# No. 19-2886(L)

19-2893(CON)

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

XY PLANNING NETWORK, LLC; FORD FINANCIAL SOLUTIONS, LLC; STATE OF NEW YORK; STATE OF CALIFORNIA; STATE OF CONNECTICUT; STATE OF DELAWARE; STATE OF MAINE; DISTRICT OF COLUMBIA; STATE OF NEW MEXICO; AND STATE OF OREGON;
*Petitioners*,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION AND WALTER CLAYTON, IN HIS OFFICIAL CAPACITY AS CHAIRMAN OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION;
*Respondents*.

ON PETITIONS FOR REVIEW OF A FINAL RULE OF
THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

BRIEF AMICUS CURIAE OF BETTER MARKETS, INC., AND THE CONSUMER FEDERATION OF AMERICA, IN SUPPORT OF PETITIONERS

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## CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure ("FRAP"), the Amici state the following:

(A) Better Markets has no parent corporation and there is no publicly held corporation that owns any stock in Better Markets.

(B) Consumer Federation of America has no parent corporation and there is no publicly held corporation that owns any stock in the Consumer Federation of America.

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## STATEMENT OF AMICI'S IDENTITY, INTEREST, AND AUTHORITY TO FILE[1]

Better Markets, Inc. ("Better Markets") is a nonprofit, nonpartisan organization that promotes the public interest in the financial markets through comment letters, litigation, independent research, and public advocacy. It fights for reforms that create a stronger, safer financial system; promote the economic prosperity of all Americans; and protect individual investors from fraud, abuse, and conflicts of interest. Better Markets has submitted hundreds of comment letters to financial regulators, including the SEC, advocating for strong rules in the securities, commodities, and credit markets. It has also filed many amicus briefs in federal district and circuit courts in cases challenging agency rules. *See generally* Better Markets, http://www.bettermarkets.com (including archive of comment letters and briefs).

Consumer Federation of America ("CFA") is a nonprofit association of more than 250 state, local, and national pro-consumer organizations, founded in 1968 to represent the consumer interest through research, advocacy, and education. More information about CFA's membership is available at https://consumerfed.org/membership/. For three decades, CFA has been a leading voice in advocating for stronger

[1] In accordance with FRAP 29(a)(4)(E), Amici state that (i) no counsel for any party authored this brief in whole or in part; (ii) no party or party's counsel contributed money that was intended to fund preparing or submitting this brief; and (iii) no person—other than the amici, their members, or their counsel—contributed money that was intended to fund preparing or submitting this brief.

protections for individual investors. CFA policy in this area is focused on ensuring that investors have a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective recourse when they are the victims of wrongdoing. CFA's advocacy for a heightened standard of care when financial professionals offer investment advice dates back to at least 2000. *See generally* CFA, http://consumerfed.org/issues/investor-protection/investment-professionals/.

Amici were heavily involved in the rulemaking process that resulted in the SEC's promulgation of Regulation "Best Interest" ("Reg. BI" or "Rule") and each submitted extensive comment letters highlighting the weaknesses in the rule proposal and urging the SEC to strengthen it.[2]

## SUMMARY OF ARGUMENT

Every year, millions of vulnerable retail investors who lack financial expertise turn to financial professionals for advice about their investments. They place their trust and confidence in financial professionals to help them plan for a secure and dignified retirement, a child's college education, or other long-term goals. Investors reasonably expect that, regardless of what type of financial professional they turn

[2] The Amici have the authority to file this brief under FRAP 29(a)(2) because all parties have consented to its filing.

to—either a broker-dealer or a registered investment adviser—the advice they receive will be in their best interest, untainted by harmful conflicts of interest.

Unfortunately, the SEC has for decades perpetuated a regulatory framework that applies different standards to the same advisory services and fails to ensure that all investors receive advice in their best interest. The agency's approach has fostered widespread confusion among investors regarding the standards of conduct applicable to their trusted financial professionals. Worse, it has allowed broker-dealers to market themselves as advisers and to function as such, while also allowing them to act on powerful conflicts of interest by recommending over-priced and under-performing investments that line the broker-dealers' pockets but cost investors tens of billions of dollars a year in lost savings.

Congress recognized these profound shortcomings in the SEC's regulation of financial advice and it responded by granting the agency ample authority to cure those deficiencies through a rulemaking pursuant to Section 913 of the Dodd-Frank Act. Section 913 was written and widely understood as a framework for the SEC to adopt a uniform fiduciary standard for broker-dealers and investment advisers who give personalized investment advice to retail investors, one that would effectively protect investors from conflicts of interest.

After years of delay, the SEC issued Reg. BI, Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019) ("Release"), but it did so in clear violation of Congress's explicit language and remedial intent under Section 913. The SEC chose to promulgate a weak and confusing rule applicable solely to broker-dealers, which solves none of the problems confronting investors in need of sound financial advice: The Rule will not impose a uniform standard of conduct on broker-dealers and investment advisers; it will not eliminate investor confusion; and it will not protect investors from the conflicts of interest and resulting financial harm that continue to plague the market for financial advice.

Instead, the Rule preserves an anti-investor regulatory environment in which different financial professionals who provide functionally identical services will continue to be subject to different standards of conduct. The burden of cutting through this regulatory web of confusion will fall on investors, yet many investors will be unable to make heads or tails of the regulatory landscape or make informed decisions about which professionals they should trust. Worse, many investors will be lulled into a false sense of security that they are receiving enhanced protections that the Rule does not actually provide. These investors will reasonably believe they are receiving high quality "best interest" advice that is untainted by conflicts of interest, but in reality, the Rule will allow brokers to dispense highly conflicted sales recommendations that undermine the financial security of those investors. In short,

if the Rule remains in place, investors will continue to suffer very real financial harm as a result of broker conflicts of interest, and the harm will be magnified by virtue of the Rule's misleading nature.

The SEC attempted to justify this weak, confusing, and misleading regulatory approach with the pretense that it would actually help investors by preserving investor "choice," a claim endlessly repeated in the Release accompanying the Rule. This was a spurious rationale, since the record does not support the notion that a strong and uniform rule would destroy the broker-dealer business model or deprive investors of valuable choices regarding investment options or payment models. In reality, the SEC blindly accepted the broker-dealer industry's self-serving claims about how a fiduciary rule would affect them, and it sought to accommodate the demands of the industry. The SEC did so at the expense of the very people it was established to protect: millions of investors who are vulnerable to harmful conflicts of interest.

A rule so clearly at odds with Congress's plain language and intent, born of such badly skewed priorities, and lacking a credible analysis and justification, is both unlawful and arbitrary and capricious under the Administrative Procedure Act ("APA"). The Petitioners' challenge to the Rule is well-founded and the Rule should be vacated.

## ARGUMENT

### I. Broker-dealers market themselves and function as investment advice providers, not salespeople.

Historically, investment advisers provided advice in positions of trust and confidence, while broker-dealers provided arms-length sales recommendations. *See* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 THE BUSINESS LAWYER 395 (2010) ("Laby"). These different professionals were regulated based on their different roles under different statutory frameworks: Investment advisers have been subject to a fiduciary duty under the Investment Advisers Act of 1940 ("Advisers Act") while broker-dealers have been subject to a more relaxed sales-based suitability standard under the Securities Exchange Act of 1934 ("Exchange Act").

Over the last three decades, however, broker-dealers have blurred the traditionally clear line between sales and advice, and they have done so with the SEC's knowledge, acquiescence, and in some respects, endorsement. Brokers have increasingly functioned as investment advisers and marketed their services as advisory in nature, without being regulated according to their advisory role. *See* Laby at 404 ("The tidy separation between brokers and advisers began to crumble initially in the 1980s when brokers started to offer financial planning services, and more significantly in the 1990s when brokerage firms began to use titles such as 'adviser' or

'financial adviser' for their broker-dealer registered representatives and even encouraged customers to think of the registered representative more as an adviser than a stockbroker.").

All aspects of brokers' communication with the investing public are designed to send the message that they are trusted advisers, committed to providing objective, trustworthy investment advice, rather than mere sales pitches. For example, they routinely use titles such as "financial advisor," "financial consultant," or "wealth manager," creating the impression they have specialized advisory expertise. They commonly describe their services as "investment advice" or "retirement planning" and market those services as designed to serve customers' best interests. In holding themselves out as impartial experts, they seek to occupy positions of trust and confidence with their customers. *See* MICAH HAUPTMAN & BARBARA ROPER, CONSUMER FEDERATION OF AMERICA, FINANCIAL ADVISOR OR INVESTMENT SALESPERSON? BROKERS AND INSURERS WANT TO HAVE IT BOTH WAYS (Jan. 18, 2017), https://consumerfed.org/wp-content/uploads/2017/01/1-18-17-Advisor-or-Salesperson_Report.pdf; *see also* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASHINGTON LAW REVIEW 707, 753-758 (2012). These practices have gone unchecked by the SEC, which has continued to permit brokers to rely on the "solely incidental to" exclusion from the Advisers Act. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange

Act Release No. 51,523, Advisers Act Release No. 2376, 70 Fed. Reg. 20,424 (Apr. 12, 2005).

Here are just a few examples of firms' marketing materials seeking to convince the investing public they are trusted advisors:

- D.A. Davidson states: "*Trust* is the cornerstone of the relationship between you, as an investor, and the D.A. Davidson & Co. financial professionals working for you. Your needs should *always come first*." *Your Rights*, D.A. DAVIDSON, http://www.davidsoncompanies.com/indv/files/DADYourRights505.pdf (last visited August 21, 2016) [https://web.archive.org/web/20101214225309/http://www.davidsoncompanies.com/indv/files/DADYourRights505.pdf] (emphasis added);
- Mass Mutual states: "Join millions of people who place their *confidence and trust* in us." MASS MUTUAL, https://www.massmutual.com/ (last visited August 21, 2016) (emphasis added) [https://web.archive.org/web/20160813114326/https://www.massmutual.com/];
- Raymond James states: "[I]t's developing a long-term relationship built on understanding and *trust*. Your *advisor* is there for you throughout the *planning* and investing process, giving you *objective and unbiased advice* along the

way." *Why a Raymond James Advisor*, RAYMOND JAMES, https://www.raymondjames.com/wealth-management/why-a-raymond-james-advisor (last visited January 3, 2020) (emphasis added);

The clear intent of this marketing is to convince investors that they should trust that their "advisor" will serve their best interests and to encourage them to rely on their expertise and recommendations. And investors place their trust in their brokers to provide them advice that will genuinely serve their best interests and maximize the value of their investments.

Moreover, when interacting with policymakers and the general public, the two leading broker-dealer trade associations clearly do not distinguish between the services that broker-dealers and investment advisers provide. According to a comment by the Financial Services Institute, for example:

> Financial products and services are complex. Investors face a massive amount of available options and conflicting information that can be overwhelming and confusing; even very highly-skilled experts and experienced investors can become lost in this ever-changing landscape of financial products and services. As a result, retail investors often find they need the help and guidance of a broker, dealer, investment adviser, affiliated registered representative, or investment adviser representative (collectively referred to as Financial Advisers) to help them make the right choices to achieve their financial goals.

David T. Bellaire, Executive Vice President & General Counsel, Financial Services Institute, Comment Letter on Request for Information Regarding Duties of Brokers,

Dealers, and Investment Advisers (July 5, 2013), https://www.sec.gov/comments/4-606/4606-3138.pdf.

Similarly, the Securities Industry and Financial Markets Association's ("SIFMA's") CEO recently claimed in a *Wall Street Journal* editorial that "there is no evidence that the advice an investor would receive [from a broker versus adviser] would differ either in kind or quality." Kenneth Bentsen, CEO, SIFMA, *Is it Time to Adopt a Uniform Fee-Only Standard for Financial Advice?*, WALL ST. J. (Mar. 18, 2018), https://www.wsj.com/articles/is-it-time-to-adopt-a-uniform-fee-only-standard-for-financial-advice-1521424980.

Only when they are at risk of being regulated as fiduciaries, based on their advisory role and the relations of trust and confidence that they cultivate with investors, do these trade associations quickly change their tune, claiming they are not true advisers, but mere salespeople, engaged in arms-length sales transactions, no different from car dealers. *See* Brief for Chamber of Commerce Plaintiffs-Appellants at 22, 39, *Chamber of Commerce of United States of Am. v. United States Dep't of Labor*, 885 F.3d 360 (2018) (No. 17-10238) (claiming that broker-dealers' relationships with their customers are "sales relationships,"); *id.* at 14 (claiming that they "engage[ ] in salesmanship,"); *id.* at 1 (arguing that subjecting broker-dealers to a fiduciary duty would "erase universally recognized distinctions between salespeople and fiduciary advisers…"); *id.* at 41 ("A broker, insurance agent, or other financial-

sales professional may make 'individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.'") (internal citations omitted).

Despite the broker-dealer industry's protestations when facing regulation as fiduciaries, the SEC concedes that investment advice relationships are indeed relationships of trust: "In seeking financial advice, a retail investor places not only money but also trust in a financial professional….one industry study of over 800 investors notes that '96% of U.S. investors report that they trust their financial professional and 97% believe their financial professional has their best interest in mind.'" Release at 33,431-33,432. The SEC also explains that levels of trust tend to be higher among the most vulnerable investors and further that trust and investor reliance go hand in hand:

> Regarding the importance of trust in established advice relationships, some studies find that trust in financial professionals is greater when investors have lower financial literacy or when purchasing complex products, such as insurance products. Further, as trust in financial professionals grows, investors may be more likely to delegate all investment decisions to the financial professional, irrespective of their level of financial education.

*Id*. Moreover, the SEC correctly acknowledges court decisions finding that broker-dealers who have a relationship of trust and confidence with their customers owe their customers a fiduciary duty. *Id.* at 33,333 n. 137; *id.* at 33,419 n. 972 (citing the classic case, *In re Arleen W. Hughes*, 27 S.E.C. 629 (1948), *aff'd sub nom. Hughes*

*v. SEC*, 174 F.2d 969 (D.C. Cir. 1949), which found that fiduciary duties are imposed on brokers who place themselves in a position of trust and confidence.).

However, the SEC failed to reconcile its acknowledgment that broker-dealers who provide personalized investment advice are in trusted relationships with its simultaneous refusal to regulate these trusted relationships as fiduciary in nature. This was arbitrary and capricious under the APA.

## II. Because broker-dealers have misled the investing public about the nature of their services and duties, investors cannot distinguish between broker-dealers and investment advisers, and they suffer real financial harm when they rely on conflicted sales recommendations.

The industry's campaign to blur the line between product sales and investment advice and effectively mislead the investing public has unquestionably "succeeded." After decades of being told they should trust their "financial advisor" to put their interests first, the majority of investors are unable to determine whether their own financial professional is a salesperson or a true adviser, whether the service being offered constitutes mere product sales or fiduciary investment advice, how these different services are regulated, and how the different regulatory landscapes affect them.

Extensive research dating back years—including research that the SEC itself commissioned—has repeatedly shown that investors do not distinguish between broker-dealers and investment advisers. Nor do they understand the different legal standards that apply to their advisory activities or the implications of working with

different financial professionals who operate under these different legal frameworks. *See, e.g.*, SIEGEL & GALE, LLC, & GELB CONSULTING GROUP, INC., RESULTS OF INVESTOR FOCUS GROUP INTERVIEWS ABOUT PROPOSED BROKERAGE ACCOUNT DISCLOSURES: REPORT TO THE SECURITIES AND EXCHANGE COMMISSION (Mar. 10, 2005), https://www.sec.gov/rules/proposed/s72599/fcrpt031005.pdf; *see also* ANGELA A. HUNG, ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 111, https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

More recent survey research by the RAND Corporation, commissioned by the SEC as part of this rulemaking, confirms these findings—in fact, it suggests that investor knowledge about key differences between broker-dealers and investment advisers appears to be *lower* than it was a decade ago. *See* BRIAN SCHOLL, OFFICE OF THE INVESTOR ADVOCATE & ANGELA A. HUNG, RAND CORP., THE RETAIL MARKET FOR INVESTMENT ADVICE 59-60 (Oct. 2018), https://www.sec.gov/files/retail-market-for-investment-advice.pdf.

When investors place their trust in brokers and rely on their highly-conflicted sales recommendations as if they constituted trustworthy advice, investors suffer enormous harm. This includes broker-dealers' selling unsuspecting investors high-cost, low-quality investments that enrich the broker-dealer firm and its registered representatives but undermine investors' financial security. Such conflicts of interest

take a huge financial toll on investors, on both an individual and systemic basis, costing them tens of billions of dollars in lost savings every year.

There is a wealth of evidence, including peer-reviewed academic studies, demonstrating that conflicts of interest influence broker-dealers' recommendations and often do so in ways that are harmful to investors. This evidence was thoroughly documented and analyzed in a 2015 RAND study, on behalf of the U.S. Department of Labor ("DOL"). JEREMY BURKE, ANGELA A. HUNG, JACK W. CLIFT, STEVEN GARBER, & JOANNE K. YOONG, IMPACTS OF CONFLICTS OF INTEREST IN THE FINANCIAL SERVICES INDUSTRY, RAND WORKING PAPER (Feb. 2015), https://www.rand.org/content/dam/rand/pubs/working_papers/WR1000/WR1076/RAND_WR1076.pdf. According to the RAND researchers, "We find empirical evidence suggesting that financial advisors [brokers] act opportunistically to the detriment of their clients." *Id*. at 2. The report continued, "Our review of the literature finds there is substantial empirical evidence that financial advisors [brokers] are influenced by their compensation schemes and that investors who purchase through advisors [brokers] earn lower returns than those who invest autonomously." *Id*. at 20.

Similarly, the DOL extensively detailed the literature documenting the "large and negative" impact that conflicts of interest have on brokers' recommendations to retirement savers, as part of its 2016 fiduciary rulemaking for retirement accounts.

*See* U.S. DEPARTMENT OF LABOR, REGULATING ADVICE MARKETS: DEFINITION OF THE TERM 'FIDUCIARY,' CONFLICTS OF INTEREST, RETIREMENT INVESTMENT ADVICE: REGULATORY IMPACT ANALYSIS FOR FINAL RULE AND EXEMPTIONS 8 (Apr. 2016), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/ria.pdf ("DOL RIA"). According to the DOL, "A careful review of the evidence, which consistently points to a substantial failure of the market for retirement advice, suggests that IRA holders receiving conflicted investment advice can expect their investments to underperform by an average of 50 to 100 basis points [0.5 to 1.0%] *per year* over the next 20 years." *Id.* at 9 (emphasis added).

The higher fees that investors pay and lower returns that they receive as a result of conflicts of interest can be very costly for individual investors. According to an SEC Investor Bulletin, for example, an investor who starts with $100,000 and pays a 1% additional fee (or receives a 1% lower return) every year would end up with a portfolio balance that has almost $30,000 less after 20 years. *See* SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, UPDATED INVESTOR BULLETIN: HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO (Sep. 2016). Thus, instead of growing from $100,000 to approximately $210,000, the investor would end up with only approximately $180,000. Even paying a 0.5% additional fee (or receiving a 0.5% lower return) would have a significant impact on the investor's portfolio,

reducing the portfolio by $10,000. *Id*. As these examples show, conflicted advice resulting in higher fees and expenses and lower returns has a huge impact on retirement income security. Furthermore, those with small accounts have fewer economic resources, and consequently any additional costs or losses diminish what little savings they have worked so hard to set aside. Lower and middle-income retirement investors need every penny of their retirement savings. Unfortunately, they are among those likely to be most hurt by the detrimental effects of conflicted advice.

Furthermore, the costs of conflicts are staggering on a systemic basis. According to the DOL's estimates, the "underperformance associated with conflicts of interest—*in the mutual fund segment alone*—could cost IRA investors between $95 billion and $189 billion over the next 10 years and between $202 billion and $404 billion over the next 20 years." DOL RIA at 9.

Even though the harm from brokerage conflicts of interest was extensively documented by RAND and the DOL, the SEC went out of its way to downplay the DOL's analysis and findings and equivocate about the nature and extent of the problem of conflicted brokerage advice. The Releases states, for example, that—

> although a significant amount of empirical evidence suggests that there *may be* investor harm due to conflicts of interest between financial professionals and investors, because of changes to the mutual fund industry (e.g., shifts from load to no-load funds and the introduction of new share classes), increased competition, and the anticipation of regulation designed to ameliorate potential conflicts of interest, several new studies indicate that potential harm to investors arising from conflicts of interest *may be* declining.

Release at 33,431 (emphasis added). The Release then actually defends brokerage conflicts of interest, suggesting that conflicted advice is better for investors than no advice at all. This is a false choice, propagated by the brokerage industry. Indeed, as many financial services providers have shown, it is possible to provide high-quality advice for a reasonable fee that is untainted by conflicts of interest. It is simply more profitable for brokerage firms to preserve a regulatory landscape that allows for harmful conflicts of interest.

More broadly, these statements are belied by new research that the SEC cited, but downplayed, showing that broker-dealer conflicts of interest continue to be significant and may in fact be increasing, to investors' detriment. *See, e.g.*, KARTHIK PADMANABHAN, CONSTANTIJN PANIS & TIMOTHY TARDIFF, THE ABILITY OF INVESTORS TO TIME PURCHASES AND SALES OF MUTUAL FUNDS (Nov. 1, 2017), https://www.sec.gov/comments/s7-07-18/s70718-5366987-184108.pdf.

The SEC's equivocation on whether a real problem exists, in the face of abundant and compelling evidence that brokerage conflicts of interest continue to inflict enormous harm on investors, is telling. It reflects the SEC's underlying agenda in this case of protecting broker-dealers rather than investors—ironically and indefensibly putting the industry's interests ahead of investors. Designing a rule around such inverted priorities constitutes not only a betrayal of the SEC's core mission but also arbitrary and capricious rulemaking under the APA.

## III. Section 913 of the Dodd-Frank Act was written and widely understood to provide for a uniform fiduciary standard for broker-dealers and investment advisers, and by refusing to follow the text and purposes of Section 913, the SEC acted contrary to law.

The plain language of Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, PL 111-203, § 913, 124 Stat 1376, 1824-25 (2010) ("Dodd-Frank"), makes clear that Congress intended the SEC to impose a strong and uniform fiduciary standard on broker-dealers and investment advisers. *See, e.g.,* Section 913(g) (requiring all advice to be provided "without regard to" the financial or other interest of the firm or financial professional). Following the enactment of Dodd-Frank, it was widely agreed that these were the chief purposes of Section 913. The benefits of doing so were also widely acknowledged: it would provide the same strong protections to investors, regardless of whether they receive advice from a broker-dealer or investment adviser, and it would significantly reduce if not eliminate any confusion about the different duties that are owed by different financial professionals.

The industry itself initially held this view. Following the 2011 SEC staff study recommending that the SEC establish a uniform fiduciary standard for broker-dealers and investment advisers, U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS & BROKER-DEALERS (Jan. 2011), industry participants confirmed that these were the underlying purposes of Section 913. For example, according to the premier broker-dealer industry trade association, SIFMA:

> The fundamental purpose of Section 913 of the Dodd-Frank Act is to provide for the establishment of a uniform fiduciary standard that applies equally to BDs and RIAs for the benefit of retail clients when personalized investment advice is provided. Section 913 requires that the uniform fiduciary standard be no less stringent than the general fiduciary duty implied under Section 206 of the Investment Advisers Act of 1940 ("Advisers Act").

Ira D. Hammerman, Senior Managing Director & General Counsel, SIFMA, Comment Letter on Request for Information Regarding Duties of Brokers, Dealers, and Investment Advisers (July 5, 2013), at 4, https://www.sec.gov/comments/4-606/4606-3128.pdf.

Similarly, the premier mutual fund trade association, the Investment Company Institute ("ICI"), agreed with the staff recommendation that a uniform fiduciary standard was the most appropriate way forward:

> We, too, believe that the SEC should establish a fiduciary standard for broker-dealers that provide personalized advice or recommendations about securities to retail customers. When acting in this capacity, a broker-dealer is performing substantially the same function as an adviser, and the legal distinctions between the two types of financial professionals are often unclear and largely irrelevant to investors. And if the conduct is substantially the same, the same standard should apply. In both contexts, the customer deserves a strong, fiduciary standard of care that puts his or her interests above those of the intermediary.

Karrie McMillan, General Counsel, ICI, Comment Letter on Request for Information Regarding Duties of Brokers, Dealers, and Investment Advisers (July 3, 2013), at 2, https://www.sec.gov/comments/4-606/4606-3103.pdf (internal citations omitted).

Despite the fact that the text and purposes of Section 913 were clear and widely viewed as the framework for a uniform fiduciary rulemaking, the SEC expressly refused to promulgate such a standard. The Rule provides neither a uniform nor a fiduciary standard. Moreover, it disregards Congress's clear directive in Section 913(g) dictating the specific formulation of that uniform fiduciary standard, requiring advice to be provided "without regard to" the financial or other interest of the firm or financial professional. Because the Rule contravenes the clear text and purposes of Section 913, it is contrary to law.

## IV. The SEC acted arbitrarily and capriciously by failing to achieve even its own modest objective of "enhancing investor protection" and by blindly accepting the broker-dealer industry's self-serving arguments as a justification.

The SEC adopted a Rule so weak and vague that it failed to achieve its own stated objective of "enhance[ing] investor protection." In fact, the Rule provides no meaningful additional protections for investors; to the contrary, it will affirmatively harm investors by lulling them into a false belief that their brokers are required to act in their best interest. In following this deeply compromised approach, the SEC blindly accepted the broker-dealer industry's self-serving claims that a strong rule would harm investors, without undertaking any effort to subject those claims to independent scrutiny. For both of these reasons—the Rule's failure to achieve the SEC's claimed objective and the absence of a credible justification—the SEC acted arbitrarily and capriciously.

### A. The Rule fails to enhance investor protection.

Rather than establish a uniform fiduciary standard for broker-dealers and investment advisers alike, Reg. BI preserves different standards, imposes weak requirements on broker-dealers that mirror existing suitability requirements, exacerbates confusion, and relies almost entirely on disclosure as the principal mechanism in the Rule, despite extensive evidence that disclosure does not protect investors. It imposes vague "best interest" requirements that may have an appealing ring but do little to solve the daunting problems confronting investors who need sound financial advice. This is not what Congress said or intended. Moreover, it belies the SEC's own claim that the Rule will enhance investor protection.

First, Reg. BI does not create a uniform standard for broker-dealers and investment advisers. As a result, investors will still bear the burden of understanding differences in the standards that apply to different types of financial professionals and how those differences might affect the services they receive.[3]

Second, Reg. BI is decidedly not a fiduciary standard. The SEC explicitly refused to impose a fiduciary duty on broker-dealers' personalized investment advice, either the one Congress set out in Section 913(g) of Dodd-Frank or any other. The

[3] Form CRS actually obscures differences by requiring broker-dealers and investment advisers to describe their respective legal obligations in identical terms. *See* Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,532-33,533 n.507-08 (July 12, 2019).

SEC's decision not to adopt the specific formulation that Congress dictated in 913(g) is especially irrational. According to the proposing release, broker-dealer industry participants had raised the concern that the "without regard to" language could be read as prohibiting all conflicts of interest, including those arising from commissions. The SEC *appeared* to reject these concerns, explaining that this formulation would not actually prohibit business or compensation methods, including those arising from commissions. *See* Regulation Best Interest, 83 Fed. Reg. 21,574, 21,586 (proposed May 9, 2018). And yet, the SEC still refused to embrace the "without regard to" standard. Instead, it shaped its policy to accommodate the broker-dealer industry's view, which it knew to be unfounded. It stated, "In lieu of adopting wording that embodies apparent tensions, we are proposing to resolve those tensions through another formulation that appropriately reflects what we believe is the underlying intent of Section 913." *Id*. But replacing the "without regard to" formulation with a standard that allows broker-dealers to consider their own interests when making recommendations was an accommodation to industry without any rational justification—as well as a violation of Congress's language and intent.

Third, Reg. BI does not even impose on brokers an unambiguous obligation to do what is best for their customers. The rule does not define "best interest," which will inevitably allow brokers—the regulated industry—to develop their own self-serving interpretations. Moreover, the phrasing of the best interest standard in the

Rule, including the prohibition against placing the adviser's interest ahead of the client's, essentially tracks the FINRA suitability rule and its related guidance and case law.

> In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendations must be consistent with his customers' best interests.' The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests *prohibits a broker from placing his or her interests ahead of the customer's interests*.

FINRA Regulatory Notice 11-02; FINRA Rule 2111 (Suitability) FAQ (emphasis added). The SEC thus adopted a close variant of an existing standard that is notoriously ineffective at curbing conflicts of interest, while falsely touting it as a significant new protection for investors.

Nothing in the ensuing discussion of Reg. BI's "best interest" standard suggests that it will depart from the FINRA suitability regime. In fact, numerous organizations sought clarification on this point in comment letters specifically asking the SEC to provide a concrete analysis of how Reg. BI would differ from FINRA suitability as applied. *See, e.g.,* Letter from Heather Slavkin Corzo, AFL-CIO, et al., to Jay Clayton, Chairman, Sec. & Exch. Comm'n, at 3 (Apr. 26, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5417927-184568.pdf ("the Commission must support its best interest definition with concrete examples of practices that are required under Reg BI that are not required under FINRA suitability as well as practices that are prohibited under Reg BI that are not prohibited

under FINRA suitability."). The SEC never acknowledged or responded to those concerns and requests, in violation of its duty to address material issues raised in the comment process.

In any event, Reg. BI does not in fact require broker-dealers to recommend the option that they reasonably believe represents the best match for the investor. The rule makes clear that broker-dealers are permitted to recommend investments that cost more for investors and pay more compensation to brokers, as long as they "consider" costs. Such a standard will invite broker-dealers to contrive justifications for recommending investments that are most beneficial to them, not their clients, allowing them to insist that they met the standard because they "considered" but rejected lower-cost options that serve the same investment purpose. And just as with the phrasing of the "best interest" standard, the requirement in Reg. BI to "consider" costs mirrors FINRA guidance. As FINRA explains:

> Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.

FINRA Rule 2111 (Suitability) FAQ. Here again, despite requests for clarification on whether Reg. BI would differ from FINRA suitability in this context, the SEC offered no analysis or even consideration of the issue—another violation of its duty under the APA.

In addition, Reg. BI continues to allow brokerage firms to artificially create harmful incentives that encourage and reward brokers for making specific recommendations that are very profitable to the firm but that are likely to taint their advice, to investors' detriment. It requires only that they "mitigate" in some undefined way the harmful incentives they themselves create. And the accompanying guidance strongly suggests that firms will be given significant discretion and deference to determine what conflicts to mitigate and how:

> [W]e believe that broker-dealers are most capable of identifying and addressing the conflicts that may affect the obligations of their associated persons with respect to the recommendations they make, and therefore are in the best position, to affirmatively reduce the potential effect of these conflicts of interest such that they do not taint the recommendation.

*E.g.*, Release at 33,390; *see also id*. at 33,391 ("we are providing broker-dealers with flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on each firm's circumstances."). For decades, many brokers dispensing investment advice have intentionally taken advantage of their clients by recommending high-cost, high-risk, and low-performing investments that enrich brokers at investors' expense. The practice is deeply engrained and deeply profitable. It is therefore fundamentally unrealistic to expect that the brokers subject to Reg. BI will use their broad discretion in a way that effectively neutralizes those conflicts of interest and maximizes investor protection.

The Release raises further doubt that the Rule will enhance investor protection by suggesting that the policies and procedures firms currently use under existing FINRA rules may constitute sufficient conflicts mitigation under the Rule. Release at 33,391 ("While many broker-dealers have programs currently in place to manage conflicts of interest, each broker-dealer will need to carefully consider whether its existing framework complies with this provision."); *see also id*. at 33,392 ("In certain instances, we believe that compliance with existing supervisory requirements and disclosure may be sufficient…"). As a result, it's not clear whether, how, and to what extent firms will be required to change their practices to comply. Here again, organizations raised concerns about the vagueness of the mitigation requirement and requested clarification on what types of conflicts Reg. BI would restrict and how. *See, e.g.*, Letter from Heather Slavkin Corzo, AFL-CIO, et al., to Jay Clayton, Chairman, Sec. & Exch. Comm'n, at 6 (Apr. 26, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5417927-184568.pdf ("the Commission must provide greater clarity regarding how the obligation to eliminate or mitigate conflicts would apply to different types of conflicts."). As with other important elements of the rule, the SEC failed to acknowledge those concerns or respond with clarification.[4]

[4] Perhaps the best example of the gap between the SEC's claims about the Rule and the disappointing reality lies in the provisions governing sales contests. The SEC proudly explains that the Rule prohibits sales contests and related incentives that are based on the sale of specific securities or specific types of securities within a limited

The SEC not only adopted an extraordinarily weak rule, essentially preserving the status quo, it also failed to at least provide investors with the tools they would need to distinguish between broker-dealers and investment advisers, to understand key differences in the services they provide, and to make appropriate choices between the two types of financial professionals. The SEC's chosen regulatory approach relies heavily on a pre-engagement Customer Relationship Summary ("Form CRS"), supposedly designed to enable investors to make an informed choice regarding which type of relationship or account would be the best option for them.

The SEC adopted this approach despite the fact that all available evidence had shown disclosure was unlikely to serve its intended regulatory function. *See*, *e.g.*, ANGELA A. HUNG, ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 111 (2008), https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf (investors' inability to distinguish between different types of financial professional persisted even after they were presented with fact sheets designed to clarify key differ-

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period of time. However, as the SEC concedes in a footnote, this narrow prohibition parallels restrictions that already exist under FINRA rules. Release at 33,395n.785. ("FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of certain types of products. *See* FINRA Rules 2310, 2320, 3221, and 5110.").

ences between broker-dealers and investment advisers); *see also* BRIAN SCHOLL, OFFICE OF THE INVESTOR ADVOCATE & ANGELA A. HUNG, RAND CORP., THE RETAIL MARKET FOR INVESTMENT ADVICE 25-26 (Oct. 2018), https://www.sec.gov/files/retail-market-for-investment-advice.pdf (same); ANGELA A. HUNG ET AL., RAND CORP., INVESTOR TESTING OF FORM CRS RELATIONSHIP SUMMARY (Nov. 2018), https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf (qualitative interviews showed a widespread lack of comprehension and confusion surrounding proposed Form CRS).

Despite this extensive body of evidence, the SEC stubbornly proceeded to finalize the Rule, and the accompanying Rule Form CRS. Here again, it flouted the most basic requirements of notice and comment rulemaking by failing to adequately consider important factors and by drawing irrational conclusions in the face of widespread evidence that contradicted its policy preferences.

The SEC made matters worse by ceding to firms the responsibility for figuring out how to describe their services, investment offerings, fees, and conflicts of interest, using their own choice of wording. Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,493, 33,502 (July 12, 2019). Just as it is unrealistic to expect firms to mitigate the conflicts that they themselves create, it is equally unrealistic to expect firms to create honest, clear, and effective disclosures, when they are the primary causes and beneficiaries of that investor confusion

through their deceptive marketing practices. Under these circumstances, the SEC's decision to delegate such enormous discretion to the regulated industry was irrational.

Far from enhancing investor protection, Reg. BI threatens to do more harm than good. Under Reg. BI, broker-dealers will be in a position to claim that they are legally required to serve investors' best interests, lulling them into a false sense of security. In reality, Reg. BI establishes a much weaker standard, one that is almost indistinguishable from the familiar and ineffective suitability requirement that has governed brokers for years. The SEC has failed even by its own modest measure to produce a satisfactory rule.

### B. The SEC acted arbitrarily and capriciously by blindly accepting the broker-dealer industry's self-serving arguments against a uniform fiduciary duty.

The overarching defect in the Rule, and what makes it so weak and ultimately irrational, is the SEC's blind acceptance of the broker-dealer industry's arguments against applying a uniform fiduciary standard to their advisory activities, without undertaking any effort to subject those claims to independent scrutiny.

Specifically, the SEC accepted the industry's false premise that applying a fiduciary duty to broker-dealers would threaten their very business model, thus depriving investors of "access" and "choice"—a proposition that finds no credible sup-

port in the Release or anywhere else.[5] *See, e.g.*, Release at 33,322 ("We have declined to subject broker-dealers to a wholesale and complete application of the Advisers Act because it is not tailored to the structure and characteristics of the broker-dealer business model"); Release at 33,466 (explaining that applying the uniform standard under Section 913(g) "would impose a new regulatory paradigm on broker-dealers relative to the baseline," supposedly leading to increased costs for retail customers and "a different menu of choices"); Release at 33,390 ("[W]e want to enhance investor protection while preserving, to the extent possible, access and choice for investors").

Yet the SEC never even attempted to determine whether these conclusory and speculative claims from industry were actually valid. Nor did it meaningfully consider what "access" and "choice" investors would be sacrificing if brokerage firms were subject to a fiduciary duty. Investors do not "choose" to be misled about the services they receive; nor do they "choose" to receive highly conflicted advisory services; and they certainly do not "choose" to suffer the extraordinary financial costs that flow from harmful conflicts of interest. The loss of such phantom "choices" benefits rather than burdens investors.

[5] Congress itself anticipated this form of resistance to the application of a fiduciary standard to brokers, and it nullified the threat to the broker business model by providing, for example, that the receipt of commission compensation would not in and of itself violate the fiduciary standard. Section 913(g)(1).

In short, the SEC blindly accepted the brokerage industry's self-serving claims and consistently favored their business interests over the needs of investors. It promulgated a rule that caters to brokers' existing business model rather than one that requires brokers to adapt to a meaningful fiduciary standard, and it strained to justify its approach by invoking the interests of investors without adequate support. This is irrational rulemaking of the first order, which violates some of the most fundamental precepts under the APA. *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (prohibiting an agency from relying on factors "which Congress has not intended it to consider" and requiring it to "articulate a satisfactory explanation for its action," one that is consistent with the evidence before the agency).

Reg. BI was divorced from any reasonable assessment of the facts and the law. It was first and foremost a regulatory action designed to preserve and protect the broker-dealer industry, not vulnerable investors. It appears by all accounts that Reg. BI's "best interest" standard is designed to operate as a slogan, not a meaningful and enforceable standard designed to ensure investors are protected from the harms that result from brokerage conflicts of interest. For these reasons, along with those articulated by the Petitioners, the rulemaking was contrary to law and arbitrary and capricious.

## CONCLUSION

The Court should rule in favor of the Petitioners and grant their requested relief, including vacatur.

Respectfully submitted,

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**CERTIFICATE OF COMPLIANCE**
**WITH TYPE-VOLUME LIMIT, TYPEFACE REQUIREMENTS, AND TYPE-STYLE REQUIREMENTS**

This brief complies with the type-volume limit of Local Rules 29.1(c) 32.1(a)(4) because, excluding the parts of the document exempted by FRAP 32(f), this brief contains 6,993 words.

This brief also complies with the typeface requirements of FRAP 32(a)(5) and the type-style requirements of FRAP 32(a)(6) because it has been prepared in 14-point Times New Roman font, a proportionately spaced, plain Roman typeface that includes serifs, using Microsoft Word for Office 365 MSO.

/s/ Dennis M. Kelleher

Dated: January 3, 2020

## CERTIFICATE OF SERVICE

I certify that on January 3, 2020, the foregoing document was served on all parties or their counsel of record through the CM/ECF system. All participants in this case are registered users of the CM/ECF system.

/s/ Dennis M. Kelleher

Dated: January 3, 2020