NOTE

Broker-Dealers and Investment Advisers: A Behavioral-Economics Analysis of Competing Suggestions for Reform

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For the average investor trying to save for retirement or a child's college fund, the world of investing has become increasingly complex. These retail investors must turn more frequently to financial intermediaries, such as broker-dealers and investment advisers, to get sound investment advice. Such intermediaries perform different duties for their clients, however. The investment adviser owes his client a fiduciary duty of care and therefore must provide financial advice that is in the client's best interests, while the broker-dealer must merely provide advice that is suitable to the client's interests—a lower standard than the fiduciary duty of care. And yet these divergent standards are not necessarily evident to the average investor. As a result, investors run the risk of being placed into suboptimal investments by broker-dealers.

Two competing solutions to this issue have been proposed: a higher fiduciary standard for both broker-dealers and investment advisers and a less burdensome disclosure standard in which broker-dealers would inform their clients that they are not fiduciaries. This Note analyzes these potential reforms using a traditional economics analysis as well as new behavioral-economics research. It concludes that a fiduciary standard more effectively protects investors and that a disclosure standard would actually have the perverse effect of making investors more susceptible to behavioral biases that can impair their ability to invest properly.

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Introduction

People often must rely on the relative expertise of others in making decisions. People rely on the advice of a waiter for good dishes at a restaurant, and they rely on their doctor to recommend a course of treatment when they have fallen ill. These situations are different, of course, but they both present a person with the fundamental decision of whether to trust another person's relative expertise. Such interactions are ubiquitous and unavoidable. They are also beneficial, because they save time and promote efficiency—just imagine having to learn every skill needed to make these decisions. Similarly, investors rely on expert advice when consulting their financial advisers. For example, retail investors, who are investing to save for retirement, college funds, or a home purchase, often possess little knowledge of investment strategies or products and therefore must trust others to help them make these decisions.[1]

Investment advisers and broker-dealers both provide retail investors with expert financial advice. Despite this similarity, however, investment advisers and broker-dealers operate under very different regulatory regimes governing their relationships with their clients. Moreover, they have different financial incentives, which often diverge from the interests of their clients. But neither of these differences is readily apparent to retail investors,

1. *See* Barbara Black, *Are Retail Investors Better Off Today?*, 2 Brook. J. Corp. Fin. & Com. L. 303, 303 (2008).

who consequently do not understand how the differences impact them.[2] Investment advisers are bound to offer investments that they believe are in the best interests of their client, and they are generally paid a fee regardless of whether the client buys or sells a particular investment. As a result, investment advisers do not have any incentive to "sell" the investor on particular financial products.[3] Not so with broker-dealers. They are bound only to find investments that are suitable for their clients—a lower standard—and they are generally paid commission on the sale of a financial product. Consequently, they have incentives to sell such products.[4] Even though these products are suitable for clients, they may not be optimal for their investment needs. This reality stems in part from the fact that broker-dealers' commission on a product is tied to its riskiness, which means that a riskier product yields a higher commission, a situation that creates divergent incentives for broker-dealers and their clients.[5]

These two financial intermediaries have different standards of care with respect to their clients. Investment advisers are fiduciaries, charged with providing investments that are in the best interests of their clients.[6] Broker-dealers, by contrast, are salesmen of financial instruments who may provide personalized financial advice but are not fiduciaries. Instead, they are charged simply with providing investments suitable to their clients' needs.[7] While investment advisers and broker-dealers serve many similar purposes

2. U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers 94–95 (2011) [hereinafter SEC Study].

3. Daisy Maxey, *How to Pay Your Financial Adviser*, Wall St. J., Dec. 12, 2011, at R1, *available at* http://online.wsj.com/news/articles/SB10001424052970204554204577024152103830414 ("Advisers have a strong incentive to boost client returns, because their fees increase as the assets grow—and fall if the assets decline."). *But see id.* ("Advisers may be tempted to take undue risks to grow their clients' accounts and thereby boost their own fees. They might also be tempted to discourage moves that benefit the client but take assets out of the account.").

4. Steve Sjuggerud, *Seven Guidelines to Handling Stock Brokers and Their Fees*, Investment U (Aug. 22, 2002), http://www.investmentu.com/article/detail/547/stock-brokers-and-their-fees ("[T]he flat-fee plan aligns your best interests with the broker's. . . . [W]hen you pay per trade, you can't be certain if [brokers are] calling because it's best for you, or because they're trying to meet their sales goal for the month, which will pay them out a lot more money.").

5. *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 Calif. L. Rev. 627, 648–49 (1996) ("The broker's economic self-interest is in generating the maximum possible amount of customer trading, since brokerage firm compensation from retail activities comes largely through the commissions and mark-ups attached to each transaction. . . . Commissions and mark-ups will vary depending on the nature of the security in question. In general, the level of broker compensation is fairly closely correlated to the expected difficulty of selling that security, which in turn is correlated with the security's level of risk."). For example, an investor who is nearing retirement age and has been contributing to a 401(k) for many years should be investing in very low-risk financial instruments such as U.S. Treasury bonds, not riskier products such as equity securities. *See Managing Investment Risk*, FINRA, http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/ManagingInvestmentRisk/ (last visited Aug. 18, 2014).

6. *See infra* notes 55–56 and accompanying text.

7. *See infra* notes 58–60 and accompanying text.

for investors today, the difference in these standards of care stems from their historically different roles.[8] Broker-dealers were originally exempted from the regulatory regime governing investment advisers because they were already regulated under their own legal regime and because the services they provided were readily distinguishable from those provided by investment advisers.[9] In the 1980s and 1990s, however, that distinction blurred as more broker-dealers started offering advising services and "us[ing] titles such as 'adviser' or 'financial adviser' for their broker-dealer registered representatives and even encourag[ing] customers to think of the registered representative more as an adviser than a stockbroker."[10]

As part of its package of reforms, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd–Frank Act") mandated a study on the regulation of investment advisers and broker-dealers. Section 913 of the Dodd–Frank Act required the Securities and Exchange Commission ("SEC" or "Commission") to conduct a study evaluating "the effectiveness of [these] existing legal or regulatory standards of care" for broker-dealers and investment advisers and identifying any "gaps, shortcomings, or overlaps . . . in the protection of retail customers."[11] The SEC Staff released a study in January 2011 ("SEC Study") outlining its findings and recommending potential rulemaking and policy changes.[12] A major finding of the study was that retail investors "do not understand the differences between investment advisers and broker-dealers or the standards of care applicable to broker-dealers and investment advisers."[13] Because investors lack this knowledge, they are more likely to accept broker-dealers' self-interested advice about suboptimal investments. The study therefore recommended unifying the standards of care required for broker-dealers and investment advisers by

8. Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 Bus. Law. 395, 400–03 (2010).

9. *Id.* at 403–04. Broker-dealers are subject to the antifraud and disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. *See infra* note 57 and accompanying text.

10. Laby, *supra* note 8, at 404.

11. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 913(b), 124 Stat. 1376, 1824 (2010) (codified at 15 U.S.C. § 78o note (2012)). A "retail customer," or a retail investor, is defined for the purposes of Section 913 as "a natural person . . . who (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes." *Id.* § 913(a). Retail investors are generally contrasted with institutional investors and accredited investors, both of whom tend to have more investment knowledge. *See, e.g.*, Ralph K. Winter, *On "Protecting the Ordinary Investor"*, 63 Wash. L. Rev. 881, 883–88 (1988).

12. Note that this study was conducted by the SEC Staff, a task force established by the Commission to research this issue and make recommendations to the SEC based on that research. SEC Study, *supra* note 2, at ii. The study, therefore, is not necessarily reflective of the SEC's views as a regulatory body. *Id.* The Commission is free to adopt or reject the Staff's recommendations. *See id.*

13. *Id.* at v.

making both fiduciaries to their clients—a change that would minimize investor confusion and better protect investors.[14] In contrast, an alternative proposal from the Securities Industry and Financial Markets Association ("SIFMA")—a major securities-industry trade group representing securities firms, banks, and asset-management companies[15]—recommended adopting a unified standard of care focused on disclosure as opposed to a heightened fiduciary standard that relies on prohibitions.[16] The SEC has so far not adopted either suggestion.

The SEC's goal is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[17] As a result, the two competing suggestions for reform should be analyzed for their effectiveness as an investor-protection tool. Which of these reforms would have a more pronounced effect on retail investors' investment decisions? Sound investor decisionmaking has positive effects not only for individual investors who get better returns but also for the market as a whole because increased investor confidence leads to stronger capital markets.[18]

A behavioral-economics analysis, which uses well-documented behavioral heuristics to assess the effectiveness of laws and policies, offers a useful method of examining the competing suggestions for reform. Behavioral economics has become an increasingly popular tool of legal analysis because it provides something more than traditional economics, which looks to the rational actor in analyzing the effects of laws.[19] More specifically, behavioral economics examines whether scientific evidence supports the assumptions of traditional economics analysis.

Using such a behavioral-economics analysis, this Note argues that, from an investor-protection standpoint, the better approach to help investors make effective long-term investment decisions would be imposing a fiduciary-duty standard. The behavioral-economics analysis of the two proposed reforms supports this conclusion by demonstrating that, in contrast to fiduciary standards, disclosure standards can actually exacerbate investors' heuristics. Part I summarizes the differences between investment advisers and broker-dealers, examines the current regulatory structures applicable to

14. *Id.* at 101–02.

15. Letter from Ira D. Hammerman, Senior Managing Dir. and Gen. Counsel, Sec. Indus. & Fin. Mkts. Ass'n, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, at 1 n.1 (July 14, 2011) [hereinafter SIFMA Letter], *available at* http://www.sec.gov/comments/4-606/4606-2952.pdf.

16. *Id.* at 9–10.

17. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 18, 2014).

18. *See, e.g.*, H.R. Rep. No. 97-626, at 2 (1982) ("[T]he SEC's historic mandate to foster the integrity of the markets, protect investors and maintain investor confidence in the markets may be undermined. Thus, capital formation in the form of investments in the U.S. securities markets, may be seriously threatened.").

19. *See* Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 Harv. L. Rev. 1593, 1595–96 (2014).

each, and outlines the underlying policy debate on investor protection. Part II explores the two suggestions for reform and breaks them down into a fiduciary-standard approach and a disclosure approach. Finally, Part III evaluates the two competing suggestions, first using a traditional economics analysis and then employing a behavioral-economics approach. Based on these analyses, this Part concludes that the original SEC Staff proposal—collapsing the standards of care into a single heightened fiduciary standard—is superior to an approach that focuses on disclosure.

I. Current Differences Between Investment Advisers and Broker-Dealers and an Analysis of the Underlying Policy of Investor-Protection Laws

Investment advisers and broker-dealers provide similar services to investors, and therefore they look the same from an investor's point of view.[20] This misleading similarity puts investors at risk when they think they are getting advice from an investment adviser but are actually getting advice from a broker-dealer.[21] The different regulatory structures governing the activities of broker-dealers and investment advisers explain their divergent incentives when advising clients and demonstrate how this difference in incentives harms investors. Section I.A details the services and financial products that these financial intermediaries offer. It also provides an overview of the compensation structures for investment advisers and broker-dealers and explains the nature of their respective client relationships. Section I.B then looks more closely at the differences in the legal and regulatory regimes governing investment advisers and broker-dealers. Finally, Section I.C examines the underlying policy question of what the SEC should be protecting retail investors from and how it can best achieve those goals. This analysis leads to a discussion in Part II of the competing suggestions for reforming the regulatory oversight of broker-dealers and investment advisers.

A. *Investment Advisers and Broker-Dealers: Services and Products Provided, Compensation Structures, and Relationships with Clients*

Investment advisers and broker-dealers serve distinct but overlapping functions for investors. From the client's perspective, either a broker-dealer

20. *E.g.*, Dep't of the Treasury, Financial Regulatory Reform: A New Foundation 71 (2009), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

21. There are actually two possibilities for investor confusion. First, an investor might believe that the person helping him with his financial planning is an investment adviser—that is, he assumes that the financial planner has his best interests in mind. Second, an investor might understand that he is transacting with a broker-dealer but may mistakenly think that the broker-dealer is required by law to work in the client's best interests (as an investment adviser would be). *See* SEC Study, *supra* note 2, at 98.

or an investment adviser will provide him with access to the financial markets in order to make investments, and each can offer advice in order to help with investment decisions.[22] Despite this initial similarity, investment advisers and broker-dealers have different compensation structures, and the divergent incentives that result can affect their relationships with clients. More specifically, broker-dealers, unlike investment advisers, need to sell something to their clients in order to generate a commission.[23] This incentive to sell, coupled with the lower standard of care, may encourage broker-dealers to make investments that are not optimal for the investor's goals and risk factors.[24]

Investment advisers provide investment advice for a wide variety of financial instruments, such as stocks, bonds, mutual funds, and exchange-traded funds.[25] These advisers also assist their clients in managing their financial portfolios to reach the client's goals, such as planning for retirement or saving for a home or college.[26] Because of the rising complexities of the financial markets and the limited amount of time most investors can dedicate to researching and evaluating their investments, investment advisers play a key role for clients looking to "evaluate their investment needs, plan for their future, [and] develop and implement investment strategies."[27] These advisers provide portfolio-management services, financial-planning services, and pension-consulting services.[28]

Generally, investment advisers charge their clients fees based on a percentage of assets under management ("AUM"), which means that the adviser is paid based on how much the investor is investing with him.[29] Because of this compensation structure, in which an investment adviser is paid a fee based on how much the client is investing into his portfolio, the adviser does not need to execute trades or move the client's money from one investment to another—that is, generate sales—to receive compensation.[30] This structure better aligns an investment adviser's interests with those of the client than does a broker-dealer's commission-based fee structure.[31] And

22. *Working with Brokers and Investment Advisers*, INVESTOR.GOV, http://www.investor.gov/researching-managing-investments/working-brokers-investment-advisers (last visited Aug. 18, 2014).

23. *See infra* notes 38–39 and accompanying text.

24. *See supra* notes 4–5 and accompanying text.

25. Office of Investor Educ. & Advocacy, *Investment Advisers: What You Need to Know Before Choosing One*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/pubs/invadvisers.htm (last visited Aug. 18, 2014).

26. SEC STUDY, *supra* note 2, at 6.

27. *Id.*; *see also Working with Brokers and Investment Advisers*, *supra* note 22.

28. SEC STUDY, *supra* note 2, at 6–7.

29. *Id.* at 7. Over 95% of SEC-registered investment advisers use this payment structure. Other options, listed on the Form ADV, include hourly rates, subscription fees, fixed fees, and commission- and performance-based fees. *Id.* at 7 & n.9.

30. *See id.* at 7–8.

31. *See supra* notes 3–4 and accompanying text.

an investment adviser's relationship with the client tends to be ongoing, as he continuously manages the client's investment portfolio.[32]

As opposed to investment advisers, broker-dealers serve as financial intermediaries for investors, giving them access to purchase investments ranging from stocks, bonds, and mutual funds to more complex financial products.[33] Broker-dealers provide two main types of services: (1) brokerage services, in which the broker acts as an agent for another party; and (2) dealer services, in which he acts as a principal in a transaction.[34] Broker-dealer activities are much broader than the activities that investment advisers engage in. For example, as market makers, broker-dealers stand ready to buy certain stocks in order to provide liquidity in the market.[35] Many of these broker-dealer activities do not necessarily include providing personalized investment assistance or recommendations to their clients, but almost 20% of registered broker-dealer firms indicated that they did engage in these investment-advisory services.[36] And broker-dealers are only subjected to the suitability standard of care when providing personalized advice to their customers. In this sense, broker-dealers are subject to the lower suitability standard of care, even when, from their clients' perspective, they are acting in virtually the same capacity as an investment adviser.[37]

Broker-dealers generally charge transaction-based fees such as a commission.[38] This fee structure, in contrast to an investment adviser's AUM-based fee structure, means that broker-dealers are paid when clients complete a transaction with them—for example, when clients buy or sell securities or financial instruments. This commission-based fee structure can create perverse incentives for broker-dealers: they might advise a client to execute more transactions than are necessary to meet his particular goals or to take

32. *See* SEC STUDY, *supra* note 2, at 6–11 (contrasting investment advisers' long-term strategies with broker-dealers' short-term services).

33. *Id.* at 8.

34. *Id.* at 9–10. Brokerage services include providing execution-only trading services, providing transaction-specific recommendations to buy or sell securities, providing financial-planning or portfolio-management services, and exercising limited trading discretion over customer accounts. Dealer services include trading securities out of the firm's own inventory, selling proprietary products, selling initial public offerings and other underwriting offerings, and acting as a market maker. *Id.*

35. If many investors are selling a particular stock at once, then, there may not be enough investors willing to buy that stock (since the stock price would be trending downward). Market makers stand ready to buy that stock and take on the risk that they will not be able to resell it in the market. Once a sell order is received, the market maker fills the order from its in-house inventory. This service provides beneficial liquidity in the market. *See* Matt Levine, *Market-Making Is Making Markets*, BLOOMBERG VIEW (Dec. 13, 2013, 4:33 PM), http://www.bloombergview.com/articles/2013-12-13/market-making-is-making-markets.

36. *See* SEC STUDY, *supra* note 2, at 8.

37. *See* David Serchuk, *Suitability: Where Brokers Fail*, FORBES (June 24, 2009, 6:00 AM), http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html; *see also infra* Section I.B.

38. SEC STUDY, *supra* note 2, at 10–11.

on an investment with a suboptimal return because it has a higher commission attached to it.[39]

Relationships between broker-dealers and their customers vary, ranging from a single execution-only order, with no personal advice given, to occasional portfolio adjustments to an ongoing interaction between client and broker-dealer.[40] Just one customer can have different types of accounts and therefore different relationships with the same broker, such as a brokerage account for which personalized advice is provided and a self-directed brokerage account in which the broker functions simply as an executor of trades on the client's orders.[41] Discount brokerages—that is, brokerages that do not provide research and investment advice to clients—often charge lower fees for their services as compared to those charged by full-service brokerages, which do provide investment-advice services.[42] Full-service brokerages offer benefits to investors by creating competition for investment advisers and by giving investors different options for how to invest.[43] Any reforms of the differing legal regimes, then, must find a balance between ensuring the continued existence and functioning of brokerage firms and protecting investors.

B. *Differences in the Legal and Regulatory Structures Governing Investment Advisers and Broker-Dealers*

Investment advisers and broker-dealers have separate legal responsibilities toward their clients and are regulated differently. This difference stems from a historical distinction in their roles in providing advice to retail customers.[44] Today, the roles of investment advisers and broker-dealers are much more similar in this respect, but the governing regimes unfortunately do not reflect this similarity. This Section examines the legislation and regulations that govern each type of adviser as well as the agencies and self-regulatory organizations ("SROs") that provide oversight and the forms of supervision and enforcement they use. Finally, this Section analyzes the differing standards of care that govern the activities of investment advisers and broker-dealers, an inquiry that serves as the ultimate focus of the economic analysis in Part III.

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39. *See* Maxey, *supra* note 3.

40. SEC Study, *supra* note 2, at 9–11.

41. *Id.* at 11.

42. *Brokers*, Investor.gov, http://www.investor.gov/researching-managing-investments/working-investment-professionals/brokers-advisors (last visited Aug. 18, 2014).

43. *See* Maxey, *supra* note 3. For example, investors who are particularly passive and have their entire investment in an index fund may not want to continue to pay an investment adviser based on the assets they have under management. Instead, these investors may choose to invest through a broker-dealer who will charge a one-off transaction fee.

44. *See supra* notes 8–10 and accompanying text.

Investment advisers are regulated by the SEC under the Investment Advisers Act of 1940 ("Advisers Act").[45] The Act defines an investment adviser as any person who (a) advises others on the value or advisability of investing in securities; (b) provides these services as a business; and (c) does so for compensation.[46] Broker-dealers are carved out from this definition and are not subject to any of the provisions of the Advisers Act.[47] Instead, broker-dealers are regulated under the Securities Exchange Act of 1934 ("Exchange Act")[48] and must become members of an SRO, the Financial Industry Regulatory Authority ("FINRA"), which directly regulates broker-dealers and is itself regulated by the SEC.[49]

The SEC is charged with periodically examining investment advisers through its Office of Compliance Inspections and Examinations ("OCIE"), while FINRA conducts these examinations for broker-dealers.[50] The OCIE typically focuses its resources on identifying and examining higher-risk investment advisers. It monitors risk factors and identifies misconduct that needs to be pursued by the SEC's Division of Enforcement.[51] FINRA's examinations of broker-dealers are conducted on a cycle that can range from annually to every four years, depending on the risk assessment of the firms, and the broker-dealers are monitored for their compliance with Exchange Act provisions and rules as well as SRO rules.[52] The SEC can bring enforcement actions against investment advisers and broker-dealers for violations of their respectively applicable federal securities laws, including violations of

45. SEC STUDY, *supra* note 2, at 14. The objective of the Advisers Act was "to protect the public and investors against malpractices by persons paid for advising others about securities." S. REP. NO. 86-1760, at 1 (1960), *reprinted in* 1960 U.S.C.C.A.N. 3502, 3503. Note that both investment advisers and broker-dealers are also regulated by relevant state entities. SEC STUDY, *supra* note 2, at 84, 89. This Note focuses only on the differences in federal treatment, however.

46. The Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2012).

47. 15 U.S.C. § 80b-2(a)(11)(C). Excluded broker-dealers are defined as "any broker or dealer: (i) whose performance of its investment advisory services is 'solely incidental' to the conduct of its business as a broker or dealer; and (ii) who receives no 'special compensation' for its advisory services." SEC STUDY, *supra* note 2, at 15–16.

48. Securities Exchange Act of 1934 § 15(a)–(b), 15 U.S.C. §§ 78a–78pp (2012).

49. *See* SEC STUDY, *supra* note 2, at 46–47 & n.198. The SEC often delegates its regulatory responsibilities to SROs such as FINRA. These SROs provide day-to-day regulation and oversight of their members, with the SEC taking on more back-end duties such as enforcement actions for egregious violations of the rules. *Id.* at A-6 to A-16; *cf. Self Regulatory Organization*, LEGAL INFO. INST., http://www.law.cornell.edu/wex/self_regulatory_organization (last visited Aug. 18, 2014) ("[An SRO] can take disciplinary actions against its members. Although the SEC has statutory power to review disciplinary actions, it rarely overturns those decisions.").

50. SEC STUDY, *supra* note 2, at A-2 to A-3. While the SEC may also examine broker-dealers' activities to ensure compliance, the Commission does not perform this function regularly. *Id.* at A-13.

51. *Id.* at A-3. The OCIE's resources are not unlimited, and therefore higher-risk advisers need to be prioritized. *Id.* at A-4 ("The growth of the investment advisory industry over the past six years has not been matched by a corresponding growth in Commission resources committed to examining Commission-registered investment advisers, but rather, there has been a decline in Commission resources.").

52. *Id.* at A-6 to A-7, A-9.

their standards of care.[53] And FINRA can bring disciplinary action against its member broker-dealer firms for violations of federal securities laws and SRO rules.[54]

Given these different legislative and regulatory regimes, investment advisers and broker-dealers owe their clients different duties. Under the Advisers Act, investment advisers are fiduciaries and must serve the best interests of their clients (the *best-interests standard*).[55] In particular, they are bound by the duties of loyalty and care; they must remove any conflicts of interest or disclose these conflicts to their clients; and they cannot stand as principal on the opposite side of a purchase or sale of a security for a client's account.[56] By contrast, broker-dealers are regulated under the antifraud provisions of the Exchange Act, the Exchange Act rules, and SRO rules.[57] Broker-dealers are not generally subject to a fiduciary duty under the federal securities laws that govern them. Instead, when offering personalized advice, broker-dealers are obligated to take into account the suitability of the investment options to their customers' needs (the *suitability standard*).[58] The main difference between these standards is that the suitability standard only requires a broker-dealer to ensure that, among a range of *suitable* options, there is not a subset—maybe one, maybe several—that is a *best* option for the investor. Therefore,

> [i]f a stockbroker finds a dozen or so stocks or funds that are merely "suitable" for [an investor], that registered person may feel pressured to push one of those products because he or she gets paid a higher commission or because their employer pressures them to move so-called "house" product or that of a favored third party.[59]

Conversely, the legal regime governing investment advisers requires them to find the best option given the investor's risk profile and investment objectives.[60]

The historically different roles of investment advisers and broker-dealers explain this disparity in approaches to investor protection. When broker-dealers deviate from their traditional role and offer personalized financial

53. *Id.* at A-17 to A-19.

54. *Id.* at A-21 to A-22.

55. *Id.* at 21–22.

56. *Id.* at 106.

57. *Id.* at 102–03.

58. *Id.* at 52; *see also* Serchuk, *supra* note 37 ("While suitability offers investors some sort of protection, it falls short in some important ways. For starters, it doesn't require brokers to find the best products, only ones that are ostensibly suitable for [the investor]. If an underwhelming house brand security lines up with the vague outlines of what is considered suitable they can still push it, even if it costs more to own, or underperforms peer securities. In other words, mere suitability alone falls short of what the fiduciary standard brings to the table.").

59. Serchuk, *supra* note 37.

60. *Id.* Of course, this does not always happen. Effective supervision and enforcement of the higher legal standard are also required. *Id.*

advice, the reasons for this disparity disappear.[61] The present regime illustrates the problems that the disparity creates. If a client is choosing between two investments and one has a greater return than the other, an investment adviser is barred, as a fiduciary, from recommending the investment with a lower return. By contrast, a broker-dealer is not barred from recommending that same investment as long as it is suitable to the client's needs (e.g., it provides a sufficiently positive return given the investor's risk profile and investment objectives[62]). Because of the broker-dealer's commission-based fee structure, he has an incentive to advise the client to make the lower-quality investment, and no legal regime bars or even tries to dissuade him from doing so.

C. *From What Should the SEC Protect Retail Investors, and How Can It Achieve These Goals?*

The policy debate underlying the potential change in the fiduciary standard focuses on the effectiveness of disclosure versus that of prohibiting certain activities. The concern that led to the Dodd–Frank study was that investors were confused about what duties their financial advisers owed them. In particular, there were concerns that self-interested financial advisers, guided by their potential personal gain, were placing unwitting investors into suboptimal investment vehicles.[63] Some commentators argue, however, that it is not the SEC's role to protect investors from what is ultimately their own poor choice and that instead the purpose of the SEC and the securities laws is to facilitate the disclosure of all relevant information to investors to enable them to make their own informed decisions.[64] After all, the structure of the securities laws was predicated on Justice Brandeis's famous statement on disclosure: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[65] But others argue that disclosure is not an effective investor-protection tool and that prohibiting certain activities is necessary to protect investors and deter bad actors.[66]

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61. *See supra* notes 8–10 and accompanying text.

62. *See, e.g.*, *Investor Questionnaire*, Vanguard, https://personal.vanguard.com/us/FundsInvQuestionnaire (last visited Aug. 18, 2014) (allowing retail investors to assess their risk tolerance and objectives); *Juggling Multiple Financial Goals*, Vanguard, https://personal.vanguard.com/us/insights/saving-investing/prioritize-multiple-goals (last visited Aug. 18, 2014).

63. *See* SEC Study, *supra* note 2, at i.

64. *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417, 418–19 (2003).

65. Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (F.A. Stokes Co. 1914); *see also* Paredes, *supra* note 64, at 417 ("Perhaps the most hotly-contested debate in the history of securities regulation has been over the need for mandatory disclosure. Scholars in the field of securities regulation have argued both sides of the debate for years. But as a matter of positive law, the debate has been settled for decades, with mandatory disclosure winning the day.").

66. *See, e.g.*, Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L.J. 269, 309–12 (2003) (arguing that, in certain

Policymakers and the SEC, in trying to achieve the goal of investor protection, have struggled to answer the questions of from what to protect investors and how best to protect them. Even during debates about the Securities Act of 1933, the rhetoric on the floor of Congress alternated wildly between portraying investors as gullible "suckers"[67] and portraying them as "clear headed, sober, intelligent workingmen who have tried to invest intelligently."[68] Since then, the latter portrayal has prevailed, leading policymakers to conclude that, rather than being a form of guardianship, regulation should enable investors to help themselves through adequate disclosure requirements.[69] The reasoning behind this conclusion was that, if investors were merely given accurate information, they would act rationally.

Unfortunately, relying on this model of human decisionmaking has created a regime of disclosure-heavy regulation that may not be appropriate for investors—especially retail investors—particularly given the increased complexity of modern financial instruments. The average investor no longer has the time or ability to actively manage a portfolio of investments and instead must delegate that responsibility to financial intermediaries.[70] With the institutionalization and growing complexity of the securities markets, investors can no longer effectively keep track of their investments on their own; products have become increasingly complex, moving away from straightforward stocks and bonds to mutual funds and arcane financial products.[71] Compounding this inability to participate actively in the markets, investor confidence is at a low point. Equity ownership by individual investors is down, whether through funds or in individual stocks.[72] Investor confidence in the markets and an effective investor-protection regime are essential to ensure the continued participation of retail investors in the markets. The investors' participation is beneficial not only for those investors looking to save for

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contexts, disclosure regimes may be insufficient as an effective means of regulation); Paredes, *supra* note 64, at 419–20.

67. John H. Walsh, *Can Regulation Protect "Suckers" and "Fools" from Themselves?: Reflections on the Rhetoric of Investors and Investor Protection Under Federal Securities Laws*, 8 J. Bus. & Sec. L. 188, 195 (2008) (quoting 78 Cong. Rec. 8490 (1934) (statement of Sen. Daniel Hastings) and 78 Cong. Rec. 8035 (1934) (statement of Rep. James Claiborne)) (internal quotation marks omitted).

68. *Id.* at 216 (quoting 78 Cong. Rec. 7867 (1934) (statement of Rep. Francis Maloney)) (internal quotation marks omitted).

69. *See id.* at 217.

70. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025, 1030 (2009).

71. *Id.* ("Increasingly . . . retail investment decisions relate to investing in a mutual fund or insurance product, making retirement plan elections, or deferring to account management by a brokerage firm or investment adviser, rather than investing directly in issuers' securities.").

72. Hibah Yousuf, *Only Half of All Americans Invested in Stocks*, CNN Money (May 9, 2013, 2:49 PM), http://money.cnn.com/2013/05/09/investing/american-stock-ownership/ (noting that part of the reason for lower stock ownership after the financial crisis is "due to [some investors'] inability to buy in" but that "others may fear the market is still too risky" to support long-term investment).

retirement but also for the market as a whole because more participation increases capital formation.[73]

Declining confidence is not the only reason that investors should enjoy more protection. At the same time as their confidence dwindles, retail investors no longer have the option to stay out of the markets if they want to save for retirement effectively.[74] Since the financial crisis, the "retirement readiness of most Americans has been slipping."[75] To preserve any hope of retiring, people must invest—rather than, for example, saving in a bank account, where their money will lose value by failing to keep up with inflation[76]—regardless of their confidence in the markets.[77] Therefore, if people who were planning to save long term are forced by their circumstances to invest, modern regulation needs to become more active in protecting investors.[78] Regulation that encourages effective and efficient long-term investing should serve as a central policy feature of investor protection. And disclosure requirements, while still a baseline tool for preventing fraud, should be supplemented by heightened standards to help retail investors navigate an increasingly unfamiliar landscape in which they must rely on financial intermediaries and their relative expertise in order to make sound investments.

II. The SEC Staff's Recommendation for Reform and SIFMA's Alternative Recommendation

The two competing suggestions for reforming the regulations for broker-dealers and investment advisers take opposite approaches to the issue of how best to protect investors. Section II.A outlines the SEC Staff's findings and conclusions in the study commissioned by Section 913 of the Dodd–Frank Act. It notes in particular the Staff's recommendation that adequate investor protection requires holding broker-dealers and investment advisers to a higher standard of care, which would ultimately require broker-dealers to recommend fewer products to their clients—a prohibition-based standard. Section II.B then highlights SIFMA's counterproposal, which is

73. *See, e.g.*, Jason Zweig, *When Will Retail Investors Call It Quits?*, Wall St. J., Aug. 2, 2012, at C1, *available at* http://online.wsj.com/news/articles/SB10000872396390443545504577563511537138938; Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Seeing Capital Markets Through Investor Eyes, Speech at the U.S. Securities & Exchange Commission (Dec. 5, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540451723.

74. Black, *supra* note 1, at 305.

75. Michael A. Fletcher, *Many Americans Accumulating Debt Faster Than They're Saving for Retirement*, Wash. Post, Oct. 23, 2013, at A12, *available at* http://www.washingtonpost.com/business/economy/many-americans-accumulating-debt-faster-than-theyre-saving-for-retirement/2013/10/23/b7a9c85e-3b3e-11e3-b6a9-da62c264f40e_story.html.

76. Dave Ramsey, *Try to Keep Up with Inflation*, N.Y. Times (Apr. 11, 2011, 3:40 PM), http://www.nytimes.com/roomfordebate/2011/04/10/if-you-save-you-have-to-take-risks/try-to-keep-up-with-inflation.

77. Black, *supra* note 1, at 305.

78. *See id.* Because investors are forced into the market by circumstance but lack confidence in its effectiveness to fulfill their goals, they may pay less attention to the best allocation of their funds.

heavily based in a disclosure rather than fiduciary regime.[79] This Section explores SIFMA's argument that broker-dealers can rely on disclosure to mend their conflicts of interest and that client agreements based on this disclosure can be sufficient to fulfill the broker-dealer's standard of care to his clients—a disclosure-based standard. This Section concludes by noting that both the SEC Staff's recommendation and the SIFMA recommendation are still on the table and should be evaluated for their effectiveness in protecting investors.

A. *The SEC Staff's Recommendation for a Uniform Fiduciary Standard That Is No Less Stringent Than the Current Standard Under the Advisers Act*

The SEC Study recommends creating a unified standard of care for broker-dealers and investment advisers. This recommendation is based on evidence that investors are confused by the different standards of care[80]—confusion that is "compounded by the fact that retail consumers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[81] Based on these findings, the study recommends that the SEC create a unified standard that is "*no less stringent* than the existing fiduciary standard of investment advisers" that governs under the Advisers Act when investment advisers are providing personalized investment advice.[82] The study concludes that "the uniform fiduciary standard [sh]ould be consistent with the standard and precedent that apply to investment advisers" under the Act[83] and that the SEC should promulgate more rules for broker-dealers to clarify the application of the uniform fiduciary standard.[84] Because broker-

79. SIFMA is a lobbyist organization for the financial-services industry, and therefore its proposals and recommendations will likely be skewed in favor of its members, which include the brokerage firms that would be affected by a rule change in this area. *See* Jeffrey H. Birnbaum, *Merger of Wall Street Groups Creates a Lobbying Powerhouse*, WASH. POST, Nov. 27, 2006, at D1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/11/26/AR2006112600647.html.

80. SEC STUDY, *supra* note 2, at 94. This evidence included investor comments and several studies commissioned by the SEC and industry groups (the Siegel & Gale, LLC and Gelb Consulting Group, Inc. Study, the RAND Report, and the CFA Study). *See generally id.* at 94–101. *See also* Aram Durphy, *Broker-Dealers vs. Fee-Only Investment Advisers*, LIBERTY HILL INVESTING, LLC (Jan. 11, 2013), http://www.libertyinvesting.com/broker-dealers-vs-fee-only-investment-advisors/ ("[T]he Consumer Federation of America found that 76% of investors mistakenly believe that professionals who call themselves 'financial advisors' are required to put their clients first.[ ] Just as troubling, only 34% of investors knew that such professionals typically receive commissions based on the fees they generate through their recommendations.").

81. SEC STUDY, *supra* note 2, at 101.

82. *Id.* at 107 (emphasis added).

83. *Id.*

84. *Id.* at 111. Notably, this recommendation is not the same as simply removing the broker-dealer exclusion from the Advisers Act. *Id.* at 139–40. The SEC Staff's alternative would have the effect of regulating brokerage firms in entirely the same manner as investment-adviser

dealers in particular would be unfamiliar with the fiduciary standard, the SEC "Staff believes that the Commission should help broker-dealers identify their conflicts of interest . . . so as to facilitate broker-dealers' smooth transition to compliance with the uniform fiduciary standard."[85]

Importantly, the study reiterates what Section 913 of the Dodd–Frank Act expressly stated: that the uniform best-interests standard will require the SEC, "where appropriate," to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[86] Therefore, if the SEC cannot harmonize certain broker-dealer activities with the best-interests standard, it should prohibit or regulate the activity in its rulemaking.[87]

Imposing the best-interests fiduciary standard on broker-dealers would mean that they would be able to recommend fewer products to their retail customers because some suitable products would not meet the standard of being in their clients' best interests. But the mere fact that the broker-dealer is paid when a client buys a particular product may not mean that his activities are contrary to the fiduciary duty.[88] Nor will it necessarily translate into a violation of this duty if the recommended product is one in which the broker-dealer has a principal interest.[89] The reform's focus is not to abolish commission-based fees and the wide variety of services broker-dealers provide but to structure the relationship differently when that relationship requires the broker-dealer to provide advice to an investor.[90] In essence, the change would unify what already seemed uniform from an investor's point of view. Under the new uniform fiduciary standard, the broker-dealer would

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firms, which would not be appropriate outside of the personalized financial-advice context. *Id.* at 140–43. Nor is this suggestion the same as imposing the standard of care in the Advisers Act. *Id.* at 140. Both of these alternatives would have the following drawbacks: (1) they would not be able to tailor the standard of care to the broker-dealer model; (2) they would result in the loss of investor choice; and (3) they would be more costly alternatives than the SEC Staff's ultimate recommendation. *Id.* at 140–41.

85. *Id.* at 111.

86. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376, 1828 (2010) (codified as amended in scattered sections of the U.S. Code).

87. The study makes clear that certain aspects of the broker-dealer business model—namely, employing a commission-based fee structure, providing episodic investment advice, trading as a principal, and offering proprietary products—are not *per-se* violations of the best-interests fiduciary standard. SEC STUDY, *supra* note 2, at 113; *accord* Dodd–Frank Act, 15 U.S.C. § 78o ("The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer."). But some broker-dealer activities—for example, a subset of principal trading—if found to be contrary to the heightened standard, would need to be regulated through SEC rulemaking. DEP'T OF THE TREASURY, *supra* note 20, at 71–72.

88. SEC STUDY, *supra* note 2, at 113.

89. *Id.*

90. *See id.*

be required to advise his client without considering how a transaction would affect his own financial interests.[91]

B. *SIFMA's Recommendation for a Disclosure Regime Instead of a Heightened Fiduciary Standard, Criticism of This Recommendation, and the SEC's Potential Endorsement of SIFMA's Alternative*

In response to the SEC's request for comments on the subject, SIFMA submitted a comment letter suggesting a uniform standard. The letter recommends that the SEC adopt a new uniform standard that would apply to broker-dealers under the Exchange Act and to investment advisers under the Advisers Act.[92] SIFMA's version of the fiduciary standard would require that conflicts of interest—such as compensation structures and principal trading—are disclosed and consented to by the customer in a customer agreement.[93]

SIFMA's recommendation focuses almost exclusively on suggestions for disclosure reform and on fitting the uniform standard to the existing broker-dealer business model. The fiduciary duty would commence after the customer signs the agreement or when he acts on personalized advice from the broker-dealer.[94] According to SIFMA, this standard is meant to "protect investors, preserve investor choice and access to cost-effective financial products and services, and adapt to the substantially different operating models

91. *Id.* at 109–10. SIFMA correctly noted the difficulty of preserving investor choice in applying to broker-dealers the fiduciary standard that was traditionally imposed only on investment advisers. SIFMA Letter, *supra* note 15, at 5. The broker-dealer business model focuses more widely on providing services to customers. In addition to providing personalized advice on securities, broker-dealers also benefit retail customers by providing them liquidity as principal, giving them access to proprietary products, and advising them on sophisticated investment strategies. *Id.* at 9. Section 913 of the Dodd–Frank Act specifically allows for adjustments in the application of the fiduciary standard in order to accommodate the broker-dealer model, including allowing for commission-based fees and the sale of proprietary products. 15 U.S.C. § 78o; *see also* SIFMA Letter, *supra* note 15, at 6. The statute also notes that the relationship between a broker-dealer and an investor may be more truncated than the investing relationship between an investor and his investment adviser—for example, some broker-dealers will offer investors one-off advisements or a mix of discount brokering and brokering with personal advice. Therefore, the fiduciary duty would need to be "non-continuing" instead of continuous, which is the duty that currently applies to investment advisers because of their generally ongoing relationship with the investor. 15 U.S.C. § 78o; *see also* SIFMA Letter, *supra* note 15, at 6. SIFMA argues that a blanket importation of the investment-adviser fiduciary standard would undermine the broker-dealer business as it exists today, reducing investor "choice of and access to financial products and services." SIFMA Letter, *supra* note 15, at 4, 8. This critique, while valid, does not prevent the SEC from evaluating whether certain financial products and certain broker-dealer activities are contrary to the retail investor's best interests on a more granular level.

92. SIFMA Letter, *supra* note 15, at 4–6.

93. *Id.* at 16.

94. *Id.*

of broker-dealers and investment advisers."[95] SIFMA couches its own proposal in the same "best-interests" language that is used in Section 913 of the Dodd–Frank Act. But it argues that, when read in the context of the rest of Section 913, the requirement that advisers "act in the best interest of the customer *without regard to the financial or other interest of the broker, dealer, or investment adviser*" does not compel broker-dealers "to operate a conflicts-free business."[96] SIFMA maintains that the standard instead can be sufficiently fulfilled in a business-neutral manner with an appropriate disclosure regime.[97] And it suggests that all conflicts of interest can be adequately ameliorated with heightened disclosures.[98] In essence, the SIFMA recommendation for a new uniform standard would dilute the heightened fiduciary standard: broker-dealers would be able to continue their current practices without much change beyond complying with an enhanced disclosure regime.[99]

The SEC has yet to adopt either standard, and it remains unclear whether the Commission plans to accept the SEC Staff's heightened fiduciary duty recommendation or SIFMA's heightened disclosure recommendation. In its recent request for data, the SEC set forth several assumptions about the standard that it would eventually adopt.[100] Notably absent from these assumptions was any reference to the best-interests standard that the Commission's original study recommended. The SEC's assumptions track

95. *Id.* at 2.

96. *Id.* at 6. One critique of SIFMA's recommendation is that it is not a best-interests standard at all. First, SIFMA states that the new standard "should allow broker-dealers to continue to offer products and services that are available today." *Id.* at 8–9. According to one critic of SIFMA's proposal, this permissive standard is contrary to what the heightened standard of care implies: that some of the products broker-dealers offer their clients, while suitable, are not optimal and would hence fail to meet the best-interests threshold applicable to investment advisers. *See* Letter from Knut A. Rostad, President, The Inst. for the Fiduciary Standard, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, at 6 (Apr. 9, 2012) [hereinafter Institute Letter], *available at* http://www.sec.gov/comments/4-606/4606-2972.pdf ("Nothing would change from moving to a uniform standard of care, according to SIFMA; it would be a change in standard without any corresponding change in the advice and recommendations that may be provided."). Second, SIFMA wants the new standard to accept, without adjustment, commission-based fees, the sale of proprietary products, and principal transactions, with the only change being heightened disclosure. *See* SIFMA Letter, *supra* note 15, at 9. This directly contradicts Section 913's requirement—reiterated by the SEC Study—that, while a *per-se* ban on these activities is not mandated under the uniform fiduciary standard, this permissive language does not "support the notion that moving to a fiduciary standard should have no impact whatsoever on the sale of proprietary products, on the sale of a limited range of products, or the sale of *any* product that involves a conflict of interest." Institute Letter, *supra*, at 6.

97. *See* SIFMA Letter, *supra* note 15, at 8–9.

98. *See* Institute Letter, *supra* note 96, at 9 ("There is no discussion of the possibility that a conflict of interest is so great that disclosure is insufficient to cure the conflict.").

99. *See id.* at 11.

100. James J. Eccleston & Christine E. Goodrich, *An Analysis of the Potential Impact of a Uniform Fiduciary Standard Upon Broker-Dealers, Registered Investment Advisers, and Dually-Registered Advisers*, Prac. Compliance & Risk Mgmt. for the Sec. Industry, May–June 2013, at 35, 36.

more closely SIFMA's recommendation that the uniform standard for both investment advisers and broker-dealers be "business-model neutral" and that, in any conflicts of interest, the SEC's focus should be on "provid[ing] clear and effective disclosures to customers."[101] Critics of this approach believe that the SEC is retreating from the Staff's original proposal and may in fact be weakening the standard for investment advisers rather than strengthening the standard for broker-dealers.[102]

It remains unclear whether the SEC will adopt the best-interests uniform standard of care that has been required for investment advisers under the Advisers Act or whether it will accept SIFMA's uniform standard of care that is based on a disclosure regime.[103] Because the SEC still has not proposed any rulemaking on this issue, both recommendations potentially remain under consideration.[104] These two competing suggestions for reform resurrect a policy debate about the relative merits of a regulatory regime based on disclosure versus a regulatory regime that prohibits certain conduct.[105]

III. A Behavioral-Economics Perspective on Disclosure Versus Prohibition

This Part evaluates from a behavioral-economics perspective the two competing suggestions for reform, assessing each suggestion's potential effectiveness in protecting investors. The Part concludes that, because of the limitations placed on investors by their cognitive heuristics—limitations that are well documented in behavioral-economics literature—the SEC Staff's fiduciary standard more effectively protects investors and fulfills the congressional mandate in Section 913 of the Dodd–Frank Act than does SIFMA's

101. *Id.* at 37, 42.

102. Joint Letter to Mary Jo White, Chairman, Sec. & Exch. Comm'n (June 4, 2013), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/FOF-Letter-to-MJW-06-04-2013.pdf; *see also* Press Release, N. Am. Sec. Adm'rs Ass'n, Investor and Adviser Groups Voice Opposition to Weakened Fiduciary Standard (June 4, 2013) ("Relying on disclosures to sidestep working in the best interest of the client is inconsistent with the Advisers Act of 1940 and would weaken the existing fiduciary standard for registered investment advisers." (internal quotation marks omitted)) (statement of L. Locker, Nat'l Chair, Nat'l Ass'n of Pers. Fin. Advisers), *available at* http://www.nasaa.org/23686/investor-and-adviser-groups-voice-opposition-to-weakened-fiduciary-standard/.

103. *See* Mark Schoeff Jr., *White Says SEC Is Moving on Fiduciary but Other Rules to Come First*, Investment News, July 30, 2013, *available at* http://www.investmentnews.com/article/20130730/FREE/130739997 ("Chairman Mary Jo White told lawmakers today that she wants the agency to decide 'as quickly as we can' whether to propose a rule to raise investment advice standards for brokers. . . . [But] the controversial issue could split the five-member commission. The SEC is currently conducting a cost-benefit analysis of a potential rule.").

104. The SEC rulemaking process generally starts with a proposed rule, after which there is a public notice-and-comment period. After this comment period closes, the final rule is drafted and then adopted. *Rulemaking, How it Works*, U.S. Sec. & Exch. Comm'n, https://www.sec.gov/answers/rulemaking.htm (last visited Aug. 18, 2014).

105. *See supra* Section I.C.

disclosure regime. Section III.A analyzes the two standards using a traditional economics approach and shows that, while this approach can be helpful, it remains incomplete. Section III.B explains how using a behavioral-economics framework can provide a more comprehensive analysis and then evaluates the two proposals for reform. This Section ultimately concludes that a disclosure standard would create more problems than it would solve and therefore recommends implementing the fiduciary standard instead.

A. *A Traditional Economics Analysis of the Two Proposals Is Helpful but Remains Incomplete*

While behavioral economics provides a more complete picture of investors' decisionmaking process when they are investing with a broker-dealer or investment adviser, a traditional economics analysis can serve as a useful starting point to guide the inquiry before a behavioral analysis fills in the gaps. The traditional rational-agent model of economics presupposes a rational decisionmaker who maximizes his utility—that is, a person who weighs the costs and benefits of all his options and chooses the option that maximizes his benefits—and, based on this presupposition, the model makes predictions about human behavior.[106] The decisionmaker behaves irrationally when the costs of acting rationally are too high or the information needed to behave rationally is either unavailable or false.[107] In a world where these assumptions hold true, there is "little need for legal protection beyond vigorous contract enforcement and the law of fraud."[108] In the interactions between a broker-dealer and an investor, there are two decisionmakers: there is the investor who must decide in which of several financial products to invest, and there is the broker-dealer who must decide which financial product or products he can recommend to the investor. This analysis attempts to determine which regulatory regime will lead an investor to choose a financial product that is safer and has a higher return.

In evaluating the investor's decisionmaking process without transaction costs,[109] a traditional economics analysis concludes that he would be indifferent in choosing between the fiduciary standard and the disclosure standard. (Recall that the investor is assumed to be rational and utility

106. *See* Langevoort, *supra* note 70, at 1043.

107. David de Meza et al., Fin. Servs. Auth., Consumer Research 69, Financial Capability: A Behavioural Economics Perspective 20 (2008), *available at* http://www.fca.org.uk/your-fca/documents/research/fsa-financial-capability-a-behavioural-economics-perspective.

108. Langevoort, *supra* note 70, at 1043.

109. Here, "transaction costs" is used in the broadest sense: the investor is assumed not only to have no search costs for the information on different financial products, but he is also assumed to have equal skill and ability to analyze the information. Of course, this might be an unrealistic assumption, as investors today are unlikely to possess a deep understanding of financial products. *See, e.g.*, U.S. Sec. & Exch. Comm'n, Study Regarding Financial Literacy Among Investors vii–viii (2012) [hereinafter Financial Literacy Study] ("[S]tudies have found that investors do not understand the most elementary financial concepts.").

maximizing.) To use a simplified hypothetical, suppose the investor can invest $1,000 in either Product A or Product B. Product A has a 90% chance of returning 5% (or $50) on the investment and a 10% chance of returning 0% on the investment—i.e., a $45 expected return. Product B—a riskier investment by design—has a 20% chance of returning 10% on the initial investment (or $100) and an 80% chance of returning 0% on the investment—i.e., a $20 expected return.[110] Given the absence of transaction costs in this scenario, the investor will be able to study the expected benefits of each investment and, at least according to a traditional economics theory, he will choose Product A, which has an expected benefit of $45, rather than Product B, which has a $20 expected return. In this case, the investor will be indifferent to the type of regulatory structure governing his relationship with the broker-dealer or investment adviser offering him the product. With transaction costs, however, the analysis is similar but must take into account which standard of care will impose lower costs.

When factoring transaction costs into the analysis, the investor may actually prefer a fiduciary-duty standard over a disclosure standard. This change of preference results because the fiduciary standard likely entails lower verification costs than the disclosure standard.[111] More specifically, a fiduciary-duty standard would require the investor to expend just enough effort to verify the fidelity and competence of his financial adviser, whereas a disclosure standard would require the investor to expend (presumably more) effort to make an independent evaluation of Products A and B.[112] As critics

110. This hypothetical is extremely simplified on several metrics. First, the analysis assumes that the investor is choosing only one product to invest in. Generally, investors should diversify by making investments in several different financial products, a strategy that reduces the risks of each investment. *Beginners' Guide to Asset Allocation, Diversification, and Rebalancing*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/investor/pubs/assetallocation.htm (last visited Aug. 18, 2014). This simplification does not adversely affect the analysis because the analysis is looking at a single decision by the investor, not his entire investment portfolio. Second, there is no temporal aspect to the rates of return and no associated discounts to present value of the returns. As a result, the two products are easier to compare because the only variable is the risk of the products. For a summary of how to compare financial products on more than this one metric, see *Evaluating Performance*, FINRA, http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/EvaluatingPerformance/ (last visited Aug. 18, 2014). Third, the hypothetical assumes that there are no associated fees with the financial products or, at least, that the fees are already incorporated into the expected return. While these aspects of financial products and investment strategies are important, they need not be considered here because they do not change the basic analysis. In other words, the hypothetical can just as easily assume that these are the expected rates of return *after* adjusting for time of investment, type of investment, and fees in connection with the investment.

111. There is no conclusive evidence to support this assumption beyond the intuition offered, however.

112. This assumption makes intuitive sense but may not be borne out in practice. The amount of time, energy, and other resources that an individual investor must devote to actively monitoring his investments varies widely based on his choice of investments, the amount of funds invested, and his background financial knowledge. The SEC's Office of Investor Education and Advocacy provides educational material for basic investment choices. Investor.gov, http://www.investor.gov/ (last visited Aug. 18, 2014). Moreover, the amount of time and effort an investor puts into verifying the integrity of his broker-dealer or investment adviser

of the heightened fiduciary standard point out, however, broker-dealers often provide discounted services to customers.[113] Therefore, while imposing a heightened fiduciary standard would potentially save investors some search costs in the initial stages of investment—assuming that verifying an adviser's fidelity is less costly than conducting independent research on the financial products—implementing this new standard may eventually increase compliance costs, which broker-dealers may pass on to their customers.[114] As a result, without more concrete information on these relative costs, a traditional economics analysis from the investor's perspective fails to indicate which regulatory regime an investor would prefer as most efficiently facilitating his ability to choose optimal investments.

Turning to the broker-dealer's decision about whether to offer the investor Product A or B, the traditional economics analysis may prove more conclusive because it shows that, in contrast to the disclosure standard, the fiduciary standard is likely to deter broker-dealers from offering a product with a lower rate of return. Because the broker-dealer generally receives a higher commission for selling the riskier product to the customer,[115] this fact should be assumed to apply to the above hypothetical as well. Therefore, the assumption is that Product A, which has an expected return of $45 for the investor, provides the broker-dealer with a 0.5% commission on the initial amount invested (i.e., a $5 commission). Product B, which has an expected return of $20 for the investor, provides the broker-dealer with a 1% commission fee (i.e., a $10 commission). Under the utility-maximizing traditional economics theory and in the absence of any regulation, a broker-dealer presented with these two expected values would try to sell the investor on Product B.

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would also vary from investor to investor. To this end, FINRA offers an online service to help investors research their broker-dealer and investment-adviser firms. FINRA BROKERCHECK, www.FINRA.org/Investors/ToolsCalculators/BrokerCheck (last visited Aug. 18, 2014).

113. *See, e.g.*, OLIVER WYMAN, SEC. INDUS. & FIN. MKTS. ASS'N, STANDARD OF CARE HARMONIZATION: IMPACT ASSESSMENT FOR SEC 5, 27 (2010), *available at* http://www.sec.gov/comments/4-606/4606-2824.pdf (showing that the costs of complying with a heightened standard of care would increase the cost to customers through raising the prices of services); SIFMA Letter, *supra* note 15, at 14–15.

114. *See* Mark Schoeff Jr., *SIFMA Tells SEC That Fiduciary Rule Would Cost a TON*, INVESTMENT NEWS, July 5, 2013, at 5, *available at* http://www.investmentnews.com/article/20130705/FREE/130709966 ("[Eighty-four percent] of financial advisers said that their business costs would increase if the SEC lifted the advice bar. The poll indicated that 43.9% of the respondents would pass on the higher costs to their clients by imposing or increasing fees . . . ."). While these costs are different, they may offset each other. But both cost estimates ultimately remain speculative since there has been no definitive study of the costs of compliance for broker-dealers under the new regime.

115. Langevoort, *supra* note 5, at 649 ("[T]he level of broker compensation is fairly closely correlated to the expected difficulty of selling that security, which in turn is correlated with the security's level of risk.").

A fiduciary standard would change a broker-dealer's incentives if the enforcement mechanism is designed to affect his expected returns.[116] Because Product B is not in the client's best interest, advising the client to invest in such a risky security would be a violation of the broker-dealer's fiduciary duty. Now assume that an enforcement regime is introduced in the hypothetical. With this regime in place, suppose that there is a 10% chance that the broker-dealer is caught violating his fiduciary duty and fined $50—in this scenario, the broker-dealer's expected return on Product B decreases, from $10 without a regulatory regime to $4 with a fiduciary-duty regime that is paired with this enforcement mechanism. As a result of the enforcement regime, then, the broker-dealer will now choose to market Product A to the investor, a product for which the broker still has an expected return of $5 in commission.

By contrast, a disclosure standard would not change the broker-dealer's decision to sell Product B, although it would conceivably make the actual sale of the security more difficult.[117] SIFMA's recommendation is premised on the assumption that a disclosure regime will cause investors—upon discovering that their broker-dealer was not a fiduciary—to investigate independently the expected rates of return for the financial products that the broker-dealer suggests or at least to discount the broker-dealer's advice as advice coming from someone who is *not* a fiduciary.[118] A traditional economics analysis of the competing regimes suggests that, given the assumption that investors are utility-maximizing, rational actors, a disclosure regime would be just as effective as a fiduciary regime. In other words, whereas a fiduciary standard affects a broker-dealer's ability to sell a product, a disclosure regime affects the investor's decision to buy that product. In reality, however, this scenario does not play out.[119] Behavioral economics

116. The broker-dealer has an incentive to cheat and try to sell Product B only if that product still has a higher expected return than Product A after the probability of getting caught and the penalty for doing so are factored in. *See* Dan Ariely, *The Mind's Grey Areas*, Forbes India, June 4, 2010, *available at* http://www.forbes.com/2010/06/15/forbes-india-dan-ariely-the-minds-grey-areas-opinions-ideas-10-ariely.html ("In standard economics, cheating is supposedly a straight cost benefit analysis. People look at the odds of getting caught and the associated punishment, and then cheat when it makes sense to do so."). A fiduciary standard for broker-dealers would have to be effectively enforced. Otherwise, the expected return for the broker-dealer is still the product that gives him the highest return, that is, Product B. *See id.* Given the SEC's broad mandate and the massive amount of new rulemaking, supervision, and enforcement that it must undertake pursuant to the Dodd–Frank Act and the JOBS Act, it seems unlikely that the agency alone will be able adequately to enforce a heightened standard. *See* Schoeff, *supra* note 103. One way to alleviate the SEC's burden in this respect would be to implement the existing FINRA SRO structure to help enforce the heightened fiduciary standard, a proposal that can be effected through additional SEC rulemaking. *See supra* notes 50–54 and accompanying text (explaining FINRA's role in supervising broker-dealers).

117. *Contra* discussion *infra* Section III.B (arguing that heightened disclosure will not actually make selling riskier securities more difficult for broker-dealers).

118. See *supra* notes 93–97 and accompanying text for a summary of SIFMA's recommendation.

119. *See infra* Section III.B.

explains why investors do not actually behave in this fashion and offers a better method for analyzing these two standards.

B. *A Behavioral-Economics Analysis of the Disclosure and Fiduciary Standards Provides a More Complete Picture and Shows That a Fiduciary Standard Is Superior to a Disclosure Standard*

This Section uses behavioral economics to demonstrate why a disclosure standard cannot adequately protect investors. In particular, it highlights investors' relevant behavioral biases and evaluates whether the two proposals can counteract them. The Section ultimately concludes that a disclosure standard would not only fail to protect investors in this case but would in fact exacerbate the problems that already plague the relationship between broker-dealers and their clients. This Section therefore recommends that the SEC adopt a fiduciary standard in order to better protect retail investors from their financial intermediaries.

Since the early congressional debates over investor protection, new theories of human behavior have created complexities that challenge the relatively simple regulatory theories underlying disclosure and prohibition standards. In contrast to a traditional theory of economics, "[b]ehavioral economics studies human behavior . . . to find regularities in judgment and choice," including statistically significant departures from purely rational decisionmaking, that is, biases and heuristics.[120] Empirical research has shown, for example, that "the availability of data does not always lead to effective communication and knowledge; understanding and intention do not necessarily lead to a desired action; and . . . contextual nuances can shape behavior and alter choices."[121] Behavioral economics demonstrates how traditional economics is limited by its assumptions: even when the traditional theory suggests that an investor can be expected to act rationally, behavioral economics posits (and shows through actual data) that this is not actually the case in many instances.[122]

Several well-documented heuristics have been found to affect investor decisionmaking. A recent study by the Financial Services Authority in the United Kingdom ("FSA Study") found that investors exhibit a large number of cognitive biases that prevent them from investing efficiently and effectively.[123] The FSA Study notes that the principal cognitive biases affecting

120. Langevoort, *supra* note 70, at 1043–44. Heuristics and biases are generally defined as "decision rules, cognitive mechanisms, and subjective opinions people use to assist [themselves] in making decisions." Lowell W. Busenitz & Jay B. Barney, *Differences Between Entrepreneurs and Managers in Large Organizations: Biases & Heuristics in Strategic Decision-Making*, 12 J. OF BUS. VENTURING 9, 12 (1997).

121. Michael S. Barr et al., *The Case for Behaviorally Informed Regulation*, *in* NEW PERSPECTIVES ON REGULATION 25, 26 (David Moss & John Cisternino eds., 2009).

122. *See, e.g.*, Paredes, *supra* note 64, at 444–45.

123. MEZA ET AL., *supra* note 107, at 2–4.

investors are "procrastination, regret and loss aversion, mental accounting . . . and information overload."[124] First, procrastination—or choice deferral—refers to the cognitive bias of placing a higher value on immediate costs and benefits while unduly discounting remote costs and benefits, a situation that creates a bias toward immediate gains.[125] Broker-dealers take advantage of this bias by selling products that purport to provide more immediate returns than comparably safer products while simultaneously downplaying the security's risk.[126]

As the second cognitive bias, regret-aversion theory states that people factor into their decisions the potential of regret in the future.[127] Broker-dealers play on this sense of regret or loss aversion when they use a riskier security to inflate a client's expectations of a future gain. Because investors typically consider expected gains from risky securities as losses if they choose *not* to invest,[128] broker-dealers' decision to take advantage of this cognitive bias can be an effective strategy. Mental accounting, the third cognitive bias, is the process by which people "bucket" their current and future assets—that is, the process by which they assign to assets of the same value different *personal* values based on their intent of use or the source of the income.[129] When a consumer or investor engages in this form of accounting, he violates basic economic principles.[130] For example, where an investment has a positive expected return (even if that return is highly uncertain), such a return is already factored into a mental account, and the potential of losing that return by investing in a safer product with a lower return triggers a greater tendency for risk taking.[131] In the fourth bias, which involves situations where people have too many options to choose from, they can experience information overload, which generally leads to inaction.[132] Broker-dealers often play on investors' anxiety while using their own relative knowledge to convert this inaction into trust.[133]

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124. *Id.* at 2. Until recently, the FSA was the main regulator of the financial-services industry in the United Kingdom. *UK Financial Regulation Overhauled*, BBC NEWS (Mar. 31, 2013, 8:06 PM), http://www.bbc.co.uk/news/business-21987829 ("The UK's banking regulator, the Financial Services Authority (FSA), has been abolished and replaced with two successor organisations."). While the study was conducted in the United Kingdom, there is no reason to believe that the results contain idiosyncrasies and cannot be generally applied to retail investors in the United States.

125. MEZA ET AL., *supra* note 107, at 22.

126. *See* Langevoort, *supra* note 5, at 652–53.

127. MEZA ET AL., *supra* note 107, at 38.

128. Langevoort, *supra* note 5, at 637–38.

129. *Id.*; *see also* Richard H. Thaler, *Mental Accounting and Consumer Choice: Anatomy of a Failure*, 27 MARKETING SCI. 12, 12 (2008) (providing anecdotes of people violating economic principles because of the way they mentally account for their money).

130. Thaler, *supra* note 129, at 12.

131. Langevoort, *supra* note 5, at 637–38.

132. MEZA ET AL., *supra* note 107, at 39.

133. Langevoort, *supra* note 5, at 653–54. Professor Langevoort details the different sales tactics that broker-dealers use to sell securities and explains their motivations more comprehensively than this Note is capable of doing.

A disclosure standard, at first blush, would seem to mitigate these biases in investors. Because the investor will be aware of his broker-dealer's mixed incentives, he will discount the broker-dealer's advice and adopt a considerably more critical view of his sales tactics.[134] As a recent study shows, however, this is not actually the case in many instances.[135] From the investor's perspective, he must not only "understand how the conflict of interest has influenced the advisor [but] must [also] be able to correct for that biasing influence."[136] The study does illustrate, however, that investors typically do not gauge the extent to which they should discount the broker-dealer's investment advice.[137] At the same time, even if they do attempt to adjust their behavior, they tend to make insufficient adjustments because they cannot "unlearn" the biased knowledge or advice.[138] These results suggest that disclosing potential conflicts of interest—such as commission-based fee structures or standing as principals in a transaction—is unlikely to correct investors' behavior such that they appropriately discount the broker-dealer's financial advice.

Moreover, disclosure can actually have the perverse effect of making the investor trust the broker-dealer *more*, not less. For example, in cases where the adviser is the person who issued the disclosure, research has shown that he actually gained credibility, not lost it.[139] And while the disclosure negatively affects the investor's behavior by making *him* more trusting, it can also negatively affect the broker-dealer's behavior.[140] For example, he may attempt to exaggerate the benefits of his position in order to offset what he perceives to be the disclosure's effects (that is, that the investor trusts him less than before). Additionally, the broker-dealer may use the disclosure as a "moral license" to act in a more self-interested way than he otherwise would have.[141] Specifically, "[w]hile most professionals might care about their clients, disclosure regulation can encourage these professionals to exhibit this concern in a merely perfunctory way."[142] In these respects, disclosure not only fails to mitigate the existing biases—after all, broker-dealers are still free to use the above-mentioned sales tactics on their clients—but it may actually exacerbate those biases while creating additional ones.

By contrast, a fiduciary standard mitigates these biases by taking the decision to invest in suboptimal investments out of the investor's hands and

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134. *See* Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. Legal Stud. 1, 2–3 (2005).

135. *See generally id.* (analyzing factors that help explain why disclosure may not positively influence an individual's decisionmaking process and may actually harm rather than help the recipient of advice).

136. *Id.* at 3.

137. *Id.* at 22.

138. *Id.* at 6.

139. *Id.* at 5–6.

140. *Id.* at 7.

141. *Id.*

142. *Id.*

entrusting it to the broker-dealer. Under the fiduciary standard, broker-dealers have an incentive—that is, avoiding the increased liability—to recommend the best product for the investor, not just a product that is suitable to his risk tolerance and objectives.[143] When attempting to create behaviorally sensitive regulations, an agency must take into account the incentives of the broker-dealer (i.e., the firm) and the investor (i.e., the individual). In cases where the firm's interests originally align with those of the individual, the firm will be motivated to correct any cognitive biases the individual has without any regulations requiring it to do so, which would enable the individual to optimize the firm's service—that is, the firm has an incentive for the individual to be as rational as possible.[144] For example, if consumers tend to procrastinate depositing money in their savings accounts, banks might try to mitigate this tendency—and thereby increase their own capital bases—by creating programs with incentives for consumers to deposit more of their earnings.[145] Similarly, broker-dealers in this example would be motivated to counteract an investor's bias to procrastinate in order to generate more sales and, therefore, more commission fees.[146]

If, however, the firm's incentives are such that it would prefer customers to act predictably irrationally—that is, with cognitive biases in their decisionmaking process—it will not have incentives to help reduce these biases by itself. One example is when companies issue rebates: consumers tend to procrastinate in returning the rebates by mail or filling out online forms, which benefits the companies because they have to issue fewer rebates.[147] Where firms have incentives to help overcome biases, disclosure requirements or "sticky default options[,]" such as opt-out 401(k) participation, work well.[148] Alternatively, where, as here, the firm's incentives are originally

143. The assumption here is that financial intermediaries are in a better position to assess risks because of their greater understanding of the markets and financial products and their greater informational access. *See* SEC STUDY, *supra* note 2, at 101 ("[R]etail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals. [They] are relying on their financial professional to assist them with some of the most important decisions of their lives."); *see also* FINANCIAL LITERACY STUDY, *supra* note 109, at 14–16 (finding that retail investors lack an understanding of even the most basic financial concepts). The assumption may not necessarily hold in all cases, however, but it implicates the issue of good and bad broker-dealers that need not surface at a policy level and remains beyond the scope of this Note.

144. *See* Barr et al., *supra* note 121, at 33.

145. *Id.*

146. This is one behavioral heuristic that works to the investor's advantage. If a client is already invested in a financial product, the broker-dealer may have a hard time selling the investor on a new product. It follows, then, that if the first product is one that is in the client's best interests, the procrastination and status-quo heuristics may keep the investor in that product instead of leading him to move to a new, less suitable financial product. *See* Langevoort, *supra* note 5, at 636.

147. Barr et al., *supra* note 121, at 33–34.

148. *Id.* Participation in 401(k) plans used to be opt in, so that people would have to choose to contribute to the plan. Because of the behavioral bias of procrastination, however, people often did not opt in, even when it was in their best interest to do so. And yet when

misaligned with those of the individual, "changing the rules alone [i.e., adding disclosure] may not work well since firms may . . . work creatively around those rule changes."[149] Instead, changing the firms' motivations, by shifting liability or by creating tax incentives, is a more appropriate form of regulation.[150] A heightened fiduciary standard with an effective enforcement mechanism is one example of shifting liability. In other words, without a regulatory regime, or with a disclosure regime, the onus is on the investor to make the appropriate decision (i.e., the investor must decide between Product A and Product B), and he bears any resulting costs for an incorrect choice in the form of lower returns on his investment. By contrast, a fiduciary standard shifts the burden from the investor to the broker-dealer.[151] Under this standard, the broker-dealer can no longer recommend Product B over Product A, and if he does so, he will be penalized under the heightened enforcement regime.[152] In this way, the new regime effectively aligns the investor's and broker-dealer's motivations: both now *want* Product A over Product B, even if the investor is ignorant of that fact. By creating and implementing a well-enforced liability regime under a fiduciary standard, an agency could align the interests of broker-dealers and investors.

C. *Two Further Behavioral-Economics Arguments in Support of a Fiduciary Standard and Against a Disclosure Regime*

Two further arguments show that a fiduciary standard, rather than a disclosure standard, would provide the most effective protection for investors. First, a regime that combines investor education with disclosure—a common alternative recommendation and one of the SEC's main policy goals[153]—is insufficient because it fails to attack the root of the problem: investor psychology. Second, the social science underlying behavioral-economics policy, although it often recommends "smart disclosures," strongly counsels in favor of using a fiduciary standard.

First, a regime that combines disclosure with more investor education would not be a good alternative to increasing the fiduciary standard. This argument suggests that educating investors can serve to negate psychological

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some companies switched their 401(k) plans to use an opt-out mechanism, the status-quo behavioral heuristic kept people from opting out, so they saved for retirement just by doing nothing. Firms often create tax incentives to encourage their employees to contribute to a 401(k) instead of taking the money as part of their salary, so the firms were happy to change the policies in this way and take advantage of their employees' behavioral heuristics. *Id.*

149. *Id.* at 34.

150. *Id.* at 34, 36 tbl.2.

151. Critics have made the argument that broker-dealers will ultimately shift the costs of compliance and increased costs of liability back to investors. *See supra* notes 113–114 and accompanying text.

152. *See supra* notes 116–117 and accompanying text.

153. Black, *supra* note 1, at 334–35.

biases and make people act more rationally and with less informational deficit when navigating the financial markets.[154] In theory, then, combining investor education with disclosure would have a positive effect on investor behavior. Such a strategy is unlikely to serve as a sufficient alternative to a heightened fiduciary standard, however, because financial education is effective only when it both improves financial literacy *and* changes behavior.[155] As the FSA Study notes, "low financial capability is more to do with psychology than with knowledge. Institutional design and regulation are probably far more effective than education" in changing investors' financial decisions.[156] Therefore, while financial education can certainly prove beneficial overall, it may not do enough to change behavior. And empirical studies that have tested the effects of financial education on investment behavior underscore this concern, reporting financial education's "positive but modest" impact.[157]

While financial-literacy education provides investors with tools that they can use in optimal conditions, behavioral heuristics are likely to counteract these positive gains in situations where investors have limited time to learn about potential investments.[158] This is not to say that investor education should be avoided but rather to point out that focusing on education without understanding behavioral heuristics will fail to protect investors in their financial decisionmaking.[159]

Second, when applied to this scenario, a behavioral-economics analysis shows that investor choice is fallible and should be restricted by a fiduciary standard. Behavioral-economics policymaking has become more common than in the past, but unfortunately the proposed solution has taken on a "one-size-fits-all" approach—the adoption of default rules and smart disclosures that gently guide investor choice in the right direction—that is not always appropriate given the underlying analysis.[160] On a social-science level, behavioral-economics policy "offers hope that proper appreciation of the actual cognitive frameworks, information-processing heuristics, and likely motivations of choice-making individuals will provide a sounder foundation than neoclassical economics . . . for the design of legislation and regulation."[161] While moving beyond a simple traditional economics analysis represents a laudable step toward a more nuanced approach to regulation, it is important not to dilute behavioral economics to a blanket solution. Indeed,

154. *See generally* Financial Literacy Study, *supra* note 109 (studying the financial literacy of retail investors and examining methods to improve disclosures to investors that will help them make informed financial decisions).

155. *See* Meza et al., *supra* note 107, at 10.

156. *Id.* at 4.

157. *Id.* at 11–20 (summarizing several U.S.-based financial-literacy and financial-education studies); *see also* Financial Literacy Study, *supra* note 109, at 2–14.

158. *See* Meza et al., *supra* note 107, at 49.

159. *See id.*

160. *See* Bubb & Pildes, *supra* note 19, at 1595.

161. *Id.*

as it has been implemented in recent years, behavioral-economics law and policy often use choice-preserving regulation in cases where the underlying theory indicates that classic prohibitions would actually be more appropriate.[162]

From an investor-protection standpoint, it is not clear that more choice is better for investors, especially in cases where some of the choices would not be in their best interests.[163] SIFMA's recommendation for a disclosure standard is based on the argument that protecting investors from their full range of choices is not a sound regulation strategy.[164] But the SEC already protects average retail investors from many financial products that they are ill equipped to handle.[165] That the SEC already limits investor choice to better protect investors represents persuasive evidence that it can do so in this instance as well.

Typical retail investors are excluded from investing in some financial products because the securities made available under these rules are less regulated, exceedingly complex, or ill suited for simple long-term investment needs. While the situation here is different—retail investors have not historically been excluded from these transactions—there is no reason to view a reduction in investor choice as antithetical to protecting investors. Therefore, a heightened fiduciary standard that limits investor choice would prove superior to a disclosure standard that preserves such choice.

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162. *Id.* at 1595–96. For a more detailed discussion of how behavioral economics as social science and behavioral economics as law and policy are at odds, see generally *id.*, which posits that these two elements of behavioral economics are in direct tension with one another ("[I]t would be surprising if the main policy implication of the mounting evidence documenting the failure of individual choice was a turn toward regulatory instruments that preserve individual choice," but this is indeed the case, as "[behavioral law and economics] does not always pursue the full implications of its own underlying social science.").

163. *See supra* Section I.C.

164. *See supra* notes 94–96 and accompanying text.

165. *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 Calif. L. Rev. 279, 280–82 (2000). For example, pursuant to Section 506 of the Securities Act of 1933, issuers can offer securities to "accredited investors" without having to register with the SEC as making a public offering of their securities. Vijay Sekhon, *Can the Rich Fend for Themselves?: Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010*, 7 Hastings Bus. L.J. 1, 2–3 (2011). Similarly, selling securities to "qualified institutional buyers" ("QIBs") under Rule 144A of the Securities Act does not require registering the security. *Id.* at 3. Both of these definitions of investors have minimum asset requirements that exclude the typical retail investor—accredited investors must have a net worth of over $1 million or annual income of over $200,000 as an individual or over $300,000 with a spouse, and QIBs must be institutional investors with $100 million of discretionary-basis investment funds. *Id.* at 2–3. Net worth and discretionary income are used as proxies for financial sophistication. These are two other areas in which retail investors are barred from engaging in investments because the SEC has made the determination that these financial products are not appropriate for them.

Conclusion

This Note uses behavioral economics to evaluate two competing investor-protection proposals. After conducting this economic analysis, the Note concludes that the SEC should adopt a fiduciary standard for broker-dealers because the alternative disclosure standard would fail to resolve the problem and would likely harm investors due to their well-documented cognitive biases. If the SEC implemented this reform, it would have a chance to fix a system that allows retail investors an opportunity to save for retirement or for a family member's college fund. While this Note engages in only a preliminary analysis of the particular reforms, this analysis could have wide-ranging implications for SEC regulations and associated research. Any future research in this area should focus on examining how to use the heuristics of broker-dealers or other financial intermediaries in order to reduce the likelihood that they would suggest suitable but suboptimal investments to their customers. In a time when Congress often legislates by crisis—waiting until massive problems develop and then passing equally massive legislation—this area of law is different in that reform could be a deliberative and thoughtful process. After all, like those who depend on doctors and waiters, investors will probably always need to rely on the relative expertise of their financial advisers. Given this reality, the SEC would do well to protect investors from the people they need to trust.