM Guidance Update No. 2017-02 February 2017 ("IM Guidance"). Former Secretary of Labor Thomas Perez has been quoted as advocating the use of computer programmed advice as less conflicted.
8. E*TRADE Financial Corporation and affiliates ("E*TRADE").
9. Best Interest Contract Exemption, Federal Register, Volume 81, No. 68, page 21002 (April 8, 2016).
10. Id. at 21058.
11. Id.
12. The Department clarifies there is a "streamlined version" of BICE for level fee advisory robo programs ("Streamlined BICE", Q13, p 12-13). One question would be whether offering the ability to interact with a human at any point in the use of the digital tool would be sufficient to render the tool not completely digital. Some firms have considered having all computer-generated investment advice be "delivered" in person by a human so that the advice will not be considered "robo" and, as a result, be able to utilize the BIC exemption.

treated differently than other forms of advice; and (iii) guidance is needed regarding certain aspects of Section 408(g) to lessen compliance risk and encourage its use.[13]

i. The Case for Additional Compliance Options for Digital Advice in the Retirement Space

A Cerulli Associates Inc. report in 2015 speculated that robo-advice platforms would reach $489 billion in assets under management by 2020.[14] Consulting firm A.T. Kearney, Inc. speculates the number will be even higher: "Between shifts from traditional advisors and 'new investors,' [approximately two] trillion will be managed under robo-advisors by 2020."[15] Given these projections, it is incumbent to offer options to provide digital investment advice that firms can be comfortable will comply with the Fiduciary Rule, and that are consistent with compliance options for advice delivered through other means.

The DOL has not offered any valid reason why the BIC Exemption should not be available in the digital channel. In fact, in a May 24, 2016 *Investment News* article, then-acting Assistant Labor Secretary Phyllis Borzi advised, "[W]hen in doubt, assume you are supposed to be under the best interest contract exemption."[16] Offering this option, to the extent firms are using the BIC exemption in other channels, simplifies compliance, lessening the (i) types of disclosure required for clients, (ii) controls and procedures for the firm, and (iii) costs.

Digital advice can take many forms and cost structures—discretionary, non-discretionary, one-time incidental, asset based, commission based, and no cost; however, Section 408(g) does not currently accommodate all of these types of advice and cost structures. On the other hand, the BIC Exemption excludes discretionary advice. We believe there are instances where in the long term, a retirement customer may be better served with a cost structure that is not level fee. For example, in certain instances, clients may actually fare better through a fee-based recommendation with a commission charged than in a discretionary managed account with an unconflicted fee structure. Yet, in order to comply with the Fiduciary Rule, some firms are offering only ongoing level-fee products for retirement accounts.

The DOL has championed the digital channel as an avenue for retirement savers to obtain the guidance and services they need, especially mass-market retirement investors like our Main Street Investors. To provide this population with choice, we need more options, more clarity, and greater flexibility. Furthermore, to take a consistent approach between digital and non-digital advice would be consistent with other regulators in the financial services industry. The SEC and FINRA are not seeking to create a legal and regulatory distinction between advice provided online versus advice provided by a human.

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13. This is particularly important given that Section 408(g) requires an annual independent audit and the consequences for audit deficiencies or findings are severe.
14. Cerulli Associates Inc. *Retail Direct Firms and Digital Advice Providers 2015: Addressing Millennials, the Mass Market, and Robo Advice.*
15. AT Kearney, Inc. *Insights from the A.T. Kearney 2015 Robo-Advisory Services Study: Hype vs. Reality: The Coming Waves of "Robo" Adoption.*
16. Skinner, Liz. "Err on the side of caution with DOL fiduciary rule, Phyllis Borzi advises." *Investment News.* 24 May 2016. http://www.investmentnews.com/article/20160524/FREE/160529962/err-on-the-side-of-caution-with-dol-fiduciary-rule-phyllis-borzi.

ii. The Need for Interpretative Guidance for Digital Advice

The 2017 Baker and Dellaert study *Regulating Robo Advice Across the Financial Services Industry*[17] posits that automated advice poses distinct regulatory challenges requiring expertise in certain capacities, such as model and architecture evaluation and information technology infrastructure.[18] However, digital advice should not be subject to distinct legal standards or requirements. In *The Evolution of Advice: Digital Investment Advisers as Fiduciaries*, the authors opine that "digital advice reflects the technological evolution of traditional advisory services and thus fits entirely within the existing regulatory framework governing investment advisers."[19] FINRA has also suggested that digital advice should not be treated differently from a regulatory standpoint, stating in its *Report on Digital Investment Advice* that "this report does not create any new legal requirements or change any existing broker-dealer regulatory obligations."[20] Any guidance in the digital space has to be agile enough for innovation, but at the same time nimble and comprehensive enough to mitigate market and industry risk as well as risks for the retail investor. Yet, the Fiduciary Rule and exemptions are not designed in a manner to provide flexibility. In addition, as previously stated, the Fiduciary Rule has specified that a streamlined BIC Exemption is available for digital advice, but only if there is level compensation. This is despite the fact that the BIC Exemption is otherwise available for "human" advice regardless of the forms of compensation so long as the requirements are met.

Why is digital advice treated differently? The DOL has stated that "the marketplace for robo-advice is still evolving in ways that both appear to avoid conflicts of interest that would violate the prohibited transaction rules and minimize cost."[21] Why limit the options available, especially if there is arguably less potential for conflicted advice? Permitting the BIC Exemption to apply to digital advice where a level fee is not involved would also simplify potential compliance structures for firms, lowering costs and potentially decreasing customer confusion.

The DOL and the SEC should work together to revise the Fiduciary Rule to provide flexibility similar to what is currently available through the Investment Advisers Act of 1940 ("Advisers Act") while simultaneously providing guidance regarding, or updating, existing regulations, and ensuring that digital advice is not treated differently from a regulatory standard as other forms of advice.

iii. The Need for Interpretative Guidance for Section 408(g)

Section 408(g) needs updating in order to be useful for digital advice providers. First, Section 408(g)(3) (the computer model) would benefit from further clarity regarding the scope of human activity permitted in order for the advice to remain subject to Section 408(g)(3). After all, "people design, model, program, implement and market these automated advisors, and many automated advisors operate behind the scenes, assisting people who interact with clients and customers."[22] In fact, more and more digital advice providers are

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17. Baker, Tom and Dellaert, Benedict G.C. *Regulating Robo Advice Across the Financial Services Industry.* University of Penn Law School, Penn Law: Legal Scholarship Repository. 27 Aug. 2017. http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2742&context=faculty_scholarship
18. Id at 2-3.
19. Klass, Jennifer L. and Perelman, Eric. *The Evolution of Advice: Digital Investment Advisers as Fiduciaries.* Practical Compliance & Risk Management for the Securities Industry. November–December 2016. https://www.morganlewis.com/~/media/files/publication/outside%20publication/article/klass-perelman-evolution-of-advice-novdec2016.ashx
20. FINRA Report on Digital Investment Advice (March 2016) at page 1.
21. BIC Exemption at 21058.
22. Baker and Dellaert, supra note 17 at page 2.

offering customers the ability to access a human, again to provide customers with desired flexibility. Should this eliminate the ability to use Section 408(g)(3) for digital advice?

Second, the regulations to Section 408(g)(2) require that the program ask for and take into account—to the extent provided by the customer—information relating to age, time horizons, risk tolerance, current investments in "designated investment options," other assets or sources of income, and investment preferences of the customer.[23] On the other hand, the statute permits all of the individual's factors to be taken into account under Section 408(g). Why do regulations require more than the statute? This requirement does not reflect the wide variety in scope that investment advice can take in the digital space or otherwise. "The appropriate question is therefore not how much information an adviser is collecting, but rather whether the information the adviser decides to collect is appropriate in relation to the nature of the advice that is provided."[24]

Customers often opt for goal-based wealth management (e.g. accumulating for retirement, planning for college education, saving for a vacation home). Arguably the advisor should be able to take the Section 408(g) factors "into account" and make a reasonable determination depending on the scope of the advice that certain information may not be necessary. "The Advisers Act does not dictate the minimum amount of information that must be collected to make a reasonable determination that investment advice is appropriate for a client," creating a flexible, principles-based regulatory regime focused on an investment adviser's fiduciary duty to "make full and fair disclosure" of all material facts, including conflicts of interest between the adviser and its clients and any other material information that could affect the advisory relationship.[25] "It follows that where advisers, digital or otherwise, provide assistance with specific and identifiable investment goals such as college or retirement savings, they need not collect the same degree of information, or conduct comparable due diligence, to that which may be required for a more expensive investment strategy."[26]

B. The Need for the SEC to Update Certain Regulations and Provide Further Guidance for Digital Advice

The IM Guidance was helpful to the industry in providing suggested practices for robo-advisers in various areas such as disclosure obligations, compliance programs, and assessing the suitability of digital advice. It has generated a dialogue within the industry, and the SEC Staff has indicated that it would welcome continued dialogue in the IM Guidance[27] and subsequent meetings with industry representatives. We believe the industry would benefit from further guidance as Rule 3a-4 was adopted some years ago, similar to Section 408(g). Further clarity would be useful regarding various aspects of Rule 3a-4, including the reasonable restrictions component of the rule, the requirements to satisfy the safe harbor, and whether factors not currently listed could be sufficient to satisfy the Rule's requirements.[28] In addition, guidance could further clarify the SEC's intent that robo-advisers are not subject to different obligations or standards than advisers who provide investment advice via other means, ensuring consistent treatment for investors regardless of how they choose to receive investment advice.

23. 76 Fed. Reg. 66136 (Oct. 25, 2011)(29 C.F.R. §2550.408g-1)
24. Klass and Perelman, supra note 19 at page 4.
25. Id at 3-4.
26. Id.
27. On page 2 of the IM Guidance, the Staff states, "to the extent that a robo-adviser believes that the organization and operation raise unique facts or circumstances not addressed by Rule 3a-4, such adviser may wish to consider contacting the Staff for further guidance."
28. For example, can reasonable restrictions include the ability to maintain a position, tax loss harvesting, transparency?

C. The Need for Coordinated Guidance in the Regulation of Digital Advice

Central to the IM Guidance is the importance of disclosure. We view the use of disclosure as a common denominator across the agencies. The SEC and DOL should be able to work together to prescribe disclosure standards for investment advice that would apply to all retail customers, regardless of account type and means by which the advice is provided. The June 30, 2017 RFI seems to allude to this sort of collaborative effort as well.

The other component that is consistent across the SEC, DOL, and FINRA is the collection of customer data to provide a suitable investment. While the standards of care and methods of enforcement vary greatly (e.g. ERISA—Case Law, SEC/FINRA—Arbitration), there is also a common theme—namely, the use of a fiduciary standard or a suitability standard. As previously mentioned, the SEC gives investment advisers flexibility regarding what they need to know about their customer based on the scope of the advice provided it is disclosed. Advisers can limit the scope of the relationship and tailor the client information requested to the scope of advice. "It is not uncommon for investment advisers of all types to limit the scope of their services and authority based on the nature of the advisory relationship with their clients."[29] The SEC provides clear guidance by requiring an investment adviser to disclose in its firm/product brochure the scope of services, conflicts, and limitations. The DOL queries whether this makes sense from the Fiduciary Rule Standpoint in their RFI (Questions 11 and 13). It is our view that it does and that the principles-based regime of the Advisers Act has served the industry well.

Conclusion

As we indicated in our 2015 comment letter to the DOL, we believe that customer choice is paramount. Our core values of choice, education, and clarity continue to be intrinsically linked with the best interests of retail investors. As currently proposed, the Fiduciary Rule is limiting customer choice by treating advice and guidance provided through digital means differently than advice and guidance provided through other means. Further, as stated above, it is impacting the ability to provide a consistent and fully transparent experience for customers, regardless of how they choose to receive advice. As a result, we believe that all will benefit from a coordinated effort amongst the SEC, DOL, self-regulatory agencies, and the industry to provide guidance for the evolving and growing digital space.

Thank you again for the opportunity to provide our comments. Should you have any questions or require additional information, please contact our Department of Labor compliance office at DOLCompliance@etrade.com or the undersigned at 703.236.8506.

Sincerely,

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29. Klass, Perelman, supra note 19 at 3.