AMERICAN RETIREMENT ASSOCIATION
Working for America's Retirement

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Re: Follow-up to October meeting on Regulation Best Interest Proposal

The American Retirement Association ("ARA") thanks the Securities and Exchange Commission ("Commission") for the thought and effort dedicated to its regulatory package. We appreciate the ongoing opportunity to work with the Commission on these issues of great importance to our diverse membership of retirement marketplace participants. We are reaching out to follow-up on a few outstanding questions presented during our October 10th meeting.

As we discussed, we believe that a regulatory gap is presented when brokers who are not ERISA 3(21) or 3(38) fiduciaries provide recommendations to small plan fiduciaries. These non-professional, small plan fiduciaries often do not have independent financial or investment expertise and therefore are more likely to rely on broker-dealers' recommendations when making investment decisions on behalf of their plan participants. In this way, small plan fiduciaries are akin to retail investors who at times lack financial literacy let alone expertise.[1]

Q1. *What need is there for regulation?*

Answer:

The potential for abuse presents itself when there is information asymmetry between the client and the broker - the latter of whom is incentivized to push higher commissioned products. Efficiency losses arise from these conflicting incentives, especially because the parties are imperfectly monitored. The Executive Office Report, "*The Effects of Conflicted Investment Advice on Retirement Savings"* finds that conflicted advice reduces investment returns by roughly 1 percent and that the total annual cost to retirement savers well exceeds $17 billion. Chairman Clayton has voiced his concern for Mr. and Mrs. 401(k) and Main St. America. We simply ask that protection is afforded to all retirement vehicles not just non-ERISA 403(b)s and IRAs as plan participants are the ultimate beneficiaries of the plan assets.

[1] This investor sophistication policy is already reflected in FINRA rules governing suitability obligations to institutional accounts (versus "non-institutional accounts") in that a broker-dealer is exempt from its customer-specific suitability obligation, in part, if they have "a reasonable basis to believe that the institutional customer is *capable of evaluating the risks independently*, both in general and with regard to particular transactions and investment strategies." It also is important to note that, where an institutional customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, Rule 2111(b) makes clear that the factors relevant to determining whether the customer meets the criteria for the institutional-customer exemption will be applied to the agent.

Q2. ***Why should the SEC and not the DOL fill this regulatory gap?***

Answer:

SEC action is necessary to preempt state legislators from filling the perceived void left in the wake of the DOL rule's vacatur – a patchwork of regulations is a bad outcome for the investment industry. The DOL's mission to foster, promote, and develop the welfare of retirees intersects with the SEC's own mission to protect investors. However, the DOL lacks jurisdiction over a significant portion of the retirement market, namely, amounts held in individual retirement accounts. In addition, the DOL has little experience in regulating the securities industry, and lacks the examination and enforcement resources that are necessary to promote compliance. We see this as an investor protection issue since these non-professional fiduciaries are themselves investors vulnerable to broker impropriety. To that end,, Chairman Clayton has expressed concern for small plan fiduciaries like his parent's family-owned business whose 401(k) plan was subject to multiple layers of undisclosed fees.[2]

Q3. ***What constitutes a "small" plan fiduciary?***

Answer:

The terms-of-art "institutional account" and "institutional investor" under FINRA Rules 2111 and 2210, respectively, are informative for purposes of defining "small" plan fiduciaries. FINRA's suitability rule (i.e., rule 2111) defines "institutional account" by reference to FINRA's "books and records" rule (i.e, rule 4512(c)) which sets the threshold for institutional status at $50 million. The Department of Labor similarly looked to the $50 million threshold in designing it's now defunct rulemaking. However, rule drafters may be more inclined toward the employee-based definition of FINRA Rule 2210 governing institutional communications. Under that rule, "institutional investor" includes both:

> (1) an employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans; and
>
> (2) a qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans

[2] "Mr. Clayton, who came to the SEC from the law firm Sullivan & Cromwell, disputed what he called a limited portrayal of him as a Wall Street lawyer. He told a story about reviewing a 401(k) plan for his parents' business and finding "multiple layers of fees that were not disclosed." *See* www.investmentnews.com/article/20170726/FREE/170729957/jay-clayton-says-sec-dol-can-give-market-clarity-on-fiduciary-rule.

Q4. ***How are non-professional, small plan fiduciaries "retail customers"?***

Answer:

As the legal representative of a plan participant's beneficial interest in the retirement plan, regulation best interest protections should apply at the plan level and flow through to the individual beneficiary - especially when those assets may sit in the plan for decades before being rolled over to an IRA.

The definition of "retail customer" includes a person, or the legal representative of such person, who:

(A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer; and

(B) Uses the recommendation primarily for personal, family, or household purposes (such as retirement)

The regulation best interest proposal expands the definition of "retail customer" beyond the Section 913 study recommendation to include non-natural persons – specifically, legal representatives like a trustee or managing agent to a trust. Since the definition applies to persons, not simply natural persons, the trustee of an ERISA plan could qualify as a person satisfying the first prong.

Meanwhile, the second prong is satisfied in that recommendations made for retirement purposes constitute recommendations for personal, family or household purposes. While the proposal consciously excluded recommendations made for business or commercial purposes, there is ERISA precedent dictating that a plan is maintained for the benefit of the plan participants and not the employer sponsor. These recommendations should be covered by the proposed regulation since they will ultimately be used by the plan participants for personal, family, or household purposes.

Q5. ***When do brokers provide "recommendations" to plan fiduciaries?***

Answer:

The Department of Labor much like the Commission has looked to FINRA guidance in determining the scope of the term "recommendation." The term is not explicitly defined by the FINRA rules and is instead a case-by-case determination. The DOL, in looking to FINRA guidance, has found that actions like offering an investment selection menu to plan fiduciaries constitutes a "recommendation" (although it is unlikely to constitute investment advice under the 5-part test[3], hence the gap). When brokers offer a single group annuity or only target-dates, they are quite clearly providing an investment recommendation.

[3] The five-part test for determining functional fiduciary status under ERISA is defined as a person who does not have discretionary authority over plan assets and who, for compensation 1. Renders advice as to the value of securities or other property; 2. On a regular basis; 3. Pursuant to a mutual agreement; 4. The advice serves as the primary basis for investment decisions; and 5. The advice is individualized. All five prongs of the test must be met to be deemed a 3(21) investment fiduciary.

Q6. ***How does the concept of "retail customer profile" apply in the plan fiduciary context?***

Answer:

While some have commented that the retail customer profile "has little to no applicability to [plan fiduciaries],"[4] we would beg to differ. When a broker is providing recommendations to a small plan fiduciary, there is a customer profile that should be considered albeit the focus is on the fiduciary's needs and not any one particular employee participant. ERISA plan fiduciaries are subject to a prudence obligation when selecting plan investments. These plan fiduciaries must invest in a low cost diversified mix of assets. Brokers advise these plan fiduciaries as to the appropriate investment strategy and individual investments that will satisfy that strategy. As is more often the case, the plan is an individual account plan offering participants the opportunity to direct their investments, picking from a menu selected by the plan fiduciaries. ERISA Section 404(c) requires a small plan fiduciary to provide participants with a broad range of investment opportunities each of which is diversified and has materially different risk and return characteristics.[5] Brokers play a critical role in helping these plan fiduciaries provide a selection of investment options that is suitable for plan participants.

Additionally, ERISA plan fiduciaries are responsible for selecting qualified default investment alternatives (QDIAs) under participant-directed individual account plans when participants otherwise fail to exercise investment discretion. Target date funds (TDFs) are typically used for this purpose to fit within DOL regulatory parameters.[6] TDFs vary considerably with respect to providers, strategies, glide paths and investment-related fees and these differences can have a significant effect on investment performance. A prudent recommendation of a TDF requires a risk tolerance assessment particular to a given participant's age (or alternatively, a target level of risk appropriate for participants of the plan taken as a whole). As such, the broker's recommendation in meeting the needs of this profile is critically important to a small plan fiduciary.

Q7. ***What protections does regulation best interest afford to these small plan fiduciaries that they do not already receive?***

Answer:

Protection under proposed regulation best interest would entitle plan fiduciaries to the care obligation and subject brokers to an explicit "duty to act in the **best interest** of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker ahead of the interest of the retail customer." Under the care obligation, brokers must "exercise reasonable diligence, care, skill, and ***prudence.***" Notably, the Commission acknowledges in the proposal that prudence with its origins in ERISA case law is "not a term frequently used in the federal securities laws." By capturing plan fiduciaries within the definition of retail customer, we are able to subject brokers to a prudence obligation that they would otherwise avoid due to the regulatory gap. Without protections afforded by 3(21) and 3(38) status under

[4] *See* https://www.sec.gov/comments/s7-07-18/s70718-4185630-172656.pdf (p. 16)
[5] Labor Reg. §2550.404c-1(b)(3).
[6] Labor Reg. §2550.404c-5(e)(i)&(ii).

ERISA or those afforded to "retail customers" under regulation best interest, brokers are subject to the mere suitability standard, if at all.

Furthermore, extending best interest protections to small plan fiduciaries would require brokers to implement policies and procedures pursuant to the conflict of interest obligation. Brokers that are not captured by ERISA as fiduciaries are otherwise not subject to a policies and procedures requirement.

With that said, the required disclosure under proposed regulation best interest's disclosure and conflict of interest obligations is already captured by ERISA's 408(b)-2 disclosure. It is for this reason that we suggest that compliance with ERISA's disclosure scheme already applicable to broker-dealers when providing investment advice to small plan fiduciaries would satisfy regulation best interest's disclosure requirements.

Conclusion

We would welcome the opportunity to discuss these comments further with you should that be necessary. Please contact Brian Graff, Chief Executive Officer, at BGraff@USARetirement.org or Doug Fisher, Director of Retirement Policy, at DFisher@USARetirement.org if you have any questions.

Thank you for your time and consideration.

Sincerely,

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