

## A TRANSACTION COST ASSESSMENT OF SEC REGULATION BEST INTEREST

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*The U.S. Securities and Exchange Commission (“SEC”) is required to provide an economic analysis of proposed regulations and to show they plausibly meet a cost-benefit test. It recently proposed Regulation Best Interest (RBI) to replace the longstanding suitability rule for securities brokers when providing their retail clients with incidental investment advice. Despite a dearth of empirical support, the proposing release concludes that a best interest standard would better mitigate the conflicts of interest brokers face between providing their clients with impartial advice and inflating their own compensation. The empirical vacuum is a result of the SEC’s failure to ask the right economic question, which Nobel laureate Ronald Coase raised over half a century ago: why does the rule of liability matter? What transaction costs prevent the parties—who in this setting negotiate face-to-face—from correcting any market failure through private ordering? This essay provides a transaction cost assessment of RBI and concludes that a far more thorough economic analysis is necessary to justify imposing a best interest standard on retail brokers.*

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“[I]f [a financial regulator] finds something—a business practice of one sort or other—that he does not understand, he looks for a [conflict of interest] explanation. And as in this field [they] are very ignorant, the number of [misunderstood] practices tends to be very large, and the reliance on a [conflict of interest] explanation, frequent.”<sup>1</sup>

## I. INTRODUCTION

This essay examines the costs of transacting investment advice and the implications for U.S. financial market

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<sup>1</sup> See R.H. Coase, *Industrial Organization: A Proposal for Research*, in 3 POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION 59, 67 (Victor R. Fuchs ed., 1972) (“[I]f an economist finds something—a business practice of one sort or another—that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of [misunderstood] practices tends to be very large, and the reliance on a monopoly explanation, frequent.”).

regulation. American retail investors get professional investment advice from one of two primary sources subject to federal regulation: investment advisers and securities brokers. Advisers are fiduciaries compensated specifically for giving advice, often in the form of a periodic share of the value of client accounts.<sup>2</sup> Securities brokers, by contrast, give investment advice only incidental to executing trades on their clients' behalf, for which they receive brokerage commissions or other fees on account transactions.<sup>3</sup> Given the evanescent quality of investment advice, there can be no doubt that transacting investment advice raises myriad conflicts of interest or that opportunities abound for the parties to take advantage of one another absent basic legal protections.

Securities brokers have long been subject to the suitability rule when providing incidental advice.<sup>4</sup> The suitability rule requires brokers to be reasonably informed of their clients' financial circumstances and to have a reasonable basis to believe their recommendations are

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<sup>2</sup> Section 2(a)(11) of the Investment Advisers Act of 1940 defines an investment adviser as

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

Investment Advisers Act § 2(a)(11), 15 U.S.C. § 80b-2 (2012).

<sup>3</sup> Section 2(a)(11) excepts from the definition of investment adviser "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." *Id.*

<sup>4</sup> See FINRA, RULE 2111 (2014), [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&record\\_id=15663](http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=15663) [<https://perma.cc/XM6J-4QRE>].

appropriate under the circumstances, with potential civil liability for failure to do so.<sup>5</sup>

The suitability rule has recently come under multiple attacks from federal regulators charged with protecting American investors. In 2011, the SEC published a study recommending that brokers be held to the same fiduciary standard as advisers,<sup>6</sup> but it took no immediate action. Until the Fifth Circuit Court of Appeals vacated it in March 2018,<sup>7</sup> the U.S. Department of Labor (“DOL”)’s Fiduciary Rule sought to extend investment advisers’ fiduciary duty to securities brokers when they provide incidental investment advice for their clients’ retirement accounts.<sup>8</sup> The U.S. Securities and Exchange Commission (“SEC”) now proposes Regulation Best Interest (RBI), which, if implemented, would hold brokers to a strict “best interest” standard—seemingly identical to a fiduciary duty—when providing incidental investment advice covering any client account.<sup>9</sup>

The best interest standard is aimed at preventing retail brokers from recommending securities to inflate their own compensation at their clients’ expense. Proposed RBI states that a broker must “act in the best interest of the retail customer at the time the recommendation is made without placing [its] financial or other interest . . . ahead of the interest of the retail customer.”<sup>10</sup> Among other things, the broker must exercise reasonable care, fully disclose all material conflicts of interest, and establish written policies

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<sup>5</sup> See, e.g., F. Harris Nichols, *The Broker’s Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435 (1977).

<sup>6</sup> SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011) [hereinafter 2011 STUDY].

<sup>7</sup> Chamber of Commerce of the U.S. v. Dep’t of Labor, 885 F.3d 360 (5th Cir. 2018).

<sup>8</sup> Dep’t of Labor Fiduciary Rule, 29 C.F.R. § 2510.3-21(a)(1) (2017) [hereinafter Fiduciary Rule].

<sup>9</sup> Regulation Best Interest, 83 Fed. Reg. 21,574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240). The public comment period for RBI closed on August 7, 2018. *Id.*

<sup>10</sup> *Id.* at 21,598.

and procedures reasonably designed to identify and disclose or entirely eliminate these conflicts.<sup>11</sup> As with the suitability rule, a breach could subject them to civil liability to aggrieved parties<sup>12</sup> and to Financial Industry Regulatory Authority (“FINRA”) and SEC enforcement actions carrying significant sanctions.<sup>13</sup>

Whether RBI is economically justified is the central question of this essay. As originally written, the U.S. Securities and Exchange Act authorized the SEC to regulate financial markets as “necessary or appropriate in the public interest or for the protection of investors.”<sup>14</sup> In addition, it must now also consider whether a proposed rule will promote “efficiency, competition, and capital formation.”<sup>15</sup> Federal circuit court case law<sup>16</sup> and the SEC’s own internal pronouncements have interpreted this language to require the SEC to perform an economic analysis of proposed rules and to quantify costs and benefits to the extent feasible.<sup>17</sup>

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<sup>11</sup> *Id.* at 21,598–625.

<sup>12</sup> *See* Fox v. LifeMark Sec. Corp., 84 F. Supp. 3d 239, 244 (W.D.N.Y. 2015); Kathy Connelly, Note, *The Suitability Rule: Should a Private Right of Action Exist?*, 55 ST. JOHN’S L. REV. 493, 504–06 (1981).

<sup>13</sup> *See* Regulation Best Interest, 83 Fed. Reg. at 21,577 n.16. *See also* Press Release, FINRA, FINRA Sanctions Fifth Third Securities, Inc., \$6 Million for Cost and Fee Disclosure Failures and Unsuitable Recommendations Related to Variable Annuity Exchanges (May 8, 2018), <http://www.finra.org/newsroom/2018/finra-sanctions-fifth-third-securities-6-million-va-exchange-violations> [<https://perma.cc/S4CN-QYJF>]; Press Release, SEC, Morgan Stanley Settles Charges Related to ETF Investments (Feb. 14, 2017), <https://www.sec.gov/news/pressrelease/2017-46.html> [<https://perma.cc/6TZB-8A2R>].

<sup>14</sup> 15 U.S.C. § 78c(a)(27) (2012).

<sup>15</sup> 15 U.S.C. § 77b(b) (2012); 15 U.S.C. § 78c(f) (2012).

<sup>16</sup> *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 178 (D.C. Cir. 2010); Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005).

<sup>17</sup> *See* Memorandum from SEC Div. of Risk, Strategy, & Fin. Innovation and SEC Office of the Gen. Counsel to Staff of the Rulewriting Divisions and Offices, Current Guidance on Economic Analysis in SEC Rulemakings 10 (2012) [hereinafter Current Guidance],

Quantified cost-benefit analysis (“CBA”) is notoriously difficult to do,<sup>18</sup> but both executive branch and independent agencies are required to perform some plausible assessment of costs and benefits when proposing new rules. In *Michigan v. Environmental Protection Agency*,<sup>19</sup> the U.S. Supreme Court recently found that the Environmental Protection Agency (“EPA”) must consider both costs and benefits in regulating under the Clean Air Act’s “appropriate and necessary” standard,<sup>20</sup> and that failure to do so rendered the rule arbitrary and capricious under the Administrative Procedure Act (“APA”). As the Court put it,

[T]he phrase ‘appropriate and necessary’ requires at least some attention to cost. One would not say that it is even rational, never mind ‘appropriate,’ to impose billions of dollars in economic costs in return for a few dollars in health or environmental benefits . . . . No regulation is ‘appropriate’ if it does significantly more harm than good.<sup>21</sup>

Other federal statutes contain the same enabling language.<sup>22</sup>

Going at least as far back as the writings of A.C. Pigou almost a century ago,<sup>23</sup> mainstream economists and policy commentators have widely asserted that government regulation is justified when markets fail to efficiently allocate resources owing to so-called “externalities”—

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[http://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf) [<https://perma.cc/32GB-DAKR>].

<sup>18</sup> Wendy L. Gramm, *Regulatory Review Issues, October 1985–February 1988*, 63 ADMIN. L. REV. 27, 33 (2011); Cass R. Sunstein, *Financial Regulation and Cost-Benefit Analysis*, 124 YALE L.J.F. 263, 264–65 (2015); see also John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUD. S351 (2014); Eric A. Posner & E. Glen Weyl, *Cost-Benefit Analysis of Financial Regulations: A Response to Criticisms*, 124 YALE L.J.F. 246 (2015).

<sup>19</sup> 135 S. Ct. 2699 (2015).

<sup>20</sup> 42 U.S.C. § 7412(n)(1)(A) (2012).

<sup>21</sup> *Michigan*, 135 S. Ct. at 2707.

<sup>22</sup> See *supra* notes 14–17 and accompanying text.

<sup>23</sup> See A.C. PIGOU, *THE ECONOMICS OF WELFARE* (1920).

situations in which one party takes an action that imposes costs or bestows benefits on another party—but fails to account for them in choosing the activity level.<sup>24</sup> As a result, self-interest will lead to too much or too little of the activity, leading to socially inefficient resource allocation. Following Pigou, the general belief is that a regulation correcting a market failure will improve resource allocation and generate benefits in excess of its costs, hence the use of CBA as a metric for social welfare.

In his path-breaking work *The Problem of Social Cost*,<sup>25</sup> Nobel laureate Ronald Coase turned this belief on its head. He showed that any threat of inefficient resource allocation creates an opportunity for market participants to gain by internalizing the externality through private transactions. If transaction costs were zero, the parties would naturally negotiate for the socially optimal activity level in their own self-interest because doing so would increase their joint gains from trade. The regulatory rule—e.g., suitability versus best interest—would have no effect on resource allocation or the parties' joint welfare, and therefore government regulation would be unnecessary.<sup>26</sup>

Transaction costs are never zero, and, in any event, they increase with the number, size, and complexity of transactions, eventually overwhelming the benefits from negotiating further adjustments. Some inefficiency will persist in the form of resource misallocation, which by definition is a state of affairs in which, at the margin, benefits fall short of costs or vice-versa. Potential gains from trade are lost, but only because the transaction costs the

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<sup>24</sup> The activity level might be the amount of trading a broker does for a client's account over which the broker has trading discretion, or the amount of research a broker does as a basis for recommending trades to a client who directs his or her own account.

<sup>25</sup> See generally R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43–44 (1960). This is arguably the most influential article ever published in economics based on citation count. See William M. Landes & Sonia Lahr-Pastor, *Measuring Coase's Influence*, 54 J.L. & ECON. 383, 383 (2011).

<sup>26</sup> Although the parties' joint wealth would be at a maximum, the distribution of wealth between them is indeterminate.

parties must incur to capture them outweigh the benefits. For a given regulatory framework, the parties will negotiate what they privately perceive as efficient resource allocation with due consideration for the costs of transacting. The outcome is an equilibrium in the sense that neither party has any incentive to negotiate further adjustments given the transaction costs they face.

The main Coasean point, often misunderstood, is that the costs of transacting can be operationalized to explain why the rule of liability indeed affects resource allocation and why one rule of liability might therefore be better than another. Rather than asking whether the overall benefits of a proposed rule will exceed the overall costs, in a Coasean framework the proper question is simply whether, at the margin, the proposed regulation is likely to reduce the parties' costs of transacting. If so, they can be counted on to make all efficient adjustments to the new rule based on their knowledge of the particular circumstances of time and place. This knowledge is fleeting, circumstantial, and inherently unavailable to outside observers because it requires them to identify a counterfactual. This is one reason why quantified CBA of proposed regulation is so difficult.<sup>27</sup>

To the extent that regulators can identify the relevant transaction costs and reduce them through regulatory rules, market participants will move toward optimal resource allocation through private ordering. This is not to say that private markets solve all problems or that government regulation is incapable of improving resource allocation. Where economic analysis is required and the parties deal directly, it simply means that regulation is justified only if,

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<sup>27</sup> See JAMES M. BUCHANAN, *COST AND CHOICE: AN INQUIRY IN ECONOMIC THEORY* (1969); F.A. Hayek, *The Use of Knowledge in Society*, 35 *AM. ECON. REV.* 519 (1945). Cass Sunstein, former Administrator of the Office of Information and Regulatory Affairs, acknowledges that financial regulators are plagued by the Hayekian knowledge problem, which is that the information necessary to formulate rational regulations is dispersed across many members of society. In some cases, "Knightian uncertainty" will make it impossible for them to perform reliable CBA. Sunstein, *supra* note 18, at 264–65.



and to the extent that, it reduces the parties' transaction costs. It is insufficient to identify problems that need correcting (including conflicts of interest) without credibly making this showing. Only then can the "problem" be properly characterized as a market failure requiring a corrective rule.

As Coase stated in his Nobel address, "What I think will be considered in the future to have been the important contribution of this article is the explicit introduction of transaction costs into economic analysis."<sup>28</sup> Three generations of scholars have developed Coase's insights into the field now known as transaction cost economics ("TCE").<sup>29</sup> Transaction costs can and have been used to predict the likely competitive effects of a change in the rule of liability on evolved patterns of economic organization, such as those found in the financial services industry.<sup>30</sup> Indeed, TCE has

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<sup>28</sup> Douglas W. Allen, *Transaction Costs*, in 1 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE HISTORY AND METHODOLOGY OF LAW AND ECONOMICS 896 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

<sup>29</sup> Nobel laureate Oliver Williamson probably coined the term "transaction cost economics" and was a leading member of a group of economists that revolutionized antitrust scholarship, and ultimately the law itself, by carefully applying transaction cost economics to various business practices, most successfully to vertical business arrangements. See, e.g., Robert Dahlstrom & Arne Nygaard, *The 2009 Nobel Prize in Economics to Oliver E. Williamson: Recognition of the Influence of Transaction Cost Economics on Business Research*, 86 J. RETAILING 209 (2010).

<sup>30</sup> For work on financial markets, see, e.g., Stephen A. Berkowitz, Dennis E. Logue & Eugene A. Noser, Jr., *The Total Cost of Transactions on the NYSE*, 43 J. FIN. 97 (1988); Harold Demsetz, *The Cost of Transacting*, 82 Q.J. ECON. 33 (1968); Kenneth D. Garbade & William L. Silber, *Best Execution in Securities Markets: An Application of Signaling and Agency Theory*, 37 J. FIN. 493 (1982); D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage*, 11 YALE J. ON REG. 75 (1994); D. Bruce Johnsen, *The Quasi-Rent Structure of Corporate Enterprise: A Transaction Cost Theory*, 44 EMORY L.J. 1277 (1995). For more general foundational work, see, for example, Armen A. Alchian, *Why Money?*, 9 J. MONEY, CREDIT & BANKING 133 (1977); Yoram Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J.L. & ECON. 291 (1977); Steven N.S. Cheung, *Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements*, 12 J.L. & ECON. 23 (1969); R.

revolutionized antitrust law.<sup>31</sup> Where federal courts once routinely condemned vertical arrangements such as exclusive retailer territories, exclusive product dealing, resale price maintenance, price discrimination, customer loyalty programs, and others, they now often embrace them as efficient methods of reducing conflicts of interest between product or service providers and their independent retailers to the benefit of consumers.<sup>32</sup> The attendant body of theoretical and empirical scholarship and antitrust case law provides a rich archive to help the SEC better address conflicts of interest in the provision of investment advice and throughout the financial services industry.

This essay assesses RBI by identifying the nature of the transaction costs retail securities brokers and their clients

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H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *J. POL. ECON.* 615 (1981); F.H. Knight, *Some Fallacies in the Interpretation of Social Cost*, 38 *Q.J. ECON.* 582 (1924). For more recent work, see, for example, Douglas W. Allen & Dean Lueck, *Transaction Costs and the Design of Cropshare Contracts*, 24 *RAND J. ECON.* 78 (1993); D. Bruce Johnsen, *The Formation and Protection of Property Rights Among the Southern Kwakiutl Indians*, 15 *J. LEGAL STUD.* 41 (1986); Gary D. Libecap & Dean Lueck, *The Demarcation of Land and the Role of Coordinating Property Institutions*, 119 *J. POL. ECON.* 426 (2011); Scott E. Masten & Keith J. Crocker, *Efficient Adaptation in Long-Term Contracts: Take-or-Pay Provisions for Natural Gas*, 75 *AM. ECON. REV.* 1083 (1985); Scott E. Masten, James W. Meehan, Jr. & Edward A. Snyder, *The Costs of Organization*, 7 *J.L. ECON. & ORG.* 1 (1991); Scott E. Masten, James W. Meehan, Jr. & Edward A. Snyder, *Vertical Integration in the U.S. Auto Industry: A Note on the Influence of Transaction Specific Assets*, 12 *J. ECON. BEHAV. & ORG.* 265 (1989).

<sup>31</sup> For early influential work in antitrust, see Lee Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 *J.L. & ECON.* 337 (1972); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297 (1978); Klein & Leffler, *supra* note 30; Howard P. Marvel, *Exclusive Dealing*, 25 *J.L. & ECON.* 1 (1982); Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 *J.L. & ECON.* 86 (1960).

<sup>32</sup> See, e.g., *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

face in transacting investment advice. It has six parts. Part II provides a brief history of CBA in federal regulation. It explains the SEC's statutory mandate to perform CBA of proposed rules and then reviews three landmark decisions from the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") rejecting the SEC's CBA as "arbitrary and capricious" under the APA.<sup>33</sup> Part III describes the assault by the SEC and the DOL on the traditional suitability rule for retail brokers, culminating in RBI. Part IV provides a basic economic overview of the neoclassical model of exchange, the foundation for traditional CBA. It reviews the standard economic rationale for government regulation based on so-called externalities that are said to cause the market to fail and takes a more careful look at market failure by accounting for the costs of transacting. Where traditional CBA is inconclusive and the parties' costs of transacting are modest, the regulator should assess the proposed rule's likely effect on the parties' costs of transacting. The rule is justified only if transaction costs are likely to fall.<sup>34</sup> Part V examines the RBI proposing release and explains the SEC's economic rationale for the best interest standard. A preliminary transaction cost assessment shows that its CBA provides insufficient analytical or empirical justification for the best interest standard. Far more work building and testing a transaction cost model of the market for retail brokerage is necessary before a compelling case can be made that a change in the rule of liability will improve investor welfare in a way that properly considers efficiency, competition, and capital formation. This conclusion is all the more forceful owing to the uncertainty such a dramatic change would entail. Part VI provides a summary and concluding remarks.

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<sup>33</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010); *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005).

<sup>34</sup> To be more precise, a rule is justified if it reduces the discounted present value of transaction costs by more than the up-front costs of implementing it.

## II. OVERVIEW OF COST-BENEFIT ANALYSIS OF FINANCIAL REGULATION

### A. Brief History of Cost-Benefit Analysis

In 1980, President Carter signed the Paperwork Reduction Act into law.<sup>35</sup> This statute created the Office of Information and Regulatory Affairs (“OIRA”) to “review and approve agency collections of information, including those related to regulations.”<sup>36</sup> Shortly thereafter, President Reagan put teeth into regulatory oversight with his Executive Order 12,291 mandating that executive agencies perform CBA of proposed rules.<sup>37</sup> In relevant part, section 2 of the Executive Order states:

(a) Administrative decisions shall be based on adequate information concerning the need for and consequences of proposed government action;

(b) Regulatory action shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society;

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(e) Agencies shall set regulatory priorities with the aim of *maximizing the aggregate net benefits to society*, taking into account the condition of the particular industries affected by regulations, the

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<sup>35</sup> 44 U.S.C. §§ 3501–21 (2012).

<sup>36</sup> Susan E. Dudley, *Observations on OIRA’s Thirtieth Anniversary*, 63 ADMIN. L. REV. 113, 114 (2011); see also Gramm, *supra* note 18, at 28; Jim Tozzi, *OIRA’s Formative Years: The Historical Record of Centralized Regulatory Review Preceding OIRA’s Founding*, 63 ADMIN. L. REV. 37, 55 (2011).

<sup>37</sup> Exec. Order No. 12,291, 46 Fed. Reg. 13,193 (Feb. 17, 1981). Subsection (1)(d) reads as follows: “‘Agency’ means any authority of the United States that is an ‘agency’ under 44 U.S.C. 3502(1), excluding those agencies specified in 44 U.S.C. 3502(10).” Note that amendments have since moved the definition of “agency” to 44 U.S.C. § 3502(5). This definition refers to “independent agencies” and specifically lists the SEC among them. 44 U.S.C. § 3502(5).

condition of the national economy, and other regulatory actions contemplated for the future.<sup>38</sup>

The Executive Order makes the Office of Management and Budget (OMB) responsible for assessing regulations to ensure they plausibly maximize aggregate net benefits to society. It requires regulatory impact analysis (RIA) of “major rules”<sup>39</sup> and requires the Director of OMB to “[m]onitor agency compliance with the requirements of this Order and advise the President with respect to such compliance.”<sup>40</sup>

In 1993, President Clinton’s Executive Order 12,866 replaced Executive Order 12,291.<sup>41</sup> It maintains the substantive cost-benefit provisions but adds others and recognizes OIRA as the authority for oversight and review of agency CBA.<sup>42</sup> Notably, it frames the call for regulation in the language of market failure. The preamble and section 1 to Executive Order 12,866 provides the following seemingly sensible foundation for justifying federal regulation:

[T]he private sector and private markets are the best engine for economic growth . . . . Federal agencies should promulgate only such regulations as . . . are made necessary by compelling public need, such as *material failures of private markets* to protect . . . the well-being of the American people.<sup>43</sup>

Section 1(b)(7) of the Order also advises federal agencies to “base [their] decisions on the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation.”<sup>44</sup>

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<sup>38</sup> Exec. Order No. 12,291, 46 Fed. Reg. at 13,193–94 (emphasis added).

<sup>39</sup> *Id.* at 13,194.

<sup>40</sup> *Id.* at 13,196.

<sup>41</sup> Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993).

<sup>42</sup> *Id.* § 6(b).

<sup>43</sup> *Id.* at 51,735 (emphasis added).

<sup>44</sup> *Id.* at 51,736.

Executive Order 12,866 remains in effect today, but in January 2011 President Obama reinforced it with Executive Order 13,563, requiring, among other things, executive agencies to allow internet submission of public comments, to provide for greater coordination with other agencies, to ensure scientific integrity, and to further provide for retrospective analysis of existing rules.<sup>45</sup> Although independent agencies such as the SEC are exempt from these orders, Executive Order 13,579 provides that they should comply with its provisions to the extent permitted by law.<sup>46</sup> At the very least, the executive orders outline best practices for all federal agency rulemaking.

## B. Cost-Benefit Analysis at the SEC

### 1. Statutory and Case Law

In 1996, Congress passed the National Securities Market Improvement Act (“NSMIA”) adding the following language to the Securities Act of 1933, Securities Exchange Act of 1934 (“SEA”), and the Investment Company Act of 1940 (“ICA”):

(b) Consideration of Promotion of Efficiency, Competition, and Capital Formation.—Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>47</sup>

Beginning in 2005, three cases from the D.C. Circuit found that the efficiency-competition-capital formation language

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<sup>45</sup> Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011).

<sup>46</sup> Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011).

<sup>47</sup> Pub. L. No. 104-290, § 106(b), 110 Stat. 3416, 3424 (1996) (codified as amended at 15 U.S.C. § 77b(b) (2012), 15 U.S.C. § 78c(f) (2012), and 15 U.S.C. § 80a-2(c) (2012)).

requires the SEC to perform CBA of all proposed rules, and in each case it found the SEC's CBA deficient.

In *Chamber of Commerce v. SEC*,<sup>48</sup> the Chamber sought review of the SEC's Investment Company Governance Rule ("Governance Rule").<sup>49</sup> Over the dissent of two commissioners, the Governance Rule would have conditioned various exemptions most mutual funds enjoy from provisions of the ICA on having boards with at least seventy-five percent outside directors and an independent chairman.<sup>50</sup>

The SEC considered the rule "necessary and appropriate in the public interest and . . . consistent with the protection of investors"<sup>51</sup> owing to recent scandals involving late trading of mutual fund shares, inappropriate market timing of fund shares, and misuse of nonpublic information about fund portfolios.<sup>52</sup> It viewed these actions as serious breakdowns in internal advisory firm controls and evidence that the funds were being used for the benefit of the advisory firm or its employees, possibly including inside directors of the affected funds, rather than for the benefit of fund shareholders.<sup>53</sup> In the SEC's view, the proposed fund governance standards would put fund boards in a better position to demand that their managers adhere to the highest of compliance

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<sup>48</sup> *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). The SEA, the ICA, and Investment Advisers Act ("IAA") all allow persons aggrieved by a final order of the Commission to obtain review of the order in the United States Court of Appeals for the circuit in which he or she resides or has his or her principal place of business or in the District of Columbia Circuit. See 15 U.S.C. § 78y(a)(1) (2012); 15 U.S.C. § 80a-42(a) (2012); 15 U.S.C. § 80b-13(a) (2012).

<sup>49</sup> Investment Company Governance, 69 Fed. Reg. 46,378 (Aug. 2, 2004) [hereinafter Governance Rule].

<sup>50</sup> *Id.* at 46,381. The ICA mandates that mutual funds have no more than sixty percent "interested" directors. See 15 U.S.C. § 80a-10(a). By ICA Rule 12(b)-1, the SEC had already conditioned various exemptions on a mutual fund having a majority of outside directors. See 66 Fed. Reg. 3733 (Jan. 16, 2001) (to be codified at 17 CFR pts. 239, 240, 270, 274).

<sup>51</sup> Governance Rule, 69 Fed. Reg. at 46,379 n.11.

<sup>52</sup> *Id.* at 46,378.

<sup>53</sup> *Id.* at 46,379.

standards and to better oversee activities involving conflicts of interest.<sup>54</sup>

The Chamber challenged the Governance Rule on two grounds. Among other things, it argued that the SEC lacked substantive authority under the ICA to adopt the two conditions and that the SEC's rulemaking process violated the APA.<sup>55</sup> The court found that the SEC does have the substantive authority to condition access to various exemptions on compliance with the Governance Rule.<sup>56</sup> It took issue with the SEC on an important point, however. The court found that the SEC had failed to adequately consider the costs of the conditions it proposed and hence their likely effect on efficiency, competition, and capital formation.<sup>57</sup> Although an empirical study is unnecessary, a regulator must nevertheless do its best to assess costs. The SEC claimed the factual record on which it had based its ruling lacked a "reliable basis for determining how funds would choose to satisfy the condition and therefore it was difficult to determine the costs associated with electing independent directors."<sup>58</sup> The court was unmoved:

That particular difficulty may mean the Commission can determine only the range within which a fund's cost of compliance will fall, depending upon how it responds to the condition but, as the Chamber contends, it does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule it has proposed

. . . .

[U]ncertainty may limit what the Commission can do, but does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the

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<sup>54</sup> *Id.*

<sup>55</sup> 5 U.S.C. § 500 (2012).

<sup>56</sup> *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005).

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 143 (internal quotations omitted) (citations omitted).



economic consequences of a proposed regulation before it decides whether to adopt the measure.<sup>59</sup>

Accordingly, the court held that the SEC had violated its obligation under the ICA, and therefore the APA, by failing to adequately consider the costs the two challenged conditions imposed on mutual funds.<sup>60</sup>

The petitioner in *American Equity v. SEC*, American Equity Investment Life Insurance Company, sought the D.C. Circuit's review of the SEC's proposed Rule 151A under the SEA.<sup>61</sup> According to the Rule, fixed index annuity contracts would not qualify for the Act's registration exemption for "annuity contracts" because they include certain elements of risk characteristic of a security, rather than those of a mere insurance contract.<sup>62</sup> Absent this exemption, as an issuer of securities American Equity was therefore subject to the Act's registration and reporting requirements.

The court rejected American Equity's claim that the SEC had exceeded its authority in excluding fixed index annuities from the annuity contract exemption but agreed with its claim that the SEC had failed to properly consider the Rule's effect on efficiency, competition, and capital formation.<sup>63</sup> The thrust of the SEC's rationale for the Rule was that the absence of a clear rule identifying the regulatory status of fixed index annuities injected sufficient uncertainty into the market that efficiency, competition, and capital formation

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<sup>59</sup> *Id.* at 143–44.

<sup>60</sup> *Id.* at 144. The aftermath of *Chamber of Commerce* is worth recounting. When the Court sent the matter back to the SEC, the SEC had only eight days to reconsider the effect of the rule on costs before Chairman Donaldson's term would expire. Having no time to add to the record, it relied on the existing record to reaffirm the rule. The Chamber of Commerce again sought review. Since the SEC had already admitted that the existing record was inadequate to assess costs, the D.C. Circuit once again found it had violated the APA and sent the case back for further consideration based on an enhanced record. *See Chamber of Commerce of the U.S. v. SEC*, 443 F. 3d 890 (D.C. Cir. 2006).

<sup>61</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010).

<sup>62</sup> *Id.* at 173.

<sup>63</sup> *Id.* at 167, 177.

were undermined.<sup>64</sup> In the court's opinion, however, it was not enough for the SEC simply to declare that *some* rule is necessary.<sup>65</sup> It must first establish a pre-rule baseline for assessing efficiency, competition, and capital formation in the market for fixed index annuities and then identify the relative merits of the proposed rule in comparison to the alternative.<sup>66</sup> It had not done so. The court explained:

Section 2(b) does not ask for an analysis of whether *any* rule would have an effect on competition. Rather, it asks for an analysis of whether the specific rule will promote efficiency, competition, and capital formation. The SEC's reasoning with respect to competition supports at most the conclusion that any SEC action in this area *could* promote competition, but does not establish Rule 151A's effect on competition.<sup>67</sup>

Accordingly, the court determined the SEC lacked a reasoned basis for imposing the specific rule it had chosen and was therefore arbitrary and capricious in violation of the APA.<sup>68</sup>

Most recently, in *Business Roundtable v. SEC*,<sup>69</sup> the D.C. Circuit vacated SEA Rule 14a-11, known as the Proxy Access Rule.<sup>70</sup> With modest limitations, the Proxy Access Rule would have required any company subject to the SEA, including investment companies, to add to their proxy materials the name of anyone nominated for a directors seat by a shareholder who had held at least three percent of the firm's voting stock for at least three years.<sup>71</sup> The effect of the rule would have been to allow qualified dissident

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<sup>64</sup> *Id.* at 177.

<sup>65</sup> *Id.* at 178.

<sup>66</sup> *Id.* at 178–80.

<sup>67</sup> *Id.* at 178 (internal citations omitted) (emphasis added).

<sup>68</sup> *Id.* at 177.

<sup>69</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

<sup>70</sup> Proxy Access Rule: Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010).

<sup>71</sup> *Id.* at 56,674–75.

shareholders partial control over the ballot to elect the company's board of directors.

The SEC reasoned that the rule could create “potential benefits of improved board and company performance and shareholder value [that] justify [its] potential costs.”<sup>72</sup> Over the dissent of two commissioners, it had rejected proposals to allow each company to choose whether to adopt and disclose the same requirements, arguing that “exclusive reliance on private ordering under State law would not be as effective and efficient” in helping shareholders exercise their control rights.<sup>73</sup> It had also rejected a proposal to exclude investment companies from the rule, which were already subject to statutory safeguards under the ICA.<sup>74</sup> Even though the SEC acknowledged the Rule might have adverse effects on corporations and their boards in terms of distraction from long-term strategic planning, it reasoned that established state law proxy rules, and not the Rule's enhanced proxy access, are the underlying cause of any adverse effects on corporate boards.<sup>75</sup>

The Court disagreed and found the rule arbitrary and capricious in violation of the APA. Among other things, it faulted the SEC for declaring the costs of board distraction from enhanced proxy access to be merely an incident of traditional state law proxy contest rules.<sup>76</sup> Citing to *Chamber of Commerce*, the Court reiterated: “As we have said before, this type of reasoning, which fails to view a cost *at the margin*, is illogical and, in an economic analysis, unacceptable.”<sup>77</sup>

## 2. The SEC's Current Guidance Memo

With three consecutive losses in the D.C. Circuit, the SEC must have resolved to take economic analysis in the

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<sup>72</sup> *Id.* at 56,761.

<sup>73</sup> *Id.* at 56,759–60.

<sup>74</sup> *Bus. Roundtable*, 647 F.3d at 1154.

<sup>75</sup> *Id.* at 1155–56.

<sup>76</sup> *Id.* at 1154 (emphasis added).

<sup>77</sup> *Id.* at 1151, 1154 (emphasis added).

rulemaking process more seriously. In March 2012, it published an internal memo titled, “Current Guidance on Economic Analysis in SEC Rulemakings” (“Current Guidance”),<sup>78</sup> which the then-Division of Risk, Strategy, and Financial Innovation (“RSFI”) and the Office of the General Counsel jointly authored. The memo is conceptually clear and appears to reflect an honest commitment to integrating economic analysis into the rulemaking process. As one commentator put it, “The 2012 Guidance has in effect amended the micro-constitution of the SEC staff, elevating the economists to the status of a co-equal branch of the agency.”<sup>79</sup> Rather than economic analysis of proposed rules being relegated to the “back-end”<sup>80</sup> of the rulemaking process, it is now included in the earliest stages, from pre-proposal to adoption.<sup>81</sup> Another commentator reports that between 2011 and 2014, the budget and staff of Ph.D. economists in RSFI (by then renamed the Division of Economics and Risk Analysis) more than doubled.<sup>82</sup>

The Current Guidance memo asserts that the SEC has no explicit statutory or executive duty to conduct CBA when it adopts a rule. As a matter of good regulatory practice,<sup>83</sup> however, it accepts the *Chamber of Commerce* court’s admonition that it has a “statutory obligation to determine

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<sup>78</sup> Current Guidance, *supra* note 17.

<sup>79</sup> Bruce R. Kraus, *Economists in the Room at the SEC*, 124 YALE L.J.F. 280, 302 (2015).

<sup>80</sup> See Jerry Ellig & Hester Peirce, *SEC Regulatory Analysis: “A Long Way to Go and a Short Time to Get There”*, 8 BROOK. J. CORP. FIN. & COM. L. 361, 365–66 (2014).

<sup>81</sup> Kraus, *supra* note 79, at 300.

<sup>82</sup> See Joshua T. White, *The Evolving Role of Economic Analysis in SEC Rulemaking*, 50 GA. L. REV. 293, 308–09 (2015).

<sup>83</sup> See also the 2011 statement of SEC Chairman Arthur Levitt, recognizing that there is “an expectation that the SEC would perform cost-benefit analyses as part of the rulemaking process.” OFFICE OF AUDITS, OFFICE OF INSPECTOR GEN., SEC, REPORT NO. 499, FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED DODD-FRANK RULEMAKINGS 6 (2012), [https://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499\\_followupreviewof-f\\_costbenefitanalyses\\_508.pdf](https://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewof-f_costbenefitanalyses_508.pdf) [<https://perma.cc/J2YK-4RNL>].

as best it can the economic implications” of a proposed rule.<sup>84</sup> It correctly recognizes the difficulty of doing reliable CBA of financial regulation—especially to the point of quantifying costs and benefits.<sup>85</sup> Nevertheless, it instructs SEC economists to “quantify anticipated costs and benefits” to the extent feasible, “even where the available data is imperfect.”<sup>86</sup>

Among the benefits a rule might provide, the memo lists reduced incentive misalignment, reduced monitoring costs, lower cost of capital, better information sharing resulting in lower risk premiums and better allocation of capital, enhanced competition leading to reduced prices or higher quality, the avoidance of collective action problems, the avoidance of moral hazard, reduced transaction costs, and more efficient enforcement of SEC rules.<sup>87</sup>

Drawing on principles set out in Executive Order 12,866, the memo relies largely on the notion of market failure as the justification for regulation.<sup>88</sup> It identifies collective action problems as a primary reason market participants cannot resolve market failures through private ordering, and it lists the following as examples of market failure: “market power, externalities, principal-agent problems (such as economic conflicts of interest), and asymmetric information.”<sup>89</sup> As discussed below, there is good reason to be skeptical that every perceived market failure justifies regulation, including those market failures specifically listed. The critical question in determining if a given regulation is justified by a market failure is whether the regulation ameliorates the market failure by lowering the parties’ costs of transacting.

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<sup>84</sup> Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).

<sup>85</sup> Current Guidance, *supra* note 17, at 10 (citing U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-151, DODD-FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION 19 (2011)).

<sup>86</sup> *Id.* at 13.

<sup>87</sup> *Id.* at 10–11.

<sup>88</sup> *Id.* at 4–5.

<sup>89</sup> *Id.* at 5.

### III. THE ASSAULT ON SUITABILITY

#### A. Fiduciary Status for Retail Brokers?

##### 1. The SEC's 2011 Study and DOL's Response

In January 2011, the SEC published its Study on Investment Advisers and Broker-Dealers (“2011 Study”) recommending that securities brokers be held to a fiduciary standard.<sup>90</sup> The 2011 Study relies heavily on a 2008 RAND Foundation report assessing retail investors’ knowledge of their investment accounts based on survey evidence.<sup>91</sup> The report finds that retail investors are generally unaware or confused “regarding the roles, titles, and legal obligations of investment advisers and broker-dealers, although . . . investors generally were satisfied with their financial professionals.”<sup>92</sup> The 2011 Study also finds that retail brokers suffer from material conflicts of interest that often go undisclosed to their clients and that brokers sometimes take advantage of their clients’ ignorance by recommending investments to maximize their own compensation.<sup>93</sup>

The 2011 Study offers little in the way of substantive analysis of retail investor ignorance or broker performance to justify its findings, let alone a penetrating assessment of the subtle trade-offs that are invariably at stake in any conflict of interest setting. Yet, with no empirical support, it asserts that brokerage clients “expect” their brokers to act in their best interest when giving advice.<sup>94</sup> To correct the problem of investor ignorance, and perhaps failed expectations, the 2011 Study recommends that retail brokers be held to the same fiduciary standard as investment advisers:

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<sup>90</sup> See 2011 STUDY, *supra* note 6.

<sup>91</sup> See ANGELA A. HUNG, NOREEN CLANCY, JEFF DOMINITZ, ERIC TALLEY, CLAUDE BERREBI & FARRUKH SUVANKULOV, RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER DEALERS 71 (2008).

<sup>92</sup> 2011 STUDY, *supra* note 6, at v.

<sup>93</sup> See *id.* at 101.

<sup>94</sup> *Id.* at i.

[T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.<sup>95</sup>

Although the 2011 Study provides an abstract cost assessment, it says little about the likely benefits of a fiduciary rule. It nonetheless recommends in favor of a uniform fiduciary standard without having performed an adequate CBA or any other thorough economic analysis.

Following collaboration with the SEC, the DOL moved to expand its longstanding fiduciary rule for investment managers who exercise investment discretion over clients' retirement accounts to cover the incidental investment advice that securities brokers provide their retail clients.<sup>96</sup> Soon after the DOL finalized it, the U.S. Chamber of Commerce challenged the expanded Fiduciary Rule.<sup>97</sup> In March 2018, the United States Court of Appeals for the Fifth Circuit vacated the Fiduciary Rule completely.<sup>98</sup> Securities brokers earn commissions and fees solely for buying or selling securities and provide their clients with investment advice only incidentally. Among other things, the court found that the Rule conflicts with the Employee Retirement Income Security Act of 1974 ("ERISA")'s clear statutory text,

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<sup>95</sup> *Id.* at vi.

<sup>96</sup> Fiduciary Rule, 29 C.F.R. § 2510.3-21(a)(1) (2018).

<sup>97</sup> The DOL issued the final rule on April 7, 2016. See Ilyse Schuman, Melissa Kurtzman, Steve Friedman & Sean Brown, *Department of Labor Issues Final Fiduciary Rule*, LITTLER (Apr. 7, 2016), <https://www.littler.com/publication-press/publication/department-labor-issues-final-fiduciary-rule> [<http://perma.cc/Q95D-AMQB>]. The Chamber filed in the U.S. District Court for the Northern District of Texas on June 1, 2016. See *Complaint, Chamber of Commerce of the U.S. v. Hugler*, 231 F. Supp. 3d 152 (N.D. Tex. 2017) (No. 3:16-cv-1476-M), *rev'd*, 885 F.3d 360 (5th Cir. 2018).

<sup>98</sup> *Chamber of Commerce of the U.S. v. U.S. Dep't of Labor*, 885 F.3d 360, 363 (5th Cir. 2018).

which applies only to persons who render investment advice for a fee or other compensation.<sup>99</sup> There is no evidence that the Trump administration plans to appeal or to amend the Fiduciary Rule to conform to the statute.

## B. The SEC's Regulation Best Interest

In June 2017, SEC Chairman Jay Clayton called for public comments on the 2011 Study.<sup>100</sup> Apparently based on these comments, the SEC proposed RBI in May 2018. Rather than holding retail securities brokers to the same fiduciary standard as investment advisers, RBI proposes that they be subject only to a best interest obligation. Since the 2011 Study states that the essence of a fiduciary standard for brokers is the obligation to act in their clients' best interest,<sup>101</sup> it does not appear that RBI proposes anything different than the 2011 Study.

The RBI proposing release occupies over one hundred pages in the Federal Register and addresses a broad range of issues.<sup>102</sup> It repeats the 2011 Study's conclusion that material conflicts of interest abound in the retail brokerage industry, that clients are ignorant of these conflicts and incapable of protecting themselves, and that brokers sometimes exploit their informational advantage by recommending investments that increase their own compensation while compromising their clients' investment returns.<sup>103</sup> A prominent example, and one the DOL relied on heavily to justify its expanded Fiduciary Rule,<sup>104</sup> occurs

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<sup>99</sup> *Id.* at 372.

<sup>100</sup> Jay Clayton, Chairman, SEC, Public Statement: 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> [<https://perma.cc/W8FQ-CMUR>].

<sup>101</sup> *See* Regulation Best Interest, 83 Fed. Reg. 21,574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>102</sup> *See id.* at 21,579.

<sup>103</sup> *See id.* at 21,583, 21,618.

<sup>104</sup> The Fiduciary Rule relies specifically on "variation in the share of front-end loads that advisers receive when selling different mutual funds



when a broker recommends that a client invest in mutual fund shares whose issuers pay the broker a sales fee—called a “load”—rather than one of the increasing number of funds that charge no load.<sup>105</sup> The RBI’s best interest standard would require brokers to disclose all such conflicts of interest or, if disclosure is ineffective, to eliminate them entirely by refraining from making the recommendation.<sup>106</sup>

In a subsection entitled Broad Economic Considerations, the proposing release relies on influential work by Jensen and Meckling to lay a proper economic foundation for understanding principal-agent relations such as those between securities brokers and their retail clients.<sup>107</sup> An agency relationship is one in which the principal delegates some decision-making authority to the agent to act on the principal’s behalf. The “principal” can consist of multiple parties, as with shareholders in a corporation. The parties’ interests will invariably diverge and lead to conflicts of interest, or agency problems.

Though costly, the principal will normally monitor the agent to ensure he or she avoids shirking or consuming the principal’s assets for his or her personal benefit, and the agent will attempt to bond himself against such behavior through contractual or reputational mechanisms. Together, monitoring and bonding constitute agency costs.<sup>108</sup> Because these costs will exceed any further benefits at some point,

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...” Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,951 (Apr. 8, 2016).

<sup>105</sup> With a traditional up-front load the client deposits, say, \$100 with a broker, who remits \$95 to the fund company in exchange for shares deposited to the client’s account. The broker pockets the five-dollar difference to compensate for marketing costs, as clearly set out in the fund’s prospectus.

<sup>106</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,603, 21,611.

<sup>107</sup> *Id.* at 21,629 n.371.

<sup>108</sup> It is tempting to think the principal bears the costs of monitoring and the agent bears the costs of bonding. This is not necessarily correct. Just as with the incidence of a tax, who bears the burden depends on the relative demand and supply elasticities—the ability of the parties to reduce the associated costs or to find suitable alternatives. See, e.g., N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 124 (8th ed. 2018).

the parties will stop short of first-best resource allocation and leave some potential gains from trade on the table. Jensen and Meckling refer to these forgone gains as the “residual losses.”<sup>109</sup> Residual losses are a cost only relative to a first-best world in which monitoring and bonding are costless. At the margin, it simply does not pay the parties to incur an added dollar monitoring or bonding if doing so reduces residual losses by less than a dollar. In this sense, the parties are content with second-best resource allocation.

#### IV. BASIC ECONOMICS

This Part reviews the basic economics of regulation, including a brief look at the neoclassical model on which CBA rests. Its focus is on describing what CBA attempts to measure, and it abstracts from thorny issues involving risk, the value of life,<sup>110</sup> and various moral conundrums. It then discusses market failure as the justification for corrective regulation and takes a closer look at market failure to account for the costs of transacting.

##### A. Assessing Welfare in the Basic Neoclassical Model<sup>111</sup>

The neoclassical model of market exchange provides the theoretical foundation for traditional CBA. It illustrates the welfare effects of trade embedded in market demand and supply assuming, among other things, that individuals and firms are rational utility maximizers, that no buyer or seller has market power, that all economic actors bear the full costs of their decisions and capture the full benefits, that all

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<sup>109</sup> Jensen & Meckling, *supra* note 30, at 308.

<sup>110</sup> See, e.g., W. Kip Viscusi & Joseph E. Aldy, *The Value of a Statistical Life: A Critical Review of Market Estimates Throughout the World*, 27 J. RISK & UNCERTAINTY 5 (2003).

<sup>111</sup> The reader in need of a more elaborate description of the Neoclassical Model can consult any intermediate price theory text. See, e.g., ARMEN A. ALCHIAN, WILLIAM R. ALLEN, *EXCHANGE & PRODUCTION: COMPETITION, COORDINATION & CONTROL* (3d ed. 1983); N. GREGORY MANKIW, *PRINCIPLES OF ECONOMICS* (8th ed. 2018).

parties have full information, and that the interacting parties face zero transaction costs. In equilibrium, the model hypothesizes that market prices will reflect marginal benefits and costs, and that the parties will capture all potential gains from trade in the form of consumer and producer surplus, or social welfare. With costless transacting, the allocation of resources is said to be socially optimal, or “first best.”

These assumptions provide a foundation for explaining how individuals and firms make decisions and are not an attempt to accurately characterize reality. All that matters is that the assumptions lead to testable predictions consistent with real-world observation. Whether or not people make cognitively rational decisions is irrelevant. The important question is whether they behave *as if* they are cognitively rational and fully informed.<sup>112</sup> Transaction cost economics has shown many times that behavior seemingly consistent with the neoclassical model can be easily explained by relaxing its assumptions to accommodate the costs of transacting.

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<sup>112</sup> See Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 3, 40–41 (1953). In a competitive market, firms that happen to zig when they should zag will be eliminated from the system. Those remaining will appear to have chosen correctly even if their managers lacked the wherewithal to make an intelligent choice. See Armen E. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 *J. POL. ECON.* 211, 220–21 (1950).

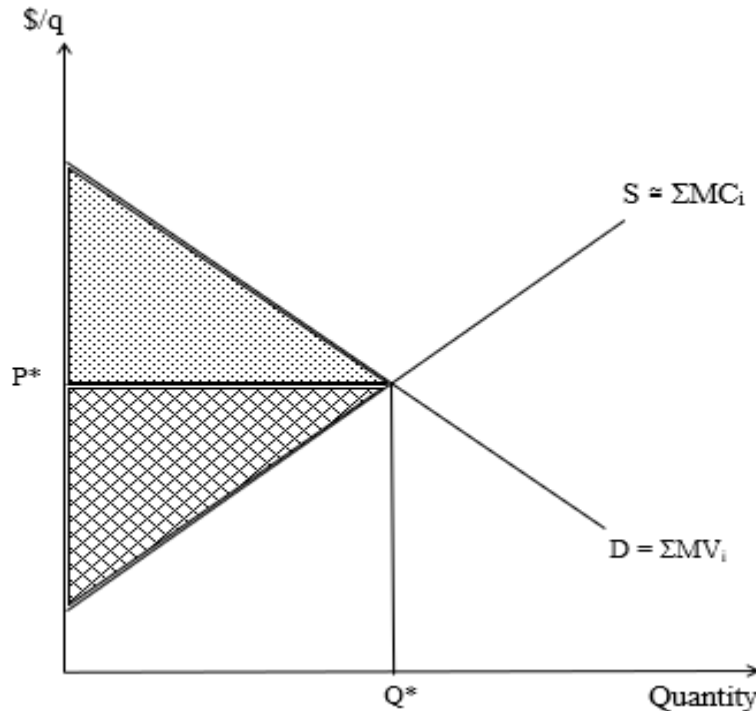
**Figure 1: Social Welfare**

Figure 1 shows the unit rate of output for a traded good,  $Q$ , on the horizontal axis and the price in dollars per unit,  $P$ , on the vertical axis. Line  $D$  shows consumer demand for the good, which is synonymous with aggregate marginal valuation ( $\sum MV_i$ ) across  $i$  consumers, or social benefit, for each possible rate of output. The demand curve slopes downward to the right to reflect diminishing marginal valuation. Line  $S$  shows aggregate supply of the good across  $i$  producers, roughly reflecting their aggregate marginal cost ( $\sum MC_j$ ) for each possible quantity, with these costs equal to the value of productive inputs if deployed elsewhere. The supply curve slopes up to the right, reflecting increasing marginal cost.

In a well-functioning competitive market with no transaction costs, the equilibrium price is  $P^*$  and output is

$Q^*$ . Consumers make total expenditures equal to rectangle  $P^* \times Q^*$ . For the marginal unit of the good, consumer valuation is exactly equal to price, and consumers are indifferent to whether they buy this unit or not, so it generates no surplus—“net benefits”—at margin. Moving backward along the demand curve, consumers’ valuation of the good increasingly exceeds the price they pay. For  $Q^*$  units per period, their total valuation is represented by the large trapezoid under the demand curve between zero units and  $Q^*$  units. Subtracting their total expenditures,  $P^* \times Q^*$ , the remaining upper dotted triangle is known as consumer surplus, one component of social welfare.

A similar story can be told for producers. For  $Q^*$  units, they are indifferent to whether or not they supply the marginal unit because  $P^* = MC$  for that unit. As a result of supplying  $Q^*$  units rather than none, they earn total revenues of  $P^* \times Q^*$ , exactly what consumers spend. Their cost of supplying  $Q^*$  units is the trapezoid beneath  $MC$  from zero to  $Q^*$ . The difference is represented by the lower cross-hatched triangle.

Together, consumer and producer surplus constitute the gains from trade, total social welfare, or what Executive Order 12,291 refers to as the “aggregate net benefits to society”<sup>113</sup> from having  $Q^*$  units rather than none at all. The resulting allocation of resources is said to be pareto optimal because no reallocation can improve social welfare. Hypothetically, if output is forced below  $Q^*$ , consumers sacrifice more value than producers save. If output is forced above  $Q^*$ , producers lose more value than consumers gain.

The neoclassical model is remarkably powerful for predicting the direction of the marginal effects from an outside shock, widely known as “comparative statics.”<sup>114</sup> Obvious examples include the imposition of a new tax or a restriction on trade that shifts either the demand or supply curve and causes predictable changes in prices, rates of

<sup>113</sup> See Exec. Order No. 12,291, 46 Fed. Reg. 13,193 § 2 (Feb. 17, 1981).

<sup>114</sup> See generally EUGENE SILBERBERG & WING SUEN, *THE STRUCTURE OF ECONOMICS: A MATHEMATICAL ANALYSIS* 1–15 (3d ed. 2001).

output, and other observable reflections of the parties' behavior. More generally, the model can be used to explain how and why observed patterns of behavior vary across time or differ cross-sectionally when the constraints that market participants face change at the margin. The model is not only testable, but has been repeatedly tested and has survived testing largely intact.

The neoclassical model's reliability falls off as we move beyond comparative statics. Quantifying social welfare, or even just the marginal effect on social welfare from a given shock, is far less reliable. Economists hypothesize that the area under a demand curve up to any arbitrary rate of output reflects total consumer valuation, but getting enough data to reliably estimate a real-world demand curve is problematic. Not only is the economy a noisy place, but most of the variation we observe is in a narrow neighborhood around the equilibrium price and quantity. Among other things, accurate quantification requires the researcher to estimate how much people would pay for the first few units of a good whose normal consumption might be in the millions. The thorny scientific question is what evidence could possibly refute any specific measure of social welfare or, by implication, any cost-benefit analysis?

The same can be said on the producer side. The supply curve roughly reflects marginal costs aggregated across all producers, but (as Executive Order 12,866 recognizes) the economic definition of cost is opportunity cost—the value of the next best opportunity forgone. Opportunity costs are seldom observable in an objective way. They have only a loose relationship to out-of-pocket expenses, do not appear on balance sheets or income statements, and, in any event, reflect the value of actions not taken and therefore unobservable. Indeed, economists generally do not assert that market participants themselves know the opportunity cost of their decisions, only that they behave as if they know. Assessing opportunity cost at the margin is also troublesome because it represents the increase in total cost owing to a one-unit increase in output while holding all else equal, a normally unobservable counterfactual. What most laymen

have in mind when they think of cost is average cost—total cost divided by total output—which is much easier to observe and measure, but in many settings it is an inappropriate basis for predicting the choices people make or the relevant costs for CBA.

This is not to say quantified CBA is hopeless. Over the years, econometricians have made tremendous progress developing empirical methods to help see through the noise in the data and to disentangle the various factors that influence market outcomes. Far more complete data is now available.<sup>115</sup> With the advent of scanners that record millions of retail transactions evidencing huge variations in prices and quantities, economists have begun to make headway estimating demand and consumer surplus, possibly bringing quantified CBA within reach. One early study estimates the demand for a new breakfast cereal, putting the annual addition to consumer surplus in the range of \$66 to \$78 billion.<sup>116</sup> Another estimates the demand for Uber rides, with total benefits to U.S. consumers also in the billions of dollars.<sup>117</sup>

These are situations in which the researchers picked the subject matter based on knowledge that sufficient data were available for analysis, rather than because of the pressing need to do CBA of proposed regulation in a specific setting. In most financial settings calling for CBA of corrective rules, the necessary data are unlikely to exist and collecting them may be unfeasibly costly or time consuming.

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<sup>115</sup> See Henry G. Manne, *Economics and Financial Regulation*, 35 REGULATION 20, 22 (2012).

<sup>116</sup> Jerry A. Hausman, *Valuation of New Goods Under Perfect and Imperfect Competition*, in THE ECONOMICS OF NEW GOODS 209, 228, 234–35 (Timothy F. Bresnahan & Robert J. Gordon eds., 1997). (“The correct economic approach to the evaluation of new goods has been known for over fifty years . . . . However, it has not been implemented by government statistical agencies, perhaps because of its complications and data requirements. Data are now available.”).

<sup>117</sup> Peter Cohen, Robert Hahn, Jonathan Hall, Steven Levitt & Robert Metcalfe, *Using Big Data to Estimate Consumer Surplus: The Case of Uber 1* (Nat’l Bureau of Econ. Research, Working Paper No. 22627, 2016).

## B. Market Failure as a Basis for Corrective Rules

The neoclassical model states that people acting in their own self-interest will efficiently allocate resources only if they bear the full costs or capture the full benefits of their actions.<sup>118</sup> When some costs or benefits fall on third parties—so-called externalities—the decision maker’s resource allocation decisions could exceed or fall short of optimality, and the market is said to fail. Every undergraduate economics major learns that market failure owing to externalities justifies government regulation.

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<sup>118</sup> See *supra* Section IV.A.



Figure 2: Externalities

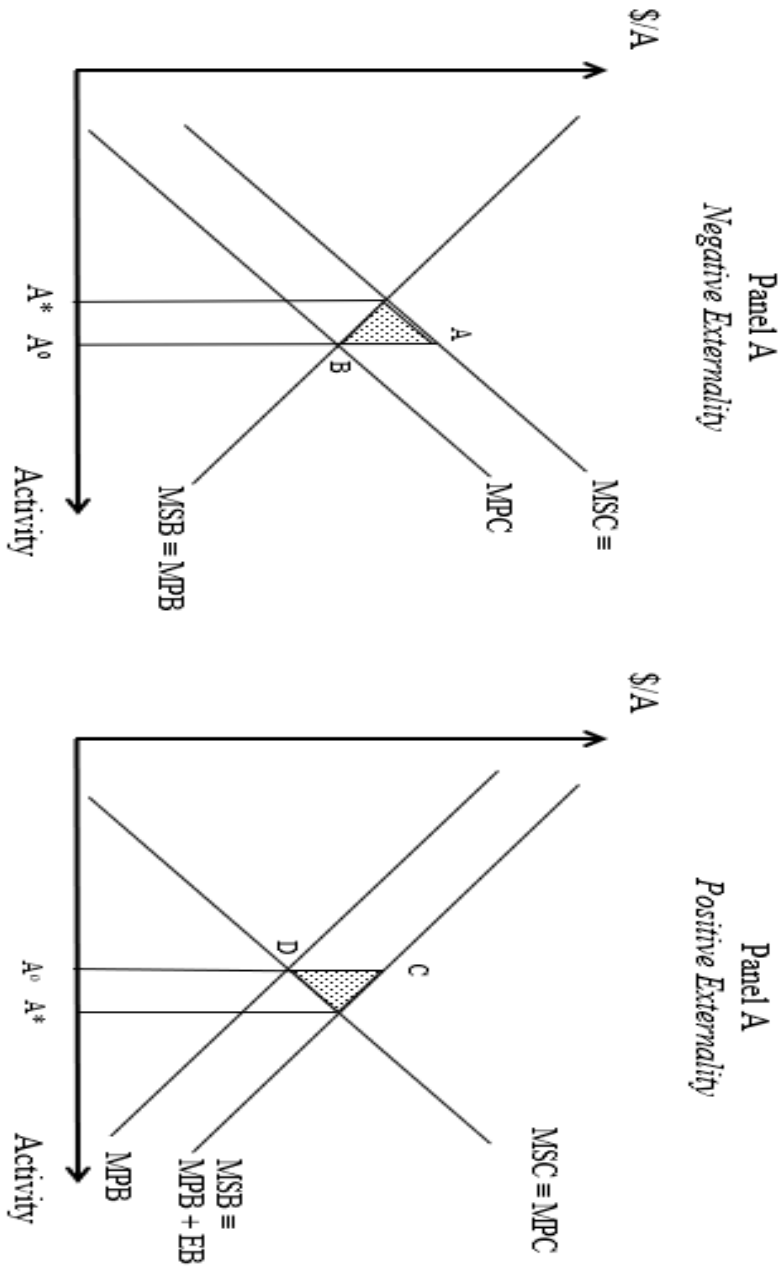


Figure 2 illustrates the accepted mechanics of how externalities lead to market failure. Panel A shows a negative externality while Panel B shows a positive externality, and in either case, the activity in question may involve a nontraded good such as driving on open-access public roads. Line MPB in Panel A reflects the marginal private benefits to a decision maker from engaging in some socially productive activity, such as driving to work during rush hour. Because the decision maker captures all relevant benefits, there are no external benefits that spill over on others; thus, marginal private benefit is identical to marginal social benefit ( $MPB \equiv MSB$ ). On the other side of the equation, the decision maker's private costs are given by MPC. Being self-interested, he or she will engage in  $A^0$  units of the activity, where  $MPB = MPC$ . According to standard welfare analysis, at  $A^0$  the decision maker does too much of the activity, neglecting to consider the marginal external costs, EC, that spill over on others in the form of traffic congestion. From society's standpoint optimality occurs at  $A^*$ , where marginal social benefits just equal marginal social costs;  $MSB = MSC \equiv MPC + EC$ . Social welfare falls short of the optimum by the shaded triangle, a deadweight loss reflecting resources use whose social value falls short of its social cost, more generally referred to as forgone gains from trade.

The mechanics of positive externalities follow much the same reasoning, shown in Panel B. Here, the decision maker equates his or her marginal private benefits with marginal private costs and ignores any external benefits that spill onto others because he or she is unable to charge a price for them. The decision maker ends up doing too little of the activity;  $\hat{A}$  falls short of  $A^*$ . The shaded triangle shows the associated loss in social welfare. A relevant example comes from the principal-agent setting.<sup>119</sup> The agent is charged with acting to increase the principal's wealth, but, although the agent bears the full costs of such actions, he or she normally receives only a small fraction of the associated benefits. The

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<sup>119</sup> Garbade & Silber, *supra* note 30, at 495–98.

decision maker therefore stops short of the activity level that maximizes the net social benefits. For example, a retail securities broker might exert too little effort identifying profitable trades for his or her client's benefit or under-search for price improvement on trades the client orders.

A simple solution to the problem of too much or too little activity is government mandates, such as limiting to  $A^*$  the number of travelers allowed to enter the roadway. A common example of a solution to negative externalities is high-occupancy vehicle ("HOV") restrictions requiring a minimum number of vehicle occupants on specific roads at peak travel times. Speed limits, in essence, are another. Examples of mandates to solve positive externalities include required vaccinations and minimum schooling requirements. Mandates can be cumbersome because they require the regulator to gather information to identify  $A^*$  and leave little discretion to market participants about how to make efficient adjustments in response.

Corrective taxes are an alternative to quantity mandates.<sup>120</sup> By forcing travelers to bear the full social cost of their travel decisions, for example, a road tax equal to  $EC$  is said to correct the market failure and restore socially optimal resource allocation while leaving people free to choose how much and when to travel. They naturally choose activity level  $A^*$  rather than  $A^o$ . Gasoline and cigarette taxes are arguable examples of corrective taxation. Where feasible, corrective taxes impose a smaller information burden on the regulator than government mandates because they allow market participants to make economizing adjustments as long as they are willing to pay the tax.

Two additional responses are available to correct market failure. One is for the government to do nothing and the other is for it to require one party to compensate the other by establishing or changing the rule of liability. These possibilities are discussed below.

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<sup>120</sup> See MANKIW, *supra* note 108, at 495–96.

### C. A Closer Look at Market Failure

Coase famously introduced the “costs of market transactions” into the market failure debate and traced the implications for the optimal rule of liability.<sup>121</sup> He used the example of a rancher’s cattle straying and trampling the neighboring farmer’s crops, a garden-variety negative externality that the common law regularly addressed under the law of nuisance, either with a liability rule or with a property rule.<sup>122</sup> Under the implausible assumption of zero transaction costs, he showed that the rule of liability would have no effect on the number of cattle the rancher raises or the extent of crop damage (resource allocation). Whether ranchers have to pay for damage to farmers’ crops or farmers have to pay ranchers to reduce their herd size, efficient resource allocation will prevail.

This irrelevance result has since come to be known as the Coase Theorem.<sup>123</sup> But Coase never touted his analysis as “the Coase Theorem,” nor did he endorse the relevance of zero transaction costs to the real world. As he lamented:

A better approach would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change and to attempt to decide whether the new situation would be, in total, better or worse than

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<sup>121</sup> See Coase, *supra* note 25. *The Problem of Social Cost* was the culmination of several of Coase’s earlier works. See generally R. H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1 (1959); Coase, *supra* note 30.

<sup>122</sup> See Coase, *supra* note 25, at 2–6. In a nutshell, a liability rule is one enforced by judicially assessed damages, while a property rule is one enforced through injunction or specific performance. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972).

<sup>123</sup> The Coase Theorem is virtually identical to the Modigliani and Miller Irrelevance Theorem (under given assumptions, a firm’s capital structure—how it is financed—will have no effect on firm value). See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). For such theorems, the explanatory power comes from relaxing the underlying assumptions.

the original one. In this way, conclusions for policy would have some relevance to the actual situation.<sup>124</sup>

In a Coasean framework, it begs the question to label one party the victim and the other the wrongdoer, or to say that one party injures or imposes external costs on another. Which parties courts deem as wrongdoers and which they deem as the victims is the outcome of a legal process influenced by the costs of transacting. Two parties simply want to use a scarce resource in mutually incompatible ways, an inevitable condition in a world of scarcity. The rancher whose cattle stray is no more economically responsible—the cause—for injury to the farmer as a result of increasing his or her herd size than the farmer is responsible for planting crops where cattle are likely to stray. In Coase's words, "[I]t is true that there would be no crop damage without the cattle. It is equally true that there would be no crop damage without the crops."<sup>125</sup> Injury, or damage, is a reciprocal problem, and, operationally, who ends up with the right to injure whom is determined by the costs of transacting.

Transaction cost economics generates testable scientific hypotheses about how the parties' choice of organization varies at the margin when the costs of transacting change over time or differ cross-sectionally. To generate implications for testing, it is absolutely essential that the researcher identify the equilibrium conditions that the parties face inclusive of transaction costs.

Looking back to Figure 2, a transaction cost equilibrium occurs where the marginal cost of transacting equals the marginal "external cost" or "external benefit," depending on the situation. For any level of activity beyond  $A^0$  in Figure 2, the gains from correcting the level of activity exceed the transaction costs, consistent with market equilibrium. The length of line segments AB and CD in Figure 2 reflect margin transaction costs at  $A^0$ . If the cost of transacting at  $A^0$  in Panel A of Figure 2 were less than the value reflected in line segment AB, the parties would find it in their interest

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<sup>124</sup> Coase, *supra* note 25, at 43.

<sup>125</sup> *Id.* at 13.

to move to a lower and more socially efficient level of activity. At  $A^0$  the marginal private cost (MPC) of the activity is equal to the marginal social cost (MSC), and the outcome is socially efficient. The parties are in equilibrium in the sense that neither is interested in adjusting given the transaction costs they would incur to do so.

Whereas the pre-Coasean market failure rationale for government regulation envisioned a frictionless world out of equilibrium owing to externalities that need correcting, the Coasean framework envisions a world in equilibrium once having accounted for the cost of transacting. Inefficient resource allocation leaves money on the table and creates the opportunity for market participants to cooperate to capture untapped gains from trade. This inefficiency can sensibly persist only where the cost of transacting exceeds the value of these untapped gains. Transaction costs are real costs, and it pays to spend a dollar transacting only if doing so would generate more than a dollar in gains. Given established legal and regulatory rules, private parties will internalize, or correct, all externalities that the cost of transacting allows because doing so makes them better off.

Where the parties negotiate face-to-face, as in retail securities brokerage, transaction costs can be presumed sufficiently low such that they have an ever-present tendency to move toward optimal resource allocation. Undoubtedly, in some subset of cases, courts of law or government regulators can step in to establish a rule of liability that reduces the cost of transacting, thereby allowing the parties to capture further gains from trade. In the event traditional CBA is problematic or incomplete, transaction cost analysis provides a workable and informative alternative. It would require the regulator to describe the initial equilibrium inclusive of transaction costs, and then to show how the proposed rule will likely reduce them, moving the parties to a superior equilibrium.<sup>126</sup> The

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<sup>126</sup> The first scholarly article to propose this approach appears to be D. Bruce Johnsen, *Transaction Cost-Benefit Analysis, with Applications to Financial Regulation* (Mar. 6, 2013) (unpublished manuscript),

informational burden this puts on the regulator in modest transaction cost settings is far lower than for traditional CBA. It avoids a grand accounting for aggregate costs and benefits based on demand and supply functions that are unobservable and not meant to be anything more than mental constructs to generate testable hypotheses. Transaction cost analysis requires merely a qualitative explanation for why, “at the margin” the rule is likely to reduce the relevant transaction costs, which is more consistent than the neoclassical model’s core comparative statics role.

## V. A TRANSACTION COST ASSESSMENT OF REGULATION BEST INTEREST

### A. Preliminaries

RBI’s economic analysis relies on influential work by Jensen and Meckling on agency theory for its theoretical foundation.<sup>127</sup> Unfortunately, it fails to fully decipher some of the obvious economic implications of their analysis for the market for investment advice. A fundamental example is that RBI treats conflicts of interest as a market failure. Conflicts of interest arise from the information asymmetry inherent in specialization. The more specialized the parties are, the greater the information asymmetry and the greater the potential losses from self-seeking behavior. But specialization has tremendous benefits and, in general, it will proceed only as long as the net benefits to principals and agents exceed the expected losses. The parties are willing to tolerate conflicts of interest and information asymmetry because they have adopted or adapted contracts, business

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[https://works.bepress.com/d\\_bruce\\_johnsen/7/](https://works.bepress.com/d_bruce_johnsen/7/) [https://perma.cc/Q36F-CYSQ].

<sup>127</sup> See *supra* note 107 and accompanying text; see also Jensen & Meckling, *supra* note 30. The proposing release also cites Coase. Regulation Best Interest, 83 Fed. Reg. 21,574, 21,630 n.378 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240). For assessing the best interest rule, agency costs can be treated as a subset of transaction costs applied to principal-agent relations.

customs, and other mechanisms to ensure, in general, that they can trust one another trading in relative ignorance. It would be socially wasteful for the ignorant party (the principal) to incur the costs of duplicating the information the informed party (the agent) already has.<sup>128</sup> In general, rather than being a reflection of market failure, persistent conflicts of interest and information asymmetries are a reflection of market success.

While it is true that agents violate principals' trust from time to time, the magnitude of the problem is undoubtedly small relative to the total gains from specialization. No doubt some gains from trade go untapped owing to the potential for breach of trust. Gains from trade that are not clearly assigned could be entirely dissipated through costly attempts by one or the other party to capture or protect them.<sup>129</sup> But because the parties want to avoid dissipation, they will find it in their interest to develop mitigating arrangements to the extent the costs of transacting allow.<sup>130</sup>

As principals, retail brokerage clients can and do monitor their brokers' investment recommendations by comparing investment performance with friends, consulting industry publications and other metrics, and seeking satisfaction for dramatic underperformance through binding arbitration, etc. Brokers take measures to bond their fidelity by, for example, providing detailed account statements that give snapshots of performance, subjecting themselves to binding arbitration, and subjecting themselves and their firms to reputational loss for wrongdoing.

In any principal-agent setting, transaction costs are low enough that the parties can engage in some measure of face-to-face bargaining, and market mechanisms are therefore likely to push their contract terms and other arrangements toward efficiency. This is especially likely in securities

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<sup>128</sup> Avoiding information duplication is apparently one reason the securities laws focus on mandating disclosure rather than mandating substantive behavior.

<sup>129</sup> See generally Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967).

<sup>130</sup> See Barzel, *supra* note 30.



markets because of the huge numbers of brokers and investment advisers, who are in constant competition among themselves to manage retail investors' money.<sup>131</sup> The same goes for mutual funds, insurance products, banks, and financial planners. Many brokerage firm clients hold assets in both brokerage accounts and advisory accounts,<sup>132</sup> and they can easily shift money between them for any reason. In a very real sense, the suitability rule for retail brokers has long been in competition with the fiduciary duty of investment advisers. It must be true, all things considered (including the costs of transacting), that the marginal investor is indifferent between these alternatives.

As the RBI proposing release correctly recognizes, any regulation that reduces agency costs is very likely to increase trade and make the affected parties better off. The “output effect” is a rough-and-ready basis for evaluating a proposed rule.<sup>133</sup> The release also recognizes that principals and agents are capable of reducing residual losses through efficient economic organization.<sup>134</sup> Owing to agency costs, however, it correctly argues that the parties may be unable to contract over certain actions, a problem that “can” best be addressed by establishing a mandatory standard of liability.<sup>135</sup> Yet it repeatedly emphasizes the inability to quantify either the costs or the benefits of the best interest standard relative to the suitability rule because the necessary data is unavailable.<sup>136</sup> Indeed, the release candidly states that it is unable to determine the extent to

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<sup>131</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,632–39 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>132</sup> 2011 STUDY, *supra* note 6, at 11.

<sup>133</sup> This is the same test that Robert Bork proposed to separate efficient from inefficient conduct in the antitrust setting. See Robert H. Bork, *A Reply to Professors Gould and Yamey*, 76 YALE L.J. 731 (1967); see also ROBERT H. BORK, *THE ANTITRUST PARADOX* (1978).

<sup>134</sup> Regulation Best Interest, 83 Fed. Reg. at 21,630–31.

<sup>135</sup> *Id.*

<sup>136</sup> See *id.* at 21,643–44, 21,647–48, 21,656, 21,658–59.

which brokers currently serve their own interests at the expense of their retail clients.<sup>137</sup>

The SEC has not only failed to empirically identify the likely benefits of the solution it proposes, but it is unable to empirically demonstrate there is any problem to be solved. Despite this, and despite its claim that investors are routinely confused over their investment representative's status and legal duties, it repeatedly asserts that a best interest standard would better match investors' "expectations" than a suitability rule.<sup>138</sup> It provides no plausible empirical evidence that investors actually hold such expectations, let alone how they might have formed such expectations over the course of decades under the suitability rule.

It is one thing to argue that *some* legal standard is necessary because certain attributes of agency relationships *might* be noncontractible and quite another to conclude, with no theoretical or empirical support, that the best interest standard better mitigates conflicts of interest than the suitability rule. This was exactly the *American Equity* court's point when it said that it is not enough for the SEC to argue that "any" rule "could" promote efficiency, competition, and capital formation.<sup>139</sup> It must make a plausible showing that the specific rule it selected will do so relative to the established baseline.

The RBI proposing release raises several empirical questions: Which legal standard is more efficient? Why does the rule of liability matter? What transaction costs impede the parties from solving the purported problem? These are questions the SEC can and should address with specificity before attempting to correct a problem that may not even exist. Simply stating that the broker-client relationship suffers from conflicts of interest that may harm clients is

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<sup>137</sup> *Id.* at 21,658 ("[T]he Commission lacks data on the extent to which current broker-dealer recommendations are subject to conflicts of interest related to financial incentives").

<sup>138</sup> *See id.* at 21,584–85, 21,630–31, 21,642–44.

<sup>139</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010).

insufficient, not least because any form of organization will suffer from conflicts of interest on some dimension or other as long as transacting is costly. Residual attempts at wealth transfer will always occur.

The RBI proposing release doubles down on its empirical ignorance by proposing that the parties be prohibited from contracting out of the best interest standard.<sup>140</sup> Jensen and Meckling, and Coase, both make clear that private contracting is a powerful mechanism for averting what might otherwise constitute market failures. By proposing a mandatory rule rather than a default rule, the release ignores this and would freeze the state of economic organization in place, despite ample theoretical and empirical evidence in the scholarly literature<sup>141</sup> and established antitrust case law<sup>142</sup> that the dynamism of private contracting can be remarkably effective. Imposing a mandatory best interest standard may increase the costs of transacting rather than lower them, and the burden of persuasion lies with the SEC according to federal case law and its own internal pronouncements.

## B. The Best Interest Standard

The RBI proposing release repeatedly states that brokers are conflicted when giving their clients investment advice, especially by the financial incentives that determine their compensation.<sup>143</sup> On one hand, the release speculates that under the suitability rule, brokers *might* give advice that

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<sup>140</sup> Regulation Best Interest, 83 Fed. Reg. at 21,595.

<sup>141</sup> Purely by way of example, see Allen & Lueck, *supra* note 30; Benham, *supra* note 31; Cheung, *supra* note 30; Johnsen, *The Formation and Protection of Property Rights Among the Southern Kwakiutl Indians*, *supra* note 30; Klein & Leffler, *supra* note 30; Libecap & Lueck, *supra* note 30; Masten & Crocker, *supra* note 30; Masten, Meehan & Snyder, *The Costs of Organization*, *supra* note 30; Masten, Meehan & Snyder, *Vertical Integration in the U.S. Auto Industry: A Note on the Influence of Transaction Specific Assets*, *supra* note 30; Telser, *supra* note 31.

<sup>142</sup> See, e.g., *Cont'l T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977); *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

<sup>143</sup> Regulation Best Interest, 83 Fed. Reg. at 21,574–76.

yields 'the maximum expected return for a given risk (net of fees) for their clients, thereby serving their clients' best interest.<sup>144</sup> On the other hand, they *might* adjust their advice, more or less, to increase their own compensation while recommending investments likely to underperform, thereby compromising their clients' best interest. Absent unambiguous agency theory to suggest retail brokers systematically give their clients tainted advice, the issue is entirely an empirical one, and yet the release ignores much of the relevant literature and case law that would help resolve the issue.

Garbade and Silber provide an agency cost analysis of securities brokers' fiduciary duty of "best execution" when trading on their clients' behalf.<sup>145</sup> Although their analysis does not deal specifically with brokers giving investment advice to retail clients, it provides a useful example of how transaction costs influence economic organization. The authors examine the general agency law rule that a broker has a fiduciary duty to "act solely for the benefit of [his customer] in all matters connected with his agency" as well as the SEC's specific formulation of this rule requiring a broker who accepts a customer's market sell order "to sell the stock at the *highest possible price*."<sup>146</sup>

A broker's job is to search for attractive trading opportunities on the client's behalf, but search is costly, and in a competitive market principals must compensate agents for these costs. The authors question why it would be in the client's interest for the broker to spend a dollar to discover a bid price that is less than a dollar higher than the highest bid the agent has already found, which is what the SEC's "highest possible price" rule appeared to require. The rule clearly fails a cost-benefit test. The above statements of

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<sup>144</sup> The proposing release points out that the suitability rule, as applied by FINRA and common law courts, requires brokers to give the investment advice that serves their clients' best interest. *See id.* at 21,577 n.15.

<sup>145</sup> *See* Garbade & Silber, *supra* note 30.

<sup>146</sup> *Id.* at 493 (internal quotations omitted) (citations omitted) (emphasis added).

fiduciary duty are therefore economically confused and, if taken literally, legally unworkable. Only in the implausible case where search is costless do these rules make economic sense.

A more economically rational general expression of the fiduciary duty requires the fiduciary to act with the “same degree of fidelity and care” as an “ordinarily prudent man . . . in the management of his own affairs of like magnitude and importance.”<sup>147</sup> Not surprisingly, the SEC has since revised its regulations to require retail brokers merely “to seek the most favorable terms reasonably available under the circumstances” on their clients’ behalf.<sup>148</sup>

Garbade and Silber’s highest-possible-price example of “best execution” applies equally to RBI’s best interest standard, which would appear to require the broker to spend a dollar to generate less than a dollar in benefit for the client. It also compounds the economic confusion by prohibiting brokers and their clients from adjusting by private agreement to the literal statement of the legal rule in an economically rational way.

According to Garbade and Silber, a sufficient fraction of clients in the marketplace know their brokers have an incentive to act in their own self-interest, and competition will therefore set the fee schedule to encourage efficient broker behavior. The article identifies the contractual arrangements that mitigate conflicts of interest by properly motivating brokers to trade on their clients’ behalf, even though the parties know this will fall short of bringing the highest (or lowest) possible price.<sup>149</sup> Such arrangements include: 1) explicit contracting to limit an agent’s discretion, such as by placing a limit order rather than a market

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<sup>147</sup> See, e.g., *Alaska Plastics, Inc., v. Coppock*, 621 P.2d 270, 278 (Alaska 1980) (citing *Nanfito v. Tekseed Hybrid Co.*, 341 F. Supp 240, 244 (D. Neb. 1972)).

<sup>148</sup> Order Execution Obligations, 61 Fed. Reg. 48,290, 48,322 (Sept. 12, 1996) (to be codified at 17 C.F.R. pt. 240).

<sup>149</sup> Garbade & Silber, *supra* note 30, at 495.

order;<sup>150</sup> 2) bonding by agents to validate claims of superior execution; and 3) collective action to reduce the transaction costs to clients of monitoring broker performance *ex post*.<sup>151</sup>

As a general matter, the authors show that rational clients will not want their brokers to uncover the “highest” available price and that the market establishes brokerage commissions accordingly.<sup>152</sup> They also show that the fine-grained patterns of economic organization in securities brokerage are consistent with the hypothesis that brokers and their clients cooperate to maximize *joint* gains from trade, net of transaction costs, rather than exclusively focusing on the client’s welfare.<sup>153</sup> The SEC can and should conduct similar studies regarding brokers’ provision of investment advice to retail clients before imposing a non-negotiable best interest requirement on them.

The SEC’s discussion of broker conflicts rests on the unsupported, and unsupportable, conclusion that any system of compensation other than one that is entirely neutral across different investment products necessarily taints the broker’s advice and compromises his or her clients’ best interest. The weight of the scholarly empirical work on conflicts of interest suggests otherwise, but RBI ignores it. By way of example, competent scholarly research from experimental economics suggests that in some cases mandatory disclosure of conflicts can actually hurt the principal. Cain, Lowenstein, and Moore show that “disclosure can increase the bias in advice because it leads

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<sup>150</sup> *Id.* at 498. With a market order, the client instructs the broker to buy or sell at the prevailing market price, whatever that might happen to be. With a limit order, the client instructs the broker to buy at a price no greater than \$X/share or sell at a price no less than \$Y/share. With a market order, the broker earns a commission no matter what price he or she uncovers during his or her search, whereas with a limit order the broker earns a commission only if he or she uncovers the stated limit price or better. The authors argue that limit orders give brokers more incentive to search for better prices. Brokers and their clients transact using many different types of orders, each with their own built-in incentives.

<sup>151</sup> *Id.* at 498–501.

<sup>152</sup> *Id.* at 495–98.

<sup>153</sup> *Id.* at 494–95.

[agents] to feel morally licensed and strategically encouraged to exaggerate their advice even further.”<sup>154</sup>

In a 2007 article, Mehran and Stulz provide an extensive literature review of conflicts of interest in financial services. They conclude:

[A]lthough conflicts of interest are omnipresent when contracting is costly and parties are imperfectly informed, there are important factors that mitigate their impact and, strikingly, it is possible for customers of financial institutions to benefit from the existence of such conflicts. The empirical literature reaches conclusions that differ across types of conflicts of interest but are overall more ambivalent and certainly more benign than the conclusions drawn by journalists and politicians from mostly anecdotal evidence.

....

The existence of a conflict of interest within a financial institution does not mean that, in equilibrium, the customers of that institution will be harmed . . . . [A] variety of mechanisms help control conflicts of interest and their impact. For instance, a financial institution’s concerns about its reputation might lead it to control conflicts of interest so that they have no material impact on its customers. Alternatively, a financial institution’s customers can rationally take into account how these conflicts affect the financial institution’s actions [and adjust accordingly].<sup>155</sup>

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<sup>154</sup> Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 1 (2005). The SEC has shown modest appreciation for the general point that disclosure can make a problem worse. In 2004, it withdrew a proposal to require funds to provide specific disclosure of how they detect market timing because the disclosure would likely provide market timers with a “road map” to evade detection. See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300 (Apr. 23, 2004) (to be codified at 17 C.F.R. pts. 239, 274).

<sup>155</sup> Hamid Mehran & René M. Stulz, *The Economics of Conflicts of Interest*, 85 J. FIN. ECON. 267, 269 (2007).

Following the DOL's Regulatory Impact Analysis for the Fiduciary Rule, the RBI proposing release pinpoints front-end sales loads as a particularly troubling form of broker compensation.<sup>156</sup> Section 22 of the ICA allows mutual funds to impose minimum sales loads on any broker who sells the fund's shares to retail investors, as set out in the fund's prospectus.<sup>157</sup> Recall that with a standard front-end load, the client might pay one hundred dollars to the broker but receive an investment in the fund of only ninety-five dollars. The brokerage firm receives the five-dollar front-end load, which it splits with the individual broker according to internal firm compensation policy. It would be a prospectus violation for a broker to depart from this prescription.

Just as in any other retail setting, the price the client pays for load shares includes compensation for the costs of marketing the good, which in this setting is itemized and disclosed to the client in the fund's prospectus. The DOL and SEC believe front-end loads raise serious conflicts of interest because a broker might recommend a load fund over a no-load fund to increase his or her compensation, even though the two funds have the same style, investment objective, expected return, and risk profile.<sup>158</sup>

Minimum sales loads are a garden-variety form of resale price maintenance ("RPM"), according to which a product manufacturer contractually obligates its independent retailers to charge no less than a stated price. Rather than compete on price, retailers—in this case retail securities brokers—compete by providing customers—in this case retail investors—with valuable information and other point-of-sale services on which the retailer might otherwise skimp, contrary to the manufacturer's wishes and consumers' best interest.

For over one hundred years federal courts summarily condemned RPM as illegal per se under the Sherman

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<sup>156</sup> Regulation Best Interest, 83 Fed. Reg. 21,574, 21,645 n.460 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>157</sup> 15 U.S.C. § 80a-22 (2012).

<sup>158</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,645 n.460.



Antitrust Act of 1890, thinking it facilitated monopoly.<sup>159</sup> Yet in the 2007 case *Leegin v. PSKS*, the Supreme Court overruled the use of the per se rule in this context, finding that RPM, like virtually all vertical arrangements, likely provides tremendous benefits to consumers.<sup>160</sup> The Court pointed out that the economic scholarship is now “replete with procompetitive justifications for a manufacturer’s use of resale price maintenance.”<sup>161</sup> Absent RPM, a retailer can free ride by neglecting to provide point-of-sale services, setting a low price, and luring customers away from high-service retailers after the customer has already acquired their services.<sup>162</sup> High-service retailers could be driven from the market. A degenerate equilibrium would ensue in which consumers value retail services but no retailer provides them. Manufacturers would then have to find alternative ways to provide consumers with valuable information that involve higher transaction costs, or consumers would have to inform themselves. The output effect would be negative and would very likely reduce net social benefits.

Among its pro-competitive effects, RPM allows the manufacturer to avoid or economize on monitoring its retailers, which reduces transaction costs. In the Court’s words, “[i]t may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform.”<sup>163</sup> RPM avoids the manufacturer-retailer conflict of interest. As the Court concluded, “the interests of manufacturers and consumers are aligned with respect to retailer profit margins.”<sup>164</sup>

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<sup>159</sup> See *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), *overruled by* *Leegin Creative Leather Prods. v. PSKS, Inc.*, 511 U.S. 877 (2007).

<sup>160</sup> *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 907 (2007).

<sup>161</sup> *Id.* at 889.

<sup>162</sup> *Id.* at 890–91.

<sup>163</sup> *Id.* at 892.

<sup>164</sup> *Id.* at 896.

One of Coase's fundamental insights regarding external costs is that injury is reciprocal.<sup>165</sup> In the retail broker-client relationship, clients also face conflicts of interest that may undermine the parties' long-run interests. A client might split his or her wealth between brokerage accounts at two different firms, one with a full-service broker that provides advice and other valuable services but sells only mutual funds subject to up-front loads and the other with a discount broker that provides no services but sells no-load funds. The client could take the full-service broker's advice as to what mutual funds are appropriate for his or her circumstances and use it, in part, to invest in similar no-load funds through a discount brokerage account, thereby reducing the total broker compensation paid.

Mutual fund companies that impose up-front loads on the sale of their shares apparently believe those investors who buy their shares are better off receiving the services and paying the load. In making this decision, the fund company's profit or loss depends on how the load affects its costs of capital. If broker-provided services are worth more to retail investors than the load they pay, the arrangement will increase their expected investment returns (net of the costs of information provision) and the investment company's cost of capital falls. If not, it rises. Just as manufacturer and consumer interests are aligned with respect to retailer compensation, there is little reason to distrust the investment company to make the load-fee decision other than to maximize the gains from trade for given costs of transacting. The gains are then shared in some way between the parties. All costs and benefits of the load decisions are internalized to the investment company.

The industry's use of front-end loads has evolved to mitigate any residual conflicts of interest. Depending on the share class, many fund companies have adopted back-end loads and even made them contingent on certain events or actions by the parties, such as minimum holding period

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<sup>165</sup> See Coase, *supra* note 25.

requirements.<sup>166</sup> Evidence the RBI proposing release cites suggests that these and other iterations have worked to better align the parties' incentives by reducing transaction costs.<sup>167</sup>

The RPM analysis applies equally to full-service brokerage. Brokers' primary function is to execute securities trades in the secondary market on their clients' behalf rather than to give investment advice.<sup>168</sup> They are normally paid a commission of pennies per share to do so. Discount brokers charge low commissions but provide no investment advice.<sup>169</sup> Full-service brokers charge premium commissions but also provide their clients with incidental advice.<sup>170</sup> Why would an investor, as principal, want to pay a premium commission for securities trades that he or she could get for far less from a discount broker?

As with point-of-sale services, sound investment advice and the execution of securities trades are complements. The better the advice a broker provides his or her client, the more trades the client will do, the greater the client's investment returns, and, appropriately, the higher the broker's compensation. Bundling advice and execution together is necessary because transacting investment advice independently is noncontractible. How is an investor to assess the quality of investment advice barring any further association with the provider?<sup>171</sup> The transaction costs

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<sup>166</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,642 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>167</sup> See *id.* at 21,657.

<sup>168</sup> *Id.* at 21,632.

<sup>169</sup> *Id.* at 21,574–75.

<sup>170</sup> *Id.*

<sup>171</sup> In the market for consumer goods, *Consumer Reports* provides information and advice that consumers might otherwise obtain from the product seller. *Consumer Reports* exists because some segment of consumer market believes product sellers face a conflict of interest in providing information about product quality. Repeated evidence shows that *Consumer Reports* is often wildly incorrect in its assessments. The problem is that consumers cannot punish it with a loss in sales of the underlying good if it is wrong. While it is true that consumers can stop consulting *Consumer Reports* if they are dissatisfied, this response does

investors would have to incur to verify the advice in most settings would be prohibitive. Paying brokers for (costly) advice only if they are willing to incur the costs of executing the associated trades is likely an informative signal to brokerage clients over the course of the potentially long-term relationship. Since the client knows the counterfactual, it is fairly easy for the marginal investor to assess the effect of the brokerage commissions on investment returns and to adjust patronage with the broker accordingly. The prospect of being terminated and losing a stream of premium commissions is an effective way to bond a broker's performance in the provision of incidental investment advice.

As with load fees, this kind of free riding reduces full-service brokers' ability to earn a return on their investment in providing incidental advice, which some investors value. Under RBI, many of these investors are likely to find themselves without advice, paying even higher commissions, or pushed into an otherwise less-preferred form of organization such as an advisory account that charges recurring fees. For small account holders who plan to trade infrequently, advisory accounts are expensive, even relative to full-service brokerage accounts.<sup>172</sup>

One way a full-service broker might prevent clients from free riding is by convincing them to place their entire investment portfolio with him. Unfortunately, the transaction costs to the broker of confirming this are extremely high. Brokers likely address this problem by giving clients with larger accounts (a crude proxy for the client's entire portfolio) preferential access to investment advice.

Surely free riding by retail brokerage clients on their brokers' investment advice is relevant to understanding why the rule of liability matters, and it is an issue the SEC staff should address both theoretically and empirically before imposing a mandatory best interest standard.

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not directly tie the marginal penalty *Consumer Reports* suffers to specific incorrect advice.

<sup>172</sup> See U.S. CHAMBER OF COMMERCE, FIDUCIARY RULE: INITIAL IMPACT ANALYSIS, 8, 11 (2017).

Pressed to its logical limit, RBI could injure investors rather than protect them. As with the “highest possible price” rule, the best interest standard seems to suggest that brokers must forgo a dollar of compensation to yield their client less than a dollar of expected investment returns. If taken literally, it could be interpreted to require brokers to work free of charge. Once having provided a client with investment advice, for example, the strict logic of the best interest rule could be construed to require brokers to advise their clients to open a discount brokerage account and to make the associated trades through that account. This is unsustainable, but at least in the short-term it is clearly in the client’s best interest. In the long term, clients must bear the cost of being informed if a degenerate equilibrium is to be avoided.

The proposing release provides no explanation about how the best interest rule would distinguish between a given client’s short-term best interest and the long-term best interest of the market of current and potential brokerage clients. The suitability standard suffers no such paradox. The likely response, consistent with both the SEC’s abandonment of the strict highest-possible-price rule and current case law under the suitability standard, is that under the best interest standard brokers be permitted to earn “reasonable” compensation.<sup>173</sup> But if so, how does the best interest standard improve on the suitability standard? Rather than being an improvement, it appears to inject substantial uncertainty into the retail broker-client relationship.

The assumption imbedded in RBI is that the parties are competing for a fixed pie, and that any value the broker captures must therefore come at his or her clients’ expense. This stance fails to come to grips with economic reality. Investment advice generates benefits for clients but requires the parties to balance delicate trade-offs if they are to expand the pie. Since the broker receives only a tiny fraction

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<sup>173</sup> See, e.g., FINRA, RULE 2121 (2014); FINRA, RULE 2122 (2014); FINRA, RULE 2341 (2017); see also 15 U.S.C. § 78j (2012); 15 U.S.C. § 78o (2012).

of any benefits he or she generates for clients, the “problem,” if one exists at all, is that the broker will have *too little* incentive to make informed recommendations.

There is nothing troubling about brokers charging clients for advice if doing so increases their account values net of commissions and other fees. But in noisy securities markets, advice expected to be profitable *ex ante* can look like bad or tainted advice *ex post*. By establishing an objective and contemporaneous basis for broker liability, however imperfect, the suitability rule guards against hindsight bias that could have a chilling effect on brokers’ willingness to make any recommendation at all.

The RBI proposing release attempts to address this problem by specifying that the best interest obligation arises at the moment the broker gives the advice.<sup>174</sup> The release fails to explain why the benefits of the best interest standard outweigh what could be enormous costs from legal uncertainty owing to hindsight bias.<sup>175</sup> Indeed, it is completely silent on this issue.

Absent clear evidence of self-dealing, common law courts are unlikely to hold a securities broker liable for selling a client a popular financial product, such as load fund shares that compete head-to-head against no-load shares or for accepting payments from proprietary mutual fund providers in exchange for marketing their investment products. This question has already been asked and answered for the SEC on at least one occasion involving revenue sharing,<sup>176</sup>

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<sup>174</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,592.

<sup>175</sup> Perhaps this is what the proposing release attempts to address when it states that the broker’s disclosure obligation would be subject to a negligence standard rather than a strict liability standard. See Regulation Best Interest, 83 Fed. Reg. at 21,604.

<sup>176</sup> 2011 STUDY, *supra* note 6, at 56 n.253 (“Revenue sharing occurs when a broker-dealer is paid by a mutual fund in exchange for promoting the funds to the broker-dealer’s customers. When a broker-dealer makes a recommendation of a mutual fund as to which it receives revenue sharing payments, it must disclose the revenue sharing arrangement to the customer because it is information about the potential bias of the investment advice.”).

another broker-compensation practice the proposing release considers conflicted.<sup>177</sup>

*In re Morgan Stanley DW, Inc.* was an SEC civil action against Morgan Stanley Dean Witter (“MSDW”) condemning its so-called “Partners Program.”<sup>178</sup> At the time, fund supermarkets had recently become popular in brokerage houses everywhere. They give retail brokers a platform of proprietary and nonproprietary mutual funds to choose from in making investment recommendations to their clients.<sup>179</sup> Fund supermarkets limit the conflicts of interest brokers allegedly face in offering their firm’s proprietary funds by making a large number of nonproprietary funds available. Yet, as with consumer choice generally, the supermarket platform presents brokers with endless options, and the costs of being adequately informed about every fund in the supermarket are overwhelming.<sup>180</sup>

The Partners Program gave preferred status, known as “shelf space,”<sup>181</sup> to certain fund complexes, but it also

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<sup>177</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,603 n.205.

<sup>178</sup> Morgan Stanley DW, Inc., Exchange Act Release No. 48789, 2003 WL 22703073 (Nov. 17, 2003).

<sup>179</sup> A broker’s proprietary funds are those issued by an affiliated investment company. Nonproprietary funds are those issued by unaffiliated investment companies. See, for example, *Nonproprietary vs. Proprietary Mutual Fund*, ZACKS, <https://finance.zacks.com/nonproprietary-vs-proprietary-mutual-fund-10416.html> [<https://perma.cc/GK6P-YW5T>].

<sup>180</sup> See, e.g., Alina Tugend, *Too Many Choices: A Problem That Can Paralyze*, N.Y. TIMES (Feb. 26, 2010), <https://www.nytimes.com/2010/02/27/your-money/27shortcuts.html> [<https://perma.cc/T9NR-AQSD>].

<sup>181</sup> Payment for shelf space is common in grocery retailing. See Benjamin Klein & Joshua D. Wright, *The Economics of Slotting Contracts*, 50 J.L. ECON. 421, 421 (2007) (“Shelf space contracts are shown to be a consequence of the normal competitive process when retailer shelf space is promotional, in the sense that the shelf space induces profitable incremental individual manufacturer sales without drawing customers from competing stores. In these circumstances, retailer and manufacturer incentives do not coincide with regard to the provision of promotional shelf space, and manufacturers must enter shelf space contracts with retailers. Retailers are compensated for supplying promotional shelf space at least partially with a per-unit-time slotting fee when inter-retailer price

required MSDW brokers to attend certain informational meetings and presentations hosted by the fund advisers. MSDW undoubtedly designed the Partners Program to overcome the information problem by promoting the sale of its partners' funds, including co-defendant Massachusetts Financial Services, through enhanced compensation to partnering retail brokers.

The SEC found that the Partners Program created a conflict of interest for MSDW brokers because they "received additional compensation for the sale of the mutual funds of a select group of fund complexes."<sup>182</sup> The participating partners provided various general disclosures about the Program in periodic reports to the SEC and in their prospectuses, concerning payments to brokers who distributed fund shares.<sup>183</sup> In the SEC's opinion, however, "none adequately disclose[d] the preferred programs as such, nor [did] most provide sufficient facts about the preferred programs for investors to appreciate the dimension of the conflicts of interest inherent in them."<sup>184</sup> Despite the absence of serious investor complaints,<sup>185</sup> the SEC found MSDW had engaged in securities fraud, ordered it to cease and desist, censured it, assessed it \$50 million in disgorgement, pre-judgment interest, and civil penalties, and required it to satisfy a list of twenty-eight ongoing compliance plans.<sup>186</sup>

Federal courts dismissed nine of the eleven civil suits that followed the SEC enforcement action on the pleadings in

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competition on the particular product makes compensation with a lower wholesale price a more costly way to generate equilibrium retailer shelf space rents.").

<sup>182</sup> Morgan Stanley DW, Inc., Exchange Act Release No. 48,789, 2003 WL 22703073, at \*2 (Nov. 17, 2003).

<sup>183</sup> *Id.* at \*5.

<sup>184</sup> *Id.*

<sup>185</sup> See D. Bruce Johnsen, *The SEC's Mistaken Ban on Directed Brokerage: A Transaction Cost Analysis*, 40 ARIZ. ST. L.J. 1241, 1260 (2008).

<sup>186</sup> Morgan Stanley DW, Inc., Exchange Act Release No. 48,789, 2003 WL 22703073, at \*12 (Nov. 17, 2003).



favor of the defendants<sup>187</sup> because they considered the payments to MSDW brokers immaterial to the average investor. Nonetheless, the SEC subsequently passed a rule prohibiting the practice in any form.<sup>188</sup>

One notable but overlooked feature of the arrangement was that the brokers who sold fund shares received only a portion of their compensation on sale. The remainder was back-end loaded in the form of trailing payments that continued for one year as long the client retained his or her shares, terminating the moment he or she sold.<sup>189</sup> If, as seems likely, retail investors are likely to discover and sell unsuitable investments within a year of buying, this method of broker compensation mitigates any tendency brokers might have to recommend ill-suited funds. This is an unremarkable but apparently overlooked form of bonding brokers' fidelity. The bond reduced clients' up-front transaction costs of assessing their broker's investment advice. Nothing in the case documents indicates that the SEC was aware of or concerned about the positive effects of the program on broker incentives.

Recall that the SEC's 2011 Study of retail broker conflicts relied on a 2008 RAND Foundation report assessing retail investors' understanding of various details regarding their

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<sup>187</sup> Johnsén, *supra* note 185, at 1286 n.177; *see also* Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006); Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100, 108, 117 (D. Mass. 2006) (denying the motion to dismiss the Investment Company Act 36(b) claim, but drastically narrowing it; the current disposition of this case is unknown). *But see* AIG Advisor Grp., No. 06 CV 1625(JG), 2007 WL 1213395, at \*7-9 (E.D.N.Y. Apr. 25, 2007); *In re* AIG Advisor Grp. Sec. Litig., 309 F. App'x 495 (2d Cir. 2009) (ruling that where broker-dealer received payments in form of revenue sharing and directed brokerage from mutual funds in exchange for recommending the funds to customers, omissions concerning such conflicts of interest are not immaterial as a matter of law).

<sup>188</sup> Prohibition on the Use of Brokerage Commissions to Finance Distribution, 69 Fed. Reg. 54,728 (Sept. 9, 2004) (to be codified at 17 C.F.R. pt. 270).

<sup>189</sup> *See* Johnsén, *supra* note 185, at 1275.

investment accounts based on survey evidence.<sup>190</sup> From this, the 2011 Study concluded that retail investors generally are unaware or confused “regarding the roles, titles, and legal obligations of investment advisers and broker-dealers, although [the report also finds] that investors generally were satisfied with their financial professionals.”<sup>191</sup>

The proper economic inference from this observation is not that it reflects a “problem” to be solved but that most retail investors consider brokerage and advisory accounts to be sufficiently close substitutes and sufficiently unproblematic that it is not worth their time and effort to identify the finer differences between them. As in any retail setting, for the market to work well it is sufficient that some investors—those who are on the margin between alternative products, forms of organization, or legal protections—do their homework and allocate their funds accordingly. Few consumers know or care whether their soft drinks are made from corn syrup or cane sugar, for example, but a select few are knowledgeable of and sensitive to the difference. These marginal consumers’ decisions guide relative prices and other terms of trade in the market for soft drinks and no doubt in the market for investment advice, where far more is at stake.

The proposing release points out that many brokerage firm clients maintain both a brokerage account and an advisory account.<sup>192</sup> Many undoubtedly transfer funds between them from time to time, and brokerage firms normally make this easy and inexpensive. Assets move fluidly between broker and adviser accounts as their relative merits vary. The hypothesis that retail investors respond at the margin in this way to changed circumstances is testable and well within the SEC’s wherewithal and competence.<sup>193</sup> For example, it is widely reported that in anticipation of the DOL’s now-defunct fiduciary rule retail clients began

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<sup>190</sup> See *supra* note 91 and accompanying text.

<sup>191</sup> 2011 STUDY, *supra* note 6, at v.

<sup>192</sup> *Id.* at 11.

<sup>193</sup> See, e.g., Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1028–29 (2007).

migrating away from transaction based-brokerage accounts and toward fee-based advisory accounts and other products.<sup>194</sup> If investors respond as predicted to marginal shocks, doubt is cast on RBI's shaky empirical foundation, specifically that retail investors are too ignorant to protect themselves from entering into sub-optimal business relationships on a significant scale.

## VI. SUMMARY AND CONCLUDING REMARKS

There is no such thing as a conflict-free transaction. Pay shop-floor workers by the hour and they will likely loaf and pad their hours. Pay them by the piece and they will likely abuse the employer's equipment to increase output and their compensation. The conflict of interest problem amplifies where one party agrees to act on behalf of another, as in the broker-client relationship. The adviser-investor relationship is no different. Rather than charging a commission, investment advisers normally charge a periodic asset-based fee. It is widely recognized, for example, that an adviser who charges a high fee to cover the cost of actively managing the portfolio might refrain from making the effort and simply invest in an index. In noisy securities markets, it is difficult for investors to discover "closet indexing" and hold their advisers accountable for misconduct, even under a fiduciary standard.

So-called "wrap fee" programs in which clients pay for brokerage and advisory services with a single all-in-one management fee also pose conflicts of interest.<sup>195</sup> Investment advisory clients normally authorize the adviser to use portfolio assets to pay brokerage commissions in exchange for portfolio trades. This can include paying full-service

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<sup>194</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,582 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240); Mark Schoeff, Jr., *The Legacy of the DOL's Fiduciary Rule: Almost Gone, but Never Forgotten*, INVESTMENT NEWS (June 2, 2018, 6:00 AM), <https://www.investmentnews.com/article/20180602/FREE/180609998/the-legacy-of-the-dol-fiduciary-rule-almost-gone-but-never-forgotten> [<https://perma.cc/4JU8-6X5D>].

<sup>195</sup> See 2011 STUDY, *supra* note 6, at 7 n.7.

institutional brokers a high commission in partial exchange for investment advice or research—so-called “soft dollar brokerage”—an arrangement some consider fraught with conflicts of interest.<sup>196</sup>

Retail investors therefore face a trade-off between alternative conflicts of interest when deciding whether to place their money with a broker or with an investment adviser. Nothing in the RBI proposing release even purports to address the relative magnitude of broker conflicts under the suitability rule and investment adviser conflicts under the best interest standard.

If merely pointing out a conflict of interest is enough to justify regulation, there is no principled limit to regulation. There can be little doubt Congress intended to address this general problem by imposing on the SEC the empirical requirement that it assess a rule’s likely effect on efficiency, competition, and capital formation, which federal courts have interpreted to mandate some kind of plausible CBA. Yet the RBI proposing release states that the data necessary to perform a traditional CBA are unavailable. As a result, it clearly fails to provide adequate empirical support for imposing a best interest standard on retail brokers.

To correct this shortcoming, the SEC should start with the foundational questions any regulator should ask in the context of direct trading relationships: Why does the rule of liability matter? What transaction costs prevent the parties from maximizing the gains from trade? What marginal effect is the best interest standard likely to have on the costs of transacting? Answering these questions is far easier and less information intensive than performing the grand accounting for costs and benefits that traditional CBA requires.

The RBI proposing release assumes the world is out of equilibrium and that retail investors are virtually helpless to protect themselves at any cost. But there is no testable economic theory of disequilibrium capable of informing

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<sup>196</sup> *Id.* at 24 n.95. For an analysis showing that soft dollar brokerage solves rather than worsens conflicts of interest, see D. Bruce Johnsen, *The SEC’s 2006 Soft Dollar Guidance: Law and Economics*, 30 CARDOZO L. REV. 1545 (2009).

regulatory policy. Sensible regulation must be premised on understanding why, and under what current circumstances, observed market practices reflect an equilibrium determined in part by the costs of transacting and how government regulation can make things better by reducing them.

Prohibiting the parties from contracting around the best interest standard would increase transaction costs and could be disastrous. Over the long run, competition in financial services has been an inexorable driver of organizational innovation, clearly reducing transaction costs to correct the revealed shortcomings of existing arrangements and dramatically improving investor welfare. In the 1970s and '80s, the brokerage industry sought and achieved the legal authority to include binding pre-dispute arbitration clauses in client account contracts to ensure clients access to swift justice.<sup>197</sup> Consumer advocates widely assumed that the industry planned to stack the deck against retail investors, who would then be even more powerless than before. Yet, a detailed 1992 Government Accounting Office report to Congress found “no indication of a pro-industry bias” in arbitration outcomes.<sup>198</sup>

Other important examples of innovation in financial services include the breathtaking arrival of money market mutual funds, the proliferation of funds with different styles and investment objectives, the creation of various market indexes to serve as benchmarks for monitoring performance, the development of mutual fund ratings, the emergence of mutual fund proxy aggregators, the appearance and

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<sup>197</sup> In *Shearson/Am. Express, Inc. v. McMahon*, the Supreme Court held mandatory pre-dispute arbitration clauses enforceable under the Securities & Exchange Act of 1934. 482 U.S. 220, 238 (1987). In 1989, the Court held them enforceable under the Securities Act of 1933 in *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 481 (1989).

<sup>198</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-92-74, SECURITIES ARBITRATION: HOW INVESTORS FARE 6 (1992). The report also notes that accounts allowing margin or options trades were far more likely to provide for pre-dispute mandatory arbitration than more simple cash accounts. *Id.* This clearly shows that the patterns of organization in securities brokerage are, on this margin, consistent with rational cooperative behavior between broker-dealer firms and their retail clients.

increasing popularity of index funds, the rise of exchange traded funds, the gradual decline of up-front loads, the appearance of no-load funds, and what the RBI reports as “clean” shares free of sales charges,<sup>199</sup> the displacement of loads with 12b-1 fees, the increasing use of back-end and contingent deferred sales loads that disappear entirely if the investor holds shares for a prescribed number of years, and so on. It is unsurprising that U.S. retirement savers have experienced investment returns over the past fifty years far in excess of most other countries across the globe,<sup>200</sup> or that the U.S. has been the leading exporter of financial innovation.

The notion that private contracting in the retail brokerage industry must be prohibited because most investors appear ignorant or confused suffers from the fatal conceit of central planning, which is that the market is incapable of performing well unless it is designed, rationalized, and administered by a committee of experts.<sup>201</sup> While the securities laws enable the SEC to make expert judgments to protect investors, the efficiency, competition, capital formation requirement constrains its ability to do so unless it can provide convincing empirical evidence that the benefits are likely to exceed the costs. Where the data necessary to do plausible CBA are unavailable, the Coasean approach provides a theoretically sound and empirically tractable alternative reflecting “the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation.”<sup>202</sup>

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<sup>199</sup> Regulation Best Interest, 83 Fed. Reg. at 21,583.

<sup>200</sup> See Alberto R. Musalem & Ricardo Pasquini, *Private Pension Systems: Cross-Country Investment Performance* (World Bank, Discussion Paper No. 1214, 2012), <http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/1214.pdf> [<https://perma.cc/2FLT-Z9QR>].

<sup>201</sup> See FRIEDRICH AUGUST HAYEK, *THE FATAL CONCEIT: THE ERRORS OF SOCIALISM* 86–87 (W.W. Bartley, III ed., 1991).

<sup>202</sup> *Supra* note 44 and accompanying text.