19-2886(L)

19-2893(CON)

United States Court of Appeals for the Second Circuit

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

Petitioners,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION and WALTER CLAYTON, in his official capacity as Chairman of the United States Securities and Exchange Commission,

Respondents.

REPLY BRIEF FOR STATE PETITIONERS

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Dated: April 14, 2020

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PRELIMINARY STATEMENT

The Securities and Exchange Commission's arguments in defense of the Final Rule disregard Congress's mandate in the Dodd-Frank Act and Investment Advisers Act and obscure the fact that the Final Rule applies a more lenient standard to broker-dealers than to investment advisers for functionally identical services—namely, providing personalized investment advice to retail consumers.

The Commission's statutory arguments rely on its startling and illogical view that Congress enacted Section 913 of the Dodd-Frank Act specifically to address the problems caused by divergent standards of conduct for functionally identical investment advice—but then was entirely indifferent to whatever rule the Commission chose to promulgate. The text and purpose of Section 913 demonstrate otherwise. Congress was deeply concerned that broker-dealers were providing conflicted investment advice to retail investors and sought to curb that practice by requiring broker-dealers to adhere to the same fiduciary standard that had applied to investment advisers for decades.

The Final Rule is also arbitrary and capricious. The Commission defends its adoption of a more lenient standard for broker-dealers

principally by pointing to purported distinctions in broker-dealers' business models, including their provision of investment advice in an episodic rather than ongoing manner. These distinctions are far less stark in practice than the Commission suggests. But the more fundamental problem is the disconnect between these distinctions and the Final Rule's specific refusal to adopt a fiduciary standard. On the dispositive question of how to protect investors from conflicted advice, broker-dealers and investment advisers are identically situated because both provide personalized investment advice to retail investors in ways that are essentially indistinguishable from each other. Indeed, because of this overlap, investors largely believe that broker-dealers are already subject to the same fiduciary standard as investment advisers. And the Commission has never found that anything distinct about the way that broker-dealers do business precludes them from providing investment advice (even episodically) "without regard to" their own selfish interests.

Thus, whatever other differences there may be between broker-dealers and investment advisers, requiring compliance with the same fiduciary standard for investment advice specifically is not only feasible, given the similarity of their advisory services, but also consistent with

investors' expectations. By contrast, the Final Rule's preservation of a distinct and less protective standard of conduct for broker-dealers only exacerbates investor confusion and unreasonably raises the risk that broker-dealers' investment advice will be tainted by conflicts of interest.

ARGUMENT

POINT I

STATE PETITIONERS HAVE STANDING

The Commission's challenge to State Petitioners' standing suffers from at least three fundamental flaws.

First, the Commission's arguments presume that State Petitioners must establish injury "as compared to the status quo"—i.e., the state of affairs before implementation of the Final Rule. Br. for Resp'ts (SEC Br.) at 35. But the Commission uses the wrong baseline. State Petitioners' legal claim in this case is that the Final Rule fails to satisfy Congress's requirement that the Commission change its current regulation of broker-dealers by imposing a fiduciary standard when broker-dealers provide personalized investment advice as a substantial part of their business. For such a claim, the relevant baseline is not "the status quo ante but instead [the] other actions [the Commission] could have taken";

State Petitioners thus have standing so long as "they would have been better off" "had the [Commission] taken the course of action that they claim the law required." *National Envtl. Dev. Ass'n's Clean Air Project v. EPA*, 752 F.3d 999, 1006 (D.C. Cir. 2014); *see also Massachusetts v. EPA*, 549 U.S. 497, 510, 521 (2007) (standing to challenge EPA's "refusal to regulate greenhouse gas emissions" as required by the Clean Air Act when status quo ante included no such regulation).[1] It is thus immaterial whether the Final Rule is an improvement over a regulatory status quo that does not include the statutorily required fiduciary standard for broker-dealers.

The Commission's erroneous baseline pervades its standing analysis, including its criticisms of State Petitioners' arguments about causation and redressability. For example, the Commission asserts (at 35) that causation requires a comparison of "harm 'before and after' an

[1] The principal case the Commission cites on this point also relied on a statutory baseline, although in that case the statutory baseline defeated petitioners' standing. In *Texas v. EPA* (cited in SEC Br. at 37), the D.C. Circuit held that petitioners did not have standing to challenge an agency regulation because the underlying statute itself, not the challenged regulation, compelled the relevant obligations. 726 F.3d 180, 198 (D.C. Cir. 2013).

agency action," when the correct comparison is between the agency's action (or inaction) and the statutory mandate. Similarly, the Commission asserts (at 37) that State Petitioners have not established redressability because vacating the Final Rule "would likely make [their injuries] worse," but the correct question is whether State Petitioners would benefit from the imposition of a fiduciary standard on broker-dealers in compliance with the Advisers Act and the Dodd-Frank Act. Here, for the reasons given in State Petitioners' opening brief (at 35-40) and further explained below, a fiduciary standard's stronger protections against conflicted investment advice will directly and materially benefit State Petitioners. Redressability requires no more.[2] *See National Envtl. Dev. Ass'n's Clean Air Project*, 752 F.3d at 1006.

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[2] State Petitioners have previously argued (at 44-45) that even without further rulemaking, the Advisers Act's fiduciary standard already applies to broker-dealers who provide investment advice as a substantial part of their business. But even assuming that further rulemaking from the Commission were required, vacatur of the Final Rule here would still redress State Petitioners' injuries by eliminating an obstacle to the imposition of such a standard. *See Tel. & Data Sys., Inc. v. FCC*, 19 F.3d 42, 47 (D.C. Cir. 1994) ("[Petitioner] may not prevail even if we vacate the Atlantic City order, but it cannot prevail unless we do so, and that is enough to ensure that the relief requested 'will produce tangible, meaningful results in the real world.'").

Second, the Commission asserts that State Petitioners have failed to explain the contours of a "hypothetical uniform fiduciary standard" on broker-dealers and thus cannot establish the benefit of this "hypothetical" standard above the Final Rule. SEC Br. at 36; *see also id.* at 38. But the fiduciary standard for investment advice is well-established and can already apply to broker-dealers under certain circumstances. As the Commission acknowledges, the fiduciary standard for investment advice derives from section 206(1) and (2) of the Advisers Act and has been articulated through decades of "judicial precedent and Commission action." SEC Br. at 12. That standard requires that investment advice be given "without regard to" the provider's own interests—the same standard articulated by the provisions of the Dodd-Frank Act at issue here. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963); *see also* Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828-29 (July 21, 2010). And there is no question that, even before the Dodd-Frank Act, broker-dealers could be subject to a fiduciary standard under federal law: as the Commission admits elsewhere in its brief, a broker-dealer who is not covered by the Advisers Act's "solely incidental" exception "*is* an

'investment adviser,' subject to the obligations of the Advisers Act, including the fiduciary duty." SEC Br. at 61 (emphasis in original). Indeed, the Commission's own 913 Study concluded that the fiduciary standard was well established under existing guidance and precedent and could "be extended to broker-dealers, as applicable." (Joint Pet'rs' Appendix (PA) 444.) Thus, contrary to the Commission's position here, neither the contours of the fiduciary standard nor its applicability to broker-dealers is any mystery.

Nor is there any serious dispute that the standard permitted under the Final Rule is more lenient than the fiduciary standard. The Commission could have straightforwardly applied the "without regard to" fiduciary standard to broker-dealers' investment advice, as its own 913 Study recommended. (*See* PA 441-443.) It deliberately chose not to do so. Instead, the Final Rule expressly permits broker-dealers to consider their own "financial or other interest" in providing investment advice, so long as they do not place their own interest "ahead of the interests of the retail consumer." Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,319 (July 12, 2019). This language effectively parallels the existing FINRA "suitability" standard (see Br. for

State Pet'rs (States Br.) at 9-10, 25 n.5, 68), which has long been understood to permit more conflicts of interest than the more stringent "without regard to" fiduciary standard. (PA 2508-2510, 3322-3326.) *See* Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker Dealers* ("2008 RAND Report") 7-15 (RAND: Inst. for Civil Justice 2008).

At most, the Commission's claims about the purported benefits of the Final Rule (at 38-39) raise a question about the *magnitude* of the injuries that State Petitioners and others will suffer due to the differences between the Final Rule and the "without regard to" fiduciary standard. But any such dispute cannot defeat State Petitioners' standing, which is sufficiently established by injury that is perceptible, and not necessarily significant. *See Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 983 (2017); *Carpenters Indus. Council v. Zinke*, 854 F.3d 1, 5 (D.C. Cir. 2017).

Finally, the Commission argues that both the existence of State Petitioners' injuries and their connection to the Final Rule are too conjectural to support standing. SEC Br. at 37. But State Petitioners described the existence and redressability of their asserted injuries with particularity and backed their claims with concrete evidence.

State Petitioners will suffer "a direct injury in the form of a loss of specific tax revenues," *Wyoming v. Oklahoma*, 502 U.S. 437, 447-48 (1992), because, unlike the "without regard to" fiduciary standard, the Final Rule will allow broker-dealers to provide investment advice while considering their own interests, a practice that demonstrably reduces investment returns and concomitantly reduces tax revenues derived from investment income by the States. See States Br. at 35-37. The Final Rule's failure to impose the "without regard to" standard will also result in reduced investment income in retirement accounts, causing more of the nation's increasing elderly population to rely on state public assistance programs. See States Br. at 37-40.

Substantial empirical evidence supports the existence of these predictable consequences of conflicted investment advice. *See, e.g.*, White House Council of Econ. Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* 2-3 (Feb. 2015); Heidi Shierholz & Ben Zipperer, *Here Is What's at Stake with the Conflict of Interest ("Fiduciary") Rule*, Econ. Policy Inst. (May 30, 2017). Indeed, the Final Rule acknowledges that conflicts of interest are detrimental: "the estimated monetized underperformance of broker-sold funds ranges from $4.1

billion per year to $9.7 billion per year." 84 Fed. Reg. at 33,458-59. And State Petitioners submitted evidence connecting these investor losses to losses to the States' treasuries. Several tax officials submitted affidavits explaining how reductions in investment returns impact state revenues and expenditures. Addendum to States Br. (States Add.) 91-108. And an expert affidavit from Dr. Manisha Padi, based on empirical studies of the impact of a fiduciary duty on investment returns, showed that New York suffers an annual total loss of $30.1 million from taxes on annuity contracts and mutual funds alone and incurred additional annual spending of at least $2.88 million.[3] States Add. 7, 8.

State Petitioners' empirical evidence also demonstrated that the imposition of a fiduciary standard on broker-dealers' provision of investment advice would redress these injuries. Dr. Padi's expert opinion (unrebutted by the Commission) explained that investors receiving advice subject to the fiduciary standard were more likely to purchase annuities "with lower fees and higher returns," achieving a net return 51 basis points higher than investors advised by broker-dealers not subject

[3] Other State Petitioners suffered similar losses in tax revenues and increases in annual expenditures. States Add. 7, 8.

to a fiduciary duty. States Add. 4. By contrast, Dr. Padi found that the failure to impose a fiduciary duty on broker-dealers causes large losses to investors in annuity markets, based on a study comparing investment returns in States in which the common law imposes some form of a fiduciary duty on broker-dealers and neighboring States without such a common-law duty. See States Add. 4, 6-9; States Br. at 16-18, 35-40. Contrary to the Commission's claim (at 37), Dr. Padi specifically traced the injuries resulting from conflicted investment advice separately from other factors that may influence returns on investment. States Add. 19-20. Indeed, Dr. Padi explained that her estimates of the States' projected injuries were substantially *underinclusive*, because those estimates were limited to certain categories of investment products and accounts. States Add. 5. This concrete evidence stands in stark contrast to the absence of evidence involved in the Commission's primary precedent (*see* SEC Br. at 37-38, 44), which concerned an unsupported fear that litigants would face surveillance because they communicate with individuals abroad. *See Clapper v. Amnesty Int'l USA*, 568 U.S. 398, 406, 409-10 (2013).

The Commission's remaining arguments against State Petitioners' evidence of standing are meritless. The Commission claims that a fiduciary standard could impair State Petitioners' tax revenues by raising the cost of investment advice or reducing the number of broker-dealers providing services in their States. SEC Br. at 38-39. But petitioners' standing to challenge the Final Rule is established by evidence of resulting injury, even if the Final Rule could potentially also confer other benefits that might to some degree offset that injury. *See Texas v. United States*, 809 F.3d 134, 155-56 (5th Cir. 2015); *Los Angeles Haven Hospice, Inc. v. Sebelius*, 638 F.3d 644, 656-57 (9th Cir. 2011). In any event, Dr. Padi's analysis took account of the potential benefits invoked by the Commission and concluded that any reduction in the number of broker-dealers would have "limited effects" on the "total size of the market." States Add. 57. The Commission has not offered any quantitative analysis to the contrary.

The Commission also questioned the relevance of Dr. Padi's findings of injury because of limitations in a study on which she relied to compare investment returns in States with and without a common-law fiduciary duty rule applicable to broker-dealers. SEC Br. at 35 n.4. But the Commission in the Final Rule merely noted "limitations of the data

sample and of the empirical methodology" used in the study without further explanation. (Special Appendix (SA) 147 n.1351.) Dr. Padi acknowledged that there were some limitations in the study, but observed that due to those limitations the study *underestimated* "the positive impact a federal fiduciary duty law would produce." States Add. 5.

POINT II

THE FINAL RULE IS CONTRARY TO LAW AND EXCEEDS THE COMMISSION'S STATUTORY AUTHORITY

A. The Commission's Sweeping Claim That It May Issue Any Regulation Regarding Broker-Dealers' Investment Advice—or No Regulation Whatsoever—Disregards Congress's Directives in the Dodd-Frank Act and Advisers Act.

As State Petitioners have explained, the Final Rule is unlawful because it disregards Congress's direction in both Section 913(g) of the Dodd-Frank Act and the Advisers Act to impose a fiduciary duty on broker-dealers who provide personalized investment advice to retail investors as a substantial rather than incidental part of their business. See States Br. at 43-55. Contrary to Congress's express direction in Section 913(g), the Final Rule's standard of conduct is concededly neither the "same as" nor "no less stringent than" the "without regard to"

fiduciary standard provided in the Advisers Act and Dodd-Frank Act. (SA 146-149.)

The Commission's arguments to the contrary contort the Dodd-Frank Act's straightforward legislative roadmap. The Commission asserts that it can disregard Section 913(g) because Section 913(f) provides an entirely independent source of rulemaking not subject to what the Commission concedes are Section 913(g)'s "mandatory constraints." SEC Br. at 54. And the Commission makes the even more sweeping argument that Section 913(f) and (g) use "permissive rather than mandatory language" that gives the Commission essentially unfettered discretion to decide how to regulate broker-dealers—"or to choose no rulemaking at all." SEC Br. at 48. Both of these arguments are unsupported by the plain text and purpose of the Dodd-Frank Act and improperly ignore the Advisers Act's long-standing imposition of fiduciary obligations on all financial professionals providing non-incidental investment advice.

1. Subsections 913(f) and (g) work together, not separately, to confer and define the Commission's rulemaking authority.

First, the Commission's contention (at 46-51) that Subsections 913(f) and (g) of the Dodd-Frank Act are entirely "separate rulemaking paths" artificially divides a unified statutory scheme. As amici Members of Congress explain, Congress sought to remedy the historical inconsistency between the standards of conduct the Commission applied to broker-dealers and investment advisers to alleviate consumer confusion and restore public trust in the markets. Br. of Current & Former Members of Cong. as Amici Curiae in Supp. of Pet'rs at 2, 9. Section 913 presents a unified approach to this problem. The early subsections require the Commission to conduct (and later publicly report) a study on "the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers." Dodd-Frank Act § 913(c)(6), 124 Stat. at 1825. Congress specifically directed the Commission to consider the impacts of imposing "the standard of care applied under" the Advisers Act and the "other requirements of the Advisers Act" on broker-dealers. *Id.* § 913(c)(9), 124 Stat. at 1826.

Subsections 913(f) and (g) then work in tandem to channel the Commission's subsequent rulemaking in accordance with "the findings[,] conclusions, and recommendations of the study." *Id.* § 913(f), 124 Stat. at 1828. Section 913(f) provides that the "Commission may commence a rulemaking . . . to address the legal or regulatory standards of care for" broker-dealers. 124 Stat. at 1827. And section 913(g) provides the substantive authority for such a rulemaking by amending otherwise disparate provisions of the Exchange Act (which governs broker-dealers) and Advisers Act (which governs investment advisers) to unify them under "the same" standard of conduct, which "shall be no less stringent than the standard applicable to investment advisers"—i.e., the "without regard to" fiduciary standard. *Id.* § 913(g)(1), (2), 124 Stat. at 1828-30. Subsections 913(f) and (g) thus act as coordinated authorizing provisions that together direct the Commission's rulemaking in accordance with the results of the study that earlier subsections of Section 913 require.

Rejecting this interpretation, the Commission instead asserts that Subsections 913(f) and (g) have nothing to do with each other because there is no "textual link" between these subsections, such as an "express cross-reference." SEC Br. at 50-51. But no cross-reference is needed.

Subsections 913(f) and (g) are adjacent subsections of the same statutory provision, enacted by Congress at the same time to address the same problem. They address "commenc[ing]" and "promulgat[ing]" rules as part of a single process. 124 Stat. at 1827-28. The Commission's insistence that Congress use talismanic words to further clarify what every other indicator of legislative intent already makes plain elevates form over substance.

Contrary to the Commission's arguments (at 51-52), it is far from unusual for Congress to authorize an agency to commence rulemaking in one subsection and then condition that rulemaking in another without "an express cross-reference." For example, adjacent subsections of 47 U.S.C. § 340(c)(1) authorize the Federal Communications Commission to "commence a rulemaking," *id.* § 340(c)(1)(A)(ii), and then to "adopt rules pursuant to such rulemaking" *id.* § 340(c)(1)(B), within a defined time period, without any explicit "textual link" between the two—other than their obvious connection as part of the same statutory provision addressed to the same subject matter.[4]

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[4] The decisions cited by the Commission are inapposite. One decision concerns wholly separate sections of a statute, not neighboring subsections. *United States v. Reorganized CF & I Fabricators of Utah*, 518 U.S. 213, 220 (1996). And *Environmental Defense Fund v. Thomas*

The Commission is also wrong to claim (at 51) that Section 913(g)'s use of a notwithstanding clause "decouple[s]" Subsections 913(f) and (g). Section 913(g) inserts that notwithstanding clause—"Notwithstanding any other provision of *this Act* or the Investment Advisers Act of 1940," 124 Stat. at 1828 (emphasis added)—into a provision of *the Exchange Act* to make it clear that the standard of conduct authorized under Section 913(g) may apply regardless of any preexisting standard under *the Exchange Act* (or the Advisers Act). The Commission is simply mistaken in asserting (at 51) that the notwithstanding clause's reference to "this Act" is to the Dodd-Frank Act (including Section 913(f)) rather than the Exchange Act.

The Commission also errs in characterizing State Petitioners' interpretation as rendering Section 913(f) "purely superfluous." SEC Br. at 53. As explained, Subsections 913(f) and (g) serve distinct but closely

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concerned the lack of a link between a provision mandating a rulemaking (Section 109 (a) and (b) of the Clean Water Act) and a substantively separate subsection providing for subsequent review and new standards "as may be appropriate" (Section 109(d) of the Clean Water Act). 870 F.2d 892, 898 (2d Cir. 1989). Unlike Section 913 of the Dodd-Frank Act, Section 109 of the Clean Water Act thus expressly contemplated separate rulemaking procedures.

related functions, with Section 913(f) generally authorizing rulemaking while Section 913(g) provides statutory authority to impose specific standards by making conforming amendments to existing statutes. By contrast, the Commission's interpretation makes Section 913(g) irrelevant. If all Congress wanted to do was authorize the Commission to impose *any* standard of conduct on broker-dealers, then there was no need for it to go beyond Section 913(f)'s general authorization to "commence a rulemaking . . . to address the legal or regulatory standards of care for" broker-dealers. 124 Stat. at 1827. But Congress also enacted Section 913(g)'s more specific substantive language. The Commission's view that it can rely on Section 913(f) alone and simply ignore Section 913(g) (and the Advisers Act fiduciary standard it references) disregards the Commission's responsibility to "give effect, if possible, to every word Congress used." *Reiter v. Sonotone Corp.*, 442 U.S. 330, 339 (1979).

2. Congress did not confer on the Commission boundless discretion to regulate as it saw fit.

Second, the Commission claims (at 46-48) that the use of the word "may" rather than "shall" in Subsections 913(f) and (g) gives the Commission essentially unbounded discretion to decide what standard to impose on broker-dealers—including no standard at all. But the Commission is wrong to construe the existence of *some* discretion as license to do whatever it wants. *See Cuomo v. Clearing House Ass'n, LLC*, 557 U.S. 519, 525 (2009) ("[T]he presence of some uncertainty does not expand *Chevron* deference to cover virtually any interpretation.").

As State Petitioners' opening brief explained (at 49-51), Congress used the word "may" in the rulemaking provisions of Subsections 913(f) and (g) to confer only limited discretion on the Commission. After the Commission's own 913 Study concluded that the disparity in standards of conduct for broker-dealers and investment advisers warranted regulatory action, the Commission had discretion either to treat broker-dealers as investment advisers pursuant to the Advisers Act—subject to all of the Advisers Act's many requirements—or, pursuant to Section 913(g), to impose *only* the Advisers Act's fiduciary standard on broker-dealers' investment advice, without applying the Advisers Act's other

requirements. Thus, for example, Section 913(g)(1) does not require a broker-dealer "to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities," as an investment adviser does. 124 Stat. at 1828. Nor does it prohibit a broker-dealer from receiving "compensation based on commission . . . in and of itself." *Id.* Section 913(g)'s use of the word "may" thus provides the Commission with discretion to forbear from applying the *other* requirements of the Advisers Act, besides its mandatory fiduciary standard.

The Commission's contrary position—that the word "may" in Subsections 913(f) and (g) conferred unlimited discretion to do anything or nothing at all—relies on the remarkable view that Congress was entirely indifferent to the outcome of any rulemaking. That view is not consistent with Congress's plain intent in enacting Section 913 to address the problem of broker-dealers being subject to a different standard of conduct from investment advisers despite providing similar advice to retail investors. As the Commission concedes (at 46-47), Congress backed up this intent with multiple provisions of Section 913 that *did* impose affirmative mandates on the Commission, including the requirement that the Commission conduct a detailed study to evaluate the "gaps,

shortcomings, or overlaps" in the disparate standards that apply to broker-dealers and investment advisers; "seek and consider public input, comments, and data" on the study; and then report the study to Congress and the public. Dodd-Frank Act § 913(b)(2), (d)-(e), 124 Stat. at 1824, 1827. Even more pointedly, Congress amended decades-old provisions of the Exchange Act and Advisers Act to expressly authorize broker-dealers to be subject to the same fiduciary standard that applies to investment advisers while continuing to be regulated distinctly for other purposes.

Here, the Commission itself found, in the study required by Section 913(b), that a more lenient standard for broker-dealers' investment advice was not warranted and that the Commission should "implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers." (PA 326.) Given the 913 Study's conclusions, it is implausible that Congress would have authorized the Commission "to choose no rulemaking at all" (SEC Br. at 48) when the Commission confirmed the existence of the specific policy problem identified by Congress and Congress amended both the Exchange Act and the Advisers Act to authorize a tailored solution to the problem. *See Stone v. INS*, 514 U.S. 386, 397 (1995) ("When Congress acts to amend a statute, we presume it

intends its amendment to have real and substantial effect."). This Court should reject "an interpretation of [Section 913(g)] that would render it a dead letter." *Wilder v. Virginia Hosp. Ass'n*, 496 U.S. 498, 514 (1990).

Contrary to the Commission's assertion (at 54-57), the legislative history of the Dodd-Frank Act does not support its position. Even under the Commission's recounting, the competing House and Senate bills that preceded the final version of Section 913 all "did mandate *some* rulemaking." SEC Br. at 54 (emphasis in original). The Commission's position—that it had the authority to do *nothing* notwithstanding the 913 Study's findings—was thus not within Congress's contemplation.

The Commission is also wrong to assert (at 58-59) that State Petitioners' arguments rely on any extraordinary interpretation of the Advisers Act. The Commission claims that there is no evidence that Congress disagreed with the Commission's long-standing exclusion of broker-dealers from the Advisers Act's requirements. But the legislative history is replete with statements of concern by members of Congress about investor confusion resulting from the more lenient standard of care applicable to broker-dealers providing investment advice and the harms

such confusion was causing.[5] If there were any doubt, Congress made plain its view that the Advisers Act should apply to investment advice—regardless of who is providing it—when it expressly said in Section 913(g) that broker-dealers should be subject to a standard of conduct that is "the same as" and "no less stringent than the standard applicable to investment advisers" under the Advisers Act. 124 Stat. at 1828-29. Applying the Advisers Act to broker-dealers is thus not some "dramatic change," as the Commission fears (at 58), but rather reflects the very premise of Section 913.

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[5] *See, e.g.*, 156 Cong. Rec. S4065 (daily ed. May 20, 2010) (statement of Sen. Kaufman) (restoring "public's trust in markets" by eliminating different standards of care essential to "a full economic recovery"); *id.* S4069 (daily ed. May 20, 2010) (statement of Sen. Akaka) ("[T]oo many investors do not know the difference between a broker and an investment advisor" and a broker's lower standard of care.); *id.* at H5237 (daily ed. June 30, 2010) (statement of Rep. Kanjorski) (noting concern that "investors are confused by the legal distinction between broker-dealers and investment advisers").

B. The Commission's Interpretation of the Advisers Act's "Solely Incidental" Exception Conflicts with the Statute.

The Final Rule expressly incorporates a concurrent interpretative guidance that purports to extend the Advisers Act's "solely incidental" exception for broker-dealers to any advice that is "provided in connection with" and "reasonably related to the broker-dealer's primary business of effecting securities transactions"—a standard so broad that it would exempt nearly all advice provided by today's broker-dealers. 84 Fed. Reg. at 33,685. The Commission contends (at 60-61) that the Final Rule does not turn on this interpretative guidance, but it is mistaken.

As State Petitioners have explained (at 7-8), the Advisers Act applies to "*any* person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing." 15 U.S.C. § 80b-2(a)(11) (emphasis added). This broad language means that broker-dealers who provide investment advice are presumptively governed by the Advisers Act, including its fiduciary standard, unless they fall within the exception for broker-dealers whose advice is "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." *Id.* § 80b-2(a)(11)(C). The

"solely incidental" exception is therefore the only statutory basis for exempting broker-dealers from the Advisers Act's requirements. The Final Rule's departure from the Advisers Act's requirements thus necessarily turns on the Commission's views on the breadth of the "solely incidental" exception. And, indeed, the Final Rule expressly references the Commission's interpretation of "solely incidental" in several places to determine whether a broker-dealer providing advisory services to a retail client is subject to the fiduciary standard under the Advisers Act or instead to the Final Rule's more lenient standard. *See, e.g.*, 84 Fed. Reg. at 33,336 n.166, 33,340 n.210. Because the Final Rule relies on and incorporates the reasoning of the "solely incidental" interpretation, this litigation properly encompasses challenges to the legal validity of that interpretation.

The Commission's suggestion (at 61) that State Petitioners are too late to challenge the "solely incidental" interpretative guidance is also misplaced. There are serious questions about whether a mere interpretive rule constitutes final agency action that is amenable to judicial review under the Administrative Procedure Act (APA). *See, e.g.*, *Association of Flight Attendants-CWA, AFL-CIO v. Huerta*, 785 F.3d 710, 716-17 (D.C. Cir. 2015). But regardless, there is no dispute here that

State Petitioners timely challenged the Final Rule (SEC Br. at 6), and nothing bars State Petitioners from basing their challenge in part on their objections to the agency's predicate legal interpretation of statutory terms. *See Natural Res. Def. Council v. Abraham*, 355 F.3d 179, 200-01 (2d Cir. 2004) (challenge to regulation encompassed companion interpretation of governing statutory provision).

On the merits, State Petitioners have already demonstrated that the Commission's broad interpretation of "solely incidental" stretches the exception beyond any reasonable interpretation of the Advisers Act. See States Br. at 51-54. The Commission agrees that the plain meaning of "incidental" refers to one aspect of a business being primary and another aspect of that business being subordinate in relation to each other. *See* SEC Br. at 62, 63. Nonetheless, the Commission insists that a broker-dealer's provision of investment advice—no matter how substantial—is "incidental" to its trade-execution business so long as the advice is "in connection with" and "reasonably related to" the broker-dealer's effectuation of securities transactions. 84 Fed. Reg. at 33,685.

That interpretation ignores the plain meaning of "incidental," i.e., subordinate to, and replaces it with a mere relationship test that has no

such limitation. And it unreasonably deems investment advice given by broker-dealers to be "solely incidental" to their trade-execution function even when broker-dealers' advisory services have become an increasingly dominant and often primary part of their overall business.

As State Petitioners have explained (at 11-14, 54-55), the advent of electronic trading has automated the process of trade execution today compared to the laborious process used in the 1940s and rendered the transactional portion of services the clearly "incidental" piece of most broker-dealers' businesses. Indeed, an increasing number of brokerage firms today no longer charge separate commissions for executing trades—confirming the subordinate role of these transactions in their businesses. At the same time, investment advice has so grown in importance that many broker-dealers predominantly market themselves as trusted financial advisors, rather than as transactional trade executors. *See* Br. for Amicus Curiae Pub. Inv'rs Arbitration Bar Ass'n in Supp. of Pet'rs Br. at 17-20. The Commission's own 913 Study recognized that broker-dealers often provide investment services that are also indistinguishable to a retail investor from the services provided by investment advisers. (*See* PA 463.) To call broker-dealers' advisory services

today "incidental" is thus precisely the opposite of what both retail investors and broker-dealers themselves believe and the Commission itself has acknowledged.

Finally, the Commission gives undue import (at 70) to the fact that Congress did not amend the "solely incidental" exception when it enacted the Dodd-Frank Act. Congress did not need to modify the exception because it addressed the problem in Section 913. The legislative history of the Dodd-Frank Act confirms that Congress was keenly aware that the increasingly dominant advisory services offered by broker-dealers should trigger the requirements of the Advisers Act. See *supra* at 23-24; States Br. at 18-24. Congress resolved this concern by requiring the Commission to study the extent to which broker-dealers' provision of investment advice was converging with the services provided by investment advisers and by directing the Commission to apply the Advisers Act's fiduciary standard to broker-dealers as well. See *supra* at 15-16, 20-23. But the Commission's "solely incidental" interpretative guidance improperly takes the opposite approach—broadly exempting broker-dealers as a class from the Advisers Act's requirements despite the increasing dominance of advisory services as a part of broker-dealers' business.

POINT III

THE FINAL RULE IS ARBITRARY AND CAPRICIOUS

The Final Rule is arbitrary and capricious because it leaves investors vulnerable to the same harms that Congress, the 913 Study, and the Commission itself sought to remedy. Although the Commission does not dispute the 913 Study's extensive findings of consumer harm from the broker-dealer regulatory gap, the Final Rule preserves the confusing disparity between investment advisers and broker-dealers that had been the principal cause of that harm. The Commission's defenses of its Final Rule are meritless.

A. The Commission's Claim that Broker-Dealers' Business Models Support a More Lenient Standard Is Unfounded.

The Commission's principal argument is that the Final Rule's more lenient standard is justified in light of broker-dealers' "episodic" or "transaction-based" provision of investment advice, which is purportedly distinct from the more long-term "ongoing advisory relationship[s]" established by investment advisers. SEC Br. at 3, 8.

As a threshold matter, it is not true that broker-dealers provide primarily "episodic" advice; rather, many broker-dealers market

themselves as trusted financial professionals offering investment strategies to help retail consumers meet long-term goals such as buying a house or saving for college tuition and retirement. The 913 Study acknowledged that broker-dealers provide "discretionary portfolio management" and "comprehensive . . . wealth management" services. (PA 343.) And research has shown that broker-dealer advertisements have "promoted the image of the relationship with the broker as a long-term one." 2008 RAND Report, *supra*, at 27-28; *see id.* at 69 (most large brokerage firms sampled provided investment management and monitoring and retirement planning services). (*See also* PA 1462 ("In an effort to adapt their business model, maintain relevance, and address a market need, the brokerage industry rebranded itself as advisers.").) The Commission offers no basis for characterizing broker-dealer advice that occurs within the context of such long-term advisory relationships as "episodic" or otherwise meaningfully distinct from the services provided by investment advisers.

In any event, there is a fundamental disconnect between the Commission's perception of broker-dealers' distinct business model and its exemption of broker-dealers from the Advisers Act's fiduciary standard

specifically. The Commission has never argued that anything prevents even episodic or transaction-based investment advice from being given without regard to the broker-dealer's own interests. Indeed, courts in several States have long imposed common-law fiduciary obligations on broker-dealers offering investment advice under particular circumstances. See States Add. 27-28. *See* 84 Fed. Reg. at 33,419.

Instead, the differences in the way that broker-dealers do business compared to investment advisers arise out of *other* features of their business aside from their shared ability to avoid conflicts in providing investment advice. But in Section 913(g), Congress expressly recognized and permitted the Commission to tailor its regulation to account for these other differences. For example, Congress recognized that broker-dealers "generally offer a pay-as-you-go fee arrangement" (SEC Br. at 8) by providing in Section 913(g) that "[t]he receipt of compensation based on commission" will not by itself be deemed a violation of a broker-dealer's fiduciary duty, 124 Stat. at 1828. Congress similarly recognized that broker-dealers might not necessarily have "an ongoing advisory relationship" with their clients (SEC Br. at 3) by providing in Section 913(g) that a fiduciary standard would not require a broker-dealer "to

have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities," 124 Stat. at 1828. The Commission has failed to explain why these and other provisions of Section 913(g) are not by themselves sufficient to tailor the fiduciary duty to the episodic nature of brokerage services and the "pay-as-you-go" business model of broker-dealers, without encroaching on the fiduciary duty's core requirement that financial advisors act "without regard" to their own interests.

The Commission's claim that the Final Rule's more lenient standard is necessary to preserve investor choice is also mistaken. The Commission asserts (at 14) that some retail investors prefer broker-dealers' pay-as-you-go model of providing investment advice, while others prefer the ongoing fees associated with investment advisers. But there is no indication that retail investors believe these distinct business models are associated with different duties of loyalty—let alone that any retail investor consciously chose broker-dealers because they could provide more conflicted advice. To the contrary, as explained in State Petitioners' opening brief (at 15-16, 73-75) and further below, there is overwhelming evidence that retail investors erroneously believe that all financial advisors

are subject to a fiduciary duty that requires them to provide investment advice without regard to their own interests. (*See* PA 314, 325, 598.) *See also* 2008 RAND Report, *supra*, at 18. The Commission has thus failed to identify any consumer demand for more conflict-ridden investment advice that would be served by the Final Rule's lenient standard.

Finally, the Commission's concern that imposing a fiduciary standard on broker-dealers would lead to substantial exit from the market is unfounded. The Commission cites studies about "reduced access to brokerage services" after the adoption of the Department of Labor (DOL) Rule. SEC Br. at 73, 75. But the DOL Rule, which never went into effect, differs from Section 913(g) in substantial respects. *See Chamber of Commerce v. United States Dep't of Labor*, 885 F.3d 360, 366, 385 (5th Cir. 2018). And in any event, the Commission's arguments rely mainly on industry surveys of "expected" behavior rather than evidence of real-world changes (SEC Br. at 75 (quotation marks omitted)), despite the Final Rule's explicit disclaimers about the limitations of such surveys (SA 104-105).

B. The Commission's Claim That the Final Rule Protects Investors Is Unfounded.

The Commission is mistaken in claiming (at 77-82) that the Final Rule effectively protects retail investors by implementing "key principles" of the fiduciary duty. The Commission appears to suggest that the only meaningful difference between the Final Rule's standard and a fiduciary standard is that the Final Rule applies "at the time the recommendation is made" and does not impose a continuing duty to monitor. *Id.* at 77-78 (quotation marks omitted). But that characterization seriously understates the disparity between the Final Rule and the "without regard to" fiduciary standard under the Advisers Act. As described above (see *supra* at 7-8), the Final Rule *does* allow a broker-dealer to consider his own interests "at the time the recommendation is made," regardless of any continuing duty to monitor. The Final Rule therefore expressly contemplates the possibility that broker-dealers will offer investment advice based on their own interest—conduct that would not be permitted under the more protective "without regard to" standard. *See, e.g.*, 84 Fed. Reg. at 33,319, 33,328, 33,332, 33,491.

The Commission is also wrong (at 79-84) to claim that the Final Rule adequately mitigates conflicts through disclosures. The Final Rule's

disclosure requirements do not require a broker-dealer to identify the difference between the standards of care for broker-dealers and for investment advisers. Moreover, the disclosure requirements leave substantial discretion to broker-dealers, including whether disclosures are made orally or in writing.[6] See States Br. at 73-75. These requirements do not add anything meaningful to FINRA's existing requirement of disclosure at the time a broker makes a recommendation.[7] (*See* PA 447.)

In justifying the Final Rule, the Commission failed to give adequate consideration to investor confusion, a primary factor animating the enactment of the Dodd-Frank Act. The Commission does not dispute that investors have been confused about the disparate standards applicable to broker-dealers and investment advisers; indeed, the 913 Study recommended a uniform fiduciary rule precisely to protect consumers in light of their "confusion and lack of understanding." (PA 434; *see* PA 440,

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[6] The Commission's conclusion that affording broker-dealers nearly unlimited "flexibility" governing the timing, form, and manner of disclosures will result in an economic benefit is mere speculation without accounting for how broker-dealers will exercise their substantial discretion. (SA 123-124.)

[7] As State Petitioners explained in their opening brief (at 64-65), the Commission is also mistaken in suggesting that its policies-and-procedures requirement does anything to protect investors.

498.) The 913 Study further noted that the opaque regulatory differences between broker-dealers and investment advisers "create[] unnecessary risk and complexity for investors"—particularly when many institutions feature both professionals, and some professionals can serve in both roles at different times. (PA 463.) This risk from consumer confusion is prevalent: approximately 88 percent of investment adviser representatives were also registered as brokers. (*See* PA 323, 345.) Nothing in the Final Rule helps to address this confusion, instead leaving the particulars of more specific disclosures to the discretion of broker-dealers.

CONCLUSION

The Court should vacate and set aside the Final Rule.

Dated: New York, New York
April 14, 2020

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 32(a) of the Federal Rules of Appellate Procedure, William P. Ford, an employee in the Office of the Attorney General of the State of New York, hereby certifies that according to the word count feature of the word processing program used to prepare this brief, the brief contains 6,994 words and complies with the typeface requirements and length limits of Rule 32(a)(5)-(7) and Local Rule 32.1.

/s/ *William P. Ford*

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing document with the Court's CM/ECF system on April 14, 2020. I certify that all parties and counsel of record in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system.

Dated: April 14, 2020
New York, NY

/s/ Mark S. Grube