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July 5, 2013

VIA E-MAIL

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Release No. 34-69013; IA-3558; File No. 4-606
Duties of Brokers, Dealers, and Investment Advisers
(Request for Data and Other Information)

Dear Ms. Murphy:

The Committee of Annuity Insurers (the "Committee")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") Request for Data and Other Information regarding Duties of Brokers, Dealers and Investment Advisers (the "RFI").[2]

The RFI focuses on the benefits and costs that could result from various alternative approaches regarding the standard of conduct and other obligations of broker-dealers and investment advisers. The RFI notes that the SEC intends to use the comments and data to inform its consideration of alternative standards of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. The RFI also indicates that the SEC will use this information to inform its consideration of potential harmonization of certain other aspects of the regulation of broker-dealers and investment advisers.

[1] The Committee of Annuity Insurers is a coalition of 28 life insurance companies that issue fixed and variable annuities. The Committee was formed in 1982 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent more than 80% of the annuity business in the United States. A list of the Committee's member companies is attached as Appendix A.

[2] *Duties of Brokers, Dealers, and Investment Advisers*, Exchange Act Release No. 69013 (Mar. 1, 2013).

The SEC has not yet determined whether it will exercise the discretionary rulemaking authority granted by Section 913 of the Dodd-Frank Wall Street reform and Consumer Protection Act (the "Dodd-Frank Act"). However, in connection with the duty of loyalty and duty of care components of potential rulemaking, the RFI asks commenters to provide comments with respect to certain assumptions that the SEC has set forth that may serve as the framework for potential rulemaking.

The Committee's letter addresses two of these assumptions:

- That each broker-dealer and investment adviser that provides personalized investment advice about securities to a retail customer would be required to deliver at the beginning of a retail customer relationship disclosure in the form of a general relationship guide similar to the Form ADV Part 2A Brochure (the "Relationship Guide"); and

- That the potential rule would prohibit the receipt or payment of non-cash compensation (*e.g.*, trips and prizes) in connection with the provision of personalized investment advice about the purchase of securities.

As we discuss below, we urge that any new disclosure obligations embrace electronic delivery. We also strongly oppose any effort to abolish FINRA's long-standing framework that applies to non-cash compensation paid with respect to sales of variable insurance and other securities products.

At the end of our letter, we briefly address the SEC request for comments on certain alternatives to a uniform fiduciary standard and note that to the extent the SEC actively considers alternatives to a fiduciary duty, we believe consideration should be given to the first alternative set forth (*i.e.*, establish a uniform disclosure requirement for broker-dealers and investment advisers). We further note that we would be happy to provide additional comments if the SEC decides to advance consideration of alternatives.

I. The Relationship Guide

The Committee generally favors a requirement that a Relationship Guide be delivered at the beginning of a retail customer relationship. However, should any potential rulemaking require the delivery of a Relationship Guide, the Committee offers the following comments:

- The Committee agrees that the Relationship Guide should take a form similar to the Form ADV Part 2A Brochure (the "Adviser Brochure"). In addition, only broker-dealers should be required to deliver the Relationship Guide. Investment advisers should only be required to deliver the Adviser Brochure, not both the Relationship Guide and the Adviser Brochure;

- The SEC should allow Relationship Guides to be tailored to the services offered to a particular customer, paralleling the treatment afforded to the Adviser Brochure; and

- The SEC should permit firms to electronically deliver the Relationship Guide and the Adviser Brochure according to an "access equals delivery" model.

A. Harmonization of Broker-Dealer and Investment Adviser Disclosures

In the RFI, the SEC asked those commenting to assume that if the potential rulemaking were to require the preparation and delivery of a Relationship Guide, it would be in a form similar to the Adviser Brochure. The Committee agrees with the SEC that the Relationship Guide should take a form similar to the Adviser Brochure. The SEC recently reviewed and enhanced the disclosure that investment advisers must now provide in the Adviser Brochure,[3] and the Committee believes that the development of the Relationship Guide should borrow as appropriate from the improvements made to the disclosures that advisory clients now receive.

If the SEC advances development of a Relationship Guide, the Committee requests confirmation that only broker-dealers would be required to deliver it. That is, investment advisers should only be required to deliver the Adviser Brochure, and not both the Relationship Guide and the Adviser Brochure. If the Relationship Guide is modeled after and similar to the Adviser Brochure, it would appear duplicative and unnecessary to require investment advisers to deliver both documents.

In addition, the Committee believes that the SEC should allow Relationship Guides to be tailored to the type of brokerage services provided in the same way that Adviser Brochures can be tailored to the type of investment advisory services provided. Instruction 9 to the Adviser Brochure addresses whether an adviser offering several advisory services can prepare multiple brochures, with each brochure tailored to a particular advisory service. This instruction advises that advisory firms are permitted to create multiple brochures, with each tailored to a particular advisory service, so long as each client receives all applicable information about services and fees. Each brochure may omit information that does not apply to the advisory services and fees it describes.

Assuming that the Relationship Guide will be modeled after and similar to the Adviser Brochure, the Committee believes that broker-dealers should be permitted to tailor their Relationship Guides to brokerage services provided in the same way that Adviser Brochures are allowed to be tailored.

[3] *Amendments to Form ADV*, Advisers Act Release No. IA-3060 (July 28, 2010).

B. "Access Equals Delivery"

The Committee believes that the SEC should permit firms to electronically deliver the Relationship Guide and the Adviser Brochure according to an "access equals delivery" model. Under an "access equals delivery" model for electronic delivery of disclosure documents, investors are assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by a company posting a document on a web site.

The SEC has adopted an access equals delivery model in various instances. In so doing, it concluded that an access equals delivery model is in the interests of investors impacted by these initiatives. Below we review each of these initiatives in turn.

1. The SEC's Adoption of Access Equals Delivery in Other Contexts

Securities Offering Rules. The SEC embraced the access equals delivery concept in the securities offering reform rules and amendments adopted in 2005.[4] These rules serve to modernize and liberalize the registration and offering of securities under the Securities Act of 1933, as amended (the "Securities Act"). Among other things, the offering reforms include relief from the requirement under Section 5 of the Securities Act to deliver a final or statutory prospectus at or prior to the earlier of the delivery of a confirmation of sale or delivery of the security.[5] The rules embrace the "access equals delivery" model for delivery of prospectuses based on the assumption that investors have access to the Internet, and permit issuers to satisfy the Section 5 delivery requirement if the prospectus is posted on the SEC's website.

According to the Securities Offering Reform Release, the SEC decided to implement an access equals delivery model in this context for the following reasons: (i) to facilitate greater availability of information to investors and the market with regard to all issuers; (ii) to eliminate barriers to open communications that have been made increasingly outmoded by technological advances; (iii) to reflect the increased importance of electronic dissemination of information, including the use of the Internet; and (iv) because Internet usage had increased sufficiently to allow the adoption of a final prospectus delivery model for issuers and their intermediaries that relies on timely access to filed information and documents.

Proxy Rules. The SEC took a somewhat similar approach to the securities offering reform rules in adopting amendments to the proxy rules relating to the electronic delivery of

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[4] *Securities Offering Reform*, Securities Act Release No. 33-8591 (July 19, 2005) (hereinafter, the "Securities Offering Reform Release").

[5] Rule 172 under the Securities Act provides that a prospectus would be deemed to precede or accompany a security for sale for purposes of Section 5(b)(2) of the Securities Act as long as a prospectus meeting the requirements of Section 10(a) of the Securities Act is filed with the Commission. This allows for the delivery to investors of only the confirmation and no prior or accompanying delivery of a written prospectus.

proxy material.[6] Rule 14a-16(d) under the Securities Exchange Act of 1934 (the "Exchange Act") governs the content of the notice that an issuer must send to its security holders in connection with the availability on the Internet of proxy material for that issuer. The rule requires the notice to state that if the security holder wants a paper copy of the proxy material, the security holder must request one. It also requires that the notice provide the security holder with a toll-free phone number, e-mail address and Internet website where current and future proxy material in paper form can be requested. One of the goals for the initiative was "increasing reliance on technology to improve proxy distribution."[7]

Mutual Fund Summary Prospectus. More recently the SEC adopted rules that permit mutual funds to use a new summary section of the prospectus as an optional "summary prospectus" to satisfy the fund's prospectus delivery requirements under Section 5(b) of the Securities Act.[8] Funds are permitted to use short-form summary prospectuses on the condition that they make their full statutory prospectus and other specified fund documents available on the Internet, with paper copies available upon request. The fund's full statutory prospectus on the Internet is in turn required to contain hyperlinks to assist investors in being able to quickly navigate from the headings in the table of contents in the full statutory prospectus to the corresponding sections in the prospectus and from the full statutory prospectus to the summary prospectus and the statement of additional information.

Interpretive Guidance on the Use of Company Websites. To encourage the continued development of company web sites as a significant vehicle for the dissemination to investors of important company information, in 2008 the SEC issued additional guidance specifically addressing company web sites.[9] Given the speed at which technological advances were developing, and the translation of those technologies into investor tools, the SEC felt it was necessary to revisit the guidance previously provided in order to update and supplement it as appropriate. The 2008 Guidance focused principally on: when information posted on a company web site is "public" for purposes of the applicability of Regulation FD; company liability for information on company web sites—including previously posted information, hyperlinks to third-party information, summary information and the content of interactive web sites; the types of controls and procedures advisable with respect to such information; and the format of information presented on a company web site, with the focus on readability, not printability.

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[6] *Shareholder Choice Regarding Proxy Materials*, Exchange Act Release No. 34-56135 (July 26, 2007) (hereinafter, the "Proxy Release").

[7] *Id.*

[8] *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 33-8998 (Jan. 13, 2009) (hereinafter, the "Mutual Fund Summary Prospectus Release").

[9] *Commission Guidance on the Use of Company Web Sites*, Exchange Act Release No. 34-58288 (Aug. 1, 2008) (hereinafter, the "2008 Guidance").

In the 2008 Guidance, the SEC recognized "the enormous potential for the Internet to promote the goals of the federal securities laws," and accordingly encouraged "companies to develop their web sites in compliance with the federal securities laws so that they can serve as effective information and analytical tools for investors." Moreover, the SEC also conceded in the 2008 Guidance that "we have reached a point where the availability of information in electronic form ... is the superior method of providing company information to most investors, as compared to other methods."

Furthermore, in the 2008 Guidance the SEC described the proxy rule amendments that are detailed above as follows:

> Perhaps the most significant change effected by this rulemaking is the shift whereby electronic availability can serve as the default means of delivery, with shareholders having to "opt out" to receive paper delivery. The requirement that any shareholder lacking Internet access, or preferring delivery of a paper copy of the proxy materials, can make a permanent request to receive a paper copy of the proxy materials (and all future proxy materials) at no charge mitigates concerns about Internet access ... Information in electronic documents is often more easily searchable than information in paper documents. Shareholders will be better able to go directly to any section of the document that they are particularly interested in.

2. Access Equals Delivery for the Relationship Guide and the Adviser Brochure

In the other contexts discussed above, the SEC provided various reasons supporting access equals delivery and the electronic availability of information. These reasons, which are equally applicable in the context of the Relationship Guide and the Adviser Brochure, are as follows:

- to facilitate greater and more immediate availability of information to investors in better, more useable formats that can streamline lengthy and complex disclosures – for example, it allows investors to go directly to any section of an electronic document that they are particularly interested in;[10]
- to eliminate barriers to open communications that have been made increasingly outmoded by technological advances;[11]
- to reflect the increased importance of electronic dissemination of information, including the use of the Internet;[12]

[10] *See* the Securities Offering Reform Release and the 2008 Guidance. *See also* the Proxy Release and the Mutual Fund Summary Prospectus Release.

[11] *See* the Securities Offering Reform Release.

[12] *See id.*

- because Internet usage has increased sufficiently to allow the adoption of an access equals delivery model,[13] and significant strides have been made in the speed and quality of Internet connections;[14]
- because we have reached a point where the availability of information in electronic form is the superior method of providing company information to most investors, as compared to other methods;[15]
- the requirement that any investor lacking Internet access, or preferring delivery of a paper copy of communications, can make a permanent request to receive a paper copy of communications (and all future communications) at no charge mitigates concerns about Internet access;[16]
- to expand the use of the Internet to ultimately lower the costs of disclosure;[17]
- encouraging investors to use the Internet in one context may encourage improved investor communications in other ways;[18] and
- the enormous potential for the Internet to promote the goals of the federal securities laws.[19]

Several years have passed since the SEC last adopted an access equals delivery model with respect to an investor communication, and since that time the popularity of the Internet as a communications tool amongst retail investors has continued to increase. In 2012, the percentage of households who were both mutual fund investors and had access to the internet increased to 91 percent.[20] Additionally, as of 2012, more than 8 in 10 mutual fund-owning households who have Internet access use the Internet daily.[21]

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[13] *See* the Securities Offering Reform Release and the 2008 Guidance.

[14] *See* the 2008 Guidance. *See also* the Mutual Fund Summary Prospectus Release.

[15] *See* the 2008 Guidance.

[16] *See* the 2008 Guidance. *See also* the Proxy Release.

[17] *See* the Proxy Release.

[18] *See id.*

[19] *See* the 2008 Guidance.

[20] ICI Research Perspective, "Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2012," at 20 ("ICI Research Perspective"). *See also*, ICI 2013 Investment Company Fact Book, 53rd Edition, at 102 ("ICI Fact Book").

[21] *Id.*; ICI Research Perspective, at 22.

Furthermore, the latest research shows that the demographic "gap" among retail investors who have and use the Internet has closed. For example, in the context of retail investors owning mutual fund shares, the incidence of Internet access traditionally was viewed as greatest among younger retail investors. However, increases in Internet access among older retail investor age groups have narrowed the generational gap considerably.[22] The use of the internet by these retail investors is no longer constrained by age or socioeconomic status.

Research has also shown that the availability of electronic media creates more knowledgeable retail investors. In 2012, 86 percent of mutual fund investors with Internet access went online for financial purposes, most often to obtain investment information or check their bank or investment accounts.[23] In addition, mutual fund–owning households were more likely than non-fund-owning households to engage in common online activities, such as accessing e-mail, obtaining information about products and services other than investments, or purchasing products and services other than investments.[24] This use of the internet by these retail investor households underscores that they expect to be able to access and store information about their investments online.

We further note that technology is now easier than ever to use, and that expanded use and access to mobile technology offers more choices for retail investors to receive information. In recent years, Internet access and use has proliferated with the advent of mobile technology. The Blackberry's release in 2000, the iPhone's release in 2007, the iPad's release in 2008, Google's mobile device technology rollout in 2010 for mobile phone and personal computing tablets, and the recent rise of smart phones and tablets mean millions of investors have access to the Internet and their account(s) when and where they choose. Concomitant with this proliferation in devices used to access electronic documents at the user's convenience, software advances have made retrieving, storing, searching, and reformatting such documents easier and far more individualized than paper documents.

Costs/Benefits. The Committee believes that an access equals delivery regime would be appropriate with respect to the Relationship Guide and the Adviser Brochure. The costs of a paper-based disclosure regime to broker-dealers and investment advisers are substantial, as they include the printing of materials, their delivery (including mailing), and the storage of paper copies. Furthermore, a paper-based disclosure regime is not environmentally friendly. When the benefits of an access equals delivery regime – *e.g.*, 24-7 access, search capability, streamlined linkage between table of contents and substantive disclosures, mobile access, and lower cost –

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[22] ICI Research Perspective, at 20; ICI Fact Book, at 102. The percentage of households owning mutual funds who accessed e-mail on a daily basis was 93%, versus 85% for those households that do not own mutual funds. ICI Research Perspective, at 23.

[23] *Id.*

[24] *Id.*

are considered in conjunction with the growing popularity of the Internet amongst retail investors, we assert that the costs of a paper-based disclosure regime are not worthwhile.

II. Non-Cash Compensation

One of the baseline assumptions in the RFI would prohibit non-cash compensation arrangements. In particular, the RFI states "[a]ssume that the rule would prohibit certain sales contests. The rule would prohibit the receipt or payment of non-cash compensation (*e.g.*, trips and prizes) in connection with the provision of personalized investment advice about the purchase of securities."

For many years, insurers have used a variety of non-cash compensation arrangements to reward and incentivize their agent sales force. These arrangements include, among other things, sales conferences and related events; trophies and other awards; and certain forms of assistance. Such arrangements are designed to serve worthwhile business goals with an ultimate goal of helping salespersons better serve consumers.

A. Background

Since 1999, FINRA Rule 2320 (formerly NASD Rule 2820) has contained provisions explicitly regulating compensation arrangements for variable contract sales. The rule was developed over the course of a 10-year rulemaking process and responded in part to recommendations in the "Tully Report" focusing on conflicts of interest created by compensation arrangements for broker-dealer registered representatives.[25] The rule was the product of an extensive rulemaking initiative that involved extensive deliberation and consideration of different approaches for addressing the conflicts created by non-cash compensation arrangements. In deciding upon the approach taken in Rule 2820, FINRA (NASD at the time) wrote that:

> NASD Regulation, a wholly owned subsidiary of the NASD, believes this proposed rule change is consistent with the characteristics of "best practices" identified in the Tully Report to the extent that the proposal helps to better align the interests of associated persons, broker-dealers and investors with respect to investment company securities and variable contracts.[26]

[25] *See* Report of the Committee on Compensation Practices, [1995 Decisions Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,614 (Apr. 10, 1995).

[26] *Order Granting Approval of Proposed Rule Change Filed by the National Association of Securities Dealers, Inc. Relating to the Regulation of Non-Cash Compensation in Connection With the Sale of Investment Company Securities and Variable Contracts*, Exchange Act Release No. 34–40214; File No. SR–NASD–97–35 (July 15, 1998).

While FINRA Rule 2320 imposes conditions on non-cash incentive programs offered by broker-dealers to its associated persons in connection with the sale and distribution of variable contracts, other rules (collectively, the "Non-Cash Rules") impose substantially similar conditions on non-cash incentive programs in connection with the sale and distribution of other securities. In this regard, we note that FINRA's Investment Company Securities Rule (NASD Rule 2830) imposes limits on a member firm's receipt of non-cash compensation in connection with the sale and distribution of investment company securities. FINRA's Corporate Financing Rule (FINRA Rule 5110) and Direct Participation Program Rule (FINRA Rule 2310) conform to the non-cash compensation provisions included in FINRA Rule 2320 and NASD Rule 2830.

The Non-Cash Rules contain a general provision prohibiting broker-dealers or persons associated with a broker-dealer from directly or indirectly accepting or making non-cash compensation payments, except in the following five circumstances:

(A) Gifts not exceeding an annual limit per person of $100 so long as the gift is not preconditioned on achieving a sales target;

(B) An occasional meal or entertainment that is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achieving a sales target;

(C) Payment or reimbursement of expenses by an offeror in connection with training or education meetings sponsored by an offeror or a broker-dealer provided, among other things, that attendance is not preconditioned on achievement of a sales target and the location is appropriate for the meeting;

(D) Incentive non-cash compensation programs sponsored by the broker-dealer or an affiliated company for registered persons so long as, among other things, the credits under the program are based on total production of all securities of a given product type distributed by the broker-dealer, with equal credit given for all such products sold; and

(E) Contributions by a non-broker-dealer or other broker-dealer to a non-cash compensation program complying with Exception (D), so long as the contributor does not directly or indirectly participate in the organization of the program.

1. Sales Contests

Exception (D) permits broker-dealers or affiliated companies (if the affiliate and the broker-dealer share the same sales force) to sponsor non-cash incentive compensation programs for the registered persons of the broker-dealer, subject to certain conditions. As noted above, production of all securities of a given product type that are offered must be counted (often referred to as the "total production" requirement). As a result, contest sponsors cannot reward producers with non-cash compensation credits for selling only selected products. In addition, equal credit must be awarded for all products sold (often called the "equal weighting" requirement). Accordingly, a non-cash compensation program cannot award more credit for the sale of one variable contract and less credit for the sale of another variable contract of the same type (*e.g.* annuities).

2. Training and Education Conferences

FINRA has stated that the Non-Cash Rules require the training portion of any educational seminar to "occupy substantially all of the work day."[27] For the training and education exception to apply, the following restrictions also must be observed:

- There can be no reimbursement for golf outings, tours, or other forms of entertainment while a registered representative is at a location for the purpose of training or education;
- The location of the training or education seminar must be appropriate based on the location of the sponsor – generally at or near the business office of the sponsor;
- There can be no reimbursement for any expenses of spouses, families, or anyone other than the registered reps;
- Record keeping requirements apply;
- Registered representatives must obtain the prior approval of their broker-dealer to attend any seminar; and
- Payment or reimbursement by the offeror cannot be preconditioned on the achievement of a sales target or other incentives and the decision of which registered reps may attend must be made solely by the broker-dealer with which the registered representatives are associated.[28]

FINRA has also issued guidance concerning the content and conduct of such meetings, as well as the provision of entertainment in conjunction with the meetings.

B. Investor Protection Afforded by the Non-Cash Rules

Since the adoption of the Non-Cash Rules, FINRA has focused on broker-dealers' non-cash compensation practices, and where it has found instances of misconduct, it has brought

[27] *See* "Non-Cash Compensation—Training or Education Meetings," NASD Regulatory & Compliance Alert, Summer 2000, at 13; Interpretive Letter from Mary Shapiro, President, NASD Regulation Inc., March 7, 2001.

[28] *Id.*

enforcement actions.[29] FINRA's enforcement of the Non-Cash Rules helps ensure that broker-dealers maintain adequate supervisory control over sales practices and that their suitability obligations are not compromised by the incentives created by non-cash compensation programs. In this respect, the Non-Cash Rules, particularly the equal weighting and total production requirements and the limitations imposed on training and education meetings, effectively mitigate the conflicts created by the payment of non-cash compensation and assure that the payment of non-cash compensation does not adversely impact the recommendations provided by registered representatives at the point of sale.

The Committee is not aware of any claim by FINRA or any other organization or agency that the Non-Cash Rules have proven to be ineffective in ensuring that registered representatives' recommendations are not unduly swayed by the incentives created by the payment of such compensation. Nor is the Committee aware of claims of systematic sales practice violations caused by the payment and receipt of non-cash compensation. As noted below, the SEC supported the NASD's approach toward non-cash compensation arrangements and approved the Non-Cash Rules. In this respect, to our knowledge the SEC itself has never suggested there are any problems or gaps with FINRA's long-standing framework governing non-cash compensation arrangements.

C. Adverse Impacts of Eliminating Non-Cash Compensation

A prohibition on non-cash compensation would severely impact insurance-affiliated broker dealers and their affiliates, without any concrete benefit to investors. For example, insurers would have to review and amend, as necessary, their compensation arrangements with their registered representatives. Prospectuses and Statements of Additional Information would have to be reviewed and in many cases revised, as would broker-dealers' compensation policies and procedures, compensation grids, training manuals and compensation payment systems (including various electronic payment systems). New payment systems, grids, and practices, as well as agent training programs and materials, would have to be designed, established and implemented.

We also note that non-cash compensation is expressly permitted by state insurance law. Any prohibition of such compensation would be contrary to compensation grids and arrangements that have been developed with a view to state insurance laws, and would also create disparate treatment and a potential conflict between non-registered fixed insurance products and registered insurance products.

[29] *See e.g.,* NASD Fines Hornor, Townsend & Kent, Inc. $325,000 for Improper Sales Contests, Email and Supervision Violations, July 8, 2005, FINRA 2005 News Releases; NASD Fines Merrill Lynch $5 Million for Call Center Supervisory Failures, Sales Contest Violations, Mar. 15, 2006, FINRA 2006 News Releases; NASD Charges Morgan Stanley with Giving Preferential Treatment to Certain Mutual Funds in Exchange for Brokerage Commission Payments, Nov. 17, 2003, FINRA 2003 News Releases.

For example, for more than a century, New York has stringently regulated agent compensation, including non-cash compensation.[30] New York Insurance Law § 4228 circumscribes the types of cash and non-cash remuneration—consisting of commissions, allowances, other compensation, fringe benefits, prizes/awards, conventions, conferences and meetings—that are permitted. That statute places limits on the form, amounts and duration of various forms of compensation and reimbursement payable to sales personnel with respect to individual products sales. [31] Section 4228 also requires insurers to report agent compensation on their Annual Statement and to file and/or obtain approval of their compensation arrangements with the New York Department of Financial Services.[32]

Any action which would prohibit non-cash compensation arrangements with respect to registered insurance products would frustrate and conflict with well-established state insurance laws.

Finally, eliminating non-cash compensation arrangements appears to run counter to Initial Assumption 4 of the RFI, which states, in relevant part, "[a]ssume that the uniform fiduciary standard of conduct would be designed to accommodate different business models <u>and fee structures</u> of firms . . . ." (emphasis added). The Committee submits that insurance affiliated broker-dealers regularly utilize non-cash compensation arrangements which have been developed over many years to comply with FINRA's regulatory framework and would be disproportionately harmed by a prohibition on such arrangements, as compared to other segments of the broker-dealer industry that do not regularly implement such arrangements.

D. Lack of Justification for Eliminating Non-Cash Compensation Arrangements and Unforeseen Consequences

The Committee cautions the SEC against eliminating long-standing compensation practices that were the result of a deliberative and consultative process. The Committee is puzzled regarding the rationale for singling out non-cash compensation arrangements as the <u>only</u> conflict that would be prohibited outright. The RFI provides no rationale for singling out non-cash compensation arrangements.

In this regard, compare the RFI's treatment of non-cash compensation with that of its treatment of principal transactions. While the RFI indicates that the uniform standard of conduct would prohibit the receipt or payment of non-cash compensation in connection with the provision of personalized investment advice about the purchase of securities it would permit principal transactions. In this regard, the RFI states that:

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[30] *See generally* N.Y. Ins. Law § 4228 (McKinney 2011).

[31] *See* N. Y. Ins. Law § 4228(d)-(e) (McKinney 2011).

[32] *See* NY Ins. Law § 4228(f) (McKinney 2011).

> Broker-dealers also would continue to be permitted to be engaged in, and receive compensation from, principal trades. To satisfy the uniform fiduciary standard of conduct, however, assume that at a minimum a broker-dealer or investment adviser would need to disclose material conflicts of interest, if any, presented by its compensation structure. . . . Assume that to satisfy its obligations under the uniform fiduciary standard of conduct, however, a broker-dealer would need to disclose any material conflicts of interest associated with its principal trading practices.

Under the RFI, principal transactions are viewed as ordinary conflicts that can be managed merely by good disclosure. The Committee struggles to see why the same should not be true of the payment and receipt of non-cash compensation. If a principal transaction, which involves a fiduciary being on the "opposite side of the table" from a customer, can be managed with mere disclosure, then it is difficult to see why a conflict created by the receipt of non-cash compensation, cannot be similarly treated. After all, the SEC has described principal transactions as posing "serious conflicts of interest and a substantial risk that the proprietary interests of the adviser will prevail over those of [the adviser's] clients."[33]

The Committee further notes that the RFI states "[a]*ssume that any rule under consideration would treat conflicts of interest arising from principal trades the same as other conflicts of interest*. . . . At a minimum, as with other conflicts of interest, the broker-dealer would be required to disclose material conflicts of interest arising from principal trades with retail customers." Interestingly, eliminating non-cash compensation arrangements would be inconsistent with the SEC's directive that principal transactions be treated "the same" as other conflicts of interest; in fact, eliminating non-cash compensation suggests the SEC views the receipt of non-cash compensation as involving a more serious conflict of interest than being on the opposite side of a transaction with a customer in a principal transaction. The Committee struggles to see how the SEC reached this conclusion.

The SEC's position in the RFI also is problematic in that it promotes form over substance. The Committee fails to see why an incentive of $100 in cash would be permissible but a non-cash compensation incentive equal to $100 would be prohibited. This is not to suggest that all compensation incentives should be prohibited; it is merely to ask why the *form* of the incentive (as opposed to the extent of the conflict) should lead to it being permissible or prohibited. The Committee cautions that regulatory distinctions built on formulistic differences rarely lead to improvements in investor protection. In this sense, the Committee envisions

[33] *See Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Advisers Act Release No. IA-2653 (Sept. 24, 2007). *See also Notice of Proposed Rulemaking*, Advisers Act Release No. IA-557 (Dec. 2, 1976) ("In contrast, where an investment adviser effects a transaction as principal with his advisory account client, the terms of the transaction are necessarily not established by arm's-length negotiation. Instead, the investment adviser is in a position to set, or to exert influence potentially affecting, the terms by which he participates in such trade. The pressures of self-interest which may be present in such principal transactions may require the prophylaxis of the disclosures specified in Release No. 40.")

broker-dealers responding to a prohibition on non-cash compensation arrangements in a number of ways including restructuring their cash compensation practices. If this were to occur, the Committee questions how a ban on non-cash compensation would further the public interest.

At the very least, we would request that the SEC not proceed in eliminating non-cash compensation arrangements without a thorough explanation of why a prohibition on non-cash compensation is consistent with Initial Assumption 4, the language quoted above indicating that conflicts of interest arising from principal trades would be treated the same as other conflicts of interest and the SEC's investor protection mandate. With respect to the last point, the Committee fails to see how differential regulatory treatment of compensation practices based on the form of the compensation furthers investor protection. The Committee also would ask that the SEC justify how the benefits of prohibiting non-cash compensation arrangements would justify the extensive costs to the industry of revising their compensation practices, prospectuses and statements of additional information, compensation policies and procedures, training practices and compensation payment systems, as discussed above. In this respect, because a complete ban on such form of compensation is, by definition, blind to the extent of the conflict created by a particular non-cash compensation arrangement, it is difficult to see how such a ban enhances investor protection without also eliminating many arrangements that do not involve a material conflict.

Most importantly, we would ask that the SEC demonstrate why, out of all the conflicts of interest raised by the broker-dealer business model, the one that the SEC believes must be eliminated is the payment and receipt of non-cash compensation. In this respect, we note the following:

- The payment of compensation is a legitimate business practice. Businesses have a perfectly legitimate business reason to compensate and incentivize their registered persons. The decision of the nature of the compensation ought to be left up to broker-dealers as they are best positioned to make such determinations.
- The form of compensation should not dictate whether it is prohibited or permitted. Regulation should instead focus on the nature and extent of a conflict of interest. Under the baseline assumption in the RFP a non-cash compensation incentive program involving a benefit worth a single dollar would be prohibited (while there would be no limit on cash compensation arrangements). The Committee fails to see the rationale underlying such a distinction.
- FINRA and the SEC have considered non-cash compensation arrangements over many years and have implemented a comprehensive regulatory regime that has proven effective in allowing broker-dealers to supervise their sales force and to ensure their recommendations are suitable. With many years of regulatory scrutiny and over 10 years of targeted rulemaking in place, the Committee believes that the equal weighting, total production and other provisions in the Non-Cash Rules are effective in mitigating the conflicts associated with non-cash compensation arrangements.

In approving the Non-Cash Rules applicable to variable contracts and investment company securities, the SEC wrote as follows:

> The Commission believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require in pertinent part that the Association adopt and amend its rules to promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, and generally provide for the protection of investors and the public interest. Specifically, the proposed rule change is designed to reduce point-of-sale impact of non-cash sales incentives that may compromise the duty of registered representatives to match the investment needs of customers with the most appropriate investment product. The Commission believes the proposal appropriately recognizes that the interest of those giving investment advice and those seeking investment advice can diverge where non-cash compensation exists as an incentive to sell specific investment products.
>
> Accordingly, the proposed rule change is designed to limit compensation arrangements that may threaten the mutuality and harmony of interest between firms, their representatives, and the investing public. To that end, the proposal addresses direct and perceived conflicts of interest stemming from non-cash compensation arrangements, such as contests offering lavish trips and expensive prizes and gifts for the sale of investment company and variable contract securities. Investor confidence in the operation of the securities markets is in turn bolstered as a consequence of the removal of such conflicts of interest.
>
> The proposal facilitates, moreover, the ability of NASD members to execute compliance and supervisory responsibilities by restricting the potential for third-party non-cash incentives to undermine the supervisory control of an NASD member with respect to its associated persons. An NASD member is thus assisted in its efforts to create unbiased compensation plans that are arranged with the approval of, and administered and recorded by, the member firm. The Commission believes greater supervisory and compliance control of compensation structures of associated persons will enhance the ability of NASD members to implement policies and procedures to ensure that registered representative compensation structures align the interests of the firm, the registered representative, and the investor.[34]

As the SEC itself has noted, the Non-Cash Rules address "direct and perceived conflicts of interest stemming from non-cash compensation arrangements" and facilitate "the ability of NASD members to execute compliance and supervisory responsibilities by restricting the

[34] *Order Granting Approval of Proposed Rule Change Filed by the National Association of Securities Dealers, Inc. Relating to the Regulation of Non-Cash Compensation in Connection With the Sale of Investment Company Securities and Variable Contracts*, Exchange Act Release No. 34–40214; File No. SR–NASD–97–35 (July 15, 1998).

potential for third-party non-cash incentives to undermine the supervisory control of an NASD member with respect to its associated persons." Until such time as the SEC demonstrates that these words are less true today than when they were first uttered, it will have failed to demonstrate why non-cash compensation arrangements should be prohibited while <u>all other conflicts of interest</u> can be managed with proper disclosure.

E. Conclusion

The Committee submits that there is no basis to believe that eliminating non-cash compensation arrangements will materially improve investor protection. At the same time we note that eliminating such arrangements will entail significant costs. Such a dynamic does not support eliminating a long-standing regulatory framework that has successfully mitigated conflicts of interest and enabled broker-dealers to effectively supervise their associated persons' sales practices.

III. Alternatives

The SEC states in its release that the Dodd-Frank Act provisions do not mandate rulemaking and that it has not yet determined whether to engage in any rulemaking or other action on the subject of a uniform fiduciary standard. In this regard, the SEC requests comment on certain alternatives to a uniform fiduciary standard. To the extent the SEC actively considers alternatives to a fiduciary duty, we believe consideration should be given to the first alternative set forth (*i.e.*, establish a uniform disclosure requirement for broker-dealers and investment advisers). We would be happy to provide additional comments if the SEC decides to advance consideration of alternatives.

We appreciate the opportunity to provide these comments and would be very happy to provide additional information or meet to discuss any of the points we discuss herein. Please do not hesitate to contact Clifford Kirsch (212.389.5052, clifford.kirsch@sutherland.com) or Michael Koffler (212.389.5014, michael.koffler@sutherland.com) if you have any questions regarding the comments in this letter.

Respectfully submitted,

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FOR THE COMMITTEE OF ANNUITY INSURERS

APPENDIX A

THE COMMITTEE OF ANNUITY INSURERS

AIG Life & Retirement
Allianz Life
Allstate Financial
AVIVA USA Corporation
AXA Equitable Life Insurance Company
Commonwealth Annuity and Life Insurance Company
Fidelity Investments Life Insurance Company
Genworth Financial
Great American Life Insurance Co.
Guardian Insurance & Annuity Co., Inc.
ING North America Insurance Corporation
Jackson National Life Insurance Company
John Hancock Life Insurance Company
Life Insurance Company of the Southwest
Lincoln Financial Group
MassMutual Financial Group
Metropolitan Life Insurance Company
Nationwide Life Insurance Companies
New York Life Insurance Company
Northwestern Mutual Life Insurance Company
Ohio National Financial Services
Pacific Life Insurance Company
Protective Life Insurance Company
Prudential Insurance Company of America
Symetra Financial
The Transamerica companies
TIAA-CREF
USAA Life Insurance Company