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July 20, 2015

By U.S. Mail and Email: e-OED@dol.gov

Office of Exemption Determinations
Employee Benefits Security Administration
Attn: D-11713
Suite 400
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: ZRIN 1210-ZA25

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to provide comments regarding the Department of Labor's ("Department") proposed exemption under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and section 4975 of the Internal Revenue Code ("Code") for certain principal transactions in debt securities between a plan or an IRA (and other individual accounts) and its investment advice fiduciary. SIFMA appreciates the opportunity to comment and hope that our comments are helpful to the Department as it assesses the impact of the proposed exemption on IRAs, plans and their participants. SIFMA shares the Department's interest in making sure that plans and IRAs are treated fairly in the market place and have the ability to trade effectively and efficiently in all markets. SIFMA respectfully requests an opportunity to testify at the Department's August 10-13, 2015 hearing.

[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Attached hereto are SIFMA's submissions for the related rulemakings being undertaken by the Department. These attachments are an integral part of this submission.[2]

The proposed exemption, as drafted, covers all plans and IRAs where the fiduciary financial institution is providing investment advice, and does not have discretionary control. SIFMA believes it is appropriate that the exemption covers all plans and IRAs, and we believe that the limitation on discretionary fiduciaries is consistent with the other proposals made by the Department.

SIFMA is concerned however, that the proposed exemption will have a deleterious effect on prices in the bond market for plans and IRAs. The delays, the lack of liquidity from taking large dealers out of the market, the costs of agency transactions, and the work-arounds to avoid riskless principal transactions all add to pricing inefficiencies. SIFMA does not understand how such a strikingly bad result could be in the interest of participants. Nor do we believe that the Department's cost analysis has identified or correctly analyzed these costs. In addition, the proposal permits only a very limited list of investments that may be purchased and sold on a principal basis by plans and IRAs. It denies exemptive relief for many types of securities, for currencies and for other investment products commonly held (and currently held) by retirement accounts. New issues of equity and debt securities where one's own financial institution is part of the underwriting syndicate will be prohibited in plans and IRAs. Moreover, municipal securities, certain agency debt securities, unit investment trusts, highly rated debt of the client's own financial institution, all noninvestment grade debt, brokered certificates of deposit, private placements, preferred shares, structured notes such as principal protected notes, securities issued by charitable institutions, agency mortgage backed securities will only be able to be purchased on an agency basis which we believe will be significantly more expensive for retail investors. We think the Department has not articulated a sensible rationale for the proposed exemption's

[2] See Appendices numbered 1-8.

limitations on the assets that can be transacted on a principal basis, and these limitations are not in the best interest of retirement investors. We also believe the Department exceeds its statutory authority in undertaking to dictate the securities that properly may be held by retirement investors.

In addition, as described more fully below, the proposed exemption seems completely focused on what securities a plan or IRA can *purchase* in a principal transaction and does not reflect the important role of a retirement investor's financial institution in providing facilitation trades when the client wants to sell a security and cannot obtain a reasonable price from a third party.

The Department also appears to have overlooked, or failed to adequately considered, the existing oversight of securities and banking regulators with respect to principal transactions, including the attendant extensive rules and guidance. Significantly, the policies, procedures, training, supervisory and compliance programs and surveillance systems of financial institutions have been long—established based on these rules and guidance; now, it appears that all of that will need to be revised to create different rules for plans and IRAs than the rules generally applicable to the institution's other customers. This is improper, and it also is improper for the Department to craft this exemption and attempt to assess its benefits and costs without taking into account existing regulatory requirements.

The proposed exemption assumes that principal transactions in the securities listed above are complex, and they are not. It assumes that principal transactions in these securities are riskier than in the three "approved" bonds, and they are not. It assumes that the conflicts of interest with respect to principal transactions are of a different, more troublesome sort than any other conflict addressed by this exemption and they are not. It assumes that the impartial conduct standards, including the best interest standard, are a nullity, and they are not. Finally, it appears to ignore a financial institution's duty to comply with FINRA rules and guidance, including the duty of best execution, which overarches all of these requirements. These are well-known and well-regarded regulatory standards with teeth, and it should not be dismissed in favor of flat prohibitions on the best and most efficient, economic way to trade these instruments.

The proposed exemption may impair a broker-dealer's ability to exercise reasonable diligence under FINRA and MSRB rules by adding a significant hurdle for dealers to act in a principal capacity. FINRA's Best Execution rule and MSRB's Best Execution rule (effective December 7, 2015) require that dealers exercise reasonable diligence to ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. FINRA and MSRB provide a list of factors that will be considered when determining whether a dealer exercised reasonable diligence. The duty of best execution applies whether a broker-dealer is acting as an agent or a principal and applies across retirement and non-retirement accounts. The Department's proposed pricing information requirements conflict with a dealer's best execution obligations, in that if a dealer has used reasonable diligence and has determined that its own principal inventory is the best available market under prevailing market conditions, under FINRA and MSRB rules it must execute in that market.

In the 40 years since ERISA was enacted, the Department has never suggested that it has superior knowledge of what types of investments are in the best interest of retirement investors. Nor has the Department attempted to upend the way these investments are traded in the markets. But once the Department amends its regulation defining investment advice fiduciaries, unless it provides appropriate relief, IRAs, plans and participants will be demonstrably disadvantaged. When buying the securities they want, their costs of execution will be higher and their pricing will be less favorable. SIFMA disagrees with this unprecedented view that the Department should be the final arbiter of the types of securities permitted to be held by retirement investors, or the way securities should be traded, as the Department has done with this proposed exemption and the proposed BIC exemption. "Legal lists" of securities for retirement accounts, crafted by the Department, is just the wrong path. SIFMA respectfully urges the Department to consider how these limitations undercut the viability of the best execution standard in the securities laws, the best interest standard required under the exemption, as well as the standards embodied in section 404 of ERISA for employer sponsored plans.

This proposed exemption covers IRAs as well as the largest most sophisticated plans in the country. SIFMA believes that these restrictions will substantially injure plans of all sizes. We are concerned that these restrictions will create the very incentive the Department seeks to avoid: clients doing everything in their power to make sure that their financial representative is not a fiduciary, so they can buy the investments they choose to buy, and trade them in the most advantageous way for their plan. To us, the proposal seems to substitute the Department's judgment for that of a participant, plan fiduciary or IRA. And the proposed exemption appears to substitute the Department's judgment for that of the primary securities and banking regulators, who understand and regulate these markets on a daily basis and have done so for years, who have far more experience than the Department does in these markets, and who have rules and regulations in place that carefully assess the conflicts and the risks of principal transactions.

SIFMA is concerned that financial professionals will be obligated to warn their retirement plan clients that other securities may be in the best interest of the account but the Department has prohibited their purchase entirely or permitted the purchase only in a manner that is demonstrably more expensive and less efficient. The exemption will have the effect of removing liquidity from the market and increasing the cost of all securities because of the need to create new mechanisms to accommodate agency trades in securities that are virtually always traded as principal. This is such a departure for the Department that we respectfully request that it reconsider this course. There is nothing inherently different about the trading of other debt instruments, or other products sold on a principal basis that should, as a policy matter, eliminate a dealer's ability to sell them to their retirement plan clients in the most efficient manner that the market can provide. It is unreasonable to make the purchase and sale of principally traded products more expensive and more burdensome because the Department is uncomfortable with those products and the way they have been sold. Neither the SEC nor FINRA, whose job it is to regulate these markets, has prohibited the purchase and sale of these publicly traded products, even for the smallest retail account nor required them to be traded as agent. We strongly urge the Department to engage with us in rethinking this proposed exemption, not only with its central theme of a very limited list of securities that can be traded on a principal basis, but on some of the conditions in this proposal, which do not achieve the Department's goals but merely substitute the Department's judgment for the expertise and experience of the SEC, FINRA and the MSRB on efficient and protective securities trading.[3]

We are also concerned that these instruments will not even be functionally available to plans. It is most typical for dealers to facilitate investor transactions with third parties on a riskless principal basis rather than a pure agency basis because third parties are typically unwilling to assume settlement risk with the investor. The dealer thus assumes this settlement risk by stepping in as principal to facilitate the trade. In this case, the dealer moves the asset through its inventory but only as a pass through to or from that third party. Given the unwillingness of most third party dealers to trade directly with an unknown investor, there will be no place else for these transactions to settle, or way for third party trades to settle, when the account is custodied at the broker-dealer.[4] Thus, the Department's restrictions on principal transactions in anything other than the few types of securities it has "approved" will be tantamount to a ban on holding

[3] The MSRB rule set has a number of customer protection rules that operate similarly, but not identically to FINRA rules, including MSRB Rule G-17 (Fair Dealing), G-18 (Best Execution), G-19 (Suitability of Recommendations and Transactions), Rule G-30 (Prices and Commissions). The MSRB's Electronic Municipal Market Access (EMMA) website was designed to provide market transparency specifically to retail investors. Discussions herein referring to FINRA rules are equally applicable to the municipal securities market, but have been truncated for ease of readability (including the discussion of FINRA Notice 14-52 on matched trades).

[4] To the extent that the assets of a plan are held at a bank trustee, securities purchased or sold by a plan are settled to the bank trustee's account at the Federal Reserve or a depository.

such other securities altogether. It is critical to permit any transaction to be traded as riskless principal so that clients retain the ability to purchase and sell any assets that trades in a principal market and at a lower cost.

Finally, many firms provide market access for self-directed investors and their brokers that combine screeners and other research tools and available aggregated inventory from the dealer and other third-party dealers. As noted throughout this letter, the ability of firms to deal with their clients on a principal basis is necessary to maintain inventory, provide access to a range of investments and deliver best execution. In these instances, the client or broker on behalf of a client is unaware of whether the bond is coming from the dealer or a third party dealer until executed. The final rule should make clear that the proposed exemption for principal transactions is not needed for such services, provided that the service does not provide an individualized recommendation to a particular plan, participant or IRA account owner.

The Contract Requirement

We urge the Department to recognize several operational difficulties with the contract requirement in this exemption. First, today, contracts, when they are signed, are signed by the client, and the individual financial adviser is not a party to the agreement for a variety of employment reasons. Second, it is unlikely in an employer sponsored plan that a contract exists between the participant and the financial institution, because the owner of the account is the trustee, and the trustee is the only entity that can bind the plan in this regard. Finally, an action to enforce a contractual agreement between a plan and a financial institution is duplicative of, and actually less valuable than, the cause of action that exists under ERISA, and in all likelihood would be preempted. Accordingly, SIFMA urges the Department to change the proposed exemption to require only a written undertaking by the financial institution, as part of the account opening process, and encompassing the impartial conduct standards as revised in the manner suggested below, and only for plans not subject to Title I of ERISA. For plans covered by Title I of ERISA, SIFMA suggests that the exemption require only a written undertaking to the plan to encompass the impartial conduct standards, revised as we suggest below, but *excluding* the best interest standard, which is already found in ERISA section 404. SIFMA also suggests that these provisions may be contained in separate documents, so that every change in a disclosed conflict of interest or change in fees does not require the contract or written undertaking to be amended.

SIFMA members are concerned that the Department has not fully considered the extraordinary amount of time that it will take, and the significant costs that will be incurred, including the renegotiation of virtually all fees, to re-document the more than 50 million accounts now held at broker-dealers. If client "wet" signatures are required, there will be no way for all of these contracts to be amended regardless of how much lead time the proposed exemption provides. Even with new IRA and plan accounts, delays in obtaining signatures may result in lost trading opportunities and market movements against the client.

In addition, the systems build to provide the data required by the proposed exemption, which is discussed more fully below, is likely to take years, not the eight month compliance period offered by the Department. In the meantime, retirement clients will be unable to trade on a principal basis for the large majority of securities, and their interests will be harmed.

- Consider, for example, a retirement client holding a relatively small, illiquid bond on the effective date, who wants to sell that bond. That client would ordinarily look to its financial institution to provide that investor with liquidity and purchase that illiquid bond; generally, the financial institution would do so. If there are no other bids, or only bids at unreasonable prices, the client will be unable to sell the bond at all. We are certain that this is not a result the Department would favor.

- Similarly, consider a retirement client with bonds or NASDAQ securities that do not meet the Department's "legal list"; how are they to be sold?

SIFMA urges the Department to craft a rule that allows the financial institution to purchase *from* a client any asset that is generally bought and sold on a principal basis for any asset held in a retirement account.

The proposed exemption, like virtually all of the new and amended exemptions in this fiduciary package, requires both the adviser and the financial institution to enter into a written contract with the retirement investor acting on behalf of a plan or IRA. In the BIC exemption, the contract must be entered into *before a recommendation is made*, which, as we note in SIFMA's comment on that exemption, is unworkable as a timing matter. In the proposed principal transaction exemption, the contract must be entered into *before engaging in the transaction*. This formulation is more workable than that used in the BIC exemption. We also believe the language is clearer in the principal transaction exemption that the contract relates not to the retirement investor, and any account it holds, but to a particular plan or IRA of the retirement investor. We are concerned that recommendations made to an individual specifically for a nonretirement account may be used instead, by that individual, to direct the financial professional to purchase or sell that asset in his retirement account, and cause that recommendation, which was clearly intended for a nonretirement account, to become fiduciary advice in a retirement account. Accordingly, we believe that all of these exemptions, and the rule itself, need to acknowledge the fact that clients may have several accounts, and ensure that advice given to a nonretirement account does not become fiduciary advice in a retirement account. Because of the significant penalties associated with prohibited transactions, our members seek bright lines so that they can build reasonably designed compliance, surveillance and supervisory systems reasonably designed to ensure compliance with the final rule.

<u>The Impartial Conduct Standards</u>

Under the proposed exemption's contract requirement, the adviser and the financial institution must affirmatively agree, and comply with the following provisions: that they are fiduciaries; that they will comply with a best interest standard that incorporates the prudent person standard of section 404 of ERISA; that they will not enter into a principal transaction with the plan, participant or beneficiary account, or IRA if the purchase or sales price of the debt security (including the mark-up or mark-down) is unreasonable under the circumstances; and that the adviser's and financial institution's statements about the debt security, fees, conflicts of interest and the principal transaction, and any other matters relevant to a retirement investor's investment decision in the debt security, are not misleading. These standards are entirely inappropriate for plans covered by Title I and are simply an effort to add an excise tax penalty to ERISA's statutory scheme. The Department does not have the authority to do so. In addition, the disclosure conditions are not reasonable and not administrable, within the meaning of section 408 of ERISA.

Congress saw no reason to have a prudence standard for IRAs and believed that a violation of the prudence standard for ERISA plans should be remedied through litigation in federal court. Nonetheless, the proposal purports to condition relief under Section 4975 of the Code on the *contractual* assumption of a prudence standard that would be enforceable by IRA owners in state court. We do not believe that Congress intended a breach of the duty of prudence to violate the prohibited transaction provisions of ERISA and the Code. Our specific comments follow.

First, SIFMA strongly objects to these standards for plans covered under Title I of ERISA. The Department acknowledges in the preamble that the best interest standard "is based on longstanding concepts derived from ERISA and the law of trusts"; in particular, the duties of prudence and loyalty imposed by ERISA section 404(a). Requiring advisers to ERISA plans or plan participants to agree to, and comply with, a best interest standard separate and apart from their existing ERISA fiduciary duty is redundant and unnecessary to achieve the Department's stated goals. For ERISA plans, requiring advisers and financial institutions to adhere to a best interest standard as a condition for relief under the principal transaction exemption ramps up the consequences of any fiduciary breach by imposing an excise tax on a prudence violation. We believe that is both inappropriate and contrary to Congress's intent. Title I has its own remedy scheme that Congress carefully crafted to be based on losses, not on foot faults. These plans are already covered by a comprehensive disclosure scheme and a regulation issued just three years ago. We urge the Department to remove this requirement from the exemption, and if the Department declines to do so, to make it applicable only to plans not covered under Title I of ERISA, but as modified below.

Second, the Department does not have the statutory authority to require compliance with a prudence rule as a condition of a prohibited transaction exemption. Congress has issued more than 20 statutory exemptions; not a single one has, as a condition, a subjective and "reasonable person" standard or a subjective "misleading disclosure" standard which is punishable by transaction reversal and an excise tax, regardless of whether there is a loss on the trade and regardless of whether the disclosure is entirely correct but simply unclear. Nor has any exemption previously issued by the Department contained such a vague and subjective condition. These conditions are not administrable and therefore do not meet the standards for issuance of an exemption under section 408 of ERISA. If the Department insists on retaining compliance with a non-misleading disclosure condition in the exemption, we suggest instead that the Department explicitly adopt FINRA guidance relating to Rule 2210 regarding the term "misleading.[5] Because violation of a prohibited transaction exemption has such dire consequences, we do not believe that an inadvertent, immaterial statement taken in the wrong way by a client should result in a reversal of the transaction, a guarantee of losses and an excise tax on the entire principal amount. We ask that the provision be clarified to require that the financial institution and any adviser acting for that institution reasonably believe that their statements are not misleading.

Third, in section II(b), the financial institution and the adviser are required to affirmatively agree that they are fiduciaries with respect to any recommendations made to a retirement investor. That language is overbroad. It suggests that it can be *any* recommendation, not simply those

[5] See e.g, FINRA Frequently Asked Questions regarding Rule 2210. http://www.finra.org/industry/finra-rule-2210-questions-and-answers

which make a person a fiduciary under the proposed regulation, and regardless of whether the recommendation is made with respect to this account *or any other account of that person*. We would revise that section to read as follows:

> (b) Fiduciary. The written undertaking affirmatively states that the Financial Institution and any adviser acting for the financial institution are fiduciaries under ERISA or the Code, or both, with respect to any recommendation regarding Principal Transactions that meets the requirements of 29 CFR 2510.3-21 with respect to the specific account of the Retirement Investor to which the written undertaking is expressly applicable.

Fourth, we believe the language in the best interest standard for Title II plans needs to be changed. The proposed exemption requires advisers and financial institutions to prove that advice was given "without regard to the financial *or other interests of* the … [financial institution] or *any other party*." We do not know what these references to other interests and other parties mean and the preamble does not explain them. Given the risks of penalties for prohibited transactions and the threat of class action litigation for getting this wrong, we request that this language be deleted from the exemption.

Fifth, the standard requires that the advice be "without regard" to the financial interests of the adviser.[6] We are concerned that under this standard as written, an adviser will fail any time a plaintiff can prove that the adviser did not recommend the investment that paid him the least. FINRA uses a much more common sense test that does not contain this flaw: that the adviser make suitable recommendations based on the client's financial circumstances and needs and that the adviser put his client's interest before his own. We urge the Department to use this formulation. This formulation is found in supplementary guidance to FINRA Rule 2111 and we respectfully request that the Department use it here.[7]

[6] We note that FINRA's markup/markdown rules expressly include consideration of the cost to the financial institution of obtaining and carrying the security. . Rule 2121.01(b)(2)("in the case of an inactive security the effort and cost of buying or selling the security";) Does the Department's formulation make the FINRA requirement impossible?
[7] FINRA RN 12-25, A1 (December 2012).

Finally, we do not believe that the price formulation in this section of the proposed exemption has a common meaning that courts and arbitrators will be able to discern. Broker-dealers acting on a principal basis are required to establish policies, procedures and supervisory systems to meet the detailed, clear and unambiguous FINRA rules on pricing. Moreover, FINRA surveils prices regularly to be certain that its rules are being met. We recommend that the Department explicitly incorporate Rule 2121 into this exemption.

> FINRA Rule 2121. Fair Prices and Commissions
>
> In securities transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

We believe that FINRA Rule 2121 is the appropriate standard for the market in general. Plans and IRAs should not be subject to a different and potentially inconsistent standard than nonretirement investors. Thus, we suggest that section II(c) should read as follows:

> (1) When providing investment advice within the meaning of 29 CFR 2510.3-21 to an account of a Retirement Investor that is subject to Title I of ERISA regarding the Principal Transaction, the Adviser will act in accordance with section 404 of ERISA. When providing investment advice within the meaning of 29 CFR 2510.3-21 to an account of a Retirement Investor that is not subject to Title I of ERISA regarding the Principal Transaction, the Adviser will provide investment advice that is in the Best Interest of the Retirement Investor (i.e., advice that 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, and put the interests of the account before the interest of the Financial Institution, its Affiliates and the Adviser);

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(2) The Adviser and Financial Institution will not enter into a Principal Transaction with the Plan, participant or beneficiary account, or IRA if the purchase or sales price of the Debt Security (including the mark-up or mark-down) is not a fair price within the meaning of FINRA Rule 2121; and

(3) The Adviser and Financial Institution reasonably believe that their statements about the Debt Security, fees, Material Conflicts of Interest, the Principal Transaction, and any other matters relevant to a Retirement Investor's investment decision in the Debt Security, are not misleading.[8]

The Four Contractual Warranties Are Not Workable

The proposed exemption also requires that the adviser and financial institution provide four warranties in the contract, each one enforceable in arbitration or in court through a class action, but not themselves a cause for denial of relief under the exemption if violated. We do not think it is possible to reasonably design a supervisory system or establish a set of policies and procedures which assures that, in every case, each warranty will be met. The Department has never, to our knowledge, created a set of conditions that requires no errors, no mistakes, and no violations.

The first warranty is problematic. It states that the adviser, financial institution and its affiliates will comply with all applicable federal and state laws regarding the rendering of the investment advice and the purchase and sale of the debt security. Fairly read, if the institution violates any FINRA rule, regardless of prompt correction, and regardless of how inconsequential the violation, it will violate this warranty, and be subject to potential class action litigation.[9] The existence of the warranty, and the threat of class action litigation, may well cause financial institutions to refuse to settle any allegation of wrongdoing for fear of violating this warranty. We believe a flat compliance standard with all federal and state laws is an inappropriate standard for an exemption with such harsh consequences for an inadvertent violation. We urge the

[8] See also the analogous MSRB rules found in Rules G-18 and G-30.

[9] All of the Department's exemption proposals are a stark departure from the administrable exemptions issued in the past, where the conditions were objective, and achievable, and did not create the possibility of missteps such as confirmation errors which could invalidate all relief under the exemption. This new approach of the Department makes all the exemptions impossible to comply with as a practical matter.

Department to clarify this provision by requiring policies and procedures that are “reasonably designed to achieve compliance with applicable law”, which is the standard that FINRA uses in its Rule 3110. We also ask the Department to clarify that the affiliates’ compliance is only required to the extent that the affiliate takes part in the transaction. We also note the Department lacks authority to restrict parties’ agreement to arbitrate on a non-class basis.

The second warranty is that the financial institution has adopted written policies and procedures reasonably designed to mitigate the impact of Material Conflicts of Interest and to *ensure* that its individual Advisers adhere to the Impartial Conduct Standards. We note that the definition of Material Conflict of Interest has no materiality standard at all. Many firms would be compelled to try to cover every single potential conflict, no matter how small due to the risk of a claim later that an insignificant omission caused a breach of the warranty.[10] We urge the Department to add a materiality standard to the definition by amending the definition of “Material Conflict of Interest” to include the following underlined text: “A ‘Material Conflict of Interest’ exists when an Adviser or Financial Institution has a financial interest that, from the perspective of a reasonable person, could affect the exercise of its best judgment as a fiduciary in rendering advice to a Retirement Investor.” In addition, the Department should make explicit that the phrase “reasonably designed to” modifies both mitigation of conflicts and adviser adherence. Otherwise, the financial institution’s policies have to be perfect, which is not a real world concept and not used in any other DOL exemption. We also believe that a standard that the written policies and procedures will “ensure” individual advisors’ adherence is impossible to meet. No policy and procedures can possibly be written to “ensure” adherence. We urge the Department to strike that requirement, or replace it with an achievable standard, such as “reasonably designed to meet the requirements of these warranties”.

[10] We are concerned that a breach of warranty could entitle a plaintiff to void the transaction, effectively giving that individual a put back to the dealer for any transaction where the account suffered a loss, regardless of whether the loss is related to a perceived disclosure failure.

The third warranty requires that the financial institution has specifically identified Material Conflicts of Interest and adopted measures to prevent the Material Conflicts of Interest from causing violations of the Impartial Conduct Standards. We do not see how the second and third warranty differ and if they are not different, one should be deleted. In addition, the financial institution cannot possibly adopt measures that will "prevent" material conflicts of interest. These transactions are principal transactions between a plan or IRA and a fiduciary and by definition, a principal transaction is a counterparty transaction, which inherently contains a conflict of interest; thus the goal must be mitigation, not prevention of all conflicts. We urge the Department to change the term "prevent" to "mitigate".

The fourth and last warranty, common to all of the exemptions, provides that:

> Neither the Financial Institution nor (to the best of its knowledge) any Affiliate uses quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differentiated compensation[11] or other actions or incentives to the extent they would tend to encourage individual Advisers to make recommendations regarding Principal Transactions that are not in the Best Interest of the Retirement Investor.

While we appreciate that the Department believes that this language does not *necessarily* require level compensation, we respectfully disagree. That is the plain meaning of "differentiated compensation". Four out of the five examples in the preamble that are provided in order to illustrate this requirement provide for level compensation. The courts will look at the words "differential compensation" and will give those words their common sense meaning. We understand that the Department believes and hopes that the industry can come up with an alternative that neither requires level compensation or time billed by the hour, but this would be extremely difficult given the compensation model that has existed for decades in the industry. We do not believe that a flat compensation structure across all products is achievable and we do not believe that the Department has correctly assessed the costs of this requirement.

[11] We note that the BIC exemption uses the term "differential compensation" and this exemption uses the term "differentiated compensation". It is unclear whether there is a distinction intended by these word differences, and if so, what that distinction might be. As more fully explained in the body of the comment, SIFMA strongly objects to the level fee requirement of this warranty.

Compliance with this warranty will require financial institutions to entirely overhaul broker compensation practices to eliminate any financial professionals with IRA or other plan clients from a firm-wide bonus pool that reflects profitability of the entire firm, including retirement clients, and to exclude financial professionals from training programs if such training programs are sponsored or supported by a mutual fund complex or similar provider of investment offerings. Changes like these will take years to plan and implement. Financial institutions cannot renegotiate the contractual arrangements with third parties and vendors and alter the pay practices of every adviser in the 8 month period provided in the proposed exemption. Although the preamble indicates that the failure to comply with these warranties will not result in a loss of the exemption, the Department warns that it may well also breach the best interest standard which will result in loss of the exemption and excise taxes, as well as reversal of the trade.

In addition, any purported breach of any aspect of these four warranties in the IRA setting, no matter how insignificant, including the warranty regarding compensation policies and procedures, would be actionable under state contract law.[12] Given their resulting exposure to state court class actions for breach of warranty, SIFMA believes that its members may either terminate their relationships with smaller plans and IRAs, restrict their roles to order takers only, or offer only fee-based compensation arrangements to plans and IRAs where it is suitable to do so, simply to avoid the risks of litigation. As the head of FINRA noted quite recently:

> …I have practical concerns with the Labor proposal in a number of areas. First, the warranty and contractual mechanism employed by Labor used to address their limited IRA enforcement jurisdiction, appears to me to be problematic. In one sweeping step, this moves enforcement of these provisions to civil class action lawsuits or arbitrations where the legal focus must be on a contractual interpretation. I am not certain how a judicial arbiter would analyze whether a recommendation was in the best interests of the customer "without regard to the financial or other interests" of the service provider. I'm not sure, but I suspect, a

[12] *See* 80 Fed. Reg. at 21970 ("Failure to comply with the [policies and procedures] warranty could result in contractual liability for breach of warranty."); *id*. at 21972 ("The Department intends that all the contractual obligations (the Impartial Conduct Standards *and the warranties*) will be actionable by IRA owners.") (emphasis added).

> judicial arbiter might draw a sharp line prohibiting most products with higher financial incentives no matter how sound the recommendation might be. Similarly, I'm not sure how a judicial arbiter would evaluate which compensation practices "tend to encourage" violations of the exemption. It would appear likely, however, that firms would be required to demonstrate, at least, that any higher compensation was directly related to the time and expertise necessary to provide advice on the product, as specifically suggested by DOL. To say the least, making that case is not a simple proof standard.
>
> This all leads to my second concern that there is insufficient workable guidance provided either to the firm or the judicial arbiter on how to manage conflicts in most firms' present business models other than moving to pure asset-based fees, or a completely fee-neutral environment…. I fear that the uncertainties stemming from contractual analysis and the shortage of useful guidance will lead many firms to close their IRA business entirely or substantially constrain the clients that they will serve. Put another way, the subjective language of the PTE, coupled with a shortage of realistic guidance, may lead to few providers of these critical investor services.[13]

We believe that these concerns are well founded. Full and prominent disclosure, brought to the client's attention with some frequency, will do far more to shed light on fee differences, and educate clients regarding these differences, than arbitrarily banning fee differences in a business model that treats agency transaction compensation, principal transaction spreads, mutual fund fees and insurance company commissions differently. It is a not a "principles based" change to require this kind of massive overhaul in the way all brokers are compensated. In 2010, the Department suggested that it wanted a change in the law to make its enforcement program easier. We are worried that this proposed exemption has the same aim at a huge cost to the financial services industry, accomplished in a manner that is disruptive and will ultimately have a negative effect on retirement savings.

As the Department is well aware, the compensation paid to brokers differs *within asset types* and *across asset types*. It is not realistic to require a change of this magnitude in 8 months. We urge the Department to eliminate this provision. Failure to make some accommodation in this area

[13] https://www.finra.org/newsroom/speeches/052715-remarks-2015-finra-annual-conference

will cause dealers to refuse to use the exemption and to allow only third party transactions if they can be appropriately structured to be settled without going through a dealer's inventory. That cannot be in the interest of retirement investors. We urge the Department to recognize an even more fundamental consequence of these provisions. The sheer enormity of operationalizing these rules will likely cause financial professionals and the institutions who employ them to use wrap fees for these accounts, set high enough to be able to offset all transaction fees, and effect a dollar for dollar offset on third party payments. Principal transactions will be done with third party dealers who will charge a higher markup that likely reflects the fact that the trade is small, and the customer is not the third party dealer's own customer. Thus, the mark up inevitably will be higher than if the transaction had been done with the plan's own financial institution and the wrap fee will cover the additional transaction fees that the client would otherwise not have been required to pay. All in all, this will be a worse result for plans and neither protective of them nor in their interest. We strongly urge the Department to reconsider this requirement.

If the Department determines to proceed with this approach, we also ask the Department to delay the differential compensation rules for 36 months, which should give financial institutions the time to redesign their compensation programs, review all bonus and incentive programs, set new policies and procedures, retrain all necessary compliance, audit and risk teams, and put in new systems to accommodate these new rules.

Other Contract Disclosures

The contract must also contain disclosures regarding principal transactions in general, the client's consent to principal transactions, and the fact that the consent can be revoked. SIFMA has no comments on these requirements. The contract cannot contain (a) any exculpatory language or (b) any provision under which the plan, IRA or the retirement investor waives or qualifies its right to bring or participate in a class action or other representative action in court in a dispute with the Adviser or Financial Institution. While we have no comment on the latter prohibited contract provision, the former is too broad. All contracts with customers disclaim liability for client-caused losses, losses caused by reliance on a client's misrepresentation, or losses caused by forces outside the financial institution's control such as force majeure, market failures, communication failures and the like. These are reasonable and standard contractual provisions found in commercial contracts. Without them, financial institutions will not do business with plans. We suggest that the Department revise this language to provide as follows:

> Exculpatory provisions disclaiming or otherwise limiting liability of the Adviser or Financial Institution for a breach of fiduciary duty under ERISA by the Adviser or the Financial Institution or a violation of the Best Interest Standard for plans not covered by Title I of ERISA.

<u>General Conditions</u>

The proposed rule covers only certain debt securities and fails to cover many other products transacted on a principal basis. The proposed exemption's "legal list" only permits debt securities and then only: (1) U.S. dollar denominated debt, issued by a U.S. corporation and offered pursuant to a registration statement under the Securities Act of 1933; (2) an "Agency Debt Security" as defined in FINRA Rule 6710(l) or its successor; or (3) a "U.S. Treasury Security" as defined in FINRA Rule 6710(p) or its successor. This list omits a vast array of securities which are commonly held by plans, including:

- equities,
- municipal bonds
- agency and GSE mortgage-backed securities guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac,
- foreign corporate securities,
- preferred securities,
- unit investment trusts,
- debt issued by a charitable organization,
- foreign sovereign debt,
- certificates of deposit, and
- all equity or debt new issues where the financial institution is the underwriter or is a manager of the syndicate.

The Department's reason for this limitation is as follows:

> Under this rationale, however, the Department is not persuaded at this point that additional exemptive relief for principal transactions involving other types of assets would be in the interests of, and protective of, plans, their participants and beneficiaries and IRA owners. Equity securities, for example, are widely available through agency transactions that do not involve the particular conflicts of interest associated with principal transactions. Other assets such as futures, derivatives and currencies, may possess a level of complexity and risk that would require a retirement investor to rely heavily on a fiduciary's advice. In such cases, the Department is concerned that the class exemption proposed here would be insufficiently protective of plans, participants and beneficiaries, and IRA owners.
>
> The Department requests comment on the limitation of the proposed exemption to debt securities. Public input is requested on whether there are additional assets that are commonly held by plans, participant or beneficiary accounts, and IRAs that are sold primarily in principal transactions. Commenters should provide specifics about the characteristics of such assets and the proposed safeguards that would apply to an exemption permitting their sale in a principal transaction.

The reference to futures in the preamble is disconcerting, in that futures are not traded as principal. The Department, in dismissing the need for principal transactions in the equity markets, overlooks the NASDAQ requirement that market makers stand ready to trade for their own account to maintain a fair and orderly market. The Department does not address the fact that many of these investments are already held in plans and IRAs, nor the cost of the rule when those existing investments cannot be sold on a principal basis to one's financial institution.

We urge the Department, especially with respect to an exemption that does not merely apply to retail investors but to the largest institutional accounts, to provide leeway on securities that can be purchased from a plan or IRA's financial institution. In the absence of this flexibility, plans will not be able to purchase these securities at all, or will have to purchase and sell these assets on an agency basis, and pay significantly more for them. They surely will not be able to participate in any block trades to obtain maximum price efficiency because the Department's rules are so inconsistent with the FINRA requirements and will require that plan and IRA trades be executed by themselves. The Department, and the Secretary on the Department's behalf, have consistently argued that the purpose of these rules is to make sure that service providers to plans and IRAs put their clients' interests first, and to make sure that this fiduciary standard is enforceable. Nowhere has the Department or the Secretary said that the purpose of the rule is to make sure that plans either do not hold particular securities, or do not buy them in the most efficient way. Nor do we think that is the Department's goal. But it surely will be the result here.

Municipal Bonds

Municipal securities are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects, such as the construction of schools, hospitals, highways, sewers, and universities. Municipal securities can be bought either as new issues that are sold by underwriters to investors or can be purchased in the secondary market where they are traded over-the-counter. Municipal securities are heavily regulated by the SEC, FINRA and the MSRB, which is charged under the Securities and Exchange Act to propose rules governing the municipal securities markets[14]. The MSRB also maintains a data base to provide transparency on bond prices.

The absence of municipal securities from the list of "Assets" is troublesome. Taxable and tax exempt municipal bonds are held by many retirement investors because they provide relatively high returns with moderate risk. The preamble is silent on why municipal bonds may not be purchased in a principal transaction from the financial institution. We do not believe that anyone would suggest that they possess a level of complexity or risk that would require heavy reliance of

[14] The MSRB protects investors, state and local governments and other municipal entities, and the public interest by promoting a fair and efficient municipal securities market. The MSRB fulfills this mission by regulating the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities. To further protect market participants, the MSRB provides market transparency through its Electronic Municipal Market Access (EMMA®) website, the official repository for information on all municipal bonds. The MSRB also serves as an objective resource on the municipal market, conducts extensive education and outreach to market stakeholders, and provides market leadership on key issues. The MSRB is a Congressionally-chartered, self-regulatory organization governed by a 21-member board of directors that has a majority of public members, in addition to representatives of regulated entities. The MSRB is subject to oversight by the Securities and Exchange Commission.

an investment professional similar to derivatives. Thus, the Department's limitation on municipal bonds is unexplained.

The municipal bond market is a dealer market. The bulk of the bonds offered for sale via any online bond search are typically owned by dealers. Municipal securities can play an important role in retirement accounts, both on a taxable and non-taxable basis. Taxable municipal bonds, such as the Build America Bonds, are not exempt from federal, state or local taxes. Depending on a number of factors including, the interest rate environment, offered yield, potential need for diversification of credit, and individual tax situation, it may be in the retirement investor's best interest to hold a taxable municipal bond in their IRA. We acknowledge that taxable municipal bonds are more typically purchased in retirement accounts as compared to tax-exempt bonds, which are exempt from federal, state or local taxes. However, on an absolute yield basis, tax-exempt municipal bonds may be appropriate for retirement investors during certain time periods in the market. We do not believe that substitution of the Department's investment judgment on this issue is appropriate and we believe that requiring these bonds to be purchased and sold in agency transactions can only hurt plans. Rather than effectively limiting retirement investors' access to these securities, we recommend that the determination of whether an investment in a municipal security is in a retirement investors' best interest be left to financial institutions and advisers who have a better understanding of the individual needs of the retirement investors they serve. We recommend the Department include municipal securities in the definition of debt security in the proposed exemption, subject to the existing section 404 standards for ERISA plans and a fiduciary best interest standard in the proposed exemption for IRAs.

Currencies

The reference to currencies as possessing a level of complexity and risk that would require a plan to rely heavily on a fiduciary's advice is perplexing. Currency prices are broadly quoted, and transparent. We do not understand any perception of complexity and risk for currencies. Even retail accounts buy and sell foreign securities daily and buy and sell the currencies necessary to settle these trades. These are not investment trades or speculative trades. They simply accommodate the client's interest in investing in a foreign market. Even the largest plans and the most sophisticated accounts will be unable to purchase currency from their own financial institution, leaving them to attempt to purchase odd lots from a third party dealer at rates potentially less favorable than the rates they can receive from their own financial institution. We do not think this restriction is in the interest of any plan.

Foreign Securities

In addition, the proposed exemption, taken together with the BIC exemption, effectively bans all foreign securities from IRAs and 401(k) accounts since they cannot be bought as agent in a retail account under the BIC exemption and they cannot be bought as principal under this exemption. It is an extraordinary restriction. In SIFMA's comments on the BIC exemption, we are urging the Department to permit foreign securities. We hope that whatever bias the Department has against global investing can be overcome. Assuming it can, this exemption absolutely must cover currency or plans and IRAs will be left to purchase currency in odd lots from third party dealers.

Brokered Certificates of Deposit

We also urge the Department to add brokered certificates of deposit to the list of assets, assuming the Department is unwilling to eliminate its "legal list" construct. Brokered CDs (CDs from third party financial institutions) are most often sold as principal and without this relief, this safe and appropriate investment generally will not be available to IRAs and plans. This omission is particularly glaring because the Department has chosen to include CDs in the list of permitted "Assets" for the Best Interest Contract Exemption. There is no rational basis for the Department to conclude that CDs are appropriate for the Best Interest Contract Exemption but not appropriate for the Principal Transactions Exemption.

Unit Investment Trusts

We urge the Department to permit unit investment trusts to be sold to plans under this exemption. Unit investment trusts are transparent investment vehicles that maintain the same investment mix for their term, allowing investors to understand exactly what the investment mix in the trust will be for the entire holding period. Thus, in a way they are like an actively managed product in that the security mix need not track an index but like a passive investment in that there is very little trading activity and transaction cost within the trust. The unit investment trusts are regulated by the SEC under the Securities Act of 1933 and the Investment Advisors Act and are accompanied by a prospectus clearly setting out all fees, both internal to the trusts and payable to financial intermediaries. They are generally sponsored by large investment managers. While these unit investment trusts can be purchased in an agency transaction, there are several cost savings inherent in the principal process. We would be happy to talk to the Department further about these vehicles.

Equities and Debt New Issues

The Department, in dismissing the need for principal transactions in the equity markets, overlooks the NASDAQ requirement that market makers stand ready to trade for their own account to maintain a fair and orderly market.

In addition, although equities may be available on an agency basis, it is not true for new issues. And of course, new issues of debt will also be prohibited in this exemption for any broker whose own financial institution is in the underwriting syndicate. Excluding these equity and debt securities from the exemption denies access to these securities altogether. For most IRA and small plan clients, their only ability to purchase these newly issued securities is from their financial institution. No other institution is likely to share these limited securities with a small account that is not a client. It will be a significant enough effort to explain to existing clients the new rules, the new fees, and the new disclosures. It will be virtually impossible to make clients understand that these products they have always been able to buy because of their relationship with a financial professional, are suddenly unavailable to them. They will not see this regulation as protective; they will see it as the Department substituting its judgment for that of retirement investors who have chosen to seek out these new issues for good investment reasons. The risks are fully disclosed to the investor prior to the time that the order is placed. We disagree with the Department that retirement accounts should not buy new issues. Had this rule been in effect over the last 10 years, IRAs and plan participants who maintain accounts at large broker-dealers would not have been able to purchase shares of Apple, Amazon, Google, GoPro, or the biotech issues in the initial public offering and the only explanation for the limitation on their investment gain is that they are no longer permitted to have a brokerage account. The result of these limitations is that retirement accounts will be forced to sit out some of the most successful equity and debt offerings over the last several years because the Department appears to think these issues are speculative.

The preamble gives no reason at all for this restriction and the reasons for it are not evident. With disclosure of the risks, the conflicts of interests and the fees to be earned by the underwriters, we do not understand the reason for the prohibition. It is disheartening that with all of the disclosure of direct and indirect fees, the requirements to identify and disclose conflicts of interest, and with the best interest standard in place, the Department is still unprepared to allow retirement investors to make their own investment choices, regardless of the size of the account or the sophistication of the fiduciary. We do not believe the Department has the statutory or legal authority to specify what retirement accounts can invest in.[15] Had Congress wanted to place investment restrictions on plans, it would have done so, as it did in Code Section 408 for IRAs. Because there are no such prohibitions in ERISA, we question the Department's ability to

[15] We do not believe that the Department has the authority to limit investments of plans and IRAs through the exemption process when Congress clearly intended these products to be available in the market place to these retirement accounts on the same footing as other investors. Section 408 permits the Department to grant an exemption if it is in the interest of plans and protective of them. The "protective" standard does not assume that retirement investors are so unfamiliar with the markets that anything other than highly rated, liquid bonds can be sold as principal.

impose them now through the exemption process. We also question the Department's ability to expand the list of prohibited investments for IRAs given the language in Code Section 408 which does not restrict any of the securities prohibited under this proposed exemption.

Financial Institution Debt

Within the limited list permitted by the Department, financial institution debt is specifically excluded. We urge the Department to reconsider financial institution debt. These debt instruments are generally highly rated, and in some cases, even provide principal protection. There is absolutely no evidence that we know of that would suggest that financial institutions imprudently cause plans to purchase their own debt. Many retirement accounts have long held these instruments, and they will not understand why they will no longer be able to do so. As noted earlier, they will see this as the Government restricting what they can own in their retirement account. Financial institutions also often offer their debt that has been developed as solutions to meet their clients' investment objectives. For example a financial institution might provide limited exposure to an equity index through the coupon on the debt while also protecting the principal of the investment. These valued products and solutions will now be off limits to retirement accounts, because it can neither be purchased under this exemption or under the BIC exemption. Nor has the Department considered in its cost estimates the effect on the capital markets when IRAs and plan participants have to sell all these debt instruments precipitously and immediately. The effect on these institutions and the capital markets would be significant. Finally, we reiterate our concern that this exemption covers all retirement plans, not just retail investors. We see no reason why financial institution debt of one's own financial institution cannot be sold as principal by a financial institution, or purchased at all by IRAs and participants in 401(k) plans. Even for the largest plans, this restriction leaves retirement accounts to buy these instruments from third party dealers at higher prices with commissions.

Agency and GSE Guaranteed Mortgage-Backed Securities (Agency MBS)

The proposed exemption also does not permit a principal transaction in agency-guaranteed MBS. These MBS are guaranteed by Ginnie Mae (a government agency), Fannie Mae and Freddie Mac (each, a government sponsored enterprise), and therefore present identical or superior (in the case of explicitly government-guaranteed Ginnie Mae MBS) credit risk as Agency debentures which are permitted under the proposed exemption (and share the same 20% risk weight under bank regulatory capital rules). Agency MBS, however, are *far* more liquid than agency debentures. In 2014, the average daily trading volume of agency MBS was $177.9 billion. In contrast, the average daily trading volume for debentures in 2014 was $5.3 billion. For reference, the same average for corporate debt was $19.9 billion, and for US Treasury securities, $505.4 billion. Agency MBS *are the second most liquid fixed-income security in the US*.[16] They are held by millions of retirement accounts. Given that liquidity and credit risk are factors in the inclusion of asset classes in this exemption, agency MBS should be allowed under the exemption. The criteria set forth by the Department do not justify the exclusion of agency MBS.

The Result of These Restrictions

We are mystified at the Department's picking and choosing among securities, blessing some and nixing others. No basis is provided in the preamble or elsewhere for the Department's choices. There is no evidence that the Department considered the knock on effect of its "legal lists" on the capital markets. Nor does the Department consider the effect on the mortgage market if all IRA holders of these securities are compelled to liquidate their holdings in 8 months. Moreover, the Department is moving away from its principles based exemptions like QPAM, toward exemptions that will quickly become outdated as new products are introduced to the markets that may be better, safer, more efficient, and/or more flexible. In 1975, there were no ETFs. If Congress or the Department had had a "legal list" of permissible securities, how long would it

[16] See http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Bond-Market-Trading-Volume-SIFMA.xls?n=30624 for details.

have taken for the Department to amend its exemptions to add ETFs, other new products and new innovative products in the future? We think this is a bad approach, for the markets in general and for retirement investors in particular. Unless the Department has no faith in its fiduciary rule, and in its impartial conduct standards, it should leave the investment choices to retirement investors.

Other Conditions

With respect to the quite minimal list of securities remaining, the proposed exemption requires that the debt security possesses no greater than a moderate credit risk and is sufficiently liquid that the Debt Security could be sold at or near its fair market value within a reasonably short period of time. We are concerned that with this further restriction, the Department is ignoring sales from plans. Moreover, it is undercutting its own best interest standard. It may well be that clients choose to purchase high yield securities, or are prepared to give up liquidity temporarily in a retirement account where they may not need liquidity for 25 years or where bonds are intended to be held to maturity.

Additionally, it would be operationally impossible to obtain precise and timely credit risk ratings for all debt securities at the point of sale due to the dynamic nature of the market. As noted in a Deloitte report assessing the anticipated operational impact of the proposed rule, depending on the specific debt security, there will be limited consistency in determining ratings as a result of securities not being rated at all, or the rating being outdated. As a result of liquidity being a point of time determination, concluding if a debt security is “sufficiently liquid” will be difficult and subjective. Furthermore, financial market fluctuations will create situations where there are changes to prices, credit ratings or liquidity conditions in the time between the initial transaction disclosure recommendation and the customer’s decision to execute the transaction. For the firm to stay in compliance with the exemption, the investment professional would be required to perform additional disclosures if prices, credit ratings or liquidity changes during this time period. Delays caused from performing repetitive disclosure process may have unintended harmful consequences to customers such as best execution requirements and pricing disparities.

Moreover, in defining these terms, the Department uses terminology borrowed from a totally different regulatory regime created for a different purpose and then substitutes different words to make the terms incomprehensible. Even if the wording can be corrected, this sets up a speculative, forward looking test that no one can be assured of meeting, and takes a standard that is potentially relevant to a securities purchase and applies it as well to sales, when the investor's needs may be quite different – liquidating a poor credit risk or an illiquid investment.

The standard used in the proposed exemption -- no greater than a moderate credit risk and is sufficiently liquid that the debt security could be sold at or near its fair market value within a reasonably short period of time -- is similar to that used by the SEC but for an entirely different purpose. Indeed, there is no similar restriction for retail or institutional accounts under the securities laws relating to risk or liquidity and we believe it is inappropriate for this exemption to have such a restriction.

The language in the proposed exemption is borrowed from the Investment Company Act and we do not think it is an apt reference here. The standard that the Department has borrowed from the securities laws relates to business and industrial development companies ("BIDCOs"), which may be deemed to be investment companies under the Investment Company Act of 1940 because they invest in securities. BIDCOs are companies that operate under state statutes that provide direct investment and loan financing, as well as managerial assistance, to state and local enterprises. Section 6(a)(5) of the Investment Company Act exempts BIDCOs from most provisions of that Act subject to certain conditions ("BIDCO exemption"). One of these conditions permits BIDCOs to purchase debt securities issued by an investment company or private fund (*e.g.*, hedge fund) if the debt security meets a standard of credit-worthiness established by the Commission. On November 19, 2012, the Commission adopted rule 6a-5 to establish this credit quality standard. Rule 6a-5 was effective on December 24, 2012. As is clear, the purpose of the rule has nothing to do with retirement investors, and is directed instead at an entirely different purpose.

More troublesome is that the Department has changed the SEC definition in a way that makes less sense and seems circular. Rule 6a-5 provides that the debt instrument is subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its *carrying value* within a reasonably short period of time. The Department has replaced "carrying value" with "fair market value." Since fair market value is the price that can be obtained in the market, and one will not know what price is obtainable in the market until one attempts to sell it, it is hard to imagine how one will meet this condition. The SEC formulation at least permits the BIDCO to look at daily carrying values rather than an unpredictable market standard.

The SEC guidance is far clearer. The rule explanation notes:

> In making credit quality determinations, a BIDCO's board of directors or members (or its or their delegate) can also consider credit quality reports prepared by outside sources, including ratings of a nationally recognized statistical rating organization ("NRSRO") that the BIDCO board or members conclude are credible and reliable for credit quality determinations.
>
> As a result of rule 6a-5, section 6(a)(5) also limits a BIDCO's investments in mutual funds to mutual funds that invest at least 65% of their assets in debt securities issued by investment companies or private funds that meet the credit quality standard in rule 6a-5.

Thus, even the standard applicable to BIDCOs does not require that all of its debt securities meet this credit and liquidity standard. We urge the Department to eliminate this standard and not further limit the debt securities that a plan participant, plan or IRA can purchase on a principal basis. As noted above, unless the Department has no faith in the impartial conduct standards and the new fiduciary rule, it should not micromanage what retirement investors can invest in and how those transactions can be effected.

But even more critical is that this condition applies to purchases and sales, ignoring the fact that financial institutions are relied on by their clients and by the SEC and FINRA to effect facilitation trades for clients who want to liquidate securities and are unable to do so with a third party. This condition would not only preclude all principal transactions except for the categories of securities that the Department's staff is comfortable with (keeping in mind that they are not familiar with the markets and have no general authority to regulate those markets), but then only if the securities are "no greater than a moderate credit risk and [are] sufficiently liquid that the Debt Security could be sold at or near its fair market value within a reasonably short period of time". We urge the Department to eliminate this condition entirely, and to expressly provide that a financial institution can facilitate a trade as principal in any security, at the client's direction, if the financial institution reasonably believes that it can offer a better price than is being offered from public sources such as alternative trading systems, Bonddesk and the like.

Pricing

The proposed exemption requires that the purchase or sale be executed at a price that the adviser and the financial institution reasonably believe is at least as favorable to the plan as the price available to the plan in a transaction that is not a principal transaction. We do not object to this.[17] But the Department goes on to require that the price be at least as favorable to the plan as the contemporaneous price for the Debt Security, or a similar security if a price is not available with respect to the same Debt Security, offered by two ready and willing counterparties that are not Affiliates.[18]

This provision ignores anonymous trading systems such as Bonddesk, although SIFMA facilitated meetings between the Department and Bonddesk in 2011. It assumes that two prices

[17] We note that the Department permits the comparison to be made against a trade away, with commission and markup or markdown from the third party dealer. "When comparing the price offered by the counterparties referred to in (2), the Adviser and Financial Institution may take into account a commission as part of the resulting price to the Plan, participant or beneficiary account, or IRA, as compared to the price of the Debt Security, including any mark-up or mark-down." This provision is appropriate.

[18] We note that FINRA, in the past, used a "3 quote" rule under 5310, but FINRA removed that requirement and replaced it with reasonable diligence, rigorous and regular review, and similar requirements. At that time, FINRA found the costs associated with the delay would not be beneficial to investors.

can be obtained, and that the dealer quoting these prices stands ready to transact at these prices, assuming also that the plan client is waiting by his phone or computer for a call back from his financial professional and nearly simultaneously, approves one of the trade prices which has not moved. More likely, hours will have gone by, dealers will no longer be willing to transact at those prices, and the process must be restarted. This will be a very inefficient process and will result in retirement investors receiving worse execution and suffering from less liquidity than non-retirement accounts. These assumptions are not based on how the markets operate, and reflect the Department's lack of understanding of market practice. The Department is intending to change how markets operate, but the markets will only be changed for retirement investors -- and not positively at that. We urge the Department to rethink this condition, replacing it with a condition that the financial professional reasonably believes it is offering a fair price under FINRA Rule 2121, and requiring the financial institution to provide evidence of other prices in the security that day upon request.

The fair pricing rules of FINRA, which should be incorporated explicitly into the proposed exemption incorporate a variety of factors and do not suggest that only a rigid "two quotes" rule is protective. The Department does not explain why these FINRA pricing rules are inadequate or unprotective. They are the rules that apply to these same customers as retail customers of financial institutions subject to FINRA supervision and the rules that apply to third party dealers who will, in the absence of adequate relief in this regulation, be selling these same instruments to all plans, from sophisticated institutional accounts to retail accounts.

Moreover, the two quote requirement actually hurts plans holding illiquid securities. This condition of the proposed exemption would not permit a sale of a security to the financial institution in a situation where the financial institution is acting as a liquidity provider, and where no one else stands ready to buy the security. We cannot understand why this condition is in the interest of plans and we urge the Department to permit sales to a financial institution where two quotes are not available and the financial institution reasonably determines that it is offering a fair price to the investor.

At the most basic level, the question being raised by the Department in the two quote requirement is the fairness of the price. However, the Department chooses to not acknowledge FINRA's extraordinarily detailed guidance on pricing. See FINRA Rule 2121. In addition, FINRA surveils prices and requires financial institutions to justify any prices that FINRA believes could be outside a reasonable market range. Dealers are further subject to a best execution standard that buttresses the fair pricing standard (see FINRA rule 5310). Tools exist today for price discovery and they are readily available and subject to continual improvements. It would be far better for participants to see how the security they are buying or selling is trading in the market, rather than seeing two indicative quotes that may not be available when the client approves the trade. TRACE, FINRA's online reporting system, provides much of that transparency to an ordinary investor. Other large firms have similarly comprehensive pricing history on their websites.

> TRACE was established in July 2002 to create a regulatory database and bring transparency to the corporate bond market. Transparency in non-144A transactions was fully phased in by January 2006, offering real-time, public dissemination of transaction and price data for all publicly traded corporate bonds—including intra-day transaction data and aggregate end-of-day statistics (most active bonds, total volume, advances and declines, and new highs and lows). Transparency in 144A transactions in corporate debt was added on June 30, 2014. Agency debentures were added in March of 2010 and are subject to real-time dissemination. On November 12, 2012, FINRA began disseminating transaction information for agency pass-through mortgage-backed securities traded "to-be-announced" (TBA). FINRA began disseminating information for so-called specified pool transactions in agency pass-through mortgage-backed securities and SBA-backed securities in July 2013. On June 1, 2015, FINRA brought transparency to the asset-backed securities market, providing investors with post-trade price information for asset-

> backed securities, including those backed by auto loans, credit card receivables and student loans.[19]

In summary, we do not believe that the two quote requirement is workable or in the interest of retirement investors. We are concerned about the lost opportunities for the retail investor, the consequences of the timing of the disclosures, and the pricing issues, including whether this process is consistent with the duty of best execution.

<u>Markup and Markdown Disclosure</u>

We urge the Department to eliminate the requirement that a markup or markdown must be disclosed. A markup or markdown could be based on many different factors, including depth of inventory, access to the security in the market at a particular time and risk. Commissions, in contrast, are shown on confirms, available upon request, disclosed as part of the section 408(b)(2) disclosure, and generally quite transparent. We believe that the reference point for the Department to focus on is the price, which will be provided to the client before the transaction, and on the confirm after the transaction. It will be confusing to retail investors to see a price, which already reflects the markup or markdown, and then the markup or markdown separately. Retirement investors will not receive it when the transaction is effected with a third party even though there will be both a markup and a commission on that trade.

While the SEC and FINRA have detailed rules relating to markups and markdowns, there is no current requirement that markups and markdowns be disclosed. The FINRA rules reflect the nuances of a regulatory authority very familiar with the markets. They are detailed and comprehensive. We urge the Department to allow FINRA to take the lead here as they consider the appropriate disclosure regime. As one can see from FINRA Notice 14-52 relating to matched trades, it took 13 examples to explain how the proposed rule's markup disclosure rule for matched trades would work in the real world. Some of the examples rely on weighted averages,

[19] FINRA, FINRA Solicits Comment on New Academic TRACE Data Set, July 16, 2015, http://www.finra.org/newsroom/2015/finra-solicits-comment-new-academic-trace-data-set (last visited July 20, 2015)

others on "last in first out." The comments received by FINRA reflect real concern that these somewhat arbitrary calculation rules don't work. Simply announcing that markups and markdowns should be disclosed, as the Department has done, without defining those terms, and without providing any methodology for calculating markups and markdowns, will create confusion and chaos, with every dealer calculating markups and markdowns differently, subject to the prohibited transaction penalty requiring reversal of the trade, guarantee of any loss, and payment of an excise tax on the entire principal amount. The more likely result is that no one will take the chance that their calculation of the markup or markdown will be deemed to be "wrong". Dealers will not transact on a principal basis with plans if they are required to provide markup and markdown information that is entirely undefined, for fear of losing the exemptive relief they need.

<u>Annual Disclosure and Additional Disclosure on Request</u>

We believe that the annual disclosure is duplicative of the pre-transaction disclosure and post-transaction confirmation disclosure. The proposed rule requires that all transactions be reported to the client within 45 days after the end of a calendar year. In the event the department is determined to proceed with an annual disclosure requirement, we believe 45 days is too short a period of time to provide this information to all the financial institution's retirement clients. SIFMA members generally provide this kind of reporting, at least in the retail setting, within 90 days after the end of the calendar year. We respectfully request a 90 day period to provide this report. With respect to the content of the report, we do not understand some of the language used in the requirement and would appreciate clarification. The report requires:

> (1) A list identifying each Principal Transaction engaged in during the applicable period, the prevailing market price at which the Debt Security was purchased or sold, and the applicable mark-up or mark-down or other payment for each Debt Security; and

We are not certain what the Department means by "the prevailing market price at which the Debt Security was purchased or sold". As noted above, the prevailing market price is the price *from* *which* the client price is calculated.[20] Thus, by definition, the prevailing market price is not the price at which the debt security was purchased from or sold to a retirement investor. We believe that the sentence should be clarified to read: "the price at which the Debt Security was purchased or sold". And again, we believe it is not appropriate to require the disclosure of the markup or markdown for the reasons described elsewhere in this comment.

The proposed exemption also requires that upon request, apparently at any time prior to the end of the six year period following the purchase or sale, the financial institution must provide any information at all about the debt security and its purchase or sale. We strongly urge the Department to provide a "reasonably available" and an "in its possession" modifier.

> (d) Upon Request. Upon the Retirement Investor's reasonable request, prior to or following the completion of a Principal Transaction, the Adviser or Financial Institution must provide the Retirement Investor with *reasonably available* additional information *in its possession* regarding the Debt Security and its purchase or sale; provided that such request may not relate to a Principal Transaction that was executed more than six (6) years from the date of the request.

Otherwise, the financial institution could be required to fully research anything the client wants to know about the issuer, or capture all transactions in the security, or some other arduous and unique request. In addition, the proposed exemption should permit a reasonable charge for the information. In the absence of such a reasonable charge, the price of the advisory services will be increased to anticipate such requests.

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[20] FINRA Rule 2121, section .02:

> (b) Prevailing Market Price

(1) A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price. Presumptively for purposes of this Supplementary Material .02, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with FINRA pricing rules. (See, e.g., Rule 5310).

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We assume that these disclosure provisions relate only to transactions made in connection with the provision of investment advice and that where the dealer is not acting as a fiduciary, the conditions of other exemptions apply. We ask the Department to clarify this point in any final rulemaking.

We appreciate the Department's consideration of this comment, and are grateful for the Department's willingness to receive additional information regarding principal transactions. We are happy to meet with the Department at its convenience. For further discussion, please contact the undersigned at 202-962-7329.

Sincerely,

Lisa J. Bleier

Lisa J. Bleier
Managing Director, Federal Government Relations
and Associate General Counsel

FINRA Appendix

(b) Prevailing Market Price

(1) A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price. Presumptively for purposes of this Supplementary Material .02, the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred, or contemporaneous proceeds as obtained, consistent with FINRA pricing rules. (See, *e.g.*, Rule 5310).

(2) When the dealer is selling the security to a customer, countervailing evidence of the prevailing market price may be considered only where the dealer made no contemporaneous purchases in the security or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price. When the dealer is buying the security from a customer, countervailing evidence of the prevailing market price may be considered only where the dealer made no contemporaneous sales in the security or can show that in the particular circumstances the dealer's contemporaneous proceeds are not indicative of the prevailing market price.

(3) A dealer's cost is considered contemporaneous if the transaction occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the security. (Where a mark-down is being calculated, a dealer's proceeds would be considered contemporaneous if the transaction from which the proceeds result occurs close enough in time to the subject transaction that such proceeds would reasonably be expected to reflect the current market price for the security.)

(4) A dealer that effects a transaction in debt securities with a customer and identifies the prevailing market price using a measure other than the dealer's own contemporaneous cost (or, in a mark-down, the dealer's own proceeds) must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or, the dealer's proceeds) provides the best measure of the prevailing market price. A dealer may be able to show that its contemporaneous cost is (or proceeds are) not indicative of prevailing market price, and thus overcome the presumption, in instances where (i) interest rates changed after the dealer's contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing; (ii) the credit quality of the debt security changed significantly after the dealer's contemporaneous transaction; or (iii) news was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction.

(5) In instances where the dealer has established that the dealer's cost is (or, in a mark-down, proceeds are) no longer contemporaneous, or where the dealer has presented evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost (or proceeds) provides the best measure of the prevailing market price, such as those instances described in (b)(4)(i), (ii) and (iii), a member must consider, in the order listed, the following types of pricing information to determine prevailing market price:

(A) Prices of any contemporaneous inter-dealer transactions in the security in question;

(B) In the absence of transactions described in (A), prices of contemporaneous dealer purchases (sales) in the security in question from (to) institutional accounts with which any dealer regularly effects transactions in the same security; or

(C) In the absence of transactions described in (A) and (B), for actively traded securities, contemporaneous bid (offer) quotations for the security in question made through an inter-dealer mechanism, through which transactions generally occur at the displayed quotations.

(A member may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information (*e.g.*, a member may consider pricing information under (B) only after the member has determined, after applying (A), that there are no contemporaneous inter-dealer transactions in the same security).) In reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information (i.e., either a particular transaction price, or, in (C) above, a particular quotation) depends on the facts and circumstances of the comparison transaction or quotation (i.e., such as whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction and timeliness of the information).

(6) In the event that, in particular circumstances, the above factors are not available, other factors that may be taken into consideration for the purpose of establishing the price from which a customer mark-up (mark-down) may be calculated, include but are not limited to:

• Prices of contemporaneous inter-dealer transactions in a “similar” security, as defined below, or prices of contemporaneous dealer purchase (sale) transactions in a “similar” security with institutional accounts with which any dealer regularly effects transactions in the “similar” security with respect to customer mark-ups (mark-downs);

• Yields calculated from prices of contemporaneous inter-dealer transactions in "similar" securities;

• Yields calculated from prices of contemporaneous dealer purchase (sale) transactions with institutional accounts with which any dealer regularly effects transactions in "similar" securities with respect to customer mark-ups (mark-downs); and

• Yields calculated from validated contemporaneous inter-dealer bid (offer) quotations in "similar" securities for customer mark-ups (mark-downs).

The relative weight, for purposes of identifying prevailing market price, of the pricing information obtained from the factors set forth above depends on the facts and circumstances surrounding the comparison transaction (i.e., whether the dealer in the comparison transaction was on the same side of the market as the dealer is in the subject transaction, timeliness of the information, and, with respect to the final factor listed above, the relative spread of the quotations in the similar security to the quotations in the subject security).

(7) Finally, if information concerning the prevailing market price of the subject security cannot be obtained by applying any of the above factors, FINRA or its members may consider as a factor in assessing the prevailing market price of a debt security the prices or yields derived from economic models (*e.g.*, discounted cash flow models) that take into account measures such as credit quality, interest rates, industry sector, time to maturity, call provisions and any other embedded options, coupon rate, and face value; and consider all applicable pricing terms and conventions (*e.g.*, coupon frequency and accrual methods). Such models currently may be in use by bond dealers or may be specifically developed by regulators for surveillance purposes.

(8) Because the ultimate evidentiary issue is the prevailing market price, isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price. For example, in considering yields of "similar" securities, except in extraordinary circumstances, members may not rely exclusively on isolated transactions or a limited number of transactions that are not fairly representative of the yields of transactions in "similar" securities taken as a whole.

(9) "Customer," for purposes of Rule 2121, Supplementary Material .01 to Rule 2121 and this Supplementary Material .02, shall not include a qualified institutional buyer ("QIB") as defined in Rule 144A under the Securities Act of 1933 that is purchasing or selling a non-investment grade debt security when the dealer has determined, after considering the factors set forth in Rule 2111(b), that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction. For purposes of Rule 2121, Supplementary Material .01 to Rule 2121 and this Supplementary Material .02, "non-investment grade debt security" means a debt security that: (i) if rated by only one nationally recognized statistical rating organization ("NRSRO"), is rated lower than one of the four highest generic rating categories; (ii) if

rated by more than one NRSRO, is rated lower than one of the four highest generic rating categories by any of the NRSROs; or (iii) if unrated, either was analyzed as a non-investment grade debt security by the dealer and the dealer retains credit evaluation documentation and demonstrates to FINRA (using credit evaluation or other demonstrable criteria) that the credit quality of the security is, in fact, equivalent to a non-investment grade debt security, or was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933.

(c) "Similar" Securities

(1) A "similar" security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment to the investor. At a minimum, the security or securities should be sufficiently similar that a market yield for the subject security can be fairly estimated from the yields of the "similar" security or securities. Where a security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security.

(2) The degree to which a security is "similar," as that term is used in this Supplementary Material .02, to the subject security may be determined by factors that include but are not limited to the following:

(A) Credit quality considerations, such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security (to the extent securities of other issuers are designated as "similar" securities, significant recent information of either issuer that is not yet incorporated in credit ratings should be considered (*e.g.*, changes to ratings outlooks));

(B) The extent to which the spread (i.e., the spread over U.S. Treasury securities of a similar duration) at which the "similar" security trades is comparable to the spread at which the subject security trades;

(C) General structural characteristics and provisions of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the security will be called, tendered or exchanged, and other embedded options, as compared with the characteristics of the subject security; and

(D) Technical factors such as the size of the issue, the float and recent turnover of the issue, and legal restrictions on transferability as compared with the subject security.

(3) When a debt security's value and pricing is based substantially on, and is highly dependent on, the particular circumstances of the issuer, including creditworthiness and

the ability and willingness of the issuer to meet the specific obligations of the security, in most cases other securities will not be sufficiently similar, and therefore, other securities may not be used to establish the prevailing market price.