VOICE OF INDEPENDENT
BROKER-DEALERS AND INDEPENDENT
FINANCIAL ADVISORS

Statement for the Record from
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Before the
U.S. House Education and Workforce Committee

On

"Examining the Policies and Priorities of the U.S. Department of Labor"

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FSI Statement for the Record

Introduction

The Financial Services Institute (FSI) is the trade association representing independent financial services firms and independent financial advisors. Roughly two thirds of all financial advisors who work with clients operate in the independent channel. FSI has 102 of the largest independent firms and 37,000 of their financial advisors as members. All told, FSI's members serve more than 15 million American Households. FSI's members play a key role in delivering retirement advice to middle-class Main Street investors.

FSI has long supported a carefully-crafted, uniform fiduciary standard of care that would be applicable to all professionals providing personalized investment advice to retail clients. However, the DOL's proposal is based on flawed assumptions and creates a new regulatory regime that is too complex, too cumbersome, and far too costly to manage. We are concerned that the Proposal will make it significantly harder for consumers to receive high quality, personalized retirement advice, thus decreasing investor access to retirement advice from a trusted advisor.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives. These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers.

FSI member firms provide business support to financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners who typically have strong ties to their communities and know their clients personally. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations and retirement plans with financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their investment goals.

FSI Members Serve Middle Class Investors

FSI's mission is to expand access to the advice provided by independent advisors, who have the ability to serve investors on a commission-basis when appropriate or through an investment advisory relationship for larger and more complex accounts. Our membership is unique because we truly serve middle class or Main Street investors, the very group that so many are worried about losing access to financial advice.

FSI's financial advisors operate in small towns around the country so they have personal relationships with their clients and a local reputation to preserve. Since they get much of their business through referrals, that reputation is their business' life blood. These financial advisors

work in the best interest of their clients every day because it is the right thing to do for their clients and their business.

FSI's Historic Support of a Fiduciary Standard of Care

FSI pursues our mission by being constructively engaged in the legislative and regulatory process, as evidenced by our lengthy comment letter and supplemental comment letter on the proposal. Both letters discuss the challenges and unintended consequences of the proposed rule and contain several suggestions for improving the rule.[1] However, FSI's engagement on this issue is not new. Since 2009, prior to the passage of Dodd-Frank, FSI has supported a uniform fiduciary duty for financial advisors who provide personalized investment advice to retail customers. FSI has strongly supported SEC rulemaking in this area, including comment letters, several meetings with officials at the SEC, and participation in Congressional hearings. Throughout this engagement, FSI has consistently advocated the position that a fiduciary duty must be paired with clearly articulated conduct rules, effective investor disclosures & balanced supervision efforts to enhance investor protection without sacrificing access to advice.

Improvement to the Proposal is Imperative

Our comment letters discuss in detail FSI's concern that the rule will result in unintended consequences of loss of access to retirement advice, products, and services. These consequences will fall most heavily on smaller investors and should not be minimized. In addition to the issues and concerns outlined extensively in our comment letters, FSI has other significant concerns about the DOL proposal that we feel are imperative to address prior to any final rule being enacted.

First, FSI questions the necessity for the proposed rule. Currently, retirement investors are protected by the existing comprehensive and multilayered regulatory system. Regulation and oversight provided by FINRA, the SEC and state regulators ensures that investors are protected and if those protections fail, an active plaintiff's bar provides opportunities for recovery. Second, we believe that investors need and want professional advice to help them plan for retirement. There is considerable evidence that investors working with financial advisors save more, obtain better returns, and are more confident that they will be ready for retirement.[2] Unfortunately, we believe the DOL has largely ignored these studies. Finally, we believe the rule will result in a loss of access to retirement advice, products and services especially by smaller investors who need the most assistance and expertise in order to adequately plan and prepare for their retirement.

Issues with the Rulemaking

Under the Administrative Procedures Act (APA), the DOL's rulemaking must not be arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law. Unfortunately, FSI has a number of concerns with the DOL's ability to meet this standard. Our calculations indicate that even if the DOL worked seven days a week and 24 hours a day during the 126 days between the close of the comment period and the submission of the rule to OMB, it would have less than one hour to dedicate to the consideration of each of the 3,134 letters submitted. Since many of these letters, including FSI's, were very detailed, substantive, and accompanied by

[1] *See* FSI's initial comment letter dated July 21, 2015 available at http://www.financialservices.org/uploadedFiles/FSI_Content/Advocacy_Action_Center/DOL/FinancialServicesInstitute-DOL-Proposal-Comment-Letter2015-07-21.pdf and FSI's supplemental comment letter dated September 24, 2015 available at http://www.financialservices.org/uploadedFiles/FSI_Content/Advocacy_Action_Center/DOL/FSI-Supplemental-Comment-Letter-20150924.pdf

[2] See, e.g., ING RETIREMENT RESEARCH INSTITUTE, WORKING WITH AN ADVISOR: IMPROVED RETIREMENT SAVINGS, FINANCIAL KNOWLEDGE AND RETIREMENT CONFIDENCE! 6 (2010), available at http://voyacdn.com/file_repository/5151/help_wanted_wp.pdf.

sophisticated economic and other research, we believe DOL would be hard pressed to address them satisfactorily in this compressed time frame. Therefore, we have little confidence that the DOL has met its obligations under the APA. In addition, we continue to believe that efforts by the DOL to create a private right of action and the ability to bring class action lawsuits are beyond its authority under ERISA and not in accordance with the law or Congress's intent.

Existing Regulations

The relevant Executive Orders require the DOL to examine whether existing regulations have created or contributed to the problem that the regulation is intended to correct.[3] Confusion surrounding the standard of care owed an investor by their financial advisor is the product of existing law which establishes two standards of care. The SEC's RAND Study determined that investors are confused by the fact that a financial advisor's registration status determines the standard of care they owe to their clients.[4] Recognizing this, Congress, through Dodd-Frank, authorized the SEC to study this issue and consider proposing a single uniform standard of care. As stated earlier, FSI has long supported this effort which SEC Chair Mary Jo White has repeatedly and publicly stated is ongoing. [5] Unfortunately, the DOL's rulemaking seeks to fix this problem not by moving in the direction of a single universal standard of care, but instead by creating yet another standard of care. The duty owed to an investor now is determined through the use of a matrix considering the registration status, account type, and which prohibited transaction exemption is being relied upon. It is undeniable that the DOL's new standard will exacerbate the confusion, not eliminate it. Clearly the SEC is in the best position to address this concern by creating a uniform standard.

Cost of the Proposal

The Executive Orders also require DOL to design its regulations in the most cost effective manner to achieve the regulatory objective.[6] The most recent proposal failed considerably in its effort to meet this test in that it did not quantify the costs and benefits of alternative approaches. As outlined extensively in our comment letters, the DOL's proposal is much too complex, cumbersome, and costly to be workable for those subject to the rule. FSI and other commentators offered detailed proposals to address the DOL's concerns along with economic analysis of the impact of the DOL's proposal. The DOL must analyze these and other options to determine whether their proposed solution is the most cost effective and demonstrate that they have undertaken this examination. However, the DOL has thus far failed to quantify the costs and benefits of the suggested alternatives. We believe the DOL can only meet its obligations if it carefully analyzes the costs and benefits of these alternative approaches as well as fully explore the costs associated with its own proposal. With the compressed timeframe we believe it will be hard pressed to read, analyze, digest, and assess the costs and benefits of each of the alternatives and its own rule in order to meet their obligation.

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[3] Executive Order 12866 (*see* 58 Fed. Reg. 51735 (October 1993)), as reaffirmed by the Administration in January 2011, pursuant to Executive Order 13563 (*see* 76 Fed. Reg. 3821 (January 21, 2011)), available at http://www.archives.gov/federal-register/executive-orders/pdf/12866.pdf and https://www.gpo.gov/fdsys/pkg/FR-2011-01-21/pdf/2011-1385.pdf, respectively.

[4] U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER–DEALERS at iii (Jan. 2011), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[5] *See, e.g.* Kenneth Herzinger, Amy M. Ross and Gregory Beaman, *SEC Talks – What to Expect in 2016*, Lexology.com (February 23, 2016) available at http://www.lexology.com/library/detail.aspx?g=49be8879-b1f1-4dad-a784-e4ba0dfd486b and Ted Knutson, *SEC Chair White Not Giving Up On Uniform Fiduciary Rule*, FA-Mag.com (February 19, 2016),
available at http://www.fa-mag.com/news/sec-chair-white-not-giving-up-on-uniform-fiduciary-rule-25258.html.

[6] *See* Exec. Order 12866.

Best Information Lacking

Next, the Executive Orders require the DOL to base its proposal on the best available information on the need for and consequences of its regulation. We believe the DOL failed to make the case that there is a substantial failure in the retirement market that requires this proposal. First, according to a study commissioned by DOL itself, the heavily cited Council of Economic Advisors estimate of investor harm "gives short shrift to the benefits consumers receive from brokers."[7] Second, the Investment Company Institute did an excellent job in its July 21, 2015 letter demonstrating that the DOL's regulatory impact analysis is not supported by the studies it relies upon, ignores investor's actual experience with broker sold funds, and ignores the harm to investors of losing access to retirement advice, products and services.[8] Instead, it appears that the DOL sought data that could be "woven together" to create a narrative demonstrating market failure rather than seeking a more well-rounded view of the relevant issues and perspectives.

Inconsistent, Incompatible, and Duplicative Regulation

The DOL is further obligated under the Executive Orders to coordinate its rulemaking with other agencies to reduce inconsistent, incompatible, or duplicative requirements.[9] Unfortunately, the DOL proposal also failed this test.

First, the proposal is inconsistent with SEC and FINRA requirements around projecting returns. The Point-of-Sale Disclosure and Annual Disclosure obligations required in the rule proposal place firms in the difficult position of having to decide whether to violate the DOL's requirements or those of the SEC and FINRA. Specifically, the SEC and FINRA have rules prohibiting broker-dealers from using communications projecting future performance of an investment. While the information contained in the Point-of-Sale Disclosure superficially resembles the information provided in the fee table included in prospectuses for mutual funds and variable annuities, its efforts are ineffective in application. The rule requires the information be expressed in terms of the amount of the proposed to be invested, rather than the $10,000 required by the SEC rule. SEC requirements also mandate that costs be calculated based on a 5% return assumption. The Best Interest Contract Exemption (BICE) of the proposed rule instead requires that the return assumption be "reasonable" and provides no safe harbor for firms or advisors making the assumption. Since the "fee table" information is not required for most Assets available under the BICE, the existing SEC requirement is not transferable to the BICE requirement. The proposed rule also requires firms and advisors to violate FINRA Rule 2210, which prohibits communications that project investment performance.[10]

Second, the proposed rule is incompatible with SEC and FINRA guidance on fees. The DOL proposal requires compensation be "reasonable." However, the definition of that concept is ambiguous in the proposal. The proposal clearly contains a push toward low, levelized, and continuous compensation, which directly conflicts with guidance from the SEC and FINRA. Obviously, this creates a compliance challenge for firms. For many years, SEC and FINRA have been concerned about customers with little to no trading activity being placed in fee-based

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[7] COMMENTS ON A REVIEW OF A WHITE HOUSE REPORT ON CONFLICTED INVESTMENT ADVICE at 4 (August 21, 2015), available at http://www.dol.gov/ebsa/pdf/conflictofinterestresearchpaper1.pdf.

[8] See Investment Company Institute comment letter dated July 21, 2015, available at https://www.ici.org/pdf/15_ici_dol_fiduciary_reg_impact_ltr.pdf.

[9] *See* Exec. Order 12866.

[10] *See* FINRA Rule 2210, Communications with the Public, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10648

accounts, which tend to be more expensive for these investors.[11] Studies have also shown that level-fee accounts generally result in higher fees over time than commission-based accounts, particularly for investors who do not engage in frequent transactions[12] Furthermore, the SEC and FINRA have already brought actions against firms for placing customers in fee-based accounts when a commission-based account was more appropriate.[13] The issue referred to commonly as "reverse churning" has also been included in the SEC's examination priorities for 2016 and the SEC also included it in its ReTIRE sweep exam initiative that began in June of 2015.[14]

The SEC has also stated that firms should be wary about recommending C-share mutual funds. C-shares pay a small annual fee (i.e., low, level, and continuous fees). However, the SEC noted that over time this could result in a higher total cost to the investor. The SEC has brought enforcement matters against firms for C-share sales over $100K and proposed rulemaking to change the ways these shares operate. With BICE encouraging these sorts of level, low, continuous fees and other regulators raising concerns about them, FSI members are placed in a very difficult position of choosing which requirement to violate.

Finally, the DOL's proposal is duplicative of other regulatory requirements around disclosures. The SEC and FINRA already impose a comprehensive set of compensation disclosure obligations on firms via the prospectus, offering memorandum, confirmation statement, web site, and other means. However, the DOL's proposal duplicates these disclosures with a far more complex, costly, and confusing disclosure regime which we believe will prove entirely ineffective and only serve to further confuse investors.

Given the failures listed above, it is clear that the DOL's once again fails to meet the requirements of the Executive Orders.

Lack of Simple and Easy to Understand Regulations

Finally, the Executive Orders require the DOL to draft regulations that are simple and easy to understand. Unfortunately, the DOL does not provide clarity regarding key terms and expectations, therefore failing the simple and easy test. FSI provides three areas of the proposal to demonstrate this failure to clearly define terms. One, the use of the BICE is limited to the purchase, sale, or holding of an investment, but it is unclear whether BICE would apply to a distribution or rollover. Two, the proposal includes at least three definitions of "best interest." Three, the proposal contains at least four different definitions of "reasonable compensation." The multitude of definitions provides absolutely no clarity for firms and thus no confidence that firms are adequately fulfilling the requirements of the rule.

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[11] *See* NASD Notice to Members 03-68, Fee-Based Compensation, available at http://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf.

[12] *See* Mercer Bullard, Geoffrey Friesen, and Travis Sapp, *Investor Timing and Fund Distribution Channels*, Social Science Research Network (June 1, 2008) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1070545.

[13] *Geman v. S.E.C.*, 334 F.3d 1183(10th Cir. 1997) and Mark Schoeff, Jr., *Regulators bare their teeth on excessive fees*, InvestmentNews.com (January 23, 2015) available at http://www.investmentnews.com/article/20150123/FREE/150129955/regulators-bare-their-teeth-on-excessive-fees.

[14] *See* SEC Examination Priorities for 2016 at 2, available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

In addition, the BICE requires a contract between the advisor and the client, which results in the use of contract law to create an enforcement mechanism. This greatly complicates compliance and risk management efforts for firms due to the inconsistent interpretations that will likely result.

These factors alone demonstrate the rule is very complex and difficult to understand and will become even more complicated to administer over time. The DOL must greatly improve the final rule to satisfy the "simple and easy to understand" test.

Conclusion

In conclusion, FSI believes that retirement investors are protected by the existing regulatory system. The value of retirement advice provided by a financial advisor to a retirement saver is enormous and not reflected in the literature the DOL cites supporting the proposal. Further, the consequences of a loss of access to retirement advice, products and services will fall most heavily on smaller investors, the very group the rule purports to try to protect.

While FSI supports a uniform fiduciary standard, we believe the proper regulator to promulgate such a standard is the SEC and we believe Congress clearly believed they were the proper regulator under Dodd-Frank. The DOL rulemaking will result in contradictory requirements that are too complex, cumbersome, and costly to be workable. Finally, we believe that, if the current proposal is any indication, the final rule will fail to meet the tests outlined in the APA, other federal law, and the Executive Orders.