TRANSCRIPT OF PROCEEDINGS

U.S. DEPARTMENT OF LABOR
EMPLOYEE BENEFITS SECURITY ADMINISTRATION

IN THE MATTER OF:)
)
CONFLICT OF INTEREST)
PROPOSED RULE, RELATED)
EXEMPTIONS AND REGULATORY)
IMPACT ANALYSIS HEARING)

Pages: 1047 through 1301

Place: Washington, D.C.

Date: August 13, 2015

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UNITED STATES DEPARTMENT OF LABOR
EMPLOYEE BENEFITS SECURITY ADMINISTRATION

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PROPOSED RULE, RELATED)
EXEMPTIONS AND REGULATORY)
IMPACT ANALYSIS HEARING)

Main Auditorium
Frances Perkins Building
200 Constitution Avenue, N.W.
Washington, D.C.

Thursday,
August 13, 2015

The parties met, pursuant to the notice, at 9:00 a.m.

ATTENDEES:

Government Panel:

JUDY MARES
Deputy Assistant Secretary, EBSA

TIM HAUSER
Deputy Assistant Secretary for Program Operations,

CHRISTOPHER COSBY
Office of Policy and Research

JOE CANARY
Office of Regulations and Interpretations

LYSSA HALL
Office of Exemption Determinations

KAREN LLOYD
Office of Exemption Determinations

JOE PIACENTINI
Office of Policy and Research

LOU CAMPAGNA
Office of Regulations and Interpretations

ATTENDEES: (Cont'd)

Panel 21:

On Behalf of Ameriprise Financial:

THERESA M. SEYS, Vice President & Chief Counsel, Retail Retirement, Corporation Compensation & Benefits, General Counsel's Organization

On Behalf of Rebalance IRA:

SCOTT PURITZ, Managing Director

On Behalf of Stifel Financial Corp.:

RON KRUSZEWSKI, Chairman and Chief Executive Officer

Panel 22:

On Behalf of American Benefits Council:

LYNN DUDLEY, Senior Vice President, Global Retirement and Compensation Policy

On Behalf of American Society of Appraisers:

JEFFREY TARBELL, ASA

On Behalf of Financial Engines:

CHRISTOPHER JONES, Executive Vice President and Chief Investment Officer

Panel 23:

On Behalf of Alternative & Direct Investment Securities Association:

JOHN H. GRADY, Legislative and Regulatory Committee Chair, Chief Strategy and Risk Officer, RCS Capital

On Behalf of Investment Program Association:

MARK GOLDBERG, Chair Emeritus of the IPA, President, Investment Management, W.P. Carey Inc. and Chairman, Carey Financial, LLC

ATTENDEES: (Cont'd)

On Behalf of the Managed Funds Association:

STUART J. KASWELL, Executive Vice President &
Managing Director, General Counsel
BEN ALLENSWORTH, Associate General Counsel

Panel 24:

On Behalf of Appraisal Institute:

SCOTT ROBINSON, President-Elect

On Behalf of Bond Dealers of America:

MICHAEL NICHOLAS, Chief Executive Officer

On Behalf of Franklin Square Capital Partners:

MIKE GERBER, Executive Vice President

Panel 25:

On Behalf of 3ethos:

DON TRONE, Founder and Chief Executive Officer

On Behalf of U.S. Securities Market Coalition:

GARY KATZ, Chief Executive Officer, International
Securities Exchange

On Behalf of Weyn LLC:

IDA BYRD-HILL, Chief Executive Officer

On Behalf of Creative Investment Research, Inc.
and National Crowdfunding Services, LLC:

WILLIAM M. CUNNINGHAM, Chief Executive Officer

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1 P R O C E E D I N G S

2 (9:00 a.m.)

3 MR. HAUSER: Okay. Welcome back to Camp
4 ERISA. How many of you have been here all four days?

5 (Show of hands.)

6 MR. HAUSER: Well, stay in touch.

7 (Laughter.)

8 MR. HAUSER: I feel like we've grown to know
9 each other. So we'll get started in just a moment,
10 but let me just run through the usual kind of
11 preliminaries. This is our public hearing on the
12 conflict of interest rule. It's the fourth and last
13 day of the hearings. It is being broadcast via
14 streaming video which you can go to at
15 www.dol.gov/live.

16 The hearing has been organized into 25
17 panels. I think we're still holding at 25, usually
18 with three on a panel, sometimes four. We'll allow
19 panelists 10 minutes to present their testimony. If
20 you could try to stick to the 10 minutes, I'd very
21 much appreciate it because we have a full agenda.

22 The basic plan is the panelists present
23 their testimony and then the government panel members
24 will be afforded an opportunity to ask questions. We
25 won't accept questions from the audience today as

1 yesterday and all the days before. We ask a lot of
2 questions, but you really shouldn't infer any
3 particular conclusions on our views or positions or
4 where we're heading based on our having asked a
5 question.
6 The hearing is being transcribed, so you
7 will be able to read it and make comments on it.
8 We're hoping that we'll be able to post it in about
9 two weeks, and after that you would get another two
10 weeks in which to make comments with the benefit of
11 the transcript.
12 When you testify, if you could help us out
13 by first just identifying yourself and the
14 organization you're affiliated with. Again, stick to
15 the 10 minutes, and please speak into the microphone
16 so that we can get a complete and accurate transcript.
17 And I don't actually know when we're going
18 to end today. We're going to end when the last
19 witness has spoken. In the event of an emergency in
20 the building, I'm hoping that will not happen, we've
21 been lucky so far, but if there is one, an alarm will
22 sound. There are two types of alarms. A long loud
23 continuous tone means we will need to evacuate to an
24 external assembly area outside the building. An
25 intermittent tone followed by a public address

1 announcement means that we will stay in the auditorium
2 to shelter in place. If either alarm sounds, a man in
3 yellow will jump up and help you. There they are.
4 Please do not plug laptops, phones, et
5 cetera, into the sockets on the wall. We don't want
6 anyone to trip or get hurt. And please make sure your
7 cell phones are turned off and silenced. And now if
8 you're ready we're ready.
9 MS. SEYS: Sure. Great. Thank you. Good
10 morning. My name is Theresa Seys. I am Vice
11 President and Chief Counsel for Ameriprise Financial,
12 a diversified financial services company that has been
13 helping individuals to save for and sustain a secure
14 retirement for over 100 years. We have almost 10,000
15 advisors who work with retirement savers and retirees
16 across the U.S.
17 I am tremendously proud of the work our
18 financial advisors do to help our clients stay on
19 track to reach their financial goals, whatever they
20 may be: reducing debt, creating an emergency fund,
21 purchasing a home, sending a son or daughter to
22 college, and importantly, accumulating a retirement
23 nest egg or creating a paycheck in retirement.
24 Ameriprise is the leader in financial
25 planning. We have more certified financial planners

1 than any other firm. All of our advisors are duly
2 registered, which means that they can offer services
3 on a commission basis or as a registered investment
4 advisor on an advisory fee basis. We believe this
5 flexibility is important because it allows our
6 financial advisors to offer the products and services
7 that are most appropriate for our clients. Ameriprise
8 supports a uniform best interest standard across a
9 client's entire portfolio.
10 We appreciate the Secretary's
11 acknowledgement that the majority of advisors are
12 doing the right thing and serving their clients'
13 interests first. However, we believe the Department
14 has not adequately accounted for the value financial
15 advisors provide. Credible, well-researched studies,
16 including one by Oliver Wyman that we helped sponsor,
17 show that Americans who receive advice from a
18 financial advisor have more assets overall and save
19 more for retirement, and small business owners that
20 work with advisors are much more likely to establish a
21 retirement plan for themselves and their workers.
22 We understand that the Department intends to
23 preserve the valuable advice and opportunities for
24 guaranteed retirement income provided to retirement
25 savers through commission-based products and accounts.

1 The sole relief the Department has left for
2 commission-based accounts within IRAs is the best
3 interest contract exemption.
4 While the Department and financial services
5 industry may disagree on certain issues related to the
6 proposal, we believe that the Department would agree
7 that if the BIC exemption is not workable then
8 advisors will no longer be able to recommend most
9 products on a commission basis. Therefore, if the
10 rule is to truly be business model neutral and not put
11 a beneficial model at a disadvantage, it is imperative
12 there be no doubt that the exemptive relief can be
13 operationalized in a manner that permits advisors to
14 continue to provide valuable, efficient, and cost-
15 effective assistance to clients.
16 Over the past few days you've heard a great
17 deal of testimony on why and how the definition itself
18 is too broad, the carve-outs are too narrow, and the
19 BIC exemption is not a viable solution. Ameriprise
20 believes you can achieve a best interest standard for
21 advice provided to 401(k) plan participants, IRA, and
22 small business owners, and do so in a way that does
23 not hamper financial advisors who are trying to help
24 those persons achieve and sustain a secure retirement.
25 We agree with the Department that financial

1 advisors should be held to a best interest standard
2 for recommendations made to retail retirement clients.
3 Compensation should be reasonable, and the client
4 should receive disclosure on fees they could pay based
5 on product or service recommendation and potential
6 conflicts. In its current form, the BIC exemption is
7 not the right vehicle for delivering this result. It
8 only addresses one portion of a client's investment
9 portfolio and comes with unnecessary, impracticable,
10 and risk-laden conditions that do not benefit and in
11 some instances may harm clients. You could transform
12 the BIC exemption by using the following framework:
13 Require that there be a legally binding
14 obligation to the client that the financial advisor
15 and her firm will put that client's interests ahead of
16 their own; in other words, act in the client's best
17 interest.
18 Receive no more than reasonable compensation
19 and provide simple, clear, and meaningful disclosure
20 on the service and products offered to clients as well
21 as any material conflicts. Such disclosure could
22 leverage existing Department, SEC, and FINRA
23 regulations.
24 Under this framework, the sole condition
25 would be that this legally binding obligation be in

1 place and covers the first recommendation made and any
2 advice that follows. This obligation would apply to
3 the initial recommendation, a rollover recommendation,
4 whether it's a prospective client, new client, or
5 long-tenured client. This framework would accomplish
6 the goal of providing the 401(k) plan participant,
7 small business owner, an IRA owner, a remedy to the
8 extent she believes she has been harmed without
9 introducing material risk that has a chilling effect
10 on the provision of advice and without adding a litany
11 of operational burdens that only make it more
12 difficult to serve clients.
13 You would not need warranties that put into
14 question whether firms can continue to recommend
15 products on a commission basis or offer affiliated
16 products. You would not need unprecedented disclosure
17 and data request conditions that may be problematic to
18 implement and where even an inadvertent error
19 resulting in no harm to the client results in excise
20 tax penalties.
21 This type of framework would truly provide a
22 principles-based exemption that could accommodate and
23 adapt to the broad range of evolving business
24 practices. Any product or service recommended would
25 need to be in the client's best interest. This

1 provides firms and innovators the ability to offer and
2 create a wide range of diverse products and services
3 to meet ever-evolving and unique investor needs
4 without sacrificing consumer protection. It also
5 allows firms to build on client guides and current
6 disclosures designed to meet existing Department,
7 FINRA, and SEC disclosure regulations while ensuring
8 that the client is informed about how much he could
9 pay for a particular product or service. And an even
10 better step forward would be a framework that would
11 apply to both the taxable and tax advantaged portions
12 of a client's portfolio in the form of a uniform
13 fiduciary standard.
14 A nonqualified brokerage account holder,
15 managed account client, IRA owner, small business
16 owner, 401(k) plan participant, and annuitant could
17 all be the same person.
18 Advice is holistic. People see all of their
19 assets as available for planning, whether it be
20 sending their children to college or saving for
21 retirement. The Department should work with the SEC
22 and FINRA to develop one standard that could truly
23 benefit retirement savers and retirees.
24 We believe that the changes we have outlined
25 meet the standard that the Secretary has indicated he

1 supports, an enforceable best interest standard. As
2 currently drafted, the potential liability under the
3 BIC exemption for a breach of fiduciary duty with
4 respect to IRAs is higher than for breach of fiduciary
5 duty under ERISA. Congress decided that if there is a
6 breach under ERISA there's a private right of action
7 but no excise taxes, and for IRAs you have excise
8 taxes but no private right of action.
9 The Department's proposal introduces both,
10 making the potential risk for providing advice to IRAs
11 higher than providing advice to ERISA plans.
12 Furthermore, the Department must also provide for a
13 sufficient time to implement this or any new
14 framework. The initial proposal providing for an
15 eight-month implementation period is inadequate.
16 Firms should be afforded the time to build the
17 necessary technology systems and client-facing tools
18 to appropriately comply, and eight months is simply
19 not feasible.
20 Also, there are still many questions to be
21 addressed and issues that will need to be resolved
22 prior to a final rule being published. We believe it
23 is critical that the Department provide for an
24 additional opportunity for the public to review and
25 comment prior to finalizing the rule.

1 Thank you for the opportunity to appear
2 before you today, and I'm happy to take any questions.
3 MR. HAUSER: Thank you. Please.
4 MR. PURITZ: It's a privilege and a pleasure
5 to be here with you this morning. I'm Scott Puritz,
6 the co-founder and managing director of Rebalance IRA.
7 My firm is a registered investment advisor with
8 approximately $280 million of assets under management.
9 We serve slightly over 500 clients.
10 Rebalance IRA is a relatively new national
11 investment advisory firm that combines top quality
12 retirement expert investment advisors with low-cost,
13 highly diversified retirement portfolios for everyday
14 Americans. Our firm's investment committee includes
15 financial luminaries Professor Burton Malkeil from
16 Princeton; Dr. Charlie Ellis, who once chaired the
17 investment committee of the famed Yale Endowment Fund;
18 and Jay Vivian, who managed IBM's $100 billion plus
19 corporate pension fund.
20 Rebalance IRA embraces a fiduciary legal
21 standard of always bringing the interests of our
22 clients' front and center. We provide retirement
23 investment advice without commissions and without
24 conflicts. This makes it very easy to embrace a
25 fiduciary standard.

1 Rebalance IRA is part of a broad trend of
2 investment advisory firms that seek to provide
3 consumers with a fundamentally better set of
4 retirement investment options. This new generation of
5 firms is offering retirement investment advice to
6 clients at all levels for very modest fees. Several
7 of these firms provide excellent retirement investment
8 management for small savers, with minimums starting as
9 low as $250. This group of investment innovators
10 includes new firms such as my own, Rebalance IRA,
11 Wealthfront, Personal Capital, but also established
12 players, such as Vanguard and Schwab.
13 This trend of retooling the financial
14 services industry is about three years old and has met
15 with considerable success in the marketplace. Tens of
16 thousands of clients have switched over. The
17 investment innovators are growing fast and
18 collectively now manage over $15 billion of client
19 assets. These investment innovators have three common
20 features: they harness technology, they leverage new
21 business models, and they deploy established, proven
22 institutional grade investment portfolios.
23 The result for consumers is nothing short of
24 extraordinary: lower costs, superior asset
25 allocation, superior investment vehicles, which are

1 not influenced by commissions, and superior
2 transparency regarding costs.
3 At Rebalance IRA, our clients seek our help
4 because they need advice about how to manage their
5 retirement savings and how to understand the
6 increasingly complex world of investment products.
7 Our clients come to us from all walks of life:
8 nurses, school teachers, plumbers, lawyers, doctors,
9 professors, farmers, welders, government employees,
10 regular Americans. We're in the marketplace every day
11 dealing with everyday Americans as they struggle to
12 find the best way to manage their investment savings.
13 We see what is actually going on in the marketplace,
14 and sometimes, frequently it's not a pretty sight.
15 I'd like to begin by telling a story of
16 Mora, one of our clients and her experience with
17 conflicted advice. Mora is a 37-year-old woman,
18 married with three children. She's a very smart, very
19 savvy individual. Mora is the type of woman, who is
20 prudent and thoughtful in virtually everything she
21 does, from planning a family vacation to negotiating a
22 refinancing on the family's home.
23 In managing her family's retirement
24 investments, Mora inherited a stockbroker from her
25 father. She used this broker for a long time and

1 believed that she was only paying the typical 1
2 percent investment fee, and Mora trusted this
3 stockbroker with her family's retirement nest egg.
4 Mora was introduced to Rebalance IRA and
5 reached out to learn more about our firm's services.
6 Upon a review of her retirement investment savings we
7 found that her broker had invested her retirement
8 funds in actively managed mutual funds which contained
9 a significant second level of fees. In addition,
10 Mora's stockbroker had recommended a new actively
11 managed mutual fund with a front-end load that took
12 5 percent right off the top.
13 When it was all said and done, Mora was
14 paying over 2.3 percent in annual fees, not the
15 typical 1 percent. What's worse, Mora had no idea
16 what was going on, none, zero, zip. Her broker had
17 never clearly disclosed the fund-level fees nor the
18 fact that he did not have fiduciary responsibilities.
19 In the end, Rebalance IRA was able to reduce the all-
20 in costs for Mora's retirement accounts by nearly 70
21 percent or over $5,000 per year.
22 Albert Einstein is said to have described
23 compound interest as the most powerful force in the
24 universe, but long-term compounding is a double-edged
25 sword. Fees also compound and unnecessarily eat away

1 at retirement savings. In the case of our client,
2 Mora, by the time she retires this extra $5,000 in
3 annual fees would have compounded potentially to over
4 half a million dollars of unnecessary fees, over half
5 a million dollars of extra fees.
6 For many Americans this extra retirement
7 investment fee burden is the difference between
8 retirement investment security and having to take on a
9 part-time job late in life. Unfortunately, Mora is
10 not alone. One-third of the Rebalance IRA client base
11 comes to our firm directly from having a suboptimal
12 relationship with a brokerage firm. At our firm we
13 refer to these clients as brokerage refugees.
14 The story we see, similar to Mora's, over
15 and over again is all too familiar: a client at a
16 brokerage firm who is stunned, absolutely stunned to
17 find out that their trusted retirement investment
18 advisor does not have a fiduciary obligation and
19 equally stunned to find out that there is almost
20 always a second layer of fees at the fund level.
21 The brokerage refugees that we see at our
22 firm average 2.37 percent of total fees per year. Now
23 this may not sound like a large amount of money, but
24 over several decades this can eat up to one-third to
25 one-half of a consumer's retirement nest egg, one-

1 third to one-half. That's a big number.
2 When Rebalance IRA takes on these brokerage
3 refugees as clients of our firm, we're able to
4 immediately reduce the retirement investment fee
5 structure by an average of 68 percent. We combine
6 these real costs with a retirement investment plan,
7 endowment style portfolios, systematic rebalancing
8 which reduces risk, and finally a highly qualified
9 two-person retirement investment team for every
10 client, high tech plus high touch.
11 American inventiveness and the
12 entrepreneurial spirit are alive and well in the
13 financial services industry, but for all consumers to
14 reap the full benefit of this extraordinary, truly
15 extraordinarily surge in innovation there needs to be
16 first greater transparency; second, greater flow of
17 information, especially regarding costs; and finally,
18 a greater alignment of economic interests. We believe
19 that a regulatory level playing field will
20 dramatically accelerate the retooling of the financial
21 services industry and provide everyday Americans with
22 fundamentally cheaper and fundamentally better ways to
23 save for retirement.
24 Americans struggling to save for a dignified
25 retirement should no longer be subjected to the

1 conflicts of interest that are draining their
2 retirement investments, and if traditional brokerage
3 firms cannot live by the simple fiduciary standard and
4 refuse to serve modest savers, that's okay. It's
5 really okay. Other financial firms who embrace a
6 conflict free, client first approach stand ready to
7 help all Americans at all income levels prepare for a
8 secure retirement.
9 Thank you. And again I appreciate this
10 opportunity to share our perspective and look forward
11 to any questions and discussion.
12 MR. HAUSER: Thank you.
13 MR. KRUSZEWSKI: Good morning. As Chairman
14 and Chief Executive Officer of Stifel Financial Corp.,
15 I appreciate the opportunity the Department of Labor
16 has given me and other interested parties throughout
17 the industry to comment on your new proposed rule. I
18 have been CEO of Stifel since 1997, have 30 years of
19 experience in the securities industry.
20 For those of you that don't know Stifel, we
21 are a financial services holding company headquartered
22 in St. Louis, Missouri. This year marks our company's
23 125th anniversary. The company's broker-dealer
24 affiliates provide securities brokerage, investment
25 banking, and related financial services to individual

1 investors, professional money managers, businesses and
2 municipalities. Stifel manages over $200 billion in
3 client assets through over 2800 registered
4 representatives in more than 340 branches in 45
5 states.
6 It is important to note that Stifel is a
7 dual registrant, meaning that it does business as both
8 a FINRA registered broker-dealer governed by the '34
9 Act, as well as an SEC registered investment advisor
10 governed by the '40 Act. As such, we have no
11 particular axe to grind as we support both a
12 commission-based and fee-based business model.
13 Over the past 75 plus years, both the
14 suitability standard espoused by the '34 Act and the
15 fiduciary model underpinning the '40 Act have well
16 served investors in capital formation critical to our
17 economy.
18 As I will more fully discuss momentarily, if
19 the DOL proposed rule results in IRAs being forced
20 into fee-based advisory models, Stifel will increase
21 its revenues. So, from a business perspective, a
22 shift to fee-based is beneficial to Stifel but
23 detrimental to our commission-based IRA clients which
24 may be forced into a fee-based account.
25 I was encouraged when I read the preamble of

1 your rule proposal where you stated the need to
2 "preserve beneficial business models for delivery of
3 investment advice, such as brokerage IRAs," and you
4 sought to do so by separately proposing new
5 exemptions. However -- and by now I am certain you
6 are tired of hearing this -- the best interest
7 contract exemption is so operationally complex and the
8 cost of compliance, not to mention the regulatory and
9 litigation risk, is so prohibitively high that the end
10 result may be the elimination of a commission-based
11 brokerage model for IRA accounts.
12 My fears are shared by many, including (8)
13 prominent Democratic senators, members of the Senate
14 Finance Committee who recently urged you to
15 "critically examine the BIC exemption to ensure that
16 it's operational". In addition, my own home state
17 representatives, Senator McCaskill and Congresswoman
18 Wagner, both expressed similar concerns on a
19 bipartisan basis. The collective fear, which I share,
20 is that if the exemption is not workable it will have
21 an adverse effect on IRA investors.
22 Does it surprise me that the best interest
23 contract exemption is so complex and difficult, if not
24 impossible to implement? Actually no. The reason I
25 say this, because I believe the rule is intended to

1 eliminate the commission-based brokerage model.
2 Upon reviewing the materials put forth by
3 the Department in support of these proposals I was
4 struck by the bright line distinction drawn between
5 conflicted advice supposedly pervasive throughout the
6 commission-based brokerage model and the conflict
7 benefit -- conflict free benefits of the advisory
8 model. The cost of conflicted advice cited by the DOL
9 ranges from between $2.5 billion and $50 billion
10 annually. Yet despite my training as a CPA I have no
11 idea in reading the report how that was determined or
12 how the range of costs could be so expansive.
13 We can debate whether or not the best
14 interest exemption is unworkable. However, I believe
15 there is no debate as to the increased, yes, increased
16 cost to investors if in fact the commission-based
17 brokerage model is effectively eliminated as an option
18 for IRA accounts, especially small accounts. The
19 increase in cost is easily measured by an increase in
20 annual fees resulting from a shift to fee-based
21 accounts and the estimated cost of losing investment
22 advice.
23 First, what is the cost of switching from a
24 brokerage IRA to a fee-based IRA? What I do know
25 about the cost to investors is derived from the hard

1 facts I gather from my position as Chairman and CEO of
2 Stifel. Allow me to share some facts.
3 Within the IRA marketplace Stifel operates
4 both an advisory-based and a self-directed brokerage
5 model. We have over 330,000 IRA accounts with assets
6 of over $47 billion. The vast majority of these
7 accounts, approximately 81 percent, are commission-
8 based brokerage accounts.
9 Stifel's experience is not unique, with the
10 vast majority of IRA accounts held at financial
11 services firms being commission-based. This is
12 particularly true for small retirement accounts.
13 Ninety-eight percent of IRA accounts containing less
14 than $25,000 in assets are held in commission-based
15 brokerage accounts.
16 One would naturally assume based on the
17 DOL's claim of "conflicted advice" that brokerage IRA
18 accounts are being charged substantially more than
19 advisory clients. I can tell you nothing is further
20 from the truth. In Stifel's case, commission-based
21 IRA accounts pay roughly half in commissions of what a
22 typical advisory account pays in fees.
23 Let me reiterate. Half the cost. Simply,
24 if we charged our brokerage accounts the same fee
25 percentage as we did advisory accounts, the costs to

1 our brokerage IRA accounts would increase by nearly
2 $150 million annually. This is what I meant by the
3 proposed rule potentially being financially beneficial
4 to Stifel yet detrimental to my commission-based IRA
5 holders.
6 These results were compared to five other
7 regional firms and yielded similar results, indicating
8 costs would double, totaling in excess of $2 billion
9 annually. Extrapolating across the industry, the
10 costs would be staggering. The reality is that the
11 more expensive advisory accounts versus simple
12 commission-based accounts will cost average IRA
13 investors in the aggregate many billions of dollars
14 more than they are paying now.
15 So I would pose a simple question. If
16 brokerage advice is so conflicted, how is it that
17 brokerage IRA accounts are charged half what is
18 charged to the advisory accounts?
19 Furthermore, at the heart of the DOL
20 proposal is the contention that commission-based
21 accountholders face a conflict of interest that causes
22 investment losses. When NERA looked at investment
23 returns, the data showed no evidence that commission-
24 based accounts underperform fee-based accounts.
25 NERA's results are consistent with my own observations

1 at Stifel.
2 In addition, the reality is that if
3 brokerage accounts are not available millions of
4 smaller investors will lose access to individualized
5 investment advice due to their modest accounts not
6 meeting most firms' minimum account size for advisory
7 accounts. In 2011, the DOL estimated that consumers
8 who invest without professional advice make investment
9 errors that costs them collectively over $100 billion
10 a year. These numbers will only go up if this
11 proposal is enacted.
12 Ultimately the overriding question is
13 whether "acting in your client's best interest" is
14 defined by the fiduciary standard in the '40 Act or a
15 more broad-based best interest standard which enhances
16 disclosures and supports both a commission-based
17 brokerage model and a fee-based advisory model. I
18 would note that this is exactly what FINRA has
19 proposed.
20 Without question, both business models are
21 viable options which provide investors flexibility and
22 choice as to the method which they want to be
23 serviced, and both options should remain available for
24 investors.
25 In light of everything I've talked about

1 today and all that has been said by the many industry
2 representatives that have preceded me, my best
3 unconflicted advice to investors saving for retirement
4 would be as follows:
5 If the size, complexity, and volume of
6 trading activity in your retirement account warrant
7 it, avail yourself to a fee-based advisory account
8 that offers the ongoing service that meets your
9 investment needs. If, however, you are a buy-and-hold
10 investor who wants to make your own investment choices
11 with the benefit of financial advice, I would urge you
12 to keep your pay-as-you-go brokerage commissioned IRA.
13 These long-term investors are best served by their
14 current brokerage accounts and should not be forced
15 into more expensive advisory accounts.
16 As an alternative to the rules proposed by
17 the Department Stifel supports the adoption of a
18 uniform best interest standard as proposed by FINRA's
19 CEO, Richard Ketchum. Specifically, Stifel believes
20 that a universal best interest standard would best
21 serve its clients' interest. We believe that a single
22 standard applicable to all nonadvisory accounts, be
23 they investment accounts or self-directed retirement
24 accounts, is the only approach that makes sense for
25 both clients and the firms that service them.

1 We believe that a universal best interest
2 standard is the only viable approach because at
3 Stifel, as with most brokerage firms, our clients
4 maintain different types of accounts, both retirement
5 and brokerage, within the same portfolio. These
6 accounts are almost always handled by the same person.
7 To have those accounts held at different standards
8 with different limitations on investment choices is
9 confusing to clients and fails to protect them in any
10 meaningful way.
11 The DOL's proposal is to be commended for
12 highlighting the need to ensure that retirement
13 investors can obtain financial advice without fear of
14 being subjected to abusive sales practices occasioned
15 by inherent conflicts of interest, which I know can
16 occur in both brokerage and fee-based models.
17 However, the proposal is flawed and in conflict with
18 existing rules and regulations, burdensome and so
19 expensive to implement it will have an unintended
20 consequence of causing many small investors to lose
21 the benefit of services of an investment advisor
22 altogether.
23 IRA brokerage accounts which are moved to
24 advisor accounts will forced to pay fees well in
25 excess of the commissions they currently pay. I would

1 urge you to reconsider this overly complex proposal.
2 Instead, Stifel supports, as I've said, a best
3 interest standard which harmonizes the rules
4 pertaining to all brokerage accounts, whether governed
5 by the '34 Act or the '40 Act.
6 This solution will preserve investor choice,
7 eliminate confusion, and provide a cost-effective
8 means for investors, particularly small investors, to
9 save for their retirement. This matter is of the
10 utmost importance to investors and as such we should
11 all work together to encourage the greatest number of
12 people to save the most they can for their retirement.
13 Limiting choice and increasing cost is not the way to
14 do so. Thank you for your consideration.
15 MR. HAUSER: Thank you.
16 So, and I apologize, but I didn't catch your
17 name at the start. Did you say it?
18 MR. KRUSZEWSKI: Yes. Ron Kruszewski.
19 MR. HAUSER: Mr. Kruszewski, I just have a
20 couple questions. Probably I'm just worn out from the
21 previous three days.
22 MR. KRUSZEWSKI: Understood.
23 MR. HAUSER: But, you know, first I can
24 assure you I appreciate your statement at the start,
25 but it is not our intention to eliminate broker-based

1 accounts, nor is the rule intended to create any
2 particular bias against those arrangements as long as
3 they can adhere to, you know, what we think are some
4 fundamental principles. And so I guess I'd just like
5 to explore a little bit of this workability issue and
6 maybe ask you just to take off the table the entirety
7 of our best interest contract exemption and start from
8 scratch. And I'll ask you about a few features that I
9 think would be part of a simple best interest contract
10 and you tell me if you think they're workable. And if
11 you think they're not workable, tell me why they're
12 not workable.
13 The first is a commitment, an up-front
14 commitment to your customer, which could be made at
15 the time money is actually transferred say, as long as
16 it's retroactive to when the advice was given, but an
17 up-front commitment those recommendations will have
18 been made in the customer's best interest in the sense
19 that the advice will have been prudent and will put
20 the customer's interests first. Would that create a
21 workability problem?
22 MR. KRUSZEWSKI: I think we do that today,
23 so, you know, the devil is in the details when you
24 say, you know, a contract or something, but the
25 suitability standard and what we do for 125 years,

1 we've been doing that, so that should be and is
2 workable.
3 MR. HAUSER: Right, but I guess I'm not
4 asking about the suitability standard, but whether,
5 you know, a commitment that when your brokers, when
6 your reps are giving advice to people, that that
7 advice isn't going to be affected by their financial
8 incentives but just going to be what's in the interest
9 of the customer.
10 MR. KRUSZEWSKI: Again, I believe that
11 that's what occurs today.
12 MR. HAUSER: Okay. And then similarly, if
13 we add as a condition to that that you agree that your
14 fees will be reasonable in relationship to the
15 services you render to the customer, I mean, would
16 there be any workability problem with that?
17 MR. KRUSZEWSKI: Again, I think the question
18 is in reasonable. I think market determines
19 reasonable. I note that my gentleman to the right, I
20 looked at his fees and his account minimums and would
21 note that our fees are reasonable compared to his, and
22 so define reasonable in a reasonable manner, and, of
23 course.
24 MR. HAUSER: Right. No, and we would view
25 it that way. I mean, the market, it's essentially a

1 market measure of what -- you know, it's always a
2 question of what you're getting for what you're
3 paying, but the governor on that's going to be a
4 market sort of measure.
5 And then does it add -- does it make it
6 unworkable for you to then, you know, make that
7 commitment in a binding way to your customers so that
8 they can enforce it, whether in FINRA proceedings, in
9 individual claims or in a class action claim if they
10 can actually meet the prerequisites of, you know,
11 class action litigation?
12 MR. KRUSZEWSKI: Well, I think arbitration
13 is alive and well in the securities industry, and
14 clients often when they have a complaint will start
15 with that you did not act in my best interest if
16 that's what they say. I think the issue, though, is
17 that what I recommend is a harmonized approach because
18 it needs to be understood that the same client that
19 you may be talking have a contract or all of the
20 things you're talking about specifically for brokerage
21 accounts often have multiple relationships at
22 brokerage firms: taxable accounts, trading accounts,
23 muni-bond accounts. They view their portfolios
24 holistically, and to try to create a set of rules, a
25 set of contracts or a set of standards for a slice of

1 their investment is going to be extremely confusing
2 and will have cross-effects on other accounts, and
3 that is why this rule is in many ways unworkable. The
4 average investor will not understand it.
5 MR. HAUSER: Well, does the average investor
6 right now think that when they get advice from a
7 Stifel rep that they're getting advice that's prudent
8 and putting their interests first?
9 MR. KRUSZEWSKI: We've been in business for
10 125 years, all right, and if we had not been doing
11 that we would not be in business. The market would
12 assure us of our failure.
13 MR. HAUSER: Right, but I guess my point is
14 so they're not going to -- your customer is not going
15 to be confused by your adhering to that standard and
16 having it be legally, you know, a binding legal
17 obligation, are they? It's what they expect.
18 MR. KRUSZEWSKI: We have account agreements
19 with our clients and I believe that the market works.
20 I do. I don't believe that there is some obligation
21 that needs to be contractually put down when the
22 securities industry has been working fine for decades,
23 decades.
24 So, look, a best interest standard, no one
25 is going to argue against that, okay. We start by

1 saying we put our client's interests first, all right,
2 and I will tell you that is good business. It is
3 smart business and we adhere to that standard. The
4 real question is is the fiduciary standard as
5 promulgated under the '40 Act applied to brokerage
6 accounts in general is unworkable. It's been
7 unworkable for decades and it would be unworkable
8 tomorrow because of the nature of the capital
9 formation, selection of investments, suitability
10 versus prudent man standards make that unworkable.
11 But an overriding best interest standard that applies
12 to all accounts is something that should be done and
13 that we would support absolutely.
14 MR. HAUSER: Okay. But I feel like I'm back
15 to where we started. So, I mean, you think it's
16 unworkable for a broker -- for a registered rep to
17 actually just adhere to a standard of prudence and
18 making recommendations that take only the customer's
19 interests into account.
20 MR. KRUSZEWSKI: With all due respect, I
21 don't think that's what I said. I said what is
22 unworkable is to take a set of rules and apply it to a
23 sliver of a client's investment portfolio without
24 harmonizing those rules across the broad spectrum of
25 investment. Our clients that this rule would impact

1 on average have five other relationships at Stifel,
2 different types of accounts that this purportedly
3 would not impact. So that confusion is one where if
4 we take a harmonized best interest standard and I
5 believe in conjunction with FINRA and the SEC is the
6 way to approach your objective.
7 MR. HAUSER: But this is essentially an
8 argument that anything the Department of Labor does in
9 this space is kind of by definition going to be
10 unworkable, isn't it, at least unless and until the
11 Securities and Exchange Commission and FINRA have
12 changed the rules? I mean, you're saying if we impose
13 a different standard that by definition is unworkable.
14 Is that the argument?
15 MR. KRUSZEWSKI: No. I'm saying that I'll
16 go back to my original comment, which is that it may
17 not be the intention of the rule, but from my
18 perspective, the application of the rule will
19 eliminate self-commission-based brokerage accounts
20 because it is unworkable across -- you can do that.
21 That's exactly what you're doing. But when you do
22 that you will eliminate the brokerage IRA.
23 MR. HAUSER: Okay. So, if we impose an
24 obligation that was nothing more than a commitment,
25 you know, up front before you've taken money from the

1 customer that the recommendations you made and are
2 going to make are going to be in your -- to the extent
3 you continue to make recommendations, you can just
4 have a one-time transaction, but the recommendation is
5 going to be in your customer's best interest the way I
6 described. It's going to be prudent and the fees are
7 going to be reasonable in relationship to the services
8 and even -- let's say that's it. You're telling me
9 that's unworkable?
10 MR. KRUSZEWSKI: No.
11 MR. HAUSER: There's no particular
12 complexity there, I don't think.
13 MR. KRUSZEWSKI: Well, there is, and I'll
14 give you the complexity very simply, and you used the
15 word "prudent". What is prudent for me may not be
16 prudent for this gentleman. Under the '40 Act,
17 prudence is defined by case law and a number of things
18 where prudence has a very pretty clear standard as to
19 what prudence is under ERISA. You're not going to buy
20 generally unrated bonds, you can go on and on and on.
21 But in most investment relations, prudence can be
22 defined as what's prudent based upon an individual
23 investor's objectives and the risk tolerance. So I
24 agree --
25 MR. HAUSER: That's what ERISA prudence is

1 as well. I mean, that's something I know a little bit
2 about. ERISA prudence is -- first off, it's not a
3 hindsight test, it's what's reasonable, you know, for,
4 you know, it's essentially a reasonableness test, and
5 it would be measured when you're talking about a plan
6 or a participant in a plan or an IRA customer, it
7 would be measured with respect to their risk
8 tolerances, their goals, their retirement needs. It
9 really would be the same sort of thing, and it
10 wouldn't be a question of, you know, in hindsight, did
11 the investment turn out poorly. It would strictly be
12 a question of, you know, did you exercise reasonable
13 judgment, did you follow a reasonable process in
14 figuring out what to recommend in light of those
15 considerations, and we could put more flesh on the
16 bones if that would help.
17 But if we're talking about that kind of
18 standard, would that create a workability problem?
19 MR. KRUSZEWSKI: Look, I would need to see
20 it in details. I understand what you're saying, but
21 I'd like to see the details. But I would like to say
22 that I have many investors, sophisticated investors
23 who believe in a brokerage account, whether it be an
24 IRA or something else, that what they believe is
25 prudent for them I may believe is risky, all right,

1 and they often tell me that it's their money. And so
2 that comes down to a question of who is defining
3 prudence and --
4 MR. HAUSER: It's an objective -- the way it
5 works is it's an objective test based on what, you
6 know, a person familiar with such matters, a person
7 with expertise in such matters, what kind of decision
8 they would make. It's not a subjective sort of test
9 at all. Does that comfort you at all?
10 MR. KRUSZEWSKI: Well, I would like to be
11 able to use you as an expert witness because the
12 litigation lawyers when I get sued under the standard,
13 I can tell you that that's not what they say, but fair
14 enough, so thank you.
15 (Laughter.)
16 MR. HAUSER: Well, you know, I plan on
17 keeping my job.
18 (Laughter.)
19 MR. KRUSZEWSKI: Okay.
20 MR. HAUSER: Well, maybe I'll let somebody
21 else go. I'm not really mulling over your offer,
22 though.
23 (Laughter.)
24 MS. MARES: Actually, Mr. Puritz, I have a
25 question for you.

1 MR. PURITZ: Sure.
2 MS. MARES: You made a comment that your
3 customers use -- that you use endowment style
4 portfolio management for your customers. Could you
5 elaborate that for us, please?
6 MR. PURITZ: Sure. I mean, one thing I
7 think is important to keep in mind is that in this
8 industry, like other industries, technology is running
9 through the industry and in the front end potentially
10 transforming industry.
11 For the better part of 50 years the great
12 endowments and pensions in the country have followed
13 and the world have followed really a simple approach
14 to investing top down. It's called modern portfolio
15 theory with six to 10 different asset classes that are
16 set up optimized for risk and reward tend to be medium
17 and long-term in orientation, and it's very important
18 to add disciplined rebalancing, which is primarily a
19 risk management tool.
20 Until recently, until as recently as five
21 years, it was really cost-prohibitive to provide that
22 to small savers. But now, with the emergence of low-
23 cost ETFs, computerized algorithms, much better ways
24 to rebalance, you can have very small -- a $1,000 type
25 starting IRA saver can have an endowment style

1 portfolio that's almost as good as Yale's.
2 MS. MARES: So one of the things in my
3 experience that endowment style portfolios have is
4 very high concentration of illiquid investments.
5 That's not what you're referring to here?
6 MR. PURITZ: I am not, no.
7 MS. MARES: Okay.
8 MR. PURITZ: No.
9 MS. MARES: So the investments within your
10 clients' portfolios are all liquid investments?
11 MR. PURITZ: Correct. Yes, as are the other
12 investment innovators, as are the Vanguard approach to
13 this innovation.
14 MS. MARES: And you don't use the illiquid
15 investments for some reason, and why don't you?
16 MR. PURITZ: Well, that is one area where
17 it's hard to transfer the endowment style model down
18 to small saving investors, and there's a lot of debate
19 even within the pension world as to the cost/benefit
20 of that, particularly for endowment pension funds that
21 are not in the top 10 percent and can have access to
22 the best funds.
23 MS. MARES: Thank you.
24 MR. PIACENTINI: Okay. I'd like to direct
25 my first question to Mr. -- I'm going to do this

1 wrong.

2 MR. KRUSZEWSKI: Kruszewski. That's all
3 right.

4 MR. PIACENTINI: Kruszewski. Okay. I'm
5 familiar with the problem, so thank you.

6 (Laughter.)

7 MR. PIACENTINI: So you made some -- part of
8 your testimony was quantitative, and I'm the guy who
9 does economic analysis for the regs, so I'm very
10 interested in that part in particular. So let me
11 start with you said that in your business the
12 commission-based accounts, their expenses are half
13 what they are in the fee-based accounts. Did I
14 understand that correctly?

15 MR. KRUSZEWSKI: I think what I said was
16 that the revenue charged by Stifel is half.

17 MR. PIACENTINI: Okay.

18 MR. KRUSZEWSKI: Okay.

19 MR. PIACENTINI: So also you mentioned along
20 the way the NERA report, which we're familiar with,
21 and there's a similar comparison across I guess a
22 different sample of business in the NERA report, but
23 in the NERA report they point out that their
24 comparison doesn't include some of the indirect
25 expenses, such as 12(b)(1) fees. They also said it

1 doesn't include markups or markdowns I guess in
2 principal transactions. So, when you're making that
3 comparison, does that -- is it including all of those
4 expenses in the two accounts, so, you know, sort of
5 the total expense from the investor's perspective, or
6 are there some things that are not included?
7 MR. KRUSZEWSKI: No. I mean, look, total
8 return is total return. An account goes up or down in
9 value inclusive of the expenses. So I'm looking at it
10 holistically.
11 MR. PIACENTINI: Well, you made a comparison
12 of returns, but I'm just asking right now specifically
13 about the comparison of the expenses.
14 MR. KRUSZEWSKI: No. As it relates to
15 expenses, what our Stifel brokerage IRAs on average,
16 and I know people always like averages, but it's
17 approximately 50 basis points per year is what we
18 charge, and our advisory accounts is 107 basis points.
19 So it's just simple math as to the difference in --
20 MR. PIACENTINI: And so I guess I'm asking
21 what's included in the 50 basis points? Is that just
22 the up-front commission? Does it include, for
23 example, if there's a 12(b)(1) fee that produces a
24 revenue stream back to Stifel, is that included in
25 that?

1 MR. KRUSZEWSKI: Yes. Yes.
2 MR. PIACENTINI: So that's all inclusive of
3 your --
4 MR. KRUSZEWSKI: Of Stifel's revenue that
5 the advisor is sharing, and we pass all revenues to
6 the advisors. So it does not include what the
7 underlying, you know, ratios can be.
8 MR. PIACENTINI: So other expenses within
9 the fund.
10 MR. KRUSZEWSKI: That's correct. Nor does
11 our advisory account revenue include fees that may be
12 charged, that may be paid to outside managers.
13 MR. PIACENTINI: Right. So do you have a
14 sense of whether those expenses which are not
15 included, because they're not paid to Stifel, are
16 those higher in one or the other from the perspective
17 of the investor? That is, do the fee-based advisors
18 put people in lower expense funds or higher expense
19 funds or the same?
20 MR. KRUSZEWSKI: Well, load funds, load
21 funds will have --
22 MR. PIACENTINI: For example, there was a
23 reference to ETFs.
24 MR. KRUSZEWSKI: Right.
25 MR. PIACENTINI: In either types of accounts

1 are people put in low-cost ETFs or --
2 MR. KRUSZEWSKI: In advisory accounts you
3 put in ETFs. I would say that in brokerage accounts
4 generally not ETFs because people want to be paid for
5 advice. I mean, there's nothing wrong -- this
6 gentleman charges 50 basis points for advice. So the
7 answer is is that at the simplest analysis, if we -- I
8 want to go back to this, and I think it's lost in this
9 whole debate. In a simple analysis, if we move our
10 brokerage accounts supposedly to a non-conflicted
11 advisory account, we will double what we charge them,
12 and I think that that is lost in this entire
13 discussion is that fact, and that fact extrapolated
14 across the industry I have not seen in any study, and
15 I know that it's real and large.
16 MR. PIACENTINI: I want to come back that
17 and I want to ask all the panel, but let me ask one
18 other question I wanted to direct specifically to you
19 first. You referenced also the comparison of
20 performance in the two different kinds of accounts,
21 and there I think you started with a reference to the
22 NERA reports.
23 MR. KRUSZEWSKI: Right.
24 MR. PIACENTINI: And they found there was no
25 difference, and then you said that was your experience

1 as well if I understood.

2 So we've looked at the NERA report and if

3 I'm understanding the NERA report correctly, they

4 report the returns in those different segments at the

5 median, so they're telling us, you know, I think

6 they've got some number of thousands of accounts they

7 look at, and at the median what you don't see then is,

8 you know, how the people who are doing better how much

9 better they are doing, and the people who are doing

10 worse. So I guess my first question is if you want to

11 compare would you want to look beyond the median

12 that's presented in the NERA report?

13 MR. KRUSZEWSKI: Whether -- you know, look,

14 numbers are numbers.

15 MR. PIACENTINI: Yeah.

16 MR. KRUSZEWSKI: And you're a statistician,

17 so I want to be careful before I wade into your thing

18 here, but --

19 MR. PIACENTINI: You did say you're a CPA.

20 MR. KRUSZEWSKI: I did, I am a CPA, you

21 know. I used to be. I don't like to admit that

22 anymore. But the fact of the matter is I think that

23 you need to take the tails off of both, okay? I think

24 the tails of overperformance and underperformance can

25 be analyzed in and of themselves. But medians and

1 averages work, and my observations are that not just
2 in IRA accounts but in general, that the broad
3 averages and statistically that commission-based model
4 and advisory-based models have very similar or really
5 no statistical difference in performance in the
6 aggregate.
7 MR. PIACENTINI: Okay.
8 MS. MARES: That's my observation.
9 MR. PIACENTINI: So the medians that are
10 presented in the NERA report, they present them across
11 a period of, I forget, 11 years or something like
12 that, and there's a range, and in fact they find it
13 across all those years on average the commission
14 accounts outperformed a little bit, but they say it's
15 not statistically significant.
16 But if you look across the years that they
17 report, the differences from year to year in the
18 medians are -- well, they range just to be specific
19 from I think minus 1.93 percent, which is the
20 commission accounts outperform by almost 2 percent in
21 that year, to .63 percent, which is the advisory
22 accounts outperformed by more than half a percent in
23 that year. So I guess my question is NERA
24 characterizes those differences in the report as
25 small. Are those small differences? I'm wondering if

1 you could explain why they would move around that
2 much.
3 MR. KRUSZEWSKI: Right, right. Look, I
4 don't think -- I don't want to be in a position to try
5 to comment on a report that I didn't author.
6 MR. PIACENTINI: Sure.
7 MR. KRUSZEWSKI: Okay? And I would --
8 MR. PIACENTINI: But are they small? Is
9 that a small difference?
10 MR. KRUSZEWSKI: Statistically speaking, I
11 would characterize them as small. I think that
12 what -- I think the point is is that there appears to
13 be no basis. If there truly is a systemic problem in
14 conflicted advice, you would see substantial change
15 differences in the performance of brokerage models
16 versus advisory models. If this was truly an issue
17 which would require a national stage like this to deal
18 with, those differences would be much greater than
19 what NERA shows, and, frankly, my experience in 30
20 years in the business, I don't see that. That's the
21 point I was making. If we want to get into whether 10
22 basis points is significant, I probably would have no
23 comment. I don't understand. Significance means
24 different things to different people.
25 MR. PIACENTINI: Understood. And I'm sorry

1 if I put you on the spot. You referenced it in your
2 report, so I thought I'd get maybe your opinion on it
3 if you had one.
4 MR. KRUSZEWSKI: I'm often on the spot. I'm
5 fine with that.
6 MR. PIACENTINI: Okay. So then coming back
7 to this question of the movement, potential movement
8 of some IRA accounts from brokerage to a fee-based
9 account, and again, you know, reiterating that I think
10 our intent is to preserve space for commission
11 accounts, but in terms of that movement, maybe
12 starting with this. So, if currently one costs twice
13 as much or some amount more than the other, are they
14 getting the same level of service or is the more
15 expensive one getting more service?
16 MR. KRUSZEWSKI: You know, I would say that
17 advisory accounts, in many cases, the advisor is
18 directing investments that can be discretionary,
19 rebalancing. They tend to trade more, which makes
20 sense.
21 MR. PIACENTINI: So it sounds like the
22 commission accounts might in fact be requiring less
23 service, so that might be one of the reasons why they
24 are being charged less.
25 MR. KRUSZEWSKI: Yeah. An example would be

1 many, many IRAs just hold ladder bond portfolios, all
2 right, and why would you need to pay 1 percent to
3 watch your bonds mature? That doesn't make sense,
4 okay?
5 MR. PIACENTINI: That is a perfect
6 transition to my next question that I'd really like to
7 invite anybody on the panel to comment on, which is if
8 an investor with that sort of need and those sort of
9 holdings is going to be served in one framework or
10 another, would they necessarily be charged the much
11 higher rate or might it be possible in a different
12 model to serve them at a similar lower rate?
13 And as part of that, we heard in earlier
14 testimony I think yesterday and the day before that we
15 shouldn't be thinking just about traditional
16 commission models and traditional asset-based fee
17 models. There could also be hourly rates that might
18 be paid in some instances. There could be flat fees
19 that could be paid for some kinds of advice service.
20 MR. KRUSZEWSKI: I will just jump in since
21 I've dominated this, but I would just say this, just
22 one thing, I think this is important, okay?
23 To the extent that you put a bond account in
24 a '40 Act scenario, okay, you're required to look at
25 prudence, to look at things that are going on that

1 otherwise the investor may choose themselves. So this
2 is a question of is it the investor-directed account
3 or is it an account that's directed by the advisor?
4 And by doing and putting in your place you're going to
5 force many firms, and I will tell you, I run a
6 brokerage firm, if I'm tasked with either complying
7 with the BIC or moving accounts to a brokerage, I'm
8 not going to try to do the BIC for all the reasons
9 I've stated, and that is why it's detrimental to
10 investors. An advisory relationship under the '40 Act
11 is different than a brokerage relationship under the
12 '34 Act.
13 MR. PURITZ: Yeah, if I could jump in here.
14 I mean, in all due respect, Ron, you know, our
15 experience, your firm has 125 years experience, you
16 have 30, but I will tell you in our experience with
17 hundreds of clients that the marketplace is not
18 working. It just categorically is not working. There
19 is not true awareness of the multi-layer fees. We
20 surveyed our clients who had come over from brokerage
21 relationships and 83 percent of them had no idea of
22 the second level of fees, and, it's, the averages that
23 we see are between 2 and 3 percent all-in in terms of
24 brokerage accounts in IRAs.
25 So I think part of the issue and the policy

1 issue that is being debated is not what the last 20,
2 30 years was about but what's the next 30 to 100
3 years, and we do have several factors, including
4 powerful technology that has the opportunity to serve
5 consumers if there is a regulatory level playing
6 field, and we're in an environment where clearly
7 Professor Burton Malkiel on our investment committee
8 and others have said a dramatically lower return
9 environment where half a percent or a percent is going
10 to make potentially a profound impact on return
11 profiles over 10, 20, 30 years.
12 MR. KRUSZEWSKI: So, if I have a bond
13 account that is a bond account with $200,000 in it,
14 should I bring it to your account, to your firm? Yes
15 or no?
16 MR. PURITZ: I mean, we don't do all bond
17 accounts.
18 MR. KRUSZEWSKI: Of course you don't because
19 the answer is no, because it would be unsuitable to
20 take a bond account and put them through your fee-
21 based model. That's a yes or no question.
22 MR. PURITZ: I'm not sure of the point
23 you're trying to make.
24 MR. KRUSZEWSKI: Well, my point is that
25 there are certain accounts the brokerage model is

1 perfectly suitable for, and by the way, to the extent
2 that you have accounts, I think you're a start-up
3 business, and there are certainly accounts -- I'm not
4 saying there are not accounts that are not charged
5 excessive fees. I'm also saying there is advisory
6 accounts that shouldn't be in advisory accounts
7 either. But on the tail-end of both of this there's
8 plenty of business models.
9 We're talking about millions and millions of
10 investors that are adequately served in their current
11 model, and to the extent that the market supports a
12 business model like yours I'm all for you.
13 MR. PURITZ: How about a regulatory level
14 playing field? What's wrong with that?
15 MR. KRUSZEWSKI: We have one.
16 MR. PURITZ: No, we don't. That's just
17 absurd.
18 MR. PIACENTINI: Can you elaborate? What's
19 not level about the playing field?
20 MR. PURITZ: You know, the complete
21 different set of standards in terms -- you know, best
22 interest is not a fiduciary standard. I mean, you
23 know, there are -- we're not advocating for any
24 wholesale reform other than it is essential that
25 consumers know what they're buying, and they're not

1 now. Whatever is going today in the marketplace we
2 believe is just not working because -- you know,
3 obviously we have a limited window, but it's
4 statistically significant. You hear from others in
5 the marketplace. Consumers in general, middle-class
6 consumers are unaware of the fee structure they're
7 playing, particularly in the second level of fees, at
8 the fund level.
9 MR. PIACENTINI: So I'm going to lapse into
10 a kind of a speak, just slightly say so. We have sort
11 of an information problem, information cost,
12 information asymmetry, right. Some of the information
13 that's out there in the market, people aren't really
14 using it, and that's making the playing field uneven,
15 is that --
16 MR. PURITZ: Yeah. I mean, that's
17 definitely the case. You know, part of baked into our
18 core philosophy is full and fair disclosure, but also
19 we have that legal obligation for full and fair
20 disclosure, and we're just not seeing that out of the
21 brokerage community. Our experience, you know, that's
22 our limited experience, but it's very consistent over
23 multiple years, over hundreds and hundreds of
24 instances.
25 MR. KRUSZEWSKI: I think the market is a

1 fair playing field. I'm on television here, so if all
2 of my IRA investors want to look at your model where
3 you charge 50 basis points, plus ETF fees, plus
4 rebalancing fees, in many cases, that's higher than
5 what we charge, they should give you a call. Okay?
6 MR. PURITZ: Okay.
7 MR. KRUSZEWSKI: And there's a level playing
8 field for you.
9 MR. PURITZ: Thank you.
10 MS. SEYS: Well, it's my understanding that
11 as a registered investment advisor under the fifth
12 exemption --
13 MR. HAUSER: Could you pull the microphone?
14 Thank you.
15 MS. SEYS: Oh, sure. Your firm wouldn't be
16 subject to liability under state claim, right, I mean,
17 and a broker-dealer would? So I think if we're
18 talking a level playing field it might actually go the
19 other way.
20 MR. PIACENTINI: So I have just one last
21 question sort of on the numbers so to speak. So, Mr.
22 Puritz, you said that, you know, you've encountered
23 hundreds I guess of clients that have been paying
24 total all-in fees at two levels at least of more than
25 2 percent. Can you unpack that a little bit? If you

1 find somebody who's paying two and a half or
2 something, what is that made up of? Where does that
3 size of a total expense come from?
4 MR. PURITZ: Well, there is the, if you
5 will, advisory piece of that or the wrap fee, and
6 then --
7 MR. PIACENTINI: So I thought we were
8 talking, though, about you're seeing brokerage clients
9 who are paying, but now you're talking about an asset-
10 based fee.
11 MR. PURITZ: Well, there's one level of fees
12 that are disclosed, if you will, or the consumer seems
13 to be aware of, you know, the classic 1 percent,
14 percent and a half, or some differing configuration.
15 But where there is almost always a lack of awareness
16 is at the fund level where there are actively managed
17 mutual funds that are typically frequently
18 recommended, and that's the missing piece in the
19 marketplace from our experience.
20 MR. PIACENTINI: Okay. So the examples
21 you're talking about are individuals who are paying an
22 asset-based fee and also paying at a high expense
23 ratio for actively-managed funds are paying sort of
24 both of those pieces? Is that where that example
25 comes from?

1 MR. PURITZ: Frequently, yes.
2 MR. PIACENTINI: Okay.
3 MR. PURITZ: There's a variety of different
4 ways you get to the 2 to 3 percent, but it's --
5 MR. PIACENTINI: Is there another one that
6 you want to --
7 MR. PURITZ: No. I mean, no. I mean, it's
8 so pervasive.
9 MR. PIACENTINI: Okay.
10 MR. CANARY: Okay. Thank you. Mr.
11 Kruszewski, I'm sorry if I mispronounce that.
12 MR. PURITZ: You're popular.
13 MR. CANARY: But a couple of questions. You
14 mentioned that some of your customers have five
15 different types of accounts with you. Is it correct
16 that those accounts are subject to different
17 regulatory requirements? And just so I'm not like --
18 MR. KRUSZEWSKI: Right, right.
19 MR. CANARY: -- confusing you too much let
20 me tell you where I'm headed with this.
21 MR. KRUSZEWSKI: Okay.
22 MR. CANARY: Which is I think what you were
23 saying is you thought having an ERISA regulation on
24 some of the accounts is going to generate confusion
25 among your customers. And to the extent they already

1 have five accounts and they're subject to different
2 regulatory requirements, could you talk a little bit
3 why you think having the ERISA structure added to that
4 is going to create confusion where the current
5 structure doesn't?
6 MR. KRUSZEWSKI: Well, I think that the
7 basic, at the highest level again, the accounts fall
8 either under the '34 Act or under the '40 Act and that
9 we have clients that have both types of accounts:
10 advisory, trading accounts, and a number of things.
11 And the market has evolved and we are dual
12 registrants, and I think that that works.
13 To take -- what becomes unworkable in the
14 BIC standard is is the contract up front. The very --
15 this will sound ridiculous, but at some point you want
16 to give advice on a taxable account and you need to
17 look at your client and say, you know, you need to
18 shut your IRA ear, okay, because I can't talk to your
19 IRA ear, and if you come -- and the client comes back
20 and said I liked buying X, Y, Z stock and I'm now
21 going to buy it in my IRA, we're going to go, well,
22 wait a minute, did I just miss the BIC exemption
23 because I gave you some advice that I didn't mean to?
24 So the problem is is that the BIC exemption
25 applied in our current environment. That's why it's

1 unworkable. Today the '40 Act and the '34 Act are
2 harmonious in brokerage firms.
3 MR. CANARY: Okay. So I wasn't really
4 getting unworkable.
5 MR. KRUSZEWSKI: Okay.
6 MR. CANARY: I was getting confusion.
7 MR. KRUSZEWSKI: Okay.
8 MR. CANARY: So, in that conversation, where
9 is the confusion? Because I would imagine that
10 conversation you could say there are different rules
11 that apply, and this advice I'm giving you because
12 it's in the taxable space, not the ERISA space, and
13 you should only be treating this as advice or guidance
14 there because there are different rules that apply,
15 much like if you were dealing with a registered
16 investment advisor versus a brokerage.
17 MR. KRUSZEWSKI: Right.
18 MR. CANARY: You'd end up saying there are
19 different rules that apply. So where's the confusion?
20 MR. KRUSZEWSKI: Well, the confusion, the
21 confusion would be in the right in the middle of what
22 I'm talking about, which is brokerage IRAs, all right,
23 which are -- today there is no confusion in the '34
24 Act bond account, all right? But in a brokerage IRA
25 where there isn't confusion, you would put in a huge

1 amount of what I think are unworkable contract
2 standard reporting where me running a firm will look
3 at all of that and say you know what, I will eliminate
4 that confusion and not offer the brokerage IRA, and
5 I'm right back to where I was, at the '40 Act and I
6 have the '34 Act. I don't have the sleeve in the
7 middle, which is completely unworkable.
8 MR. CANARY: Do you want to --
9 MR. HAUSER: Well, I guess I'm just back to
10 the confusion because now I'm confused, which is maybe
11 part of my natural state. But, I mean, first off, is
12 it the case that you tell your customers in the
13 brokerage account as opposed to the advisory account
14 that you're adhering to a different standard or don't
15 you just essentially hold yourself as applying a best
16 interest standard both times out?
17 MR. KRUSZEWSKI: No, we adhere to a best
18 interest standard, of course.
19 MR. HAUSER: Right, and that's what you
20 would do in the ERISA space as well. As far as your
21 customer is concerned you'd be adhering to the same
22 standard across the board because it would always be
23 essentially a best interest standard. That's just how
24 you work commercially, right?
25 MR. KRUSZEWSKI: Right, but I think --

1 MR. HAUSER: So where is the confusion in
2 that?
3 MR. KRUSZEWSKI: The confusion is that you
4 cannot take the best interest standard promulgated
5 under the '40 Act today and apply it to '34 Act
6 accounts. You can't do it. All right? You have fee-
7 based accounts. You don't have principal-based. You
8 have restriction of a number of things that apply in a
9 '40 Act the clients choose and we adhere to.
10 To try to carve out what is otherwise a '34
11 Act brokerage account and create a whole 'nother set
12 of standards setting right next to another '34 Act
13 account is like creating three standards. And what
14 firms will do is not do that because the costs of
15 compliance litigation does not work, and from my
16 perspective, it's really simple. Thank you very much.
17 I'll just tell my clients I get to charge them more,
18 and I'm going to move them into an advisory model.
19 That is not in the best interest of clients even
20 though it may be in the best interests of my firm.
21 MR. HAUSER: So if the prudence standard is,
22 look, what would a reasonable investment professional
23 have recommended in light of the particular
24 circumstances of this customer, which is what the
25 prudence standard is under ERISA. That's the standard

1 we're talking about. Is that really different than
2 the standard you hold yourself to with respect to a
3 '40 Act account, a '34 Act account or any other
4 account, or isn't that exactly the same standard that
5 you right now adhere --
6 MR. KRUSZEWSKI: Exactly --
7 MR. HAUSER: -- that you would adhere to?
8 MR. KRUSZEWSKI: Exactly the same standard
9 because --
10 MR. HAUSER: Right. So, again, so why is
11 that a problem? I mean, when you launched into the
12 workability objection this last time, you dragged in
13 the notice provisions and the document retention and
14 all that. But right now I'm just talking about
15 suppose all there was was a promise that I'm going to
16 act in -- I'm going to adhere to the best interest
17 standard. I'm going to give you advice that's
18 prudent, the fees are reasonable in relationship to
19 the services, and this is enforceable. That's all
20 there is, and it would be enforceable, by the way,
21 both in the IRA space in whatever action is available
22 there, and it would be enforceable in the ERISA
23 context, in an ERISA action, but that would be it.
24 What's unworkable about any of that?
25 MR. KRUSZEWSKI: There's nothing unworkable,

1 and it should be enforceable in the '34 Act accounts.
2 It should be a uniform, universal, best interest
3 standard that umbrellas the entire brokerage
4 relationship. And if I remember my testimony, that's
5 exactly what I recommended that you do.
6 MR. HAUSER: Okay. So, as I said at the
7 start of my question, quite possibly I'm confused.
8 So, if you have all of that, I mean, I can't -- we
9 don't have authority to say what happens in the non-
10 retirement accounts. I mean, that's just outside of
11 our purview. We do have, you know, authority when it
12 comes to the retirement assets. That's the way our
13 statute is structured. You know, we have the
14 obligation to write the fiduciary rules when it comes
15 to retirement accounts. We have the obligation to say
16 what those standards are. That's built into the
17 statutory structure.
18 You know, it might be that you would prefer
19 that there would be one set of legal obligations that
20 apply across the board, but Congress made a decision
21 that when it comes to tax-preferred assets there would
22 be a special regulatory regime and we're it.
23 And so the question that I have is if you're
24 comfortable with prudent as I described it, you're
25 comfortable with best interest as I described it, you

1 don't have an issue with the contract, you know, as I
2 described it, and the standards you hold yourself to
3 in any case under the non-retirement assets, you know,
4 under those accounts are the same as these, where is
5 the confusion? What's the problem? Why doesn't that
6 work for you? Because I'd like to make it work.
7 MR. KRUSZEWSKI: Well, look, you know, what
8 you're saying should fit on three pieces of paper,
9 okay? Three. You just said it in less than a minute.
10 So, if you can say it in less than a minute, then we
11 should write it simply, okay?
12 MR. HAUSER: Yes.
13 MR. KRUSZEWSKI: However, what you wrote I
14 think is in 2500 pages with footnotes and this and
15 this and this, and so it's not -- I don't think it's
16 really fair to sit there and say would I agree with
17 you on these very basic principle-based rules. I do.
18 Let's just not make them 2800 pages of exceptions.
19 MR. HAUSER: So two, three things maybe
20 there. One is I think I took longer than a minute.
21 (Laughter.)
22 MR. KRUSZEWSKI: I could write it in three
23 pages, I promise you.
24 MR. HAUSER: But second is it's not -- I
25 mean, people do love to take the picture of the stack

1 of paper and have it bow tied and stuff, but the fact
2 is the rule and the exemptions are this much. The
3 rest of it is regulatory impact analysis and preamble.
4 It really isn't that long and complex. So it's not
5 thousands of pages that you're going to have to
6 memorize or anything. But this is a notice and
7 comment proceeding, and the truth is this is what we
8 want to achieve. I mean, we do not want to make the
9 broker model impossible.
10 We would agree with you that, you know, not
11 everyone needs an ongoing advisory relationship, you
12 know, or the kind of advisory relationship that is
13 typically provided by an IRA. Some people need
14 exactly the brokerage kind of relationship. We want
15 to make that happen. We just want to tamp down the
16 conflicts, and it's important to me.
17 If what you're telling me is the biggest
18 problem with the exemption is all the bells and
19 whistles that go with it, but you'd be okay with these
20 fundamental principles, that tells me, okay, there's
21 something there for us to do that can make this work
22 for your firm. But if you're telling me that no, even
23 if we just do those -- if we were to streamline it
24 that way it still wouldn't work for you, that's a
25 different thing.

1 MR. KRUSZEWSKI: I want to be clear here,
2 all right? This is very important. This is not about
3 working for my firm, okay?
4 MR. HAUSER: Yes.
5 MR. KRUSZEWSKI: Working for my firm, I am
6 completely happy putting every one of my clients on a
7 fee-based, okay? I told you it's hundreds of millions
8 of dollars, and the industry will do that, and that
9 cost needs to be done. I'm talking about investors,
10 primarily small investors that need the ability to
11 choice, and I would support what you're saying as long
12 as a best interest standard does not buy us customers
13 who want to be buy-and-hold investors and not be
14 forced into a fee-based model.
15 It can be done with enhanced disclosures and
16 any standard which encompasses both, that does what
17 you want to do to tamp down conflicts and all of that.
18 It's good for savings, it's good for a lot of things,
19 and I would support that. Unfortunately, the rule as
20 written does not accomplish that.
21 MR. HAUSER: You made that point and you can
22 finish up.
23 MS. SEYS: I'd like to also address your
24 question and I think if what you're saying is in your
25 hypothetical you would have a best interest contract

1 exemption where the requirements are the best interest
2 standard and we can quibble over without regard to and
3 other language and reasonable compensation. I
4 definitely think that's a step in the right direction
5 and something that we'd be very interested in taking a
6 look at.
7 MR. HAUSER: Okay. So thank you very much
8 for your time.
9 MR. CANARY: So, but --
10 MR. HAUSER: Sorry, we're not done.
11 MR. CANARY: Right. Sorry. I only have a
12 little bit, so short for everyone.
13 I think I'm hearing from you, Ron, that a
14 seller's exception is not critical to your business
15 model, but could everyone talk about that? There's
16 been a certain amount of commentary that we've gotten
17 that says there needs to be circumstances where people
18 can make things that amount to investment
19 recommendations but in a sales environment. What do
20 you think about that?
21 MS. SEYS: Sure, I'll go ahead. So, you
22 know, I think consistent with some trades in our
23 industry peers, you know, we do think the rule is
24 overbroad and that it brings in traditional sales
25 activities and makes them fiduciary activities.

1 However, as for our brokerage and IRA businesses for
2 our specific business model, we have no issue with our
3 financial advisors being held to a best interest
4 standard for any discussion. So there I wouldn't try
5 to rely on a sales carve-out or the education safe
6 harbor because at some point the discussion is likely
7 to turn to which products are available to fulfill the
8 client's goals, and so I need a viable bright line
9 exemption from the Department.
10 MR. HAUSER: And is the important thing in
11 that regard where we draw the line on what counts as
12 that recommendation, do you think, as opposed to a
13 seller's carve-out? At what point does the
14 communication kind of cross the line from, you know,
15 sort of the counseling that doesn't really add up to a
16 recommendation to not, or do you see it even
17 differently than that?
18 MS. SEYS: I think I would see it
19 differently than that. I think, as I said, at some
20 point we're going to talk about products. I mean, we
21 do --
22 MR. HAUSER: You just think that's a given.
23 MS. SEYS: I think it's something -- you
24 know, we do have the option for clients and some
25 choose them to just get a financial plan, pay for

1 that, and they're free to take that plan and take it
2 to any firm that they would like. But oftentimes they
3 want to work with their advisor who has helped them
4 develop that plan and they'll say, okay, you think
5 that I should take X, Y, Z strategy. I agree with
6 that. And what do you have for me? And so instead of
7 trying to develop compliance and monitoring and
8 supervision and surveillance for when was it sales,
9 when was it education, and when did it turn into a
10 recommendation where there was a call to action, I
11 think why not just make the recommendation workable.
12 MR. HAUSER: Yeah, right.
13 MR. CANARY: Mr. Puritz, I don't know if --
14 MR. PURITZ: Yeah, I would say, you know,
15 we're not in a position to opine on the specifics of
16 the rule, but where we feel very comfortable talking
17 is about what we see in the marketplace, and in our
18 experience, very consistently the marketplace just
19 isn't working. It's not working in terms of consumer
20 awareness around costs, consumer awareness around
21 conflicts, consumer awareness around sort of the fact
22 that the individual in front of them or that
23 institution is getting ongoing commissions, and that's
24 a -- we see that as a pretty fundamental problem that
25 needs to be addressed.

1 MR. CANARY: Thank you. Ron.
2 MR. KRUSZEWSKI: Look, I was told I wasn't
3 even going to get any questions.
4 (Laughter.)
5 MR. KRUSZEWSKI: So I'm not going to -- I'm
6 done.
7 (Laughter.)
8 MR. CANARY: I don't think you heard that
9 from us.
10 MR. KRUSZEWSKI: No, my advisors are about
11 to get an ear full.
12 (Laughter.)
13 MS. SEYS: You did a great job.
14 MR. HAUSER: Thank you all very much.
15 (Panel switch.)
16 MR. HAUSER: Good morning. So I never know
17 what order we're supposed to go in. Do you have any
18 preference on the panel? Alphabetical? Okay. Ms.
19 Dudley.
20 MS. DUDLEY: Thank you very much.
21 Hi. Hi, everybody. I'm Lynn Dudley with
22 the American Benefits Council. First of all, I'd like
23 to start by thanking you all. I want to thank you not
24 only for the opportunity to testify but the amazing
25 ability to listen over the last four days and over the

1 past few months and years that we've been working on
2 this, and we think it's a really, really important
3 topic, and we're here to help. We hope we're offering
4 constructive comments. We appreciate your dedication.
5 We know this is hard.
6 That being said, what I'd like to do today
7 is, despite the many, many issues that we have talked
8 about over the past few days, I want to share with you
9 input that I've received from plan sponsors, directly
10 from them over the past few months, and I hope it's
11 helpful to you as you go back and look at the
12 regulations.
13 The one overarching point we are hearing
14 from large plan sponsors is that the redefinition
15 seems to be at odds with employer efforts to
16 facilitate employee engagement. Plan sponsors are
17 trying to efficiently utilize both internal and
18 external resources to enhance education and encourage
19 more engagement with the plan. Plan sponsors around
20 the country have noted, and it is all over the country
21 that I've talked with them, have noted that they are
22 concerned that the new rules will make many of the
23 tools that they are using more difficult, more
24 expensive, and may result in their having to pull back
25 on those tools rather than encouraging more engagement

1 through the use of them. I'd like to share a few
2 examples of that if I might.
3 The impact on employee assistance is the
4 most common issue that's raised with me. More
5 specifically, they're concerned that the new rules as
6 written currently will make sponsors and their
7 providers, as one sponsor put it, unable to provide
8 helpful responses and helpful information in many
9 instances, and that's because they feel like the
10 fiduciary advice standard is exceptionally easy to
11 trigger and that the generic information permitted as
12 education is either not going to be directly
13 responsive or provides insufficient context to be
14 useful to the participant.
15 A good example of this are call centers.
16 Employers really very much value the helpful
17 educational information exchange that goes on in call
18 centers because employees tell them that they like the
19 call centers. Many plan sponsors actually actively
20 help shape the structure of their call centers to meet
21 their participants' needs. Call centers often receive
22 very basic questions from employees that are not very
23 familiar with retirement programs. They may get
24 questions where the employee is simply describing
25 their situation or they may get questions about, you

1 know, what do similarly situated employees invest in,
2 or they may get questions about whether they should
3 consider putting more money in one fund than another
4 fund, why or why not.
5 Call centers today can provide some very
6 basic information in an unbiased fashion, consistent
7 with the direction of the plan sponsor without
8 crossing the line, and employees value that
9 information and it helps them engage in the plan, and
10 we don't want to see the rule push us away from being
11 able to do that.
12 Alternatively, an employee may already be in
13 the plan and may call and ask about their existing
14 investment decisions. They may ask about target date
15 funds and age appropriateness. This is a very common
16 question. They may ask if it's appropriate to invest
17 in multiple -- this is a common thing too -- multiple
18 target date funds and why wouldn't you do that. They
19 may ask about brokerage windows or they may describe a
20 social conscience issue and whether a brokerage window
21 can solve that concern. They may ask about the
22 employer's stock fund. Sometimes they don't exactly
23 know the question they want to ask and you have to
24 have the conversation to get the question, and it's a
25 matter of helping them frame their question.

1 Under the proposal, sponsors are concerned
2 that answers to those questions would be fiduciary
3 advice and would make the call center a fiduciary, and
4 that's true even when plan sponsors have a policy in
5 place which is being followed and directs the call
6 center representative to redirect the caller to an
7 investment professional when they're asking for
8 investment advice. Also, if it's being operated by a
9 financial institution, they're concerned about the
10 prohibited transaction rules. But very briefly, there
11 are concerns that call centers would not be as
12 effective as they are today.
13 Onsite briefings are another example of
14 concerns that plan sponsors have. Currently, it's not
15 uncommon for service providers to help out with onsite
16 briefings. They cover enrollment contributions,
17 investment loans, distributions, access to the tools,
18 and other helpful questions. They don't want to see
19 these sessions eliminated or have to be restructured
20 and unable to have that conversation with employees.
21 Another example and one that you all have
22 talked a lot about already and, you know, I don't plan
23 to spend time on it today is really the interaction of
24 HR employees, human resource employees, with other
25 employees. I understand from the conversation that

1 you don't mean to pick up the casual conversations,
2 but we are concerned that human resources departments
3 are called upon all the time to answer very basic
4 questions for employees, and we don't want to see that
5 source of information pulled back on in a way that
6 people can't be helpful to plan participants.
7 In addition, we're concerned about the
8 limitation on investment education. Under the 2015
9 proposal, providing examples of investments that fit
10 within asset classes would be fiduciary advice. That
11 would force education to be around theoretical
12 conversations, and that may not be very helpful to
13 plan participants. We think the end result would be
14 that if our education materials are restricted that
15 way we'll get more calls into our HR department to
16 answer questions, and then they'll be frustrated
17 because they can't answer the questions because of the
18 narrow definition of what HR employees can really do.
19 Another concern that we have is oftentimes
20 our large plans make investment advisory services
21 available to provide additional help in managing plan
22 participation. We're concerned that our frontline HR
23 employees and our frontline call center reps won't be
24 able to refer people to those advisory services
25 because it's triggered too soon. The fiduciary

1 liability is triggered too soon.
2 Very briefly, I'd like to talk about some
3 solutions. We think it's very important that you all
4 go back and clearly exclude casual conversations from
5 the definition of fiduciary advice. We think it's
6 also probably a very good idea to go back and look at
7 the four consideration standard. Look at the
8 possibility of adding back in there a mutual
9 understanding of some sort so that that line of where
10 you're triggering that fiduciary duty allows people to
11 be responsive to the question that's being asked. And
12 I realize that's hard to do, but we think it's really
13 important. We'll try and help you as you go through
14 that.
15 But the information that the recipient is
16 receiving needs to play a significant role. It needs
17 to reflect the considered judgment of the advisor.
18 There are some elements we can work with you on to try
19 to solve that problem, that gray area.
20 We also think safe harbor for co-fiduciary
21 liability for the plan sponsor is very important where
22 they have a clear policy, a clear written communicated
23 policy that employees and service providers are
24 prohibited from providing fiduciary advice and
25 reasonably follow that policy and take steps when it's

1 violated. Also a safe harbor, a similar safe harbor
2 for plan sponsor employees who are not intentionally
3 violating a policy, and again, education needs to be
4 broadened out again a little bit.
5 And finally, we think it's very important
6 that you really think seriously about a longer
7 transition period. You're going to have a lot of
8 operational issues for existing agreements, and you're
9 going to have a lot of uncertainty. You know how this
10 is when we have these major rule changes. It takes a
11 long time to iron out the uncertainties, so we would
12 urge you to take a little extra time there. Thank
13 you.
14 MR. HAUSER: Thank you.
15 MR. JONES: My name is Christopher Jones,
16 and I'm proud to serve as Chief Investment Officer and
17 Executive Vice President of investment management for
18 Financial Engines. Thank you for the opportunity to
19 testify this morning.
20 As a third employee when I joined Financial
21 Engines nearly 19 years ago, I've had the privilege to
22 be part of the transformational impact of technology
23 on the financial advisory industry. What once was
24 only the wealthy could expect access to investment
25 counsel from an independent fiduciary, now millions of

1 Americans, even those with modest balances, are able
2 to enjoy the benefits of high-quality, conflict-free
3 investment advice.
4 We applaud the Department's proposed rule to
5 update the definition of fiduciary under ERISA. Since
6 it was established in 1996, Financial Engines has
7 provided advisory services in a fiduciary capacity to
8 millions of plan participants in defined contribution
9 plans. We believe the proposed rule is not only
10 workable for providers of advisory services but will
11 create substantial benefits and protections for
12 recipients of those services, and we further believe
13 the Department has provided adequate time for our
14 industry to assess the rule and its requirements.
15 I'd like to spend my time today here
16 focusing on four key points. First, now more than
17 ever, individuals need unconflicted investment advice.
18 Second, the proposed rule is workable for advisors and
19 beneficial for investors. Third, the technology can
20 facilitate advice to individuals regardless of wealth.
21 And fourth, although we strongly support the proposed
22 rule, there are a few areas where we believe it could
23 be strengthened.
24 First, individuals need unconflicted
25 investment advice. The American landscape, retirement

1 landscape, has changed dramatically in the last few
2 decades. There has never been a greater demand for
3 high-quality investment advice. A recent Financial
4 Engines study found, for example, that nearly seven
5 out of 10 401(k) participants have portfolios with
6 inappropriate risk and/or diversification.
7 However, current investment regulations
8 crafted nearly 40 years ago allow advisors to operate
9 with conflicts of interest that can result in great
10 harm to investors. The status quo is no longer
11 tenable given the immense stakes of our nation's shift
12 to the defined contribution model for retirement
13 savings.
14 Under current regulations, conflicted
15 advisors can steer investors towards products that
16 offer higher fees and commissions for the advisor, not
17 towards what would be in the best interest or the best
18 retirement outcome for the investor. Complex fee
19 sharing arrangements, commission structures, and other
20 conflicts create pressures to shade recommendations
21 towards the interests of the advisor, such as steering
22 investors away from low-cost 401(k) plans and into
23 more expensive retail IRA accounts.
24 The vast majority of individual investors
25 are entirely unaware that these conflicts exist. This

1 makes them vulnerable to firms that claim to be on
2 their side but eschew any fiduciary responsibility to
3 act in the sole best interests of the client. As a
4 result, many workers end up with investments that have
5 lower returns and higher fees. Every day our nation's
6 newspapers recount stories of individual investors
7 being taken advantage of by unscrupulous advisors and
8 the ingrained conflicts that permeate the retirement
9 industry. It is time that investment regulations are
10 updated to reflect this new reality facing retirement
11 investors in America.
12 ERISA's fiduciary standards provide crucial
13 protections against these conflicts. The proposed
14 rule critically and necessarily applies these
15 protections more broadly in light of a changing
16 retirement landscape.
17 Second, based on our experience over the
18 last two decades, we believe the proposed rule is
19 entirely workable for financial advisors and
20 beneficial for investors. Financial Engines is the
21 leading provider of independent advisory services to
22 large plan sponsors, working with more than 600 large
23 employers, including 143 of the Fortune 500, and nine
24 of the largest retirement plan providers serving the
25 defined contribution market. We are the largest

1 independent registered investment advisor in the
2 United States. We offer advisory services to over
3 9.4 million participants in 401(k) and similar plans,
4 and since 2010, Financial Engines has been a publicly
5 traded company.
6 We assist individuals with developing a
7 personalized and comprehensive savings, investing, and
8 retirement income plan. So 401(k) plans are not
9 devoid of retirement advice. Financial Engines can
10 either professionally manage an employee's account on
11 a discretionary basis with access to human advisors or
12 provide online advice through expert recommendations
13 and interactive tools.
14 Additionally, Financial Engines provides a
15 retirement readiness assessment, including estimated
16 annual retirement income from Social Security,
17 401(k)s, IRAs, and pensions, if applicable, to all
18 employees in the plans we serve. With our income plus
19 feature, participants can receive payouts that are
20 designed to last for life with the purchase of an
21 optional out-of-plan fixed annuity.
22 Participants can also use our services to
23 generate an income plan which brings together all of
24 the sources of retirement income with guidance on
25 Social Security claiming strategies all at no

1 additional fee.

2 We provide investment advisory services as a
3 fiduciary under ERISA and under the parallel
4 prohibited transaction restrictions of the Internal
5 Revenue Code. We are also regulated by the SEC as a
6 federally registered investment advisor. From the
7 beginning we have carefully structured our business to
8 ensure that we have no conflicts that would compromise
9 the objectivity of our investment advice.

10 What does independence mean? It means we do
11 not sell any investment products of any kind. We do
12 not receive differential compensation or commissions
13 on the investments that we recommend. We do not vary
14 our investment methodology across our customers, nor
15 do we play any role in the selection of a particular
16 retirement plan's fund lineup.

17 In short, our experience demonstrates that
18 it's possible to provide personalized unconflicted
19 investment advice and produce solid business results
20 even when compliance costs are factored in.

21 Third, technology can facilitate affordable,
22 high-quality and objective investment advice to
23 individuals regardless of their wealth. Technology
24 has democratized the advice once only available to
25 high net worth investors, dramatically increasing the

1 accessibility and affordability.

2 Moreover, we are confident the proposed rule
3 will further accelerate the trend towards low-cost
4 technology-based financial services and products which
5 will, in turn, make unconflicted advice increasingly
6 cost-effective for both advisors and accessible for
7 investors of all means.

8 Since 1996 when Financial Engines was first
9 established by Noble Laureate William Sharpe, former
10 SEC Commissioner Joseph Grundfest, and the late Craig
11 Johnson, our vision has been to provide high-quality,
12 independent investment advice to everyone regardless
13 of their wealth or investment experience. Innovative
14 and powerful technology has been at the core of our
15 business, allowing us to provide services at
16 unprecedented scale to individuals that may not
17 otherwise have access to high-quality investment
18 advice.

19 We model over 39,000 different securities
20 while considering investment style, risk, tax
21 implications, expenses, redemption fees, loads, and
22 other distributions. As a result, over 3 million
23 people have used Financial Engines' online advice and
24 approximately 900,000 have their retirement account
25 professionally managed by our company.

1 The median balance of our discretionary
2 managed account clients is $57,000, and nearly 240,000
3 of our clients have less than $20,000 in their 401(k)
4 portfolio. Of the more than 9 million plan
5 participants with access to our services, the median
6 balance is $32,000 in their account, and approximately
7 43 percent of these participants have less than
8 $25,000 in their 401(k) portfolio.
9 We offer advisory services both through the
10 web and through trained investment advisor
11 representatives in our Phoenix and Boston call
12 centers.
13 Fourth, although we strongly support the
14 proposed rule, we urge the Department to address
15 certain areas that may result in unintended
16 consequences. Financial Engines' comment letter
17 outlines certain areas of the proposed rule that could
18 be strengthened. As the Department considers
19 potential changes to the proposed rule, we urge you to
20 weigh how each change will result in more investors
21 getting access to unconflicted advice.
22 For example, the proposed rule may restrict
23 the ability of advisors to present services to
24 investors. In order to increase access to
25 personalized, unconflicted investment advice, it is

1 essential that investment advisors are able to
2 communicate to investors information about their
3 services.
4 The Department has also asked whether it is
5 appropriate to omit provisions of IB 96-1 related to
6 specific investment products and alternatives. We
7 believe that the investment education carve-out is
8 appropriate without including specific investment
9 products and alternatives under the plan or IRA.
10 However, we recognize that there may be circumstances
11 in which the identification of specific products does
12 not create a conflict. We suggest that the language
13 be modified to allow the presentation of specific
14 investment products if additional criteria are met.
15 In conclusion, on behalf of Financial
16 Engines, I would like to thank you again for the
17 opportunity to testify today. In our experience,
18 there is simply no truth to the assertion that
19 unconflicted advice costs more to provide than
20 conflicted advice. Conflicted advice often makes it
21 difficult for investors to understand what they are
22 truly paying, and we strongly believe that all
23 investors deserve a fiduciary standard of care, and we
24 welcome the opportunity to work with the Department on
25 these important issues. Thank you.

1 MR. HAUSER: Thank you.
2 Mr. Tarbell.
3 MR. TARBELL: Good morning. My name is Jeff
4 Tarbell, and I'm testifying on behalf of the American
5 Society of Appraisers. The ASA is a multi-disciplined
6 nonprofit professional appraisal organization which
7 teaches, tests, and credentials high quality
8 appraisers of businesses and business interests, real
9 estate, personal property, and machinery and
10 equipment.
11 By way of personal background, I'm employed
12 at Houlihan Lokey, an investment bank that, among
13 other things, provides valuation and fairness opinion
14 services related to ESOPs and other employee stock
15 plans under ERISA. I have more than 25 years of
16 experience performing such valuations and fairness
17 opinions, many of them related to employee stock
18 ownership plans. I'm an accredited senior appraiser
19 with the ASA in business valuation and the past chair
20 of the ESOP association's evaluation committee. I
21 also hold a chartered financial analyst designation
22 and a general securities license.
23 The ASA appreciates the opportunity to
24 testify at today's hearing on EBSA's proposed conflict
25 of interest rule. My testimony will be limited to the

1 valuation provisions of the rule, most importantly,
2 issues governing the fiduciary status of individuals
3 who provide appraisals, fairness opinions, and other
4 valuation services to ESOPs, IRAs, 401(k)s, and other
5 plans under ERISA. Our written comments in response
6 to the proposal were submitted several weeks ago.
7 To begin, the ASA greatly appreciates EBSA's
8 decision to amend the 2010 proposal by removing from
9 the current proposal's definition of fiduciary
10 appraisals and fairness opinions of employer
11 securities held by ESOPs. Such valuations are
12 typically provided pursuant to ERISA reporting
13 requirements and constitute the largest number of
14 valuation engagements for ESOPs. Their exclusion from
15 fiduciary status is a welcome development and a
16 noteworthy example of EBSA's willingness to
17 constructively consider and respond to stakeholder
18 concerns.
19 We're hopeful that this same spirit of open-
20 mindedness will continue because while the newly
21 proposed regulation is a significant improvement over
22 the 2010 proposal, we are still troubled by the fact
23 that it continues to apply fiduciary status to an
24 important category of valuation and fairness opinions,
25 specifically, those involving the purchase, sale or

1 exchange by ESOPs and other plans of all assets other
2 than company securities.
3 While we are aware of no hard data on the
4 number of these individual transactions and on the
5 specific types of property purchased, sold or
6 exchanged by plans, we do know they are a common
7 occurrence that most often involve the valuation of
8 real property or privately-held securities in the
9 portfolio of non-ESOP ERISA plans. These transactions
10 are important to plan participants and to the
11 appraisers who value the assets involved.
12 ASA members and I would expect the entire
13 community of professional appraisers strongly oppose
14 what can be characterized as a carve-out from the
15 carve-out in the proposed rule. We do not believe
16 there is any reasonable public policy rationale that
17 supports EBSA having two separate and distinct
18 appraisal policies, one involving the valuation of
19 employer securities held by ESOPs and another
20 involving all other assets that a plan might purchase,
21 sell or exchange. We believe EBSA should have one
22 appraisal policy governing the valuation of plan
23 assets.
24 Accordingly, we urge that the proposed rule
25 be amended by excluding from the definition of

1 fiduciary appraisals and fairness opinions not simply
2 of ESOP securities but of all assets held by ESOPs and
3 other ERISA plans and that EBSA continue with its
4 efforts to address its valuation concerns in a
5 separate initiative.
6 EBSA's decision not to exclude all property
7 categories from appraisal fiduciary requirements
8 resurrects the many substantive reasons ASA, the
9 community of professional appraisers, and many ESOP-
10 owned companies strongly oppose the appraisal
11 provisions of the 2010 rule. I want to discuss just a
12 few of those reasons this morning because they remain
13 relevant to the valuations that would be subject to
14 fiduciary status under the 2015 proposed rule.
15 First, appraisers firmly believe that an
16 unavoidable conflict exists between, one, the ethical
17 and legal obligations of appraisers to be independent
18 of all parties to a financial transaction, and two,
19 the ethical and legal obligations of fiduciaries to
20 act solely in the interest of plan beneficiaries.
21 Notwithstanding EBSA's dismissal of this concern, we
22 believe this conflicting duties issue is real and
23 impassable. We think the issue will be raised by plan
24 fiduciaries or other parties to plan transactions when
25 someone believes the appraiser who valued the property

1 has made a decision that is not in the best interest
2 of the plan beneficiaries.
3 Our concern is widespread. We're confident
4 that it is shared by the entire community of
5 appraisers, including members of the appraisal
6 foundation, and very likely by other plan
7 stakeholders. We respectfully disagree with the
8 Department's view that the duties of professional
9 appraisers to be independent of all parties and the
10 duties of fiduciaries to safeguard plan assets are not
11 in conflict. If the final rule includes appraisers
12 within the fiduciary duty -- excuse me -- within the
13 fiduciary definition for plan-related valuations, we
14 think it's inevitable that this issue will have two
15 adverse consequences.
16 One, it will be a major source of confusion
17 among appraisers trying to reconcile and balance these
18 two obligations, and two, it will give rise to
19 disputes, some of which will surely end up in
20 litigation between appraisers, plan trustees, and
21 participants.
22 Our concerns about this conflicting duties
23 issue are no less acute simply because under the
24 proposed rule these conflict issues will only affect
25 valuations of property that do not involve employer

1 securities held by ESOPs. While individual
2 transactions most likely represent a minority of ESOP
3 and other plan valuation engagements, we believe they
4 are of sufficient number and importance to put many
5 providers' valuation services to ERISA plans in great
6 jeopardy. In short, this is impractical and it's
7 unfair to expect appraisers to adhere to conflicting
8 legal obligations.
9 Second, including appraisers in the
10 proposal's definition of fiduciary would substantially
11 increase the cost of these appraisals covered by
12 fiduciary requirements, costs that would be incurred
13 by plan beneficiaries and their sponsor companies.
14 This is because appraiser ENO insurance policies do
15 not currently exclude claims -- include claims based
16 on fiduciary liability. Adding such coverage to
17 existing policies, if possible, would require carriers
18 to initiate a complex and time-consuming underwriting
19 process to determine the costs and conditions of such
20 coverage.
21 Third, making appraisers fiduciaries is an
22 unproven way to improve and ensure the reliability of
23 plan appraisals, and it is inconsistent with the way
24 other federal agencies regulate appraisal practice.
25 Given the fact that no federal agency and no state

1 agency has ever regulated appraisal practice by
2 imposing fiduciary status on appraisers, there is no
3 evidence that doing so will produce better valuations.
4 DOL's proposal, if it were incorporated into
5 a final rule, would be a case of first impression, an
6 experiment that we believe would produce a series of
7 negative consequences and impassable conflict without
8 a meaningful likelihood that appraisal reliability
9 would be improved.
10 The appraiser as fiduciary concept is an
11 experiment with a highly uncertain outcome. However,
12 there are other tried and true ways to accomplish
13 EBSA's worthy objective of better quality appraisals.
14 Agencies such as the IRS have adopted workable
15 policies that have proven both effective and
16 manageable.
17 Finally, EBSA has commented that
18 notwithstanding its decision to exclude valuations of
19 ESOP securities from fiduciary requirements it
20 continues to have concerns about such valuations that
21 it may want to address in a separate regulatory
22 initiative. The possibility of such an initiative
23 adds weight to our position that all ERISA-related
24 appraisals should be excluded from the current
25 proposal.

1 It would be inconsistent, burdensome, and
2 frankly unfair to require an appraiser valuing company
3 stock held by an ESOP to be subject to different
4 duties than an appraiser valuing company stock held by
5 a 401(k), for example. The same could be said about
6 an appraiser valuing real estate held by an ESOP
7 having different duties than an appraiser valuing
8 company stock held by an ESOP.
9 The logical and straightforward way to avoid
10 such inconsistencies is to exclude all appraisals from
11 the fiduciary provisions of the 2015 proposal and
12 instead cover them through an alternative process such
13 as that underway for ESOPs.
14 We hope EBSA agrees with our assessment and
15 will expand the ESOP stock carve-out to other assets
16 and other ERISA plans, and we respectfully urge the
17 agency to take this important step before finalizing
18 the rule.
19 In closing, the ASA supports EBSA's goal to
20 improve the quality of appraisals made for ERISA
21 plans. In the event that EBSA undertakes a separate
22 rulemaking initiative, ASA would be pleased to work
23 with the agency to fashion an approach that satisfies
24 the DOL's regulatory goals and is cost-effective and
25 fair. Given ASA's multi-discipline membership, we

1 believe we're in a unique position to assist EBSA in
2 connection with that initiative.
3 I'd be happy now to answer any questions you
4 have about ASA's testimony.
5 MR. HAUSER: Thank you.
6 Ms. Dudley, maybe starting with you. First,
7 maybe just to put your mind at ease, the rule does not
8 cover casual conversations, unless by causal
9 conversations you mean somebody like wearing a
10 polyester while making a specific investment
11 recommendation, but the rule requires to trigger
12 fiduciary status that there be a recommendation, and a
13 recommendation really is a call to action, you know, a
14 suggestion that you purchase an investment, that you
15 pursue an investment strategy. So, with that
16 understanding, does that take care of your concerns
17 about the call centers and what have you?
18 MS. DUDLEY: Well, partially because I trust
19 you, Tim, and I think it's great that you're saying
20 that, and if you would clearly write it in the
21 regulations, I think that would even be greater
22 because I do think there is some uncertainty in the
23 terminology that's used in what you've proposed and I
24 think people interpret it differently, and I think
25 people have that concern, so why not just be really

1 explicit.
2 MR. HAUSER: Right. Well, we try to be
3 quite explicit by specifically referencing the FINRA
4 standard and by defining recommendation as we did, and
5 I guess, I mean, it would be helpful to know what
6 other things you think we need to say or where you
7 think that, you know, the issue stems.
8 MS. DUDLEY: We can come back and give you
9 some examples of things that would help, and you might
10 want to also consider doing some frequently asked
11 questions and some examples of what's --
12 MR. HAUSER: Okay.
13 MS. DUDLEY: -- okay and what's not okay. I
14 mean, I think that that would help a lot too.
15 MR. HAUSER: Right. And again just so we're
16 clear, I mean, sometimes this observation is coupled,
17 and I think it was in your comment letter, with a
18 statement that it's information specifically directed
19 and that's where the problem is, but that's not quite
20 right because it needs to be a recommendation
21 specifically directed, and so you pick up, you know,
22 this concept that I was just discussing, and maybe
23 that's one area to give some clarity. But it
24 certainly does not pick up casual conversation.
25 MS. DUDLEY: And it's also -- you know, it's

1 not just the -- and I appreciate that very much and
2 appreciate the public statement that it doesn't, but I
3 think it's also those conversations that are not just
4 casual but also the concern that we have about
5 conversations that are in and around investments but
6 aren't specific to a specific recommendation, and I
7 think we need to work together on that to make that
8 clear what people can and can't do.
9 MR. HAUSER: So, if we talk about that for a
10 second, the chief change that maybe contracted the
11 scope of investment education from the previous
12 guidance was saying that when it comes to asset
13 allocations you can't associate, you know, the
14 specific product reference to the asset allocation.
15 You can't tell somebody, you know, 40 percent in a
16 large cap and such as and then say, you know, the
17 Hauser large cap fund. That seems like a
18 recommendation to us.
19 But the suggestion has been made that one
20 way to deal with that in the plan context is to permit
21 that once you give that kind of asset allocation
22 guidance to permit the person giving the guidance to
23 illustrate the asset allocation with -- populate it
24 with all of the funds that fit the bill under the plan
25 menu. Does that work for you guys?

1 MS. DUDLEY: I heard that in the exchange
2 over the past few days, and I think that's a really
3 good, you know, solution to explore. I'm a little bit
4 concerned, just if I can throw one thought your way,
5 that in doing that you want to be careful that you're
6 not confusing the participant by saying, you know,
7 okay, there's this and there's this and there's this,
8 when really what they're asking is something more
9 specific or more targeted to their situation. So you
10 don't want to overwhelm them. So there has to be a
11 fine -- there's a little bit of a give and take on
12 that, you know.
13 MR. HAUSER: Right.
14 MS. DUDLEY: So maybe all of the funds that
15 would be applicable or, you know, but maybe not --
16 MR. HAUSER: Sure.
17 MS. DUDLEY: You know, something along those
18 lines. I mean, I think it's a great solution to
19 explore, but I think we need to massage it a little
20 bit.
21 MS. MARES: So let me just follow up on that
22 because having lived in that world --
23 MS. DUDLEY: Uh-huh.
24 MS. MARES: -- I understand, and I just
25 wanted to add some clarity. So I think if the asset

1 allocation was large cap, small cap, and the fund had
2 four large cap options and three small cap options,
3 today you'd populate it with one of the four choices
4 and one of the three choices.
5 MS. DUDLEY: Uh-huh. Right.
6 MS. MARES: If you had to give all four
7 choices and all three choices, how does then -- how
8 should we expect then the person that's narrowing that
9 choice to be making that decision, and what procedures
10 are in place so that the decision is neutral or maybe
11 it's not neutral and someone is actually expressing
12 some analysis and advice? So talk to me about how you
13 would then narrow that.
14 MS. DUDLEY: And I'll go back and get more
15 input for you guys on this.
16 MS. MARES: Okay.
17 MR. HAUSER: So, you know, I'm more of a
18 messenger than having lived in that world.
19 MS. MARES: Okay.
20 MS. DUDLEY: But let me just make a couple
21 of suggestions in that regard. So your question is
22 around the person that's narrowing the list to then
23 share with the participant.
24 MS. MARES: A specific recommendation of a
25 specific choice.

1 MS. DUDLEY: Well, I think you're going to
2 have to give them a little bit of guidance in the
3 regulations about narrowing the choice there, but I
4 think that to the extent that the person has been
5 directed and educated about the funds they can say,
6 you know, there are four funds that fall into this
7 category, you know, so that they're identified. And
8 then they might want to specifically say I'm not
9 telling you which fund to choose within that category.
10 MS. MARES: Okay.
11 MS. DUDLEY: A lot of our plan sponsors have
12 policies in place that at that point they would say we
13 offer you a service and this is how you access a
14 service such as Financial Engines, and you want them
15 to be able to do that as part of that conversation.
16 MS. MARES: Okay.
17 MS. DUDLEY: So does that help a little bit?
18 MS. MARES: That does.
19 MS. DUDLEY: But I'm glad to collect input
20 on that specifically.
21 MR. HAUSER: So, and then getting back -- so
22 apart from that issue and let's suppose it were
23 resolved that way, you know, by letting people
24 populate with all of the matching funds essentially in
25 the plan context. You know, after that the way in

1 which we've changed the interpretive guidance is by
2 expanding it.
3 MS. DUDLEY: Uh-huh.
4 MR. HAUSER: We have actually added more
5 education as treated as not fiduciary --
6 MS. DUDLEY: Right.
7 MR. HAUSER: -- rather than the converse.
8 So I assume there's no objection there.
9 MS. DUDLEY: No, there's no objection there.
10 MR. HAUSER: Okay. And then so maybe if we
11 could talk for a minute about --
12 MS. DUDLEY: But, Tim, I have to add one
13 more thing if I can.
14 MR. HAUSER: Please do.
15 MS. DUDLEY: I'm sorry. But one thing you
16 have to -- you need to rephrase or reframe some of
17 what you're doing around education because messaging
18 is pretty important in this environment and pretty
19 important to plan sponsors, and so you want to take
20 some extra steps to illustrate some potential uses of
21 education and of the interpretive bulletin so that
22 people don't have the sense -- when I go around and I
23 really have talked to lots of plan sponsors, as you
24 know, and they have the sense that you're telling them
25 to pull back.

1 MR. HAUSER: Well, do you think they might
2 be influenced at all by those talking points that say
3 casual conversations are treated as fiduciary?
4 Because I think they might be.
5 MS. DUDLEY: Well, I don't actually have
6 talking points out on this because I really haven't
7 done that, but I don't think that they're influenced.
8 They're not a membership that lets me tell them.
9 They're a clear membership that tells me, and I am
10 very aware of my role as the recipient of information.
11 MR. HAUSER: So, on that score, you know,
12 obviously, when you submit additional comments, I
13 mean, we tried to be pretty specific in the education
14 guidance. If you read it, it's the long -- I mean, in
15 terms of rule text, it's easily the longest section of
16 the fiduciary rule, and it goes on, you know, quite a
17 bit about all the different things you can talk about,
18 you know: plan or IRA contributions, the impact of
19 pre-retirement withdrawals and retirement income,
20 retirement income needs, varying forms of
21 distributions and on and on with, you know, the
22 attributes of the investments and all the rest.
23 So, if there are specific conversations that
24 you think it would be helpful for us just to make
25 clear where you think there's some ambiguity, it would

1 be good if you provided that for us.
2 MS. DUDLEY: Glad to do it.
3 MR. HAUSER: And then if you could tell me
4 why you think if -- assuming a recommendation in this
5 context means that and the person making the
6 recommendation is, you know, really telling the
7 customer effectively -- an objective person would
8 think they're telling me to invest in this fund, to
9 pursue this strategy.
10 MS. DUDLEY: Uh-huh.
11 MR. HAUSER: Once that's established, why
12 would anything need to hinge on an agreement? If
13 they've done that and they're an investment
14 professional, they've essentially told the person you
15 should put your money here, pursue this strategy, and
16 they're going to get a fee out of that, why should we
17 layer on on top of that a requirement that there be a
18 mutual understanding, and after answering that, a
19 mutual understanding of what exactly?
20 MS. DUDLEY: I think that what plan sponsors
21 are saying is that when a conversation happens both
22 parties need to understand that the back-and-forth
23 communication is about the plan assets, about what
24 they're -- and their plan participation. It's a
25 considered judgment, it's a judgment, and maybe that's

1 where we get into solving the problem by dealing with
2 clarifying the recommendation side of it.
3 So I think it sort of hinges on the fact
4 that the person had a thoughtful, considered response
5 that is telling them to do something. And so I don't
6 know that it has to hinge on the words in my solution
7 of a mutual understanding versus a recommendation, but
8 there has to be some understanding that that is a
9 recommendation.
10 MR. HAUSER: Well, why isn't it adequate
11 that there is an understanding -- I mean, is it --
12 well, maybe that's the question. I mean, is it enough
13 that an objective person would have understood that,
14 look, you're recommending I make this particular
15 investment? Do we need more to get to fiduciary
16 status?
17 MS. DUDLEY: I don't know that you do. I
18 think that if the recommendation is actually a
19 recommendation and not just for consideration. You
20 know, there's a difference between a recommendation
21 and something that's just for you to think about, and
22 so I think maybe that's where we need to be sure we're
23 all on the same page. And I think we can give you
24 some examples and that might help you.
25 MR. HAUSER: Okay. Mr. Tarbell, just very

1 quickly, two things maybe. The first is you are aware
2 that the current regulation, the 1975 regulation,
3 covers appraisals except for ESOPs? Yes or no?
4 MR. TARBELL: No.
5 MR. HAUSER: So you're asking for us to
6 change the status quo rule because the rule as
7 currently done, there's a five-part test, but if
8 you're giving a statement as to value, it covers both
9 recommendations in the sense of invest in this asset
10 and valuation work.
11 MR. TARBELL: My understanding is the test
12 valuations currently do not fall under fiduciary
13 standard because they do not meet that five-part test.
14 Is that -- are you saying that's incorrect?
15 MR. HAUSER: I'm saying if you render advice
16 as to the value of a security and you do it -- and you
17 meet the five-part test you're in. So, if you do that
18 on a regular basis, you have a mutual agreement
19 arrangement or understanding with the plan fiduciary,
20 that that advice is going to serve as a primary basis
21 for the investment decision, and it will be
22 individualized. That would appear to me to meet the
23 five-part test. We carved out --
24 MR. TARBELL: So under your logic, we're
25 already fiduciaries?

1 MR. HAUSER: Not ESOPs because we had a
2 carve-out for ESOPs. I guess what I'm telling you is
3 while we've changed the five-part test, you know, we
4 had an old advisory opinion that said it was different
5 for ESOPs, but under the rule as it exists, it
6 literally covers advice as to the value of a security,
7 for example, or advice as to the value of other
8 properties.
9 So, if you do that regularly, say you're
10 retained by a plan and you on a regular basis do the
11 valuation work for them in connection with new asset
12 purchases, you do it with respect maybe to annual
13 valuations and the like, at least arguably you're
14 picked up here. I mean, so part of the thinking, I
15 guess maybe this is just explaining, we are changing
16 the five-part test, but in a way we're just preserving
17 the status quo as far as the distinction between ESOPs
18 and other classes of property go.
19 But anyway, there's not really a question
20 thereafter did you know that. But the other, you
21 know, question I guess I have is, and maybe this is
22 just one of those things we have to agree to disagree
23 about, but I just don't think the advice relationship,
24 you know, a duty of loyalty under the advice
25 relationship requires one to slant that advice to tell

1 the recipient what they want to hear, and that's
2 always what it seems to me like your position is when
3 you say there is an incompatibility between the duty
4 of loyalty and the appraiser's job.
5 It seems to me the appraiser's job is to
6 arrive at the best estimate of what the asset's likely
7 trade, you know, at in a market transaction, and your
8 job as a fiduciary is to give the investment
9 decisionmaker your best judgment on what that number
10 is so they can make the best possible decisions for
11 the plan, but you don't do them any favors by giving
12 them a slanted number, do you?
13 MR. TARBELL: Well, we sure would if we made
14 it a lower value and they were buying securities.
15 That would absolutely be in their best interest to
16 have a lower price.
17 MR. HAUSER: And I suppose one -- but I
18 don't think that's the job of the appraiser.
19 MR. TARBELL: Oh, no, it absolutely is not.
20 MR. HAUSER: And I don't -- no, no, I don't
21 think that's --
22 MR. TARBELL: And that's the point. You're
23 right.
24 MR. HAUSER: No, no, that's not the point,
25 and I don't think that's what loyalty means in this

1 context either. It's strictly, you know, giving the
2 best advice, and in the case of an appraiser, it's
3 giving that best estimate, and we can clarify that
4 however you want, but would a statement in the
5 preamble or in the text that just made that clear,
6 here's what that duty means in this context so that
7 you had no question that all we were asking for was
8 that you give your impartial best judgment of what the
9 right price is? Would that remove the incompatibility
10 as you perceive it with your appraisal duty?
11 MR. TARBELL: Well, I don't think so because
12 if that was the clarified objective, then it wouldn't
13 follow that there's any need to make us a fiduciary.
14 MR. HAUSER: Well, but there's no -- I'm --
15 MR. TARBELL: Because all you're doing is
16 making a statement of fact which is what an asset is
17 worth, but we're making no recommendation as to
18 whether it's the proper investment for the plan. I
19 mean, we're basically akin to when one makes a
20 purchase of a publicly traded security and they look
21 up in the newspaper what Bloomberg or what the quoted
22 price is that day. That's no more of a recommendation
23 than what we do.
24 MR. HAUSER: Well, as you know, I've done a
25 lot of appraisal cases, and that just isn't so. I

1 mean, an appraisal reflects your expert judgment. If
2 we don't have a ready market price, that reflects your
3 judgment as, you know, based on a whole host of
4 calculations, assumptions, and expert judgment calls
5 about what that asset is going to trade at.
6 MR. TARBELL: I agree.
7 MR. HAUSER: So it's not just a fact. I
8 mean, it's expert advice.
9 MR. TARBELL: But none of those items are a
10 recommendation on what action to take. There's no
11 investment decision --
12 MR. HAUSER: I see your --
13 MR. TARBELL: -- inherent in an appraisal.
14 MR. HAUSER: Well, it's advice in a sense on
15 what price one should pay, yes?
16 MR. TARBELL: It's not a price -- no, it's
17 not. It's not advice on what price one should pay.
18 It's advice on what the fair market value is. Whether
19 the plan should pay it or not pay it is the trustee's
20 decision. We don't care. That's what independent
21 means. We don't care whether you act on this price or
22 not, and we don't care whether you're a buyer or a
23 seller. It's simply the fair market value. Do what
24 you want with it.
25 MR. HAUSER: Right. But it's I guess the

1 nature of virtually all advice, isn't it, that the
2 recipient of the advice in a sense is ultimately the
3 decisionmaker? I mean, that's no different than any
4 other context.
5 MR. TARBELL: Well, no because the other
6 constituents that are testifying about the impact on
7 their business are providing advice, I believe, which
8 is this is what we recommend for you, and there's no
9 aspect of that in an appraisal.
10 MR. HAUSER: Right. And then just one other
11 point and then I'll stop talking. But what we do have
12 in mind in the rule, though, and maybe here is an area
13 where it needed -- there's additional clarity needed
14 was that the advice would only -- you know, we really
15 did have in mind the plans hire somebody in connection
16 with a specific transaction and they're looking for an
17 appraisal in connection with that transaction. It's
18 true we have a separate carve-out that deals with, you
19 know, valuations required by law, but unless the plan
20 -- but that's what we're picking up. We're not trying
21 to pick up kind of these annual appraisals, these
22 reporting obligation sort of things, these fund
23 values, you know, divorced from that kind of --
24 MR. TARBELL: So transactional only.
25 MR. HAUSER: Yeah, that's --

1 MR. TARBELL: That would greatly clarify.
2 MR. HAUSER: Yeah.
3 MR. TARBELL: We would like it to go further
4 and not include the transactions, but that would be a
5 great step.
6 MR. HAUSER: Right. And we're definitely
7 thinking hard about that comment as well. Thank you.
8 MR. CANARY: Okay. Lynn, a couple of
9 questions. In your comments, there seemed to be a
10 recognition of a difference between the HR employees
11 and call center employees. So let's talk about HR
12 employees just to begin with.
13 MS. DUDLEY: Sure.
14 MR. CANARY: One of the things as we went
15 through this we thought was important was to be a
16 fiduciary you have to be receiving a fee for the
17 advice, and I think what we've heard is in the case of
18 HR employees that's not really happening unless you
19 classify their normal salary as a fee that would bring
20 them within the rule. So rather than trying to
21 clarify other provisions, would approaching the HR
22 issue from that direction be helpful just to clarify
23 what would constitute a fee?
24 MS. DUDLEY: Yes, very clear recognition of
25 that in some way is really valuable, Joe. There is --

1 I've heard that discussion over the past few days and
2 I've heard that discussion even before that, and there
3 is just -- anytime there's a major change like this
4 there's just huge uncertainty, and it's not worth that
5 confusion or having that tested in some court
6 somewhere. Just clarify it.
7 MR. CANARY: Okay. So call center employees
8 seem a little different, though.
9 MS. DUDLEY: Yeah.
10 MR. CANARY: Because the call center
11 employees actually can be an affiliate of the
12 investment provider --
13 MS. DUDLEY: Yes.
14 MR. CANARY: -- or an affiliate of the
15 advice provider to the extent you're talking about
16 referring somebody to the advice provider.
17 MS. DUDLEY: Right.
18 MR. CANARY: In those circumstances, there
19 seems to be a different kind of tension where that
20 call center -- even a compensation structure where
21 they're getting bonuses or other compensation based on
22 the number of referrals or other measures, you could
23 end up with a conflict being built into that
24 relationship. No?
25 MS. DUDLEY: You could, but go ahead. You

1 were going to ask.

2 MR. CANARY: And I suppose -- I was

3 listening to some of the comments and again there is

4 there a sense you focus on what constitutes a fee,

5 where the call center employee is not being paid in a

6 conflicted space?

7 MS. DUDLEY: I think that's possible. A lot

8 of call center employees are not specific to a

9 particular plan. There's some flexibility as to who's

10 answering the phone. I think there is some clarity

11 that you can add around additional compensation, you

12 know, over what they get paid as salary, but I also

13 think you all need to maybe take a look at the kinds

14 of questions, and we can share some of those with you,

15 but I think there is some need to kind of make sure

16 that it's clear that the line -- that people are not

17 crossing the line when they're helping people frame

18 the question or when they're talking about an age-

19 appropriate target date fund, or, you know, in some

20 cases, somebody may notice, a call center employee may

21 notice that a person has split their, you know

22 investments into multiple target date funds that have

23 nothing to do with what they ought to be in, and, you

24 know, calling their attention to taking a look at

25 that, that's not really investment advice. It's

1 helpful information that they need to go back and
2 follow up on. It engages them, but it's not advice.
3 MR. CANARY: Okay. Thank you.
4 Mr. Jones, I think the last panel, there was
5 an observation that if there was a need to move
6 someone from a brokerage account into an advisory
7 account that that would inevitably result in doubling
8 the fees, and the example was given of a laddered bond
9 investment portfolio. Can you give your reactions to
10 that?
11 MR. JONES: Sure. I think there have been a
12 number of assertions that somehow a fee-based account
13 is inherently more expensive than a brokerage account,
14 and there is certainly -- you can come up with
15 examples where that might be true, but there are a
16 wide range of ways that nonconflicted advice or
17 unconflicted advice is charged for. It's charged for
18 by the hour in some cases for fixed fees, in some
19 cases it's for asset-based fees. It's certainly not
20 always 100 basis points or 150 basis points. There
21 are a number of vendors, ourselves included, that have
22 fees that are quite a bit lower than that.
23 With respect to something like a bond
24 ladder, obviously if the individual is able to
25 construct the ladder and maintain it on their own,

1 there's no need for an advisory fee at all in that
2 circumstance. They could simply open a brokerage
3 account and do it themselves. To the extent that they
4 need more hand-holding to understand how to set that
5 process up, that might be a fixed-fee type of contract
6 up front. It might be an advisory fee on some sort of
7 periodic basis.
8 So we would categorically reject the notion
9 that the commission-based sort of conflicted advice
10 model is somehow always cheaper than the unconflicted
11 model. We certainly don't think that's true.
12 MR. CANARY: Thank you.
13 Mr. Tarbell, one question for you is so we
14 adjusted the definition provision on valuation from
15 the 2010 proposal to the current to make it clear that
16 the valuation information has to be in connection with
17 a specific transaction, and we also broadened out some
18 of the sort of carve-out provisions where valuation
19 information to an investment funds in which plans
20 invest would not be covered by the rule.
21 With the ESOP exclusion, can you help me?
22 What are the main classes of investments that are
23 still of concern to you where the rule would make the
24 valuator potentially a fiduciary?
25 MR. TARBELL: I think one example might be

1 sponsor or company stock held by a 401(k) plan or
2 another -- I don't think it's realistic that it's in
3 an IRA, but that theoretically could happen.
4 MR. CANARY: Okay. So stop on the 401(k)
5 for a second.
6 MR. TARBELL: Yes.
7 MR. CANARY: So where is the specific
8 transaction where that valuation of the 401(k)
9 employer securities would meet the definitional
10 provision?
11 MR. TARBELL: The day that the 401(k) bought
12 the stock or the day that the 401(k) sells the stock.
13 MR. CANARY: But it's the valuation for that
14 purpose, or is it just a valuation that's provided for
15 the plan which that information is then used or
16 potentially could be used in connection with
17 particular transactions?
18 MR. TARBELL: Well, I mean, if your question
19 is -- let's back up. The 401(k) had to buy the stock
20 at some point, and when it bought the stock, let's
21 assume that the fiduciary of the 401(k) sought a
22 fairness opinion or at a minimum sought a valuation.
23 My reading of the rule is that that valuation or
24 fairness opinion would qualify for fiduciary status.
25 MR. CANARY: Okay.

1 MR. TARBELL: And here's the example of the
2 inherent silliness of that, is that if -- let's say
3 that you have a 401(k) that buys 1,000 shares of that
4 company's stock, and that transaction would qualify
5 the appraiser for fiduciary status. But if in the
6 same company an ESOP bought the same 1,000 shares, it
7 wouldn't qualify for fiduciary status, but it's the
8 exact same question. In each case, the question is
9 what is the fair market value of the stock that the
10 qualified -- ERISA plan is buying. Why should those
11 two transactions which are asking the appraiser the
12 exact same question be subject to different standards?
13 I mean, it's almost as if you expect the
14 values to be different in those two situations, and
15 there's absolutely no reason they should be. So, if
16 not different values, why different standards?
17 MR. CANARY: So can you give me -- what's an
18 example other than an employer's security where you'd
19 be concerned about the scope of the rule reaching
20 valuations that are provided in connection with
21 specific transactions?
22 MR. TARBELL: I am a business appraiser, so
23 I can't say that it would affect me in any other
24 aspect than securities, but I think from an ASA
25 perspective, you know, we cover real estate, personal

1 property, machinery and equipment. The real estate
2 would seem to me to be the most likely example of an
3 asset that could be acquired by an ERISA plan.
4 MR. CANARY: Thank you.
5 MR. HAUSER: You're overarching our classes;
6 just that if we're going to look at appraisals we do
7 it entirely separately from this project.
8 MR. TARBELL: Did you say ovearching or -- I
9 heard overreaching, but I think -- you said
10 overarching.
11 (Laughter.)
12 MR. HAUSER: I would not and I did not bring
13 that to the question.
14 (Laughter.)
15 MR. TARBELL: Well, the idea is this.
16 Ninety-nine percent of appraisals for ERISA plans are
17 going to be employer stock held in ESOPs. And your
18 plan to address those separately, and I'm making this
19 up now, but in some form of maybe replacing the '88
20 proposed reg with a new reg on --
21 MR. HAUSER: Adequate consideration reg,
22 yeah.
23 MR. TARBELL: Awesome plan. That plan is,
24 if good for 99 percent, why not good for 100?
25 MR. HAUSER: So you want it to be just

1 completely awesome.

2 (Laughter.)

3 MR. TARBELL: Absolutely right, but it seems

4 to me that whatever form that alternative idea

5 takes --

6 MR. HAUSER: Yes.

7 MR. TARBELL: -- place in, maybe the

8 preamble to that should just say this is fair -- this

9 concerns adequate consideration (fair market value)

10 for any asset acquired by any ERISA plan, and then if

11 we have solid rules, the DOL to me it seems like then

12 has a cause to go after appraisers if they violate

13 that reg, but we're still not fiduciaries and we're

14 all happy because you have a cause and rules that we

15 can be held to, and we're happy because we have

16 defined rules finally of what to be held to, but we

17 don't take that gigantic step of being fiduciaries,

18 which we don't feel we are.

19 MR. HAUSER: Okay. I understand your view.

20 Thank you very much.

21 MR. TARBELL: Thank you.

22 (Panel switch.)

23 MR. HAUSER: Good morning. So, if we're

24 doing this in alphabetical order, Mr. Goldberg?

25 MR. GOLDBERG: Oh, I'm first?

1 MR. HAUSER: Am I right? Makes no
2 difference to me. Makes no difference.
3 MR. GRADY: We could say ADISA before IPA.
4 How about we try that?
5 MR. HAUSER: There you go.
6 MR. GOLDBERG: Yeah. There you go,
7 alphabetically.
8 MR. GRADY: Good morning, and thank you for
9 taking the time to really put so much energy and
10 effort into these hearings. We appreciate it, B&C
11 appreciates it, and your stamina is remarkable. I can
12 note.
13 My name is John Grady. I'm the Chief Risk
14 and Strategy Officer for RCS Capital, but I'm here
15 today on behalf of ADISA, which is the acronym for the
16 Alternative and Direct Investment Securities
17 Association, an association with roughly 4,000 members
18 who focus primarily on the creation, management,
19 distribution and servicing of alternative investments,
20 many of which are what we'll call non-listed or non-
21 traded. My colleague, Mark Goldberg, on behalf of the
22 IPI -- IPA, excuse me, and I are going to talk about
23 them in more detail, but they are in many cases direct
24 sold and non-traded to distinguish them from other
25 types of investments.

1 So before I get to what we really want to
2 focus on as ADISA I wanted to just echo a few points
3 that we put into our comment letter that we think are
4 important to reiterate in this context.
5 I think I would start with the idea that the
6 hearings and the proposal itself are based on the
7 concept of conflicted advice. It's all over the
8 proposal, it's in the rationale, and you've had full
9 panels testifying to the concept of conflicted advice
10 and how the rule proposal exemption would function in
11 that context.
12 I think I would just like to take a step
13 back and say that I think it's a difficult and perhaps
14 unfortunate lens through which to look at, at least
15 the community of financial professionals that are
16 being held out as acting with conflict, consider them
17 the independent broker-dealer community for ease of
18 reference. I think that to view everything through
19 the conflict lens, which really comes down to a cost
20 and compensation lens, that's how we're defining
21 conflict, tends to do several things, and I'll just
22 touch on a couple of them and then go back to the
23 alternative products point that I want to focus on.
24 I think first and foremost by emphasizing
25 cost and emphasizing compensation as conflict items it

1 tends to minimize the total relationship involved in a
2 financial services professional's client relationship
3 with his or her and the firm's clients. Those
4 relationships go typically far beyond an IRA or other
5 retirement savings account. They involve everything
6 from advice on taxable monies, savings, insurance,
7 planning, including estate planning and current
8 lifetime planning, and a host of, and as the gentleman
9 from Stifel said, a host of accounts that go well
10 beyond the retirement savings account context.
11 So, in doing so or in focusing on the idea
12 that there's conflicted advice here and focusing on,
13 of course, the accounts that the Department of Labor
14 has special statutory purview of, I think it tends to
15 cause the entire regulatory regime in which the
16 financial professionals we're talking about operate
17 in. In other words, what you're proposing is the
18 creation of regime that would sit side by side but
19 mostly ignore the regulation through FINRA and through
20 the SEC of the industry and of the professionals that
21 work in the industry.
22 So I think that by defining this as
23 emanating from conflict and using that as the lens,
24 and I understand the tools are somewhat limited, we're
25 talking about whether someone is a fiduciary or not,

1 and going back to 2010 and 2011 hearings that was
2 obviously an enormous focus of your proposal then and
3 now, which is to ensure that the right people are
4 picked up by that definition, but that definition is
5 very far-reaching and tends to focus on cost and
6 conflict at the expense of some of the other factors
7 that go into these relationships, which to boil them
8 down you might put under the category of return of
9 result.

10 I don't think that looking solely at cost
11 and compensation is necessarily the only way to look
12 at the availability of that financial model and the
13 desirability and really ultimately the survivability
14 of that model. And because we've put that business
15 model in place and on the table in these discussions,
16 I just want to make two additional points.

17 Many of us have said that we don't see the
18 broker-dealer community adopting the BIC exemption,
19 instead moving away from it. But there are always
20 those who will move toward new regulations and those
21 who I think could be counted on or at least
22 theoretically counted on to adopt whatever that
23 exemption requires.

24 If so, what I would point out is that then
25 you will have, if that exemption holds the way it's

1 been proposed, a very different set of rules
2 applicable to one set of assets or accounts inside a
3 much broader and complicated financial relationship.
4 I don't think that's advisable, particularly
5 if the types of investments that can be sold pursuant
6 to the exemption are limited as the definition of
7 asset provides and as Mark and I want to talk about in
8 a moment.
9 So even if we go forward with the exemption
10 I think there's a problem with respect to differential
11 treatment of retirement saving accounts from the other
12 types of accounts that are typically in the purview of
13 a financial advisory relationship, and then there are
14 those who say they won't do it, that they will
15 effectively abandon the space because they can't serve
16 it or won't serve it, whether it's because of
17 paperwork, cost, viability or otherwise. I think the
18 witnesses who have talked about those factors are
19 truthfully telling you that they would radically
20 rethink whether to serve those clients if those are
21 the rules for doing so.
22 So I think what we have to be careful of is
23 the unintended consequence here of what in the U.K. is
24 being called the advice gap that resulted from
25 effectively disincenting a portion of the financial

1 services industry from serving clients, which can be
2 the abandonment of newer investors with small
3 balances, older investors with small balances, and in
4 general, investors who have lower retirement savings
5 levels.
6 When you named it the best interest contract
7 exemption, I admired your use of the English language,
8 but I hope you would understand that from our
9 perspective the best interests of the investor is
10 advice. I say that because I think, although there
11 are many studies and many different ways of slicing
12 the data you've received, I think folks have shown and
13 I think the industry believes it can be demonstrated
14 objectively that advice helps the outcome, advice
15 helps the result.
16 So I think if we can do anything to achieve
17 the best interest of the investor and retirement saver
18 community it would be to augment or to build out to
19 the greatest extent possible the access to advice, and
20 to call it conflicted and leave the analysis there I
21 think underserves the issue and potentially has
22 unforeseen consequences that I just don't know are in
23 the best interests of either the retirement saver
24 community or the American saving public generally.
25 With that, and Mark's going to talk in more

1 detail about our products, on the assumption that
2 there is an exemption and that broker-dealer firms
3 would have to comply with the best interest contract
4 exemption to transact or recommend to their clients
5 products that have variable compensation arrangements,
6 there's a definition of asset that at the proposal
7 level excludes many of the types of products that
8 ADISA members distribute, manage, sponsor, and
9 service.
10 These are, as I said, non-traded. They are
11 typically investments more in assets than in
12 securities, so they might be investments in real
13 estate, in the case of non-traded REITs or non-listed
14 REITs, business development companies which are
15 effectively lending vehicles that have grown in place
16 of the banks' withdrawal from the middle market
17 lending, as well as oil and gas programs, 1031s, DSTs,
18 private funds, there's a host of products and
19 descriptions, I would say all of which would be
20 excluded by the definition as proposed.
21 I think that we can all read in and infer
22 from the language in the release that the basis for
23 that exclusion would be lack of liquidity, lack of
24 transparency, and/or lack of marketability, and it is
25 true that those are factors in the construction of

1 these products. It's also the case that these are
2 factors in their attractiveness inside the regime of
3 an overall advisory account or advice program.
4 So what we want to basically reiterate is
5 that there's been a great deal of financial
6 inventiveness and we are one of the world leaders in
7 creating products that work to serve the needs of
8 investors. If we use a list-based approach to
9 identifying what is and what is not appropriate for
10 retirement investors, I think we run the risk of not
11 keeping up with innovation and of actually cutting off
12 retirement savers from products that could work to
13 their ultimate advantage as savers and as investors.
14 I'll stop there.
15 MR. GOLDBERG: I'm pleased to represent the
16 investment program association and it's good to see
17 you again. John and I didn't quite coordinate as much
18 as you might think, although it was interesting to
19 hear his comments. We would firstly like to thank the
20 Department for reviewing our submission, it was long,
21 had a long appendix to it, and for our meeting on
22 June 4 that went quite long. We appreciate your
23 willingness to listen and to get to a final rule that
24 is workable.
25 Our focus of our commentary relates very

1 narrowly to the best interest contract exemption. Our
2 concern is twofold: first, the Department -- the way
3 it's currently written seems to deviate from
4 principal-based approach with the use of a list; and
5 second, the definition of assets is narrowly defined
6 and precludes access to investments that we think
7 otherwise fit under the Department's definition of
8 common investments.
9 Until the early 1940s many states required
10 trustees to select investments from a statutory list
11 and purportedly safe investments. Periodic economic
12 crises and market corrections have demonstrated that
13 virtually no investment is immune from risk and that
14 even the safest investments can experience steep and
15 permanent declines in value. The use of legal lists
16 reflect a since discredited assumption that past
17 performance reliably predicts risk, and strict use of
18 lists will fail to adapt to changing economic and
19 business conditions.
20 The drafters of the Restatement of Trust
21 concluded that knowledge, practices and experience in
22 the modern investment world have demonstrated that
23 arbitrary restrictions on trust investments are
24 unwarranted and often counterproductive. Modern
25 fiduciary investment principles were driven by

1 dissatisfaction with poor investment performance in
2 legal list jurisdictions and by a large body of
3 academic research. ERISA was the first legislation
4 commendably to apply modern portfolio series to a
5 fiduciary investment standards, and I'd like to read
6 an excerpt outlining a particular dissatisfaction.
7 "We do not consider it appropriate to
8 include in regulation any list of investments, classes
9 of investments, or investment techniques that might be
10 permissive under the prudence rule. No such list
11 could possibly be complete and investment reasonably
12 designed as part of a portfolio to the further
13 purposes of a plan that is made upon appropriate
14 consideration surrounding facts and circumstances
15 should not be imprudent."
16 This excerpt is not my words but the
17 Department's words on prudence taken from the preamble
18 to the 1979 regulations, Section 404 of ERISA.
19 Beyond the DOL's own guidance as to the
20 unsuitability of legal lists, the notion of common
21 securities is somewhat problematic. The rulemaking
22 process is lengthy and complex. In this case, it
23 comes about once every 40 years. What is common
24 practice today was unimaginable years ago, and what
25 will be commonplace in five to 10 years is equally

1 unimaginable.
2 By way of illustration, if we were to turn
3 the clock back to 1993, the very first exchange traded
4 fund was established. It would not become common for
5 another decade. Had this law been written at that
6 time, it might have excluded ETFs and also might have
7 inhibited the adoption of this important investment
8 vehicle.
9 The Department suggested that future
10 exemptions can be requested either by a separate PTE
11 or as an addition to the list. Such a procedure is
12 long, expensive, and uncertain. It would also
13 suppress innovation. Assuming common in the market is
14 a requirement for a PTE, how could a new idea arise
15 and become common if it hasn't yet been allowed in
16 retirement accounts, which as you know holds trillions
17 of dollars of investments?
18 A legal list would invariably fall behind in
19 ever-changing market conditions and fail to keep pace
20 with advances in products and portfolio construction
21 theory. As we understand it, it was not the
22 Department's intention to pick winners and losers, but
23 that is exactly what a legal list does. We encourage
24 the Department to reconsider using the methodology
25 previously discredited by the Department itself and

1 the single most respected secondary source, the
2 Restatement of Trust published by the American Law
3 Institute, which brings me to my second point.
4 If the Department generates a list with
5 common securities as its core principle, then the list
6 must be fully inclusive as possible. Millions of
7 Americans already hold public products in their IRA
8 accounts. These investments typically offer
9 individual investors access to a variety of asset
10 classes with different correlations, including
11 publicly-registered non-listed REITs, business
12 development companies, as well as other direct
13 participation programs.
14 These investments are distinguished by
15 providing income distributions and less on projected
16 growth. They offer the potential to hedge inflation
17 through the ownership of real or indexed -- inflation
18 indexed assets while providing a limited level of
19 liquidity and avoiding exposure to the volatility of
20 traded markets.
21 The IPA believes these products possess
22 attributes that complement retirement investment
23 objectives. In moderation, these portfolio additions
24 can provide asset class diversification, incremental
25 portfolio diversity beyond traded securities, and

1 within the broad context of the definition of prudence
2 these products would have to be included as options
3 for an appropriate investor. The duties of prudence
4 and loyalty are sufficiently robust to protect retail
5 investors regardless of the product type.
6 The Department may ask if an allocation to
7 real estate is needed why not simply construct a
8 portfolio using exchange traded REITs? We believe it
9 prudent to employ both exchange traded REITs as well
10 as non-exchange listed funds. Major institution
11 pension plans have historically done so through direct
12 ownership of real estate and non-exchange traded
13 funds, a strategy that helps insulate portfolios from
14 price volatility in the securities markets because
15 while the value of an underlying real estate asset may
16 not change dramatically prices can.
17 For example, the RMZ price index, which is a
18 basket of traded REITs, has experienced large one-day
19 declines ranging as high as 19.7 percent, value swings
20 exceeding 5 percent have occurred once on average
21 every 20 days in the past 10 years. The value of
22 owned real estate held by these entities hasn't
23 changed nearly 20 percent in a day or even 5 percent a
24 day. What changed is the price of that security that
25 it represents as a proxy.

1 The difference between price and value is
2 representative of the volatility of liquid markets.
3 Changes in perceived values at the Federal Reserve,
4 rumors about China, Greece, or the price of oil can
5 impact market prices as money flows into and out of
6 the market even if the underlying fundamental values
7 have not changed. Fluctuations in price tend to
8 induce retail investors to sell in declining markets,
9 purchase in rising ones. This is exemplified by the
10 Morningstar Investor Return Matrix.
11 Such volatility in our opinion is a tradeoff
12 for the benefit of optimal liquidity. While generally
13 positioned as long-term investments, the public
14 products we represent are often structured to provide
15 opportunities to obtain liquidity through redemptions,
16 tender offer of shares, which is determined by an
17 independent third party based on the value of assets.
18 This in turn ensures price received is equal or close
19 to value of assets irrespective of a good or bad day
20 in the traded market.
21 Although limited liquidity of these products
22 is not equal to market liquidity, realizing value that
23 is not tied to systemic market movements is indeed an
24 advantage, particularly as one contemplates portfolio
25 construction to the client's best interest. We want

1 to ensure the Department has a full understanding of
2 our products as currently structured and registered
3 and regulated as they have changed from earlier
4 generations of these non-listed products.
5 Non-listed products have evolved to in
6 accordance with recent rulemaking provide even higher
7 standards of transparency. They require annual
8 independent valuations for BDCs that takes place
9 quarterly. They have shorter life cycles. They have
10 enhanced governance and independent director approval
11 of all sensitive corporate actions.
12 Unlike traded public -- unlike traded
13 securities public products do not benefit from the
14 federal pre-exemption. They therefore not only
15 require SEC registration and review and distribution
16 oversight by FINRA but individual state-by-state
17 reviews. Forty states require merit reviews. State
18 regulators hold the authority to deny security sale in
19 their state if they are unfair, unjust and
20 inequitable.
21 One minute. State requirements include the
22 qualification of income, minimum net worth
23 concentration limits in the portfolio, and investors
24 must acknowledge receipt of a prospectus five days
25 prior to a purchase, the initial amount of time to

1 review disclosures. Each of these items is further
2 vetted by compliance personnel at respective broker-
3 dealer firms. This subscription process is evidence
4 of the level of protection afforded investors in these
5 products and go well beyond what is inherent in an
6 instantaneous purchase that can be made of traded
7 securities which are exempted from these protections
8 by statute.
9 In short, one, these are common investments
10 for retail investors; two, they have superior
11 disclosures and protections within the existing
12 regulatory regime; three, they offer critical benefits
13 for building portfolios that reflect the tenets of
14 modern theory. In summary, we believe the BIC
15 exemption should be principal-based. Standards of
16 prudence and duty and loyalty are currently provided
17 in the exemption and not limited to a list of
18 securities, and if not, the legal list of securities
19 needs to be more complete so that investors can
20 benefit from diversification and choice. Thank you.
21 MR. KASWELL: Okay. Good morning. Managed
22 Funds Association appreciates the opportunity to
23 testify at the Department's conflict of interest
24 hearing. My name is Stuart Kaswell, and I'm general
25 counsel of MFA. My colleague, Ben Allensworth, is

1 with me today as well.

2 MFA represents the global alternative
3 investment industry and its investors. MFA strongly
4 supports the Department's goal of protecting benefit
5 plans and their participants. We recognize that
6 imposing fiduciary status on certain service providers
7 to plans can further that goal. We appreciate the
8 Department's determination that valuations provided to
9 collective investment vehicles do not create an ERISA
10 fiduciary relationship. We also appreciate the
11 Department's efforts to exclude sales activity to
12 sophisticated plan investors from being deemed
13 providing investment advice.

14 We believe a tailoring of the proposal is
15 needed to achieve these two objectives. Absent
16 changes, we believe that the proposal could impair the
17 ability of sophisticated retirement plan investors to
18 invest in hedge funds and other private funds.

19 Before discussing the specific concerns
20 about the proposal I'd like to discuss the value that
21 hedge funds provide to sophisticated retirement plan
22 investors. The addition of hedge funds to a
23 retirement plan's portfolio may provide
24 diversification, risk management, and returns that are
25 not correlated to traditional markets. These benefits

1 help retirement plans meet their obligations to plan
2 participants and help sophisticated IRA holders
3 achieve their financial goals.
4 It's also important to note that securities
5 laws subject hedge fund managers to comprehensive
6 regulation and that investment advisors are
7 fiduciaries to their clients, though not necessarily
8 ERISA fiduciaries. Of course, we understand that
9 ERISA regulation of fiduciaries is not identical to
10 regulation under the Investment Advisors Act.
11 We note that hedge funds generally may not
12 be sold to the general public or retail investors and
13 are usually offered only to accredited investors or
14 qualified purchasers. These are investors who are
15 deemed to have sufficient sophistication and ability
16 to absorb the risks associated with making such
17 investments.
18 In light of the existing regulatory
19 frameworks applicable to private fund managers, we
20 believe that the policy concerns about gaps in the
21 protection of plan investors, particularly retail
22 investors, are not applicable to private funds.
23 When considering the application of ERISA to
24 hedge funds, we believe it is important to focus on
25 the manager's investment decisionmaking on behalf of

1 the fund. Accordingly, the investment advisor to a
2 plan asset fund is a fiduciary under ERISA with
3 respect to the investment management decisions that
4 the advisor makes on behalf of the fund, including
5 funds of one owned by a benefit plan. We believe that
6 expanding fiduciary status to cover ancillary
7 activities does not provide additional protections to
8 plan investors. In fact, such a change could
9 inadvertently harm those investors.
10 I'd now like to address two areas of concern
11 with the proposal: first, statements of value, and
12 second, marketing issues.
13 First, MFA supports the Department's
14 proposal to exclude from the scope of the rule
15 statements of value and appraisals that are provided
16 to collective investment vehicles. We are concerned,
17 however, that it is not clear whether the pooled fund
18 carve-out would extend to all statements that are
19 provided to all fund investors or that are provided to
20 a specific fund investor.
21 Many funds have service providers, such as
22 administrators and data aggregators, that prepare and
23 disseminate the fund's net asset value in transparency
24 reports to investors with information about the fund's
25 investments and providing verification of asset

1 pricing. Uncertainty regarding the proposal is likely
2 to create a disincentive for fund managers and service
3 providers to disclose routine and relevant information
4 to fund investors. Uncertainty also may make funds
5 unwilling to accept plan investors in the first place.
6 Both outcomes are detrimental to retirement plan
7 investors.
8 We do not believe that managers and service
9 providers are likely to conclude that the current
10 exclusions for communications that are not made in
11 connection with a specific transaction or that are
12 required by law apply to the range of communications
13 typically provided to fund investors. As such, a
14 manager or a service provider to a non-plan asset fund
15 risks being considered a fiduciary in connection with
16 routine statements made to a plan investor even though
17 the manager is not an ERISA fiduciary with respect to
18 its investment management decisions.
19 We respectfully submit that imposing
20 fiduciary status on managers and service providers to
21 non-plan asset funds is inconsistent with ERISA.
22 Moreover, we don't believe that restricting the flow
23 of information helps investors.
24 We note that the pooled fund carve-out does
25 not take into account a fund of one, a structure that

1 many larger plans use. Excluding funds of one could
2 result in less information being available to
3 investors in funds of one, interfering with the
4 structures adopted by plan fiduciaries to prudently
5 make and monitor plan investments.
6 To address these issues, we recommend that
7 the Department revise the proposal to permit fund
8 managers and service providers to communicate directly
9 with plan investors by providing information relevant
10 to their investment in the fund and responding to
11 investor questions without creating fiduciary
12 obligations.
13 We urge the Department either to clarify
14 that such communications are not considered in
15 connection with a specific transaction regardless of
16 what use the plan investor may make of them or to
17 amend the pooled fund carve-out expressly to include
18 communications to plan investors in investment funds,
19 including funds of one.
20 It's important to remember that even under
21 this proposed approach the securities laws would still
22 protect plan investors from inaccurate or misleading
23 information. We again note that fund managers to
24 investment funds that are deemed to hold plan assets
25 under ERISA are ERISA fiduciaries with respect to the

1 investment advice they provide to the investment fund,
2 including funds of one.
3 The second principal area of concern is the
4 marketing and selling of hedge funds to retirement
5 plans, which we believe should not be deemed fiduciary
6 in nature. MFA believes that asset managers should be
7 able to market their products and services to plan
8 investors without being deemed an ERISA fiduciary with
9 respect to that marketing activity. When a manager or
10 placement agent is marketing a private fund, they are
11 not making a recommendation to potential investors,
12 nor are they in a position to make a fiduciary
13 determination regarding whether the potential investor
14 should invest in the fund being marketed.
15 The Department has long recognized the
16 distinction between communications that are intended
17 to sell a product or service and communications that
18 constitute investment advice. The Department's
19 existing guidance demonstrates that a fiduciary does
20 not engage in a prohibited transaction when it acts on
21 its own behalf to propose that a plan buy an
22 additional service or product from the fiduciary for
23 additional compensation.
24 We are concerned that the proposal could
25 cause the sales activities of all persons who sell or

1 market interest in funds to be a fiduciary. Absent
2 revision, the proposal will make it difficult or
3 impossible to market private funds to plan investors.
4 MFA respectfully requests that the Department amend
5 the proposal to make clear that a fund manager is not
6 acting as an ERISA fiduciary when it markets its
7 private funds to a retirement plan.
8 Alternatively, the Department could revise
9 the seller's carve-out to permit fund managers to
10 market investment products to retirement plan
11 investors without acting as fiduciaries in connection
12 with their marketing activities. MFA urges the
13 Department to make the following amendments to the
14 seller's carve-out:
15 First, remove the condition requiring a
16 minimum number of plan participants which we do not
17 believe is a good proxy for sophistication.
18 Two, clarify that the restriction on
19 receiving a fee in connection with a transaction does
20 not apply to the receipt by a manager or its
21 affiliates of an asset management or performance fee
22 or allocation from a fund.
23 Three, confirm the condition that the
24 independent plan fiduciary have $100 million in
25 employee benefit plan assets under management to

1 existing law, namely, the QPAM exemption, which
2 requires $85 million in assets under management.
3 And four, apply the seller's carve-out to
4 marketing and sales to all retirement plan investors
5 eligible to invest in private funds so as not to
6 exclude to plan asset funds IRAs and other eligible
7 retirement plans.
8 Finally, I want to talk about the BIC
9 contract exemption. Further revisions to the proposal
10 also are needed to permit an advisor to use placement
11 agents or other third-party salespersons that are
12 compensated in connection with the sale of an interest
13 in a private fund. Although the proposed BIC
14 exemption permits salespersons to receive commissions
15 in connection with sales of certain investment
16 products, the exemption only applies to a limited
17 universe of investment products defined as assets,
18 which we believe is too restrictive. It does not
19 include private funds.
20 Because private funds are not sold to retail
21 investors, revising the definition of asset in the BIC
22 exemption to include privately offered funds would not
23 permit retail investors to purchase such investments.
24 It would allow plans and IRAs that are already
25 eligible to invest in private funds to continue to

1 meet their financial goals by purchasing interest in
2 such funds and benefit from the conditions of the BIC
3 exemption.
4 MFA appreciates the opportunity to testify
5 and we appreciate your considering our views carefully
6 and would be happy to try to answer your questions.
7 Thank you.
8 MR. HAUSER: Thank you.
9 MS. MARES: So, Mr. Goldberg, maybe I'll
10 start with a few questions for you.
11 MR. GOLDBERG: Sure.
12 MS. MARES: I certainly appreciate the
13 diversity of investments that real estate and business
14 development corporations, oil and gas can in fact
15 bring, and I think our intent when we provided a list
16 of assets was to -- and by our calculation, it covers
17 96 percent of the assets that are held in IRAs, so I
18 recognize that this is a minority of the ownership but
19 very important to you.
20 MR. GOLDBERG: Okay.
21 MS. MARES: So I wonder if you could just
22 walk us through a typical non-traded REIT in terms of
23 what its structure is, how investors get visibility
24 into the assets, how the assets are valued and
25 managed, and the different oversight of the fees in

1 that process just so we can understand what's inside
2 it.
3 MR. GOLDBERG: Well, that probably would
4 take about a half-hour, so I'll give it topically.
5 Part of that was in our submission and we're certainly
6 willing to follow up with greater detail.
7 As I noted in the comments, first of all,
8 there's the traditional SEC review. These are
9 publicly registered vehicles, so they conform to all
10 the public registrations that are required in reviews
11 and disclosures on an ongoing basis.
12 Before they're deemed defective and after
13 they're deemed defective they file the 10-Q, the 8-K,
14 and all the formalities associated with all public
15 products themselves. So the transparency into those
16 products are the same as they might be in any SEC
17 registered product or very similar so.
18 When you get beyond that, obviously the
19 governance of the distribution and the sale is by
20 FINRA, and then further to that is the states. So the
21 states undergo, all 50 states, Blue Sky, but there are
22 50 merit states, there are many states that are very
23 active in the review of that. So all the disclosures
24 that investors see, and as I pointed out, somewhat
25 ironically, see, prior with the five-day prospectus

1 rule, is very robust, so all fees are described within
2 the context of those disclosures. They're further
3 guided by the states regarded by the NASA guidelines,
4 which has nothing to do with the space agency. That's
5 the securities administrators, and there are
6 provisions in there in terms of the capping of fees.
7 There are provisions in there with regard to the
8 determination of qualifications for the investment.
9 It goes much further than the traditional
10 traded security sale, so I would say it's rather
11 robust, has improved greatly, particularly over the
12 last five to 10 years, and it's my general impression,
13 speaking somewhat myopically, you know, you're
14 involved in your own business for a while, that the
15 impression externally of these products is much
16 different than the reality of them today.
17 MS. MARES: So given the robustness of all
18 the disclosures, and I brought along a sample of a
19 private placement memorandum. It's 400 pages, this
20 particular one. So there's lots of information in
21 there. Talk a bit then about the kind of investor
22 that can digest all that information and really
23 understand the investment for incorporating it in the
24 portfolio.
25 MR. GOLDBERG: Okay. So is that a public or

1 private placement?

2 MS. MARES: Private.

3 MR. GOLDBERG: Private. So my remarks were
4 directed towards public just as an aside. But the
5 question as to, you know, how they go through it is
6 none of these products, at least any of the ones that
7 I'm aware of, are available directly to the public.
8 You need to go through a financial intermediary in
9 order to purchase them.

10 So the heft associated with these
11 disclosures is such that it almost requires that
12 somebody sit down and explain to a client what's
13 involved, what are the inherent risks, obviously the
14 risks are on the front pages of that document, I'm
15 sure, and the document in terms of providing it to an
16 investor is to me somewhat of a cheat sheet for the
17 investor to ask a lot of good questions that they
18 should, and the regulation that requires its delivery
19 five days before a sale is allowed to be made is just
20 yet a further protection that exists in these products
21 that just does not exist elsewhere.

22 MS. MARES: So let's talk about the
23 conversation between -- so the investor may have this,
24 but you've said really needs to work with an advisor
25 in assessing its suitability for their portfolio.

1 What conditions should the advisor consider in looking
2 at this as part of the portfolio?
3 MR. GOLDBERG: Well, generally speaking,
4 both by statute, in some states by prudence alone, and
5 by regulations through their dealers there are
6 concentration limits that needs -- the liquidity of
7 the individual needs to be taken into account. The
8 concentration within the portfolio needs to take into
9 account, and traditionally these are limited generally
10 speaking to well under 10 percent of a portfolio
11 concentration.
12 So I think the first point of view is the
13 need for diversification and the appropriate nature of
14 something that is far less liquid to be a smaller
15 portion of anybody's portfolio, particularly if you're
16 dealing with the general public.
17 MS. MARES: So would there be minimum
18 investments that someone would need to meet?
19 MR. GOLDBERG: Yes, there are minimum state
20 requirements as to income, as to net worth, and as to
21 liquid net worth.
22 MS. MARES: So could you talk about just an
23 example of what that might be?
24 MR. GOLDBERG: It's $70,000 would be -- each
25 state has their own.

1 MS. MARES: Okay.
2 MR. GOLDBERG: But $70,000 of income,
3 $70,000 liquid net worth or total net worth $250,000.
4 I would add to that that the state securities
5 administrations are currently meeting on that topic to
6 review and reset those standards.
7 MS. MARES: So we've heard a lot of data on
8 what typical IRA accounts are, and the $250,000 is
9 well in excess of the typical IRA account.
10 MR. GOLDBERG: Yeah.
11 MS. MARES: So these investments, as I'm
12 hearing you discuss it, are for a select portion of
13 IRA investors, would that be correct?
14 MR. GOLDBERG: Oh, gosh, yes, that would be
15 correct.
16 MS. MARES: And so, if we were to consider
17 including them -- I know you don't like the legal list
18 environment, but if we were to consider including
19 them, what kind of parameters would you think would be
20 reasonable for their inclusion?
21 MR. GOLDBERG: Well, certainly the general
22 parameters of prudence and loyalty. I paid close
23 attention both through the webcast, which we
24 appreciate you making available, and some of the
25 commentary that I've heard directly about the issue of

1 conflict and compensation. As I shared at the meeting
2 on June 4, we don't have an issue with that in terms
3 of the conflict and how people are paid.
4 Whether or not people should be paid within
5 the context of a commission or a fiduciary or as a
6 fee, they should pay the right amount and it shouldn't
7 be determined whether or not it took the form of a
8 commission or a fee, fee for service or fee on assets.
9 So we have no issue with coming up with a contextual
10 way within the BIC exemption to equalize that.
11 So, to remove that concept of conflict
12 around the consideration for the financial
13 intermediary, I think some thought needs to be given
14 to how that is accomplished and defined because once
15 you remove the conflicts associated with that
16 compensation a lot of the issues that surround
17 providing an exception or exemption I think will go
18 away or I hope will go away I should say.
19 So, if I were to think about productively
20 trying to make a suggestion associated with, you know,
21 buttressing that exemption, it would be to address the
22 core conflict, which is the compensation, and not to
23 suggest one's better than the other, but to equalize
24 them in some manner, shape or form because these are,
25 as I said before, long duration, limited liquidity,

1 they don't belong in substantial portion in anybody's
2 account, whether it's a brokerage account or an IRA,
3 but within a certain context they do belong and they
4 do provide diversity and they do provide the
5 correlation that people are looking for, and we'd
6 certainly, you know, be anxious just to work on some
7 of those things.
8 MS. MARES: Thank you. I have just a couple
9 more questions. You talked about liquidity that came
10 through redemptions. Could you talk a minute about
11 how the valuation is done? And I understand that
12 there can be discounts, at redemption there are
13 discounts to that valuation price. Can you talk about
14 how the valuation gets established and why there would
15 be discounts?
16 MR. GOLDBERG: Yeah, sure. So there are
17 certain parts of it that are uniform.
18 MS. MARES: Okay.
19 MR. GOLDBERG: There are certain parts that
20 are becoming more uniform by regulation, recent
21 regulation, and let me try to summarize that really
22 quickly.
23 So what is required under the rule that was
24 adopted under 23-10, which is a FINRA rule, is that an
25 independent valuation needs to be conducted and it

1 needs to be conducted with the valuation from
2 assistance with a third party, and it needs to be
3 confirmed by the independent board of directors. So
4 it's an issue in a fiduciary type capacity of that
5 valuation.
6 So, when one goes to redeem shares or
7 they're tendered for, they're under two formats within
8 the SEC, you can either redeem shares through the
9 sponsor or they can tender for those shares. They're
10 generally done quarterly. Depending on which product
11 we're talking about it ranges somewhere between 5 and
12 20 percent of the outstanding shares on an annual
13 basis. And the tendering of the shares take place
14 quarterly. They notify that you want to tender their
15 shares or are opting to have your shares redeemed, and
16 they're redeemed in net asset value for some funds.
17 Some funds have some discounts associated with them.
18 I think the average discount would probably range
19 somewhere 3 to 4 percent or maybe a little bit higher
20 in the early stages of the fund.
21 If you were holding to liquidity or the
22 stated liquidity of the fund, there would be no
23 discount to NAV typically.
24 MS. MARES: I think I'll stop for now and
25 let others ask questions.

1 MR. CANARY: Maybe just a little. I'm
2 trying to get a handle on scope. We have the seller's
3 carve-out which would deal with your large money
4 managers and assuming there are some changes made on
5 the dollar threshold for that and large plans on one
6 level. And we also have the rule which says you have
7 to be giving a communication it's a recommendation.
8 So struggling with two points a little bit.
9 One, so what's the market that you're
10 focused on that isn't covered by the seller's
11 exception that is going to be you think an appropriate
12 investor for your products? That's question one, so
13 you can start with that.
14 MR. GRADY: Okay. I don't believe that
15 we're necessarily focused on the seller's exemption in
16 our comments. I mean, I think it was part and parcel
17 of Mr. Kaswell's remarks, but from --
18 MR. CANARY: Mr. Kaswell, you can start
19 then.
20 MR. KASWELL: Okay. Sorry, I wasn't sure I
21 was on the right -- one of the concerns about the
22 seller's exemption we have is if you provide -- there
23 are two things we're really focused on. First is if
24 you provide information that is like providing NAV,
25 we're concerned that that triggers the fiduciary

1 standard. We think that's problematic because an
2 investor is looking for what's the NAV of the fund.
3 And if you answer that, which may involve some
4 judgment calls, that can then trigger --
5 MR. CANARY: Okay. So we're talking about
6 there's the valuation provision where as it's drafted
7 they're talking about providing that information to
8 the fund manager rather than the investors in the
9 fund, and you're concerned that there's going to be
10 circumstances where you, not the fund manager, are
11 going to be providing information to the investors
12 regarding valuation which then would not be covered by
13 that carve-out.
14 MR. KASWELL: The fund manager will be
15 providing information to the fund, but the fund is
16 just, it's an entity. So the question is if it
17 provides that information to investors in the fund or
18 to potential investors in the fund, is that covered by
19 the --
20 MR. CANARY: So this would be not the
21 valuation information going to the fund, but now the
22 fund has that and you're providing communications to
23 your investors, and that's what you're concerned
24 about?
25 MR. KASWELL: Yes, in a sense. It's the

1 manager who's going to do the calculations. It's not
2 some -- you know, I mean, they may use third parties
3 to help them prepare that.
4 MR. CANARY: And when you cross over to the
5 definition, that information has to be in connection
6 with a specific --
7 MR. KASWELL: That's right.
8 MR. CANARY: -- transaction or
9 recommendation. You're saying those two you think are
10 not especially clear.
11 MR. KASWELL: And the net effect is people
12 being cautious, who will say sorry, I can't give it to
13 you.
14 MR. CANARY: Okay. So let's go to the
15 seller's exception for a second. So what's the
16 investing population that you want to be covered by
17 the seller's exception that are not covered now?
18 MR. KASWELL: Okay. We want the seller's
19 exception to cover -- you know, we have to remember
20 that my constituency are private funds and
21 sophisticated investors and we think those people
22 should be covered, whether it's in a plan, a fund of
23 one, a traditional hedge fund or, you know, in any of
24 those circumstances, if those people were in an IRA,
25 which also can include those investments. And we

1 think that the relationship in that setting is
2 different from the traditional retail investment where
3 you come in and you say well, let's look at your
4 situation, let's make some assessments.
5 We're selling, you know, the hedge fund
6 industry is selling a product in the same way that IBM
7 is selling its shares in secondary offerings. And so
8 it then becomes the obligation of the purchaser to
9 make the assessment, ask lots of questions, which is
10 why you get those kinds of memoranda.
11 And, you know, the idea is that the investor
12 is making those determinations based on its own
13 evaluation, but it's not a sort of here's a product, I
14 have a fiduciary relationship with you because I know
15 who you are, I know how old you are, I know how much
16 money you make, and therefore this is a good product
17 for you. That's just not the dynamic that goes on in
18 the hedge fund business.
19 MR. CANARY: Okay. Maybe I'll just have to
20 review the comment letter a little bit more, because
21 I'm thinking your average participant or beneficiary
22 in a 401(k) plan isn't going to be investing in a
23 hedge fund.
24 MR. KASWELL: That's correct.
25 MR. CANARY: And that it's going to be the

1 institutional investor or a larger plan. I was
2 wondering whether you were concerned about the 100
3 participant plan threshold, you end up with plans with
4 50 participants investing in a hedge fund and that's
5 what you're concerned about, or whether it's an IRA
6 investment market where you potentially could end up
7 with a sophisticated investor and a significant
8 holdings in IRA that would be looking to access hedge
9 fund investments.
10 MR. KASWELL: I mean, the individual
11 investor in the plan has to meet the threshold. If
12 the whole plan meets it, that's not good enough.
13 MR. CANARY: Fair enough. That's why I
14 think you're probably not talking about participants
15 and beneficiaries in a typical 401(k) plan investing
16 in a hedge fund.
17 MR. KASWELL: That's right. When I heard
18 the numbers about the average size, that doesn't get
19 you in the door. And we like it that way because we
20 are not a retail industry. Retain entails tremendous
21 amounts of protections, appropriately so. In the
22 hedge fund industry, you don't get to invest unless
23 you meet those minimum amounts which are significant.
24 MR. KASWELL: All right. Thank you.
25 MR. KASWELL: Thank you.

1 MS. MARES: So, Mr. Kaswell, maybe I can ask
2 you some of the same questions. You talked about
3 sophisticated investors, accredited investors,
4 qualified purchasers. Could you give us the
5 parameters that define that so that we can understand
6 clearly the type of investor that you think meets the
7 standards for the type of product you're talking
8 about?
9 MR. KASWELL: Sure. One of the things to
10 think about is how do we get to these numbers, okay?
11 The history here, in the securities laws, there are
12 public offerings, of course, where the public needs
13 the protection of basically the SEC saying you need to
14 have this information available to you because you
15 probably don't know the right questions to ask and
16 even if you did you wouldn't get your question
17 answered. And so the SEC says we're not going to tell
18 you whether it's good or bad, but we want to make sure
19 that you have the full complete information, okay?
20 That's the public offering, which we all know.
21 The private side, which is, you know, just
22 as old, says for the sophisticated investor you can
23 fend for yourself. You know, pick an easy example.
24 You're Warren Buffett. You have very deep pockets,
25 and that's the first prong of sophistication. And the

1 second is that you can withstand risk. The test is
2 the double sophisticate standard, which doesn't mean
3 you know which wine to order and which fork to use.
4 It means that you have the financial depth and the
5 acumen to be able to ask these questions.
6 The problem with that standard is it's
7 fairly easy to articulate, but in practice it was hard
8 to put into effect. So 30-something years ago the SEC
9 adopted rules and said here are the rules and if you
10 trip over these that means that it's not a perfect
11 proxy for sophistication, but it's a pretty good one.
12 So what's the first one? The first one is
13 under Reg D an accredited investor, so a million
14 dollars in assets, recently excluding residence, and
15 income of $200,000 in each of the two most recent
16 years or joint income with that person's spouse in
17 excess of $300,000. Now that's the bottom rung, okay?
18 But that's probably a 3(c)(1) fund.
19 But for a 3(c)(7) fund, the threshold is
20 higher than that. That's the qualified purchaser
21 standard. It's $5 million in investments for
22 individuals and $25 million for entities such as
23 pension plans.
24 Then there's a third test, the qualified
25 client, and in order to charge a performance fee you

1 have to trip over that. And so that amount is a
2 person whose net worth is at least $2 million or
3 $1 million managed by the advisor.
4 And so where does this all lead you? You
5 know, Dodd-Frank has urged the SEC to take another
6 look at these numbers and we hope they will, but I
7 think one thing that's important to realize is it does
8 have the effect of screening out the average retail
9 investor. You're in the stratosphere basically on a
10 statistical basis.
11 MS. MARES: Thank you.
12 MR. HAUSER: I'm trying to experiment with
13 not asking any questions, so thank you all very much.
14 I appreciate your time.
15 (Panel switch.)
16 MR. HAUSER: Whenever you all are ready.
17 MR. ROBINSON: Do you want to do
18 alphabetical order again? Does that work? Okay with
19 you guys?
20 MR. HAUSER: Okay.
21 MR. ROBINSON: All right. Well, first of
22 all, thank you for the opportunity to on behalf of the
23 Appraisal Institute testify. We are the world's
24 largest association of real estate appraisers. My
25 name is Scott Robinson. I am the 2015 President-

1 Elect. I also have with me today Bill Garber, who is
2 our Director of Government and Industry Relations. We
3 certainly appreciate your tenure in this process and
4 also your attention to all the input that you've been
5 able to get.
6 Real estate appraisals play an important
7 role in protecting pension plans that invest in real
8 estate. Appraisals prepared by designated members of
9 the Appraisal Institute and other valuation
10 professionals are frequently used for financial
11 reporting purposes. Such appraisals are prepared on a
12 quarterly or annual basis with such information
13 frequently included in financial disclosures. We
14 appreciate the consideration that has been given to
15 our input on this type of appraisal service.
16 Another way that pension plans may use
17 appraisals is when deciding whether to purchase or
18 sell assets or when investments are moved into and out
19 of plans. While we agree with the general intent of
20 the proposed rule, we remain deeply concerned that the
21 proposal will unnecessarily increase costs on
22 consumers and users of appraisal services in important
23 buy and sell decisions relative to plan investments.
24 Specifically in its proposed rule the
25 Department has exempted the former from the proposed

1 fiduciary standard but retains the inclusion of the
2 latter, meaning an appraisal firm who does financial
3 reporting of appraisals for a pension plan would not
4 carry a fiduciary responsibility, but one doing
5 appraisals for buy/sell decisions would be considered
6 as a fiduciary.
7 Under the proposed rule, we could also see
8 investors claiming that an appraisal for a loan, say
9 to an LLC that served as the investment vehicle for a
10 401(k) or IRA investments, was in connection with the
11 transaction.
12 The proposed rule as is clearly increases
13 liability on real state appraisers and at the worst
14 time when the profession already faces challenges in
15 attracting the next generation of valuation
16 professionals through overregulation.
17 Our concerns stem primarily from the lack of
18 distinction between appraisals prepared for investment
19 managers and fairness opinions. These two are
20 completely different services with their differences
21 being central to questions about responsibilities to
22 plan investors.
23 Specifically, this proposed rule confuses
24 the role of appraisals in buy and selling decisions as
25 the role of fiduciary is maintained by the investment

1 manager, not the appraiser.

2 The investment manager considers the
3 appraisal and compares that with other information,
4 such as offers made on the property, to make
5 determinations in the best interest of the fund. The
6 appraiser does not carry that responsibility or
7 decisionmaking authority and contrary to the proposed
8 rule performs such work in accordance with generally
9 accepted appraisal standards without advocacy to the
10 client or conflict of interest.

11 This mandate is specifically addressed in
12 both the USPAP ethics rule -- Uniform Standards of
13 Professional Appraisal Practice rule -- and the
14 Appraisal Institute's Code of Professional Ethics.

15 Once the appraiser has completed the
16 valuation assignment fairness opinions may then be
17 developed by the investment manager or a third party
18 who holds the fiduciary decision responsibilities
19 regarding the transaction.

20 The current version of the proposed rule
21 mentions appraisals and advice in the same sentence.
22 It is not the role of the appraiser to advise the
23 client. The role of the appraiser is to provide their
24 client with information that can be analyzed for the
25 purposes of use of that asset within the plan.

1 An example of an unintended consequence of
2 this proposal is found within the fact that a key part
3 of any appraisal is identifying the intended use and
4 the intended user of the appraisal. The intended use
5 and intended users gives the appraiser the ability to
6 develop a scope of work appropriate for both.
7 This proposal would create a potential
8 unlimited number of intended users of the appraisal.
9 This casts a wide net of liability onto the appraiser.
10 In contrast, fairness opinions differ vastly
11 from appraisals as they essentially represent the work
12 an investment manager might perform as a third party.
13 Fairness opinions answer a different question than
14 appraisals. While appraisals may provide information
15 to an investment manager or answer whether the value
16 of the property is within a stipulated range or price,
17 it does not answer the question as to whether the
18 price or the terms are fair. Such opinions can be
19 offered by real estate appraisal professionals, but
20 such advice would be beyond an appraisal.
21 This is an important distinction that is
22 currently not found in the proposed rule but is
23 essential to any final rule.
24 We have consulted with professional
25 liability insurance providers to the appraisal

1 profession and such a change will likely compound the
2 difficulty in finding coverage for this type of
3 service or result in increased costs for valuation
4 firms providing these services. Most insurance
5 policies to appraisers exclude ERISA related claims,
6 so coverage is difficult to obtain already.
7 While plans such as those endorsed by the
8 Appraisal Institute do include coverage for this, we
9 expect that the increased liability created by the
10 proposal would have a corresponding effect on those
11 insurance costs.
12 Unfortunately, this will likely cause some
13 to reconsider providing such important services
14 altogether. We believe this is needless and
15 unnecessary as the Department of Labor has still not
16 provided evidence for why appraisers should be covered
17 under the fiduciary definition. To our knowledge, the
18 Department of Labor has not attempted bringing
19 enforcement actions against real estate appraisers and
20 has not explained how the process will be weakened by
21 the lack of fiduciary coverage.
22 Further, the real state appraisal profession
23 has an ever-present regulatory structure where public
24 interests are actively protected. In fact, real
25 estate appraisal is one of the most highly regulated

1 professions in financial services through state
2 licensing and certification and federal oversight just
3 to name a few.
4 Valuation professional organizations such as
5 the Appraisal Institute maintain active ethics and
6 standards enforcement. In contrast, the realm of
7 fairness opinions is less defined and not subject to
8 regulations similar to that seen in the real estate
9 appraisal profession.
10 We urge the Department of Labor to resolve
11 these concerns by undertaking two specific actions in
12 any final rulemaking. First, provide clear
13 definitions for appraisals and fairness opinions; and
14 two, provide an exemption for appraisals prepared for
15 specific transactions involving the acquisition,
16 disposition, or exchange of real estate. Doing these
17 would distinguish fairness opinions, whether provided
18 by appraisers or others, as carrying a fiduciary
19 responsibility, a position that is reasonable given
20 the purpose of the fairness opinion.
21 I want to thank you again for the
22 opportunity to testify. I'd be happy to answer any
23 questions that you may have. And we are offering to
24 provide any assistance as the Department works towards
25 maintaining a higher level of quality in the appraisal

1 product used in this business. Thank you very much.
2 MR. HAUSER: Thank you.
3 MR. NICHOLAS: Go in reverse order?
4 MR. GERBER: Sure.
5 MR. NICHOLAS: All right. Good afternoon.
6 I'm Mike Nicholas, CEO of the Bond Dealers of America.
7 I'd like to thank the Department of Labor and its
8 staff for the opportunity to testify today.
9 The Bond Dealers of America is the only DC-
10 based trade association exclusively representing
11 middle market and regional securities firms and banks
12 active in the U.S. fixed income markets. A core
13 mission of the BDA since our founding in 2008 has been
14 investor education and protection and fostering
15 competitive capital markets that benefit all
16 participants.
17 Through our previous comment letter and
18 today's testimony I'll explain why the BDA does not
19 believe the proposed rule or the associated exemptions
20 represent the right approach for improving the market
21 for retirement investment advice and services.
22 BDA believes the proposal naturally favors
23 an investment advisory business model over a
24 commission-based brokerage model. Therefore, the BDA
25 does not believe the proposal as written is in the

1 best interest of investors because it will reduce
2 investor choice and access to advice. Yet we do
3 believe, as others have testified and commented, that
4 there are more suitable solutions that will achieve
5 the DOL's objectives to create an enforceable
6 standard.
7 To start with, the BDA encourages and
8 supports a harmonized, multi-agency approach in which
9 the DOL and the SEC develop a uniform best interest
10 standard of care. The Department's proposal would
11 create differing standards for care for retirement and
12 non-retirement accounts that would ultimately confuse
13 the overall advisor/investor relationship.
14 As Janney Montgomery Scott states, the
15 proposal will create "three standards of care
16 applicable to investment accounts: one, a FINRA
17 suitability standard; two, a fiduciary standard for
18 advisory accounts operating under the SEC's Investment
19 Advisors Act of 1940; and three, a DOL promulgated
20 ERISA fiduciary standard of care for IRAs. We
21 question whether that outcome makes sense for
22 retirement investors." The BDA agrees.
23 BDA supports a harmonized best interest
24 standard of care for broker-dealers based on the
25 following principles:

1 Disclosure of conflicts. Advisors should
2 disclose material conflicts of interest to investors
3 and obtain acknowledgment and consent of conflicts
4 related to a recommendation.
5 Disclosure of fees. Require firms to
6 develop policies and procedures to govern the clear
7 disclosure of fees.
8 Three, disclosure related to principal
9 transactions. Allow advisors to recommend securities
10 out of inventory only if accompanied by disclosure to
11 the customer of the conflicts associated with
12 principal transactions, rigorous enforcement of the
13 best interest standard of care.
14 Additionally, BDA strongly favors vigorous
15 enforcement of the recommended uniform best interest
16 standard of care so that bad actors are effectively
17 sanctioned and deterred from wrongful conduct and
18 investors have the ability to recover losses due to a
19 violation of the best interest standard.
20 Second, the BDA believes the best interest
21 exemption is not in the best interest of investors for
22 the following reasons:
23 The proposed legal liability associated with
24 the proposed definition of fiduciary and the best
25 interest exemption will make commission-based advisory

1 business economically and legally impossible for
2 broker-dealers. As Raymond James notes in their
3 comment letter, "Given the uncertainty of financial
4 markets, the odds of an alternative perhaps lower fee
5 product outperforming the selected product are quite
6 high. This makes plaintiffs' attorneys cases
7 significantly easier. Our potential legal exposure
8 will increase exponentially if the recommended
9 products cost more than a possible alternative."
10 Additionally, the best interest exemption
11 unnecessarily restricts the assets available to
12 retirement investors. Investors cannot transact in
13 taxable or tax-free municipal bonds under the terms of
14 the exemption and brokers cannot earn commission
15 related to a municipal bond transaction under the
16 terms of the general rule.
17 Ultimately the impact of the best interest
18 exemption is that advisors will feel compelled to
19 either recommend the lowest fee investment no matter
20 what or to shift from brokerage accounts to more
21 expensive fee-based accounts.
22 As Stifel CEO Ron Kruszewski stated, moving
23 non-managed IRAs to Stifel's advisory program would
24 cost those investors in excess of $150 million
25 annually in increased fees.

1 Third, the principal trading exemption
2 explicitly restricts investor asset choice and ignores
3 the existing broker-dealer regulatory regime. The BDA
4 believes that the assets listed in the principal
5 trading exemption are too limited. The exclusion of
6 taxable and tax-free municipal bonds, unit investment
7 trusts, CDs and non-agency mortgage backed securities
8 are especially problematic. BDA believes that
9 advisors should be permitted to recommend securities
10 out of inventory if the advisor discloses the
11 conflicts inherent in principal trading to the
12 investor as part of a harmonized best interest
13 standard of care.
14 Finally, the exemptions requirement to get
15 two comparable quotes for a principal transaction
16 ignores existing best execution standards for which
17 broker-dealers execute transactions at the best price
18 possible given market conditions. The two quote
19 requirement would unnecessarily slow the trading
20 process down and may not result in transactions at the
21 best possible price for investors.
22 The BDA agrees with Wells Fargo's comment
23 letter where they state, "We believe the Department's
24 assumption that it will only take five minutes to get
25 two quotes based on our experience is faulty in many

1 instances and that retirement investors will be harmed
2 if they are forced to wait the duration of time it
3 will take to accumulate the necessary information."
4 BDA believes a uniform, harmonized and
5 rules-based approach based on existing best execution
6 standards is the most logical standard for the
7 Department to follow.
8 In conclusion, the BDA understands the need
9 for the Department to fortify the rules applicable to
10 retirement investors and investment recommendations.
11 However, BDA believes that the Department's approach
12 is not in the best interest of investors, especially
13 investors with fewer resources for retirement savings.
14 As stated above, the BDA urges the
15 Department to act in concert with the SEC in order to
16 best protect all investors by designing a harmonized
17 best interest standard of care and expanding the
18 universe of permissible investments.
19 As FINRA notes, "A best interest standard
20 would align the interests of intermediaries with those
21 of their customers, better protect investors by
22 providing a more consistent set of obligations across
23 financial service providers, help ensure that
24 intermediaries eliminate or manage conflicts of
25 interest, and help ensure that intermediaries

1 establish an ethical culture throughout their firms."
2 The BDA agrees. Thank you again for the
3 opportunity to deliver these remarks.
4 MR. HAUSER: Thank you.
5 MR. GERBER: Good afternoon. My name is
6 Mike Gerber and I'm the Executive Vice President at
7 Franklin Square Capital Partners. We appreciate the
8 opportunity to participate today.
9 Franklin Square shares the Department's
10 goals of increasing retirement savings for all
11 Americans and protecting investors in all retirement
12 settings. We applaud the obvious care and
13 thoughtfulness that went into the preparation of both
14 the proposed conflicts of interest rule and the best
15 interest contract exemption, which today I'll just
16 refer to as the proposed exemption.
17 Today I'll offer a narrow technical change
18 to include non-traded BDCs on the list of eligible
19 assets in the proposed exemption and explain why we
20 believe this change is consistent with the objectives
21 of the Department.
22 Before I get into the details I'd like to
23 spend a few moments telling you about Franklin Square
24 and our funds. Franklin Square was founded in 2007 in
25 Philadelphia. Our mission is to enhance mainstream

1 investors' portfolios by providing access to asset
2 classes, strategies and asset managers typically
3 available only to wealthy individuals and
4 institutional investors, such as university
5 endowments, foundations and public pension plans.
6 We also strive to lead the industry in best
7 practices, transparency, investor protection, and
8 education. To that end we launched the industry's
9 first-ever non-traded business development company or
10 BDC in 2009 which we listed on the New York Stock
11 Exchange in April of last year to provide permanent
12 liquidity for our investors.
13 Today Franklin Square manages four BDCs,
14 both traded and non-traded, and has more BDC assets
15 under management than any other manager in the
16 industry. By way of background, BDCs are a type of
17 closed-end investment company created by Congress
18 under the Investment Company Act of 1940 to enable
19 mainstream investors to invest in and in turn increase
20 the flow of capital to private and small public
21 companies in the United States.
22 At Franklin Square we also manage one closed
23 end registered investment company which is also a 1940
24 Act fund, and we have two additional non-traded BDC
25 funds currently in registration with the SEC.

1 Our investors hail from all 50 states and
2 our funds have portfolio companies in 39 states. Most
3 importantly, our funds have a record of delivering
4 strong risk-adjusted returns for our investors.
5 At Franklin Square we believe our funds
6 embody the principles of the proposed rule and have
7 initiated positive trends in the industry. By
8 offering a combination of strategies and investor
9 protections never before offered to mainstream
10 investors, we disrupted the marketplace and have
11 emerged as a leader.
12 While we are democratizing investing we are
13 also delivering heightened investor protections, best
14 practices, and more robust education. This is at the
15 core of our identity and our business strategy.
16 Nearly 200,000 investors have voted with their feet,
17 choosing our more transparent and investor protected
18 funds over those previously available in the
19 marketplace, such as the non-traded REITs. As a
20 result, we now see competitors launching similar funds
21 emulating some of our heightened investor protections,
22 best practices, and education programs.
23 We believe the Department can accelerate
24 these positive changes we have initiated by including
25 non-traded BDCs on the list of investments defined as

1 assets under the proposed exemption. This can be
2 accomplished simply by replacing the phrase registered
3 investment companies with the phrase investment
4 companies regulated pursuant to the Investment Company
5 Act of 1940 in Section 8(c) of the proposed exemption.
6 A markup to the text of the proposed exemption is
7 provided on pages 1 and 2 of our comment letter.
8 By amending the proposed exemption in this
9 narrow manner only non-traded BDCs would be added to
10 the list of eligible assets and registered investment
11 companies would remain on the list.
12 We believe this change is consistent with
13 the spirit of the proposed rule for two reasons. One
14 reason is that non-traded BDCs are among the most
15 highly regulated and transparent investment vehicles
16 in the marketplace. Like registered investment
17 companies and traded BDCs, both of which are covered
18 by the proposed definition of asset and both of which
19 we manage at Franklin Square, non-traded BDCs register
20 shares under the Securities Act of 1933, elect
21 treatment as a BDC under the 1940 Act, and are subject
22 to the extensive public filing requirements of the
23 Securities Exchange Act of 1934.
24 Beyond this, however, non-traded BDCs must
25 also comply with state Blue Sky laws, meaning they

1 register their offerings under the Securities Acts of
2 each state. Registered investment companies in
3 exchange traded securities like traded BDCs do not.
4 In other words, non-traded BDCs are more heavily
5 regulated than many types of investments already
6 included in the proposed exemption.
7 I would also like to note that at Franklin
8 Square we go above and beyond these statutory
9 requirements with our own best practices which I'd be
10 happy to discuss during our Q&A session as those best
11 practices could be embedded in the proposed exemption
12 to further protect investors.
13 The other reason this change is consistent
14 with the Department's efforts is that non-traded BDCs
15 meet the four criteria set forth in the proposed
16 exemptions preamble.
17 First, as I just discussed, non-traded BDCs
18 are subject to robust disclosure requirements under
19 the federal and state securities laws that
20 collectively provide investors a high level of
21 transparency.
22 Second, non-traded BDCs can be an important
23 part of a well diversified portfolio because they (a)
24 primarily lend to private companies; (b) often deploy
25 capital when other investment vehicles cannot; and (c)

1 have an offering price tied to their net asset value
2 which offers some protection from market volatility.
3 Third, non-traded BDCs have a ready market
4 price established through valuations conducted in
5 accordance with the 1940 Act and publicly disclosed at
6 least quarterly.
7 Finally, while non-traded BDCs are initially
8 less liquid than publicly traded securities, they are
9 designed to provide full liquidity to investors
10 through a permanent liquidity event, such as a listing
11 on a national securities exchange. Additionally, non-
12 traded BDCs provide limited liquidity prior to this
13 permanent event through quarterly tender offers.
14 For the reasons discussed today and in our
15 comment letter Franklin Square respectfully requests
16 the Department include non-traded BDCs as an eligible
17 asset in the proposed exemption. This change would be
18 consistent with the objectives of the proposed rule
19 because non-traded BDCs are among the most highly
20 regulated investments available in the marketplace and
21 because they meet the Department's criteria for
22 inclusion in the proposed exemption.
23 Franklin Square believes that having a
24 robust proposed rule in place coupled with a practical
25 proposed exemption that includes non-traded BDCs will

1 protect investors while allowing them to build well-
2 diversified retirement portfolios. Thank you again
3 for allowing us to participate today and I look
4 forward to answering your questions.
5 MR. HAUSER: Thank you.
6 MR. CAMPAGNA: I just had a couple questions
7 for Mr. Robinson.
8 You talked a lot about the difference
9 between fairness opinions and appraisals and it seemed
10 to be that you are characterizing fairness opinions as
11 those that are considered or put out by the investment
12 manager. Is that the only situation that the idea of
13 a fairness opinion is used where appraisals are
14 presented to an investment manager and they create the
15 fairness opinion? Is that the -- so you asked us to
16 create a definition. Is that -- I'm just trying to
17 get the --
18 MR. ROBINSON: Yeah. And I don't know if
19 this is on -- the difference between the appraisal and
20 the fairness opinion we believe is fundamentally based
21 on the fact that the appraisal is presented as a piece
22 of market value evidence which then whoever is
23 producing that fairness opinion uses in their total
24 decision. Now that does not mean that an appraiser
25 cannot step out of the realm of the appraiser and

1 provide additional services that may step into a realm
2 that puts them in the fiduciary position, but we
3 believe fundamentally that the real estate appraisal
4 as it stands on its own is again a piece of
5 information that the manager or whoever is making that
6 fairness opinion uses in their final decision.
7 MR. CAMPAGNA: Well, it's a very important
8 part of our rule that appraisals are very influential
9 in making these decisions. So how is it different in
10 this particular context where the investment manager
11 is presented with appraisals and makes a decision even
12 though what you characterize as their decision is a
13 fairness opinion? It's still the kind of model we
14 thought of, is that an appraisal presented to a plan
15 fiduciary is a very influential piece of information
16 and that's why.
17 MR. ROBINSON: No doubt, and we certainly
18 believe, you know, the existing rule captures it in
19 some ways and certainly the removal of that in the
20 current proposal we appreciate for the opportunity to
21 have that taken out for reporting for financial
22 reporting on an annual or quarterly basis. But we
23 believe that the appraisals used in transactions again
24 are a piece of stand-alone information that whoever is
25 producing that opinion will then take at face value.

1 They may not. They may order another appraisal.
2 That's the other issue. The fund manager is not in
3 any way prohibited from getting more than one opinion.
4 And again, this is an opinion from a real estate
5 appraiser as to the market value of that property.
6 And as I stated, our ethics rules, both our
7 ethics rules internal to the Appraisal Institute and
8 those set forth by the uniform standards, require
9 independence, require a lack of advocacy or bias, and
10 so we believe that the appraiser is in a unique
11 position to stay out of that realm unless, again, they
12 choose to go into the next area and put themselves in
13 a fiduciary position.
14 MR. CAMPAGNA: Is it often the case that an
15 investment manager will just use one appraisal? What
16 does the --
17 MR. ROBINSON: I can't speak to that
18 because, again, they are using the best information
19 they have. Hopefully they're using appraisers that
20 have a reliable reputation for that property type and
21 that location. Certainly competency is a big issue in
22 the determination of hiring that appraiser, and we
23 believe that it's that independence and that
24 credibility that the fund manager believes in as they
25 gather that piece of information to make a decision

1 for the fund.
2 MR. CAMPAGNA: Just one more question. You
3 mentioned the need for an exemption. Could you
4 describe what the particular prohibited transaction
5 you have in mind would be? You're right, we're
6 talking about an appraisal -- appraiser as a
7 fiduciary.
8 MR. ROBINSON: Right.
9 MR. CAMPAGNA: But what is it exactly that
10 they're doing that would influence their fees or cause
11 themselves to get --
12 MR. ROBINSON: Well, again, it casts a wide
13 net of liability if the intended users go beyond a
14 specific client. In other words, if the client
15 definition includes all the potential investors in
16 that plan, then that casts a net of liability that
17 most appraisers and a lot of the insurance companies
18 would look unfavorably to.
19 We've asked specific questions to this issue
20 to our -- the plan that we endorse and they do say
21 that this would be a wider net of risk. And I think
22 there's also maybe a public misperception about where
23 we are right now. That risk may already be there, but
24 the proposed plan has taken out part of it, and we
25 would like to take out the remaining part of it.

1 MR. HAUSER: Understood. Can I just ask,
2 and this is maybe as much out of curiosity as
3 anything. So, if you're a reasonable investor, what
4 are the circumstances in which you'd want a fairness
5 opinion rather than an appraisal? I mean, why would
6 one ever get anything other than an appraisal?
7 MR. ROBINSON: I guess I don't understand
8 the question because a fund manager would be
9 developing the fairness opinion of the appraisal and
10 it's, again, we believe a small part of the overall
11 decisionmaking process. So would you want an
12 appraiser to say okay, here is the market value and
13 here is what we believe is fair to that investor?
14 Those are two different questions because fairness to
15 the investor may have a significant number of deeper
16 decisions based on the plan's anticipated growth
17 model, whether it's a tax-based plan. There are a
18 number of items that may put that appraisal not
19 necessarily into a clear definition as to the final
20 decision that's made. So fairness goes way beyond the
21 opinion of market value in our opinion.
22 MR. HAUSER: But you would never view the
23 fairness opinion as a substitute in any sense for the
24 appraisal, I mean, if you're looking at a transaction
25 that involves, you know, a non-publicly traded asset I

1 guess. Is that right?
2 MR. ROBINSON: No. We believe that an
3 important part of the fairness opinion is a qualified
4 appraisal on the property, done in a credible manner
5 by someone who understands the market and the
6 property.
7 MR. HAUSER: Yeah, I understand. Thank you.
8 MR. COSBY: I had a question for Mr.
9 Robinson. In your comment letter you had testified
10 that you had talked with insurers in your business and
11 they had indicated to you that there could be
12 increased costs due to these issues that you're
13 talking about. I just wonder if you can elaborate on
14 that and maybe just talk a little bit about the
15 insurance market in your industry.
16 MR. ROBINSON: Yeah. Well, appraisers
17 liability insurance is incredibly difficult to get in
18 a lot of areas already and relative to ERISA-based
19 opportunities it can be even more difficult already.
20 There's a fundamental part of an appraisal
21 where you must identify the intended use and the
22 intended users of the appraisal, and those two things
23 help the appraiser determine a scope of work that
24 answers the questions and meets the needs of both that
25 intended use and of all those intended users. And

1 when you have this inclusion in these particular
2 transactional situations of the appraisal report and
3 the fiduciary position, what you essentially have done
4 is put an unlimited number of potential users out
5 there, which enhances the liability exposure that the
6 appraiser has for the work product he's providing to
7 the plan manager or the developer of the fairness
8 opinion. And that's where the insurance companies
9 latch onto it because the possibility for any kind of
10 litigation or additional liability is expanded
11 dramatically.
12 MR. COSBY: And I had a question for Mr.
13 Robinson -- Mr. Nicholas, I'm sorry. You had
14 mentioned, you talked about policies and procedures
15 that you were in favor of.
16 MR. NICHOLAS: Right.
17 MR. COSBY: And as I understood it, most of
18 those policies and procedures seem to be more or less
19 disclosure-based policies and procedures. And as you
20 know in working on the rule we found a lot of
21 literature that's shown that disclosure is not
22 necessarily effective. So my question was one major
23 purpose of the rule is to try to tamp down on the
24 conflicts of interest, so I was wondering what type of
25 policies and procedures in your experience you think

1 would be effective in doing that.

2 And then I was hoping that you could maybe,

3 you said that your company has effective procedures

4 that have been working, so I was just wondering if you

5 could expand on that as well.

6 MR. NICHOLAS: Sure. Well, I'll start off

7 just by ticking off some of the suggestions we make

8 actually in our comment letter.

9 First is fee disclosure. As part of fee

10 disclosure, you know, specifically ensure the receipt

11 of fees and commissions does not trigger a violation

12 of the best interest standard of care, thereby

13 restricting the flexibility of investors to receive

14 advice and choose from a wide variety of securities

15 that may suit their investment needs or restrict the

16 provision of financial advice in general.

17 Second would be a conflict of interest

18 disclosure as you just highlighted. Requiring

19 disclosure and consent at account opening.

20 Prominently display the conflict disclosure on the

21 website, require disclosure and confirmation of

22 consent annually through company-based web disclosure

23 or at the client's request via delivery of hard copy

24 material.

25 Third is principal transaction disclosure,

1 disclosing the conflicts generally at account opening,
2 referring to the trading, the inherent conflicts of
3 trading out of inventory versus as agent. And
4 disclosing the conflicts of pre-trade by settlement on
5 a principal transaction and require pre-trade consent
6 by the investor. Next is preserve investor choice and
7 last is cost/benefit analysis.
8 MR. COSBY: Yeah. I was more focused on
9 like internal controls. I don't know what type of
10 mechanisms there might be because this is kind of
11 putting the onus on the investor to actually go
12 through the disclosures and figure some of this out.
13 So that's what I was focused on. I don't know, Mr.
14 Gerber, if you had any suggestions in that area.
15 MR. GERBER: Yeah, and obviously slightly
16 different space that we're in, but when I was
17 referring to what I think you were referencing was my
18 reference to our best practices that go above and
19 beyond what's required of us in the '40 Act. That
20 doesn't necessarily touch the relationship between an
21 advisor or broker and an investor. It's germane to
22 how we structure and run our funds, but they do
23 provide further investor protections.
24 So, in our case, there are three best
25 practices that I would highlight that go above and

1 beyond the '40 Act, and one is that while we're not
2 required to, we use third-party valuation firms to
3 value the assets in our portfolios. We believe that
4 just helps investors have greater confidence in the
5 information that we are providing.
6 Also above and beyond the '40 Act we mark
7 every investment in our portfolio every quarter. The
8 '40 Act does not require that. The '40 Act requires
9 that you mark every investment once a year. So the
10 standard practice for BDCs is to mark 25 percent of
11 the portfolio every quarter so you get 100 percent
12 over the course of a year. We do 100 percent every
13 quarter using those third-party valuation firms.
14 And lastly, it's our commitment not to
15 overdistribute, and that's a feature of our funds that
16 we use to distinguish how we manage our funds from
17 those that were in the marketplace before we were,
18 particularly the non-traded REITs. Overdistribution
19 is a fairly common practice with non-traded REITs. We
20 structure our funds so that we don't have to do that.
21 We think it's in the best interest of our investors
22 for obvious reasons not to do that. So those would be
23 the three better practices that I was referencing.
24 MR. COSBY: Okay. Thank you.
25 MR. GERBER: Yes.

1 MS. MARES: So can I follow up on the notion
2 that I appreciate that you mark your portfolio to
3 market every quarter, because I understand that there
4 are provisions to facilitate some liquidity in the
5 portfolio through those quarterly valuations.
6 For those that don't mark, if it's not a
7 requirement to mark to market every quarter and there
8 is this option for quarterly redemptions, what's the
9 risk that the valuation is inaccurate?
10 MR. GERBER: You know, I can't speak to how
11 the other folks run their funds, but we engage in that
12 practice in part because we do think it would result
13 in our achieving a more accurate price at those
14 quarterly redemption periods.
15 So, in our case, and again I can't speak to
16 our competitors, but in our case, we base those
17 redemptions on what we call the POP, the Public
18 Offering Price, and that's tied to the net asset
19 value, and the net asset value obviously is tied to
20 those marks. So we're using third-party firms to help
21 establish those marks. Our independent directors are
22 approving those third-party valuations or at least the
23 process through which the third party and our staff
24 achieve, reach those valuations.
25 And then those valuations contribute to the

1 calculation that we engage in every day to establish
2 net asset value. And then it's based off of that net
3 asset value that we get to the public offering price.
4 So it's a pretty long continuum, if you will, and a
5 lot of steps in there, but we believe that helps us
6 get to a more accurate price. So, when one of our
7 investors does seek to redeem some shares, it's being
8 done at a price that's very closely tied to NAV and is
9 based on that elaborate robust process.
10 MS. MARES: So a previous witness told us
11 that there were traditionally discounts that come at
12 the redemption period to that asset value that you
13 created. Could you describe what your practice is and
14 how you think through that liquidity event?
15 MR. GERBER: Yeah, and if I'm not mistaken,
16 I think that previous witness was talking about non-
17 traded REITs, not about non-traded BDCs. The rules
18 governing the two types of funds are very different,
19 primarily because we're '40 Act and they are not. So
20 I don't want to compare those processes.
21 MS. MARES: Okay.
22 MR. GERBER: We believe ours are far more
23 robust and it's partly how we've marketed ourselves in
24 the marketplace as having more investor protections,
25 more transparency, and part of that does come from the

1 fact that we strike a NAV, a net asset value, every
2 day and that's based on those marks that we establish
3 every quarter and then any fluctuations with our more
4 liquid investments that are in the portfolio. And
5 that way at the end of every week we're able to do an
6 analysis which at the end of every week is when we
7 clear the transactions. We believe we can reach a
8 very accurate price by doing it that way.
9 I can't speak to the discounts that he
10 referenced in the non-traded REIT context, but in our
11 context it's based on the public offering price, which
12 is tied to the NAV. Now it is less any distribution
13 fees that an investor would have paid at the time of
14 the transaction. We have investors that come into our
15 funds through brokers who charge a commission, through
16 advisors that charge a wrap fee, through RIAs, a whole
17 host of intermediary types, and so it depends on the
18 individual investment. We offer it at that public
19 offering price, which is tied to the NAV.
20 MS. MARES: You mentioned that your third
21 practice was not to overdistribute. For those of us
22 who don't understand that technical term, could you
23 describe what that means?
24 MR. GERBER: Sure. So funds of different
25 types, REITs, BDCs, bring capital into the fund in

1 three ways: investor capital, the investment that an
2 investor makes; borrowings, leverage that's brought in
3 from a bank; and then investment returns. That's how
4 you accumulate the assets in a fund, and then you go
5 deploy that capital over time in different
6 investments.
7 Overdistribution is the concept of paying a
8 distribution or a dividend to an investor using
9 offering proceeds or the investor's capital or
10 leverage that's brought in from a loan as opposed to
11 just using the proceeds of investment returns to pay
12 the distribution. And that's a practice that's been
13 in the marketplace for years, particularly in the non-
14 traded REIT context, and that's something that we at
15 Franklin Square committed not to do.
16 Now, under the '04 Act, BDCs are not able to
17 do that unless they disclose where those distributions
18 come from. And so technically you could argue that
19 under the '40 Act BDCs are permitted to do it, but we
20 go above and beyond that with our best practices and
21 commit to not doing that.
22 MS. MARES: So take me through the
23 development. You borrow money, you create this
24 offering, investors invest in your fund. At the time
25 of initial investment are there any investments that

1 are specified? Do they have -- you have a strategy?
2 MR. GERBER: Right.
3 MS. MARES: But do they actually see any
4 investments at the time they --
5 MR. GERBER: Well, maybe.
6 MS. MARES: Okay.
7 MR. GERBER: And let me tell you why I give
8 you that answer. In our case, yes, because one of our
9 other better practices at Franklin Square is to make a
10 significant what we call sponsor commitment. So we
11 invest our own money in the funds and we get the funds
12 launched with our own money. We believe, although
13 it's a different conflict than what you're driving at
14 with the rule, in our case, we believe that aligns our
15 interests as the manager with the interests of the
16 investor. So yes, there are some initial investments
17 that are made as we're out raising money from our
18 early investors, but like most investment funds that
19 are in their early stages, the investors don't know
20 once the fund is fully ramped what investments will be
21 in that fund. But they see, they can see some of the
22 investments that we've already made. But not all BDCs
23 are required to do that, make that sponsor commitment,
24 so that's why I said maybe. It's not across the
25 board.

1 MS. MARES: And so my understanding is that
2 you have a couple layers of fees that are part of your
3 structure.
4 MR. GERBER: Yes.
5 MS. MARES: I wonder if you could talk about
6 those.
7 MR. GERBER: Sure. So the management fees
8 that come with investing in our funds come in two
9 forms. There's an asset management fee and then what
10 we call the incentive fee. The incentive fee is not
11 required, but again, we believe that aligns our
12 interests as the manager with the interests of the
13 investor. Those are the fees that we charge to manage
14 the fund.
15 When we launch our funds, they're in a
16 traditional what's called 2 and 20 structure, so it's
17 2 percent of assets under management and then 20
18 percent on the incentive fee after we've reached our
19 hurdle. In other words, we return a certain amount of
20 the investment earnings to the investor before we
21 participate in the upside. And we've led the industry
22 with high hurdles which are in the best interest of
23 the client. So those are the asset management fees.
24 On the distribution side, there are fees as
25 well, but that's determined between -- we don't

1 determine that at Franklin Square as the fund manager.
2 That's something that's established between the
3 investor and the intermediary with whom the investor
4 is working. So it could be a broker, it could be an
5 advisor, could be an RIA, and they all have different
6 fee structures.
7 MS. MARES: But it's paid out of the
8 investor's assets that are --
9 MR. GERBER: Yes, the investor pays those
10 fees, whether it's a commission up front or an ongoing
11 wrap fee. That's borne by the investor.
12 MS. MARES: So, when you think about the
13 structure, it has some unique characteristics. It's
14 long-term. It's generally illiquid. You may or may
15 not have the opportunity to exit before a public
16 offering or the conclusion of the --
17 MR. GERBER: Well, you do through the court
18 of intenders, but it's limited.
19 MS. MARES: Right.
20 MR. GERBER: I don't mean to interrupt you,
21 but if I could just speak to that point.
22 MS. MARES: Sure.
23 MR. GERBER: Again, that's something we
24 introduced to the marketplace that was an improvement
25 over what was previously available. The average non-

1 traded REIT was offering anywhere from 3 to 5 percent
2 per year. We came in and we doubled it or more than
3 doubled it and we offer 10 percent. So that again was
4 an improvement that we introduced to the marketplace
5 in the form of a greater tender opportunity. I didn't
6 mean to interrupt you. I just wanted to make that
7 point.
8 MS. MARES: Yeah. So you offer some
9 liquidity through the tender opportunity.
10 MR. GERBER: Yes. That's why we refer to it
11 as limited liquidity.
12 MS. MARES: Right. Right. So it strikes me
13 that this investment while different than publicly
14 traded stocks and bonds may have some unique, because
15 of its unique characteristics, may have a unique
16 investor. And when you look at are there certain
17 minimum criteria that you have for your investors, how
18 do you think about that?
19 MR. GERBER: Yes. So that's a great point.
20 So first and foremost we know illiquidity isn't for
21 everybody, so that is a discussion that we think ought
22 to take place between an investor and the investor's
23 advisor. But we do believe that illiquidity has a
24 place in retirement accounts. Retirement accounts are
25 designed to be long-term savings accounts, and there

1 are benefits that come with illiquidity which I'm
2 happy to talk about if you'd like. But would you just
3 remind me the --
4 MS. MARES: So let me go back and reframe my
5 question. One of the things in considering the assets
6 that are covered under the best interest contract is
7 whether or not they all have similar characteristics.
8 And if they have different characteristics, should
9 there be some unique conditions that go along with
10 those unique characteristics?
11 MR. GERBER: Got it. Got it. Thank you.
12 MS. MARES: So I'm trying to get to whether
13 we should think about any unique conditions.
14 MR. GERBER: Yes. In our previous meetings
15 with the Department and with OIRA we offered some
16 suggestions around better practices that could be tied
17 to funds like ours that carry with them
18 characteristics such as illiquidity. So certainly
19 while we provide limited liquidity during the life of
20 the investment and then ultimately full liquidity
21 through a listing on an exchange, they are different
22 than stocks and bonds that you can buy and sell in
23 liquid markets.
24 And so we do believe that with that
25 illiquidity there ought to be some other investor

1 protections that are required of the fund or the
2 investment and something certainly that should be
3 considered by an advisor or broker when putting a
4 client into a limited liquidity fund like ours and
5 certainly could be something that could be mandated
6 through the rulemaking process or in the exemption.
7 MS. MARES: To the extent you have some
8 thoughts as to what those conditions might reasonably
9 be, we'd like to hear them.
10 MR. GERBER: Yes. We've offered those and
11 I've mentioned some of those today. So third-party
12 valuations, quarterly valuations so you have more
13 current marks, commitments to not overdistribute. And
14 it is a technical term, but there are ways to work out
15 that language. So there are hosts that we've offered.
16 A majority of the board being independent. You know,
17 a lot of our better practices that we've introduced in
18 the marketplace come with the '40 Act, but some of
19 them that I've just mentioned go above and beyond. So
20 we'd be happy to share that list with you again.
21 MS. MARES: Would you say that the non-
22 traded business development company is an appropriate
23 investment for all IRA investors, or should we
24 consider it to be restricted to a certain set?
25 MR. GERBER: Yeah. No, I think I would look

1 at it as a choice. So there are benefits that come
2 with the non-traded model and there are benefits that
3 come with the traded model, and it just depends on
4 what's most appropriate for the investor.
5 And so just to give you a couple of
6 examples. In the non-traded model, we're able to
7 deploy capital through our continuous fundraising
8 model through all market cycles. So we're getting
9 exposure in those funds to deals that those folks in
10 the traded BDC space -- remember we have a traded BDC
11 -- aren't getting exposure because they don't have
12 ready capital. So the portfolio construction within
13 the fund will look different in a non-traded than in a
14 traded over time.
15 There's the fact that it enables us to
16 invest the underlying assets into which we're
17 investing are illiquid themselves, and so that enables
18 us to get stronger yields for our investors. And then
19 of course there's the fact that it will be less
20 correlated with the market.
21 But to get those benefits you're buying
22 illiquidity or at least limited liquidity. And so, if
23 you don't want limited liquidity and you want
24 liquidity, you can get that. You can go buy a traded
25 BDC. We prefer that you buy ours. But you can go buy

1 a traded BDC, but when you buy that traded BDC you're
2 not necessarily getting the benefits that the non-
3 traded model offers.
4 And so they both have benefits and they both
5 have limitations, if you will. So, in our view, it
6 depends on the investor, it depends on how the
7 investor is designing the investor's portfolio and how
8 they want to use that particular type of investment in
9 the portfolio. We would just like for there to be a
10 choice and that's why we're asking that the non-traded
11 BDC be included on the list of eligible assets.
12 MS. MARES: Do you think an investor's
13 portfolio should have concentration limits as to how
14 much could or should be in a non-traded BDC?
15 MR. GERBER: Yes, I think there should be
16 concentration limits on any type of investment. You
17 know, I think the idea of putting 100 percent of
18 someone's portfolio in a traded index fund is a
19 terrible idea. That's not to say traded index funds
20 aren't good. It's just to say that if you
21 overconcentrate in any particular type investment it's
22 unwise.
23 I served for a number of years as a
24 fiduciary for one of Pennsylvania's two large pension
25 funds, a defined benefit fund. I served there for

1 eight years. And if you look at our portfolio
2 construction, it's well diversified. We don't overly
3 concentrate -- we didn't, I should say past tense.
4 I'm not there anymore. But we never would have put
5 100 percent of the fund in any particular strategy or
6 even 50 percent of the fund in any particular
7 strategy.
8 So I think that no individual's portfolio
9 should be overly concentrated in any particular type
10 of investment, whether it's illiquid, has limited
11 liquidity, full liquidity, whether it's equities,
12 whether it's fixed income. I hope that over time and
13 through this rule that individuals will be able to
14 construct well-diversified portfolios that perform
15 better than portfolios they've been constructing in
16 the past.
17 And if you look at the history of individual
18 portfolio construction, you know, when my grandad was
19 investing, his advisor, his broker was saying hey, buy
20 this company, it's a really good company, and buy this
21 municipal bond. We think that that municipality is a
22 good credit. And so you diversified by names and
23 maybe by type.
24 And then in the '80s we had a proliferation
25 of mutual funds in thousands of varieties. And so

1 people started building portfolios using all these
2 different mutual fund opportunities.
3 But what's been lacking for all these years
4 is exposure to true alternatives, and that's what
5 we've introduced into this marketplace. And so our
6 view of the world is that ultimately we're going to
7 see individual portfolios being constructed with a
8 certain allocation to true alternatives where folks
9 can benefit from those benefits that illiquidity or
10 limited liquidity present.
11 But we would never suggest 100 percent of a
12 portfolio should be in our BDC, non-traded BDCs or in
13 any non-traded product. We think that a well-designed
14 portfolio is well-diversified. And so we worry about
15 concentration for our investors, whether it's our
16 funds or any other type of funds.
17 MS. MARES: So this is just an intellectual
18 curiosity. You mentioned you use leverage in your
19 funds.
20 MR. GERBER: Yes.
21 MS. MARES: About how much leverage do you
22 have?
23 MR. GERBER: Well, that's prescribed by law.
24 MS. MARES: Okay.
25 MR. GERBER: And that's another distinction

1 between non-traded BDCs and non-traded REITs. There
2 are no legal limits on the REITs, but in the case of
3 non-traded BDCs, under the '40 Act, non-traded BDCs
4 can only lever up on a one-to-one basis.
5 To give you perspective, banks that are
6 lenders like our non-traded BDCs are lenders are
7 anywhere from 8 to 15 to 1 right now. Hedge funds
8 that also do private lending like we do have no limits
9 at all. They're in the mid to high teens, maybe even
10 in the low 20s in terms of their use of leverage.
11 So at one to one, we are extremely low and
12 extremely conservative. And even though we're allowed
13 to go up to one, we don't, and I don't know of any BDC
14 that does because with the fluctuations you could have
15 in a portfolio, you never want to risk being out of
16 compliance, so you're always going to keep some kind
17 of buffer in place. So we are hovering I think in our
18 most mature fund around 80 percent of the leverage
19 that we're allowed to use.
20 MS. MARES: Thank you.
21 MR. GERBER: Yes.
22 MS. MARES: Mr. Nicholas, I have a question
23 for you. I know it seems counter-intuitive that there
24 are times when tax-free bonds earn more than taxable
25 bonds because you'd think it didn't -- shouldn't

1 occur, but I know that it does occur. How often do
2 you think it does occur? Do you have a sense of that?
3 MR. NICHOLAS: Well, we don't have an actual
4 percentage of time that that occurs, but as you know,
5 the markets move daily, hourly. There are times when
6 the tax exempt security can yield more than an
7 equivalent taxable corporate bond without considering
8 the tax equivalent yield on the municipal. And so you
9 have a lot of examples right now in the current
10 interest rate environment where municipals, tax-free
11 municipals can do very well. And certainly when you
12 talk about, you didn't ask about taxable, but taxable
13 municipal bonds can be a good investment.
14 One problem we have, one reason I referenced
15 munis, and God bless your grandfather for buying that
16 municipal bond, is that we're concerned about being
17 overly prescriptive with what a retirement investor
18 can and cannot purchase, and limiting that investor to
19 a mutual fund as opposed to a direct purchase
20 municipal bond, taxable or tax free, we just think is
21 inappropriate and there's consequences. There's
22 consequences to what you heard earlier I know from Ron
23 Kruszewski and others about changing business models,
24 securities firms altering business models and the
25 consequences seen by investors. And when you talk

1 about municipals issuers, if you're hampering
2 liquidity in a municipal space because fewer
3 securities firms are buying and holding municipals in
4 inventory, ultimately that hurts the investor through
5 higher borrowing costs and taxpayers through higher
6 borrowing costs.
7 MS. MARES: Thank you.
8 MS. LLOYD: Can I follow up on that? I
9 think from your comment you mentioned municipal bonds
10 both for the best interest contract exemption and the
11 principal trading exemption. So they are traded both
12 on an agency and a principal basis?
13 MR. NICHOLAS: Right.
14 MS. LLOYD: Okay.
15 MR. NICHOLAS: Yes.
16 MS. LLOYD: Okay.
17 MR. NICHOLAS: You mean generally by
18 securities firms?
19 MS. LLOYD: Right.
20 MR. NICHOLAS: Right. Yes.
21 MS. LLOYD: Okay. And then you talked about
22 our two price quote requirement in the principal
23 transactions exemption and you suggested the FINRA and
24 MSRB best execution rule as sort of a substitute.
25 MR. NICHOLAS: Right.

1 MS. LLOYD: So the two quote proposed
2 requirement was sort of to support the notion that we
3 thought you shouldn't trade out of inventory unless
4 you were sure that you could get the best deal. And
5 I'm wondering, is that the result that we'll end up
6 with if we rely on the best execution rules? Can you
7 explain a little bit about that?
8 MR. NICHOLAS: Well, again, it's about being
9 prescriptive. So there are rules and procedures in
10 place, there have been for a while from FINRA's
11 standpoint and now you mentioned MSRB and municipal
12 execution standards. And the concern is that if the
13 DOL implements very prescriptive rules related to best
14 execution that it will ultimately hamper the investor,
15 because those rules are already in place, you know,
16 the suitability rules, the fair dealing rules, et
17 cetera, are already in place and that ultimately it's
18 being too prescriptive means jumping through
19 artificial hoops, so to speak, and as the market's
20 moving in the question about municipal bonds, as the
21 market's moving you risk giving the investor a price
22 for a security that's not as good as it was 10 minutes
23 ago because of the artificial hoops that are
24 prescriptively being handed down to the BD.
25 MS. LLOYD: All right. So I guess just to

1 follow up, I mean, if you're following those best
2 execution rules, do you get to the same result,
3 though, that you can't trade out of your own inventory
4 unless you've sort of assured yourself that that's the
5 best deal?
6 MR. NICHOLAS: For municipals?
7 MS. LLOYD: Well, I guess is that your area
8 of expertise?
9 MR. NICHOLAS: Well, I mean, according to
10 the proposed rule, municipals are not part of the --
11 MS. LLOYD: Right, but --
12 MR. NICHOLAS: You can't anyway, right?
13 MS. LLOYD: -- well, that was your
14 suggestion, though, that we include them and then we
15 also --
16 MR. NICHOLAS: Well, yes, municipals, that
17 we include municipals, right.
18 MS. LLOYD: Right.
19 MR. NICHOLAS: Right. So I think you're
20 right. I think you grant investors more options,
21 which benefit -- you know, under current best ex
22 rules, right, which ultimately benefit not only the
23 investors but issuers of municipal bonds if you want
24 to continue talking about municipals as well.
25 MS. LLOYD: Okay. I'm not sure I

1 understand, though, fully, though, how the best
2 execution rule works in this context, so maybe we
3 should put aside municipal bonds. Can we talk about
4 the FINRA best execution or is that not something that
5 you're --
6 MR. NICHOLAS: No, that's fine.
7 MS. LLOYD: Okay.
8 MR. NICHOLAS: For corporate, for taxable
9 securities.
10 MS. LLOYD: Right. So following the best
11 execution rules, will you end up only being able to
12 trade out of your own inventory if that is the best
13 deal? I know you don't have to specifically go out
14 and get two quotes, but I understand that you have to,
15 you know, do some kind of market surveillance. So I'm
16 just wondering if that's --
17 MR. NICHOLAS: Right, does it force you to
18 trade from inventory as opposed to acting as agent?
19 MS. LLOYD: Does it only allow you to trade
20 from inventory if that is the best deal? Because
21 that's sort of the result that we want and I just am
22 not clear on how that all works.
23 MR. NICHOLAS: Right. No, I think that's
24 correct. Yeah, no, I think that the answer is yes.
25 MS. LLOYD: Okay.

1 MR. NICHOLAS: I can get back to you on
2 that, but I think the answer is yes.
3 MS. LLOYD: Okay. Thanks. And then I guess
4 just to kind of finish up, I heard at the beginning
5 that you have a desire for a harmonized multi-agency
6 approach. I wasn't clear on whether your members are
7 comfortable with the enforceable best interest
8 commitment that would be part of both the BIC
9 exemption and the principal transaction exemption.
10 MR. NICHOLAS: Well, no is the short answer
11 because of the extra steps, the limitations. You
12 know, the BIC excludes, going back to municipals,
13 excludes municipals. And so the short answer is no,
14 we're not comfortable.
15 MS. LLOYD: Well, I'm just asking
16 specifically not about the whole exemptions --
17 MR. NICHOLAS: Yeah.
18 MS. LLOYD: -- because I think we've heard a
19 lot about the workability.
20 MR. NICHOLAS: Right.
21 MS. LLOYD: I'm just talking about sort of
22 what we've been identifying as kind of one of the
23 baseline principles of each of those exemptions is an
24 enforceable best interest commitment.
25 MR. NICHOLAS: Right. No, the answer is no,

1 our members are not. We think it fundamentally
2 changes the broker-dealer business model, which
3 ultimately negatively impacts not the broker-dealer,
4 as you heard earlier today, but the investor.
5 MS. LLOYD: Why? Why does it -- I mean,
6 just, you know, putting aside the requirements that
7 people have been really worried about --
8 MR. NICHOLAS: Yeah. It essentially
9 eliminates the commission-based model.
10 MS. LLOYD: Because you can't act in your
11 customer's best interest in a commission-based --
12 those two are completely incompatible?
13 MR. NICHOLAS: It makes the -- as others
14 have said, it makes the legal liabilities too
15 daunting, so that you'll see more and more -- you see
16 this already today, more and more securities firms
17 moving away from the traditional commission model as
18 related to retail and to more of a fee-based advisory
19 approach for retail, to the detriment, as you heard
20 earlier today, to the individual investor.
21 And I'm not sure if you heard this earlier
22 today, but the other issue with individual investors
23 is if you only have a certain amount of investable
24 funds, you're not attractive anymore to a securities
25 firm that's charging a flat fee unless that fee goes

1 dramatically up. So you're limiting options all of a
2 sudden for individuals that have less than X number of
3 dollars to invest.
4 MR. HAUSER: So just so we can -- I just
5 want to be clear on what it is that you think is
6 incompatible with the broker model here. So again
7 just focused on up-front commitment, act in your
8 customer's best interest, prudence, fees reasonable in
9 relationship to the services provided, and it's
10 enforceable. And in individual cases, it can be
11 enforced through, you know, FINRA binding arbitration,
12 and in class cases, it would be enforced through class
13 actions. This is also true under FINRA. So which of
14 those do you think is incompatible with a commission-
15 based model or with brokers?
16 MR. NICHOLAS: Well, the fiduciary standard
17 generally, moving away from a suitability standard, is
18 in conflict with the commission-based approach of a
19 brokerage firm.
20 MR. HAUSER: And why? I mean, you indicated
21 earlier that you supported a sort of standard that
22 would align the customers' interests with the
23 financial intermediary's interest.
24 MR. NICHOLAS: Right.
25 MR. HAUSER: I thought you were quoting Mr.

1 Ketchum with approval. So why is there an
2 incompatibility assuming that can be done with a
3 commission model?
4 MR. NICHOLAS: Well, I think the biggest
5 concern with our members is that the fiduciary
6 standard comes with a much higher legal liability,
7 potential legal liability than suitability standards.
8 That makes it incompatible to act in the best interest
9 of your client on a commission basis when many times
10 broker-dealers have a client on both sides of the
11 transaction. They're not just acting like an
12 investment advisor with one -- you know, managing one
13 person's retirement account or estate planning, right?
14 And so for that reason alone it's incompatible with
15 the commission model, which would --
16 MR. HAUSER: But is it greater legal
17 liability in your mind because you're more likely to
18 be found to have breached the standard or because you
19 think there's some difference in the remedy that's
20 available? I'm just --
21 MR. NICHOLAS: Well, we just think there's a
22 different legal view of suitability and fair dealing
23 versus fiduciary.
24 MR. HAUSER: Right. One's a higher
25 standard. And you emphasized, and I know we're eating

1 into the last, and I apologize to all of you four-day
2 folks, but you indicated that you would prefer to
3 manage this with disclosure. Could you just describe,
4 so when you talk about conflict disclosure, what are
5 your firm's conflict disclosures? How do you describe
6 the conflicts?
7 MR. NICHOLAS: Well, I mean, that's from the
8 outset of the account opening.
9 MR. HAUSER: Right.
10 MR. NICHOLAS: And so from the outset and
11 through the process, you know, whether it's certainly
12 trade by trade and then on a monthly basis, highly
13 regulated by the way, our broker-dealers that are
14 members of the BDA are working with clients to
15 disclose any conflict of interest, whether it's
16 training by agent, training by principal, and then all
17 the other risks that are engaged, you know, with the
18 trading of securities, including market risks and
19 interest rate risks, et cetera.
20 MR. HAUSER: I guess I'm just wondering if
21 you could put a little more meat on the bones there.
22 I mean, what does that look like? Is it I may have a
23 financial interest? What is the conflict?
24 MR. NICHOLAS: Every firm to meet the
25 requirements and demands of FINRA has best practices

1 in place, so every firm could be different, but
2 meeting the same goal, best practices in place that
3 sends out on a regular basis to the client the
4 potential conflicts of interest, disclosing, you know,
5 whether acting as principal, whether acting as agent,
6 the fees, et cetera, and then verbally that's
7 communicated as well on a regular basis to the client.
8 So I can get you if you'd like, I can get you, you
9 know, real prescriptive information as an example from
10 a typical regional middle market securities firm.
11 MR. HAUSER: Well, if you send another
12 follow-up --
13 MR. NICHOLAS: Sure.
14 MR. HAUSER: -- comment, but go ahead and
15 attach that.
16 MR. NICHOLAS: Sure.
17 MR. HAUSER: That would be nice.
18 MR. NICHOLAS: Sure.
19 MR. HAUSER: Thank you very much. I
20 appreciate your input.
21 MR. NICHOLAS: Sure.
22 MR. HAUSER: Last panel.
23 (Panel switch.)
24 MR. HAUSER: Mr. Katz, would you like to
25 start?

1 MR. KATZ: Sure. Well, good afternoon and
2 thank you very much for inviting me to speak with you
3 today. My name is Gary Katz. I'm President and CEO
4 of the International Securities Exchange, one of 12
5 regulated options exchanges in the United States.
6 This coming February I will mark 30 years in the
7 options industry, the first 12 at the New York Stock
8 Exchange and the last 18 as a co-founder of the
9 International Securities Exchange, which is the first
10 all electronic options exchange in the United States.
11 I'm here today representing the U.S.
12 Securities Market Coalition. That group is made up of
13 all 12 options exchanges in the U.S., as well as the
14 Options Clearing Corporation, the clearinghouse for
15 the 12 exchanges. I've submitted our written
16 testimony for the record, but I'd prefer instead of
17 reading the same material that you have in front of
18 you to speak in my own voice and highlight the issues
19 that we'd like you to focus on.
20 It's a narrow aspect of the proposed rule
21 that gives the options industry concern and that is
22 that listed options are not included as an asset in
23 the best interest contract exemption and we think that
24 it should be.
25 The options industry in the United States is

1 a large market and a substantial amount of trading is
2 being done in retirement accounts. In 2014,
3 3.8 billion option contracts traded in the United
4 States and the TAB group estimates that 29 percent of
5 that is being done by individual investors, and of
6 that amount 15 percent are being done in retirement
7 accounts, IRAs specifically. That means that
8 approximately 165 million option contracts are being
9 traded in IRAs.
10 Now it's important that we distinguish the
11 listed options market or what we would call the
12 exchange-traded market from the over-the-counter
13 market and other options contracts. These are
14 contracts that are traded on exchange. It's a
15 transparent marketplace, fully regulated, where two-
16 sided markets are continuously displayed throughout
17 the day. We trade options on stock, exchange-traded
18 funds, and indexes. All the underlying assets that we
19 trade are listed on exchanges like the New York Stock
20 Exchange and NASDAQ, and we have listing rules and
21 maintenance rules that require that we trade options
22 on liquid public securities. The same way that stocks
23 are traded, options are traded on listed exchanges.
24 A good example of how important it is to us
25 to give a investor a positive experience is to ensure

1 that the underlying stock has appropriate liquidity.
2 So, for example, one of our rules says that when a
3 company goes public, the day of its IPO, we cannot
4 list options. In fact, for at least five days the
5 options exchanges do not list options on that
6 underlying stock. It allows the market to find an
7 equilibrium price. It allows the liquidity providers
8 to determine the proper volatility so that they can
9 make an appropriate market in the option. So we give
10 it time for the marketplace to experience the
11 underlying asset before we begin trading options.
12 It's also important to say that I don't
13 think there's any industry that has more competitive
14 pricing. There are 12 options exchanges. We all
15 trade the same products. And so the market that is
16 being made to the customer is deep in its liquidity,
17 but it's super competitive and the best prices
18 available at all times continuously in the
19 marketplace.
20 So why is it so important to preserve the
21 right for an investor to trade options from their IRA
22 account? The way the options product is designed is
23 to work one for one with stock. So one contract in an
24 option is associated typically with 100 shares of
25 stock. If you own 100 shares of a company, you can

1 buy one put option or sell one call option. And the
2 two primary strategies that investors use in their IRA
3 accounts are the two most conservative options
4 strategies. They're covered call writing and they're
5 protective puts, and I'll go into that in a little
6 more detail. But it's important to note that both of
7 those strategies provide those investors with the
8 ability to manage the risk of the stocks that they own
9 in their IRA.
10 When an investor sells a call against a
11 stock position that they already own, they are
12 actually collecting premium. And it provides them a
13 small amount of downside protection if the stock
14 declines, but primarily it brings in money to the
15 investor and enhances the return on their stock. When
16 they buy a protective put against a stock position
17 that they already own, they are managing the risk that
18 the stock will decline and they have an opportunity to
19 protect themselves from a decline in the value without
20 actually selling the security that they own.
21 Importantly, it's the investor that's making the
22 decision what option strategy they should use and not
23 a broker that's giving advice.
24 Many people say that only wealthy people
25 trade options, but it's simply not the case. As I

1 shared with you, you can trade one options contract on
2 100 shares of stock. So any size IRA account with
3 stock positions in it has the ability to make use of a
4 very important risk management tool.
5 Now though options don't require wealth to
6 trade they do require education. There is a unique
7 set of terminology associated with options trading:
8 calls, puts, how much time there is to expiration,
9 strike prices, volatility, and it's important to teach
10 the investor all of these terms so that they can
11 understand the options market. The brokerage firms
12 provide this educational material to their customers
13 to help them understand how to trade options, the
14 different terminology that's used, the different types
15 of strategies that are used, but importantly what they
16 are teaching them is how to use the product. They are
17 not giving them investment advice on the stocks in
18 their portfolio.
19 Importantly, education does not necessarily
20 mean risk. When people ask me to explain the
21 difference between stocks and options, I sometimes use
22 a car analogy, an automatic car versus a manual car.
23 We all know how to drive an automatic car. We were
24 taught that very early on in drivers ed. But if I
25 wanted to know how to drive a stick shift, a manual,

1 I'd have to learn what's the stick shift, what's the
2 clutch, what's an odometer and how do I use it.
3 Now using that analogy compared to stocks
4 and options, options give you greater control over
5 your portfolio, just like a manual car gives you
6 greater control, but you need to learn how to use it.
7 The person who teaches you how to use it is not
8 telling you when it's better to use it, but they are
9 giving you all the tools that you need to be able to
10 drive safely.
11 One other very important safeguard, the
12 industry requires that the brokerage firms qualify
13 these investors before they began to trade options to
14 ensure that they have the knowledge and the experience
15 to be able to trade this product. This is something
16 that has been involved in the industry from the very
17 beginning when we first started the listed markets in
18 1973. Depending on the knowledge and experience that
19 a customer has, they will be afforded a certain level
20 where they are able to trade, level one being the most
21 conservative options strategies, the two that I talked
22 to you about, the covered call writing and protective
23 puts.
24 Using the same analogy of a car, I'll tell
25 you that my son just got his drivers license at 17, so

1 for the first couple of months we're telling him that
2 when we're not in the car he's allowed to drive
3 locally, but if he wants to get on the highway, that's
4 going to take a few months and some knowledge and
5 experience before we allow him to go on there. We're
6 not telling him where to drive or how to drive, but we
7 are ensuring that he has the knowledge and experience
8 before he takes on more faster driving in essence.
9 What are we asking from the Department of
10 Labor? Three things. The first is to include listed
11 options in the definition of assets for the best
12 interest contract exemption. These are fully
13 transparent products on regulated exchanges. They are
14 the sister product of stocks and of bonds that are
15 publicly traded, traded in the very same manner.
16 Importantly, there are no hidden fees or costs
17 associated with trading options.
18 Secondly, we'd like clarification that if
19 brokerage firms provide this educational material
20 explaining the terminology and the risk reward profile
21 of options that this is not advice for specific
22 investment recommendations and should not cause the
23 broker to become a fiduciary.
24 And likewise, determining the qualification
25 level of an investor, whether they're level one or

1 higher, is an important aspect, an important mechanism
2 for protecting investors, and that too should not
3 cause the broker to become a fiduciary.
4 I'd be happy to answer any questions that
5 you have.
6 MR. HAUSER: Thank you.
7 Ms. Byrd-Hill?
8 MS. BYRD-HILL: Twenty-six years ago when I
9 graduated from the University of Michigan with a
10 degree in economics, I embarked upon a life mission to
11 assist the financial stability of my community, both
12 women and people of color. I sit here because I have
13 a multifaceted view of the need to protect vulnerable
14 citizens, that is, the low and middle income, women,
15 and people of color, and when I define people of
16 color, that's African, Arabic, Asian, Hispanic, and
17 Indian descent in their pursuit to save for
18 retirement.
19 These vulnerable populations often receive
20 conflicted written advice and oftentimes none at all.
21 But I'm going to give you my experience so, as I
22 speak, you know where I'm coming from. I started my
23 career as a plan sponsor of a defined contribution
24 plan for a large privately-held retailer. I then
25 migrated to be a financial advisory firm president of

1 a firm that grew to $353 million of assets under
2 management. In doing so I was able to create a
3 program for UAW Chrysler called Smart Money, the
4 Financial Fitness course. I authored a book called
5 *Breaking Out of Your Financial Funk*. And the last 11
6 years I spent as the president of a nonprofit,
7 assisting low and middle income residents to move out
8 of poverty. Today out of that nonprofit we have
9 created a company called Weyn LLC where I am the
10 president of a mobile video game developer of economic
11 strategy games.
12 Before I go into testimony, let's talk about
13 the real problem of why we want to increase the
14 standard. I do believe that the standard needs to be
15 increased. I do believe that it needs to be broad in
16 how we increase it and let me tell you why. First of
17 all, the poverty rates of adults age 65 and above are
18 strikingly terrible. Right now, when we look at the
19 Native American population, poverty among senior
20 citizens is 29.2 percent. When you look at the
21 Hispanic Americans, it's 28 percent. When you look at
22 African-Americans, it's 22 percent, Asian Americans
23 12.3. But for Caucasian Americans, it's only 7
24 percent. Then when we start to look at it by gender,
25 men, the poverty rate above age 65 is 7 percent and

1 women is 17 percent.
2 Now a lot of times you want to say that's
3 because when they started they were in poverty, and
4 that is not true. There are some factors that move
5 that poverty. First of all, when we have investments,
6 in the last 50 years a lot of the ethnic populations
7 have grown in influence. They also have been saving
8 as part of their influence. Sadly, the advice that
9 they're given is not so good. Not only is the advice
10 not so good, a lot of churning of investment accounts
11 happen with those who are not at the top of the
12 charts.
13 And I'll give you a good example. I had a
14 guy who retired from the UAW as an officer and when he
15 gave me his $500,000, I realized that he's afraid of
16 the market, and even though he wants the market high
17 side potential, I don't look at suitability about the
18 high side potential. I look at what happens when the
19 market drops, what is going to be your response,
20 because that's where a lot of money is lost. So, when
21 I put him in the investment, I considered that. A
22 couple years after he sat in the investment, he's
23 watching everybody talk about 25 percent returns and a
24 stockbroker gets him to move. So even though at that
25 point his return went from half-a-million dollars to

1 550, he thought that he could get more because of what
2 the stockbroker told him, so he moved.
3 Well, unfortunately he moved to that
4 stockbroker and that stockbroker moved him from four
5 different mutual fund accounts. Well, when he died,
6 and I have to talk about reality, he had $250,000 in
7 his account over 10 years. Well, he went from a half
8 a million to $250,000, which means he didn't go up, he
9 went down, which is not the place to be. I had to sit
10 in front of that widow, because I had her for other
11 products, to explain the reason why the account went
12 down.
13 And I don't blame the customer. I blame the
14 subsequent advisor because they didn't do what was in
15 the best interest of the customer. Because the
16 customer is afraid of the market, you know that going
17 into the door, so why would you put him in a product
18 that when he sees the stock market says it's going
19 down, he's going to give you the order to move when
20 everything is tanking? That is the recipe for
21 disaster and that's what happened in 2008 during our
22 recession.
23 But we don't want to talk about that. So,
24 as we're having the discussion about the fiduciary
25 interest, we have to talk about what happens to the

1 customer on Main Street, not the affluent customer who
2 has two and three and four and five, 20 million.
3 We're talking about the base customer who lands in
4 poverty not because they started in poverty, but they
5 had full intentions to be able to live out their
6 retirement, but because the financial advisor is in a
7 position of trust, the customer relies upon that
8 financial advisor and some of the advice, I would say
9 a lot of the advice is not good.
10 Number two, while I loved the industry when
11 I was in it for 15 years, a lot of the individuals who
12 come into the industry are not financial experts.
13 They are salespeople. It is what it is. You get
14 compensated not based on educating, you get
15 compensated based on what you sell, so consequently,
16 all of the activity is based on the numbers of what
17 you sell. So we need to toughen those standards
18 because of the population that we have because they're
19 creating poverty where there should not be any
20 poverty.
21 I felt really horrible to have to explain to
22 a widower that half of her portfolio went because of
23 some unscrupulous advisor who ironically never went to
24 jail even though it's thievery, never was prosecuted,
25 never landed in prison, got a pat on the back and said

1 atta-boy, you did good because you churned the
2 customer multiple times. That is inappropriate and
3 that's what occurs in reality.
4 Now, with that being said, a lot of that
5 wouldn't occur if there was education. So I've
6 listened to a lot of the testimonies and we went from
7 having a debate over fee-based advisors versus
8 commission-based advisors. To me, it doesn't really
9 matter. As long as you have assets under management,
10 you have conflict. I've been both. And as long as
11 you're managing assets, you do have a responsibility
12 to those assets, to make money from them.
13 So what I want to present is a third option,
14 not just fee-based or commission-based but what we
15 call a financial wellness advisor. Their job is to be
16 a counselor or coach and to help you move through your
17 retirement because retirement planning is not just
18 about money. It's a whole process. It's about
19 looking at emotional health. It's about looking at
20 your physical health. It's about understanding
21 product knowledge. But the bulk is about
22 understanding financial concepts and tools.
23 What I have seen is most customers do not
24 understand the concepts. One of the testimonies
25 talked about his grandfather and the investment that

1 they were learning from the grandfather. Reality, a
2 lot of investment is learned at home. But if you have
3 populations who are not privy to be able to learn
4 those investments, they are at a significant
5 disadvantage, which means they have to have financial
6 education to bring them up to speed two, three, four,
7 five generations. I've not seen that. And an advisor
8 sitting and having a discussion over one product is
9 not sufficient education to me.
10 So what I propose is that we look at a third
11 option of advisor called financial wealth advisors,
12 but we also look at a different way to educate. One
13 of the things that I've noticed is most education is
14 very lecture-based, it is very jargon-based, it is
15 very numbers-oriented, when the bulk of the population
16 are neither. But what we do know is that the
17 population today and yesterday love mobile video
18 games. They play them by the millions. But what we
19 don't know is that women generate 45 percent of the
20 revenues in gaming, which means they obviously love
21 it, and these are women ages 25 to 54, and that people
22 of color dominate the revenues of 64 percent of gaming
23 across the country led by African-Americans.
24 But yet, when we start to talk about
25 financial education, we never bring those options to

1 the table unless it's children. We never look at
2 adults. There are ways to be able to teach financial
3 concepts that are very easy to people, and video
4 gaming is a mechanism that really should be used for
5 adults, to just look at the concepts and to understand
6 what is an option? You can build that into a game.
7 What is a stock? What is a mutual fund? What is
8 asset allocation? Those are basic financial concepts
9 that people need to be able to understand before you
10 embark on any investment program of any type, and
11 they're not understanding those.
12 So what I am requesting for the Department
13 of Labor to look at is expanding educational options
14 in the ruling but to also expand the advisor options
15 to include a financial wellness advisor who has no
16 assets under management, whether that advisor is human
17 or whether that advisor is technology, and that can be
18 funded by retirement fees or any other discretionary
19 dollars. I'm also asking for the Department of Labor
20 to consider a pilot of new standards of financial
21 education, to include gaming, and we would love to be
22 able to host that for you.
23 And lastly what I would like the Department
24 of Labor to do is to share this testimony about what
25 really happens in Main Street and the beauty of

1 potential new options of financial education with your
2 fellow colleagues on the Financial Literacy and
3 Education Commission. Those are the three things that
4 I'd like to see today.
5 MR. HAUSER: Thank you.
6 Mr. Trone?
7 MR. TRONE: Well done. What if I was to
8 tell you that over the last 15 to 20 years fiduciaries
9 have stolen more money from investors and retirement
10 savers than brokers? Now, by the way, I don't know
11 whether that's true or not. But when you consider
12 Bernie Madoff, we're probably not far off the mark.
13 So I thank you for allowing me to share this
14 day with you today. I've been involved with the
15 fiduciary movement for 28 years, very involved with
16 the movement. I'd love to say that I'm here to
17 support you today, but I'm not. My concern is that
18 what you're proposing is not a fiduciary standard but
19 rather punitive rules that are going to make it easier
20 for dishonest advisors to hide behind the complexity
21 of the rules and harder for honest advisors to provide
22 their services. And as you've heard from other
23 witnesses, those services, the people that are going
24 to be most harmed will be the small pension plans,
25 small retirement savers, small investment advisory

1 firms.

2 In my first career, I was a Coast Guard
3 helicopter pilot, and military pilots literally live
4 or die by the quality of their checklists and their
5 training programs. So, when I came into the financial
6 services industry in 1987, I was appalled to find that
7 the men and women who were serving as investment
8 fiduciaries had no checklists to help them manage
9 their critical decision-making process, had not
10 received any formal training, many didn't even realize
11 they were serving in a fiduciary capacity. So I have
12 spent this second professional career focusing on
13 developing fiduciary checklists.

14 These checklists have been used in my
15 speeches, 11 books that I have written and co-
16 authored, and in the training of thousands if not tens
17 of thousands of advisors and brokers, trustees, and
18 investment committee members. What's important to
19 point out about these checklists, and there's one in
20 my written remarks and then I passed one out as a
21 handout to the audience, what's important to remember
22 about these checklists is that all of the practices on
23 the checklist are fully substantiated by existing DOL
24 regulations, regulatory opinion letters and bulletins,
25 and case law.

1 To be clear, when we talk about principles
2 and practices, we define a principle as a fundamental
3 truth and a practice as a specific application to
4 support the principle. As an example, the best
5 interest standard is a principle, writing an
6 investment policy statement is a practice to satisfy
7 the principle. I think it's safe to say that from
8 most of the witnesses there's agreement on the
9 principle, a best interest principle, but where
10 there's no agreement because there's been no dialogue,
11 at least none that I have heard, is on the practices
12 to define the details of that principle.
13 For the sake of time, I'm not going to read
14 the 17 practices that I have on the list into the
15 record, but I do want to highlight several of the
16 important practices, such as I mentioned the
17 investment policy statement, controlling and
18 accounting for fees and expenses, having a defined due
19 diligence process for selecting and monitoring
20 investment options, and periodically providing plan
21 sponsors and participants with a performance report to
22 show how they're progressing against their goals and
23 objectives.
24 When I read the Department's proposal 122
25 days ago, what I couldn't see in the proposal was

1 reference to these long-established fiduciary best
2 practices. So I started asking other industry experts
3 the following two questions: is the Department
4 proposing additional fiduciary practices to those
5 already required, so in addition to the 17 I have in
6 my outline, or is the Department saying that a
7 fiduciary only has to demonstrate compliance with the
8 new rules? No one seems to know the answers to these
9 two questions, and I would suggest the Department
10 provide answers to those two questions and give the
11 industry an opportunity to contemplate the
12 consequences to those answers for if the answer to the
13 first question is that there will be new practices
14 added to those that are already established, then I
15 think it's going to be almost impossible to provide
16 that bundle of fiduciary practices to portfolios of
17 less than $300,000, and I'm really being conservative.
18 I think the number is north of that.
19 And if the answer to the second question is
20 that fiduciaries will only have to demonstrate
21 compliance to the new rules, then I'm afraid that the
22 Department will destroy the very essence of a
23 fiduciary standard of care you're trying to promote.
24 On a related issue, you can't simply wave a
25 wand and make every advisor a fiduciary. In my

1 professional opinion, an advisor needs at least five
2 years of industry experience and additional education
3 and training on fiduciary best practices before that
4 person is capable of judging wisely and objectively,
5 before that person is capable of ethical discernment.
6 If the Department is going to move forward,
7 I would suggest four steps. Step one, build a
8 checklist. Build a checklist to answer the following
9 question: to be compliant, what practices will a
10 fiduciary have to demonstrate?
11 Number two, once the checklist is complete,
12 determine which PTEs need to be edited. Trying to
13 address the fiduciary standard at the same time as the
14 PTEs I think is out of sequence. Try to do them
15 together. The analogy I use is building a house. You
16 need to wait until the architect is finished before
17 you let the general contractor begin.
18 Step three, apply the checklist, implement
19 the checklist and see how long it takes to implement
20 each practice with a participant. Then multiply that
21 time by a reasonable professional billing rate to
22 determine what the minimum account size can be
23 properly served with a fiduciary standard of care.
24 And then step four, determine how much
25 training is required, how much training, experience,

1 and expertise is required before an advisor can
2 properly implement the checklist.
3 I believe that if the Department follows
4 these four steps it will determine that the better
5 course of action is not to proceed with the current
6 proposal. Whatever next steps the Department takes,
7 it will need to support the organizations that are
8 providing training and education to fiduciaries and to
9 participants. Unfortunately, there are organizations
10 today that are deliberately interfering with training
11 and others that are making false and misleading
12 statements about their experience, expertise, work
13 experience. Something as simple as the Department
14 identifying an ombudsman for fiduciary training would
15 be a great help.
16 In closing, a positive statement I can make
17 about your initiative is that you have everybody in
18 the industry standing at attention. If you did
19 nothing more, you have every service provider looking
20 at their business model and determining whether that
21 model measures up to a fiduciary standard or not.
22 Thank you.
23 MR. HAUSER: Thank you.
24 Mr. Cunningham?
25 MR. CUNNINGHAM: All righty. Boy, end of

1 the road. You all want to stretch? You all want to
2 stand up and stretch or something? You know, it's
3 been a long three days.
4 I've got a torn muscle in the back of my
5 neck. I'm going to go through this very, very
6 quickly, okay? I'm not stopping. So my head might
7 kind of bounce around a little bit. Firstly, let me
8 say that your work has been spectacular. I don't
9 recall seeing another proposal which was pulled back
10 and then reworked and put out there. I thought that
11 was outstanding. I'm from Washington, D.C.
12 Now I'm going to spend a couple of minutes -
13 - I'm going to spend one minute going through my
14 background just so you know who I am, because I'm not
15 affiliated with a large financial institution or with
16 a trade association. My background is I was born and
17 raised in Washington, D.C. I have a cousin, Calvin
18 Copeland, who worked in this building for 25 years.
19 My family works in all of the federal agencies. You
20 know, it's a company town and, you know, we grew up
21 here.
22 Now my educational background is I hold an
23 MBA in finance and a Master's in economics from the
24 University of Chicago. Now that's important because
25 I'm going to reference two of my University of Chicago

1 professors in coming back and analyzing your proposal.
2 The other thing that I want to point out is
3 that I posted my first website, which was the first
4 investment advisor website, on November 16, 1995,
5 November 16, 1995, at creativeinvest.com.
6 Now the other thing I want to point out by
7 way of background are some of the things that I've
8 been involved in. So I was registered as an
9 investment advisor with the U.S. SEC. On July 3,
10 1993, I wrote to the SEC and I warned them about a
11 scam that I had been made aware of, the Nigerian
12 letter scam. I looked at that and I said it was
13 brilliant. I said there are going to be a lot of
14 people that are going to be damaged by this. The
15 SEC's response was to investigate me. I'm Black.
16 You're talking Nigeria. I identified that scam. They
17 did absolutely nothing. There were thousands and
18 thousands of people who were damaged by that scam
19 needlessly, who did not need to be hurt but for the
20 SEC's lack of action.
21 On December 22, 2005, I testified in front
22 of Elaine Hartmann at the Division of Market
23 Regulation at the SEC and I let her know that my
24 economic models indicated that a crisis was coming and
25 that they needed to do something to tap down the

1 elevated levels of fraud in the marketplace. Most
2 recently, just to show you I'm not making this up, I
3 developed a financial modeling system that
4 incorporates financial and social data to forecast
5 economic activity. Two Mondays ago we forecast that
6 Black unemployment would fall from 9.5 percent to 9.1
7 percent. Last Friday this Department reported Black
8 unemployment at 9.1 percent. So that's a little bit
9 of background and some of the tools that we use.
10 Now I believe that my experience, borne of
11 education and experience, can be helpful here.
12 Further, my operating philosophy is this -- it's taken
13 from Martin Luther King -- all investors are caught in
14 an inescapable network of mutuality tied in a single
15 garment of destiny. Whatever affects one investor
16 directly affects all investors indirectly.
17 That's what you're struggling with with the
18 proposal that you've put forth, which, by the way, I
19 think is good, but all of these exemptions, it's
20 regulation that looks like Swiss cheese, you know.
21 And I would suggest that you pull back and go for what
22 you want to go for, which is a fiduciary standard that
23 is applicable across the board.
24 Now a couple of other things I want to talk
25 about, why you even need to have a fiduciary standard.

1 In my testimony, which I'm not sure if you guys
2 have -- do you guys have this? It says "William
3 Michael Cunningham." One of the things I want to
4 point out is page 2 lists all of the issues that have
5 occurred in the financial marketplace since about
6 2003. That listing rolls on to page 11, all right?
7 These are all cases starting with, you know, some of
8 the fraud that we observed, April 28, 2003, every
9 major U.S. investment bank -- Merrill Lynch, Goldman
10 Sachs, Morgan Stanley, Citigroup -- basically were
11 found to have aided and abetted efforts to defraud
12 investors.
13 Now I don't know if Goldman Sachs showed up
14 here this week. I don't know if Bear Stearns
15 testified. I don't know if Lehman Brothers testified.
16 I don't know if Bernie Madoff testified. But the
17 reason why you're doing this is because the financial
18 marketplace is broken, all right? I will tell you
19 that as a graduate, free market guy, graduate of the
20 University of Chicago.
21 Now specifically how it is broken is in this
22 way. You've had a multi-decade set of unethical
23 business practices that have spanned every major
24 financial institution in the country. There are
25 hundreds of cases. Envy, hatred, greed, and other

1 negative behaviors have flourished in capital market
2 institutions. This has propelled ethical standards of
3 behavior downward.
4 Now why is this important? This is
5 important for this reason only. Listen to me very
6 carefully, all right? Markets cannot survive
7 continuously elevated levels of fraud. The reason
8 they can't survive continuously elevated levels of
9 fraud is because fraud mis-allocates resources from
10 deserving companies to undeserving companies. What
11 you eventually wind up with is the financial crisis
12 where assets have gone to companies and investments
13 that did not deserve the money.
14 What happens, and we've outlined this in our
15 writings, what happens is the level of trust in the
16 financial marketplace plummets. People don't know who
17 they can trade with. And by the way, I was on the
18 futures and options desk on the institutional side at
19 Merrill Lynch. I was also director of investor
20 relations for a New York Stock Exchange 500 company.
21 And I also managed a money market portfolio for an
22 insurance company. So I just happen to have a very
23 broad set of experiences that encapsulates all of
24 this. That's one of the reasons why I wanted to come
25 down here today.

1 So, when you have this mis-allocation of
2 resources, eventually markets fail. That's what you
3 saw in 2006, 2007, 2008. The reason why nobody -- and
4 it's probably the first time you've heard this -- the
5 reason why nobody has actually brought this to your
6 attention is because they don't really -- the large
7 financial institutions did very well. They actually
8 did very well. It was the smaller guys that got
9 damaged. Black homeowners, Prince George's County,
10 Wells Fargo targeted them for subprime loans. Nobody
11 at Wells Fargo went to jail, okay? So they did fine.
12 I mean, you know, that's the issue.
13 In wrapping up, let me point out a couple of
14 other facts. According to the U.S. Department of the
15 Treasury, the financial impact of the financial crisis
16 was $19.2 trillion, a $19.2 trillion loss, all right?
17 And if you have to look at one entity that would be
18 responsible for that loss, it would be the Securities
19 and Exchange Commission.
20 Now why is the Securities and Exchange
21 Commission responsible for that loss? Because they
22 say their mission is to protect investors. I would
23 submit to you that you can't say that you have
24 competently carried out that mission when you have a
25 $19.2 trillion loss. That loss came about because of

1 the -- I'm going to go back to University of Chicago
2 now, just a warning -- because of the theories of
3 George Stigler, one of my professors, captured. The
4 institution was captured by the industry that they
5 ostensibly regulated.
6 This is also one of the reasons why you're
7 getting a lot of comments, oh, let the SEC handle it.
8 Why don't you guys coordinate with the SEC? Why would
9 you do that when they're responsible for a
10 $19.2 trillion loss? They're incompetent with respect
11 to this issue. I'm not saying they're bad people.
12 They're just incompetent. They've just been captured
13 by the industry that they are supposed to regulate.
14 You would do well to avoid that same issue.
15 That is also, by the way, the reason why
16 you're getting letters from U.S. Senators. Where do
17 they get their money from? Is there a capture part of
18 the financial regulatory structure that has embedded
19 itself on Capitol Hill? What do you think? What do
20 you think? Of course there is. So I know these are
21 your bosses. I know you've got to pay attention to
22 them. I'm just saying you should factor in the
23 regulatory capture theory as you look at what's going
24 on.
25 Finally, and going back to University of

1 Chicago again, one of my professors, who is a guy
2 named Merton Miller -- you guys ever heard of Merton
3 Miller, Capital Asset Pricing Model -- people have
4 talked about modern portfolio theory up here without
5 recognizing one key point. In the classes I took with
6 Merton Miller, ethical behavior was always assumed as
7 part of the modern portfolio theory, okay? Why is
8 ethical behavior assumed? Because of what I just told
9 you. If ethical behavior is not a part of the
10 marketplace, assets are allocated to companies that
11 don't deserve the assets. And eventually over time,
12 10 years, it might take 10 years, five years, 10
13 years, the markets crumble. That's what you're
14 looking at preventing with your fiduciary standard.
15 That's actually where you are.
16 So I think that pretty much captures most of
17 my testimony. If you have any comments and questions,
18 again -- and thank you for squeezing me in. Thank
19 you, panelists, all right.
20 MR. HAUSER: All right. Thank you.
21 MR. CUNNINGHAM: They've got to squeeze me
22 in on this thing at the last minute.
23 MR. HAUSER: All right. Thank you.
24 MR. CUNNINGHAM: But I appreciate it.
25 MR. HAUSER: Thank you very much.

1 Judy?
2 MS. MARES: So, Mr. Katz, I wonder if I
3 could ask you a question or two.
4 MR. KATZ: Yes.
5 MS. MARES: You were talking about the
6 listed options and you referred to different levels
7 of -- I'm trying to think of -- you talk about the
8 covered option strategies of puts and calls were level
9 one.
10 MR. KATZ: Right.
11 MS. MARES: Could you just give us a sense
12 of what some of the other levels are? I know all
13 option strategies aren't created equal. A little
14 lesson on that might be helpful.
15 MR. KATZ: Right. There are many different
16 option strategies and option strategies that have
17 clearly defined risk reward where there is limits to
18 loss tend to be the more conservative and the ones
19 that are used for risk management. The ones at the
20 higher end of the scale are the ones that have the
21 potential for large losses where they're unsecured,
22 where you don't own the shares of stock. And that's
23 why the options product is so well aligned with the
24 investors in these IRAs, because they're aligned to
25 the shares of stock that they own and that controls

1 the risk and why they're at level one.

2 MS. MARES: So, as you talk about your
3 recommendation that we include the listed options, are
4 you reserving that to level one strategies or
5 unlimited strategies? I'm just not clear.

6 MR. KATZ: We're reserving it to the
7 strategies that are allowed in IRA accounts.

8 MS. MARES: Okay.

9 MR. KATZ: And that's done on a firm-by-firm
10 basis. The vast majority of trading that's done in
11 IRAs is the covered call writing. The next second
12 level is this protective puts, but it's far below that
13 and those are the two largest. And so I don't believe
14 that we're recommending that you limit it to level
15 one, but as you move higher up in the levels, those
16 investors have greater experience with those types of
17 strategies and at all times the IRA levels secure the
18 investment that's being made. So the opportunity for
19 entering into an option strategy that could wipe out
20 the entire IRA are absolutely not allowed in these
21 accounts.

22 MS. MARES: That's helpful. Thank you. You
23 talked about the desire to ensure that the broker's
24 education of the customer was strictly just education.
25 So, in your experience, the IRA investors who use the

1 puts and call strategies do this through their own
2 self-directed accounts?
3 MR. KATZ: That's correct.
4 MS. MARES: And how do you -- what are the
5 tests that are necessary for them to get qualified?
6 You know, we've got a party that's educating and then
7 they're going off and saying, okay, now I want to do
8 this. How does that education ensure that the
9 investor who really should be doing very conservative
10 strategies doesn't end up with very risky strategies?
11 MR. KATZ: So really there are two
12 independent efforts: one is education; the other is
13 the qualification of your level to trade.
14 MS. MARES: Okay.
15 MR. KATZ: You can take classes in the
16 trading of options and you can go to multiple classes,
17 you can go online, you can use software and simulate
18 trading. But up until you go and open up an account
19 and say that you want to trade options you don't go
20 through that qualification process. So they're really
21 independent of each other.
22 MS. MARES: Okay.
23 MR. KATZ: And just because you're educated
24 doesn't mean you have knowledge and doesn't mean you
25 have experience. And so they work well together, but

1 they're independent.

2 MS. MARES: Okay.

3 MS. LLOYD: Could I follow up on that, well,
4 on some of Judy's questions to Mr. Katz? So first
5 question, do you have to open a margin account when
6 you trade in listed options or is that not necessary?

7 MR. KATZ: I don't know the answer to that.
8 That's a question that the firms would have to answer.
9 There are certain strategies that would require that
10 and other strategies that don't where you have to have
11 the full amount of the investments in the account to
12 be able to make the trade.

13 MS. LLOYD: Okay. And then I guess I was
14 hearing sort of competing things in terms of self-
15 direction and sort of you wanting clarification that
16 some of the things that brokers were going to do were
17 not going to be fiduciary, but yet you do want this
18 included in the exemptions. So that seems to
19 contemplate that brokers will be providing advice on
20 these, or is it sort of just in case they cross the
21 line?

22 MR. KATZ: Well, let me use stock as an
23 example that we're all very comfortable with and where
24 they are on the list as an asset that has the
25 exemption, but there's a very clearly defined process

1 where you would test whether a broker is a fiduciary
2 or not. If they are giving advice on what stocks to
3 buy, just because they're part of the asset list for
4 the exemption doesn't mean that they're not a
5 fiduciary in that situation.
6 And we're saying the same thing with
7 options. They are a highly liquid exchange traded
8 product like stock and bonds. The education process
9 and the qualification process without recommendation
10 of what trades to do should be clarified to not make
11 the broker a fiduciary. However, if the broker is
12 giving advice --
13 MS. LLOYD: Okay.
14 MR. KATZ: -- then they clearly are a
15 fiduciary.
16 MS. LLOYD: Okay. Thank you.
17 MR. CAMPAGNA: Do you have any more that you
18 could tell us in a comment or otherwise about this
19 education process and how it might work? I mean, is
20 it kind of one-on-one with the broker? Is it some
21 kind of training class with the individual
22 participant?
23 MR. KATZ: I think the list is varied.
24 There's material that can be handed out. That
25 material is vetted by the regulators, in this case

1 FINRA. And there is a certain oversight by FINRA in
2 the exchanges of the qualification process, so that it
3 can be online education. It can be taking classes.
4 But typically, you know, there's no one formula for
5 how you would educate a customer.
6 What we're finding today is that investors
7 that are coming out of universities today have far
8 greater knowledge of the options product than they did
9 25 years ago. Today in a business class or any class
10 you are educating the students in the variety of
11 products that are out there. And that's why I keep
12 going back to the concept of stock and bonds, because
13 what the investors recognize today is there are
14 exchanges, not just the stock exchanges but the
15 options exchanges where they have a transparent,
16 highly liquid, constant bids and offers, and a
17 secondary market where they can buy and they can sell.
18 It's not a pricing issue like some of these more
19 complex products. And as a result, it's important
20 that they understand the different asset classes that
21 are out there and available that they can trade in a
22 transparent marketplace.
23 MR. CAMPAGNA: And just to reiterate, you're
24 only talking about options that have this conservative
25 strategy associated with it?

1 MR. KATZ: And listed options that are
2 traded on exchanges.
3 MR. CAMPAGNA: And listed options, right.
4 Thank you.
5 MR. COSBY: Mr. Katz, I was curious about
6 the compensation model for the brokers that sell these
7 option products. Is it similar -- you mentioned --
8 you know, you just were mentioning stocks. Is it
9 similar to brokers that sell stocks and mutual funds
10 and other more typical assets?
11 MR. KATZ: It's the same as the model for
12 stocks.
13 MR. COSBY: Okay. And, Ms. Byrd-Hill, I had
14 a question for you.
15 MS. BYRD-HILL: Sure.
16 MR. COSBY: With regard to your financial
17 wellness advisor concept --
18 MS. BYRD-HILL: Uh-huh.
19 MR. COSBY: -- the rule has an education
20 carve-out now where certain type of education
21 activities are considered to be fiduciary investment
22 advice. So I was wondering if that's sufficient for
23 what you're trying to do with your product or were you
24 looking for something else with respect to that?
25 MS. BYRD-HILL: I don't think that it's

1 sufficient. Part of the reason why I don't think it's
2 sufficient, you can't make up generations of knowledge
3 that are passed across the kitchen table with one
4 session with an advisor. And so, when I looked at the
5 financial session in your rule, it's very narrow. I
6 mean, you divide whether you're giving advice on a
7 product as education or whether it's advice, and I
8 just don't think that that's sufficient.
9 The way that the financial world works,
10 there are thousands and thousands and thousands of
11 products. You can't do that in a session, and that's
12 where the rub is. You just can't do it in one or two
13 sessions. So there has to be something that as an
14 individual is going into a retirement plan, that there
15 is a more substantive education that is occurring.
16 And I just don't see it happening. I've been at all
17 facets and I'm not seeing it. So I think that if
18 you're going to say that you're going to have a higher
19 fiduciary standard someone has to have the
20 responsibility to educate the participant.
21 Now let's talk reality. When these plans,
22 particularly 401(k)s and 403(b)s and 457s, came out,
23 the discussion was that the actual plans themselves
24 were going to be able to be responsible for the
25 investments. But when they realized that the

1 companies would have a much higher fiduciary standard,
2 they decided to make them self-directed. Well, what
3 happened when they made them self-directed? No one
4 put in a really substantive education process in that
5 self-direction, and that's the problem.
6 And so even though you have discussed it on
7 the periphery, at the end of the day people won't get
8 cheated if they have knowledge. One of the reasons
9 they're getting cheated and they're getting involved
10 in scams is because they just don't know and there's
11 no real place for them to go. And even though we want
12 to say, well, we're going to put it in the literature,
13 I've looked at that literature. It's compliance
14 written because the compliance department decides how
15 it's written. It's written at a 12th grade level when
16 the bulk of the people reading it are at a 6th grade
17 level. It's written for a college person when we
18 already know in this country only 25 percent of the
19 individuals in totality have a Bachelor's degree. So
20 that says 75 percent of the people don't. And it's
21 just not written for the common person.
22 Now let's talk reality. All week I've heard
23 about, you know, that if we increase fiduciary
24 standards we're going to squeeze out the small- and
25 middle-size investor. The real truth of the matter,

1 the financial industry really doesn't cater to those
2 people. They cater to them to churn to make extra
3 money to beef up their commissions because the whole
4 industry is catered to the wealthy. Let's just be
5 very honest. They've survived hundreds and fifties of
6 years because that's who they cater to.
7 So the issue is that in order to take a
8 person who's low and middle income and give them
9 three, four, five generations that the wealthy have of
10 knowledge, there has to be a broader spectrum of
11 knowledge. And even though we have this Financial
12 Literacy Education Commission which includes all of
13 these agencies, I am not seeing that broader education
14 occurring. But then we want to say, well, we're going
15 to leave it to the K-12 schools. That's not happening
16 there either. Then we say we're going to leave it to
17 the colleges. And while it happens in business
18 school, it doesn't happen anyplace else.
19 So, in order to protect the citizenry of the
20 United States, someone has to step up to the plate and
21 say, guess what, we have got to broaden the knowledge
22 for all Americans, not just for the wealthy, for all
23 of us. And that requires a substantial discussion so
24 that when they're at the kitchen table and you're
25 learning finances from your parents, not just the

1 child knows, the parent knows, the grandparent knows,
2 and et cetera, and that's not happening.
3 MR. HAUSER: Thank you very much. And that
4 concludes the panel. Okay? Thank you all very much
5 for your time.
6 I'd just like to make, you know, a very
7 short at the end of four days concluding remark, which
8 is primarily just to thank everybody who participated
9 in the hearings, all the people who have submitted
10 comments to us. It really has been enormously
11 helpful, it's been enormously informative to us, and
12 we are, you know, taking all of your comments into
13 account, and I think you'll see that it makes a
14 difference.
15 And to that end, I just remind everybody
16 that in about two weeks we hope we'll have the
17 transcript posted and we would encourage you to
18 reflect on all of the back and forth of this hearing,
19 as well as what, you know, people submitted in their
20 other written comments and give us the benefit of your
21 thoughts if you're so inclined about what people had
22 to say and about what's in the other comment letters
23 as well and really with respect to all aspects of the
24 project.
25 I mean, we have, as Assistant Secretary

1 Borzi said at the outset of the hearing, what we think
2 is largely a common goal, which is to make sure that
3 when people consult investment professionals about
4 their retirement investments that they can count on
5 receiving advice that's in the best interest and they
6 can count on that advisor's interests being aligned
7 with their own.
8 But obviously, as I think four days of
9 hearings have made completely clear, there are, you
10 know, many views on how best to achieve that goal and
11 many views on how best to even articulate the goal.
12 So I would just encourage everybody to fully
13 participate and I thank you all. And in light of the
14 comments maybe of the last group, I would also thank
15 the folks at the SEC, who actually were enormously
16 helpful as we developed this project in terms of
17 technical assistance, and I certainly plan to continue
18 to get as much help as we can not just from you all
19 but from our co-regulators. So thank you very much.
20 That's it.
21 (Whereupon, at 2:17 p.m., the hearing in the
22 above-entitled matter was concluded.)
23 //
24 //
25 //

REPORTER'S CERTIFICATE

CASE TITLE: Conflict of Interest Proposed Rule Meeting

HEARING DATE: August 13, 2015

LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the U.S. Department of Labor.

Date: August 13, 2015

Jen Metcalf
Official Reporter
Heritage Reporting Corporation
Suite 206
1220 L Street, N.W.
Washington, D.C. 20005-4018