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Requiring Broker-Dealers to Disclose Conflicts of Interest: A Solution Protecting and Empowering Investors

DANIEL P. GUERNSEY, JR.*

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") instructed the Securities and Exchange Commission ("SEC") to analyze the gaps in the regulatory regimes of investment advisers and broker-dealers. After analyzing the differences between the two regimes, the SEC proposed a rule that essentially created a fiduciary duty for broker-dealers equivalent to that of investment advisers. In theory, a uniform fiduciary duty would increase investor protection; however, such a drastic overhaul of broker-dealer regulation has attendant consequences. Indeed, as seen from the federal government's previous attempts to create a broker-dealer fiduciary duty, increasing broker-dealer regulatory requirements limits lower-capital investors' access to investment services. This Note proposes that instead of a uniform fiduciary rule, the federal government should require broker-dealers to disclose their conflicts of interest. This would fill a gap present in investment adviser and broker-dealer regulation and increase investor protection by allowing investors to make better, more informed decisions.

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INTRODUCTION

Currently, investment advisers[1] and broker-dealers[2] are governed

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[1] Investment advisers are required to take state-issued exams and can only register under the Investment Advisers Act of 1940 if they hold more than $100 million in client assets. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 84 (2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf [hereinafter SEC STUDY]. Investment advisers are required to go through more rigorous examinations than broker-dealers, and most states require them to be bonded if they have discretion over client accounts. *Id.* at 84–86. Investment advisers are also required to have a minimum net capital. *Id.* at 85. "Most investment advisers charge their clients fees based on the percentage of assets under management, while others may charge hourly or fixed rates," which can make an adviser's services more expensive than a broker-dealer's. *Id.* at iii.

[2] Broker-dealers are investment professionals that are only required to take a state-law exam, usually a Series 63 or Series 66 exam, and register with a self-regulatory organization such as the Financial Industry Regulatory Authority

by separate regulatory regimes.[3] Each has its own disclosure requirements and standards of care, with those of investment advisers typically being more stringent.[4] The federal government has been paying close attention to these differences and is now trying to harmonize the regimes by increasing broker-dealer regulation. Indeed, the Department of Labor ("DOL") enacted the Fiduciary Rule, which requires all broker-dealers to stand as fiduciaries when giving investment advice for retirement accounts.[5] Most relevant to this Note, the Securities and Exchange Commission ("SEC") proposed the Regulation Best Interest rule in 2018.[6] Both the Fiduciary Rule and Regulation Best Interest attempt to require investment advisers and broker-dealers to stand as fiduciaries.[7] However, such a sweeping overhaul of broker-dealer regulation will greatly increase compliance costs for the industry, which can have adverse effects for investors with small capital.[8]

This Note proposes that the federal government should not require broker-dealers to stand as fiduciaries. Instead, meaningful reform can be achieved by requiring broker-dealers to disclose their conflicts of interest. This approach would impose relatively low costs on investors and broker-dealers and can allow investors to make better investment decisions. Thus, a conflicts of interest disclosure requirement can benefit investors without decreasing access to investment services. However, in its current form, disclosure is

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("FINRA"). *Id.* at 89–90. Moreover, "[m]ost broker-dealers receive transaction-based compensation." *Id.* at iii. The word "broker-dealers" can also be used to refer to institutions that buy and sell securities for their own account. *Brokers*, FINRA, http://www.finra.org/investors/brokers (last visited Apr. 5, 2019). For the purposes of this Note, the term broker-dealers will refer solely to individuals that buy securities on behalf of their customers—for example those acting as an agent or acting as a broker.

[3] *See infra* Section I.A.

[4] *See infra* Section I.A.

[5] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, and 2550).

[6] Regulation Best Interest, Exchange Act Release No. 34–83062, 83 Fed. Reg. 21,574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

[7] *See infra* Parts II, III.

[8] PINAR ÇEBI WILBER, AM. COUNCIL FOR CAPITAL FORMATION CTR. FOR POLICY RESEARCH, DOL'S RETIREMENT ADVICE RULE: HELPING OR HARMING SOUND RETIREMENT PLANNING? 11 (2015).

ineffective. Accordingly, any increase in disclosure requirements must be accompanied by an overhaul of the form in which disclosure is provided to investors. This Note proposes a method for such an overhaul based on the current disclosure requirements of investment advisers.

Part I of this Note will begin by diving into the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")—which provides the framework for regulatory action in this space—and its requirements. It will then address the SEC Study, conducted pursuant to Dodd-Frank, as well as its findings. Parts II and III will then discuss the federal government's responses and proposals from the SEC and DOL relating to regulatory reform for broker-dealers. Finally, Part IV will argue that requiring broker-dealers to disclose their conflicts of interest should be favored and will present the manner and form that a conflict of interest disclosure should take to be effective.

I. DODD-FRANK AND THE SEC STUDY

Under the Obama administration, Congress passed Dodd-Frank in part to "protect consumers from abusive financial services practices."[9] As one commentator noted,

> [i]n enacting Dodd-Frank, Congress was attuned to the main issues regarding the different regulatory regimes. It sought input, however, from experts in the field before requiring the creation of new or different obligations that might adversely impact the economy, businesses, and important investor choices without providing meaningful . . . investor protection.[10]

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[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) (codified in scattered sections of the U.S.C.). For the purposes of clarity, short-form citations are to the Dodd-Frank sections rather than the U.S. Code sections.

[10] James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 7 (2012).

Dodd-Frank has an entire subtitle focused on improving investor protection.[11] For instance, this subtitle established the Investor Advisory Committee,[12] called for the appointment of the Ombudsman,[13] and directed the SEC to "analyze the need for enhanced examination and enforcement resources for investment advisers."[14] Most pertinent to this Note is section 913 of Dodd-Frank, in which Congress orders the SEC to conduct a study on the regulatory regime governing investment advisers and broker-dealers.[15] Dodd-Frank lists fourteen considerations the SEC should consider when conducting its study, which boil down to three things: (1) whether investors are confused by the current regulatory regimes that govern investment advisers and broker-dealers; (2) the impact that any rulemaking may have on retail customers, including the range of products they have access to; and (3) any potential costs that investors or broker-dealers may incur as a result of any rulemaking.[16] Section 913(f) of Dodd-Frank then gives the SEC the authority to commence any rulemaking necessary to address differences in the regulatory regimes for broker-dealers and investment advisers.[17]

Pursuant to section 913 of Dodd-Frank, the SEC completed the study.[18] In its study, the SEC did two things. First, it laid out the difference in the standards of conduct that govern investment advisers and broker-dealers.[19] Second, it noted that retail investors are confused by the differences in those standards of conduct.[20]

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[11] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 911–919D.

[12] *Id.* § 911. The Investor Advisory Committee is responsible for consulting with the SEC on "issues relating to the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure," and "initiatives to protect investor interest[s]." *Id.*

[13] *Id.* § 919D. The Ombudsman is the person to whom investors can go when they have problems with the commission or agencies such as FINRA. *Id.*

[14] *Id.* § 914(a)(1).

[15] *Id.* § 913(b)(1)–(2).

[16] *Id.* § 913(c).

[17] *Id.* § 913(f).

[18] *See id.* § 913(b).

[19] *See* SEC STUDY, *supra* note 1, at 106–09.

[20] *Id.* at 101.

A. *Regulatory Regimes for Investment Advisers and Broker-Dealers*

This Section will lay out the different regulatory regimes that govern investment advisers and broker-dealers. It will also note how the regulatory regimes differ. This information provides the backdrop for any proposed rulemaking related to investment advisers or broker-dealers and how any proposed rulemaking could address the gaps in the different regulatory regimes and provide for investor protection.

1. INVESTMENT ADVISERS

The duties of an investment adviser are laid out in the Investment Advisers Act of 1940 ("Investment Advisers Act").[21] Investment advisers are fiduciaries for their clients.[22] Interestingly, the Investment Advisers Act fails to specifically mention the term "fiduciary duty." [23] Instead, the investment adviser's fiduciary duty arose as a result of the interpretation of section 206 of the Investment Advisers Act, which, relevant here, contains language preventing "fraudulent, deceptive, or manipulative" practices.[24]

In its seminal case on the matter, the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* relied upon the committee reports surrounding the Investment Advisers Act to find that the Act implied a fiduciary duty for investment advisers.[25] According to the Supreme Court, "Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and

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21 Investment Advisers Act of 1940, Pub. L. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to -21 (2012)). For the purposes of clarity, short-form citations are to the Investment Advisers Act sections rather than the U.S. Code sections.

22 *See* Wrona, *supra* note 10, at 7 (noting that "the Advisers Act . . . do[es] not expressly impose a fiduciary obligation" but that "[t]he courts and the SEC . . . have held that the Advisers Act implicitly imposes a fiduciary duty").

23 *Id.*; *see* Investment Advisers Act of 1940 §§ 201–24.

24 Wrona, *supra* note 10, at 8–9.

25 *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963); *see also* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (stating that "the [Investment Advisers] Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations").

to 'bona fide investment counsel.'"[26] The Supreme Court then stated that due to this language and other language in the committee reports, "[t]he Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship.'"[27]

The fiduciary duty of investment advisers comprises a duty of loyalty and a duty of care.[28] The duty of loyalty that investment advisers owe to investors has two parts. The first part requires investment advisers to act in the client's best interest, "which includes an obligation not to subordinate the clients' interests to [her] own."[29] The second aspect requires investment advisers to disclose their conflicts of interest to clients.[30] This disclosure is done through Form ADV that is initially given to potential clients.[31] Form ADV is supposed to be in "plain English."[32]

An investment adviser's duty of care also has two parts. The first part requires investment advisers to provide "suitable investment advice. To fulfill [this] obligation, an adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives."[33] This duty also requires that "an investment adviser . . . make a reasonable investigation to determine that [she] is not basing [her] recommendations on materially inaccurate or incomplete information."[34]

The second prong of an investment adviser's duty of care requires that the investment adviser seek the best execution for transactions.[35] This duty exists "where [investment advisers] have the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts)."[36] In seeking that best

[26] *Capital Gains Research Bureau, Inc.*, 375 U.S. at 191 (internal citations omitted).
[27] *Id.*
[28] SEC STUDY, *supra* note 1, at 22.
[29] *Id.*
[30] *Id.*
[31] *Id.* at 18–19.
[32] *Id.* at 19 n.71.
[33] *Id.* at 27–28.
[34] *Id.* at 28.
[35] *Id.*
[36] *Id.*

execution, the investment adviser must execute transactions in "such a manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."[37]

Aside from the fiduciary duty, investment advisers are subject to numerous additional specific requirements. For example, the Investment Advisers Act has special provisions governing registration,[38] advertising,[39] supervision,[40] and recordkeeping[41] for investment advisers.

2. BROKER-DEALERS

In 2007, the Financial Industry Regulatory Authority ("FINRA") was created by the merging of the National Association of Securities Dealers ("NASD") and the member regulation, enforcement, and arbitration operations of the New York Stock Exchange ("NYSE").[42] FINRA is a self-regulatory agency subject to the oversight of the SEC.[43] FINRA is responsible for the registration, qualification, licensing, and continuing education requirements of broker-dealers.[44]

In contrast to the fiduciary duty of investment advisers, broker-dealer conduct is largely rule-based and only requires that brokers make "suitable" investments.[45] Sometimes referred to as the "suitability rule," FINRA Rule 2111 states that a broker-dealer "must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[46] According to FINRA, "a customer's

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[37] *Id.*

[38] Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b-3 (2012).

[39] *Id.* § 206(1)–(2); *see also* SEC STUDY, *supra* note 1, at 29–30.

[40] Investment Advisers Act of 1940 § 203.

[41] *Id.* § 204.

[42] Press Release, FINRA, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA (July 30, 2007), http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority.

[43] Wrona, *supra* note 10, at 2 n.4.

[44] *Id.* at 17–19.

[45] *Id.* at 3, 20.

[46] Wrona, *supra* note 10, at 23 (citing FINRA Rule 2111(a) (2014)).

investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose."[47]

Rule 2111 "codifies . . . three primary suitability obligations: reasonable basis, customer-specific, and quantitative suitability."[48] The reasonable basis obligation requires that a broker "(1) perform reasonable diligence to understand the nature of the security or strategy, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least *some* investors based on that understanding."[49] The customer-specific suitability obligation is grounded in the second sentence in Rule 2111(a), which lays out the factors a broker-dealer must consider before recommending a security or product.[50] Lastly, "[q]uantitative suitability requires a member or [broker-dealer] who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together."[51]

FINRA Rule 2020, like section 206 of the Investment Advisers Act, does not allow broker-dealers to engage in fraudulent practices with investors. Specifically, FINRA Rule 2020 states that "[n]o [broker-dealer] shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."[52] In addition to the aforementioned rules, FINRA allocates specific rules to different

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47 *Id.*; *see also* FINRA Rule 2090 (2012) (requiring broker-dealers "to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer").

48 FINRA Rule 2111.05 (2014).

49 Wrona, *supra* note 10, at 24.

50 *See* FINRA Rule 2111(a); *see also* Wrona, *supra* note 10, at 24–25.

51 FINRA Rule 2111.05(c) (2014). A broker-dealer would have de facto control over an account if the customer routinely follows the broker-dealer's advice "because the customer is unable to evaluate the broker's recommendations and exercise independent judgment." Harry Gliksman, Exchange Act Release No. 42,255, 54 SEC Docket 471, 475 (Dec. 20, 1999).

52 FINRA Rule 2020 (2008).

products.[53]

Unlike investment advisers, broker-dealers do not have extensive requirements for the disclosure of conflicts of interest.[54] Indeed, there are few rules which govern conflict of interest disclosure requirements for broker-dealers when they are acting as brokers (i.e., agents) for their customers.[55] For example, FINRA Rule 2232, which adopts SEC Rule 10b-10, requires broker-dealers to deliver a confirmation to customers at or before the completion of a transaction, meaning that broker-dealers are not required to disclose their commissions to investors until a trade is fully executed and irrevocable.[56] This confirmation must contain any "remuneration" that a broker-dealer will receive as a result of the customer's transaction.[57] There was an effort in 2004 by the SEC to require disclosure for certain products at the time of sale,[58] but this rule never made it past

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53 *See, e.g.*, FINRA Rule 2310 (2016) (governing direct participation programs); FINRA Rule 2320 (2016) (governing variable contracts).

54 *See* Wrona, *supra* note 10, at 46.

55 *See, e.g.*, FINRA Rule 2232 (2018); 17 C.F.R. § 240.10b-10(a) (2018). There are rules for broker-dealers (the members or institutions, as opposed to the individuals) when they are acting as principals or dealers. *See, e.g.*, FINRA Rule 5121(a)(1) (2014). Broker-dealers are also required to disclose material information, the omission of which could be considered fraudulent or misleading. *See* FINRA Rule 2020 (2008).

56 FINRA Rule 2232 (2018) (incorporating 17 C.F.R. § 240.10b-10(a)). While FINRA Rule 2232 cites Rule 10b-10 as being part of the Securities Exchange Act of 1934, Rule 10b-10 is technically not part of the Securities Exchange Act, but is rather an SEC Rule. I will cite to the C.F.R. when referring to SEC Rule 10b-10. 17 C.F.R. § 240.10b-10(a). The time of the transaction is defined as "the time of execution . . . of the customer's order." *Id.* § 240.10b-10(d)(3). Execution is defined as "the point at which the counterparties become irrevocably bound to a transaction under applicable law." *Id.* § 240.15Fi-1(e). Therefore, under Rule 10b-10, a broker-dealer is not required to disclose her fees until the customer is legally bound to the purchase of the security, meaning that the customer would not have that information before he or she makes the decision to purchase the security. *See id.* § 240.10b-10(a)(2)(i)(D) (stating that a broker-dealer must disclose her fees "*at* or before" the time of the transaction (emphasis added)).

57 *Id.* § 240.10b-10(a)(2)(i)(D).

58 Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, 69 Fed. Reg. 6438, 6438 (proposed Feb. 10, 2004) (to be codified at 17 C.F.R. pts. 239, 240, & 274).

the proposal stage.[59]

3. KEY DIFFERENCES IN THE REGULATORY REGIMES

There are two main differences that exist between investment adviser and broker-dealer regulation: (1) the duty that each owes their customers or clients[60] and (2) conflict of interest disclosure requirements.[61] The investment adviser's fiduciary duty is comprised in part of a suitability and best interest obligation,[62] while broker-dealers only have suitability obligations.[63] In addition, broker-dealers are generally not required to disclose conflicts of interest,[64] while investment advisers are required to disclose all conflicts through the use of a Form ADV.[65] Thus, the two pieces of the fiduciary duty that broker-dealers lack are the requirement to act in their customer's best interest and to disclose conflicts of interest.

B. *Investor Confusion with the Different Standards of Conduct*

In addition to laying out the different standards of conduct applicable to investment advisers and broker-dealers, the SEC asked

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59 *Cf.* Forms Prescribed Under the Securities Act of 1933, 17 C.F.R. pt. 239 (2018); General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. pt. 240 (2018); Forms Prescribed Under the Investment Company Act of 1940, 17 C.F.R. pt. 274 (2018).

60 SEC STUDY, *supra* note 1, at 22, 27–28.

61 *Id.* at 26, 29. Some may point out that investment advisers have a duty to monitor. *See, e.g.*, Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 89–92 (2010). However, section 913(g)(1) of Dodd-Frank specifically prevents the SEC from imposing such a duty on broker-dealers. *Id.* at 91 ("Section 913(g)(1) of Dodd-Frank states that 'nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.'" (quoting Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g)(1), 15 U.S.C. § 78o(k)(1) (2012))).

62 *See supra* Section I.A.1.

63 *See supra* Section I.A.2; *see also* FINRA Rule 2111(a) (2014). Some scholars argue that a "best interest" standard is not part of an investment adviser's duty of care, but is part of an investment adviser's duty of loyalty governing conflict of interest. *See, e.g.*, Black, *supra* note 61, at 86. Whichever bucket one wishes to drop a best interest standard into, there is no rule explicitly requiring a broker-dealer to act in her client's best interest.

64 *See supra* Section I.A.2.

65 *See supra* Section I.A.1.

investors about their understanding of the differences between these two types of financial professionals.[66] The SEC sponsored studies and surveys to obtain a sense of how investors perceive the standards of conduct for investment advisers and broker-dealers.[67] The SEC found that "despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities."[68] While the SEC focused on numerous factors that could potentially confuse investors,[69] the factor most relevant to this Note is the alleged confusion regarding the standards of conduct applicable to investment advisers and broker-dealers. However, one might question the reliability of the SEC's findings of investor confusion based on the studies it used.[70]

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[66] SEC STUDY, *supra* note 1, at 94–95.

[67] *Id.* at 95–101.

[68] *Id.* at 101.

[69] *See, e.g.*, *id.* at 96 (discussing the different titles used by investment advisers and broker-dealers, and the services offered by the different investment professionals as a factor).

[70] *See id.* at 95–101 (citing SIEGEL & GALE, LLC & GELB CONSULTING GRP., INC., RESULTS OF INVESTOR FOCUS GROUP INTERVIEWS ABOUT PROPOSED BROKERAGE ACCOUNT DISCLOSURES: REPORT TO THE SECURITIES AND EXCHANGE COMMISSION (2005), https://www.sec.gov/rules/proposed/s72599/fcrpt031005.pdf [hereinafter SGG REPORT]; ANGELA A. HUNG ET AL., RAND INST. FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008), https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf [hereinafter RAND STUDY]; Letter from Barbara Roper, Dir. of Inv'r Prot., Consumer Fed'n of Am., & Micah Hauptman, Fin. Servs. Counsel, Consumer Fed'n of Am., to Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n (Sept. 14, 2017), https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2447346-161075.pdf [hereinafter CFA Survey]). The SGG Report cited by the SEC is not reliable and even states, "[d]ue to the dynamic nature of focus group interviews, small sample sizes, and group influences on responses, one should not conclude that these results are representative of the entire population of investors." SGG REPORT, *supra*, at 6. In addition, the CFA Survey cited by the SEC states that investors are not confused at all by the different standards of conduct. CFA Survey, *supra*, at 7 ("As we have discussed at length in a series of comment letters spanning nearly 20 years, the central problem in the market for investment advice is not that investors are confused, it's that investors are being actively misled."). In addition, the Rand Study focused largely on the titles used

While the SEC Study is detailed and provides logical support for its propositions, some commentators have "acknowledged . . . that [it was] not prepared in a vacuum."[71] This is because "[p]olitical concerns and public perception—and, to a lesser extent, occasional competing perspectives between different regulatory agencies and even between different departments within those agencies—can sometimes influence how such documents approach issues under consideration."[72] This is not to discredit the SEC's findings. However, it is useful to note the conditions under which the SEC created its study when analyzing the SEC's findings.[73] In fact, after the submission of the Study, the SEC issued a letter in June 2017 requesting comments for a solution to the problem of investor protection, including approaches its staff refuted in the SEC Study.[74] Ultimately, the SEC decided to pursue a best interest rule approach.[75]

II. REGULATION BEST INTEREST

On April 18, 2018, the SEC proposed a rule that would require broker-dealers to act in a customer's best interest when making recommendations.[76] Regulation Best Interest is comprised of two parts: a care obligation and a disclosure obligation.[77]

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by different investment professionals, making it hard to determine if investors were confused by different titles used by broker-dealers and investment advisers, or the many titles used by each. *See* RAND STUDY, *supra*, at 109–11.

71 Wrona, *supra* note 10, at 7.

72 *Id.*

73 *See* SEC STUDY, *supra* note 1, at 4–5.

74 *See* Public Statement, Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers (June 1, 2017), https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31. Some of these approaches included requiring enhanced disclosure, which the SEC staff refuted in its study. *See* SEC STUDY, *supra* note 1, at ii, 165–66.

75 *See* Regulation Best Interest, Exchange Act Release No. 34–83062, 83 Fed. Reg. 21,574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

76 *Id.* at 21,575, 21,592–95. In this release, the SEC also requested comments on its proposal. *Id.* at 21,574, 21,628–29.

77 While Regulation Best Interest states that it is comprised of a care obligation, a disclosure obligation, and two conflict of interest obligations, the conflict of interest obligations are logically and practically subsumed by the disclosure obligation because the conflict of interest requirements entail disclosure. *See id.* 21,598, 21,617.

A. *The Care Obligation*

The care obligation of the Regulation Best Interest requires broker-dealers, when making a recommendation, to

> (1) Understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (2) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile[.][78]

According to the SEC, the care obligation is more demanding than a broker's existing suitability requirements, but "is intended to incorporate and enhance existing suitability requirements" rather than replace them.[79] In addition, Regulation Best Interest "would not require a broker-dealer to analyze all possible securities, all other products, or all investment strategies to recommend the single 'best' security or investment strategy for the retail customer, nor necessarily require a broker-dealer to recommend the least expensive or least remunerative security or investment strategy."[80]

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[78] *Id.* at 21,575. The first prong requires broker-dealers to make a reasonable inquiry into the strategy or product they are recommending and make sure that the strategy or product is suitable for at least some retail customers. *Id.* at 21,609–10. The second prong requires the broker-dealer to put her customer's interest ahead of her own and consider which product is in the best interests of her client, considering the customer's investor profile. *Id.* at 21,611. The third prong requires the broker-dealer "to exercise reasonable diligence, care, skill, and prudence" when recommending transactions. *Id.* at 21,613.

[79] *Id.* at 21,608–09.

[80] *Id.* at 21,609.

B. *The Disclosure Obligation*

Beyond requiring broker-dealers to act in the best interests of their customers, Regulation Best Interest requires broker-dealers to disclose material facts to their customers that "relat[e] to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation."[81] The SEC does not provide an exhaustive list of "material facts" that relate to the relationship between the broker-dealer and customer.[82] However, the SEC does provide examples of what facts could be considered material, including the fact that the broker-dealer is acting as a broker-dealer, the broker-dealer's conflicts of interest, the fees and commissions associated with the customer's transactions,[83] and the types of services offered by the broker-dealer.[84]

Broker-dealers are also required to provide a relationship summary to investors.[85] The relationship summary is to be a four-page electronic document called a Form CRS.[86] The Form CRS is supposed to abate customer confusion by delineating the standard of care that governs the broker-dealer as well as the broker-dealer's fees and any existing conflicts of interest.[87] The Form CRS is to be delivered when the customer first engages a broker-dealer's services.[88] The SEC, however, distinguishes between the Form CRS and the disclosure obligations: the former contains general information about the broker-dealer, while the disclosure obligation is focused on individual recommendations the broker-dealer makes.[89]

The SEC does not specifically provide the manner in which a broker-dealer must disclose material facts. For example, rather than

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[81] *Id.* at 21,599. This disclosure requirement differs from that under SEC Rule 10b-10 because the disclosure here is required at the time of the recommendation by the broker-dealer, and not once the trade or transaction has been executed. *See supra* notes 55–57 and accompanying text.

[82] *See* Regulation Best Interest, 83 Fed. Reg. at 21,600–01.

[83] Interestingly, the SEC's fee disclosure requirement is based on "general descriptions regarding types of fees and charges, rather than . . . a comprehensive or personalized schedule of fees or other information about the amounts, percentages or ranges of fees and charges." *Id.* at 21,602.

[84] *Id.* at 21,599.

[85] *Id.* at 21,600.

[86] *Id.* at 21,600 & n.182.

[87] *Id.* at 21,600.

[88] *Id.*

[89] *Id.*

provide the exact form for which broker-dealers must disclose conflicts of interest, like the Form ADV used by investment advisers, the SEC offers broker-dealers flexibility.[90] But, the SEC does mandate that disclosure be in "plain English," meaning it should be comprised "of short sentences and active voice, and avoid[] . . . legal jargon, highly technical business terms, or multiple negatives."[91] The disclosure must also be in writing but can include graphs or charts.[92]

It is not entirely clear how Regulation Best Interest is different from a uniform fiduciary standard. For instance, as previously noted, the key differences between investment advisers and broker-dealers are the best interest standard and conflict of interest requirement for investment advisers.[93] Because Regulation Best Interest compels both a best interest standard, through its care obligation, and a conflict of interest requirement, through its disclosure obligation, for broker-dealers, it essentially creates a fiduciary duty for broker-dealers, without using so few words.[94]

Regulation Best Interest is not the only federal government response to the differences between investment adviser and broker-dealer regulation. The DOL also took action in 2010, attempting to harmonize the standard of conduct between investment advisers and broker-dealers by requiring broker-dealers to stand as fiduciaries.[95]

III. THE FIDUCIARY RULE

In 2010, the DOL first proposed requiring all financial professionals giving advice for individual retirement accounts ("IRAs") or employer-sponsored retirement plans to stand as fiduciaries.[96] Prior

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[90] *Id.* at 21,605 ("[W]e preliminarily believe that broker-dealers should have the flexibility to make disclosures by various means (*e.g.,* different types of disclosure documents), as opposed to requiring a single standard written document.").

[91] *Id.* at 21,604.

[92] *Id.*

[93] *See supra* Section I.A.3.

[94] Of course, differences between broker-dealers and investment advisers still exist, such as registration and examination requirements. *See supra* notes 1–2 and accompanying text.

[95] *See* Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263, 65,263–64 (Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510). This rule adds broker-dealers to the definition of "fiduciary," under the Employee Retirement Income Security Act of 1974 ("ERISA"). *See* 29 C.F.R. § 2510.3-21(c) (2018).

[96] Definition of the Term "Fiduciary," 75 Fed. Reg. at 65,263–64.

to 2010, under the Employee Retirement Income Security Act of 1974 ("ERISA")[97] only financial professionals rendering investment advice for employer-sponsored retirement plans have fiduciary duties, while those who issue investment advice to IRAs do not.[98] Under section 3(21)(A) of ERISA,

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B).[99]

The DOL withdrew the 2010 Fiduciary Rule in September 2011, in response to public outcry,[100] and re-proposed its Fiduciary Rule in 2015. On February 23, 2015, President Obama gave a speech at AARP where he stated, "today, I'm calling on the Department of Labor to update the rules and requirements that retirement advisors put the best interests of their clients above their own financial interests. It's a very simple principle: You want to give financial advice, you've got to put your client's interests first."[101] On April 20, 2015,

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[97] Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 26 and 29 U.S.C.). For the purposes of clarity, short-form citations are to the ERISA sections rather than the U.S. Code sections.

[98] *See id.* § 4(a) ("[T]his title shall apply to any employee benefit plan . . . .").

[99] *Id.* § 3(21)(A). "Plan" is used to include only employer sponsored plans. *Id.* at § 3(2)(A).

[100] David A. Pratt, *Focus on . . . Lawsuits Challenging the Department of Labor's Fiduciary Rule*, J. PENSION BENEFITS, Autumn 2016, at 4, 5.

[101] President Barack Obama, Remarks by the President at the AARP (Feb. 23, 2015), https://obamawhitehouse.archives.gov/the-press-office/2015/02/23/remarks-president-aarp.

the DOL re-proposed its fiduciary rule.[102] The DOL stated,

> If adopted, the [2015] proposal would treat persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under ERISA and the Code in a wider array of advice relationships than the existing ERISA and Code regulations.[103]

Closely related to the Fiduciary Rule, Congress proposed a Best Interest Contract ("BIC") Exemption.[104] "ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving a plan or IRA."[105] Therefore, anyone who is a fiduciary under ERISA cannot accept common fees, such as commissions, 12b-1 fees, and revenue sharing payments.[106] However, the BIC Exemption allows fiduciaries to receive these fees when making a recommendations, although the fiduciary must

- Acknowledge fiduciary status with respect to investment advice to the Retirement Investor;
- Adhere to Impartial Conduct Standards requiring them to:
  - Give advice that is in the Retirement Investor's Best Interest (*i.e.,* prudent advice that is based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to financial or other interests of the Adviser, Financial Institution, or their Affiliates, Related Entities or other parties);
  - Charge no more than reasonable compensation;

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102 *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509 & 2510).

103 *Id.* at 21,928.

104 Best Interest Contract Exemption, 81 Fed. Reg. 21,002, 21,002 (Apr. 8, 2016) (codified at 29 C.F.R. pt. 2550).

105 *Id.*

106 *Id.*

and
    - Make no misleading statements about investment transactions, compensation, and conflicts of interest;
- Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;
- Refrain from giving or using incentives for Advisers to act contrary to the customer's best interest; and
- Fairly disclose the fees, compensation, and Material Conflicts of Interest, associated with their recommendations.[107]

The BIC Exemption had an applicability date of April 10, 2017.[108]

Finally, on April 8, 2016, the DOL published a final rule that requires anyone giving investment advice to IRAs to stand as a fiduciary.[109] However, the applicability date of the Fiduciary Rule was pushed forward to June 9, 2017.[110] In addition, the DOL changed the applicability date of the BIC Exmpetion, creating a transition period through January 1, 2018.[111] Three months before implementation, President Trump issued a memorandum.[112] In his memorandum, President Trump wrote that the DOL's fiduciary rule

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[107] *Id.* at 21,007. Essentially, the BIC Exemption allows investors with IRAs to have a contract in writing through which they can bring a breach of contract claim against fiduciaries that they believe wronged them. *See id.* at 21,008.

[108] *Id.* at 21,069.

[109] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, & 2550).

[110] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016–02); Prohibited Transaction Exemptions 75–1, 77–4, 80–83, 83–1, 84–24 and 86–128, 82 Fed. Reg. 16,902, 16,902 (Apr. 7, 2017) (to be codified at 29 C.F.R. pt. 2510).

[111] *Id.*

[112] *See* Memorandum from President Donald Trump to the Sec'y of Labor (Feb. 3, 2017), https://www.whitehouse.gov/presidential-actions/presidential-memorandum-fiduciary-duty-rule/.

> may significantly alter the manner in which Americans can receive financial advice, and may not be consistent with the policies of my Administration.
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> . . . .
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> . . . [The DOL is] directed to examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice. As part of this examination, you shall prepare an updated economic and legal analysis concerning the likely impact of the Fiduciary Duty Rule . . . .[113]

While the fiduciary aspect of the rule was implemented,[114] the DOL pushed back the BIC Exemption applicability date again. On November 29, 2017, the DOL extended the applicability date of the BIC Exemption by eighteen months, pushing the applicability date to July 1, 2019.[115] The DOL stated that, "[t]he primary purpose of the amendments is to give the Department of Labor the time necessary to consider public comments under the criteria set forth in the Presidential Memorandum of February 3, 2017, including whether possible changes and alternatives to these exemptions would be appropriate."[116] Interestingly, Mercury Analytics conducted a survey in 2017 and found that many comments critical to the fiduciary rule were fake.[117]

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113 *Id.*

114 *See* 29 C.F.R. § 2510.3-21(c) (2018).

115 18-Month Extension of Transition Period and Delay of Applicability Dates; Best Interest Contract Exemption (PTE 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (PTE 2016–02); Prohibited Transaction Exemption 84–24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters (PTE 84–24), 82 Fed. Reg. 56,545, 56,545 (Nov. 29, 2017) (to be codified at 29 C.F.R. pt. 2550) (noting that the DOL is extending "the special transition period under section II and IV of the Best Interest Contract Exemption . . . to July 1, 2019").

116 *Id.*

117 James V. Grimaldi & Paul Overberg, *Many Comments Critical of 'Fiduciary' Rule Are Fake*, WALL STREET J. (Dec. 27, 2017, 5:30 AM), https://www.wsj.com/articles/many-comments-critical-of-fiduciary-rule-are-

Given the continuing delays, industry opposition, and this recent finding of fake comments, a question remains open as to whether the Fiduciary Rule will ever take effect in all its parts.[118] In fact, it seems the Fiduciary Rule may be unconstitutional as the rule was struck down in its entirety by the Fifth Circuit.[119]

IV. A CONFLICT OF INTEREST FOCUSED APPROACH

Conflicts of interest plague investment advice in this country. To quote former President Obama, "bad advice that results from conflicts of interest costs middle-class and working families about $17 billion a year."[120] However, our wallets are not the only thing affected by conflicted investment advice. When broker-dealers give conflicted investment advice, "it offends [this country's] basic values of honesty and fair play."[121] Therefore, a conflicts of interest disclosure requirement can go a long way. Rather than adding a disclosure requirement and best interest standard for broker-dealers at the detriment of lower-income investors, the federal government should require a conflicts of interest disclosure requirement when broker-dealers render investment advice. This approach would provide meaningful regulatory reform as it allows investors to make better investment decisions without substantially raising compliance costs.

A. *The Cost of Regulatory Compliance*

The harm to lower-capital investors caused by Regulation Best

fake-1514370601 (finding that "[m]any of the comments weren't written by the people they were attributed to").

118 There was a bill introduced by the House of Representatives aimed at totally removing the DOL's Fiduciary Rule, but it was never enacted. *See* PASS Act of 2017, H.R. 3857, 115th Cong. (2017).

119 Chamber of Commerce of U.S. v. U.S. Dep't of Labor, 885 F.3d 360, 388 (5th Cir. 2018) (striking the Fiduciary Rule in its entirety). While a recent Tenth Circuit Court of Appeals decision seemingly created a circuit split, the Tenth Circuit's holding does not address the Fiduciary Rule as a whole, but only the issue of whether the DOL's Fiduciary Rule violated the Administrative Procedure Act ("APA") by preventing investment professionals selling fixed indexed annuities from receiving commissions. Mkt. Synergy Grp., Inc. v. U.S. Dep't of Labor, 885 F.3d 676, 681 (10th Cir. 2018). The court held that the DOL's exclusion did not violate the APA. *Id.* at 683–85.

120 President Barack Obama, *supra* note 101.

121 *Id.*

Interest is not immediately apparent. Indeed, at first glance, a rule requiring broker-dealers to put their customers' interests first should be favored.[122] However, with every increase in regulation there is a requisite increase in compliance costs.[123] In the case of Regulation Best Interest, the increase in broker-dealer regulation will lead to increased compliance costs for broker-dealers.[124] Because Regulation Best Interest essentially creates a fiduciary duty for broker-dealers,[125] one can infer that its costs will be similar to that of a uniform fiduciary rule, such as the Fiduciary Rule.[126] While Regulation Best Interest could not calculate the costs for its implementation,[127] a study has demonstrated that a uniform fiduciary standard can cost the industry upwards of $4 billion.[128]

The cost of increased regulation will likely not be swallowed by broker-dealers.[129] Requiring a uniform fiduciary standard may force

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122 *See, e.g.*, *id.*

123 *See* WILBER, *supra* note 8, at 11 ("The prospect of increased recordkeeping and paperwork for compliance purposes, as well as the possible increase in litigation volumes, will push up the cost for brokerage services, making them uneconomical, especially for small account sizes.").

124 *See id.*

125 *See supra* Part II.

126 *See supra* notes 96–103 and accompanying text. In fact, it may even exceed the cost of the DOL's Fiduciary Rule because the DOL's fiduciary rule only pertains to advice for retirement accounts. *See* 29 C.F.R. § 2510.3-21 (2018). Because Regulation Best Interest has no such limitation, it would apply to advice for *all* customer accounts and therefore impose costs on a larger amount of accounts than the Fiduciary Rule.

127 Regulation Best Interest, Exchange Act Release No. 34–83062, 83 Fed. Reg. 21,574, 21,648 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

128 Bruce Kelly, *DOL Fiduciary Rule Compliance Costs Exceed $4.7 Billion: SIFMA Study*, INVESTMENT NEWS (Aug. 10, 2017, 2:00 PM), http://www.investmentnews.com/article/20170810/FREE/170819991/dol-fiduciary-rule-compliance-costs-exceed-4-7-billion-sifma-study?mod=article_inline (finding that a new Securities Industry and Financial Markets Association ("SIFMA") study projected the DOL's fiduciary rule to cost $4.7 billion as opposed to the $2 billion cited by the DOL).

129 *See* WILBER, *supra* note 8, at 11. One study found that compliance costs could increase anywhere from 73% to 196% on average. OLIVER WYMAN, MARSH & MCLENNAN COS., THE ROLE OF FINANCIAL ADVISORS IN THE US RETIREMENT MARKET 7 (2015), https://www.napa-net.org/sites/napa-net.org/files/uploads/2015.07.13-Oliver-Wyman-Report.pdf.

broker-dealers to change their business models to respond to heightened standards of care.[130] In such instances, broker-dealers are discouraged from taking clients with small capital because they will not be compensated sufficiently for providing advice.[131] For example, suppose a broker charged a two percent (2%) flat fee for her services instead of fluctuating commissions based on the products she sells. In the flat fee scenario, she will naturally be more willing to provide advice to someone with $1 million in capital than someone with $200,000 in capital. Our broker-dealer will not likely offer her services to the investor with $200,000 at all. This is because she will earn $20,000 from her customer with $1 million to invest, but only $4,000 from her customer with $200,000 to invest. However, if our broker-delaer makes varying commissions on different products and her $200,000 customer wants a product that offers a ten percent (10%) commission, she will be more willing to offer services to that customer because our broker-dealer would make $20,000 in commissions. The flat fee approach leaves investors with two choices: (1) go to fly-by-night, or so-called "cockroach firms,"

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130 *See, e.g.*, Laura J. Keller, *BofA Weighs Allowing Commissions on Merrill Lynch Retirement Accounts*, BLOOMBERG (June 15, 2018, 1:26 PM), https://www.bloomberg.com/news/articles/2018-06-15/bofa-weighs-allowing-commissions-on-merrill-retirement-accounts (stating that Merrill Lynch restructured most of its retirement accounts after the Fiduciary Rule by making them fee-based, meaning they charge customers a percentage of their assets as a fee); Greg Lacurci, *DOL Fiduciary Rule Pushing Broker-Dealer Assets to Fee-Based Accounts, away from Commissions*, INVESTMENT NEWS (May 24, 2017, 2:43 PM), https://www.investmentnews.com/article/20170524/FREE/170529958/dol-fiduciary-rule-pushing-broker-dealer-assets-to-fee-based (noting that in the wake of the Fiduciary Rule, fee-based accounts increased for Morgan Stanley by 219% in one quarter, Raymond James by 33% in one quarter, and Kovack Securities by 21% in one year); *see also* Letter from Marc R. Bryant, Senior Vice President, Fidelity Invs. to Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n (Aug. 11, 2017), https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2216673-160638.pdf ("[W]e have observed the large number of companies considering . . . switching to investment advisor fee-based arrangements because of the DOL Fiduciary Advice Rule, . . . which . . . we believe will ultimately make it harder and more expensive for retail investors to get the advice they need . . . .").

131 For an argument that fee-based accounts will not cost investors more money, see CFA Survey, *supra* note 70, at 72.

who aim for quantity not quality;[132] or (2) turn to self-trading platforms, such as E-Trade.[133] In either case, the investor is either receiving poor advice or none at all, which can negatively affect their portfolio performance by at least 3.3%.[134]

In contrast, given the significantly lower costs for implementing a conflict of interest disclosure requirement, firms are less likely to completely overhaul their payment regimes and squeeze out investors with small capital. Costs associated with requiring conflict of interest disclosures are the costs of the due diligence for and preparation of the disclosure provided to investors.[135] The SEC did a cost analysis and determined that it would cost an initial $1.39 million and a subsequent aggregate annual cost of $460.81 million to implement its disclosure requirements, which include in the analysis more than a conflict of interest disclosure.[136] Therefore, one could expect the cost of requiring broker-dealers to only disclose conflicts of interest to be slightly less than that amount. While it is unlikely this amount would be regarded as insignificant, it is notably less than the estimated cost associated with regulating broker-dealer standards of conduct, which was upwards of $4 billion.[137]

Further, a conflicts of interest disclosure requirement will not squeeze out lower-capital investors. For one, broker-dealers are already required to disclose conflicts of interest to investors, albeit only after the transaction is binding.[138] My proposal simply requires

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132 *See* Mason Braswell, *FINRA Cracks Down on 'Cockroach' Brokers*, INVESTMENT NEWS (Sept. 15, 2015, 1:31 PM), https://www.investmentnews.com/article/20150915/FREE/150919947/finra-cracks-down-on-cockroach-brokers.

133 *Trading Platforms*, E-TRADE, https://us.etrade.com/platforms (last visited Apr. 24, 2019).

134 *See* OLIVER WYMAN & SIFMA, STANDARD OF CARE HARMONIZATION IMPACT ASSESSMENT FOR SEC 31 (2010), https://www.sifma.org/wp-content/uploads/2017/05/study-standard-of-care-harmonization-impact-assessment-for-sec.pdf (noting that "[p]articipants in 401k plans administered by Schwab achieved returns that were 3.3% higher on average if some level of financial advice was provided").

135 *See* Regulation Best Interest, Exchange Act Release No. 34–83062, 83 Fed. Reg. 21,574, 21,650 & n.478 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

136 *Id.* at 21,650 & n.479.

137 *See* Kelly, *supra* note 128; *supra* notes 127–28 and accompanying text.

138 *See supra* notes 56–59 and accompanying text.

this disclosure to occur at the time of a recommendation rather than after consummation of the transaction. Thus, it is unlikely to force broker-dealers to completely overhaul fee-structures to save compliance costs. In addition, some broker-dealers, such as Merrill Lynch, have reconsidered their decision to shift to fee-based brokerage services in the wake of a "lighter regulatory climate in the Trump era."[139] Given the lighter regulatory burden that accompanies a disclosure-only requirement, one could expect to see a halt in the trend of shifting to fee-based services, which is what is driving out lower-income investors.[140]

B. *Informed Decision Making*

A conflicts of interest requirement can allow investors to make better investment decisions. The heart of the existing problem between brokers and investors is simple and perhaps best explained by what economists call "information asymmetry."[141] When information asymmetry exists, a broker-dealer can take advantage of an investor's inability to properly assess the quality of the product shown to her.[142] In the broker-dealer/investor relationship, investors tend to have less information about the stocks they are purchasing and come to broker-dealers for their expertise.[143] Investors often rely on the broker for critical information when investing and therefore any misinformation the broker gives to the investor comes at a detriment to the investor.[144] Under the current regulatory framework, when a broker-dealer's interests are not in-line with an investor's—perhaps because a broker-dealer will receive a huge commission from a sale—investors would not have knowledge of this misalignment because broker-dealers are not currently required to disclose conflicts of interest until it is too late.[145] By bringing a broker-

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[139] Keller, *supra* note 130.
[140] *See id.*; *supra* notes 129–34 and accompanying text.
[141] *See* Debi Prasad Mishra et al., *Information Asymmetry and Levels of Agency Relationships*, 35 J. MARKETING RES. 277, 277 (1998) (explaining that information asymmetry occurs when the seller of a product has more information than the buyer of the product). In the investor/broker-dealer relationship, the broker-dealer would be the seller and the investor would be the buyer.
[142] *See id.*
[143] *See id.* at 277–78.
[144] *See id.*
[145] *See supra* Section I.A.

dealer's conflicts to the forefront, investors can note when their broker-dealer's interests diverge from their own and use this information when deciding whether to heed their broker-dealer's advice.

Indeed, while studies focusing on the effectiveness of conflict of interest disclosures have provided mixed results, one study performed in the investment context shows that conflict of interest disclosures can allow investors to make better investment decisions by accounting for this divergence of interest.[146] That study showed that requiring disclosure of conflicts of interest can reduce the amount of money that investors place in risky investments.[147] In their experiment, the researchers used 484 subjects from the Czech Republic, Germany, and the United Kingdom.[148] Subjects were given investment advice from either advisers with a conflict of interest or from advisers without a conflict of interest.[149] In Task A1 of the study, some advisers knew about the ultimate success or failure of the securities from which the subjects would choose.[150] Regardless of whether the advisors knew the outcome of the investment in advance, they could deceive the subjects if they wished.[151] The subjects were given the equivalent of €10,000 to invest in increments of €1,000.[152] The investors needed to decide how much to invest in risky investments using advise provided by conflicted advisers.[153] The study revealed that subjects invested about €900.00 less when their adviser disclosed her conflict of interest.[154] The researchers found that when there is a full disclosure of conflicts of interest, "advisees exhibit substantial care when they know their advisor is biased."[155]

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146 *See* CHATER ET AL., CONSUMER DECISION-MAKING IN RETAIL INVESTMENT SERVICES: A BEHAVIOURAL ECONOMICS PERSPECTIVE 360 (2010), https://ec.europa.eu/info/sites/info/files/retail_investment_services_2010_en.pdf.

147 *Id.* Risk was determined from a control experiment where subjects chose how to invest their money without any assistance. *Id.* at 357.

148 *Id.* at 345.

149 *Id.* at 347–48.

150 *Id.* at 350.

151 *Id.*

152 *Id.* at 349.

153 *Id.* at 349–50.

154 *Id.* at 360.

155 *Id.* at 359. Although another task studied in the same report found that investors were likely to place less money in optimal investments when advisers disclosed conflicts of interest, this does not refute the original study's findings. *Id.* at

Another study conducted by Sah and Loewenstein suggests that disclosure of conflicts of interest can be effective.[156] Sah and Loewenstein ran an experiment with 101 advisors in which there was a 30 x 30 grid of dots.[157] The advisors knew that there were 455 dots on the grid that were filled in and the rest were blank.[158] The subjects were given a 3 x 3 grid with some dots filled in and were asked to guess the number of dots filled in the larger grid, with the help of the advisor.[159] The advisors were allowed to choose a reward structure, either receiving $5 if the subject guessed the number of dots within ten or $10 if the subject gave an estimate of 100 dots above the actual correct number.[160] There were two experiments, one in which the advisor's conflict would be disclosed and one in which it would not.[161] Sixty-three percent (63%) of the advisors in the non-disclosure group chose the $10 structure, while only thirty-three percent (33%) in the disclosure structure chose the $10 reward structure.[162] The results found that advice was more biased in the non-disclosure group, meaning the average for dots guessed was higher (M = 62.12 dots vs. M = 7.85 dots).[163]

Sah and Loewenstein found that disclosing conflicts can be beneficial to advisees by focusing on the conduct of the individuals making the disclosure, as opposed to the conduct of customers or

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370–71. This phenomenon was only an effect seen when advisers had a conflict with one investment, Investment F, and that conflict was aligned with the advisee's incentives. *Id.* ("[W]hen the advisor is biased to recommend Investment F (i.e. has aligned incentives), advisees trust their advice less than the same advice from unbiased advisors, investing almost €1,600 less in the optimal investment.") However, when advisers had a conflict with a different investment, Investment P, advisees invested more money in optimal investments when advisers disclosed their conflicts of interests and that conflict was adversely aligned with the advisee's incentives. *Id.* at 371 ("When the advisor is biased to recommend Investment P (i.e. has adversely-aligned incentives), advisees invested around €1,800 more in the optimal investment.").

156 Sunita Sah & George Loewenstein, *Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest*, 25 PSYCOL. SCI. 575, 583 (2014).

157 *Id.* at 576–77.

158 *Id.* at 577.

159 *Id.* at 576–77.

160 *Id.* 577.

161 *Id.* at 578.

162 *Id.*

163 *Id.* "M" means "mean" or "average."

buyers.[164] According to Sah and Loewenstein, people are averse to being viewed as corrupt.[165] Because people do not like being viewed as biased, people will avoid conflicts of interest if they have to disclose them, which "encourage[es] low-quality providers to improve quality or exit the market."[166]

However, there are some studies showing that disclosing conflicts of interests can have an adverse effect. For example, Cain, Loewenstein, and Moore conducted an experiment with 147 undergraduate students at Carnegie Mellon University.[167] Participants were either estimators or advisers.[168] The estimators were required to guess the value of coins in a jar with the help of the advisers, who submitted suggestions of how much money was in the jar based on their own observations and the information provided to them that was not provided to advisors.[169] "In a control treatment, advisors, like estimators, were paid more when estimators answered accurately. This alignment of incentives was disclosed."[170] There was also two conflict of interest scenarios where advisers would be paid more if estimators overestimated the total value of coins in the jar.[171] The researchers conducted this study in one instance where this conflict was disclosed and another where the conflict was not.[172] The results were as follows: "[E]stimators earned less money when conflicts of interest were disclosed than when they were not, and advisors made more money with disclosure than without disclosure. In addition, estimators made the most money . . . [when] there was no conflict of interest."[173]

The researchers explain their results through two phenomena. First, they argue that disclosing conflicts of interest creates a moral license for the disclosing party.[174] According to Cain, disclosing

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164 *Id.* at 582.
165 *Id.*
166 *Id.* However, Sah and Loewenstein found that disclosure is not as effective in situations in which conflicts of interest are unavoidable. *Id.*
167 Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 9 (2005).
168 *Id.* at 8.
169 *Id.* at 8–9.
170 *Id.* at 8.
171 *Id.*
172 *Id.*
173 *Id.* at 18.
174 *Id.* at 22.

conflicts of interests can create a problem by "reducing advisors' feelings of guilt about misleading estimators and thereby giving advisors a moral license to bias advice even further than they would without disclosure."[175]

The second problem with disclosure builds off this moral licensing. The researchers argued that when conflicts of interests are disclosed, advisees cannot sufficiently discount the effect of the moral licensing.[176] The researchers even argued that "in some circumstances, disclosure may even lead estimators to put greater weight on biased advice."[177]

The studies I analyzed come to different results in their attempt to determine the effectiveness of disclosing conflicts of interests. However, it is important to keep in mind that these studies were conducted in controlled settings with consequences that do not extend beyond the parameters of the experiment. In real life, broker-dealers are faced with external pressures, such as lawsuits and regulatory oversight, and as noted by Hung, Gong, and Burke, "the monetary incentive, the cognitive load, and the decision environment are very different when people are estimating the value of a jar of coins as opposed to when they are making a financial decision regarding retirement."[178] Moreover, the only study involving investments suggested that disclosing conflicts of interest can reduce the amount of money people place in more risky products.[179]

The disclosure of conflicts of interest is only effective to the extent that investors can gauge how much of a conflict actually exists. This next section will propose how conflicts of interests should be disclosed if such disclosure is to be impactful.

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[175] *Id.* at 7.

[176] *Id.* at 22.

[177] *Id.* at 6. In another study, Sah, Loewenstein, and Cain argue that disclosing conflicts of interests can reduce the trust that advisees places on the advice, but that the disclosure increases the pressure to comply with the advice. Sunita Sah, George Loewenstein & Daylian M. Cain, *The Burden of Disclosure: Increased Compliance with Distrusted Advice*, 104 J. PERSONALITY & SOC. PSYCHOL. 289 (2013).

[178] ANGELA A. HUNG, MIN GONG & JEREMY BURKE, EFFECTIVE DISCLOSURES IN FINANCIAL DECISIONMAKING 9 (2015).

[179] CHATER ET AL., *supra* note 146, at 360.

C. *The Form of Disclosure*

1. Previous Examples of Effective Disclosure

Before I propose how a broker should disclose her conflicts of interest, I believe it useful to lay out two situations in other industries where disclosure proved effective. I will then base my recommendation on these successful disclosures.

The first example of effective disclosure is the Bridgestone/Firestone scandal in 2000. In 2000, Bridgestone/Firestone was responsible for a series of tire blowouts that caused vehicles to roll over.[180] This tire scandal revealed that the SUVs people thought were safer were actually more likely to roll over than the smaller cars.[181] Moreover, some SUVs were more likely than others to roll over.[182] Most of the public did not know this, despite the fact that rollovers were responsible for almost one-third of auto fatalities in the United States.[183] In November of 2000, the Transportation Recall Enhancement, Accountability, and Documentation ("TREAD") Act "[r]equired auto companies for the first time to give car buyers the facts about each model's rollover risks so that they could make their own safety choices."[184] Congress implemented a five-star rating system, where each star would represent a range of probabilities of an SUV rolling over.[185] In a single-vehicle crash, five stars indicated that a vehicle had a ten percent (10%) or less chance of rolling over, while a one-star vehicle had a forty percent (40%) chance of rolling over.[186] Moreover, a few years later, this information was required to be presented on showroom new-car stickers.[187]

This system of disclosure was very effective in refining vehicle design and reducing rollover risks.[188] When Congress first enacted TREAD, there was only one SUV model that received a four-star

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[180] ARCHON FUNG ET AL., FULL DISCLOSURE: THE PERILS AND PROMISE OF TRANSPARENCY 1 (2007).
[181] *Id.* at 2.
[182] *Id.*
[183] *Id.* at 1–2.
[184] *Id.* at 2.
[185] *Id.*
[186] *Id.* at 2, 4.
[187] *Id.* at 4.
[188] *Id.* at 2, 4.

rating, while thirty models received a one- or two-star rating.[189] But by 2005, twenty-four models received a four-star rating and only one model received a two-star rating.[190] According to some, this method of disclosure proved effective because the information was presented in a user-centered manner that allowed "car buyers, regardless of their math or language skills, [to] compare risks and identify rollover-prone models."[191]

Another example of effective disclosure involves the disclosure of hygiene inspections in Los Angeles County. In many areas around the country, "public health inspectors visit restaurants to make sure they comply with local hygiene codes."[192] However, in an overwhelming number of communities, the information and hygiene reports gathered are stored in government files that are not readily available to the public.[193]

However, in Los Angeles County, restaurants have been required to post their hygiene ratings in their window since 1998.[194] In order to simplify the rating system so that the public could understand, restaurants must place a letter from "A" to "C" in their window to reflect their hygiene status, where an A-rating represents a cleaner restaurant than a C-rating.[195] Unlike other counties that are not required to post this information in an easily digestible form, "[a] glance at the restaurant's storefront tells them how clean it is."[196]

The posting of these hygiene ratings had a positive impact on the overall cleanliness of restaurants in Los Angeles County. According to one study, the implementation of this grading system led to a reduction in food-related illnesses and created economic incentives for good quality hygiene. [197] Another study agreed with these findings and reported that this grading program was "associated

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189 *Id.* at 4.

190 *Id.*

191 *Id.* at 2.

192 *Id.* at 50.

193 *Id.* In some areas, "results are posted in searchable electronic databases that foresighted and tech-savvy restaurant-goers may learn to access." *Id.*

194 *Id.*

195 *Id.*

196 *Id.*

197 Ginger Zhe Jin & Phillip Leslie, *The Case in Support of Restaurant Hygiene Grade Cards*, CHOICES, 2nd Quarter 2005, at 97, 98–99.

with a 13.1 percent decrease in the number of people hospitalized with food-borne diseases."[198]

2. Discussion

The SUV safety ratings and the hygiene ratings shed some light on what any conflict of interest disclosure should look like and how it can be effective. Specifically, there are two things that these examples highlight.

First, any potential disclosure must be simplified. For instance, SUV ratings were helpful to consumers because they simplified the likelihood that an SUV would roll over.[199] Instead of providing consumers with all the complicated factors that would make an SUV more likely to roll over, the ratings combine a plethora of factors to create a probability that any given SUV would roll over.[200] Likewise, restaurants had to present their hygiene ratings in Los Angeles using letter grades from "A" to "C" that are easily understood, rather than disclose everything that made the restaurant more or less hygienic.[201]

Second, the form of disclosure must be comparative. In the SUV rollover example, the probability of a rollover was not listed as a percentage, but on a scale of 1 to 5 stars.[202] Consumers might not be able to understand that a forty-one percent (41%) chance of rolling over was one of the worst probabilities. But, as the results show, consumers can understand that a one-star rating is the worst rating a vehicle could have.[203] In the hygiene example, the decrease in food-related illnesses and decrease in food-related hospitalization shows that customers were able to easily distinguish between "A" quality restaurants and "C" quality restaurants.[204] This would likely not be the case if consumers had to call the health inspector's office, ask about all the health code violations, and compare these violations amongst restaurants.

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198 Paul A. Simon et al., *Impact of Restaurant Hygiene Grade Cards on Food-borne-Disease Hospitalizations in Los Angeles County*, J ENVTL. HEALTH, March 2005, at 32, 34.

199 FUNG ET AL., *supra* note 180, at 2.

200 *Id.*

201 *Id.* at 50.

202 *Id.* at 2.

203 *Id.* at 2.

204 *Id.* at 50.

I propose that a broker-dealer's conflicts of interest should be disclosed in a manner similar to how investment advisers disclose their advisory fees. For example, if an investment adviser charges an advisory fee over two percent (2%), she must disclose "that [her] fee is higher than that normally charged in the industry and that other investment advisers provide the same or similar services at lower rates" or be in violation of the antifraud provisions of the Investment Advisers Act.[205] However, in the broker-dealer context, conflicts of interest disclosure should be tailored to the services the broker-dealer provides.

First, instead of disclosing that a lower fee may be charged by another broker-dealer, any disclosure should state that the fee charged by a broker-dealer may be influencing her investment advice. In essence, a broker-dealer would want to make more money and thus, will be inclined to sell the product with the largest commission.[206] In addition, products with higher commissions tend to be riskier investments than those with low commissions.[207] The misalignment of interests and the fact that products with higher commissions can carry more risk leaves the investor with a potentially disastrous product and a broker-dealer with a large commission. Therefore, the proposed broker-dealer conflicts of interest disclosure would disclose the potential for the broker-dealer's bias based on the size of her commission.[208]

Second, the average broker-dealer commission for all products needs to be disclosed. This is another departure from the investment

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[205] The Consultant Publications Inc., SEC No-Action Letter, 1975 WL 12078 (Jan. 29, 1975).

[206] *See* Sah & Loewenstein, *supra* note 156, at 578, 578 tbl.1 (finding that sixty-three percent (63%) of participants acting as advisors in the nondisclosure condition chose the reward structure that would provide them with the largest commission).

[207] Christopher M. Gorman, Note, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?*, 9 FORDHAM J. CORP. & FIN. L. 475, 481 (2004); *see* Norman S. Posner, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U. L. REV. 1493, 1525.

[208] Gorman, *supra* note 207, at 481 ("[B]roker-dealers seeking to maximize their compensation are likely to recommend that a customer frequently buy and sell securities, particularly risky securities, even if this is not in the customer's best interests. This compensation scheme clearly fails to align the interests of broker-dealers with the interests of their customers.").

adviser's requirement, which does not necessarily list the average commission of two percent (2%), but only that the advisory fee is higher than average.[209] The average should not be based on the type of product—for example, non-traded real estate investment trusts ("REITs"). Instead, the average should be based on the overall average commission for the broker-dealer. This is because products in the same category are likely to have similar commissions; therefore, disclosing the product-specific average would not necessarily put the investor on notice about the potential bias that may accompany the high commission unless the average commission for all products is disclosed[210]

For instance, let us assume non-traded REITs typically offer a ten-percent (10%) commission, but a broker-dealer is recommending a particular non-traded REIT that offers a thirteen-percent (13%) commission. Telling the investor the average commission is ten percent (10%) and this product offers a thirteen percent (13%) commission might seem normal. But if the broker-dealer's average commission for all products is between six and seven percent (6–7%), and the broker-dealer discloses that she is making thirteen percent (13%), the investor can see the huge disparity and the potential influence the large commission is having.[211] Investors need to be able to compare the average commission and the commission the broker-dealer would earn on a particular product in order to see the full extent of their broker-dealer's monetary incentive.

This disclosure cannot just be buried in all the paperwork that an investor receives from a broker-dealer, or the investor will overlook the disclosure. Instead, I propose that at the time[212] an investor receives any information about a particular security, the broker-dealer presents the investor with a tablet or similar device that lists this information. There are two reasons why I suggest the use of a tablet or similar device. First, one study found that subjects have a better

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[209] The Consultant Publications Inc., *supra* note 205.

[210] *See* Gorman, *supra* note 207, at 481 ("Generally, commissions are higher for lower-priced, riskier securities than the commissions for higher-priced, safer securities.").

[211] *See* CHATER ET AL., *supra* note 146, at 360.

[212] It is important to require disclosure at the time of recommendation. If we require the disclosure of conflicts of interest before a recommendation, a broker-dealer can bury their disclosure to an investor within information given during their first meeting about all the products he may offer.

comprehension of what it is they are signing when the information is presented on an iPad as opposed to paper.[213] Second, using a tablet can allow for the information to be presented in different formats.[214] For instance, even on a rudimentary program, such as Microsoft Excel, raw data can be transformed into any type of graph the viewer wishes. Presenting information in a way an individual prefers has been shown to significantly increase one's understanding of risk.[215]

CONCLUSION

Dodd-Frank gave the SEC the authority to promulgate a rule addressing the regulatory regimes of broker-dealers and investment advisers. Pursuant to Dodd-Frank, the SEC proposed Regulation Best Interest that would require broker-dealers to act in the best interests of their customers. Regulation Best Interest also includes various disclosure requirements, and essentially creates a fiduciary duty for broker-dealers similar to that of investment advisers. Likewise, in 2016 the DOL enacted its Fiduciary Rule, which required broker-dealers to stand as fiduciaries when giving advice to retirement accounts. Thus, Regulation Best Interest and the Fiduciary Rule require the same thing of broker-dealers—albeit the Fiduciary Rule is narrower in scope as it applies only to retirement advice. One can therefore assess the effects of Regulation Best Interest by drawing inferences from the effects of the Fiduciary Rule.

A disclosure-based approach to broker-dealer reform should be preferred. In the wake of the Fiduciary Rule, a number of broker-dealers shifted to fee-based accounts, which can have the adverse effect of squeezing out lower-capital investors. Therefore, the SEC should be cautious in enacting a rule that is similar to the Fiduciary Rule as one can expect the same effect. Indeed, this effect may be magnified given the broader scope of the proposed Regulation Best Interest. Instead, the SEC should consider a disclosure-based approach. This approach is a lighter regulatory load for broker-dealers

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[213] Kapil Chalil Madathil et al., *An Investigation of the Efficacy of Electronic Consenting Interfaces of Research Permissions Management System in a Hospital Setting*, 82 INT'L J. MED. INFORMATICS 854, 861 (2013).

[214] *See, e.g.*, *id.* tbl.4 (finding that a "pagination interface is preferred to a scrolled interface").

[215] Alan R. Tait et al., *Using Animated Computer-Generated Text and Graphics to Depict the Risks and Benefits of Medical Treatment*, 125 AM. J. MED. 1103, 1107 (2012).

to bear and thus can mitigate, or even eradicate, the shift to fee-based accounts, allowing lower-capital investors to have access to meaningful financial services. In addition, studies show that investors can use the disclosure of conflicts of interest to make better investment decisions. Thus, a conflicts of interest disclosure requirement can provide meaningful regulatory reform.

Still, disclosure alone is not enough. A broker-dealer's conflict of interest disclosure should be simplified in a way that can easily be understood by investors. The disclosure should be provided in electronic form as it can allow investors to better understand the information they are reading, and can allow them to adjust the format of the information with the push of a button. The disclosure should also be presented in a way that enables investors to ascertain exactly how large of a conflict a broker-dealer has. This can be accomplished by presenting a broker-dealer's commissions in a way that allows the investor to gauge how much the conflict may be affecting the broker-dealer's recommendation. Borrowing from the investment adviser context, a broker-dealer's commission and other remuneration should be listed as a percentage alongside the average percentage for all products available to the investor. This allows an investor to see how much a broker-dealer's recommendation may be driven by her remuneration.