# REGULATING BROKER-DEALER INVESTMENT RECOMMENDATIONS—LAYING THE GROUNDWORK FOR THE NEXT FINANCIAL CRISIS

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## ABSTRACT

*Securities and Exchange Commission Regulation Best Interest (RBI) sought to mitigate or remove conflicts of interest on the part of broker-dealers that receive transaction-based commissions. As this Article demonstrates, RBI will effectively force broker-dealers to abandon such compensation arrangements in favor of fixed-fee arrangements. This will reduce investment choices, limit access to personalized professional investment advice and adversely affect the quality of services.*

*More significantly, RBI provides incentives for broker-dealers to hold customer funds in low return cash accounts that can be exploited through so-called "carry" trades. The financial services industry is already restructuring in order to capture the value of such trades, at the expense of retail investors. As was the case during the financial crisis of 2008, those investments will implode during a market meltdown. This will likely cause the failure of many large financial institutions, absent a massive, politically unpalatable government bailout.*

*RBI will also cause investors to be steered into cookie cutter accounts that will result in a dangerous concentration of investment assets, as occurred with subprime mortgages in the run up to the Financial Crisis of 2008. The liquidation of concentrated assets in a market panic will have a cascading effect that will force market prices into a downward spiral. This will wreak havoc in the financial markets. The coronavirus securities market selloff in March 2020 proved, if proof is needed, that market selloffs are inevitable. The next*

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*such event will only be accentuated by the panicked liquidation of RBI induced portfolio concentrations.*

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## INTRODUCTION

Securities and Exchange Commission (SEC) Regulation Best Interest (RBI) seeks to resolve decades of controversy over the duties owed by broker-dealers when making investment recommendations.[1] This proposal was controversial and resulted in the submission of over 6,000 comment letters.[2] The adopting release also needed 770 typewritten pages and 1,671 footnotes to explain and justify the RBI requirements.[3] Despite its length, the SEC's analysis of the supposed costs and benefits of RBI is based mostly on conjecture and speculation. That is evidenced most starkly by its use of the word "may" nearly 1,000 times in explaining its mandates and describing the costs that RBI "may" impose on broker-dealers and the supposed benefits that "may" result to retail investors.[4] As described in this Article, RBI is a deep state monstrosity of blinding complexity that will result in massive costs to broker-dealers, which will be passed onto customers. The hazards created by RBI will result in reduced investor choice in available investment opportunities and fee arrangements. It is also creating a systemic risk to the economy as customer portfolios

1. 17 C.F.R. § 240.15l-1 (2020).

2. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,320 (July 12, 2019) (to be codified at 17 C.F.R. § 240.15l-1).

3. *See* SEC, Release No. 34-86031, Regulation Best Interest: The Broker-Dealer Standard of Conduct, Securities Exchange Act (2019), https://www.sec.gov/rules/final/2019/34-86031.pdf.

4. *Id.*

migrate to cookie cutter accounts in concentrated investments at a few large broker-dealers.

Under long-established common law rules, financial services firms owed only minimal fiduciary duties to customers when acting as brokers and none when acting in a dealer capacity.[5] The SEC sought to enhance those duties in the 1930s through a somewhat vague "shingle theory," which posited that broker-dealers are professionals who, like lawyers, owe a duty of fair dealing to their customers.[6] This included a duty to not make unsuitable investment recommendations.[7] The shingle theory did not address some basic broker-dealer conflicts of interest. For example, stockbrokers were allowed to continue their historical per transaction commission arrangements (transaction-based compensation).[8] Such compensation created a conflict of interest because it provided an incentive to recommend unnecessary investments or securities with higher commissions or sales loads.[9]

In 1995, after decades of criticism of the conflicts associated with such transaction-based compensation, an SEC advisory committee recommended replacement of transaction-based compensation with fixed-fee arrangements (fee-based compensation).[10] Such fee-based compensation is calculated as a percentage of assets under management (AUM).[11] An appellate court struck down a rule adopted by the SEC to implement its advisory committee's recommendation because it conflicted with a provision in the Investment Advisers Act of

5. *See infra* notes 29–35 and accompanying text.

6. *See infra* notes 51–53 and accompanying text (describing the shingle theory).

7. *See infra* notes 65–67 and accompanying text (describing the suitability requirement).

8. *See infra* notes 61–65 and accompanying text (identifying transaction-based compensation as a conflict of interest).

9. *See infra* note 64 and accompanying text (describing this conflict of interest).

10. *See infra* text accompanying notes 145–49.

11. *See infra* notes 148–53 and accompanying text (describing this fee arrangement and advisory committee recommendation).

1940 (Investment Advisers Act).[12] Congress responded by adding a section in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which authorized the SEC to study broker-dealer conflicts of interest and to adopt rules addressing such conflicts.[13] Dodd-Frank, however, prohibited the SEC from banning transaction-based compensation.[14]

The SEC staff conducted the study directed by Dodd-Frank and recommended the adoption of a uniform fiduciary duty for broker-dealers and investment advisers.[15] The SEC rejected that recommendation.[16] Instead, it adopted RBI, which prohibits broker-dealers from placing their financial interests above those of customers when making investment recommendations to retail customers.[17] RBI requires broker-dealers to identify conflicts of interest and imposes disclosure, supervisory, record keeping and other burdensome requirements.[18]

RBI did not expressly defy the Dodd-Frank prohibition against banning transaction-based compensation. Indeed, the SEC claimed that RBI continues to allow such compensation.[19] Despite that protestation, as this Article explains, RBI will effectively force broker-dealers to abandon such compensation arrangements.[20] This will reduce investment choices, limit access to personalized professional investment advice and

12. 15 U.S.C. § 80b-2(a)(11)(C); *see* Fin. Plan. Ass'n v. SEC, 482 F.3d 481, 487–93 (D.C. Cir. 2007) (describing this statutory conflict); *see also infra* notes 157–58 and accompanying text (describing that decision).

13. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 913, 124 Stat. 1376, 1824–31 (2010); *see infra* notes 187–90 and accompanying text (describing that provision and its implementation by the SEC).

14. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g)(2).

15. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS ii, v–viii, 110–28 (2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

16. *See infra* note 231 (quoting the SEC's reasons for rejecting its staff's recommendation).

17. 17 C.F.R. § 240.15l-1(a)(1) (2020).

18. *See infra* Section III.C.

19. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,319.

20. *See infra* Section V.A (describing the effect of RBI provisions on the feasibility of transaction-based compensation arrangements).

adversely affect the quality of services.[21] Among other things, RBI provides incentives for broker-dealers to hold customer funds in low return cash accounts that can be exploited through "carry" trades, which seek to arbitrage the difference between long and short-term interest rates.[22] The financial services industry is already restructuring in order to capture the value of such trades, at the expense of their customers.[23] Once that process is complete, as was the case in the Financial Crisis of 2008, those investments will be set to implode during the next fixed-rate driven financial crisis.[24] This will threaten the failure of many large financial institutions, absent a massive, politically unpalatable government bailout.[25]

More significantly, RBI will cause investors to be steered into robo-advisors and other cookie cutter accounts that will result in a dangerous concentration of investment assets.[26] Their liquidation in the next economic downturn will have a cascading effect that will force market prices into a downward spiral, which will wreak havoc in the financial markets.[27] The market plunge that occurred during the Stock Market Crash of 1987 and the gyrations that were experienced during the Coronavirus Panic in 2020 present real evidence that the herd instinct on Wall Street is alive and well and can destroy billions of dollars in market values in a short period of time.[28]

This Article is divided into the following parts: Part I describes historical concerns over broker-dealer conflicts of interest. It shows how the SEC created a "shingle theory" that imposed limited fiduciary-like duties on those registrants. Part

21. *See infra* Section V.A (describing those effects).

22. *See infra* notes 396–401 and accompanying text (describing the nature of carry trades and RBI inducements to engage in such transactions).

23. *See infra* Section V.D and accompanying text (describing this ongoing restructuring).

24. *See infra* note 402 and accompanying text (describing the role that carry trades played in the 2008 Financial Crisis).

25. *See infra* notes 400–02 and accompanying text (describing the potential consequences of the trend toward carry trades).

26. *See infra* notes 215–16 and accompanying text (describing robo-advisers).

27. *See infra* note 394 and accompanying text (describing this phenomenon).

28. *See infra* notes 405–06 and accompanying text (describing those events).

II describes the long running debate over the conflicts of interest created by transaction-based compensation charged by broker-dealers. It also describes the unsuccessful efforts by the SEC and the Department of Labor (DOL) to move broker-dealers to a fee-based regime. Part III describes the SEC's rejection of the recommendations of its own staff study on how to address broker-dealer conflicts. It also describes the mandates in RBI. Part IV describes the deep flaws in the SEC's economic analysis of the costs and benefits of RBI. Part V analyzes the future likely adverse effects of the RBI mandates, including less investor choice, higher costs for investors and dangerous concentration of investments in limited asset classes.

## I. BROKER-DEALER CONFLICTS OF INTEREST

### A. *Common Law Duties of Broker-Dealers*

Broker-dealers were not subject to federal regulation before the enactment of the federal securities laws in the 1930s.[29] Instead, they were governed by state common law requirements, which included certain limited fiduciary duties for stock "brokers."[30] For example, in an 1869 decision, *Markham v. Jaudon*, the court held that stockbrokers are agents of their customers.[31] As stated in the Restatement of the Law of Agency, agents have "a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."[32]

In contrast to stockbrokers, "dealers" in securities, i.e., firms buying and selling securities from inventory, were not treated as fiduciaries.[33] Rather, dealers could act at arms-length with

29. 23 JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SEC. AND COMMODITIES LAWS §§ 2:1–2:2 (2019).

30. *See id.* § 2:1.

31. *See* 41 N.Y. 235, 245 (1869). This common law approach to the duties of brokers and other agents was incorporated into the Restatement (Third) of Agency, which states that agency is a "fiduciary relationship." RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. L. INST. 2006).

32. RESTATEMENT (THIRD) OF AGENCY § 8.01.

33. CHARLES H. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES 249–50 (1931).

customers on a principal-to-principal basis.[34] This allowed hard bargaining because dealers did not owe a duty of loyalty to their customers.[35]

Another hole in the application of fiduciary duties to broker-dealers was their extension of credit to customers. At common law, both brokers and dealers could act in an arms-length creditor capacity in extending credit to customers through so-called margin loans.[36] This meant that fiduciary duties did not apply either to brokers or to dealers when extending such credit.[37]

## B. *The SEC Examines the Conflicting Roles of Brokers and Dealers*

Where separating the roles of brokers and dealers had been a long-standing practice in the United Kingdom, the combination of these roles has been a mainstay of the American market since their inception.[38] For that reason, the Securities Exchange Act of 1934 (34 Act) did not require the separation of the roles of broker-dealers, hence their dual regulation as "brokers and dealers."[39] Nevertheless, the 34 Act directed the SEC to conduct a study to determine whether such a separation was feasible.[40] The resulting study described the common law duties of a stock broker as "fiduciary in [] nature," like those of an attorney,

34. *See id.*

35. *See id.*

36. *See* JOHN R. DOS PASSOS, A TREATISE ON THE LAW OF STOCK-BROKERS AND STOCK-EXCHANGES 141 (1882).

37. *See id.*

38. Historically, the London Stock Exchange divided the roles of its members into "brokers" and "jobbers." TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS 513 (1935). Brokers were agents for customer orders. *Id.* Jobbers were dealers for their own accounts and were prohibited from dealing directly with public customers. *Id.* Traders were not allowed to act as both brokers and dealers in London markets until the 1980s. 23 MARKHAM & HAZEN, *supra* note 29, § 2:31 n.2.

39. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o(a).

40. SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER xiii (1936) [hereinafter SEC FEASIBILITY STUDY].

requiring brokers "to exercise the utmost fidelity and integrity."[41]

In contrast to a broker, the SEC study recognized that dealers act for their own accounts and not as the agents of customers.[42] When dealers act for their own accounts, customers are charged a markup or markdown above or below inventory cost.[43] The SEC study noted that a dealer "receives no brokerage commission but relies for his compensation upon a favorable difference or spread between the price at which he buys and the amount for which he sells. The risk of loss is entirely his own."[44] This meant that dealers maintained arm's-length relationships with their customers.[45] At common law, dealers could not mislead their counterparties, but owed them no fiduciary duties.[46]

The SEC study also determined that the fiduciary duties of a broker could conflict with those of a dealer.[47] The SEC asserted that while the self-interests of a stand-alone dealer, which does not also act as a broker, could "conflict with the interests of his

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41. *Id.* at xiv. The SEC's study defined a broker as follows:

> He does not undertake to sell to or buy from his customer but rather to negotiate a contract of purchase or sale between the customer and a third party. The transaction is solely for the account of the customer who becomes the owner of securities purchased by the broker on his behalf, is entitled to the profits realized and is liable for the losses incurred. The broker has no beneficial interest in the transaction except the commission or other remuneration which he receives for his services.

*Id.*

42. The SEC defined the role of a dealer in securities as being:

> [S]imilar to those of a dealer or jobber in merchandise. The dealer sells securities to his customer which he has purchased or intends to purchase elsewhere or buys securities from his customer with a view to disposing of them elsewhere. In any such transaction he acts for his own account and not as agent for the customer.

*Id.*

43. *See id.*

44. *Id.*

45. *See id.*

46. *See, e.g.*, Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 195 (1817) (holding that there is no duty on the part of an arms-length buyer to disclose information affecting the value of a commodity that was not known by the vendor).

47. SEC FEASIBILITY STUDY, *supra* note 40, at 75 ("The exercise of the latter function may interfere with the proper fulfillment of the fiduciary obligations created by the former.").

customer, the problems presented thereby are not an outgrowth of the combination of functions."[48]

Although the SEC study thoroughly examined broker-dealer conflicts and duties, it did not provide a direct solution for resolving the conflicts of interest that were pervasive in broker-dealer relationships with their customers.[49] That solution would have to await the SEC's creation of what it called the "shingle theory."

### C. *The SEC Adopts the Shingle Theory*

The SEC study did not seek the separation of the inherently conflicted roles of broker and dealers. Instead, the agency developed principles and standards that created fiduciary-like duties designed to mitigate those conflicts.[50] This was done under the "shingle theory,"[51] which was "an extension of the common law doctrine of 'holding-out."[52] Under that doctrine, someone holding themselves out as an expert is subject to the higher standards associated with such expertise.[53]

Because broker-dealers play a dual role of either agents or principals, the shingle theory could not be based on the law of agency.[54] Instead, it posited that, as professionals, broker-

48. *Id.*

49. Rather, the SEC focused its reform efforts on floor traders and specialists on the New York Stock Exchange that act as dealers with other exchange members. *See* MARKHAM & HAZEN, *supra* note 29, § 2:11.

50. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisors*, 55 VILL. L. REV. 701, 722 (2010) ("Under the shingle theory, the SEC did not impose strict fiduciary duties on broker-dealers. Rather, the standard applied by the Commission was that the brokers' conduct be reasonable under the circumstances.").

51. The shingle theory had its origins in a 1939 SEC administrative decision. *See* Granite Partners, L.P. v. Bear, Stearns & Co., 58 F. Supp. 2d 228, 265–66 (S.D.N.Y. 1999) (citing *In re* Duker & Duker, 6 SEC 386, 388 (1939) and *In re* Trost & Co., 12 SEC 531 (1942)).

52. MARKHAM & HAZEN, *supra* note 29, § 10:1 ("In brief, the shingle theory is based on a belief that broker-dealers are professionals on whose advice the public relies. In hanging out its shingle, the broker-dealer is making an implied representation that the public may seek and will receive professional advice from the broker-dealer.").

53. *Id.* ("When brokers hold themselves out as experts, they will be held to a higher standard of care in making recommendations.").

54. Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1275 (1995) (describing the shingle theory and its elements).

dealers make an implied representations of "fair dealing."[55] This meant that investment recommendations to customers "should not be based on the self-interest of the broker-dealer in selling securities owned by the firm or which may provide a higher commission or markup to the firm or individual associated person."[56] Rather, a recommendation should be based on the investment needs and objectives of the customer.[57]

The SEC's views on broker-dealer duties borrowed some fiduciary-like standards from the law of trusts.[58] That borrowing was based on the view that a stockbroker is a "quasi-trustee" required to act with the "utmost good faith and integrity."[59] There were, however, some nettlesome problems in applying trustee fiduciary standards to broker-dealers. Historically, conflicts of interest between a trustee and the beneficiaries of a trust had been strictly prohibited under the fiduciary duty of loyalty.[60] Applying that duty of loyalty standard to broker-dealers would have put them out of

55. *See id.* at 1275.

56. MARKHAM & HAZEN, *supra* note 29, § 10:1.

57. *Id*.

58. *See* Manuel F. Cohen and Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 L. & CONTEMP. PROB. 691, 702–03 (1964). As a former SEC chairman noted:

> Commission decisions as to the obligations of broker-dealers to their customers are usually rationalized as falling within two theories. These are known as the "shingle" or "implied representation" theory and the "fiduciary" or "trust and confidence" theory . . . . Although referred to as separate doctrines, these theories are, in fact, closely connected.

*Id*.

59. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 10:6 (1982) ("When brokers hold themselves out as experts, they will be held to a higher standard of care in making recommendations.").

60. As one author has noted:

> The duty of loyalty requires a trustee "to administer the trust solely in the interest of the beneficiary." This "sole interest" rule is widely regarded as "the most fundamental" rule of trust law. . . . The sole interest rule prohibits the trustee from "placing himself in a position where his personal interest . . . conflicts or possibly may conflict with" the interests of the beneficiary. . . . The conclusive presumption of invalidity under the sole interest rule has acquired a distinctive name: the "no further inquiry" rule.

John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 931 (2005).

business because of their arms-length role as a dealer and their inherent conflicts when acting as a broker in charging transaction-based commissions.[61] Consequently, the SEC's shingle theory imposed only limited fiduciary-like duties.[62] This was important on a number of grounds, particularly because the absence of a duty of loyalty permitted broker-dealers to charge transaction-based commissions.[63] Such commissions would be a breach of the duty of loyalty in a true fiduciary relationship; they create a conflict of interest because they present an inducement for broker-dealers to recommend excessive or unnecessary transactions in order to generate commissions.[64]

In order to mitigate the conflicts associated with the dual roles of a broker-dealer, those entities were required to weigh the interests of customers before making a recommendation.[65] This duty, known as the "suitability doctrine," was adopted by the SEC under its shingle theory.[66] It prohibits broker-dealers from recommending securities to customers that are unsuitable in light of their individual financial circumstances and investment objectives.[67] This requires a case-by-case consideration of each customer's financial circumstances and investment goals.[68] The subjective nature of that analysis has long raised concerns that it leaves much room for the second-guessing of investment

61. *See id.* at 934 for a description of the incompatibility of inherent conflicts of interest when a trustee benefits personally while acting on behalf of the beneficiary with fiduciary duties.

62. *See* Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 544 (2002).

63. *See* Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO STATE L.J. 181, 213–14 (2017).

64. *See infra* note 130 and accompanying text (describing how transaction-based compensation can create an inducement for "churning").

65. *See* Karmel, *supra* note 54, at 1275–77.

66. *See id.* at 1276–77.

67. *See id*. (describing the suitability obligation).

68. For example, a young well-educated customer with a high income and a goal of portfolio growth might be suitable for investing in higher-risk securities that would allow higher returns. In contrast, an older retired individual with the same education and background might not be suitable for such a recommendation because capital preservation is generally more critical in retirement. MARKHAM & HAZEN, *supra* note 29, § 10:1 (describing such concerns).

recommendations by broker-dealers.[69] That is, if a recommendation results in losses, customers may claim that the recommendation conflicted with their investment goals and risk profile because they sought profits rather than losses.[70]

Applying fiduciary duties to broker-dealer recommendations raised other issues. At common law, trustees' fiduciary duties strictly limited their investment of trust funds to those selected by a "prudent man."[71] Initially, courts interpreted this rule to prohibit trustees from investing trust funds in most stocks.[72] If the SEC's shingle theory had applied that requirement to broker-dealers, their business would have been crushed and the stock markets badly crippled, if not destroyed.

The prudent man rule also presented many uncertainties as to what were appropriate investments for trusts, leading several states to adopt statutes that contained a "legal list" of permitted investments.[73] Initially, such statutes allowed investments in railroad bonds, but not stocks, which effectively disqualified most broker-dealers from acting as trustees.[74]

69. *See, e.g.*, Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REGUL. 345, 365–69 (1995) [hereinafter Markham, *Jungle Predator*] (discussing the concern that protections, including suitability, enable investors to use litigation to pass their risk onto broker-dealers); *see also, e.g.*, Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44742 (proposed Sept. 6, 1977) (to be codified at 17 C.F.R. pt. 1, 166) (asserting that the CFTC would not "second guess" broker-dealer choices to address existing concerns).

70. *See generally* MARKHAM & HAZEN, *supra* note 29, § 10:1 (describing the complexities of the suitability requirement).

71. The prudent man rule was defined as follows:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

72. *See, e.g.*, King v. Talbot, 40 N.Y. 76, 88–90 (1869); *see also* Alfred E. Cleveland, *Trust Investments—Prudent Man Rule*, 37 N.C. L. REV. 522, 522–27 (1959) (describing application of that rule).

73. Comment, *Legal Lists in Trust Investment*, 49 YALE L.J. 891, 893–94 (1940).

74. *See* FRANK C. MCKINNEY, LEGAL INVESTMENTS FOR TRUST FUNDS viii–ix (1914) (describing the development of legal lists in the United Kingdom and the United States).

The SEC made an effort in the 1960s to create more objective standards for determining what securities would be suitable for broker-dealer recommendations. In a Special Study of the Securities Markets published in 1963, the SEC staff asserted that greater emphasis should be given to identifying the suitability of particular securities for particular customers.[75] The Special Study urged the adoption of guidelines by the SEC specifying categories or amounts of securities that are "clearly unsuitable in specified circumstances, and practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to persons other than known customers."[76] That recommendation was not adopted.[77]

Eventually, the prudent man and legal list trustee limitations were upended by the widespread acceptance of something called the "modern portfolio theory."[78] It posited that no individual stock picker could outperform the overall market.[79] This meant that "prudent" investors should diversify their portfolios across all asset classes, including stocks, fixed income securities, and real estate.[80] It was widely asserted in the financial press that these assets' respective risks would offset each other and lead to greater overall portfolio performance.[81]

75. SEC, REP. OF SPECIAL STUDY OF SEC. MARKETS OF THE SEC, H.R. DOC. NO. 88–95, pt. 2, at 28–30 (1963).

76. Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. 6,693, 6,695 (Feb. 14, 1989) (citing H.R. DOC. NO. 88–95).

77. Such rules were not adopted until after passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. *See* 17 C.F.R. §§ 240.15g-2–240.15g-9 (implementing those requirements). The SEC did propose in 1962 to impose sales restrictions on broker-dealers marketing so-called low price "penny stocks" that were the subject of widespread high-pressure boiler room operations. *See* Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. at 6,695.

78. Numerous books have been published that analyze this theory. *See, e.g.*, EDWIN J. ELTON, MARTIN J. GRUBER, STEPHEN J. BROWN & WILLIAM N. GOETZMANN, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS (8th ed. 2010); JACK CLARK FRANCIS & DONGCHEOL KIM, MODERN PORTFOLIO THEORY: FOUNDATIONS, ANALYSIS, AND NEW DEVELOPMENTS (2013).

79. *See* Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 103 (1990).

80. *Id.* at 101–02.

81. *Id.*

Application of the modern portfolio theory allowed, indeed encouraged, investments in securities or other investments that once were unsuitable for risk averse investors.[82] Even high-risk investments in volatile asset classes such as commodities, including gold and silver, could now be recommended as part of a prudent diversification strategy.[83]

### D. *Conflicting Supreme Court Decisions*

The SEC's suitability mandate that was, as described above, adopted as a part of its shingle theory, is premised on the belief that "a broker-dealer who makes unsuitable recommendations . . . can be liable to its customers under the antifraud provisions of the Federal securities laws."[84] Applying the SEC's broadly-worded anti-fraud standards was an uncertain process due to the "highly subjective nature of the suitability doctrine."[85] That uncertainty was heightened after the U.S. Supreme Court handed down conflicting decisions on whether the 34 Act's principal antifraud provision in Section 10(b),[86] and SEC Rule 10b-5[87] thereunder, could be violated by a breach of a fiduciary

82. *Id.* at 103.

83. *See The Role of Gold in Modern Portfolio Theory*, FEEDROLL, (Jan. 26, 2018) https://www.feedroll.com/investments/2651-role-gold-modern-portfolio-theory/. A uniform state law, called the Prudent Investor Act, was adopted by several states that endorsed modern portfolio theory.

> The Prudent Investor Act, which was adopted in 1990 by the American Law Institute's Third Restatement of the Law of Trusts ('Restatement of Trust 3d'), reflects a 'modern portfolio theory' and 'total return' approach to the exercise of fiduciary investment discretion. This approach allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments.

FDIC, TRUST EXAMINATION MANUAL § 3, pt. 1, subsec. C, https://www.fdic.gov/regulations/examinations/trustmanual/section_3/fdic_section_3-asset_management.html#c (May 10, 2005).

84. Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. 6,693, 6,696 (Feb. 14, 1989) (footnote omitted).

85. *See* MARKHAM & HAZEN, *supra* note 29, § 10:7 (2019) ("Because of the highly subjective nature of the suitability doctrine, limits have not been as firmly established by the SEC as might be expected."); *see also id.* (describing SEC cases charging fraud on the basis of a failure to disclose that securities recommendations were unsuitable for customers).

86. 15 U.S.C. § 78j(b).

87. 17 C.F.R. § 240.10b-5 (2020).

duty.[88] In the first round of those cases, the Supreme Court endorsed the traditional view that fiduciary duties, such as those on which the suitability doctrine is premised, were concepts that required duties higher than those demanded by common law fraud standards.[89] Thus, in *Ernst & Ernst v. Hochfelder*, the Supreme Court held that Section 10(b) of the 34 Act imposed a more demanding *scienter* requirement than that traditionally imposed on fiduciaries.[90] This meant that mere negligence did not amount to fraud under that statute.[91] Thereafter, In *Santa Fe Industries, Inc. v. Green*, the Supreme Court ruled that Section 10(b) required a showing of express deceptive fraudulent or manipulative conduct, i.e., a mere breach of a state law fiduciary duty was not a sufficient such showing.[92]

Since suitability determinations are largely subjective and intentional fraud is hard to prove, the *Ernst & Ernst* and *Santa Fe* decisions raised concerns that the SEC's suitability doctrine and shingle theory would be unenforceable.[93] After those decisions, however, the Supreme Court held in *United States v. O'Hagan* that a breach of fiduciary duty was sufficient to establish a violation of Section 10(b) by persons engaged in

88. *Compare* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212–14 (1976) *and* Santa Fe Indus. v. Green, 430 U.S. 462, 473–74 (1977), *with* United States v. O'Hagan, 521 U.S. 642, 651–55 (1997) (disagreeing on whether breach of fiduciary duty alone is sufficient to constitute a violation of the statute and rule).

89. *See Ernst & Ernst*, 425 U.S. at 212–14.

90. *Id*. at 201; *accord* Aaron v. SEC, 446 U.S. 680, 691 (1980).

91. *See Ernst & Ernst*, 425 U.S. at 201.

92. *Santa Fe Indus.*, 430 U.S. at 473–74.

93. Karmel, *supra* note 54, at 1281–83. Shingle theory claims became harder to plead and prove after these Supreme Court decisions. For example, the Second Circuit held in *Brown v. E.F. Hutton Grp., Inc.* that in order to make out a suitability claim:

> A plaintiff must prove (1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.

991 F.2d 1020, 1031 (2d Cir. 1993).

insider trading.[94] The *O'Hagan* decision was based on the premise that insider traders breach a fiduciary duty owed to the source of the information.[95] The Court held that insider trading is a "'deceptive device' . . . because 'a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.'"[96]

This conflicting jurisprudence on the scope of Section 10(b) may be interpreted as holding that a mere breach of fiduciary duty does not violate Section 10(b) unless it involves insider trading. This leaves dangling the issue of whether the SEC's shingle theory and its suitability doctrine, which are premised on fiduciary concepts, could be enforced through 1934 Act antifraud actions.[97] That issue was not resolved before the SEC adopted RBI, which embraced and sought to enhance its suitability doctrine.[98]

### E. *SRO Suitability Efforts*

The SEC's regulation of broker-dealers is supplemented by the rules of self-regulatory organizations (SROs), which are now largely concentrated in the Financial Industry Regulatory Authority (FINRA).[99] SROs were not historically limited by the niceties of drawing distinctions between fraud and breach of fiduciary duties.[100] In furtherance of a long-standing industry

94. *O'Hagan*, 521 U.S. at 651–55 (1997); *see* Jerry W. Markham, *Regulating the Sale of Stock Exchange Market Data to High-Frequency Traders*, 71 FL. L. REV. 1209, 1245–48 (2019) [hereinafter Markham, *Regulating the Sale of Stock*] (describing the background of that decision).

95. *O'Hagan*, 521 U.S. at 653.

96. *Id.* at 652 (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980)).

97. *See* Karmel, *supra* note 54, at 1271–72.

98. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

99. *See* Kenneth Durr & Robert Colby, *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010*, SEC HIST. SOC'Y (Dec. 1, 2010), http://www.sechistorical.org/museum/galleries/sro/ (describing the history and role of SROs).

100. *See, e.g.*, MARKHAM & HAZEN, *supra* note 29, § 10:32 (demonstrating that the North America Securities Administration Association's ethical guidelines prohibits broader conduct than fraud or breach of fiduciary duty).

tradition, FINRA requires broker-dealers to "observe high standards of commercial honor and just and equitable principles of trade."[101] FINRA and its predecessors have imposed suitability requirements under this rubric.[102]

FINRA sought to strengthen SRO suitability standards and apply some nuance to their application. For example, it imposed special suitability standards on products that are particularly complex or susceptible to abuse.[103] This included limited partnerships, index warrants, collateralized mortgage obligations, and options.[104] A debate arose over whether SRO suitability obligations applied to sophisticated financial institutions that have the resources to make their own informed investment decisions and suitability determinations.[105] One side of that debate argued that parental suitability controls were unneeded for those institutions because they could protect themselves.[106] Other law professors argued that an institution might be sophisticated as to some investment products, but not others.[107] They claimed that this justified applying the suitability requirement to the latter.[108] The National Association of Securities Dealers (NASD), FINRA's predecessor, responded to those concerns by asserting that the suitability obligation was met when a broker-dealer had a reasonable basis for concluding

101. *Rule 2010. Standards of Commercial Honor and Principles of Trade*, FINRA, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010 (last visited Sept. 24, 2020).

102. Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. 6,693, 6,695 (proposed Feb. 14, 1989) (to be codified at 17 C.F.R. pt. 240).

103. MARKHAM & HAZEN, *supra* note 29, § 10:2 (describing those requirements).

104. *Id.*

105. *Compare* Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU. L. REV. 1493, 1514–18 (2001) *and* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996), *with* Markham, *Jungle Predator*, *supra* note 69, at 371.

106. Markham, *Jungle Predator*, *supra* note 69, at 347.

107. Poser, *supra* note 105, at 1514–18; Langevoort, *supra* note 105, at 627.

108. Poser, *supra* note 105, at 1514–18; Langevoort, *supra* note 105, at 690–91, 697.

that an institutional customer was making an independent evaluation of a recommended investment.[109]

FINRA published a Report on Conflicts of Interest in 2013 that provided guidance to broker-dealers on how to manage and mitigate conflicts of interest with respect to, among other things, sales force compensation.[110] The report recommended enhanced internal procedures for identifying and mitigating conflicts of interest.[111] With respect to compensation, the FINRA report identified various compensation practices that could mitigate conflicts of interest. For example, the report suggested the use of "agnostic" or "neutral" compensation, such as a set percentage of the revenue generated by sales agent, whatever the product being recommended.[112] Another FINRA suggested compensation practice was capping the credit given for mutual fund sales in order to reduce the incentive for recommending mutual funds that paid the highest sales incentives.[113] The FINRA report further recommended enhanced surveillance of investment recommendations by associated persons near their compensation thresholds.[114]

Violations of the FINRA suitability rule may result in sanctions by FINRA, including fines and suspension, or even a bar from acting as a broker-dealer in the securities markets.[115] However, the courts have held that there is no private right of action for SRO rule violations.[116] That omission effectively

109. *See* MARKHAM & HAZEN, *supra* note 29, § 10:4 (describing that interpretation and its nuances).

110. FINRA, REPORT ON CONFLICTS OF INTEREST 1 (2013), https://www.finra.org/sites/default/files/Industry/p359971.pdf.

111. *Id.* at 2–3.

112. *Id.* at 4.

113. *Id.*

114. *Id.*

115. *See, e.g.*, Richard G. Cody, Exchange Act Release No. 64565 at *32, 35, 2011 WL 2098202 (May 27, 2011), https://www.sec.gov/litigation/opinions/2011/34-64565.pdf (suspending a broker-dealer and imposing a $20,000 fine for suitability violations).

116. "The clear weight of authority holds that a violation of the rules of a financial self-regulatory entity like FINRA (or its predecessor, NASD) does not give rise to a private right of action." Interactive Brokers LLC v. Saroop, No. 3:17-cv-127, 2018 WL 6683047, at *10 (E.D. Va. Dec. 19, 2018), *rev'd on other grounds*, 969 F.3d 438 (4th Cir. 2020).

defanged the suitability requirement since FINRA has only limited enforcement resources and usually only targets small or especially aggressive broker-dealers.

## II. THE DEBATE OVER TRANSACTION-BASED COMMISSIONS

This Part will describe the historical role of transaction-based commissions and how the Investments Advisers Act of 1940 prevented broker-dealers, at least those not dually registered as investment advisers, from charging fee-based commissions. It will then address the debate over whether the securities industry should turn to fee-based compensation as a means of mitigating the conflicts raised by transaction-based compensation. Lastly, it will describe the SEC's and the Department of Labor's aborted efforts to adopt rules that would have shifted broker-dealers to fee-based compensation. Those failures led to the adoption of the Dodd-Frank Act provision on which RBI is based.

### A. *Regulation of Broker Commissions*

Historically, stockbrokers charged transaction-based compensation, which created a conflict of interest with their customers.[117] Such charges provided an incentive to recommend unnecessary investments or securities with the highest sales loads.[118] After a market disruption by speculators in 1792, a group of New York traders met under a buttonwood tree on Wall Street and signed an agreement in which they set their commissions at a fixed rate.[119] That agreement laid the

117. *See, e.g.*, JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492-1900) 118 (2002) [hereinafter MARKHAM, COLUMBUS]; Olivia B. Waxman, *How a Financial Panic Helped Launch the New York Stock Exchange*, TIME (May 17, 2017, 9:00 AM), https://time.com/4777959/buttonwood-agreement-stock-exchange/.

118. *See* Stewart Mayhew, *Conflicts of Interest Among Market Intermediaries*, SEC, https://www.sec.gov/about/offices/oia/oia_market/conflict.pdf (last visited Sept. 24, 2020).

119. This "Buttonwood Agreement" stated that:

groundwork for the creation of the New York Stock Exchange.[120] It also created a system of minimum transaction-based compensation that stockbrokers were required to charge customers.[121] Those fixed transaction-based commissions were set by the exchanges.[122] That arrangement lasted until 1975, when the SEC ordered the exchanges to drop such requirements, allowing customers to negotiate their commissions.[123]

The SEC mandate resulted in the creation of a new broker-dealer model in the form of "discount" brokers. Previously, so-called "full service" brokers provided investment advice to their clients.[124] That advice was costly to formulate, required professionally trained brokers to disseminate, and resulted in reputational and compliance costs in meeting suitability standards.[125] In contrast, discount brokers do not provide investment advice, which freed them of the suitability obligation and its attending costs.[126] After the SEC prohibited fixed commissions, large "full service" brokers continued to charge high rates of transaction-based compensation.[127] Those

> We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell, from this day, for any person whatsoever, any kind of public stock, at a less rate than one-quarter per cent commission on the special value, and that we will give preference to each other in our negotiations.

MARKHAM, COLUMBUS, *supra* note 117, at 118.

120. *Id*.

121. *Id*.

122. *Id*.

123. *Id*.; *see* JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970–2001) 30 (2002) [hereinafter MARKHAM, DERIVATIVES].

124. Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 295, 406 (2010).

125. *See id*. at 405–06; Jason Zweig, *Lessons of May Day 1975 Ring True Today: The Intelligent Investor*, WALL ST. J. (Apr. 30, 2015, 11:20 PM), https://www.wsj.com/articles/lessons-of-may-day-1975-ring-true-today-the-intelligent-investor-1430450405.

126. *See* sources cited *supra* note 125.

127. *See* MARKHAM, DERIVATIVES, *supra* note 123, at 29–30.

higher commissions were justified on the grounds that full service firms provided valuable investment advice.[128]

In addition to unfixing commission rates and suitability obligations, the SEC had historically imposed some other restrictions on abusive practices associated with transaction-based compensation.[129] For example, the SEC deemed as fraudulent excessive trading in a customer's account in order to generate commissions, a practice known as "churning."[130] However, that prohibition is applied only to accounts in which the trading is actually controlled by the broker-dealer.[131]

The SEC's shingle theory also imposed other fiduciary-like duties on broker-dealers when acting in their dealer capacity, including a requirement of "fair pricing and full disclosure."[132] This means that "a dealer may not exploit the ignorance of his customer to extract unreasonable profits resulting from a price which bears no reasonable relation to the prevailing price."[133] Broker-dealers were additionally deemed by the SEC to have a "best execution" duty, which required them to execute customer orders at the best available price.[134] SEC Rule 10b-10 further requires broker-dealers to make certain disclosures to customers when confirming trades.[135] Thus, when acting as a broker, the amount of the transaction-based compensation must be disclosed.[136] Rule 10b-10 further mandated disclosure

128. *Id.*

129. *See id.* at 30–31.

130. *See* MARKHAM & HAZEN, *supra* note 29, § 10:25 (describing the elements of churning).

131. *Id.*

132. Franklin D. Ormsten, *SEC Shingle Theory: Continuing Viability; Continuing Questions*, SEC. ARB. COMMENTATOR, [http://web.archive.org/web/20180805014643/www.sacarbitration.com/shingle.htm] (citing *In re* Duker & Duker, 6 SEC 386, 388 (1939)) (last visited Oct. 15, 2020); *see* MARKHAM & HAZEN, *supra* note 29, § 10:1 (describing the application of this requirement); *see also* Karmel, *supra* note 54, at 1275–76 (describing this duty).

133. *In re Duker & Duker*, 6 SEC at 388; *see also* Ormsten, *supra* note 132 (citing Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943)).

134. *See* MARKHAM & HAZEN, *supra* note 29, § 9:2 (describing the best execution requirement). The best execution is premised on the fiduciary duty of loyalty. Malouf v. SEC, 933 F.3d 1248, 1264–65 (10th Cir. 2019).

135. 17 C.F.R. § 240.10b-10.

136. *Id.* § 240.10b-10(a)(2)(i)(B).

to customers of whether the firm was acting in the capacity of broker or whether it is acting as a dealer.[137]

The SEC also imposed some dealer specific obligations that sought to mitigate the conflicts of interest associated with market maker spreads and markups or markdowns from securities in inventory.[138] Those practices created a conflict of interest because dealers had an incentive to charge excessive markups or markdowns.[139] The SEC sought to mitigate those conflicts by prohibiting excessive markups and markdowns.[140] Nevertheless, a broker-dealer's investment recommendations to customers could "include recommending transactions where the broker-dealer is buying securities from or selling securities to retail customers on a principal basis or recommending proprietary products."[141] Dealers acting as "market makers" also profited from a "spread" between buying and selling prices.[142] Wider spreads increase dealer profits and increase the costs of investments to investors.[143] The SEC sought to regulate market makers by requiring them to maintain a continuous and fair and orderly market.[144]

### B. *The Fee-Based Compensation Controversy*

Continuing concerns over transaction-based compensation led the SEC to create an advisory Committee on Compensation

137. *Id.* § 240.10b-10(a)(2).

138. *See* discussion *infra* notes 139–44 and accompanying text.

139. *See* MARKHAM & HAZEN, *supra* note 29, § 10:23 (describing markup and mark down abuses).

140. *Id.*

141. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,319 (July 12, 2019) (to be codified at 17 C.F.R. § 240.15l-1).

142. "Market makers" seek "to profit off tiny differences between what investors [are] willing to pay for heavily traded stocks and what others [are] willing to sell them for." Aaron Lucchetti, *Firms Seek Edge Through Speed as Computer Trading Expands*, WALL ST. J. (Dec. 15, 2006, 12:01 AM), https://www.wsj.com/articles/SB116615315551251136; *see also* Jerry W. Markham, *High Speed Trading on Stock and Commodity Markets—From Courier Pigeons to Computers*, 52 SAN DIEGO L. REV. 555, 560 (2015) [hereinafter Markham, *High Speed Trading*] (describing profiting from the spread).

143. *See* Lucchetti, *supra* note 142.

144. *See* Markham, *High Speed Trading*, *supra* note 142, at 584 (describing those obligations).

Practices in 1994.[145] Chaired by former Merrill Lynch executive Daniel P. Tully,[146] the Tully Committee's mandate was to "review the retail brokerage industry's compensation practices, identify potential conflicts of interest of brokerage industry employees, and recommend industry best practices for eliminating or reducing these conflicts of interest."[147] The Tully Committee's report recommended the adoption of fee-based compensation as an industry best practice and as an alternative to transaction-based arrangements.[148] Such fee-based accounts would charge an annual fee based on the AUM regardless of the amount of trading in the account.[149]

The Tully Committee thought that fee-based accounts reduced broker-dealer conflicts of interest associated with churning and recommendations of higher cost securities.[150] The committee favored a fixed fee arrangement because it removed the incentive to make such recommendations.[151] Fixed fee arrangements also provided an incentive for brokers to make investment recommendations that would result in an increase in the fixed fee paid by the customer when a portfolio increased in value.[152] Conversely, the fixed fee would be reduced if the

145. SEC, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 1 (1995), [hereinafter TULLY COMMITTEE REPORT], https://www.sec.gov/news/studies/bkrcomp.txt.

146. *Id.* at 5.

147. DEP'T TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 123–24 (2008), https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

148. *See* TULLY COMMITTEE REPORT, *supra* note 145, at 10.

149. The SEC has described fee-based brokerage accounts as follows:

> Fee-based brokerage accounts are similar to traditional full-service brokerage accounts, which provide a package of services, including execution, incidental investment advice, and custody. The primary difference between the two types of accounts is that a customer in a fee-based brokerage account pays a fee based upon the amount of assets on account (an asset-based fee) and a customer in a traditional full-service brokerage account pays a commission (or a mark-up or mark-down) for each transaction.

Temporary Rule Regarding Principal Trades with Certain Advisory Clients, 72 Fed. Reg. 55,022, 55,022 n.2 (Sept. 28, 2007).

150. *See* TULLY COMMITTEE REPORT, *supra* note 145, at 10.

151. *See id.*

152. *See id.*

value of the customer portfolio decreased.[153] Nevertheless, the Tully Committee's report acknowledged that customer accounts with low rates of trading activity, such as those with a buy-and-hold strategy or those mainly invested in mutual funds, might be better served by a transaction-based account.[154]

The Tully Committee's fee-based recommendation raised the issue of whether fee-based compensation is "special compensation" that would require an otherwise exempt broker-dealer to register under the Investment Advisers Act.[155] This was of concern because that statute imposed broad fiduciary duties on its registrants, the costs of which were unpalatable to many broker-dealers because of the attending compliance costs.[156] In response to that concern, the SEC adopted a rule exempting fee-based compensation arrangements for non-discretionary accounts from the reach of the Investment Advisers Act.[157] However, that rule was stricken by the U.S. Court of Appeals for the District of Columbia Circuit in

153. *See id.*

154. *See* NASD, NOTICE TO MEMBERS 03-68, 743–44 (2003), https://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf (describing those concerns) [hereinafter NASD, NOTICE TO MEMBERS].

155. Section 202(a)(11)(C) of the Investment Advisers Act exempts broker-dealers from registration when their investment advice is "solely incidental" to their broker-dealer business and when such advice is provided without "special compensation." 15 U.S.C. § 80b-2(a)(11)(C) (2020); *see generally* Broker-Dealer Exclusion, Investment Adviser Act Release No. 5249, 2019 WL 2417616 (June 5, 2019) (describing the scope of the "solely incidental" exclusion from investment adviser registration). Transaction-based compensation was viewed to be compensation for execution services provided by broker-dealers, and advice supplied in connection with those order executions was considered to be incidental to those execution services. In contrast, fee-based compensation was charged by investment advisers for research and advice, which was the core of their business. Transaction compensation was viewed to be special compensation when charged by investment advisers.

156. *See* SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 190–92 (1963) (applying broad investment advisers' fiduciary duties to an investment adviser). The Supreme Court has stated that the anti-fraud provisions in Section 206 of the Investment Advisers Act establish "'federal fiduciary standards' to govern the conduct of investment advisers . . . ." Transamerica Mortg. Advisers v. Lewis, 444 U.S. 11, 17 (1979) (citations omitted). *Compare* Leib v. Merrill Lynch, Pierce, Fenner & Smith Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (describing the more narrow range of duties of broker-dealers handling non-discretionary accounts), *with* De Kwiatkowski v. Bear, Stearns, & Co., 306 F.3d 1293, 1302 (2d Cir. 2002).

157. 17 C.F.R. § 275.202(a)(11)-1 (2011).

*Financial Planning Association v. SEC*.[158] The Court held that fee-based compensation is special compensation that would require investment adviser registration.[159]

The SEC subsequently adopted a "final temporary rule" allowing broker-dealers with dual investment adviser and broker-dealer registration to continue to offer fee-based accounts when they acted in a principal capacity in transactions with certain advisory clients.[160] This ameliorated the effects of the *Financial Planning Association* decision because several large broker-dealers were dually registered as investment advisers.[161] Nonetheless, many broker-dealers were not dually registered and did not want to incur the costs associated with investment adviser registration.[162] This meant that the SEC was back to square one in the effort to allow standalone broker-dealers to offer fee-based accounts.

### C. *Wrap Accounts*

The Tully Committee's recommendation for fee-based compensation would have allowed, but not required, broker-dealers not dually registered as investment advisers to offer fee-based accounts.[163] Such accounts were already available to customers of dual registrants and were popularly called "wrap" accounts.[164] Those accounts had been introduced in 1992, some

158. 482 F.3d 481, 491 (D.C. Cir. 2007).

159. *See id.* at 488.

160. 17 C.F.R. § 275.206(3)-3T (2009).

161. RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 124 (2008) [hereinafter RAND Study] (analyzing the number of dually registered firms and concerns with heightened fiduciary duties).

162. *See id.* at 116–17 (detailing that most financial service industry firms engaged in either investment advisory or broker-dealer services but not both).

163. *See* TULLY COMMITTEE REPORT, *supra* note 145, at 3 (expressing that while the brokerage industry's compensation practices often lead to conflicts, "the current compensation system is too deeply rooted to accommodate radical alteration" and "fee-based charges for various investment-related services . . . is taking shape.").

164. *See, e.g.*, *Investor Bulletin: Investment Advisor Sponsored Wrap Fee Programs*, SEC (Dec. 7, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_wrapfeeprograms; MARKHAM & HAZEN, *supra* note 29, § 2:33 n.18.

three years before the Tully Committee's report.[165] Within a year of their introduction, wrap accounts had $90 billion under management.[166] A few years later, one million investors had placed $300 billion in those accounts.[167]

Wrap accounts allowed broker-dealer affiliated advisers to charge a flat fee based on assets under management (AUM).[168] Wrap fees typically varied from 1.25 to 3% of AUM and were "paid by customers in lieu of individual fees and commissions based on trading activity."[169] Wrap account fee-based compensation raised concerns with so-called "reverse churning," which occurred when "too few transactions are executed or wrap fees amount to more than what would be earned in commission."[170]

The SEC responded to such concerns by adopting a rule under the Investment Advisers Act requiring a disclosure brochure to be given to customers describing the risks and possible disadvantages associated with wrap accounts.[171] The NASD had also provided guidance in 2003 concerning the appropriate use of wrap accounts.[172] Once again, standalone

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165. MARKHAM & HAZEN, *supra* note 29, § 2:33 n.18.

166. *Id.* (citing Ellen E. Schultz, *How to Unwrap a Wrap Account*, WALL ST. J., Feb. 5, 1993, at C1).

167. SEC, Temporary Rule Regarding Principal Trades with Certain Advisory Clients, 72 Fed. Reg. 55,022, 55,022 (Sept 28, 2007) (to be codified at 17 C.F.R. pt. 275).

168. *See, e.g.*, MARKHAM & HAZEN, *supra* note 29, § 2:33 n.18; Jonny Frank & Tristan Cecala, *No Longer Under Wraps—SEC Wrap Fee Scrutiny on the Rise*, STONETURN (Feb. 11, 2016), https://stoneturn.com/insight/no-longer-wraps-sec-wrap-fee-scrutiny-rise/.

169. Frank & Cecala, *supra* note 168.

170. *Id*.

171. 17 C.F.R. § 275.204-3(d) (2020).

172. That guidance stated that NASD rules prohibited placing

> a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer. Accordingly, before opening a fee-based account for a customer, members must have reasonable grounds to believe that such an account is appropriate for that particular customer. . . . In addition, members should disclose to the customer all material components of the fee-based program, including the fee schedule, services provided, and the fact that the program may cost more than paying for the services separately.

NASD, NOTICE TO MEMBERS, *supra* note 154, at 744.

broker-dealers were excluded from fee-based wrap account offerings.

### *D. Fee-Based Accounts and Broker-Dealer Fiduciary Duties Revisited*

Following the D.C. Circuit's decision in *Financial Planning Association v. SEC* that struck the SEC's fee-based rule, the SEC retained the RAND Corporation to examine the roles and public perceptions of the duties of broker-dealers and investment advisers.[173] The resulting report (the "RAND Study") compared the fiduciary duties owed to customers of broker-dealers with those duties owed by investment advisers.[174] The RAND Study concluded that fiduciary standards imposed on investment advisers were not generally applicable to broker-dealers handling nondiscretionary customer accounts.[175] In such accounts, the customer makes the actual trading decision even when receiving and following investment advice from the broker-dealer.[176] To the extent a broker-dealer is handling only non-discretionary accounts, the RAND study determined that courts saw no need to impose anything other than the most basic duties, e.g., refraining from engaging in unauthorized trades.[177] In contrast, the RAND Study found that fiduciary duties imposed on investment advisers require them to either refrain from acting when they have a conflict of interest or to fully disclose the conflict and receive consent from the client before acting.[178]

173. *See* RAND Study, *supra* note 161, at xiii. The author acted as a peer reviewer of this study.

174. *Id.* at 8–15.

175. *Id.* at 11–15.

176. *See generally* De Kwiatkowski v. Bear, Stearns, & Co., 306 F.3d 1293 (2d Cir. 2002) (describing non-discretionary accounts).

177. *See* Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953–54 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (describing the differences of duties owed to non-discretionary and discretionary accounts).

178. RAND Study, *supra* note 161, at 13.

The RAND Study also found that most retail investors were unaware of the distinctions in the duties of broker-dealers and investment advisers.[179] Rather, investors were more concerned with product choices and the quality of the services provided by their broker-dealer or investment adviser.[180] The RAND Study also determined that investors generally do not read or understand the disclosures provided to them by their investment advisors or broker-dealers.[181] In addition, investors were generally confused over what fees they paid for their investments.[182] Nevertheless, investors generally were satisfied with the services they received from their broker-dealers and investment advisers.[183]

A subsequent report issued by the Treasury Department (Treasury Study) revisited concerns over the respective roles of investment advisers and broker-dealers.[184] Ironically, the Treasury Study concluded that, while broker-dealers with non-discretionary accounts had lesser fiduciary duties, SEC regulations provided greater financial protections for investor funds than those applicable to investment advisers.[185] The Treasury Study recognized the confusion existing over the roles and duties of investment advisers and recommended statutory changes that would subject investment advisers to oversight by an SRO in a manner similar to that for broker-dealers.[186]

The enactment of section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) renewed the controversy over transaction-based compensation.[187] It required the SEC to conduct a study to

179. *Id.* at xviii.

180. *See id.* at xix.

181. *Id.* at xviii.

182. *Id.* at xix.

183. *See id.*

184. DEP'T TREAS., *supra* note 147, at 120–21.

185. *See id.* at 121–22. The SEC drew similar conclusions; *see also* 70 Fed. Reg. 20,424, 20,433 n.94 (Apr. 19, 2005) (citations omitted).

186. DEP'T TREAS., *supra* note 147, at 124–26.

187. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1825–30 (2010).

determine whether additional regulatory requirements should be imposed on broker-dealers that provide personalized investment advice to retail customers.[188] The study was also to determine whether retail customers understand that there are different standards of care in the form of fiduciary duties that are applicable to brokers-dealers and investment advisers.[189] After completion of that study, Dodd-Frank authorized the SEC to adopt rules to establish standards of care for broker-dealers and investment advisers that provide personalized investment advice to retail customers.[190]

### E. *The Labor Department Fiasco*

Before the SEC could complete its Dodd-Frank directed report, the U.S. Department of Labor (DOL) sought to ban transaction-based compensation for individual retirement accounts (IRAs) through a new "Fiduciary Rule."[191] IRAs are important to the business of most broker-dealers. This effort by the DOL was conducted under the aegis of the Employment Retirement Income Security Act of 1974 (ERISA).[192] Title I of ERISA imposed broad fiduciary duties, including duties of loyalty and prudence, on managers of union or employer pension funds.[193] This fiduciary status also included prohibitions against the charging of transaction-based fees by managers of those pension funds.[194] Title II of ERISA created tax-advantaged IRA accounts.[195] Title II did not make broker-

188. *Id.*

189. *See id.*

190. *Id.*

191. Chamber of Com. of the U.S. v. U.S. Dep't of Lab., 885 F.3d 360, 363 (5th Cir. 2018) ("The Fiduciary Rule is a package of seven different rules that broadly reinterpret the term 'investment advice fiduciary' and redefine exemptions to provisions concerning fiduciaries that appear in the Employee Retirement Income Security Act of 1974 . . . .").

192. *See* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

193. *Chamber of Com. of the U.S.*, 885 F.3d at 364.

194. *Id.* at 366.

195. *Id.* at 364.

dealers handling such accounts fiduciaries of their clients.[196] This meant that broker-dealers were not subject to the fiduciary duty of loyalty and could continue to act as dealers and charge transaction-based commissions.[197]

Despite the longstanding distinctions in the application of fiduciary duties to pension fund managers and broker-dealers, the DOL inexplicably decided in 2010 to adopt a rule that would have made broker-dealers fiduciaries.[198] This would have effectively prohibited them from charging transaction-based fees.[199] The DOL's rulemaking process for accomplishing this change was highly controversial and was carried out over a period of some six years.[200] The DOL finally adopted its Fiduciary Rule in April 2016.[201] It created a customer's "best

196. *Id.*

197. *Id.*

198. *See id.* at 366.

199. *See id.* ("[T]he new rule purports to withdraw from fiduciary status communications that are not 'recommendations,' *i.e.*, those in which the 'content, context, and presentation' would not objectively be viewed as 'a suggestion that the advice recipient engage in or refrain from taking a particular course of action.'" (quoting 25 C.F.R. § 2510.3-21(b)(1) (2017))).

200. *See id.* ("[T]he new definition . . . encompasses virtually all financial and insurance professionals who do business with ERISA plans and IRA holders. Stockbrokers and insurance salespeople, for instance, are exposed to regulations including the prohibited transaction rules. The newcomers are thus barred, without an exemption, from being paid whatever transaction-based commissions and brokerage fees have been standard in their industry segments because those types of compensation are now deemed a conflict of interest.").

201. One report noted:

> Because broker-dealers routinely interact directly with customers in the retail space, the impact of the Fiduciary Rule will be particularly severe. Currently, broker-dealers are required to abide by a "suitability" standard of care under the securities laws when they make investment recommendations. However, broker-dealers generally take the position that they do not provide fiduciary investment advice under either ERISA or the securities laws. Under the new Fiduciary Rule, many broker-dealer sales interactions, for the first time, will be deemed fiduciary advice subject to the more rigorous best interest standard of care. . . . Consequently, many broker-dealers will need to develop entirely new policies and procedures to ensure that they are complying with the best interest standard of care . . . , and financial institutions will need to find ways to effectively supervise their large retail salesforces.

*Keeping Current: The Impact of the Department of Labor's Fiduciary Rule*, AM. BAR ASS'N (Nov. 20, 2016), https://www.americanbar.org/groups/business_law/publications/blt/2016/11/keeping_current/.

interest" standard for advice, which the SEC later used as the foundation for RBI.[202]

The DOL Fiduciary Rule caused a significant reduction in retail investor access to brokerage services.[203] One survey of mostly large broker-dealers found that "53% eliminated or reduced access to certain brokerage advice services and 67% migrated away from open choice to fee-based or limited brokerage services."[204] In addition, 95% of the participants in that study reduced or eliminated various asset or share classes, and "86% . . . reduced the number or type of mutual funds (e.g., 29% eliminated no-load funds, while 67% reduced the number of mutual funds)."[205] Another study found that "customers with smaller account balances were nearly ten times more likely to have been negatively affected by the DOL Fiduciary Rule than customers with larger account balances."[206]

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202. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,946–47 (Apr. 8, 2016).

203. The SEC chairman stated that: "With the adoption of the DOL Fiduciary Rule, it was widely reported that there was a significant reduction in retail investor access to brokerage services, and the available alternative services were higher priced in many circumstances." Statement at Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to Our Main Street Investors, Jay Clayton, Chairman, SEC (June 5, 2019), https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd. The U.S. Court of Appeals for the Fifth Circuit observed in overturning that rule as outside the authority of the DOL:

> The Fiduciary Rule . . . spawned significant market consequences, including the withdrawal of several major companies, including Metlife, AIG and Merrill Lynch from some segments of the brokerage and retirement investor market. Companies like Edward Jones and State Farm have limited the investment products that can be sold to retirement investors. Confusion abounds . . . . The technological costs and difficulty of compliance compound the inherent complexity of the new regulations. Throughout the financial services industry, thousands of brokers and insurance agents who deal with IRA investors must either forgo commission-based transactions and move to fees for account management or accept the burdensome regulations and heightened lawsuit exposure . . . . It is likely that many financial service providers will exit the market for retirement investors rather than accept the new regulatory regime.

*Chamber of Com. of the U.S.*, 885 F.3d at 368.

204. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,421 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

205. *Id.*

206. *Id.* at 33,422.

In 2017, newly elected President Donald Trump directed the DOL to reexamine its Fiduciary Rule and provide an updated economic and legal analysis of its requirements.[207] The Fiduciary Rule was subsequently stricken by the U.S. Court of Appeals for the Fifth Circuit on the grounds that the DOL had exceeded its authority.[208] Undeterred by that decision or President Trump's campaign promises of reducing regulatory burdens, the Secretary of Labor announced that the DOL was working on a replacement fiduciary rule that could pass judicial muster.[209] The Secretary resigned before that task could be completed, but the new Secretary of Labor, who had argued for the plaintiffs the Fifth Circuit case striking the Fiduciary Rule, announced in June 2020 that the DOL proposed to adopt the same Fiduciary Rule that the Fifth Circuit struck down.[210] That proposal, however, excluded SEC registrants from its reach.[211] This means that broker-dealers would be regulated by RBI instead of the DOL's Fiduciary Rule.[212]

### F. *The Rise of the Robo-Adviser*

The DOL Fiduciary Rule had other effects, including increased fees and decreased product choice.[213] Surveys also

207. *See* Memorandum from Donald Trump, U.S. President to the Secretary of Labor, 82 Fed. Reg. 9,675 (Feb. 3, 2017).

208. *See Chamber of Com. of the U.S.*, 885 F.3d at 388.

209. *Acosta Exit Could Slow New Fiduciary Rule*, BARRON'S (July 15, 2019, 2:16 PM), https://www.barrons.com/articles/acosta-exit-could-slow-new-fiduciary-rule-51563214593.

210. *See U.S. Department of Labor Proposes to Improve Investment Advice and Enhance Financial Choices for Workers and Retirees*, DOL (June 29, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200629.

211. *See* Anne Tergesen, *Labor Department Proposes Fiduciary Exemption for Retirement Plans*, WALL ST. J. (June 30, 2020, 10:23 AM), https://www.wsj.com/articles/labor-department-proposes-fiduciary-exemption-for-retirement-plans-11593520499.

212. *See id.*

213. The SEC observed that various surveys had determined that, in response to the DOL's Fiduciary Rule, some broker-dealers "reported that they encouraged customers toward self-directed accounts and/or advisory accounts . . . [and] other participants reported that they reduced or eliminated certain securities within certain types of retirement accounts that they offered. Finally, certain participants reported that they increased certain fees for some of their customers." Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,421 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

indicated that smaller customers were being steered to robo-advisers after the creation of the DOL's Fiduciary Rule.[214] A robo-adviser "is a service that uses highly specialized software to do the job of wealth managers or investment advisors . . . ."[215] Typically, potential robo-adviser clients "answer a few questions about things like their age, salary and financial goals. Computer algorithms then propose one of several cookie-cutter portfolios . . . [that] usually use a range of exchange-traded funds, or ETFs, which invest in stocks, bonds and other assets such as natural resources and corporate debt."[216]

Investment analysis tools, which presumably include most robo-advisers, were largely exempted from FINRA's suitability rule.[217] Consequently, the costs of robo services are usually less than those of managed or self-directed accounts.[218] "They charge around 0.25%, or $125 on a $50,000 investment. Contrast that to the typical fee of 1% charged by human advisors."[219] For this reason, the popularity of robo-advisers has grown rapidly. First launched in 2010,[220] robo-advisers had some $47 billion of AUM in 2015. That amount doubled in the following year.[221] By 2020, robo-advisers' AUM totaled over $600 billion.[222] One study predicted that if the DOL Fiduciary Rule had not been stricken, it would have caused $2 trillion in redistribution of

214. *See id.* at 33,423.

215. Andrew Goldman, *What's a Robo Advisor*, WEALTHSIMPLE, https://www.wealthsimple.com/en-us/learn/what-is-robo-advisor (Aug. 19, 2020).

216. Peggy Collins, *Robo-Advisers*, BLOOMBERG, https://www.bloomberg.com/quicktake/robo-advisers (June 6, 2017, 2:05 PM).

217. *See* FINRA Rules 2210, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210 (last visited Oct. 10, 2020); FINRA Rules 2214, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2214 (last visited Dec. 19, 2020).

218. *See, e.g.*, Amy Lancaster, *The Pros and Cons of Robo-Advisors*, MILBORN ADVISORS (Feb. 20, 2019), https://www.milbornadvisors.com/blog/2019/2/20/the-pros-and-cons-of-robo-advisors; Jack Otter, *The Pros and Cons of RoboAdvisors*, BARRON'S (Jan. 16, 2019, 8:00 AM), https://www.barrons.com/articles/the-pros-and-cons-of-robo-advisors-51547643601.

219. Otter, *supra* note 218.

220. *Id.*; *see also Robo-Advisers: An Introduction*, CHARLES SCHWAB, https://www.schwab.com/public/schwab/investment_advice/what_is_a_robo_advisor (last visited Dec. 19, 2020).

221. *See Robo-Advisers: An Introduction*, *supra* note 220.

222. Bailey McCann, *Robo Advisers Keep Adding On Services*, WALL ST. J. (March 8, 2020, 10:11 PM), https://www.wsj.com/articles/robo-advisers-keep-adding-on-arms-11583331556.

assets from broker-dealers to robo and other advisers or to self-directed accounts.[223] Regulation Best Interest (RBI) will continue that trend, and one study estimates that robo-adviser AUM will reach $5 to $7 trillion by 2025.[224]

## III. REGULATION BEST INTEREST

This Part describes the SEC staff study of broker-dealer conflicts of interest mandated by Dodd-Frank and the rejection of its recommendations by the SEC commissioners. This Part then addresses the scope of RBI, its mandates, and the blinding complexities of that regulation.

### A. *The SEC Staff's Dodd-Frank Study*

In 2011, the SEC staff study on broker-dealer conflicts and duties mandated by Section 913 of Dodd-Frank in 2010 found that many broker-dealers charged transaction-based compensation, while investment advisers used fee-based arrangements.[225] Like the RAND report, the SEC staff study found widespread confusion among investors over the respective differences in the duties owed by broker-dealers and investment advisers.[226] The study recommended adopting a fiduciary standard for broker-dealers that would be consistent with the standard already applicable to investment advisers.[227]

223. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,423 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240). The SEC staff has warned elsewhere of the dangers of self-directed IRA accounts: "Self-directed IRAs allow investment in a broader—and potentially riskier—portfolio of assets than other types of IRAs. While a broader set of investment options may have appeal, investors should be mindful that investments in self-directed IRAs raise risks including fraudulent schemes, high fees, and volatile performance." *Investor Alert: Self Directed IRAs and the Risk of Fraud*, SEC (Aug. 8, 2018), https://www.sec.gov/investor/alerts/sdira.html.

224. *Robo-Advising Platforms Carry New Risks*, DELOITTE, https://www2.deloitte.com/us/en/pages/risk/articles/robo-adviser-platform-risks-asset-wealth-management-firms.html (last visited Oct. 10, 2020).

225. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 15, at iii.

226. *Id.* at v–vii.

227. *Id.* at ii.

### B. *RBI Did Not Follow the Dodd-Frank Study Recommendation*

The SEC's initial effort to implement the Tully Committee's recommendation was a sound policy choice for allowing, but not requiring, fee-based accounts as a consumer choice. As the Tully Committee found, both types of accounts have inherent advantages and disadvantages that make one or the other more desirable to particular investors.[228] Although the D.C. Circuit struck that rule, Dodd-Frank tried to rectify that result by requiring the SEC to further study the roles and rules governing advice provided to customers by investment advisers and broker-dealers.[229] The SEC study mandated by Dodd-Frank appeared to provide a solution to concerns over broker-dealer conflicts by recommending a uniform fiduciary standard for both broker-dealers and investment advisers.[230] The wheels flew off this carefully constructed approach when the SEC decided not to follow that recommendation.[231] Instead, RBI created a separate framework of enhanced duties for broker-dealers making investment recommendations to "retail" customers.[232]

228. *See* TULLY COMMITTEE REPORT, *supra* note 145, at 10–15.

229. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, § 913, Pub. L. No. 111-203, 124 Stat. 1376, 1824–27 (2010).

230. *See* SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 15, at ii.

231. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,322 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240). The SEC described the reasons for that rejection of the staff recommendation as follows:

> We have declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Advisers Act because it is not appropriately tailored to the structure and characteristics of the broker-dealer business model (i.e., transaction-specific recommendations and compensation), and would not properly take into account, and build upon, existing obligations that apply to broker-dealers, including under FINRA rules. Moreover, we believe (and our experience indicates), that this approach would significantly reduce retail investor access to differing types of investment services and products, reduce retail investor choice in how to pay for those products and services, and increase costs for retail investors of obtaining investment recommendations.

*Id.* (footnotes omitted).

232. *See* 17 C.F.R. § 240.15l-1(a)(2) (2019).

1. *"Retail investors" defined broadly in RBI*

In adopting RBI, the SEC broadly defined retail investors as including high-net-worth individuals.[233] This was a sharp departure from traditional SEC regulations that excluded "accredited investors" from SEC disclosure requirements.[234] Accredited investors were thought to have the sophistication and wherewithal to inform and protect themselves.[235] The inclusion of high net worth individuals in RBI also conflicted with FINRA suitability standards,[236] and with a Dodd-Frank directed SEC study and other SEC regulatory proposals embracing and expanding the accredited investor concept.[237]

233. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,342–43.

234. An accredited investor is defined by SEC regulations to be a natural person with a net worth, or joint net worth with their spouse, in excess of $1 million, exclusive of their primary residence. 17 C.F.R. § 230.501(a)(5)(i)(A). In contrast, RBI has no such limitations. *See* 17 C.F.R. § 240.15l-1(b)(1).

235. *See supra* notes 69–70 and accompanying text (describing the debate over whether institutional investors have the ability to look out for themselves). An SEC staff study on accredited investors noted that this exclusion was:

> "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." Qualifying as an accredited investor is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by hedge funds, private equity funds and venture capital funds. . . . Investors in unregistered offerings can be subject to investment risks not associated with registered offerings because some securities law liability provisions do not apply to private offerings, issuers of unregistered securities generally are not required to provide information comparable to that included in a registration statement and Commission staff does not review any information that may be provided to investors in these offerings.

SEC, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 2 (2015) (footnotes omitted) (quoting Regulation D Revisions; Exemption for Certain Employee Benefit Plans, 52 Fed. Reg. 3015 (Jan. 16, 1987)).

236. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,342–43.

237. *See generally* SEC, Amending the "Accredited Investor" Definition (Dec. 18, 2019), https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

2. *"Recommendations" remains undefined*

RBI is rife with uncertainties. For example, it did not answer the question of what constitutes a recommendation, which had long plagued the application of suitability requirements.[238] The DOL Fiduciary Rule had tried to address such issues by citing several examples that broadly expanded the concept of what constitutes a recommendation, including robo-adviser generated advice.[239] The SEC's guidance under RBI follows a similar path, but generally omits robo-advisers from its mandates,[240] even though such platforms present conflicts of interest in their fee arrangements and bias risks to investors.[241]

Instead of a definition providing clarity, the SEC asserted that this issue would be addressed on a case-by-case basis.[242] The SEC acknowledged the difficulty of defining what constitutes an investment recommendation, stating that, in its view, "the

238. Back in the day, broker-dealer order tickets were manually marked as "solicited" or as "unsolicited." In the author's experience, very few orders were marked as "solicited." MARKHAM & HAZEN, *supra* note 29, § 6:2 (describing the "common" practice of marking order tickets as unsolicited).

239. The DOL had opined that:

> The determination of whether a "recommendation" has been made is an objective rather than subjective inquiry. In addition, the more individually tailored the communication is to a specific advice recipient or recipients about, for example, a security, investment property, or investment strategy, the more likely the communication will be viewed as a recommendation. Providing a select list of securities as appropriate for an advice recipient would be a recommendation as to the advisability of acquiring securities even if no recommendation is made with respect to any one security. Furthermore, a series of actions, directly or indirectly (e.g., through or together with any affiliate), that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program.

Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,948 (Apr. 8, 2016).

240. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,338. The SEC has advised that robo advisers are subject to the provisions of the Investment Advisers Act. SEC, Investor Bulletin: Robo Advisers (Feb. 23, 2017), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_robo-advisers.html.

241. As one consulting firm has noted, "the inability of the robo-adviser platform to better capture a client's risk tolerance than a human financial adviser may lead to misalignment in asset allocations or conflicts of interest based on fees. Automated questionnaires may not account for behavioral biases." *Robo-Advising Platforms Carry New Risks*, *supra* note 224.

242. Regulation Best Interest, 84 Fed. Reg. at 33,335.

determination of whether a broker-dealer has made a recommendation . . . should turn on the facts and circumstances of the particular situation and therefore, whether a recommendation has taken place is not susceptible to a bright line definition."[243]

This lack of guidance is troubling. For example, what if a broker-dealer provides a customer with a menu of investment options and the customer selects an unsuitable or higher cost investment from that menu? Does the broker-dealer have a duty to prevent a customer from committing financial suicide or paying higher costs even when the customer is making the trading decisions?[244]

What if the broker-dealer describes a particular investment in glowing terms but does not explicitly recommend it? What if a competitor has a comparable but lower cost proprietary product? Does a broker-dealer have the duty to refer retail customers to a discount broker providing lower execution costs when recommending a cookie cutter strategy, such as dividend oriented "safe" stocks or bonds?[245] As will be described in the next section of this Article, the mind boggling complexities of the RBI mandates provide no clear answers to these troubling questions.

243. *Id.*

244. MARKHAM & HAZEN, *supra* note 29, at 41, § 10:1 (describing these conundrums).

245. The SEC guidance states that:

> Factors considered in determining whether a recommendation has taken place include whether the communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities." The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a "recommendation."

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,335 (internal footnote omitted).

### C. *RBI Mandates*

RBI is based on the customer "best interest" concept on which the much reviled DOL Fiduciary Rule was centered.[246] RBI also adopted many of the requirements contained in the DOL Fiduciary Rule that had proved so costly to investors and disruptive to the securities industry.[247] In fact, as described below, RBI goes even further than the DOL Fiduciary Rule in imposing additional costs and blindingly complex compliance requirements on broker-dealers.[248] RBI contains the following four obligations for broker-dealers that advise retail customers:

> (1) providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer ("Disclosure Obligation");
>
> (2) exercising reasonable diligence, care, and skill in making the recommendation ("Care Obligation");
>
> (3) establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"), and
>
> (4) establishing, maintaining, and enforcing policies and procedures reasonably designed to

246. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,947 (April 8, 2016).

247. As the SEC stated in adopting RBI, "we believe Regulation Best Interest is consistent with many of the key components of the DOL's Impartial Conduct Standards." Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,333.

248. *See generally* SIFMA & DELOITTE, A FIRM'S GUIDE TO THE IMPLEMENTATION OF REGULATION BEST INTEREST AND THE FORM CRS RELATIONSHIP SUMMARY (2019), https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-Reg-BI-Program-Implementation-Guide.pdf (describing the myriad considerations required for compliance with the RBI mandates).

achieve compliance with Regulation Best Interest ("Compliance Obligation").[249]

1. *The RBI Disclosure Obligation*

The RBI Disclosure Obligation requires "full and fair" disclosure of all material facts related to a broker-dealer's relationship with their retail customers.[250] This Disclosure Obligation follows the SEC's classic regulatory full disclosure model.[251] Full disclosure posits that the role of the agency is to assure that investors are provided with information that allows them to make an informed decision, rather than mandating what products may be sold to investors.[252] However, another RBI mandate goes beyond full disclosure.[253] The RBI Disclosure Obligation also ignores the fact that very few investors actually read the disclosures required by SEC regulations.[254] RBI will only add more disclosures that will go unread.

The RBI Disclosure Obligation requires broker-dealers to provide retail customers with a Relationship Summary.[255] That

249. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,320.

250. *Id.* at 33,326.

251. The SEC's website states: "The federal securities laws we oversee are based on a simple and straightforward concept: everyone should be treated fairly and have access to certain facts about investments and those who sell them." *What We Do, Protecting Investors*, SEC, https://www.sec.gov/Article/whatwedo.html (last visited Jan. 9, 2021).

252. SEC ANN. REP. 73–80 (2001), https://www.sec.gov/pdf/annrep01/ar01fulldisc.pdf.

253. *See infra* note 257 and accompanying text (discussing the Relationship Summary).

254. The RAND Study found from its research surveys that "the majority of interviewees expressed the opposite viewpoint—that disclosures do not help protect or inform the investor, primarily because few investors actually read the disclosures. Many participants said that they think that the disclosures themselves are the root of the problem." RAND Study, *supra* note 161, at 19. Another survey found that "many investors do not read disclosure documents, and those that do spend relatively little time reviewing them, considering the breadth of information they contain." ABT. SRBI, MANDATORY DISCLOSURE DOCUMENTS TEL. SURVEY iv (2008), https://www.sec.gov/pdf/disclosuredocs.pdf. In adopting RBI, the SEC also stated that:

> As noted by one commenter, the academic literature on disclosure effectiveness notes that in certain circumstances, disclosure of financial information may induce a "panhandler effect," whereby disclosure increases the pressure to comply with the advice if the advisee (e.g., the retail customer) feels obliged to satisfy the financial interest of the advice provider (e.g., the associated person).

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,449.

255. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,347.

document must disclose "succinct information about the relationships and services the firm offers to retail investors, fees and costs that retail investors will pay, specified conflicts of interest and standards of conduct, and disciplinary history, among other things."[256]

The Relationship Summary required by RBI is only "an initial layer of disclosure, with the Disclosure Obligation reflecting more specific and additional, detailed layers of disclosure."[257] This open-ended mandate leaves broker-dealers adrift in determining what is the full extent of their Disclosure Obligations under RBI. For example, for disclosures relating to conflicts of interest, RBI defines such conflicts as those that "might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—*consciously or unconsciously*—to make a recommendation that is not disinterested."[258] The SEC did not define how a broker-dealer will be able to identify "unconscious" conflicts, other than to cite a 1963 Supreme Court decision that set a negligence standard for investment advisers.[259] That reference suggests that broker-dealers are now subject to the same fiduciary standards as investment advisers. That suggestion comports with the recommendations of the Dodd-Frank SEC staff study that was supposedly rejected by the SEC in adopting RBI.[260]

RBI's Disclosure Obligation will serve only to add more costly and complex compliance requirements for broker-dealers. The SEC rejected proposals that it adopt standardized disclosure forms that would meet the Disclosure Obligation.[261] Instead, the

256. *Id.*

257. *Id.*

258. 17 C.F.R. § 240.15l-1(b)(3) (emphasis added); *accord* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,325.

259. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,366 n.480 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)).

260. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 15, at 101–02.

261. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,367, 33,485. Nevertheless, the SEC asserted that "[w]e believe that many or most small entities will develop a standardized conflict disclosure document and deliver it to their retail customers." *Id.* at 33,487. However, they do so at their peril.

SEC opted for vaguely worded explanations of what broker-dealers must disclose to customers.[262] In contrast, the Commodity Futures Trading Commission (CFTC) mandates that standardized risk disclosures be given to customers of futures commission merchants (FCMs), which are the analogue of broker-dealers in the futures markets.[263] The CFTC has largely rejected a suitability requirement.[264] Instead, it uses those standardized forms to disclose the risks inherent in trading derivative instruments and directs FCM customers to make their own suitability decisions in light of those risks.[265]

### 2. *The RBI Care Obligation*

The RBI Care Obligation mandates that broker-dealers "exercise reasonable diligence, care, and skill" in making recommendations to retail customers.[266] The SEC asserted that the RBI Care Obligation was made "significantly" stronger than historical suitability obligations by:

> (1) [e]xplicitly requiring in Regulation Best Interest that recommendations be in the best interest of the retail customer and do not place the broker-dealer's interests ahead of the retail customer's interests;
>
> (2) explicitly requiring by rule the consideration of costs when making a recommendation; and
>
> (3) applying the obligations relating to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of

262. *See id.* at 33,367.

263. *See, e.g.*, 17 C.F.R. § 1.55.

264. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,887 (July 24, 1978).

265. *See* JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS § 10:3 (2019) (comparing the approach of the SEC's suitability requirement with that of the CFTC). As a result of Dodd-Frank, however, the CFTC imposed suitability requirements for swap transactions. *See* JERRY W. MARKHAM, REGULATION OF SWAP AND OTHER OVER-THE-COUNTER DERIVATIVE CONTRACTS 70–71 (2014) (describing that requirement).

266. 17 C.F.R. § 240.15l-1(a)(2)(ii).

> whether a broker-dealer exercises actual or *de facto* control over a customer's account.[267]

The elimination of the de facto control requirement is a sharp departure from the traditional dividing line between the limited scope of broker-dealer duties owed to non-discretionary accounts versus the broader duties applicable to discretionary accounts.[268]

In adopting the RBI Care Obligation, the SEC emphasized the importance of considering the costs to customers in making recommendations.[269] The SEC asserted, however, that cost "is not a dispositive factor and its inclusion in the rule text is not meant to limit or foreclose the recommendation of a more costly or complex product that a broker-dealer has a reasonable basis to believe is in the best interest of a particular retail customer."[270] Indeed, the SEC asserted that costs "should never be the only consideration."[271] Other factors to consider include such things as liquidity, volatility, firm reputation and business practices and level of service.[272]

This "on-the-one hand and on-the-other" analysis effectively means that a broker-dealer must recommend the "best" investment whatever its cost and whoever is selling it. That analysis will inevitably be judged on the piercing perception of twenty-twenty hindsight, which sets the stage for second-guessing any and all recommendations that do not perform as expected.[273]

267. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,374.

268. *See supra* notes 174–76 and accompanying text (describing the RAND study's view that enhanced duties were not needed in non-discretionary accounts).

269. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,372–73.

270. *Id.* at 33,373.

271. *Id.*

272. *Id.* at 33,373 n.567.

273. As the SEC stated:

> a broker-dealer would not satisfy the Care Obligation by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer's investment profile. A broker-dealer could

3. *The RBI Conflict of Interest Obligation*

The RBI Conflict of Interest Obligation imposes a requirement that broker-dealers create and maintain written policies that identify all conflicts of interest associated with investment recommendations to retail customers.[274] This obligation requires these identified conflicts to be either disclosed to customers, mitigated, or eliminated.[275]

The Conflict of Interest Obligation requires disclosure and mitigation of conflicts of interest that provide incentives for broker-dealer sales staff to place their interests ahead of the interests of their retail customers.[276] Identification and disclosure is also required of conflicts created by restrictions on recommended securities or investment strategies.[277] This would include instances where broker-dealers provide only limited menus of investment options or recommend only proprietary products to carry out an investment strategy that could be fulfilled equally as well by competing non-proprietary products.[278] Among the other conflicts of interest that must be identified and mitigated are sales commissions or other sales charges, compensation tied to asset accumulation, special awards, differential or variable compensation, and incentives tied to performance reviews.[279] In determining whether its Conflict of Interest Obligation is met, unlike the standard the

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> recommend a more expensive security or investment strategy if there are other factors about the product that reasonably allow the broker-dealer to believe it is in the best interest of the retail customer, based on that retail customer's investment profile. Similarly, a broker-dealer could recommend a more remunerative security or investment strategy if the broker-dealer has a reasonable basis to believe that there are other factors about the security or investment strategy that make it in the best interest of the retail customer, in light of the retail customer's investment profile.

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,380–81.

274. 17 C.F.R. § 240.15l-1(a)(2)(iii).

275. *Id.*

276. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,390–91.

277. *Id.*

278. *Id.* at 33,393.

279. *Id.* at 33,391. The SEC described a number of the best practices for mitigating compensation related conflicts of interest. *Id.* at 33,392.

SEC seeks to impose for the Disclosure Obligation, the Conflict of Interest Obligation does not impose strict liability but will instead be measured under a "reasonableness" standard.[280]

Unlike the RBI Disclosure Obligation, the Conflict of Interest Obligation departs from the historical role of the SEC as a "full disclosure" regulator.[281] This is because the Conflict of Interest Obligation creates mandates "that cannot be satisfied through disclosure alone," i.e., RBI requires broker-dealers to identify and eliminate entirely certain conflicts of interest.[282] This prohibition is directed at sales contests, bonuses, and other compensation based on production.[283] Such prohibited compensation arrangements include paid vacations or attendance at company sponsored events that are based on the sale of specific securities or sales within a limited period of time.[284]

The SEC asserted that such compensation "practices, particularly when coupled with a time limitation, create high-pressure situations for associated persons to engage in sales conduct contrary to the best interests of retail customers."[285] The SEC found that "the point of these practices is simply to increase the sale [of] a particular security or type of security, for

280. *Id.* at 33,386.

281. As described above, the historical mission of the SEC has been to require disclosure of material information about investment products so that investors can make their own informed decisions. *See supra* notes 250–59 and accompanying text (describing the RBI Disclosure Obligation). That regulatory approach shifted with the agency's ban on fixed commissions in 1975. *See supra* note 123 and accompanying text. At about the same time, the SEC mandated a National Market System (NMS), which sought to enhance competition by requiring all customer orders to be executed at the national best bid or offer (NBBO). Regulation NMS, 17 C.F.R. §§ 242.600–242.613 (2019); MARKHAM & HAZEN, *supra* note 29, § 2:15 (describing development of the National Market System, which was initially called the Central Market System); *see also* Jerry W. Markham, *Regulating the Sale of Stock Exchange Market Data to High-Frequency Traders*, 71 FLA. L. REV. 1209, 1235 (2019) (describing how the SEC has used Regulation NMS to impose utility-like controls over exchange fees).

282. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,319, 33,385–88.

283. *Id.* at 33,321.

284. *Id.*

285. *Id.* at 33,396.

example, in the context where a broker-dealer is attempting to reduce its inventory of or exposure to that security."[286]

The Conflict of Interest prohibition does not extend to some volume-based compensation.[287] Exempted from this prohibition is compensation based on total products sold, asset accumulation and growth, or minimum sales or production requirements contained in an employment contract.[288] This means that conflicts of interest associated with compensation that is based on annual volume and production quotas will continue to widely persist because such employment arrangements are common in the securities industry.[289] Indeed, even where production goals are not explicit, common business sense dictates that low producers will be fired or encouraged to seek employment elsewhere.

#### 4. *The RBI Compliance Obligation*

The RBI Compliance Obligation requires broker-dealers to "establish[], maintain[], and enforce[] written policies and procedures reasonably designed to achieve compliance with" the other RBI mandates.[290] The Compliance Obligation seeks to ensure that broker-dealers have strong systems of internal controls in place to prevent RBI violations.[291] The SEC declined, however, to specify which controls are required, leaving that decision to broker-dealers to determine based on their own business models.[292] Once again, broker-dealers are left adrift and subject to second-guessing in implementing the RBI

286. *Id.*

287. *Id.*

288. *Id.*

289. *See, e.g.*, *Frequently Asked Questions*, AM. EQUITY INV. CORP., http://www.investforyou.com/frequently-asked-questions (last visited Sept. 30, 2020) (describing how one firm's "aggressive pay structure" and comparing its annual minimum production requirements with other industry participants).

290. 17 C.F.R. § 240.15l-1(a)(2)(iv).

291. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,397.

292. *See id.* at 33,397. The SEC did state that such controls generally would include remediation of non-compliance, training and periodic reviews and testing. *Id.* at 33,397–98.

mandates. The consequence is a greater exposure to regulatory actions that are based on hindsight evaluations when a problem occurs, as they inevitably do.

The SEC also amended the recordkeeping requirements in existing rules 17a-3 and 17a-4 to specify minimum requirements for records that broker-dealers must create and maintain to document their compliance with RBI.[293] This includes records identifying customers receiving recommendations and a record of all information collected from and provided to those customers pursuant to RBI and the identity of the person making the recommendation.[294] The "neglect, refusal, or inability of a retail customer to provide or update any such information would excuse the broker-dealer from obtaining that information."[295] These recordkeeping requirements also do not impose record keeping on a recommendation-by-recommendation basis but rather on the basis of the customer's already documented investment profile.[296]

## IV. THE SEC'S ECONOMIC ANALYSIS OF RBI'S COSTS AND BENEFITS WAS DEEPLY FLAWED

The SEC's adopting release for RBI is largely devoid of any hard evidence that its economic costs are outweighed by its benefits. Rather, the SEC's analysis is based on surmise and conjecture.

293. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,398; 17 C.F.R. §§ 240.17a-3(a)(35), a-4(e)(5).

294. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,398.

295. *Id.*

296. *Id.*

### A. *The SEC's Economic Analysis Is Based on Possibilities and Surmise*

The SEC is required by law to analyze the costs and benefits of proposed regulations before their adoption.[297] The agency has, on more than one occasion, failed to meet this requirement.[298] For example, in *Business Roundtable v. SEC*, the United States Court of Appeals for the D.C. Circuit held that the SEC's adoption of a rule governing proxy access was arbitrary and capricious.[299] The court was unmoved by the agency's seventy-three pages of cost-benefit analysis and the 21,000 hours spent by the SEC staff in seeking to justify its costs.[300]

RBI was challenged in the Second Circuit under the Administrative Procedure Act.[301] That court ruled in *XY Planning Network, LLC v. SEC*, that the SEC had correctly interpreted RBI to allow it to craft out an exemption from the special compensation provisions of the Investment Advisers Act of 1940 for broker-dealers.[302] The court found that the SEC had substantial evidence that the compliance costs of a uniform fiduciary rule to broker-dealers outweighed its benefits to consumers and that the SEC's decision was not based on speculation.[303]

Unlike the *Business Roundtable* decision, the Second Circuit in *XY Planning Network* failed to recognize the lack of any hard economic data analysis in the SEC's cost and benefit analysis. [304]

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297. Rachel A. Benedict, *Judicial Review of SEC Rules: Managing the Costs of Cost-Benefit Analysis*, 97 MINN. L. REV. 278, 282 (2012) (footnotes omitted) ("The Securities Exchange Act [of 1934] requires the SEC to take into consideration a rule's impact on efficiency, competition, capital formation, and protection of investors. Courts have interpreted this statutory mandate to require the SEC to conduct an economic analysis for proposed rules.").

298. *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011); Am. Equity Life Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 177–78 (D.C. Cir. 2010); Chamber of Comm. v. SEC, 412 F.3d 133, 143–44 (D.C. Cir. 2005).

299. 647 F.3d at 1148–49.

300. Benedict, *supra* note 297, at 286.

301. 5 U.S.C. § 706(2).

302. XY Planning Network, LLC v. SEC, 963 F.3d 244, 256 (2d Cir. 2020).

303. *Id.* at 256–57.

304. *See id.* at 255–57.

Indeed, no in-depth analysis was given in *XY Planning Network* to any aspect of the SEC's cost-benefit claims.[305] This was because that court was of the view that "[p]etitioners' preference for a uniform fiduciary standard instead of a best-interest obligation is a policy quarrel dressed up as an APA claim."[306]

The SEC's economic justification for RBI is based almost entirely on speculation. In adopting RBI, the SEC double-downed on its effort to use word counts instead of hard economic data that it failed to obtain. Although RBI is only a few pages in length, the SEC's adopting release needed 770 typewritten pages and 1,671 footnotes to explain and rationalize its mandates.[307] Some 400 of those pages were dedicated to the SEC's economic justification of the costs and benefits of RBI, but that analysis was based mostly on surmise and conjecture.[308] Indeed, the adopting release uses the word "may" nearly 1,000 times.[309] The use of that word is particularly prevalent in the SEC's description of the costs that RBI "may" impose and the benefits to investors that "may" result from its mandates.[310]

In support of its economic justification for adopting RBI, the SEC asserted that RBI "enhances the broker-dealer standard of conduct beyond existing suitability obligations and aligns the standard of conduct with retail customers' reasonable expectations."[311] This is seemingly a noble sentiment, but there

305. *See id.*

306. *Id.* at 255.

307. *See generally* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019) (the text of the rule only comprises five pages of the 770-page document).

308. *See id.* at 33,373–96.

309. *See generally id.*

310. The following is just one example of this conjecture by the SEC:

> For example, a disclosure that a firm is acting in the capacity of a broker-dealer *may* encourage a retail customer to seek additional information about commissions, which *could* give the firm or its financial professional an incentive to recommend transactions that *may* be inconsistent with the client's most efficient investment strategy, such as a buy-and-hold strategy.

*See, e.g.*, *id.* at 33,439 (emphasis added).

311. *Id.* at 33,400.

is little data supporting those supposed expectations. Indeed, the SEC admitted that it did not have data to justify the benefits of the regulatory structure existing before RBI.[312] The SEC even conceded that it does "not have reliable data to determine the precise number of broker-dealers that provide recommendations (and the extent to which broker-dealers that provide recommendations do so, as opposed to executing unsolicited trades)."[313]

The SEC stated that while it purportedly was able to quantify the costs of "limited" portions of RBI, i.e., its recordkeeping requirements, the agency continued believed that it was not possible to "meaningfully" quantify the costs and benefits of RBI because of the "many contingent factors that render any estimate insufficiently precise to inform our policy choices"[314] and the fact that "anecdotal evidence of investor harm in these studies does not lend itself to aggregation."[315] The SEC found that the quantification of the economic effects of RBI was "particularly challenging" because of the number of assumptions required to predict how broker-dealers will implement the RBI mandates and how their responses will affect the market for investment advice and retail customer participation in the financial markets.[316] In effect, the SEC admitted that it did not conduct the required costs and benefits analysis because there is no data to support the benefits of the RBI mandates.

The SEC identified several factors that could affect compliance with RBI and stated that those "sources of

312. The SEC stated that:

> While *we do not have evidence to establish* the degree to which broker-dealers can extract large informational rents from retail customers under the current legal and regulatory regime that governs the broker-dealers' standard of conduct, the existing agency costs of the relationship between the retail customer and the broker-dealer *would likely* be larger, absent the current legal and regulatory regime.

*Id.* at 33,404 (emphasis added).

313. *Id.* at 33,407.

314. *Id.* at 33,437.

315. *Id.* at 33,436.

316. *Id.* at 33,401.

uncertainty and complexity make meaningfully quantifying many of the costs and benefits of the rule difficult and, particularly over long time periods, inherently speculative."[317] The SEC further conceded that, "[i]f it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with Regulation Best Interest."[318] Nevertheless, the SEC claimed that while it could not "provide a quantified estimate of the magnitude of this agency cost, the existence of these costs and their persistence justifies regulatory intervention."[319]

Instead of quantitative economic data, the SEC relied on assumptions that it surmised "may" affect the efficiency of recommendations made by broker-dealers.[320] The SEC posited that investment recommendations "may" be influenced by broker-dealer compensation conflicts, which "may" result in inefficient recommendations.[321] The agency was concerned that such recommendations "may lead to various results for the retail customer, including inferior investment outcomes, such as risk-adjusted expected returns that are lower relative to other similar investments or investment strategies."[322] This begs the questions: how was it that the securities industry grew and

317. *Id.* at 33,435. The SEC further stated that: "[E]ven if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with Regulation Best Interest." *Id.* at 33,434–35. The SEC noted eleven different assumptions that would be needed to quantify the costs and benefits of RBI. *See id.* at 33,434.

318. *Id.* at 33,434–35.

319. *Id.* at 33,404.

320. The SEC stated that:

> The efficiency of a recommendation to a retail customer *may* depend on: (1) the menu of securities transactions and investment strategies the broker-dealer or its associated persons considers and makes available to the retail customer; (2) the return distribution and the costs of these securities transactions and strategies; (3) the associated person's understanding of these investment options and the retail customer's objectives, such as the retail customer's risk tolerance and time preference; and (4) the retail customer's resource constraints.

*Id.* at 33,402 (emphasis added).

321. *Id.*

322. *Id.* at 33,403.

prospered through the use of transaction-based commissions? Why make these assumptions now in a rule that is designed to preclude their use?

The SEC's economic analysis conceded that investor decisions accepting or rejecting investment advice are based on multiple factors.[323] Nevertheless, the SEC argued that, where there is a competing investment choice available, "agency costs *may* be higher for those retail customers that make their decision of whether to act on a recommendation received without an assessment of the efficiency of the recommendation."[324]

Despite these shortcomings, the SEC's adopting release made some remarkably exact cost estimates that will be incurred by broker-dealers in complying with RBI. Those estimates are staggering in their amounts. For instance, with respect to the Disclosure Obligation alone, the SEC estimated compliance would initially require 6,216,125 hours of work as well as an ongoing aggregate burden of 2,101,493 work hours at an estimated initial cost of "$1,508.88 million" (presumably this means about $1.5 billion) and an ongoing aggregate annual cost of $499.59 million.[325]

With respect to the Care Obligation, the SEC noted that its costs may be passed onto customers and that some broker-dealers may stop offering and recommending some securities to customers.[326] The SEC was, however, "unable to fully quantify the costs . . . because the magnitude of these costs depends on firm-specific factors that are inherently difficult to quantify given the principles-based nature of Regulation Best Interest."[327]

323. *Id.* at 33,402 (listing various factors investors consider before accepting or rejecting investment advice).

324. *Id.* at 33,403 (emphasis added).

325. *Id.* at 33,443.

326. *Id.* at 33,446.

327. *Id.* at 33,447.

The SEC was also unable to determine the full costs of the Conflict of Interest Obligation,[328] but estimated its initial paperwork burden would be an aggregate $110.73 million.[329] It estimated that this obligation would thereafter impose an annual aggregate industry cost of at least $20.44 million.[330] The Compliance Obligation also did not lend itself to a cost-benefit analysis.[331] Nevertheless, the SEC estimated this obligation "would impose an initial aggregate cost of at least $214.66 million and an ongoing aggregate annual cost of at least $110.86 million on broker-dealers."[332]

The SEC estimated that just the record making requirements imposed by RBI would impose a stunning:

> initial aggregate burden of 17,684,020 hours and an additional initial aggregate cost of $375,732 as well as an ongoing aggregate annualized burden of 5,520,800 hours on broker-dealers. After monetizing the burden hours, the record-making and recordkeeping obligations will impose an initial aggregate cost of at least $4,121.73 million and an ongoing aggregate annual cost of at least $1,736.52 million on broker-dealers.[333]

As shown in the next section of this Article, the supposed benefits that offset these staggering costs are equally based on surmise and conjecture.

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328. *Id.* at 33,449 ("[I]t is not possible to meaningfully quantify the potential costs and benefits of the Conflict of Interest Obligations because such analysis would depend on many contingent factors that render any estimate insufficiently precise to inform our policy choices.").

329. *Id.* at 33,455.

330. *Id.*

331. *See id.* at 33,455–56.

332. *Id.* at 33,456.

333. *Id.* at 33,456–57. Some of the SEC cost estimates appear to be preposterously small. For example, its estimates that the cost of outside counsel assistance in preparing fee schedules that comply with RBI to be $2,485 for small broker-dealers and $4,970 for large broker-dealers. *Id.* at 33,473. That claim is absurd because no respectable lawyer would spend such a small amount of time to understand the sweeping mandates in RBI and the SEC's 770-page adopting release explaining those requirements. *Id.* at nn.1427–28 (anticipating five hours to research and create a compliant fee schedule for small brokers and ten hours for larger brokers).

### B. *The Supposed Benefits of RBI are Also Based on Guess Work*

Despite the agitprop in the RBI adopting release extolling the benefits that "may" result from its costly mandates, RBI seems to be aimed at a problem that does not exist. As one industry study of over 800 investors had found, "96% of U.S. investors report that they trust their financial professional today, [and] 97% believe their financial professional has the investor's best interest in mind already."[334] The RAND Study had also found that investors are more concerned with product choice and the quality of the services they receive than any distinction between regulatory requirements for broker-dealers and investment advisers.[335]

In any event, like its cost analysis, the SEC's analysis of the supposed benefits to customers did not lend itself to quantitative analysis.[336] The SEC had only anecdotal evidence

334. CENTER FOR CAPITAL MARKETS COMPETITIVENESS, WORKING WITH FINANCIAL PROFESSIONALS: OPINIONS OF AMERICAN INVESTORS 6 (2018), https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/CCMC_InvestorPolling_v5-1.pdf.

335. RAND Study, *supra* note 161, at xix (finding a high rate of satisfaction among investors despite their widespread confusion over the distinction between brokers and investment advisors). An issue unaddressed by the SEC in adopting RBI is the financial literacy of investors. As a joint study by the SEC staff and the RAND Corporation found:

> [R]esearch consistently shows that investors who are more financially literate are more likely to seek out investment advice and that unsolicited advice is less likely to be followed. Together these imply that the availability of financial advice might not act as a sufficient substitute for low financial literacy. Once investors are working with a financial professional, the likelihood of those investors following the investment advice is higher when the advisor is seen as more trustworthy; in turn, trust is affected by advisors' communication style, credentials, and other factors.

Memorandum from the Office of the Inv. Advocate on Inv. Testing Regarding Standards of Conduct for Inv. Prof'l 77 (Oct. 12, 2018), https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf.

336. For example, the SEC's adopting release conceded that it was unable to quantify the supposed benefits of RBI:

> Enhancing the standard of conduct that applies to series of recommended transactions and reducing the incidence of recommendations that result in excess portfolio turnover should result in more efficient recommendations, benefiting retail customers. We are unable to specifically quantify these potential benefits because, in addition to the reasons cited above, we do not have and cannot reasonably obtain comprehensive data on how often broker-dealers, for accounts they do not control, recommend series of transactions that result in excessive portfolio turnover and are therefore not in the best interest of their retail customers.

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,445–46.

to consider in evaluating existing harms to investors from broker-dealer compensation conflicts.[337] In that regard, the agency stated that while a "potential benefit of Regulation Best Interest is [] a reduction in [] harm" to investors, "the anecdotal evidence of investor harm [contained in various] studies does not lend itself to aggregation."[338] The SEC also concluded that even if agency costs are higher due to such conflicts, customers may have no real choice in selecting lower cost alternatives because of the limited investment menus offered by many broker-dealers.[339]

The SEC's conjectural analysis of economic benefits to investors was based, at least in part, on various scenarios in DOL and other studies relating to mutual funds.[340] The SEC cited those studies as proof that comparability and competition can reduce agency costs.[341] Elsewhere, however, the SEC concluded that the DOL had misapplied the results of a study it relied on that used mutual fund charges as support for its adoption of the Fiduciary Rule.[342] The SEC stated that, when correctly applied, "the aggregate estimate of investor harm obtained using this approach is negligible."[343] The SEC also conceded that its cost estimates could not be directly compared with its benefit estimates because the latter applied to mutual funds only.[344]

The SEC benefit analysis did not quantify offsetting costs to investors that will result from RBI's mandates. As described below, RBI's mandates are skewed in favor of forcing broker-

337. *Id.* at 33,435–36.

338. *Id.*

339. *Id.* at 33,452.

340. *See id.* at 33,458.

341. The SEC asserted that "in the market for mutual funds—particularly index funds—comparability and competition, among other factors, have driven down fees significantly." *Id.* at 33,403. As described below, however, inducements that move investors into diversified index funds will pose a systemic risk to the economy. *See infra* notes 404–05 and accompanying text.

342. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,322.

343. *Id*. at 33,436.

344. *See id.* at 33,459.

dealers to switch to fee-based compensation.[345] Fee-based compensation is unsuitable for investors that trade infrequently. As the SEC noted in adopting RBI, "investors who have brokerage or advisory accounts typically trade infrequently, with approximately 31% reporting no annual transactions and an additional approximately 30% reporting three or fewer transactions per year."[346] Such non-active accounts, particularly those with buy and hold strategies that had not previously generated substantial per transaction commissions, will pay the same fixed fee as an actively traded account that requires constant supervision and advice by a broker-dealer.[347] RBI's forced use of fee-based accounts will consequently increase investor costs because broker-dealers can make more money from fee-based accounts. For example, one study estimated "that the average annual costs associated with commission-based accounts are approximately 75 bps [basis points], while the average fee-based account costs 130 bps."[348]

In adopting RBI, the SEC decreed that investors could not waive the obligations imposed by RBI.[349] Such a waiver would have allowed broker-dealers to offer retail customer accounts free of the RBI-imposed costs.[350] At the same time, RBI provided retail customers with no remedy for damages caused by a breach of duties because the SEC asserted RBI created no private right of action.[351] This declaration defanged concerns of private rights of action that were a threat to broker-dealers under the DOL Fiduciary Rule, which was stricken by the Fifth Circuit.[352] RBI thus adopted most of the costs associated with

345. *See infra* notes 353–54 and accompanying text.

346. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,416.

347. *See id.* at 33,425–26.

348. *Id.* at 33,425 (footnote omitted). One basis point equals 0.01%.

349. *Id.* at 33,327.

350. *See id.*

351. *Id.* ("[W]e do not believe Regulation Best Interest creates any new private right of action or right of rescission, nor do we intend such a result.").

352. Chamber of Com. v. U.S. Dep't of Lab., 885 F.3d 360, 384–85 (5th Cir. 2018).

the DOL Fiduciary Rule's overreaching, while deleting the key element of its investor protection provisions.

## V. THE HAZARDS OF RBI

### A. *RBI Will Result in Less Investor Choice and Higher Costs*

Dodd-Frank prohibited the SEC from banning transaction-based compensation, and the SEC gave lip service to that limitation in promulgating RBI.[353] Nevertheless, the agency inexplicably decided to adopt a complex and costly regulatory structure that will effectively force abandonment of transaction-based compensation and personalized investment advice. Discount broker fees are the lowest available because discount brokers do not provide investment recommendations, and full-service broker-dealers charging higher transaction-based commissions for personalized advice will inevitably be charged by the SEC with a breach of RBI if their advice proves to be

353. The SEC stated that:

> Notwithstanding the[] inherent conflicts of interest in the broker-dealer-customer relationship, there is broad acknowledgment of the benefits of, and support for, the continuing existence of the broker-dealer business model, including a commission or other transaction-based compensation structure, as an option for retail customers seeking investment recommendations.

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,319. The SEC also claimed that:

> Importantly, Regulation Best Interest is designed to preserve, to the extent possible, (1) access and choice for investors who may prefer the transaction-based model that broker-dealers generally provide, or the fee-based model that investment advisers generally provide, or a combination of both types of arrangements, and (2) retail customer choice of the level and types of services provided and the securities available. For example, retail customers who intend to buy and hold a long-term investment on a non-discretionary basis may find that paying a one-time commission to a broker-dealer who recommends such an investment is more cost effective than paying an ongoing advisory fee to an investment adviser merely to hold the same investment. Retail customers who would prefer advisory accounts but have not yet accumulated sufficient assets to qualify for investment advisory accounts, which may require customers to have a minimum amount of assets, may similarly benefit from recommendations from broker-dealers. Other retail customers who hold a variety of investments, or prefer different levels of services from financial professionals, may benefit from having access to both brokerage and advisory accounts.

*Id.* at 33,401.

wrong.[354] RBI further discourages personalized broker-dealer recommendations by replacing the existing fraud-based scienter requirement with a lesser negligence standard.[355] This means that a broker-dealer may be sanctioned by the SEC for simply making an "unconscious" mistake when providing personalized recommendations.[356]

RBI further encourages migration away from personalized advice because it exempts "asset allocation models that are based on a generally accepted investment theory."[357] Retail customers will now be pushed into cookie cutter robo-accounts concentrated at large broker-dealers. Such arrangements lend themselves readily to standardized low cost disclosure forms,[358] and can be implemented cheaply.[359] In effect, retail investors will be unable to obtain personalized investment advice.

Fixed-fee arrangements also remove incentives for broker-dealers to provide informed advice to their clients.[360] Broker-dealers receiving fee-based compensation have little incentive to enhance their expertise, develop new products for clients, or actively seek out new investment opportunities because the compensation model provides little reward for their efforts. Under the RBI mandate, full-service broker-dealers will receive the same fixed fee, whatever the quality of their advice or the innovative nature of the products they make available to their

354. *See supra* note 353 and accompanying text.

355. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,366.

356. *See* 17 C.F.R. § 240.15l-1(b)(3); Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,325. *See generally* Lowe v. SEC, 472 U.S. 181 (1985) (distinguishing personalized advice that is subject to the registration requirements of the Investment Advisers Act, and its negligence standard for such advice, from general investment advice not directed to particular individuals).

357. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,337–38.

358. *See id.* (showing that broker-dealers will employ "education" tactics such as standardized disclosure forms to avoid being subject to RBI).

359. *See supra* notes 214–16 and accompanying text.

360. *See generally* Bob Pisani, *A Breakdown of Whether Investors Are Safer After the SEC Passes Financial Protection Rule*, CNBC (June 6, 2019, 4:44 PM), https://www.cnbc.com/2019/06/06/a-breakdown-of-whether-investors-are-safer-after-the-sec-passes-financial-protection-rule.html.

clients.[361] This encourages lazy broker-dealers to recommend only standardized cookie-cutter portfolios that will not meet the investment needs and objectives of investors seeking personalized advice. It also incentivizes "reverse churning" in less active accounts because a fixed-fee will exceed transaction-based commissions.[362]

Another foreseeable effect of a change in the existing standard of care is that broker-dealers will restrict retail customers' product choices to only a limited number of firm-approved proprietary products for their cookie-cutter portfolios.[363] These will likely be products that provide maximum rewards to the broker-dealer through fee-based

361. "Nowadays, the name of the game is. . . . to offer only what keeps the fees in-house." Jason Zweig, *What the E*Trade Deal Tells You About the New Investing Game*, WALL ST. J. (Feb. 21, 2020, 11:00 AM), https://www.wsj.com/articles/what-the-e-trade-deal-tells-you-about-the-new-investing-game-11582300803.

362. *See* Frank & Cecala, *supra* note 168 and accompanying text (describing reverse churning in wrap accounts); Paul Radvany, *Reverse Churning in Fee-Based Accounts*, 26 No. 1 PIABA B.J. 19, 19 (2019) ("Reverse churning is the illegal practice characterized by the absence of trading activity in a fee-based investment account."). In *In Re Edward D. Jones & Co., L.P. Sec. Litig.*, No. 2:18-cv-00714-JAM-AC, 2019 WL 2994486 (E.D. Cal. July 9, 2019), a class action alleging a "reverse churning" scheme was dismissed because adequate disclosures were made and the elements required for a suitability claim under SEC Rule 10b-5 were not established. The defendant broker-dealer was claimed to have shifted clients' commission-based accounts to fee-based advisory programs in order to collect more fees from low-profit commission-based accounts. *Id.*

363. RBI's obligations would impose some confusing and conflicting standards when it comes to limited choice investment recommendations:

> We are clarifying that an evaluation of reasonably available alternatives does not require an evaluation of every possible alternative (including those offered outside the firm) nor require broker-dealers to recommend one 'best' product, and what this evaluation will require in certain contexts (such as a firm with open architecture). Furthermore, we clarify that, when a broker-dealer materially limits its product offerings to certain proprietary or other limited menus of products, it must still comply with the Care Obligation—even if it has disclosed and taken steps to prevent the limitation from placing the interests of the broker-dealer ahead of the retail customer, as required by the Disclosure and Conflict of Interest Obligation—and thus could not use its limited menu to justify recommending a product that does not satisfy the obligation to act in a retail customer's best interest.

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,326.

compensation, proprietary products and inventory purchase and sales.[364]

Accompanying this paradigm shift in broker-dealer compensation incentives is the effort to remove historical investment accountability metrics. Instead of measuring the value of an investment on the rate of return for the portfolios they manage, large asset managers are now promoting socially responsible investments in "sustainable" business models.[365] Those programs stress environmental, social, and corporate governance goals (ESG), rather than profits and returns.[366] As BlackRock, Inc., the world's largest money manager with over $7 trillion AUM, has observed, "[c]limate change is driving a

364. RBI also continues to encourage even fee-based accounts to recommend investments in which the firm acts as a dealer because it can then also capture mark ups, mark downs and dealer spreads. The SEC sought to counter such conflicts through its Disclosure Obligation. The SEC stated that:

> [T]he broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make a recommendation that is not disinterested, including, for example, conflicts associated with proprietary products, payments from third parties, and compensation arrangements.

*Id.* at 33,321. As noted above, however, retail investors are unlikely to read or understand such disclosures. *See id.* at 33,326 and accompanying text; RAND Study, *supra* note 161, at xviii.

365. As the promotional materials of one large bank states, sustainable investing has the potential "to drive both long term growth and positive impact," while aligning investors with their values. *Sustainable Investing*, JPMORGAN PRIVATE BANK, https://privatebank.jpmorgan.com/gl/en/services/investing/sustainable-investing (last visited Jan. 9, 2021).

366. Led by Jamie Dimon, the head of JPMorgan Chase & Co., one of the world's largest investment banks, the Business Roundtable issued a statement of corporate purpose in 2019 signed by the leaders of 180 public companies. It proclaimed that their business models will be modified from profit seeking enterprises to ones that provide fair wages and benefits to employees, support their communities and protect the environment. Elizabeth Dilts, *Top U.S. CEOs Say Companies Should Place Social Responsibility Above Profit*, REUTERS (Aug. 19, 2019, 12:03 PM), https://www.reuters.com/article/us-jp-morgan-business-roundtable/top-u-s-ceos-say-companies-should-put-social-responsibility-above-profit-idUSKCN1V91EK. This volte-face in managing business risks and investment goals is not without its critics: "The Business Roundtable knows better, but corporate America is buckling under the pressure of political correctness. This is an unhealthy development that will make business the servant of politics. Few things are more dangerous than big government in cahoots with big business." Nikki Haley, *This Is No Time to Go Wobbly on Capitalism*, WALL ST. J. (Feb 26, 2020, 12:47 PM), https://www.wsj.com/articles/this-is-no-time-to-go-wobbly-on-capitalism-11582739248; *see also* BUSINESS ETHICS: READINGS AND CASES IN CORPORATE MORALITY 236 (W. Michael Hoffman, Robert E. Frederick & Mark S. Schwartz eds., 2014) (describing the heated debate over whether it is proper for business managers to pursue such goals and questioning their capabilities to make such decisions).

profound reassessment of risk and we anticipate a significant reallocation of capital."[367] Other giant money managers, including Morgan Stanley[368] and Goldman Sachs,[369] are also pursuing ESG goals, as are many mutual funds.[370] This has led to a significant shift in investment strategies and asset reallocations.[371] To illustrate, "[t]he Global Sustainable Investment Alliance [has] estimate[d that] there has been a 34% increase over the past 2 years in global sustainable investing assets under management, reaching $30.7 trillion."[372] The success of these sustainable strategies is mostly immeasurable, except in terms of money spent on such programs.[373] This

367. *A Fundamental Reshaping of Finance*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited Jan. 7, 2021). "Sustainability is fundamentally reshaping finance." *Sustainable Investing: Resilience Amid Uncertainty*, BLACKROCK, https://www.blackrock.com/corporate/about-us/sustainability-resilience-research (last visited Jan. 7, 2021).

368. *See* Vladimir Demine, *The ESG Advantage in Long-Term Investing*, MORGAN STANLEY (Dec. 16, 2019), https://www.morganstanley.com/ideas/the-esg-advantage-in-long-term-investing ("Investing in companies that lead in environmental, social and governance best practices is no longer niche—it's one of the strongest ways to help ensure long-term, sustainable returns.").

369. *See* @GoldmanSachs, TWITTER (Dec. 16, 2019, 9:53 AM), https://twitter.com/GoldmanSachs/status/1206588106427764739 ("Today, sustainable finance is no longer on the sidelines, but increasingly core to a company's business.").

370. *See* Britton O'Daly, *Beleaguered Money Managers Find Bright Spot in ESG*, WALL ST. J. (July 11, 2019 11:12 AM), https://www.wsj.com/articles/beleaguered-money-managers-find-bright-spot-in-esg-11562846400 (noting the record amount invested in socially responsible mutual funds). As one source found:

> The numbers back up the view that the capital markets are in the midst of a sea change. In 2006, when the UN-backed Principles for Responsible Investment (PRI) was launched, 63 investment companies (asset owners, asset managers, and service providers) with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. By April 2018, the number of signatories had grown to 1,715 and represented $81.7 trillion in AUM. According to a 2018 global survey by FTSE Russell, more than half of global asset owners are currently implementing or evaluating ESG considerations in their investment strategy.

Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, HARV. BUS. REV. (May–June 2019), https://hbr.org/2019/05/the-investor-revolution.

371. *See* sources cited *supra* note 370.

372. *ESG Funds & Sustainable Investing*, HEDGEROW (Sept. 23, 2020), https://www.hedgerowinc.com/news/esg-funds-sustainable-investing/.

373. To be sure, to date, "numerous studies have not concluded that incorporating sustainable investing factors results in a negative impact on performance." *Id*. ESG investment increased during the COVID-19 pandemic with uncertain performance results. *See* James

means that broker-dealers, and other money managers, in addition to the pernicious effects of mandatory fee-based compensation, are replacing personalized investment advice, which seeks to protect assets and provide investment returns, with non-accountable social goals.[374]

In sum, RBI removes incentives for professional brokers to monitor their customers' accounts and provide personalized advice based on the individual objectives and investment needs of customers. Instead, RBI incentivizes brokers to limit product choice to firm products that have higher costs. RBI exacerbates this problem by playing into the ESG movement that seeks to replace the rate of return accountability metric with non-accountable green objectives. As shown in the next section of this Article, RBI is also inconsistent with the norms of a free market upon which the U.S. economy is premised.

### B. *RBI Is Inconsistent with the Market for Other Goods and Services*

Allowing consumer choices between transaction and fee-based arrangements is highly desirable, but RBI tips the scale in favor of fixed-fee arrangements.[375] In so doing, RBI's regulatory coercion is inconsistent with normal free markets.[376] For

Mackintosh, *ESG Investing in the Pandemic Shows the Power of Luck*, WALL ST. J. (July 15, 2020, 7:00 AM), https://www.wsj.com/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802.

374. This concern is not conjectural. In June 2020, U.S. Labor Secretary Eugene Scalia announced a proposed rule governing ESG investments in accounts protected by the Employee Retirement Income Security Act of 1974 (ERISA). News Release, U.S. DEP'T OF LAB., U.S. Department of Labor Proposes New Investment Duties Rule (June 23, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623. That proposal would prohibit pension fund managers from making ESG investments that have an underlying investment strategy that is subordinate to returns or that increase risk for non-financial objectives. *See id.* Thereafter several large fund managers, including State Street and Vanguard, objected to that proposal. *See* Ross Kerber, *Top Fund Firms Oppose Planned U.S. Roadblock to Green Retirement Funds*, REUTERS (July 31, 2020), https://www.reuters.com/article/us-climate-change-funds/top-fund-firms-oppose-planned-u-s-roadblock-to-green-retirement-funds-idUSKCN24W1US.

375. *See supra* notes 315–17 and accompanying text.

376. *See* Maurice Stucke, *Is Competition Always Good?*, 1 J. ANTITRUST ENF'T 162, 167 (2013), https://academic.oup.com/antitrust/article/1/1/162/274807 (describing the virtues of

example, despite the annoyance it causes to consumers, airlines are free to charge different prices for identical seats on the same flight.[377] Retail stores and online sales operations are free to charge higher costs for the same product, and "comparison shopping" is an essential part of most consumer purchases, at least for high ticket items.[378]

Professionals, such as lawyers, are also free to charge higher fees than other equally-licensed professionals.[379] Lawyers have a conflict of interest in setting their fees, which are based on hourly rates, but they are not required to disclose that their fees are higher than those of other lawyers.[380] Under the theory espoused by RBI, it could be argued that the law is the law, so why should one lawyer be allowed to charge more for legal advice than any other lawyer? If this were a required disclosure, a lawyer charging $1,200 per hour at a large law firm for advice on the federal securities laws would be required to provide

competition and the premises for government regulation of competition). As Adam Smith has also observed:

> To widen the market and to narrow the competition, is always the interest of the dealers. . . . The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 231–32 (1st ed. 1910).

377. Airlines have sophisticated "yield management" strategies that allow them to charge different fares for the same seat by targeting business travelers with higher fares. *How Airlines Charge Different Fares for the Same Seat*, SEATMAESTRO, https://www.seatmaestro.com/how-airlines-charge-different-prices-for-the-same-seat/ (last visited Jan. 7, 2021).

378. *Comparison Shop*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/comparison%20shop (last visited Jan. 7, 2021).

379. Historically, partners in larger law firms have charged higher fees than small law firms and that gap has widened over the last few years. However, a major source of this discrepancy is due to the nature of the work. The largest tier of law firms is more likely to work on mergers and acquisitions, investment work, and corporate and tax work, which all demand higher rates than any other practice area or category. *Survey: Hourly Rates Higher at Nation's Largest Law Firms*, NALFA: NEWS BLOG (Sept. 26, 2019), http://www.thenalfa.org/blog/survey-hourly-rates-higher-at-nation-s-largest-law-firms/.

380. MODEL RULES OF PRO. CONDUCT r. 1.5 (AM. BAR ASS'N 2020) (showing that lawyers have no obligation to disclose higher fees).

disclosures to clients advising that small law firms charge only say $350 per hour for qualified advice on the same subject or that another large law firm charges only $800 per hour.

Artificial intelligence is also being developed that will provide legal advice at a low cost.[381] Will disclosure of the availability of such services be required by actual lawyers charging higher fees for the same services? Indeed, online services are even now providing wills and other legal documents for those seeking basic legal protection at a low cost.[382] However, consumers, particularly those with a large estate and dependent heirs, use those cookie cutter, robo-legal services at their peril. Instead, they may need the services of a high-priced lawyer skilled in estate planning. The same is true for many high net worth investors. RBI removes incentives for brokers to develop their investment skills and reduces investor access to professional advisors employed by broker-dealers.[383] The incentives in RBI are thus inconsistent with normal free markets. As will be shown in the next section of this article, RBI also provides incentives for the dangerous concentration of investor assets.

### C. *RBI Encourages Economically Dangerous Broker-Dealer Concentration*

Concentration of broker-dealers was already underway in the securities industry before the adoption of RBI.[384] More than two-thirds of all brokerage assets and close to one-third of all customer accounts are now held by the seventeen largest

381. Harmon Leon, *Artificial Intelligence Is on the Case in the Legal Profession*, OBSERVER (Oct. 16, 2019, 8:30 AM), https://observer.com/2019/10/artificial-intelligence-legal-profession/.

382. *See generally* Lars Lofgren, *Best Online Legal Services*, QUICK SPROUT (Sept. 11, 2020), https://www.quicksprout.com/best-online-legal-services/ (describing online legal services).

383. *See* Ian Hunley, *Development in Banking & Financial Law: 2019: XII. Regulation Best Interest*, 38 REV. BANKING & FIN. L. 610, 618 (2019).

384. Maggie Fitzgerald, *Charles Schwab To Buy TD Ameritrade in a $26 Billion All-Stock Trade*, CNBC (Nov. 25, 2019, 7:13 PM), https://www.cnbc.com/2019/11/25/charles-schwab-to-buy-td-ameritrade-in-a-26-billion-all-stock-deal.html ("Consolidation in the brokerage industry is expected given the massive amount of disruption occurring with all the major brokers dropping commission fees for trading in recent months.").

broker-dealers.[385] The nature of the compensation arrangements at those large firms are skewed toward fee-based compensation.[386]

In 2019, after the adoption of RBI, two of the largest discount brokers, Charles Schwab and TD Ameritrade, merged with each other to create a "mammoth" broker-dealer holding more than $5 trillion in customer assets.[387] Those and other discount brokers had reduced their per transaction-commission charges to zero.[388] Subsequently, Morgan Stanley, one of the largest full service firms, announced a $13 billion acquisition of E*Trade, another large discount broker with zero commissions, which had been the principal competitor of Schwab and TD Ameritrade.[389] Franklin Resources' acquisition of Legg Mason for $4.5 billion in February 2020 created another giant $1.5 trillion brokerage firm.[390]

The concentration of AUM in large money managers is proving to be profitable; Fidelity Investments with $3.2 trillion

385. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,407 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

386. As the SEC noted:

> The level of revenues earned by broker-dealers (including dually registered firms) for commissions and fees increases with broker-dealer size, but also tends to be more heavily weighted toward commissions for broker-dealers with less than $10 million in assets and is weighted more heavily toward fees for broker-dealers with assets in excess of $10 million.

*Id.* at 33,408. As one source notes, fee-based accounts already "have roughly $5 trillion in assets under management in them, with just two firms representing a third of the total." Jacqueline Matthews, *Why Your Fee-Based Account Costs Too Much*, FORBES (Aug. 12, 2019, 8:00 AM), https://www.forbes.com/sites/forbesfinancecouncil/2019/08/12/why-your-fee-based-account-costs-too-much/#3cec1f456071.

387. Fitzgerald, *supra* note 384.

388. Paul R. La Monica, *E-Trade Cuts Commissions to Zero Along with Rest of Brokerage Industry*, CNN BUSINESS (Oct. 3, 2019, 6:26 AM), https://www.cnn.com/2019/10/02/investing/etrade-zero-commissions/index.html.

389. Liz Hoffman, *Morgan Stanley Is Buying E*Trade, Betting on Smaller Customers*, WALL ST. J. (Feb. 20, 2020, 4:20 PM), https://www.wsj.com/articles/morgan-stanley-is-buying-e-trade-betting-on-littler-customers-11582201440.

390. Sophie Baker & James Comtois, *Franklin Deal for Legg Mason Turning Heads*, PENSIONS & INV. (Feb. 24, 2020, 12:00 AM), https://www.pionline.com/money-management/franklin-deal-legg-mason-turning-heads.

in AUM had record profits and revenue in 2019.[391] BlackRock, with more than $7 trillion in AUM, had a net income in 2019 of $4.5 billion on revenues totaling $14.54 billion.[392] Charles Schwab earned $3.53 billion last year on revenue totaling $10.72 billion.[393] Although lucrative, this continuing concentration poses a systemic risk in the event of a market crisis. The failure of even a single large financial services firm can wreak havoc on the entire economy, as was demonstrated by Lehman Brothers' bankruptcy in 2008.[394]

The RBI-induced model that is developing from the concentration of brokerage firms will reap profits from funds held in retail investor accounts.[395] Those profits will be gained through payments for order flow directed to particular market makers, margin loans, and through the use of customer funds.[396]

391. Justin Baer, *Fidelity Reports Record Operating Profit, Revenue*, WALL ST. J. (Mar. 3, 2020, 12:53 PM), https://www.wsj.com/articles/fidelity-reports-record-operating-profit-revenue-11583253000.

392. Trefis Team, *Why BlackRock's Stock Looks Overvalued*, FORBES (Feb. 19, 2020, 6:00 AM), https://www.forbes.com/sites/greatspeculations/2020/02/19/why-blackrocks-stock-looks-overvalued/#24ecf46b438e; Dawn Lim, *BlackRock's Assets Top $7 Trillion for First Time*, MARKETWATCH (Jan. 15, 2020, 7:46 AM), https://www.marketwatch.com/story/blackrocks-assets-top-7-trillion-for-first-time-2020-01-15.

393. Baer, *supra* note 391.

394. *See* JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE SUBPRIME CRISIS TO THE GREAT RECESSION (2006–2009) 524–31 (2011) [hereinafter SUBPRIME CRISIS] (describing that failure).

395. "Firms need large cash on hand to make up lost commission revenue." Ryan W. Neal, *More Consolidation Coming in Online Brokerage Market*, INVESTMENTNEWS (Jan. 13, 2020), https://www.investmentnews.com/consolidation-online-broker-market-176333.

396. *See* Annie Massa, *Brokers Profit from You Even if They Don't Charge for Trading*, BLOOMBERG BUSINESSWEEK (Oct. 10, 2019, 8:32 AM), https://www.bloomberg.com/news/articles/2019-10-10/brokers-profit-from-you-even-if-they-don-t-charge-for-trading (describing how brokers that do not charge commissions profit by using customer funds). To illustrate, Robinhood Financial, LLC agreed to pay $65 million to settle SEC charges that it had failed fully to disclose how it made money from its no-commission trading. The SEC charged that Robinhood had failed to disclose that it was receiving payments from HFTs to route customer orders to them for execution. This resulted in poorer execution prices. In the Matter of Robinhood Fin., LLC, Exchange Act Release No. 90694 (Dec. 17, 2020), https://www.sec.gov/litigation/admin/2020/33-10906.pdf. In a separate action, the State of Massachusetts charged that Robinhood had turned stock trading into a video like game that attracted large numbers of unsophisticated traders. This "gamification" of trading was alleged to have violated a new Massachusetts rule that, like the SEC's RBI, required brokerage firms to act in the best interests of their customers. The State charged that Robinhood was effectively making customer

Carry trades are another concern. Carry trades are the classic banking practice of paying low short-term interest rates on customer deposits that are then loaned out and invested elsewhere at higher long-term rates.[397] This incentivizes broker-dealers to keep investor funds in low-paying money market accounts.[398] Broker-dealers have a countervailing incentive not to invest customer funds in stocks or other securities in SEC regulated accounts in which broker-dealers are largely prohibited from hypothecating or otherwise using for carry trades.[399]

Carry trades pose a systemic risk because investor funds will be invested by broker-dealers in longer-term investments paying higher returns.[400] Such investments typically become illiquid in an economic crisis, and financial institutions engaging in such trades will face a liquidity crisis when customers demand their cash en masse.[401] The Federal Reserve and the U.S. government will then be called upon to bail out those institutions, as was the case in the Financial Crisis of

recommendations by listing popular stocks for trading without making a suitability analysis for each trader receiving those lists. Caitlin McCabe, *Massachusetts Regulators File Complaint Against Robinhood*, WALL ST. J. (Dec. 17, 2020, https://www.wsj.com/articles/massachusetts-regulators-to-file-complaint-against-robinhood-11608120003.

397. "A carry trade is a trading strategy that involves borrowing at a low-interest rate and investing in an asset that provides a higher rate of return." James Chen, *Carry Trade*, INVESTOPEDIA, https://www.investopedia.com/carry-trade-definition-4682656 (May 28, 2020).

398. "Firms no longer want to offer investment products from all sources. Instead, they want to milk their customers' cash and manage all the assets themselves." Zweig, *supra* note 361; *see also* Massa, *supra* note 396 (describing how brokers obtain a substantial part of their revenues by sweeping customer free credit balances into low interest money market accounts that the firms loan out at a higher rate).

399. *See* 17 C.F.R. § 240.15c3-3; *see generally* MARKHAM & HAZEN, *supra* note 29, at ch. 5 (describing the SEC's Customer Protection that precludes most such hypothecations).

400. *See* Chen, supra *note* 397.

401. *See, e.g.*, *supra* note 394 and accompanying text (describing the role of carry trades in subprime mortgages that laid the groundwork for the Financial Crisis in 2008).

2008.[402] However, Dodd-Frank now precludes such bailouts.[403] This means that financial Armageddon will follow as the giant financial institutions holding most retail customer funds tumble one after the other.

### D. *RBI Encourages Dangerous Concentration of Portfolio Assets*

RBI's compulsion toward cookie-cutter portfolios will also result in the concentration of investments; fee-based accounts will be mostly invested in the same "diversified" mutual funds and ETFs.[404] Concentration in the securities industry will now be magnified as accounts of both small and large investors are invested in carry trades and cookie cutter portfolios. These cookie-cutter portfolios will lose the advantage of their purported diversification through the concentration of their portfolio investments that are held in accounts at a few large firms.

Although portfolio diversification is thought to be a safeguard against stock market losses, robo-adviser and other cookie-cutter recommendations will magnify economic trauma in the event of a market sell-off. This will occur when investors seek to cut their losses and drive the market further downward in a cascade of sell orders that will affect a broad class of assets contained in those portfolios. The market plunge that occurred during the 1987 Market Crash was strong evidence of such a

402. The SEC had imposed a separate regulatory scheme for large investment banks before that Financial Crisis that eased their capital requirements. *Id.* at 714–15. When their carry trades became illiquid, those institutions had to be bailed out by the federal government, and they all either failed (Lehman Brothers), were rescued by a larger commercial bank (Bear Stearns and Merrill Lynch) or were converted to commercial bank status so that they could access the borrowing facilities of the Federal Reserve (Goldman Sachs and Morgan Stanley). *Id.* at 524–70.

403. *See id.* at 737–38 (describing the restrictions imposed by Dodd-Frank on investment banking bailouts).

404. *See* Jacqueline Matthews, *Why Your Fee-Based Account Costs Too Much*, FORBES (Aug. 12, 2019, 8:00 AM), https://www.forbes.com/sites/forbesfinancecouncil/2019/08/12/why-your-fee-based-account-costs-too-much/ (describing how fee-based accounts are bundled to increase fees and "continue to underperform their benchmarks.").

phenomenon from concentrated selling.[405] More recently, in 2020, the drastic declines in the stock market as a result of the coronavirus shutdown presented contemporary evidence that the herd instinct that exists on Wall Street can destroy billions of dollars in market values in a short period of time.[406] In future crises, such a selloff may trigger catastrophic failures in firms holding concentrated investments with great loss to customers.

To be sure, economists like to point out that, despite occasional downturns, the stock market has out-performed other asset classes over the long term.[407] Those claims are historically true, but the long-term benefits can take a long time to unfold. For instance, the Dow Jones Industrial Average did not recover its 1929 high before the market crash in that year until 1954.[408] The stock market was flat between 1966 and 1982 and was decimated by inflation during that period.[409] As one source also notes, "it took 8 years for S&P 500 [stock index]

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405. "Between October 13 and October 19, 1987, the stock market suffered its worst decline since the Great Depression. New York Stock Exchange stocks lost $1 trillion in value and the Dow Jones Industrial Average plunged 508 points in a day that came to be known as Black Monday." Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993, 1993 (1988) (footnotes omitted). "A small number of institutions, portfolio insurers and mutual funds were central to Monday's crash." *Id.* at 2010.

406. *See Coronavirus: US Stocks See Worst Fall Since 1987*, BBC NEWS (Mar. 17, 2020, 4:10 PM), https://www.bbc.com/news/business-51903195. High-frequency traders (HFTs) took advantage of market volatility during the coronavirus panic, accentuating price swings. Scott Patterson & Alexander Osipovich, *High-Frequency Traders Feast on Volatile Market*, WALL ST. J. (March 27, 2020, 4:10 PM), https://www.wsj.com/articles/high-frequency-traders-feast-on-volatile-market-11585310401. Predictably, the increasing concentration of portfolios in indexed products coupled with the HFTs fueling sell-offs will result in an even greater market meltdown. *See generally* Jerry W. Markham, *High Speed Trading on Stock and Commodity Markets—From Courier Pigeons to Computers*, 52 SAN DIEGO L. REV. 555 (2015) (describing the growth and trading methods of HFTs).

407. *See* David Dierking, *Benefits of Holding Stocks for the Long Term*, INVESTOPEDIA, https://www.investopedia.com/articles/investing/052216/4-benefits-holding-stocks-long-term.asp (Nov. 12, 2020).

408. Gary Richardson, Alejandro Komai & Daniel Park, *Stock Market Crash of 1929*, FED. RES. HIST., https://www.federalreservehistory.org/essays/stock_market_crash_of_1929 (last visited Jan. 7, 2021).

409. *See* Mark Gongloff, *Back to the '70s*, CNN MONEY (May 11, 2004, 3:14 PM), https://money.cnn.com/2004/05/11/markets/seventies/.

prices to recover after the dot-com bubble burst in 2000 . . . ."[410] Following the Financial Crisis in 2008, the Dow fell from its pre-crisis high on October 9, 2007 of 14,164.53 to 6,594.44 on March 5, 2009.[411] Indeed, "it took about 6 years for prices to recover to their previous all-time highs."[412] The length and intensity of future panics and resulting economic downturns are undeterminable, but are certain to occur. [413] Those crises will be magnified as the result of the concentration of investment assets that will follow the adoption of RBI.

## CONCLUSION

The SEC asserted in adopting RBI that certain costs associated with the DOL fiduciary rule had been reduced after the Fifth Circuit's decision striking it.[414] In addition, the SEC found that "the trend toward reduction in retail investor access to services and securities offerings that may have been caused in part by the DOL Fiduciary Rule appears to have ended and may be reversing."[415] RBI is even now reversing that healing process because it effectively forces full-service brokers to switch to fee-based accounts. Many broker-dealers, particularly the larger ones, had already made that conversion after the DOL

410. *Here's How Long the Stock Market has Historically Taken to Recover from Drops*, FOUR PILLAR FREEDOM (June 21, 2018), https://fourpillarfreedom.com/heres-how-long-the-stock-market-has-historically-taken-to-recover-from-drops/ [hereinafter FOUR PILLAR FREEDOM].

411. Kimberly Amadeo, *Stock Market Crash of 2008*, BALANCE, https://www.thebalance.com/stock-market-crash-of-2008-3305535 (Apr. 20, 2020).

412. FOUR PILLAR FREEDOM, *supra* note 410.

413. The Dow dropped by nearly 3,000 points in a single day in March 2020, which was the largest single day decline in its history. *The Dow's Biggest Single-Day Gains and Losses in History*, FOX BUS. (June 11, 2020), https://www.foxbusiness.com/markets/the-dows-biggest-single-day-drops-in-history. However, the Dow and other indexes quickly recovered, indicating that this was a health scare and not a Wall Street induced panic. In future years, when a large financial services institution fails, recovery may take years, as evidenced by the events in 2008 that were triggered by the failure of Lehman Brothers. *See, e.g.*, *supra* note 394 and accompanying text (describing that failure and its effects).

414. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,420 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

415. *Id.*

Fiduciary Rule was adopted.[416] That outcome is in defiance of the appellate court that struck the prior SEC and DOL fee-based regulations.[417] It is also inconsistent with the terms of the Dodd-Frank Act, which prohibited the SEC from banning per transaction fees.[418] The SEC's economic analysis of the supposed costs and benefits of RBI is based mostly on conjecture and devoid of quantitative support. That analysis only offers support for the agency's alleged stance of adopting a regulation it deems too morally desirable, notwithstanding its cost or the uncertainty of its supposed benefits.

Like the DOL Fiduciary Rule, RBI is in a deep state of monstrosity of blinding complexity that will result in massive costs to broker-dealers and eventually customers. The hazards created by RBI will result in reduced investor choice in available investment opportunities and fee arrangements. It is also creating a systemic risk to the economy as customer portfolios migrate to cookie cutter accounts held at a few large broker-dealers.

416. *See* Bruce Kelly, *Broker-Dealer CEO Sees Rapid Escalation of Brokers Abandoning Commissions in Favor of Fee*s, INVESTMENTNEWS (Nov. 8, 2018), https://www.investmentnews.com/article/20181109/FREE/181109938/broker-dealer-ceo-sees-rapid-escalation-of-brokers-abandoning (describing how broker-dealers were converting their commission arrangements into fixed fees).

417. *See* Fin. Plan. Ass'n v. SEC, 482 F.3d 481, 492 (D.C. Cir. 2007).

418. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 913(g)(1) (2010).