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January 2, 2024

Submitted Electronically

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor

Re: **Proposed Retirement Security Rule: Definition of an Investment Advice Fiduciary (RIN 1210-AC02)**
Proposed Amendment to Prohibited Transaction Exemption 2020-02 (ZRIN 1210-ZA32)

Dear Sir or Madam:

I am writing on behalf of Capital Group¹ to comment on the Department of Labor's proposed new definition of an investment advice fiduciary and proposed amendments to Prohibited Transaction Exemption 2020-02. As discussed more fully below, we urge the Department to clarify that:

1. Investment managers are not treated as investment advice fiduciaries with respect to sales activity solely because a retirement investor invests in the manager's mutual funds, ETFs or CITs; and
2. PTE 2020-02's conflict of interest mitigation and differential compensation requirements are compatible with traditional A share mutual funds in IRA brokerage accounts.

Definition of Investment Advice Fiduciary

The proposal would treat an investment recommendation made to a retirement investor by a person who "directly or indirectly (e.g., through or together with any affiliate) has discretionary authority or control . . . with respect to purchasing or selling securities or other investment property for the retirement investor" as fiduciary investment advice. The rationale is that discretionary investment management authority is a hallmark of a relationship of trust and confidence, and that a reasonable retirement investor would perceive a recommendation given by their discretionary manager as made in their best interest.

We appreciate the logic but believe that this provision would benefit from clarification and revision. The regulatory text and the preamble to the proposal are silent on what constitutes discretionary authority over investment property other than to note that the rule is triggered even if the discretion is over non-retirement assets. And while this prong of the definition has been

¹ Capital Group is one of the oldest and largest asset managers in the nation. We, through our investment advisory companies, manage assets in various collective investment vehicles and separate accounts. Most of these assets consist of the American Funds family of mutual funds, which are widely held in retirement plans and IRAs.

around since 1975 in a narrower form, we are not aware of any guidance addressing this trigger for investment advice fiduciary status and, in our experience, the current iteration is not widely appreciated. For these reasons, we urge the Department to address certain basic issues.

As a threshold matter, we think it is appropriate for the Department to confirm that investment management responsibility for mutual fund and ETF assets does not constitute discretionary asset management under the proposed definition of an investment advice fiduciary. ERISA section 3(21)(B) provides that an investment by a retirement investor into a registered investment company (such as a mutual fund or ETF) does not cause the investment company's investment adviser to be a fiduciary. It should follow that an investment in a mutual fund or an ETF cannot be the predicate for investment advice fiduciary status.

We also believe that CITs should be treated similarly to mutual funds and ETFs. We agree that investors in our collective investment trusts (and our mutual funds and ETFs) have entrusted us with their investment dollars and that they should have trust and confidence in our stewardship of their investment. But that is quite different than concluding that a reasonable investor would view themselves as being in a relationship of trust and confidence with a CIT's trustee (much less with every employee of the trustee or any affiliate) with respect to investment recommendations. The investor is buying or holding shares or units in a collective investment vehicle. There is no "relationship" with the fund's trustee and certainly not one that should suggest to a reasonable investor that sales activity with respect to other investments is anything other than sales activity. Moreover, the manager's relationship is with the fund; that is, the trustee is the trustee to the fund not to the investor. Put simply, we do not believe that a reasonable investor should have an expectation that a recommendation made by a person who works for an entity that is affiliated with the trustee to a fund is acting in their interest when selling another fund.

We realize that CITs are potentially distinguishable as plan asset vehicles but do not think this distinction is meaningful. The fact that the assets of a CIT are viewed as the assets of the plan for certain purposes of ERISA is a technical point that is fundamentally not relevant to the reasonable perception of participants or plan fiduciaries and should not be used as a touchstone to determine whether participants or plan fiduciaries are in a relationship of trust and confidence with the trustee of the CIT.

Moreover, unlike 1975 when the narrower iteration of the rule was adopted, CITs today are widely used as investment vehicles for defined contribution plans. Treating a plan's investment in a CIT as a trigger for investment advice fiduciary status would have far-reaching implications that were not at all relevant when the 1975 regulation was adopted. This issue is particularly acute because the proposal is ambiguous as to whether discretionary management of a defined contribution plan's assets would trigger potential fiduciary adviser status with respect to participants in the plan. A participant is a retirement investor but the participant is not in a relationship with the trustee of the CIT, and often the participant will not even know the entity managing their CIT. It would be wholly anomalous to treat a participant's investment in a CIT option in a defined contribution plan as the type of relationship of trust and confidence that makes sales recommendations to the participant by an affiliate's employee into fiduciary investment advice.

In our view, discretionary authority or control should be limited to discretionary control over the investor's non-commingled assets. For many asset managers, this arises primarily in the context of a separate account. Separate accounts are investment vehicles that are only available to the very largest retirement plans. These plans are typically advised by investment consulting firms. The probability that the plan sponsor fiduciaries or their consultants would see a pitch for another investment opportunity - separate account or otherwise - as anything other than a sales pitch is vanishingly small.

In this regard, we believe that an asset manager and a plan fiduciary (both intermediaries and sponsor-fiduciaries) should have the ability to define their relationship. Without some flexibility, it would, for example, be challenging for an investment adviser who manages an emerging markets separate account for a large plan to participate in a request for proposal for a US equity mandate without complying with PTE 2020-02 which is obviously ill-suited to sales activity. The second prong of the new definition covering firms that are in the business of making investment recommendations allows for the parties to define their relationship by focusing on whether the circumstances indicate that the recommendation may be relied upon by the investor as a basis for investment decisions that are in the investor's best interests. We suggest that the same should be true of recommendations made where there is a discretionary investment management relationship. Asset managers working with sophisticated plan fiduciaries should be able to engage in sales conversations where it is clear to both parties that such conversations are not meant to involve a best interest recommendation.

It is, however, important to avoid the solution to large plans and sophisticated financial intermediaries that arose from the 2016 fiduciary rule. The 2016 carve out applied only if a person "fairly informs the independent fiduciary that the person is not undertaking to provide impartial investment advice".² This disclosure requirement resulted in standard disclaimers being sent to large RIAs and broker-dealers with little if any value and consumed significant resources. Instead, we suggest modeling the solution on the approach taken in the context of recommendations made by persons working for or affiliated with an advice provider. That approach looks at all the facts and circumstances rather than a mechanical disclosure. We may choose to include a disclosure around the nature of our sales activity, but we think in the large majority of conversations with large plan fiduciaries and financial intermediaries that there is no question as between the parties about whether sales recommendations are in fact best interest recommendations.

We also note that these issues are exacerbated by the lack of a requirement in the context of discretionary asset management that the recommendation be individualized. Conversations with financial intermediaries about investment products are usually not individualized. We firmly believe that these conversations are perceived by plan fiduciaries and intermediaries as sales conversations. Thus, the addition of a requirement that the recommendation be individualized in order to potentially trigger investment advice fiduciary status would meaningfully narrow the issue. However, in the large end of the market, these sales conversations may be tailored to the plan, for example, how a long duration fixed income fund may align with a defined benefit plan's liability profile. For this reason, we think it is important to add an individualized

² 81 Fed. Reg. at 20999-21000.

requirement to the discretionary management definition, but we do not think that is sufficient to address the overinclusive nature of the definition. The parties need and should have the flexibility to define the nature of their relationship and we have little doubt that large plan fiduciaries understand when an asset manager is engaged in selling.

A related issue is raised where an asset manager is hired to act as a subadviser to provide fund-of-fund models recommendations to an RIA. In these situations, the asset manager typically enters into an advisory agreement with the RIA acknowledging that it is acting as an investment adviser under the Investment Advisers Act but the asset manager will not tailor or individualize the advice to any end investor. The asset manager will have no visibility or relationship with any investor. Typically, there is no fee charged by the asset manager to the RIA (and certainly not to the investor); the only compensation is the investment management fee on the funds. If the discretionary asset management prong of the proposed definition of investment advice fiduciary is read broadly to include commingled funds, asset managers in this context would be categorically treated as investment fiduciaries with respect to clients that they have no relationship with and for which a sophisticated financial institution is playing a critical intermediary role. The RIA is the person recommending the investment and they have discretion to modify, reject or leverage the model fund-of-fund allocations recommended by the asset manager. These fund-of-fund recommendations often involve some use of the asset manager's proprietary funds and we readily acknowledge and disclose this conflict of interest. However, the intervening role played by the RIA would be effectively ignored if managers of commingled funds are viewed as having discretionary authority or control over retirement investor assets.³

For these reasons, we urge the Department to (i) clarify that “discretionary authority or control” does not include control over the assets of comingled investment funds, including mutual funds, ETFs and CITs; (ii) add to the discretionary asset management prong language imposing a fiduciary obligation only in circumstances in which a reasonable person would view the asset manager as making a recommendation in their best interest; and (iii) provide that a recommendation must be such that a reasonable person would expect that it was an individualized recommendation.

Amendments to PTE 2020-02

The proposed definition of an investment advice fiduciary would treat all financial professionals who provide brokerage recommendations to IRA owners as fiduciaries and require compliance with the requirements of PTE 2020-02. Many broker-dealer firms have relied on PTE 2020-02 for rollover recommendations but relatively few have relied on PTE 2020-02 for non-rollover brokerage recommendations.

We urge the Department to clarify that financial institutions may comply with PTE 2020-02 when making recommendations of traditional commission-based mutual funds in IRA brokerage

³ We also believe that a subadviser should not be viewed as an investment advice fiduciary under the third prong of the proposed definition, which applies if a person acknowledges fiduciary status. While we act as an adviser to an RIA under the Advisers Act and the RIA may be a fiduciary to a retirement investor, it seems clear that this is not an acknowledgement that we are providing fiduciary investment advice with respect to an IRA or retirement plan.

accounts (“A shares”). Proposed PTE 2020-02 requires that a financial institution adopt policies and procedures that:

mitigate Conflicts of Interest to the extent that a reasonable person reviewing the policies and procedures and incentive practices as a whole would conclude that they do not create an incentive for a Financial Institution or Investment Professional to place their interests ahead of the interests of the Retirement Investor. Financial Institutions may not use ... differential compensation ... that a reasonable person would conclude are likely, to result in recommendations that are not in Retirement Investors’ Best Interest.

Class A share mutual funds provide excellent value for certain investors yet have a number of features that may raise conflict of interest mitigation questions under this strict standard. Broker-dealers are typically compensated for mutual fund-related investment services through receipt of a commission and an ongoing service fee paid pursuant to the mutual fund’s plan of distribution under Rule 12b-1 (a “12b-1 fee”). Ordinarily, the applicable commission varies based on the type of fund with equity and balanced funds bearing somewhat higher commissions than fixed income funds. The annual payments from a fund for service under Rule 12b-1 cannot exceed 0.25% of the balance of the investment.⁴ This combination of upfront payment at the time of an investment plus a modest ongoing fee aligns with the cost of providing investment advice and related services.

One important benefit for investors is that Class A share mutual funds typically have rights of exchange within the fund family that allow investors to exchange mutual fund investments without paying a new commission or otherwise changing the broker’s compensation. This allows an investor to, for example, rebalance their investments from equity to fixed income as they approach retirement without incurring any additional costs. With rights of exchange, the investor pays only one commission at the time of initial investment and does not pay another commission so long as the investor stays invested in the fund family. In addition, commissions are typically reduced based on the size of the investment and the total of all prior purchases into the fund family. Taken together, rights of exchange and rights of accumulation mean that the investor is in some respects buying the fund family through a one-time commission.

The mutual fund sets the commission rates, breakpoints and the 12b-1 rate on A shares. Section 22(d) of the Investment Company Act of 1940 prohibits a broker-dealer from setting their own compensation. Section 22(d) means it is impractical for broker-dealers to set a harmonized commission schedule across mutual funds. In order to eliminate differential compensation to the broker-dealer firm, each available fund family would have to align on the same commission schedule, breakpoints and 12b-1 rate for all similar products and that schedule would need to be harmonized with the commission schedule set on other comparable investment products, which may include, for example, ETFs. Moreover, valuable shareholder rights, specifically rights of exchange and accumulation, may raise concerns because recommendations of a fund within a

⁴ FINRA rules distinguish between a payment for distribution and a payment for ongoing service. Any payment in excess of 0.25% is included in calculating maximum allowable sales loads.

fund family versus a fund with another fund family could result in differential compensation issues.

In the run up to implementation of the 2016 DOL fiduciary rule, there were two innovations that increased flexibility over mutual fund pricing – clean shares and the ability for broker-dealers to waive all or a portion of the commission they would otherwise receive.⁵ In the context of mutual fund pricing, the simplest reconciliation of the fiduciary standard with commissions is reflected in the so-called clean share letter, which was issued by the SEC to our firm on January 11, 2017. The approach in the clean share letter solves the core conflict of interest issues associated with commissionable mutual funds by allowing the broker-dealer, rather than the mutual fund complex, to set commissions but at the cost of prohibiting the payment of any other distribution-related compensation to the broker-dealer, such as a 12b-1 fee.

While we believe that the clean shares approach plays an important role in preserving the brokerage service and compensation model – that is, preserving investor choice – we do not think it should be the only option available for recommending mutual funds on a commissionable basis. The lack of any ongoing compensation in the clean shares model discourages ongoing service, which is exactly why the 12b-1 fee was added to the A share originally. Sales load waivers are also not a satisfying solution because they only affect future commissions and are limited in the extent to which they allow a broker-dealer to harmonize commission schedules across asset managers. Moreover, broker-dealers would need to entirely waive all commissions to eliminate the conflict of interest associated with rights of exchange or accumulation. For these reasons, we do not expect clean shares or A share waivers to displace the existing compensation structures and believe that A share pricing will remain in the hands of the fund family.

Broker-dealers making A share recommendations to retail investors already comply with Regulation Best Interest and maintain robust conflict of interest mitigation policies. We recognize and appreciate that PTE 2020-02 and Regulation Best Interest are closely harmonized. There are, however, differences that raise questions about the A share. First, unlike Regulation Best Interest, PTE 2020-02 requires mitigation of conflicts of interest for both the financial institution and the registered representative. Regulation Best Interest explicitly rejected conflict mitigation at the financial institution level and instead reflects an obligation to fully and fairly disclose financial institution conflicts.⁶ The notion that there must be mitigation at the financial institution level is obviously challenging where as a result of section 22(d) the institution does not have the ability to set its own compensation structure. A firm can, for example, cap or pool commissions payable to financial professionals but it cannot cap or pool A share commissions paid to the firm.

Second, unlike Regulation Best Interest, PTE 2020-02 strongly suggests conflicts of interest associated with differential compensation can only be mitigated through fee leveling. Many firms have adopted fee leveling approaches like capping and pooling A share commissions payable to brokers at different break points to mitigate conflicts of interest. These arrangements

⁵ See SEC No-Action Letter to Capital Group (January 11, 2017); IM Guidance 2016-06 (December 2016).

⁶ 84 Fed. Reg. at 33390 (“rather than requiring mitigation of all firm-level financial incentives, we have determined to refine our approach by generally allowing firm-level conflicts to be generally addressed through disclosure”). Special requirements apply to limited product menus and listed incentives.

are strong and compelling ways to mitigate financial professional conflicts of interest but they may only apply when a commission is paid and not to commission-free exchanges. In this regard, it is entirely inconsistent with the economics of brokerage to neutralize the conflict by paying commissions on commission-free exchanges. Instead, broker-dealers typically maintain and adhere to long-established FINRA conflicts of interest mitigation policies and procedures to ensure that investments are only exchanged outside of a fund family where it is in the client's best interest. Specifically, FINRA guidance provides that:

Members must not recommend that a customer switch from one mutual fund to another based on the compensation that the member or its associated persons will receive for effecting the switch. Members are obligated to ensure that their supervisory and compliance procedures are adequate to monitor switching of customers among funds, and should be prepared to document their reasons for switching a customer from one fund to another.

Notice to Members 94-16; see also Notice to Members 95-80. These procedures typically involve contemporaneous written explanations of the reasons for a "switch" to the investor.

We believe the Department should make clear that these policies and procedures are appropriate and that the prohibition on differential compensation is not inconsistent with such an approach. Not only is that practice a long-standing method of conflict mitigation, it also aligns closely with the approach in PTE 2020-02 to rollovers and account-type recommendations which also involve structures where fee leveling is impracticable and which involve mitigation through delivery to the investor of a contemporaneous written explanation of why a recommendation is in the investor's best interest.

Third, Regulation Best Interest requires mitigation, not elimination of conflicts. In contrast, PTE 2020-02 mandates that the conflict of interest be neutralized so that a reasonable person would conclude that the incentive practices and conflict mitigation "do not create an incentive" for the financial institution or broker to put their interests ahead of those of the investors. This "no incentive" standard is more stringent than the Regulation Best Interest standard which requires reducing the conflict of interest.

These differences between Regulation Best Interest and PTE 2020-02 could be potentially impactful for traditional A share investments since there is no apparent way to eliminate differential compensation at the financial institution. It is not practical to completely eliminate differential compensation at the broker level given rights of exchange, and it is not possible to completely eliminate the conflict of interest since the financial institution does not have control over pricing. As a result, the proposal could be disruptive for investors who are holding traditional commissionable mutual funds.

Our concern about the impacts to investors is not a theoretic or potential concern. The 2016 Best Interest Contract Exemption had similar conflict of interest mitigation requirements – prohibiting differential compensation that was not justified by neutral factors like time and effort – and some significant broker-dealer firms choose to stop recommending A shares. Some fund families even felt compelled to create an entirely new class of commissionable shares, called T shares, which

eliminated rights of exchange and accumulation and had a standardized 2.5% commission schedule.

The elimination of valuable economic rights like rights of exchange and accumulation would have been enormously harmful to investors. Rights of exchange allow investors to rebalance their portfolios as they approach retirement, for example, by exchanging from an equity fund to a fixed income fund, without incurring a new sales charge and while preserving access to advice for a very reasonable 25 basis points. Significantly, rights of exchange and accumulation are rights that the investor purchased when he or she invested in an A share mutual fund.

It would be damaging to the retirement system and to the many retirement investors currently holding A shares if these rights were undermined. This disruption could affect millions of middle-income American investors. We conservatively estimate that more than 25 million Americans are invested in A shares.⁷ The median A share account balance in IRAs on our books is approximately \$22,000. These investors are buy-and-hold investors with an average holding period of 12 years (without considering commission-free exchanges). It is critical that the combined effect of a broader definition of an investment advice fiduciary and the conflict-of-interest mitigation requirements of PTE 2020-02 not harm middle income, buy-and-hold investors who have already paid a commission and have the right to future commission-free exchanges.

Accordingly, we believe the Department should recognize the unique attributes of A share mutual funds, including rights of exchange and rights of accumulation. Specifically, we urge you to confirm that (i) differential compensation is permissible at the financial institution level provided that the financial institution does not transmit its conflicts of interest to the broker; (ii) a financial institution may mitigate conflicts of interest associated with rights of exchange and accumulation through a process modeled on FINRA's switch guidance; and (iii) a firm may reasonably conclude that funds with different objectives may bear differential commission schedules.

We appreciate your consideration and would be happy to answer any questions. Please call the undersigned if we can be helpful at 213-615-4007.

Sincerely,



Jason Bortz
Senior Counsel

⁷ There does not appear to be a publicly available study that captures the total number of A share investors. However, we have data on the number of A share investors in the American Funds, the market share held by the American Funds, and industry data on total AUM in front-end load mutual funds. Combing these data points suggests that somewhere between 25 and 30 million investors are holding A shares.