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# Conflicts & Capital Allocation

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# Conflicts & Capital Allocation

BENJAMIN P. EDWARDS*

*The regulatory structure for financial advice now tolerates incentives motivating financial advisors to manipulate and deceive retail investors. While scholars thus far have argued for ways to improve investor protections, the literature has largely ignored how these flawed incentives affect the economy.*

*This Article contends that these flawed incentives cause financial advisors to negatively affect capital allocation throughout the overall economy.*

*This Article draws on literature about manipulation and deception in principal-agent relationships to show how conflicts of interest cause the market for financial advisor services to generate excessive intermediation, driving harms to the real economy. This Article uses case studies of non-traded real estate investment trusts and closed-end funds to illustrate how financial advisor conflicts of interest contribute to inefficient capital allocation and inefficiency in the market for institutional intermediation.*

*To address this issue, this Article argues that an effective policy response will address compensation incentives and focus on limiting the ability of conflicts of interest to skew capital allocation.*

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## I. INTRODUCTION

In December 2015, JPMorgan Chase paid $307 million to the U.S. government because it failed to inform its clients about its conflicts of interest.[1] In particular, JPMorgan did not tell clients that it was investing client assets in JPMorgan's proprietary, higher-fee funds.[2] These higher-fee funds would generate more revenue for JPMorgan, but cause clients to earn significantly lower returns.[3]

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[1] Press Release, U.S. Sec. & Exch. Comm'n, J.P. Morgan to Pay $267 Million for Disclosure Failures (Dec. 18, 2015), https://www.sec.gov/news/pressrelease/2015-283.html [https://perma.cc/6KDL-UEPX] (describing related settlements totaling $307 million).

[2] *Id.*

[3] *See* OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, PUB. NO. 164, INVESTOR BULLETIN: HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO (Feb. 2014), http://www.sec.gov/investor/alerts/ib_fees_expenses.pdf [https://perma.cc/AA2K-MXBS] (explaining the significant impact of fees over time on returns).

JPMorgan's actions are hardly unique.[4] Undoubtedly, many financial advisors direct clients to invest in higher-fee funds that generate greater revenues for the advisors.[5] This regularly occurs even though client interests are almost always better served through simpler, lower-fee funds.[6] While others have argued that advisor conflicts of interest hurt savings outcomes for ordinary investors,[7] this Article argues that these conflicts of interest also cause systemic capital misallocation.[8]

Commission compensation structures may lead even well-meaning financial advisors to recommend unwise investments to their clients.[9] The

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[4] One former employee alleged that at Goldman Sachs, "people push the envelope and pitch lucrative and complicated products to clients even if they are not the simplest investments or the ones most directly aligned with the client's goals[.]" Greg Smith, *Why I Am Leaving Goldman Sachs*, N.Y. TIMES (Mar. 14, 2012), http://www.nytimes.com/2012/03/14/opinion/why-i-am-leaving-goldman-sachs.html [https://perma.cc/HJ4Y-LZG8]. Other banks have faced fines for similar behavior. WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 86–87 (2016) (explaining that Edward Jones, Morgan Stanley, Ameriprise, and Citigroup have faced similar fines).

[5] *See generally* Susan E.K. Christoffersen et al., *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, 68 J. FIN. 201 (2013) (documenting that broker recommendations increase broker profits).

[6] *See* Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L.J. 1476, 1488 (2015) ("The issue of fees is important because a substantial body of academic and industry research suggests that high-cost funds are poor investment options.").

[7] For decades, financial services firms have advertised their services and stressed that consumers should come to them for advice. *See* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 756 (2012) (documenting that brokerage firms have long advertised that they provide personalized advice); Joseph C. Peiffer & Christine Lazaro, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty: Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard*, 22 PIABA B.J. 1, 1 (2015) (contrasting advertisements purporting to put client interests first with arbitration defenses from the same institutions arguing that they do not owe a duty to put client interests before their own). Most Americans operate under the mistaken belief that all financial advisors have some legal duty to provide advice in the best interests of their clients. While some financial advisors may have such a duty, many do not. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS i (2011) [hereinafter FIDUCIARY STUDY], http://www.sec.gov/news/studies/2011/913studyfinal.pdf [https://perma.cc/ZRE7-PA3Q].

[8] The ultimate goal for financial regulation must be to improve capital allocation. *See* Wallace C. Turbeville, *A New Perspective on the Costs and Benefits of Financial Regulation: Inefficiency of Capital Intermediation in a Deregulated System*, 72 MD. L. REV. 1173, 1176 (2013) ("[T]he principal social value of financial markets is not to assure the lowest transaction costs for market participants. Rather, it is to facilitate the efficient deployment of funds held by investors to productive uses.").

[9] To be sure, some financial advisors do owe fiduciary duties to give advice in the best interests of their clients. For discussions of the divergent standards governing financial advisors, see generally Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 MICH. BUS. &

average investor, like someone trying to save for retirement, has many choices in how to invest her money. Many such investors turn to financial advisors for guidance, and those advisors are often compensated through sales commissions.[10] Some products offer the advisors larger commissions, and advisors have an incentive to steer clients toward products that maximize advisor commissions.[11] This incentive structure causes significant losses for ordinary savers—an estimated $17 billion per year.[12]

This Article argues that these incentive structures do not merely hurt individual investors and reward advisors, but in fact, drive the creation of needlessly complex financial products and retard economic growth.[13] These structures also increase systemic risk and magnify the likelihood of future financial crashes.[14]

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ENTREPRENEURIAL L. REV. 47 (2014), and Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will a Uniform Fiduciary Duty Make a Material Difference?*, 14 J. BUS. & SEC. L. 105 (2014).

[10] Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 445 (2010).

[11] *See id.* at 448–49 (suggesting that one solution to the problem might be to limit "differential commissions that cannot be justified in terms of the effort necessary to sell the product knowledgeably and responsibly, for example").

[12] In the aggregate, conflicted financial advice causes ordinary retail investors, i.e. individual, household, or noninstitutional investors, to transfer significant sums from their savings to their financial advisors. In February of 2015, the White House Council of Economic Advisers released a report on conflicted investment advice, conservatively estimating that "the aggregate annual cost of conflicted advice is about $17 billion each year" for retirement savers. COUNCIL OF ECON. ADVISERS, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS 2 (Feb. 2015). In practical terms, retirees receiving conflicted advice will run out of savings more than five years earlier than if they had received unbiased advice. *Id.* at 3. When these retirees deplete their savings, they may consume more public resources or depend on support from their families, reducing the next generation's ability to save and invest for the future. *See* Lynn A. Stout, *The Corporation as a Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE U. L. REV. 685, 686 (2015) (describing how current shareholders can have intergenerational impacts).

[13] *See, e.g.*, Siong Hook Law & Nirvikar Singh, *Does Too Much Finance Harm Economic Growth?*, 41 J. BANKING & FIN. 36, 36 (2014); Jean-Louis Arcand et al., *Too Much Finance?* 3 (Int'l Monetary Fund, Working Paper No. 12/161, 2012), http://www.imf.org/external/pubs/ft/wp/2012/wp12161.pdf [https://perma.cc/XSL2-5VLP]; Stephen G. Cecchetti & Enisse Kharroubi, *Reassessing the Impact of Finance on Growth* 1 (Bank for Int'l Settlements, Working Paper No. 381, 2012), http://www.bis.org/publ/work381.pdf [https://perma.cc/X3G9-U5YM]; *cf.* Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 575 (2015) ("[R]ecent studies suggest that the relationship between the size of a country's financial sector and the rate of its development is an inverted 'U'—having a robust financial system is critical for economic growth, but too much finance impedes development.").

[14] *See* Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 725 (2012) ("[C]omplexity arising from the spread of financial innovations may contribute to systemic risk . . . ."); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198–99 (2008) ("[F]inancial institutions . . . are

This Article argues that prohibiting commission-based compensation for financial advisors will substantially reduce these problems.[15] Eliminating this corrosive conflict of interest will improve the flow of capital, reduce systemic risk, and reshape financial services culture in a way that protects ordinary investors.

The Article proceeds in three parts. Part II discusses how financial advisor conflicts of interest negatively affect the capital markets and destabilize the financial system as a whole. Part III argues that banning commission compensation for financial advisors will improve capital allocation and market functioning. Part IV considers alternative solutions and the implications of regulating commission compensation structures.

## II. THE CONFLICTED INVESTMENT ADVICE PROBLEM

The capital markets exist for two purposes: (i) to allocate capital to the most profitable opportunities (on the macroeconomic level); and (ii) to help market participants invest or borrow money (on the microeconomic level).[16] Much has been said about the second purpose and how conflicts of interest between financial advisors and retail investors frustrate individual attempts to save for the future.[17] Yet these conflicts of interest also affect the broader economy by distorting the ways in which capital flows to fund business opportunities.

The capital markets drive economic growth by moving capital from savers to opportunities in need of capital.[18] The capital markets' ability to allocate

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important sources of capital. Therefore, their failure, especially in large numbers, can deprive society of capital and increase its cost. Increases in the cost of capital, or decreases in its availability, are the most serious direct consequences of a systemic failure.").

[15] While the proposal might appear radical in the United States, other nations have already taken this approach; commission-driven investment advice for retail investors has been banned in the United Kingdom, Australia, and the Netherlands. JEREMY BURKE & ANGELA A. HUNG, FINANCIAL ADVICE MARKETS: A CROSS-COUNTRY COMPARISON 8, 12, 20–21 (2015), http://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1269/RAND_RR1269.pdf [https://perma.cc/H6AC-XP3E].

[16] Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 35 (2010) ("The basic goals of the markets have remained the same – namely, the efficient allocation, transfer, and deployment of capital resources and risk-bearing."); *see also* Stout, *supra* note 12, at 686 (explaining that capital markets "can transform wealth that will be generated in the future into wealth that can be enjoyed today in the form of a higher share price").

[17] *See generally* Tamar Frankel, *The Regulation of Brokers, Dealers, Advisers and Financial Planners*, 30 REV. BANKING & FIN. L. 123 (2010); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710; Steven D. Irwin et al., *Wasn't My Broker Always Looking Out for My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41 (2009).

[18] *See* JOHN KAY, OTHER PEOPLE'S MONEY: THE REAL BUSINESS OF FINANCE 135 (2015) ("A central function of financial markets is to direct money from savers to

capital to fund the development of more real assets depends on how well financial assets are priced to faithfully reflect the value of the real assets behind their returns.[19] For example, if two firms both seek capital to open a restaurant or build a plant, the opportunity that will "generate more profits per invested dollar is the more desirable real investment and should attract funds first."[20] If the market prices for these new financial assets reflect the underlying merits and risks of the opportunity, the better opportunity will offer better returns.[21] If financial assets are not priced accurately, the capital markets will not allocate capital as efficiently.[22] There is an inexorable link between capital allocation and the health of the macroeconomy.[23] As explained below, conflicted investment advice drives capital misallocation, causing significant macroeconomic and other harms.

A variety of financial intermediaries play significant roles in moving capital through the economy.[24] Institutional intermediaries, such as pensions and mutual funds, manage pools of assets for their investors. Banks, broker-dealer firms, insurance companies, and others may innovate and create new

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businesses, home-owners and governments. They in turn use these savings to build, own and operate houses, shops, offices, warehouses and factories . . . .").

[19] *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 769 (1985) (explaining that in a fundamentally or allocatively efficient market, the financial returns for a particular investment opportunity will correspond to the discounted present value of its shares).

[20] *Id.*

[21] The capital markets function well when capital flows to its best use and funds these opportunities. *See* Alicia J. Davis, *Market Efficiency and the Problem of Retail Flight*, 20 STAN. J.L. BUS. & FIN. 36, 45 (2014) ("Allocative efficiency requires capital to be directed to its highest and best use."); Kevin Haeberle, *Stock-Market Law and the Accuracy of Public Companies' Stock Prices*, 2015 COLUM. BUS. L. REV. 121, 137 ("[W]hen stock prices are accurate, firms with superior prospects—that is, those with higher values—will generally draw more capital and firms with inferior ones—that is, those with smaller expected future cash flows—will draw less.").

[22] *See* James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC*, 95 VA. L. REV. 941, 956 (2009) ("[I]naccurate securities prices impair the allocational efficiency of capital markets, a central objective of securities regulation."); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1005 (1992) ("Inaccurate stock prices can result in an inefficient allocation of capital.").

[23] Binyamin Appelbaum, *This Time, Cheaper Oil Does Little for the U.S. Economy*, N.Y. TIMES (Jan. 21, 2016), http://www.nytimes.com/2016/01/22/business/energy-environment/this-time-cheaper-oil-does-little-for-the-us-economy.html [https://perma.cc/UU84-834X] ("There's a feedback between financial markets and the economy. . . . [Even if] markets are irrational . . . that spills over into the real economy." (quoting Andrew T. Levin, former adviser to Federal Reserve Chair Janet L. Yellen)).

[24] For a definition of financial intermediaries, see Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 187 n.2 (2013), who defines "financial intermediaries" as "privately owned and controlled businesses that provide fundamental financial services to financial market participants."

financial products. Many investors now rely on different financial advisors for assistance navigating this constantly evolving landscape.[25]

Of course, these financial advisors have their own interests to pursue as well. Collectively, conflicts of interest at the retail level have macroeconomic impacts because of the size of the capital pool being allocated.[26] Recent information indicates that as of 2013, U.S. households controlled equity securities valued at over $13.3 trillion.[27] For the most part, retail investors now channel these assets through institutional intermediaries.[28] This Article focuses on how and why retail investor funds flow to particular intermediaries and what this means for the market for institutional intermediation, business culture, and the economy as a whole.

## A. *Assessing the Quality of Financial Advice*

In some respects, financial advice may resemble wine ratings for two reasons: (i) opinions about quality vary wildly; and (ii) higher-cost does not yield higher quality.[29] With respect to the first, no uniform standard exists to set the scope for personalized financial advice. Some investors may prefer a financial advisor that assists only with asset allocation. Others may prefer more assistance with other financial decisions, such as whether to buy a home and how and when to claim their Social Security benefits. In some instances, a preference for a higher level of customer service may justify the decision to pay a financial advisor more for assistance.

While it may be difficult to identify the best advice in any particular situation, basic care and loyalty standards seem likely to generate higher quality advice. Investors may receive higher quality advice when their financial advisor exercises reasonable care to understand the customer's

[25] For a detailed discussion of the different types of financial advisors now serving the retail market, see *infra* Part III.B.

[26] The retail capital allocation problem will continue to expand because shifting economic relationships have also fundamentally restructured the retail investment. For a thorough discussion of this change and its implications, see JACOB S. HACKER, THE GREAT RISK SHIFT: THE ASSAULT ON AMERICAN JOBS, FAMILIES, HEALTH CARE, AND RETIREMENT AND HOW YOU CAN FIGHT BACK (2006).

[27] SIFMA, 2016 FACT BOOK 80 (2016).

[28] *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1026 (2009) ("The last thirty years or so have brought a rapid shift toward institutionalization."); Anne M. Tucker, *The Outside Investor: Citizen Shareholders & Corporate Alienation*, 11 U. ST. THOMAS L.J. 99, 105–06 (2013) ("With self-directed defined-contribution plans, participants began to rely heavily on mutual and index funds as investment options, thus increasing the number of indirect investors and the significance of institutional investors." (footnote omitted)).

[29] *See Further Evidence that Wine Tasting Is Wildly Subjective*, FREAKONOMICS (July 8, 2013), http://freakonomics.com/2013/07/08/further-evidence-that-wine-tasting-is-wildly-subjective/ [https://perma.cc/7KMF-V2PW] ("A few years ago, we did a podcast on whether expensive wine tastes better. There is now further evidence that the answer to that question is no—even for elite wine critics.").

situation and confirm that the advice given about particular products or strategies is not based on inaccurate or incomplete information.[30] Good advice will also be loyal advice—given in the customer's best interests as opposed to the best interests of the financial advisor.

## B. *Puzzling Product Purchases*

At present, a significant volume of investment advice is not given in investors' best interests. This may be inferred because far too many investors make decisions that appear irreconcilable with wealth-maximization motives. Consider puzzling investor decisions to purchase Non-traded or Non-listed Real Estate Investment Trusts (Non-Traded REITs) and the initial public offering (IPO) of closed-end funds. As explained below, frequent purchases of these products seem unlikely absent a commission-based incentive to steer clients into these products. While this Article profiles two frequently exploitative offerings, there are many other financial products that either should not be sold or should be sold much less often.[31]

### 1. *Non-Traded Real Estate Investment Trusts*

Non-traded REITs appear cynically designed to make it possible for financial intermediaries to advance their own interests at the expense of their clients in the primary market. Curiously, while non-traded REITs have long been a concern for consumer advocates, they are little discussed in the legal literature.[32] Despite this, financial advisors have channeled billions of dollars of retail investor capital into non-traded REIT offerings.[33]

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[30] *See* FIDUCIARY STUDY, *supra* note 7, at 120–21.

[31] *See, e.g.*, JOSHUA M. BROWN, BACKSTAGE WALL STREET 209–22 (2012) (describing a range of financial products as "murder holes"); Ann Lipton, *I Do Not Think It Means What You Think It Means*, BUS. L. PROF BLOG (May 7, 2016), http://lawprofessors.typepad.com/business_law/2016/05/you-keep-using-that-word-i-do-not-think-it-means-what-you-think-it-means.html [https://perma.cc/HNM2-MG28] ("The story begins with variable annuities, a product that might be suitable if you're trying to shelter your assets from a lawsuit, but otherwise one whose chief virtue lies in its capacity to serve as a litmus test for the honesty of your broker.").

[32] *See* BROWN, *supra* note 31, at 219 ("[T]here are huge questions surrounding the selling of private real estate investment trusts . . . ."); Barbara Black, *Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer a Better Approach?*, 48 WAKE FOREST L. REV. 771, 778 (2013) ("FINRA and State Attorneys General have brought enforcement actions against broker-dealers for abusive practices in the sale of non-traded REITs to unsophisticated investors.").

[33] *See* Micah Hauptman, *Why Investors Should Think Twice About Nontraded REITs*, WALL STREET J. (Nov. 13, 2015), http://blogs.wsj.com/experts/2015/11/13/why-investors-should-think-twice-about-nontraded-reits/ [https://perma.cc/M3AY-HEFA] ("Investors purchased at least $116 billion in nontraded REITs over the last 25 years and are at least $45 billion worse off than they would have been if they had merely invested in a diversified portfolio of traded REITs . . . .").

Non-traded REITs are a subset of REITs. REITs are quasi-corporate entities that provide a tax-advantaged vehicle for investors to invest in real estate.[34] A REIT takes a pool of investor capital and uses that money to buy income-producing properties.[35] Typical REIT holdings include apartment buildings, commercial properties, or even timber-producing land.[36] Often, investors will purchase REITs to access the steady income from tenants' rent payments.[37]

There are a variety of REITs available for retail investors seeking income or to diversify their portfolio by holding real estate.[38] Both traded and non-traded REITs are registered with the SEC and provide the public with annual and quarterly reports.[39] Both invest in real estate and receive preferential tax treatment for paying dividends.[40] There are other differences—particularly in the fees charged. Non-traded REITs generally come with initial offering fees and expenses between 12% to 15% of the offering, which is quite high.[41]

Given the fee level, financial advisors receive extraordinarily high compensation for selling these non-traded REIT shares to retail investors.[42] One recent study found that these non-traded REITs average upfront fees amounting to 13.2% of invested capital.[43] This means that, on average, an investor seeking to put $100,000 to work in the capital markets will actually only put in about $86,800, losing $13,200 to commissions and fees. In contrast, an investor seeking real estate exposure could also buy $100,000 worth of traded-REIT shares for a trading commission of $10 or less.

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[34] *See Public Non-Traded REITs—Perform a Careful Review Before Investing*, FINRA, http://www.finra.org/investors/protectyourself/investoralerts/reits/p124232 [https://perma.cc/LWL7-7TJS] (last updated Nov. 30, 2016).

[35] *See id.*

[36] SIMON LACK, WALL STREET POTHOLES 3 (2016).

[37] *Id.*

[38] *See* Office of Inv'r Educ. & Advocacy, *Investor Bulletin: Non-Traded REITs*, U.S. SEC. & EXCH. COMM'N (Aug. 31, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html [https://perma.cc/4WMA-CW84].

[39] *Id.*

[40] *Id.*

[41] Robbie Whelan, *Nontraded REITs Are Hot, but Have Plenty of Critics: As Investors Pour Money into Funds, Skeptics See Better Alternatives*, WALL STREET J. (June 15, 2014), http://www.wsj.com/articles/nontraded-reits-offer-high-returns-but-critics-cite-fees-and-illiquidity-1402670753 [https://perma.cc/V9DV-58EW]. Writing about a high-fee REIT in 2005, David F. Swensen, the chief investment officer of Yale University, argued that the "most generous characterizations of [these] fees range from obscene to despicable." DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 71 (2005).

[42] *See* Office of Inv'r Educ. & Advocacy, *supra* note 38.

[43] Brian Henderson et al., *An Empirical Analysis of Non-Traded REITs*, 19 J. WEALTH MGMT. 83–84 (2016).

Non-traded REITs allow financial advisors to exploit a sophistication gap between themselves and their clients.[44] Retail investors struggle to understand the actual fees and expenses involved with non-traded REITs because they do not pay the commissions directly, rendering the true cost opaque until and unless the investor reads and understands the fine print.[45] Indeed, it seems unlikely that many fully informed persons would opt to purchase shares in a non-traded REIT if they understood the fee structure and other options available. One critic of non-traded REIT sales encapsulated what an honest discussion of the typical non-traded REIT fees would sound like, with the representative saying:

> If you invest $100,000 I will be paid a commission of $7,000. My firm is going to get $1,500 – $2,000 in revenue share. My wholesaler, the salesman that works for the investment's sponsor company, will get $1,000. He is a great guy, buys me dinner all of the time and takes me golfing. The sponsor company is going to get around $3,000 to pay for some of the costs they incurred in setting up the investment. So all in on Day 1 there will be around $87,000 left over to actually invest. I bet you are getting excited.[46]

Financial advisors may not have paid appropriate reputational costs for selling non-traded REITs with outsize fees and expenses because the illiquid products have, for some time, appeared on retail investor brokerage statements at the price retail investors paid for them.[47] Investors purchasing these non-traded REITs for $10 per share saw post-purchase statements listing a price per share of $10—notwithstanding that a significant percentage of the investment had already been diverted to fees and expenses.[48] When the price per share updates to a more accurate figure after a long expanse of time, a financial advisor may deflect responsibility by pointing to uncertainty within

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[44] To be sure, many financial advisors may not personally understand the superior alternatives. Their broker-dealer firm may have only trained them to sell non-traded REITs.

[45] BROWN, *supra* note 31, at 219 ("[O]f course that 7 percent commission is built into the offering price; the client never sees it or feels it (and in many cases doesn't even know about it).").

[46] Joshua M. Brown, *Scenes from an Independent Brokerage Firm*, REFORMED BROKER (May 21, 2014), http://thereformedbroker.com/2014/05/21/scenes-from-an-independent-brokerage-firm/ [https://perma.cc/FW7V-FY2Z] (describing non-traded REITs as "just absolute murderholes for clients – they pay the brokers so much that they cannot possibly work out").

[47] Order Approving FINRA Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities, Exchange Act Release No. 34-73339, 79 Fed. Reg. 62489 (Oct. 10, 2014).

[48] *See id.* at 62491 (approving a valuation rule change to alter the "practice of displaying a DPP or REIT security's immutable offering price as its per share estimated value on customer account statements throughout the offering period (which can last several years)").

the broader financial markets.[49] Or, the product may show gains above the purchase price, effectively camouflaging the portion raked off by intermediaries. While a recent rule change requiring the disclosure of a more accurate per-share value post-sale may provide more transparency, the impact of the alteration remains to be seen.[50]

Still, early reports indicate that some financial advisors intend to sell less of these products now that clients may be more likely to appreciate the fees. For example, one financial advisor with Cetera Financial Group recently said that he would no longer sell the products because he did not "want to have any clients ever saying, 'Oh, yeah, by the way, how come this is $88,000 instead of $100,000?'"[51] While the financial advisor claimed to have previously discussed fees and expenses with his clients, the decision to stop selling the products under a modified disclosure regime supports the inference that the products were sold because clients did not appreciate the costs.[52] In contrast, purchasers of publicly traded REITs immediately know the market value of their shares from the public market price.

Capital misallocation may also be observed because non-traded REITs tend to underperform publicly traded REITs.[53] One analysis found that "had non-traded REIT investors instead invested in a low-cost and liquid REIT mutual fund, they would have accumulated $44 billion more than they accumulated in the non-traded REITs. Non-traded REITs' average annual returns are 4.0%, compared to 11.3% in a traded REIT portfolio."[54] The

[49] Given a long enough expanse of time, the updated per share value may even show an increase over the initial sale price if the underlying assets have appreciated in value. While a retail investor may see a positive return in absolute terms, the product will almost certainly have significantly underperformed a publicly traded REIT.

[50] Under soon-to-be-enforced rules, broker-dealer firms will have to provide updated per share valuations to their clients. *See* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 15-02: DPP AND UNLISTED REIT SECURITIES (Jan. 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf [https://perma.cc/Y74R-AW9U] (explaining the new valuation methods to go into effect in April of 2016); *see also* LACK, *supra* note 36, at 8 (explaining that the lack of a public trading market for non-traded REITs inhibits investors from discovering the actual value of their shares—and by extension the REIT); Chuck Jaffe, *Non-Traded REIT Is a Non-Starter*, MARKETWATCH (Nov. 4, 2011), http://www.marketwatch.com/story/non-traded-reit-is-a-non-starter-2011-11-04 [https://perma.cc/Y554-JCRR] (explaining that investors should not rely on the stated share value because "management won't even calculate net asset value until 18 months after the completion of the offering, and that the current share value is 'arbitrary'").

[51] Ann Marsh, *Commissions Exposed, Adviser Stops Selling Nontraded REITs*, FIN. PLAN. (June 8, 2016) (quoting Colin Mackenzie, financial advisor, Cetera Financial Group), http://www.financial-planning.com/news/commissions-exposed-adviser-stops-selling-nontraded-reits [https://perma.cc/DSW4-9RVQ].

[52] *See id.* (quoting Knut Rostad of the Institute for the Fiduciary Standard as remarking that the financial advisor "only made these sales because he could hide what he charged for them").

[53] *See* Henderson et al., *supra* note 43, at 84.

[54] *See id.*

underperformance of non-traded REITs appears even more puzzling because illiquid assets should return a premium over liquid assets.[55]

This underperformance indicates likely fundamental, allocative inefficiency in the capital markets. Some of this allocative inefficiency may be attributable to the deceptive and manipulative marketing strategies employed by the issuers and financial advisors—raising a question as to whether the non-traded REIT sector attracts capital on its merit or its ability to bias intermediaries by paying above average fees. To the extent that it attracts capital by biasing intermediaries, other issuers suffer from increased capital costs and attract less investor capital than would be expected on the merits of their offerings.

This inefficiency affects the real economy. When non-traded REITs use conflicted financial advice to gather an outsized amount of capital, it causes excessive capital to flow to the real estate market—driving up the prices of real assets.[56] If the equilibrium were different—rewarding more competition on the merits and the risks instead of efforts to bias financial advisors, these products would likely attract less capital, freeing it for more productive uses.

### 2. *Closed-End Funds*

Capital misallocation on account of financial advisors manipulating and deceiving retail investors may also be observed with the sale of closed-end funds (CEFs) to retail investors.[57] Few investment options seem less attractive than buying the shares of a closed-end fund in an IPO, particularly if similar CEFs already exist.[58] Indeed, the continuing existence of CEFs has puzzled economists for decades.[59] Because the IPO shares are sold at a premium and will soon trade at a significant discount, economists cannot discern any good reason why a rational investor would purchase CEF shares in an IPO instead

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[55] *See* Yair Listokin, *Taxation and Liquidity*, 120 YALE L.J. 1682, 1689 (2011) ("A considerable body of both theoretical and empirical evidence demonstrates that the liquidity of an asset is an important determinant of its return, with more liquidity being associated with a lower return.").

[56] *See* SWENSEN, *supra* note 41, at 75 ("No rational buyer can compete with the [REITs'] willingness to overpay for product. . . . [I]nvestors suffer the double indignity of high fees and poor investment prospects.").

[57] For an argument that CEF IPOs do not appear to be in the best interests of customers, see Benjamin P. Edwards, *Closed-End Fund IPO Considerations*, 22 PIABA B.J. 283, 283 (2015), who notes that "absent a compelling reason, investors should generally avoid purchasing CEF shares in an initial public offering (IPO)."

[58] *See* BROWN, *supra* note 31, at 221 ("These funds should only be bought at a discount in the secondary market. Within 90 days of the IPO, the 'penalty bid' phase ends and brokers can freely dump shares while keeping their commissions—you will be down 15 percent in a blink.").

[59] *See* Charles M.C. Lee et al., *Anomalies: Closed-End Mutual Funds*, 4 J. ECON. PERSP. 153, 154 (1990).

of purchasing the shares of a CEF already on the market.[60] If no rational investor would buy CEF shares during an IPO, then CEFs should eventually cease to exist in a rational expectation equilibrium because new CEFs would not be created.[61] Yet CEF IPOs persist, and stockbrokers continue to sell CEF shares to retail investors, despite a long record of underperformance.[62] Their continued existence is best interpreted as revealing capital misallocation caused by commission compensation structures.

Importantly, not all capital markets participants can be taken by CEF IPOs.[63] Recent empirical information regarding CEF holders confirms the impression that sophisticated investors do not purchase CEF shares in IPOs.[64] The evidence indicates that "institutional ownership in recent CEF IPOs is extremely low compared to operating company IPOs."[65] This means that, when more sophisticated institutional money managers evaluate investment opportunities, they generally pass on CEF IPOs.[66]

Many explanations for CEF IPO sales point to purchasers' lack of sophistication. Economists and other experts studying the products have theorized that the CEF IPO shares are bought by "noise traders, or 'suckers,' who are sufficiently optimistic to buy overpriced assets."[67] Some assert that

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[60] *See id.* ("So, puzzle one: Why does anyone buy these funds when they are first issued?"); Charles M.C. Lee et al., *Investor Sentiment and the Closed-End Fund Puzzle*, 46 J. FIN. 75, 75 (1991) ("Few problems in finance are as perplexing as the closed-end fund puzzle.").

[61] *See* Kathleen Weiss Hanley et al., *The Marketing of Closed-End Fund IPOs: Evidence from Transactions Data*, 5 J. FIN. INTERMEDIATION 127, 128 (1996) ("[I]n a rational expectations equilibrium, these [CEFs] should not get started at all.").

[62] One recent study revealed that when compared against CEF shares already on the market (seasoned shares), shares purchased during a CEF IPO underperformed seasoned shares by 8.52% after six months and 11.05% after one year. Diana Shao, Closed-End Fund IPOs: Sold Not Bought 1–3 (unpublished manuscript), http://ssrn.com/abstract=2652432 [https://perma.cc/24T3-XHG7] (last revised Mar. 17, 2016).

[63] *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 725 (2003) ("[I]nstitutions hold only a very small percentage of closed-end mutual fund shares, leaving individual investors as the central clientele for this type of investment.").

[64] *See* Shao, *supra* note 62, at 18.

[65] *Id.* at 3.

[66] If an institutional money manager purchased and held CEF IPO shares, they would significantly underperform and likely attract less capital than their competitors. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 893 (2013) ("For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly."); *see also* LACK, *supra* note 36, at 27 ("It's generally the dumb money that buys a CEF IPO at [issue price].").

[67] Lee et al., *supra* note 59, at 162 (noting that "[i]t helps to have a gimmick," such as a famous asset manager). In the economics literature the term "noise trader" is frequently used as a euphemism for idiot. Lawrence Summers famously "began a paper on finance by

"[i]nvestors who wish to hold closed-end funds should never buy them at the IPO and the suggestion that they should by financial advisors is suspect."[68]

One anecdotal account from a financial advisor indicates that the intermediaries serving the retail market understand that purchasing CEF IPO shares is unwise:

> I once had a conversation with a Wall Street analyst at a very big firm about an upcoming CEF IPO. She had briefly forgotten about my background in finance and must have been thinking of me as another one of the patsies who willingly part with 6% of their investment for no good reason. She was attempting to get me interested in becoming a Day One investor, and I pointed out that many investors know to avoid CEF IPOs and wait for the secondary market price to buy 6% cheaper. Quickly recognizing her mistake, she breezily acknowledged the correctness of my view! Even though her job was to write research that would help persuade investors to overpay for the securities, she understood the fallacy in the message she was pushing.[69]

### C. *Harms Caused by Conflicted Financial Advice*

The harms from conflicted financial advice extend far beyond the harms to individual investors. While these investors suffer subpar returns, the misallocation of social resources caused by conflicted investment advice causes widespread harm.

#### 1. *Misdirected Financial Innovation and Amplified Systemic Risks*

The 2008 financial crisis clearly demonstrated that financial innovation has a dark side and that financial complexity may be used to exploit investors.[70] In some instances, intermediaries

> can exploit the investors mistakes by creating financial instruments that pay off in the states that investors overweight and pay off less highly in the states

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declaring: 'THERE ARE IDIOTS. Look around.'" Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES (Sept. 2, 2009), http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html [https://perma.cc/L9ND-Y3EH] (explaining that "the preferred term in the academic literature" for idiots is "noise traders").

[68] *See* Edward S. O'Neal, Closed-End Fund IPOs (June 29, 2007) (unpublished manuscript), http://www.slcg.com/pdf/workingpapers/Closed%20End%20Fund%20IPOs.pdf [https://perma.cc/G8G3-BVLE].

[69] *See* LACK, *supra* note 36, at 27.

[70] *See* Henry T.C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1647 (2012) ("There certainly is empirical evidence to suggest that financial product complexity can be used to exploit investors."); Frank Partnoy, *Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories About the Function, and Dysfunction, of Markets*, 26 YALE J. ON REG. 431, 431–32 (2009) (explaining that "financial innovation often has a dark side" that can be driven by "disclosure gaps and misunderstandings").

> that investors underweight, leading the investors to value the new instruments more highly than they would if they understood financial markets and correctly evaluated information about probabilities of future events.[71]

For example, the structured equity products Morgan Stanley markets to retail investors provide such abnormal negative returns that their purchase cannot be explained by any "benign reasons" and "most . . . investors would likely have been better off investing in non-interest bearing accounts."[72] Rather, their creation best indicates that sophisticated financial intermediaries profit by exploiting their counterparties' relative lack of sophistication.

Financial innovation designed to allow financial intermediaries to exploit conflicts of interest poses a particular danger to the financial system.[73] For example, innovations that simply increase capital intermediation within the financial sector—such as Morgan Stanley's structured equity products—may provide no significant social benefit and only amplify systemic risk.[74] Needless, complexity-increasing financial innovation contributes to systemic risk and fragility by increasing the length of intermediation chains.[75] For example, a financial advisor might earn a rich incentive payment for transferring client assets to a fund of funds—an institutional intermediary that invests assets with other institutional intermediaries.[76] Systemic risk increases with each additional intermediary added because every new intermediation node creates another opportunity for fragmentation.[77]

This is not to say that financial innovation does not ever unlock benefits benefiting all parties. Frequently, it allows market participants to price and allocate risks in new, socially useful ways.[78] Often, this process shifts risks to parties better able to bear them and allows new forms of diversification. As an example of a worthwhile financial innovation, consider the problem faced by

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[71] Brian J. Henderson & Neil D. Pearson, *The Dark Side of Financial Innovation: A Case Study of the Pricing of a Retail Financial Product*, 100 J. FIN. ECON. 227, 228 (2011) (concluding that retail investors pay, on average, an 8% premium over fair market value for certain complex financial products).

[72] *Id.* at 246.

[73] *See* Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 218–20 (2013) (explaining how complexity that merely moves capital within the financial sector and not to the development of real assets may threaten financial stability).

[74] *Id.* at 220–21; *see also* Henderson & Pearson, *supra* note 71, at 229 (discussing Morgan Stanley's Structured Equity Products).

[75] *See* Judge, *supra* note 13, at 630 ("The lengthening of intermediation chains increases systemic risk through multiple mechanisms.").

[76] *See id.* at 608.

[77] *See* Judge, *supra* note 14, at 657 (explaining how increased complexity generates systemic risk).

[78] *See* Cathy Hwang & Benjamin P. Edwards, *The Value of Uncertainty*, 110 NW. U. L. REV. 283, 285–88 (2015) (describing the securitization process used to spread risk).

the artist David Bowie in 1997.[79] He held a portfolio of ownership rights to royalties from music and film.[80] While these royalties would likely pay Bowie substantial revenues over time, he wanted access today to the capital that these assets would generate over the tomorrows to come.[81] The capital markets created a solution, dubbed Bowie Bonds, where David Bowie transferred his royalty rights to a trustee for a ten-year period of time.[82] The expected revenue stream from David Bowie's royalties allowed him to sell $55 million worth of bonds, allowing David Bowie to shift his consumption of the gains from his music into the present.[83]

While David Bowie shifted consumption from the future to the present, the other party to the deal shifted its consumption from the present to the future.[84] In buying the Bowie Bonds, the investor on the opposite side of the deal took funds it did not need today and used the Bowie Bonds to gain more funds in the future, spending $55 million dollars today for a greater amount over time.[85] In these instances, financial innovation does good, unlocking benefits for all parties to a deal.

### 2. *Conflicts of Interest Increase Capital Costs*

Pervasive conflicts of interest raise the cost of capital both directly and indirectly, inhibiting economic growth.[86] Conflicts of interest directly increase the cost of capital by forcing issuers to compete with each other to bias intermediaries. Consider the dilemma faced by an issuer, Company A, willing to offer 4% of the capital raised to intermediaries as compensation for their services selling the product to investors. If another issuer, Company B, offers 6% of the capital raised as compensation to intermediaries that recommend it, Company A will need to either find another intermediary or increase the amount of capital it offers the intermediaries in exchange.[87]

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[79] *See* Tommy Stubbington & Mike Bird, *David Bowie: The Man Who Sold the World. . . and Bonds*, WALL STREET J. (Jan. 11, 2016), http://www.wsj.com/articles/david-bowie-the-man-who-sold-the-worldand-bonds-1452542807 [https://perma.cc/NZM7-PTCM].

[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] Stubbington & Bird, *supra* note 79.

[86] The cost of capital influences economic growth because it determines how existing businesses and entrepreneurs will access capital to pursue development in the real economy. *See* Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 945 (1993) ("The lower the cost of capital to a nation's entrepreneurs, the more that will be purchased.").

[87] While it is possible that intermediaries could compete with each other on fees and lower the cost of capital by underbidding each other, the market for financial services does not appear particularly competitive. *See* Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517,

Conflicts of interest and exploitative practices may also raise the cost of capital by causing investors to distrust the securities markets.[88] This may cause them to discount the amount they are willing to pay for securities to the extent that they lose faith in the judgment of the intermediary recommending a particular transaction.[89] Of course, the existence of this discount depends on investors recognizing that conflicts of interest exist and responding to the conflict. While not all investors will appreciate or react to conflicts of interest, a significant enough portion may respond, effectively increasing the cost of capital.

While this harm may be difficult to measure, distrust of financial institutions can drive significant macroeconomic harms and lead to panics.[90] In relationships where transaction partners trust each other's integrity, it frees them "to act quickly and with confidence, again and again."[91] When an investor does not trust a financial advisor, it forces the expenditure of additional resources to assess the quality of a recommendation, further increasing the cost of capital.[92]

### 3. *Inefficient and Excessive Institutional Intermediation*

Conflicts of interest skew how institutional intermediaries gather investor capital. Many different institutional intermediaries—mutual funds, defined-benefit pension plans, insurance companies, and others—manage retail investor capital.[93] Indeed, for most retail investors, all their capital flows to the market through these institutional intermediaries.[94] In every case, their

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1545 (2013) ("[F]inancial intermediaries often operate in industries where there are a limited number of market participants and high barriers to entry, increasing the likelihood that they will be able to earn *supra*-competitive fees on some types of transactions." (emphasis added)).

[88] *See* Ziven Scott Birdwell, *The Key Elements for Developing a Securities Market to Drive Economic Growth: A Roadmap for Emerging Markets*, 39 GA. J. INT'L & COMP. L. 535, 545 (2011) ("[A]buses . . . eat away at capital markets, destroy investor confidence, and increase the cost of capital.").

[89] *Cf.* Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 967 (2014) ("If investors come to see the securities markets as a rigged game—one that seems by design to systematically disadvantage ordinary investors—they could respond by discounting the amount that they are willing to pay for all securities, thereby raising the cost of capital.").

[90] *See* ANNA BERNASEK, THE ECONOMICS OF INTEGRITY 8 (2010) ("The result of all that integrity and trust unraveling was an economic contraction so profound that it affected every American together with vast populations around the world.").

[91] *Id.* at 11 ("Partners in trust are spared a multitude of worries—whether they'll get paid, whether they'll get what they think they're paying for.").

[92] *See id.*

[93] *See* Langevoort, *supra* note 28, at 1026 (discussing the rise of institutional intermediation).

[94] *See* Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 177–78 (2013) ("While there are individual

continued existence as intermediaries depends on their ability to gather a pool of capital to manage—without assets, you cannot have an asset manager.

Institutional intermediaries compete against each other on a variety of fronts within the market for institutional intermediation.[95] While relative performance is certainly a factor, they also compete through ordinary marketing and by providing incentives for financial advisors to recommend their funds.[96] Successful intermediaries grow larger as they attract more net capital inflows.

Financial advisor incentives affect which institutional intermediaries receive capital.[97] Before reaching the traditional securities markets, investor assets frequently pass through at least two layers of intermediation: (i) intermediation from a financial advisor selecting an institutional intermediary; and (ii) the institutional intermediary then investing the assets.[98] Consider, for example, the recent SEC enforcement proceeding against Everhart Financial Group, an investment advisory firm, for skewing its recommendations.[99] Clients came to Everhart for assistance.[100] Everhart "nearly always" steered non-retirement clients into mutual funds that routed fees back to Everhart's owners.[101] These conflicts of interest explain how many institutional intermediaries collect capital even though investing in their funds or at particular fee levels appears unwise.[102]

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differences among many investors (i.e., priority, time horizon, risk tolerance, level of diversification), citizen shareholders have commonalities in how they enter the market, their investment in indirect funds, and a rational preference for long-term growth to fund future retirement." (footnote omitted)).

[95] The market for institutional intermediation is the market for the services of institutional intermediaries. Institutions that manage capital compete against each other.

[96] *See* Gilson & Gordon, *supra* note 66, at 893 ("For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly."). For a description of different fees and expenses in the mutual fund space, see John A. Haslem, *The "Many Faces" of Mutual Fund Revenue Sharing*, J. INDEX INVESTING, Winter 2014, at 59, 59–60, and Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 1.

[97] *See* Christoffersen et al., *supra* note 5, at 229.

[98] In some instances, there may be additional layers of intermediation if the institutional intermediary invests the assets gathered with other intermediaries. One example of this dynamic would be intermediaries known as funds of funds—an investment fund that invests in a variety of other investment funds.

[99] Everhart Fin. Grp., Inc., Exchange Act Release No. 76897, 2016 WL 159329, at *2 (Jan. 14, 2016).

[100] *Id.*

[101] *Id.*

[102] Illustrating the powerful draw of conflicted payments, Everhart collected these fees even though the Investment Advisers Act required it "to seek the most favorable terms reasonably available under the circumstances" when executing client transactions. *See* Fidelity Mgmt. & Research Co., Investment Advisers Act Release No. 2713, 2008 WL 598424, at *6 (Mar. 5, 2008) (citing Interpretative Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-23170, 51 Fed. Reg. 16004 (Apr. 23, 1986)).

The current market for institutional intermediation is best explained by financial advisor preferences, not investor preferences.[103] In the idealized world of economic theory, one populated by perfectly rational, well-informed and high-functioning persons with the time to critically consider the differences between institutional intermediaries, the market for institutional intermediation would look strikingly different.[104] Institutional intermediaries would compete by undercutting their rivals and lowering costs—a form of competition benefiting investors. Rational investors would select the firms that offered them the best results. In theory, this seemingly creates a powerful incentive for some entrepreneur to provide better advice to retail investors for a reasonable fee. If the upstart providing superior advice secured large profits from serving the retail market, we would expect others to follow and for competition to drive prices down still further to an efficient equilibrium point.

A similar dynamic exists for assets within employer-sponsored, defined-contribution plans.[105] While the assets funneled to many mutual funds ultimately belong to employee-investors, the employer or the plan administrator actually determines whether the plan will offer a particular fund.[106] Given this reality, funds may have stronger interest in pleasing the employer or plan administrator than the underlying investors.[107]

Competition among financial intermediaries has not yet solved this problem and seems unlikely to do so. Consider, for example, the proliferation of funds tracking the S&P 500.[108] Many of these funds charge significantly different fees for tracking the same index, and many investors purchase the higher-fee funds—a reality that appears inconsistent with a model of the world that assumes investors are acting in ways that will maximize their returns.[109] This is particularly puzzling because the only real difference between the funds is the fees.[110] Higher-fee index funds will *always lose* to lower-fee index funds if they track the same index. Even persons we would expect to exhibit

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[103] Often, commentators describe the market for mutual funds without discussing the financial advisors' incentives. *See* Christoffersen et al., *supra* note 5, at 201 ("The decision to invest in a mutual fund is usually traced to the investor's preferences and information.").

[104] At the least, this market would be informationally and fundamentally efficient—the price paid for institutional intermediaries would fairly reflect the value delivered.

[105] *See* Tucker, *supra* note 28, at 121–22.

[106] *Id.* at 112.

[107] *Id.* at 123.

[108] *See* Jacob Hale Russell, *The Separation of Intelligence and Control: Retirement Savings and the Limits of Soft Paternalism*, 6 WM. & MARY BUS. L. REV. 35, 62–63 (2015) (discussing the puzzling fee differential between index funds).

[109] *See, e.g.*, Edwin J. Elton et al., *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261, 286 (2004) (noting that while minor differences exist, the funds all advertise that they track the same indexes).

[110] *Id.* at 261.

financial sophistication—Wharton MBA students—often make the same mistake and do not minimize fees.[111]

The institutional intermediaries offering these higher-fee index funds know that they are not in the best interests of the persons that purchase them but they do so anyway because financial advisors will recommend them to their clients.[112] For example, purchasing Morgan Stanley's high-fee index fund instead of a lower-fee index fund simply misallocates capital and diverts more fees to Morgan Stanley. In this sense, the providers of high-fee index funds appear to be profiting by presenting opportunities for retail investors to buy something more aligned with the seller's interest than the investor's. But the issuers of these high-fee index funds are not the only ones at work here—many of these higher fee index funds charge high fees to kick back a portion of those fees to the financial advisors that recommend them.[113]

Since institutional intermediaries often lack direct relationships with investors, they compete through financial advisors, and employer-sponsored retirement plans.[114] Unsurprisingly, to access the pool of retail capital, institutional intermediaries offer products that compensate financial advisors for recommending these products to their clients.[115] While funds adopting these bias-inducing structures tend to underperform in terms of gains to their investors, they gain additional net capital inflows—increasing returns to the asset manager because the asset manager's compensation often derives from the size of the asset pool managed, not its performance.[116]

Because of the skewed incentives of financial intermediaries, the market for institutional intermediation is both informationally and fundamentally inefficient. In informationally efficient markets, it is not possible to lay out "a trading rule that systematically outperforms the market (net of transaction costs) absent possession of inside information."[117] Yet it is possible to lay out a trading rule to systematically outperform in the market for institutional intermediation. The rule is straightforward and well-known—buy a broadly diversified, low-cost index fund.[118] Put differently, if the market for

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[111] James J. Choi et al., *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, 23 REV. FIN. STUD. 1405, 1407, 1429–30 (2010).

[112] Russell, *supra* note 108, at 64–65.

[113] *Id.* at 57 (explaining that people pick high-fee funds because of an "advice-giver who is financially incentivized through (entirely legal) direct or indirect kickbacks").

[114] *See* Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1240 (2011); Tucker, *supra* note 28, at 121–22.

[115] *See* Christoffersen et al., *supra* note 5, at 204 ("New investment increases with the load paid to the broker, in particular when the brokers are unaffiliated . . . .").

[116] *Id.*

[117] *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 913 (1989).

[118] *See* Russell, *supra* note 108, at 59 n.102 ("[T]here is no debate over indexing versus active management."); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational*

institutional intermediation were informationally efficient, it would not be possible to outperform this market by picking the intermediaries that offer low-cost passive investing strategies.[119]

This inefficiency persists because the market for institutional intermediation does not function like the stock market. Unlike identifiable inefficiencies in the stock market, potential arbitrageurs in the institutional intermediation market do not have access to easy mechanisms to profit off the inefficiency. In the stock market, one winning strategy would be to identify reliable losers—stocks that are likely to suffer abnormal negative returns. By shorting these stocks and betting on their predictable failure, an investor could book substantial profits. In the market for institutional intermediaries, picking losers is easy—as a group, the funds that charge high fees for active management are going to suffer relative underperformance.[120] Yet, investors cannot usually short mutual funds the same way they would short stocks to drive the price down.[121] When an investor sells a share of a traditional open-end mutual fund, the mutual fund itself buys the share back—the market price is set by the net asset value of the fund, not by the market's demand for the fund.[122]

An informationally and fundamentally efficient market for institutional intermediation would look significantly different than the current overly dispersed and actively managed landscape. At the least, reducing conflicts of interest should cause more assets to flow from active to passive management.[123] Ideally, this would continue until it would no longer be true, as a general rule, that passive investing will outperform active investing. This consolidation process would likely result in passive intermediaries holding substantially more assets than they do now.

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*System of Corporate Governance*, 33 J. CORP. L. 1, 4 (2007) ("If you are acting with the most rationality, you will invest in index funds, which hold broad baskets of securities and bonds reflecting the opportunities and risks faced by the market, recognizing that it is nearly impossible to pursue an active trading strategy that will beat the market over time.").

119 The market for institutional intermediation is not efficient. *See* Tucker, *supra* note 28, at 137 ("Criticisms that the mutual fund market is inefficient point to the wide variety of fees charged for substantially similar services and information asymmetries among securities consumers facilitating the persistence of high fees despite the detrimental impact of returns." (footnote omitted)).

120 *See* Russell, *supra* note 108, at 59 n.102 (likening the debate over active versus passive investing to the debate over climate change because the debate persists even though the relative underperformance of active management has been conclusively established for decades).

121 Ian Ayres & Quinn Curtis, *Protecting Consumer Investors by Facilitating "Improved Performance" Competition*, 2015 U. ILL. L. REV. 1, 9–16 (discussing barriers to shorting mutual funds).

122 For a description of the difference between traditional open-end mutual funds and closed-end mutual funds, see Daniel S. Alterbaum, *Control Share Acts, Closed-End Funds, and the Battle for Corporate Control*, 17 STAN. J.L. BUS. & FIN. 310, 316–17 (2012).

123 *See* BURKE & HUNG, *supra* note 15, at 28 (reporting that after the United Kingdom banned retail commissions, "flows into index funds increased substantially").

### 4. *Excessive Speculative Trading*

The high volume of speculative trading has long seemed puzzling because "stock trading is a zero-sum game."[124] While it is possible for an individual to make trading profits by buying "winning" stocks from others, each transaction comes at a cost—brokerage commissions and research and analysis costs.[125] Unsurprisingly, the more a person trades, the more money they tend to lose.[126]

Similarly, actively managed institutional intermediaries tend to underperform the market.[127] This raises the obvious question—why do they continue actively managing funds? The asset manager's own interests may best explain the activity.[128] Active trading allows an asset manager to justify its fees without necessarily delivering value. Of course, because many asset managers know that they will also be evaluated by their relative performance against other funds or some market benchmark, many may engage in a practice known as closet-indexing.[129] These closeted funds mimic an index by simply buying largely the same stocks as the index and uselessly trading within the diversified portfolio.[130] Closet-indexing protects the asset manager from exhibiting significant relative underperformance—the closet index will do about the same as the index, less the fees and expenses collected by the intermediaries.[131] These practices simply extract funds from investors without delivering any social benefits. In this instance, the deceptive practice—closet-indexing—contributes to the excessive volume of trading.

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[124] *See* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 622 (1995) (describing the puzzle of speculative trading).

[125] *See id.*

[126] *See generally* Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773 (2000) (showing that returns decline with trading activity).

[127] Stout, *supra* note 124, at 622–64, 664 nn.167–68.

[128] *See* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 301 (2012) ("One explanation is that livelihoods depend on trading."); Tucker, *supra* note 94, at 182 (explaining that investor time horizons "conflict with investment horizons of mutual fund managers where the models of performance evaluation and compensation drive short-term time horizons at the funds").

[129] *See* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2018 (2010) (describing closet-indexing).

[130] *Id.*

[131] *See* K.J. Martijn Cremers & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay For? Securities Law and Closet Index Funds*, 11 VA. L. & BUS. REV. 31, 45–46 (2016) (explaining that closet-indexing allows a risk-adverse manager to avoid significantly underperforming a benchmark).

### 5. *Toxic Business Cultures*

It is no secret that financial intermediation is known for an abnormally high frequency of manipulative and deceptive behavior.[132] This may also be viewed as a problem with corporate culture in the financial services industry.[133] To address this problem, policymakers have begun to focus on altering the corporate and business cultures of intermediaries in the aftermath of the 2008 financial crisis.[134] For example, FINRA, the self-regulatory organization for broker-dealer firms, recently declared its intention to scrutinize culture at financial institutions, going as far as defining culture "as firm norms—those practices and behaviors within the workplace that have a 'profound influence' on" how institutions manage their business and deal with conflicts.[135]

Many cultural problems of financial firms may flow from conflicts of interest in the compensation structures for financial advisors.[136] Persons that

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[132] *See* ROBERT J. SHILLER, FINANCE AND THE GOOD SOCIETY 159 (2012) ("Certain finance-related fields are among those that often put people in positions offering more than the usual temptation to be manipulative or less than honest."); *see also* KAY, *supra* note 18, at 246 ("Finance is an especially attractive field for fraudsters . . . .").

[133] For a definition of corporate culture, see *Corporate Culture*, BLACK'S LAW DICTIONARY (10th ed. 2014), which says it is "[a] prevalent attitude or atmosphere created by a company's rules, policies, practices (esp. hiring practices), and communications from management, such as those touching on compliance or noncompliance with legal requirements."

[134] *See* Nizan Geslevich Packin & Benjamin P. Edwards, *Regulating Culture: Improving Corporate Governance with Anti-Arbitration Provisions for Whistleblowers*, 58 WM. & MARY L. REV. ONLINE 41, 45–47 (2016), http://wmlawreview.org/sites/default/files/Packin%20%26%20Edwards-Final.pdf [https://perma.cc/P5G5-WJCY] (discussing efforts to improve corporate cultures).

[135] *See* Megan Leonhardt, *FINRA to Scrutinize Firm Culture*, WEALTH MGMT.COM (Jan. 8, 2016), http://wealthmanagement.com/regulation-compliance/finra-scrutinize-firm-culture [https://perma.cc/VC69-BS6M]. Other regulators adopting a focus on culture include, William C. Dudley, president and chief executive officer of the New York Federal Reserve, who called on banks to reform their cultures, adding that regulators might move to break up banks if behavior patterns did not change. William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry: Workshop on Progress and Challenges (Nov. 5, 2015) (transcript available at https://www.newyorkfed.org/newsevents/speeches/2015/dud151105 [https://perma.cc/966J-9H75]). Similarly, the Commodity Futures Trading Commission's Commissioner Sharon Bowen stated in 2015 that "[w]e have a culture problem in finance at present," and pushed for reform. Sharon Y. Bowen, Comm'r, U.S. Commodity Futures Trading Comm'n, Keynote Speech Before the Quadrilateral Meeting at the European Central Bank in Frankfurt, Germany (June 24, 2015) (transcript available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-5 [https://perma.cc/ZM99-ATBF]).

[136] *See* Hilary J. Allen, *The Pathologies of Banking Business as Usual*, 17 U. PA. J. BUS. L. 861, 861–62 (2015) ("The trouble, instead, is that the structural conditions of the financial industry have fostered certain cultural norms."); Donald C. Langevoort,

do not perform well within this competitive environment will not remain with financial intermediaries—a market force that drives the development of firm culture.

Consider, for example, the employment equilibrium within a broker-dealer firm. The firm hires two different brokers, say Afra and Betsy, with two different approaches to their clients. Afra takes the strictly ethical approach and only recommends transactions if she believes them to be in her customer's best interest. Betsy takes a more flexible approach and simply sells her client the highest commission product her supervisor deems suitable.[137] At the end of the first quarter, firm managers will compare how much revenue Afra generated for the firm to the revenue generated by Betsy. After this meeting, firm managers will likely ask Afra to either produce more or leave the firm. If Afra leaves the firm, Betsy will take over Afra's accounts.[138]

The dynamics giving rise to this equilibrium may explain the amount of unethical behavior swirling through the financial services industry. Indeed, one recent survey found that 23% of financial services employees "believe it is likely that fellow employees have engaged in illegal or unethical activity in order to gain an advantage over competitors or others at the company."[139] When asked whether "industry professionals have to engage in illegal or unethical activity in order to be successful," nearly one in five said yes.[140]

These survey numbers likely understate the extent of the problem. Few people would admit to themselves that they exploit their customers. Instead, they may rationalize their conduct or gradually become desensitized as they

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*Psychological Perspectives on the Fiduciary Business*, 91 B.U. L. Rev. 995, 998 (2011) ("Nor, however, is it likely that this setting favors the naturally honest, candid fiduciary.").

[137] Of course, the market imposes some discipline on an overly manipulative retail intermediary. So long as the retail investor does not attribute underperformance to the retail intermediary's advice or believe that the retail intermediary has exploited him, the relationship will likely continue.

[138] For a description of this dynamic in practice, see BROWN, *supra* note 31, at 23, which states that "[f]or the broker, this equation hits a bit closer to home: 'Doing more transactions means that I keep my job. It also means that over time I add the assets of other brokers who are fired for doing too few transactions.'" *See also* Langevoort, *supra* note 136, at 1001 ("[T]oo great a tendency to adhere to social norms of honesty and respect interferes with sales production.").

[139] ANN TENBRUNSEL & JORDAN THOMAS, UNIV. OF NOTRE DAME, THE STREET, THE BULL AND THE CRISIS: A SURVEY OF THE US & UK FINANCIAL SERVICES INDUSTRY 4 (May 2015), www.secwhistlebloweradvocate.com/LiteratureRetrieve.aspx?ID=224757 [https://perma.cc/QZ3G-2JJ4].

[140] *Id.* at 6.

accept the norms of the environment.[141] This environment will tend to contain persons that are somewhat Machiavellian and "adept at self-deception."[142]

This dynamic may affect some financial services firms more than others. Recent studies have found that certain financial services firms hire and employ financial advisors with abnormally high numbers of customer complaints or other indicia of possible misconduct.[143] For example, even though only about 7% of financial advisors have indicia of possible misconduct on their records, about 20% of the financial advisors employed by Oppenheimer & Co., have disclosures on their records.[144] A similar study considered a broader set of data and found that the financial advisors at six other firms had even higher rates of misconduct indicia.[145] Firms with particularly high concentrations of brokers with indicia of possible misconduct on their records may have different firm-specific cultures than other financial services firms and may behave differently. For example, one recent study found that analysts at firms with higher numbers of FINRA violations issued less accurate earnings forecasts.[146]

### 6. *Manipulative Sales Practices*

Conflicts of interest also drive manipulative sales practices. Recent work on the economics of manipulation and deception provides a theoretical framework for thinking about these issues.[147] Sensible reforms must address compensation structures that reward financial advisors for influencing retail customers to act against their own interests, causing harms within the financial sector and the real economy.[148] Cass Sunstein recently summarized work on

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[141] *See* Langevoort, *supra* note 114, at 1240 ("Those who get all the way to the top are often quite gifted at rationalization and dissembling—a high Machiavellian style—carrying very little of the heavy baggage of moral anxiety."); Langevoort, *supra* note 136, at 1001 ("Firms have a large number of tools at their disposal to make rationalizations easy and convenient.").

[142] Langevoort, *supra* note 136, at 1001.

[143] Mark Egan et al., The Market for Financial Adviser Misconduct 27 (Mar. 1, 2016) (unpublished manuscript), http://ssrn.com/abstract=2739170 [https://perma.cc/XC23-L8TG].

[144] *Id.* at 1.

[145] Craig McCann et al., How Widespread and Predictable Is Stock Broker Misconduct? 1, 31 (Apr. 22, 2016) (unpublished manuscript), http://ssrn.com/abstract=2768942 [https://perma.cc/Q6K8-QALC] ("These six firms – Aegis Capital, Summit Brokerage Services, National Securities, Centaurus Financial, Independent Financial Group and Kovack Securities employ a far higher percentage of brokers associated with investor harm events than other firms.").

[146] Joseph Pacelli, *Integrity Culture and Analyst Forecast Quality* 1 (Kelley Sch. of Bus., Research Paper No. 15-57, 2016), http://ssrn.com/abstract=2641041 [https://perma.cc/A6KV-WV98].

[147] *See generally* GEORGE A. AKERLOF & ROBERT J. SHILLER, PHISHING FOR PHOOLS: THE ECONOMICS OF MANIPULATION & DECEPTION (2015).

[148] *Cf. id.* at 24 (citing Carl Shapiro, *Consumer Information, Product Quality, and Seller Reputation*, 13 BELL J. ECON. 20 (1982)).

the economics of manipulation and deception as follows: "companies exploit human weaknesses not necessarily because they are malicious or venal, but because the market makes them do it. Those who fail to exploit people will lose out to those who do."[149]

The economics of manipulation and deception explain that a free market also leaves market participants free to exploit the psychological and informational weaknesses of others.[150] In any situation where abnormal profits may be secured by preying on these weaknesses, the default expectation should be that manipulation and deception will occur.[151]

Businesses that do not take advantage of these opportunities to exploit human weaknesses may find themselves at a disadvantage or go out of existence. Consider casinos for example. Slot machines are addictive by design, but a losing bet for the player.[152] These machines are major revenue sources for casinos and are known to cause compulsive addictions in many people.[153] If a casino opted against installing the latest machines that most efficiently and sustainably separate players from their money, it would gradually lose market share and suffer lower revenues than its competitors using newer, more addictive models. If the casino were publicly traded, it might even face takeover bids from outsiders seeking to more profitably monetize the casino floor for stockholders.

Given this incentive and accompanying pressure, some level of manipulation and deception should always be expected. Market participants may use different mechanisms to induce consumers to make unwise decisions. In the most egregious instances, this takes the form of outright fraud where an intermediary simply presents "information that is intentionally crafted to mislead."[154] Psychological techniques may also be used to induce retail investors to make decisions more in the interest of a financial advisor than

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[149] Cass R. Sunstein, *Why Free Markets Make Fools of Us*, N.Y. REV. BOOKS (Oct. 22, 2015), http://www.nybooks.com/articles/2015/10/22/why-free-markets-make-fools-us/ [https://perma.cc/DG87-TBXA] (book review).

[150] *See* AKERLOF & SHILLER, *supra* note 147, at 1.

[151] *Id.* at 170 (challenging the idea that "revealed preferences" should be viewed as the norm).

[152] *See generally* NATASHA DOW SCHÜLL, ADDICTION BY DESIGN: MACHINE GAMBLING IN LAS VEGAS (2012) (describing slot machines).

[153] *Id.*

[154] AKERLOF & SHILLER, *supra* note 147, at xi. The securities laws clearly prohibit outright, intentional fraudulent statements. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (limiting actions under Rule 10b-5 to instances involving fraudulent intent).

their own.[155] One particularly crude approach involves agitating retail customers so that their emotions override their common sense.[156]

Similarly, the brokerage industry's infamous "Straight Line" sales pitch is calculated to generate impulsive purchases.[157] When brokers learn the pitch, they are taught to envision themselves "chasing a prospective customer down a hallway" filled with doors.[158] Each door represents an excuse that a client might make to say no to a trade.[159] The pitch arms financial advisors with rebuttals to close the doors through which a client might escape, herding the client in a straight line toward a sale.[160] For example, if a male client indicates that he would like to speak with his wife before buying, the financial advisor will deliver calculated arguments "in the most mocking and emasculating tone that could be employed without going over the line."[161]

In the alternative, financial advisors may exploit some social heuristic that leads retail investors to misperceive reality and place too much trust in a financial advisor.[162] One common way to induce action from a prospective client is by exploiting human reciprocity norms. Investors may incur a feeling of obligation if they accept something from a financial advisor. The widespread norm of repaying even small favors is a psychological vulnerability manipulative sales practices exploit because a "small initial favor can produce a sense of obligation to agree to a substantially larger return favor."[163]

Financial advisors and institutional intermediaries have exploited the reciprocity dynamic and psychological dynamics with "'free lunch' seminars."[164] Often, these seminars have offered a free meal plus the promise

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[155] *See* Langevoort, *supra* note 136, at 997–98 ("The very moment the 'fiduciary' becomes interested in consumer psychology, he or she starts down a slippery slope, away from the ethical ideals of candor and respect for the integrity of the client and toward the objectification of the client as an excitable bundle of wants, hopes, and fears.").

[156] In one annuity sales training seminar, participants were told to "[t]oss hand grenades into the advice to disturb the seniors," and they should "[t]reat them like they're blind 12-year-olds," and that seniors "buy based upon emotions! Emotions of fear, anger and greed." Ellen E. Schultz & Jeff D. Opdyke, *At Annuity University, Agents Learn How to Pitch to Seniors*, WALL STREET J. (July 2, 2002) (quoting Tyrone Clark, lecturer, Annuity University), http://online.wsj.com/news/articles/SB1025561802229705600 [https://perma.cc/9EAC-7YWZ].

[157] *See* BROWN, *supra* note 31, at 174 ("The Straight Line is impulse selling at its most aggressive . . . .").

[158] *Id.* at 175–76.

[159] *Id.* at 176.

[160] *Id.*

[161] *Id.* at 200.

[162] AKERLOF & SHILLER, *supra* note 147, at xi.

[163] ROBERT B. CIALDINI, INFLUENCE: SCIENCE AND PRACTICE 33 (4th ed. 2001).

[164] *See* SEC. & EXCH. COMM'N ET AL., PROTECTING SENIOR INVESTORS: REPORT OF EXAMINATIONS OF SECURITIES FIRMS PROVIDING "FREE LUNCH" SALES SEMINARS 11 (Sept. 2007), http://www.sec.gov/spotlight/seniors/freelunchreport.pdf [https://perma.cc/8Q4E-

of "'free' advice by 'experts.'"[165] When the SEC reviewed these seminars, it found that, while many of them were advertised as "educational," they were all designed to do one thing—sell products.[166] In many instances, seminar attendees were not aware that the seminar itself may have been paid for by an insurance company or mutual fund under the expectation that the financial advisor would sell their products.[167] The typical securities law response—requiring more publicly filed disclosure from issuers[168]—seems unlikely to diminish the efficacy of the reciprocity effect.

Financial intermediaries may also induce unwise decisions by exploiting "investors' behavioral quirks" and misperceptions about the world.[169] Behavioral economists have identified a series of different cognitive biases and ways in which people are predictably irrational.[170] For example, some investors may simply make a decision about whether to invest by how confident their financial advisor appears to be.[171] This confidence heuristic may lead them to be too willing to trust overconfident advisors.

A significant level of manipulation and deception may persist because financial advisors will only rarely face any consequence for recommending that their retail clients purchase financial products that imperfectly serve their needs.[172] For skewed advice to affect a financial advisor's reputation, two things must occur: (i) the retail client must realize that the financial advisor made a recommendation that was not in her best interest; and (ii) the retail

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VBH5] ("Some ads and mailers used tactics to scare seniors into thinking that they might not be using the right investment professional, or to question their current investments.").

165 *Id.* at 3.

166 *Id.* at 11.

167 *Id.* at 4–5.

168 *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003) ("Securities regulation is motivated, in large part, by the assumption that more information is better than less. Perhaps this is no surprise since the SEC's chief regulatory tool is to require companies to disclose more.").

169 Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 18 (2003).

170 *See* Alan Schwartz, *Regulating for Rationality*, 67 STAN. L. REV. 1373, 1390 (2015) (discussing how many different, and possibly offsetting, cognitive biases may be in play whenever a person makes a decision).

171 Sunita Sah et al., *Cheap Talk and Credibility: The Consequences of Confidence and Accuracy on Advisor Credibility and Persuasiveness*, 121 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 246, 254 (2013) (showing that projecting excessive confidence can trigger investor reliance).

172 For a discussion illustrating the vital importance of reputation in a different economic context, see Jamila Jefferson-Jones, *A Good Name: Applying Regulatory Takings Analysis to Reputational Damage Caused by Criminal History*, 116 W. VA. L. REV. 497, 527 (2013).

client must somehow broadcast that discovery to other retail clients that use the financial advisor.[173]

For retail investors, both mechanisms for reputational consequences to function appear inhibited. Retail clients may be particularly unlikely to recognize when they have been bamboozled into buying a high-fee product because they are often financially illiterate.[174] Even if a retail investor becomes dissatisfied and brings an arbitration proceeding against a financial advisor, the financial advisor will often be able to remove the complaint from public records, further inhibiting the reputation consequence.[175] One recent study found that, for cases settled between mid-May 2009 and the end of 2011, requests to expunge customer complaints from public records were granted 96.9% of the time.[176] In this market, reputation does not appear to function as an effective constraint because retail investors do not detect exploitation or broadcast their findings effectively.

## III. ALIGN INCENTIVES TO IMPROVE CAPITAL ALLOCATION

Banning commission compensation for personalized financial advice will better align financial advisor incentives with their clients' interest and improve capital allocation.[177] Other nations with well-developed financial sectors, including Australia and the United Kingdom, have already adopted this approach, sharply limiting commission compensation in connection with the provision of personalized investment advice to retail customers.[178] This Part

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[173] *See* Judge, *supra* note 87, at 1550 (describing the two reputation feedback channels in general terms).

[174] *See* Jeffrey T. Dinwoodie, *Ignorance Is Not Bliss: Financial Illiteracy, the Mortgage Market Collapse, and the Global Economic Crisis*, 18 U. MIAMI BUS. L. REV. 181, 181–84 (2010) (documenting widespread financial illiteracy); Tucker, *supra* note 94, at 188 (same).

[175] *See* Christine Lazaro, *Has Expungement Broken Brokercheck?*, 14 J. BUS. & SEC. L. 125, 146–47 (2014) (describing the process through which stockbrokers remove complaints from their records).

[176] *See* Press Release, Pub. Inv'rs Arbitration Bar Ass'n, PIABA Study: Stockbroker Arbitration Slates Wiped Clean 9 out of 10 Times When "Expungement" Sought in Settled Cases (Oct. 16, 2013), https://www.piaba.org/system/files/pdfs/PIABA%20Expungement%20Study.pdf [https://perma.cc/7UBB-48G6].

[177] The problem has been apparent for far too long. In May 1994, the SEC convened a committee to review "actual and potential conflicts of interest in the retail brokerage industry." U.S. SEC. & EXCH. COMM'N, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 3 (Apr. 1995), http://www.sec.gov/news/studies/bkrcomp.txt [https://perma.cc/WMB3-9VMM]. A majority of that committee declared that because of the conflicts of interest involved, they "would not design a compensation system based only on commissions paid for completed transactions." *Id.* (recommending only partial measures because commission compensation structures were "too deeply rooted to accommodate radical alteration in the near-term").

[178] *See* Francis J. Facciolo, *Symposium Introduction: Revolution in the Regulation of Financial Advice: The U.S., the U.K. and Australia*, 87 ST. JOHN'S L. REV. 297, 299 (2013)

presents the proposal to ban commissions and sales incentives in connection with the provision of personalized investment advice.

## A. *The Proposal*

Congress should replace the current patchwork regulatory structures for financial advisors and simply ban commission-based compensation for financial advisors providing personalized financial advice.[179] As explained above, commission compensation should be banned because it erodes both investors' savings and macroeconomic stability.

While the proposal would restructure the U.S. financial services model, other nations have already enacted similar reforms to put market forces to work for consumers.[180] When the United Kingdom embraced this approach, it did so "to establish remuneration arrangements that allow competitive forces to work in favor of consumers."[181] Similarly, Australia banned commissions because of "mis-selling scandals in which sales targets incentivized financial advisers to persuade clients to switch out of safe term deposit accounts into funds that delivered banks increased compensation."[182]

Available evidence indicates that banning this most corrosive form of compensation will improve capital allocation.[183] After the United Kingdom banned commission compensation in connection with the provision of personalized investment advice to retail customers, capital flows shifted with a substantial increase in funds flowing into index funds.[184]

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("The United Kingdom and Australia have also been pursuing radical reforms of the regulation of financial advice given to retail customers. The purpose of these reforms is to restrict compensation practices for investment advisers that might influence the advice that they give to retail customers because of their compensation arrangements with financial product producers."); Gerard McMeel, *International Issues in the Regulation of Financial Advice: A United Kingdom Perspective—The Retail Distribution Review and the Ban on Commission Payments to Financial Intermediaries*, 87 ST. JOHN'S L. REV. 595, 596 (2013) (explaining that the United Kingdom has outright banned "payments by product providers" to financial advisors providing investment advice to retail customers); Victoria Stace, *New Zealand's Financial Adviser Regulation: Falling Behind in the Wake of Overseas Reforms*, 26 N.Z.U. L. REV. 869, 870 (2015) ("Both the United Kingdom and Australia have rules that, broadly speaking, prohibit the receipt of commissions in relation to advice given to retail clients.").

[179] While we did not discuss the impact of conflicted advice on capital allocation, Christine Lazaro and I previously called for compensation reform. *See* Lazaro & Edwards, *supra* note 9, at 87–88.

[180] BURKE & HUNG, *supra* note 15, at 9–12.

[181] *Id.* at 9 (emphasis omitted) (describing reforms in the United Kingdom).

[182] *Id.* at 12.

[183] *Id.* at 31.

[184] *Id.* The shift should also significantly improve industry culture by freeing financial advisors from the current forced competition in an environment favoring manipulation and deception.

This, of course, will require a move to different forms of payment for financial advisors. While any payment structure will create some conflict of interest, alternatives are unlikely to cause the same sorts of harms as commission-driven financial advice. There are at least three different payment models that would avoid the capital misallocation caused by commission-driven advice: (i) fixed, upfront fees; (ii) hourly fees; or (iii) fees calculated as a percentage of assets under management for ongoing management and oversight services.[185] None of these compensation structures creates a financial incentive to recommend one product over another.[186]

Upfront or hourly fees provide the most transparent solutions for retail investors.[187] With these compensation structures, the investors are most likely to understand that they are paying for services.[188] Hourly fees directly tie compensation received to the amount of work performed.[189] Retail investors receiving bills for time spent on their behalf may be more able to effectively monitor their financial advisors than retail investors paying through commissions embedded inside complex products.[190]

Fees calculated from a percentage of assets under management do create conflicts of their own, although not the kind that skew capital allocation. A financial advisor compensated in this way may simply seek to gather a sizeable pool of assets to manage without delivering much value. To improve the ability of investors to monitor the amount of fees collected by financial advisors under this compensation structure, Congress should require that financial advisors give their clients an annual statement, clearly showing the amount of fees collected for advisory services. To ensure that retail investors understand the structure, financial advisors should be required to secure consent for this structure on an annual basis.[191]

While a general ban on commission compensation will do much good, it may be desirable to allow certain investors to opt in to receiving commission-driven sales pitches. One possibility may be to only allow accredited and institutional investors to opt in to receiving commission-driven sales pitches. Under section 3(a) of the Securities Act, accredited investors include, among

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[185] Daisy Maxey, *How to Pay Your Financial Adviser*, WALL STREET J. (Dec. 12, 2011), https://www.wsj.com/articles/SB10001424052970204554204577024152103830414 [https://perma.cc/W84M-JC6T].

[186] To be sure, banning commission compensation would not be a silver bullet solving all problems. It would simply shift the industry to less troubling forms of compensation. *Id.*

[187] *Id.*

[188] *Id.*

[189] Hourly compensation is not without its drawbacks. It creates an incentive to work inefficiently because spending more time on a project results in increased revenues. *See* Cathy Hwang, *Unbundled Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions*, 164 U. PA. L. REV. 1403, 1436 (2016) (discussing concern that hourly billing leads to an incentive to work inefficiently).

[190] Maxey, *supra* note 185.

[191] While disclosure will not solve every problem, well-tailored disclosures may potentiate more effective monitoring.

others, banks, investment companies, and persons with a net worth exceeding $1 million (excluding the value of a primary residence) or with income exceeding $200,000 in each of the two most recent years.[192] To ensure that the recipient of a pitch understands that she is receiving a commission-driven sales pitch, a financial advisor making such a pitch might be required to secure written client consent before making each pitch.

While commission compensation structures will likely lead to some capital misallocation, the effect seems unlikely to be as large outside of the retail market.[193] Retail investors require special treatment because they are the least sophisticated and the least able to protect their own interests.[194]

Critics may contend that this would cause investors either to pay more for advice or not receive it at all. Even if these were both true, it might yield better outcomes. For example, an investor paying 1% of assets under management to an advisor would likely make better capital allocation decisions—perhaps buying publicly traded REITs instead of non-traded REITs. While the cost of the advice might be higher, the gains derived from selecting a superior asset would outweigh the marginally higher cost and improve economy-wide capital allocation.

## B. *Impact on Current Advisors*

For the proposal to work, Congress must pass legislation that covers all persons receiving compensation in exchange for providing personalized investment advice because such a broad variety of financial advisors now directly or indirectly sell personalized financial advice to the retail market.[195] Adding to the complexity, policymakers concerned with addressing the problem face a Gordian knot of overlapping regulatory structures. The person providing personalized investment advice may be a stockbroker, registered investment advisor, insurance salesperson, confidence artist, lawyer, some other financial professional or some combination of the foregoing.[196] In many instances, the financial advisor will have no legal obligation to put the

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[192] 17 C.F.R. § 230.501(a) (2016).

[193] *See* OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS iii (2012) [hereinafter SEC, FINANCIAL LITERACY STUDY], http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf [https://perma.cc/4UXW-P9QX] (extensively documenting widespread financial illiteracy).

[194] *Id.* at viii.

[195] *Rules and Resources*, FINRA, http://www.finra.org/Investors/ToolsCalculators/ProfessionalDesignations/RulesandResources/ [https://perma.cc/TY7F-FPEH] ("[B]e aware that Financial Analyst, Financial Adviser (Advisor), Financial Consultant, Financial Planner, Investment Consultant or Wealth Manager are generic terms or job titles, and may be used by investment professionals who may not hold any specific credential.").

[196] *See id.*

investors' interests before her own.[197] While not much research has been done on the differences in outcomes under different regimes, one recent study found that the kind of advice investors receive may be partially determined by the regulatory regime governing its provision.[198]

Three significant types of financial advisors now play a major role in dispensing personalized investment advice and influencing retail capital allocation decisions: (i) brokers or stockbrokers; (ii) insurance salespeople or producers; and (iii) registered investment advisers.[199] Importantly, many financial advisors now operate within all three roles at the same time.[200] For these financial advisors, the proposal will significantly reduce the amount of regulatory complexity they face.[201] While the proposal will significantly affect stockbrokers and insurance producers, it will not significantly alter the business model of most registered investment advisers.[202]

### 1. *Brokers*

Banning commission compensation will have a significant impact on the business model for many broker-dealer firms. Brokers, the registered representatives of broker-dealer firms, now provide extensive, personalized investment advice to retail customers—a shift from their past as providers of execution services.[203] For the most part, brokers receive transaction-based

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[197] *See* Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 77–78 (2010) (discussing different standards); Lazaro & Edwards, *supra* note 9, at 61–71; Russell, *supra* note 108, at 41 ("Individual savers now make those decisions with the assistance of financial services players who have deeply misaligned incentives").

[198] Matthew L. Kozora, The Effect of Regulatory Regimes on the Provision of Retail Investment Advice 8 (Sept. 9, 2013) (unpublished manuscript), http://ssrn.com/abstract=2323519 [https://perma.cc/FF8G-Y5NA].

[199] COUNCIL OF ECON. ADVISERS, *supra* note 12, at 6.

[200] *Id.*

[201] *Cf. id.* ("[I]ndividual advisers can switch back and forth between . . . regimes as they engage in different activities, a practice known as dual hatting.").

[202] *See* Lazaro & Edwards, *supra* note 9, at 48 (describing the fragmented market for personalized investment advice in detail).

[203] While brokers once provided execution services, they now describe themselves as financial advisors. *See* FIDUCIARY STUDY, *supra* note 7, at i. *See generally* Laby, *supra* note 7 (explaining how changes in the industry made the existing regulatory structure incoherent). Broker business cards frequently employ titles such as "financial advisor," "financial consultant," "financial representative," "investment specialist," "investment representative," and "registered representative." ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 74 (2008), https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf [https://perma.cc/4DUN-Y3K7].

commission compensation—if the customer does not buy or sell something, the broker does not get paid.[204]

Differential commissions also bias advice from brokers. Importantly, a broker may receive more compensation for selling one product over another—justifying a concern that brokers give skewed, self-serving advice.[205] The differential commission problem has given rise to the rule of thumb known as "Brown's law of brokerage product compensation," instructing that "[t]he higher the commission or selling concession a broker is paid to sell a product, the worse that product will be for his or her clients."[206]

While brokers have an obligation not to commit outright fraud, the law does not always require them to act in their clients' best interests.[207] FINRA has rules requiring that brokers and brokerage firms giving personalized advice "observe high standards of commercial honor and just and equitable principles of trade."[208] Adding specificity, FINRA also requires brokers to adhere to FINRA Rule 2111 when giving advice to retail customers. FINRA's "Suitability" rule provides that:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any

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[204] *See* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 5–6 (2012). The requirement that brokers do transactions in order to get paid has, of course, created a bias toward action. In the extreme, this has given rise to a "churning" problem—where brokers cause excessive trading in client accounts to generate more fees. *See* Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1010–11 (2002) ("Churning is excessive trading by a broker in a customer's account in order to generate commissions.").

[205] *See* Langevoort, *supra* note 10, at 448 (discussing differential commissions).

[206] *See* BROWN, *supra* note 31, at 217–18.

[207] 15 U.S.C. § 78j (2012) (prohibiting "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"). In some instances, brokerage firms may simply conduct a cost-benefit analysis and decide to simply evade or ignore legal norms, accepting later sanctions as a cost of doing business. *See* Vincent Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 FORDHAM J. CORP. & FIN. L. 765, 773 (2006) (presenting a case study focused on conflicts of interest in connection with "misleading reports issued by securities analysts").

[208] FIN. INDUS. REGULATORY AUTH., FINRA MANUAL r. 2010, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607 [https://perma.cc/VR4E-G5E2].

> other information the customer may disclose to the member or associated person in connection with such recommendation.[209]

FINRA's broad "suitability" standard seemingly leaves brokers substantial leeway to recommend a variety of investments, so long as they are not manifestly unsuitable—a vague standard in application.[210] Notably, FINRA's "high standard of commercial honor" or suitability rule does not require brokers to give their clients advice that is in their best interest.[211] When a range of different investments appear "suitable," this standard is frequently read as allowing brokers to sell their clients the one that pays the broker the most.[212] Still, FINRA's suitability rule does place some limits on rapacious exploitation. Although they do not go so far as to say that brokers must act *in* their customers' interests, enforcement decisions and guidance materials have claimed that suitable recommendations are ones that are "*consistent with* [a] customer['s] best interests."[213]

This leaves substantial room for manipulation. Inducing retail investors to make decisions that are not in their best interest may be a type of manipulation and deception that falls short of outright fraud—and a tremendously profitable business opportunity for more sophisticated parties to profit from the suboptimal decisions of less sophisticated parties.[214]

For the most part, the law now regulates brokers as salespeople who owe limited duties at the time of sale.[215] Only in particular circumstances—such as when the broker assumes discretionary control over the account—will a broker

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[209] *Id.* r. 2111(a) (A "member" is a broker-dealer and an "associated person" is a broker).

[210] Vague legal standards allow financial entities to argue that they have complied with their obligations because the exact action required may not be clear. *See* Di Lorenzo, *supra* note 207, at 786 ("Neither the legal mandate nor the required course of action is clear, and, therefore, denial of noncompliance becomes a prevailing practice.").

[211] *See* BIRDTHISTLE, *supra* note 4, at 149 ("Brokers . . . are subject merely to a standard under which they may recommend only investments that are 'suitable' for their clients . . . ."); Christine Lazaro, *Fiduciary Duty - Now and in the Future*, 17 PIABA B.J. 129, 132 (2010) ("[T]he suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer's best interest.").

[212] *See* Patricia A. McCoy, *Degrees of Intermediation*, 50 WAKE FOREST L. REV. 551, 571 (2015) ("Because the duty of suitability is not a fiduciary duty, securities brokers are not required to act in their clients' best interests or diversify their portfolios . . . . Nor must brokers avoid recommending investments that will maximize their fees if their advice is suitable otherwise.").

[213] *See* Wrona, *supra* note 204, at 19 & n.137 (emphasis added) (quoting a collection of sources).

[214] *Cf.* Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309, 1311 (2015) ("In a growing number of consumer transactions today, firms exploit consumer confusion and promote poor buying choices. The resulting transactions are often lousy, whether one uses autonomy, welfare, or fairness as the metric.").

[215] Wrona, *supra* note 204, at 93; *see also supra* text accompanying note 205.

owe continuing duties to monitor a retail investor's account or provide ongoing advice in the best interest of the investor.[216]

The proposal does not impose any ongoing duties on brokers or otherwise modify their suitability obligation. Rather, it simply removes the incentive to misallocate retail investor capital to secure commission revenues. This focus on compensation will not necessarily ensure that brokers give higher-quality advice. At the least, it will remove the temptation to misallocate capital in exchange for a commission.

### 2. *Insurance Producers*

The proposal will also significantly affect insurance salespersons providing investment advice. Importantly, securities intermediaries are not the only financial intermediaries extracting revenue from retail investors. Insurance salespersons, also known as producers, now market themselves as financial advisors and pitch increasingly complex products to retail investors in exchange for commission-based compensation.[217]

While the suitability standard and other FINRA rules govern the personalized investment advice retail customers receive from brokers, insurance salespeople operate within a looser, state-by-state regulatory framework.[218] Now, many states impose a suitability framework modeled on FINRA's rules for annuity sales.[219] Still, commissions—some as high as 12%—may create powerful conflicts of interest for insurance producers to sell complex deferred annuities to retail investors that do not need them.[220]

### 3. *Registered Investment Advisers*

Registered Investment Advisers (investment advisers) are a different class of retail and institutional financial intermediaries and may not be significantly

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[216] Sec. & Exch. Comm'n v. Zandford, 535 U.S. 813, 823 (2002) (recognizing that the broker managing a discretionary account owed fiduciary duties); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) ("[T]he broker handling a discretionary account becomes the fiduciary of his customer in a broad sense."), *aff'd*, 647 F.2d 165 (6th Cir. 1981). For a discussion of other circumstances where brokers may owe ongoing fiduciary duties, see Edwards, *supra* note 9, at 112–16.

[217] *See* Lazaro & Edwards, *supra* note 9, at 68–71.

[218] *Id.*

[219] *Id.* at 79.

[220] Zeke Faux & Margaret Collins, *Indexed Annuities Obscure Fees as Sellers Earn Trip to Disney*, BLOOMBERG (Jan. 20, 2011), http://www.bloomberg.com/news/2011-01-20/indexed-annuities-obscure-fees-as-sellers-earn-trip-to-disney.html [https://perma.cc/TS6Y-2X9W] ("Salespeople are paid commissions as high as 12 percent, and some are rewarded with free trips to Disney World. Unlike the fees on mutual funds, those costs aren't disclosed.").

affected by the proposal.[221] Investment advisers are directly regulated by the states and the SEC under the Investment Advisers Act of 1940 (Advisers Act).[222] The statute defines investment advisers as

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[223]

Investment advisers differ from brokers and insurance producers in the duties they owe and the form of compensation they receive. Although the Advisers Act does not explicitly provide for fiduciary duties, the federal courts have interpreted it as imposing a fiduciary duty.[224] Yet, what, exactly, does this duty require? As Justice Frankfurter famously explained, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"[225] To answer this question, the SEC has explained that investment advisers owe duties of loyalty and care to their clients.[226] An investment adviser's duty of loyalty requires it to "serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own."[227] The Supreme Court has recognized that in passing the Advisers Act, Congress sought "to eliminate conflicts of interest between the investment adviser and the clients"

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221 Advisers provide a "wide range of advisory services and play an important role in helping individuals and institutions make significant financial decisions." Amendments to Form ADV, Investment Advisers Act Release No. 3060, 75 Fed. Reg. 49234, 49234 (Aug. 11, 2010) (codified at 17 C.F.R. pts. 275, 279) (explaining that investment advisers help "individuals and families seeking to plan for retirement or save for college to large institutions managing billions of dollars").

222 15 U.S.C. § 80b-2(a)(11) (2012). *See generally* Christine Lazaro, *The Future of Financial Advice: Eliminating the False Distinction Between Brokers and Investment Advisers*, 87 ST. JOHN'S L. REV. 381 (2013) (describing regulation under the Advisers Act).

223 15 U.S.C. § 80b-2(a)(11). While this broad definition would seemingly include brokers who also make money by providing personalized investment advice, the statute specifically exempts brokers from the statute. *Id.* § 80b-2(a)(11)(C) (stating the definition does not apply to "any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor").

224 *See* Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (holding that under the Advisers Act, a relationship between an investment advisor and a client is fiduciary in nature).

225 Sec. & Exch. Comm'n v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

226 *See* FIDUCIARY STUDY, *supra* note 7, at 22.

227 *Id.*

to "safeguard[]" unsophisticated investors.[228] Where the conflicts cannot be eliminated, the Advisers Act requires disclosure.[229]

To further limit conflicts of interest, the Advisers Act also closely regulates investment adviser compensation.[230] Investment advisers must clearly disclose to clients how they receive compensation and only "charge fees that are fair and reasonable, and when an [investment] adviser's fee is higher than others, an adviser must disclose this."[231] Reducing the incentive to recommend one product over another or to trade simply to generate commissions, the overwhelming majority (approximately 95%) of investment advisers charge clients fees "based on [a] percentage of assets under management."[232]

These limits do not mean that the registered investment adviser model entirely prevents compensation incentives from skewing the advice provided.[233] Because most investment advisers receive compensation for assets under management, they may hesitate to recommend wise actions that move assets outside of their management—such as paying down a loan or purchasing a life insurance policy.[234] Alternatively, they may recommend risk-increasing transactions that increase assets under management—for example, suggesting that an investor mortgage a paid-off home to put the money in the market.[235]

While asset-based fees do come with some conflicts, these conflicts appear less likely to cause the misallocation of retail investor capital.[236] The proposal seeks to mitigate these harms by requiring clear annual disclosure of asset-based fees and for retail investors to confirm that they desire to continue receiving the investment adviser's services on an annual basis.

Moreover, asset-based fees may be particularly inappropriate for passive buy and hold investors. The SEC has recently begun to focus on a new problem—reverse churning.[237] This occurs when investment advisers regularly collect fees for assets under management even when the account

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[228] *Capital Gains*, 375 U.S. at 191.

[229] *Id.* at 191–92 (explaining that the disclosure requirement is intended "to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested").

[230] *See* FIDUCIARY STUDY, *supra* note 7, at 40.

[231] *Id.*

[232] *Id.* at 7. While most charge based on assets under management, a small number charge hourly or fixed rates or receive some commission-based compensation. *Id.*

[233] *See* Edwards, *supra* note 9, at 110.

[234] *Id.*

[235] *Id.*

[236] While this compensation structure does not entirely eliminate conflicts of interest, it does remove the incentive to recommend one mutual fund over another. *See id.*

[237] Daisy Maxey, *SEC Targets 'Reverse Churning' by Advisers*, WALL STREET J. (Feb. 24, 2014), http://www.wsj.com/articles/SB10001424052702304610404579403251590760602 [https://perma.cc/VM76-A8CU].

requires little to no management.[238] For example, consider the needs of a twenty-five-year-old receiving a modest inheritance. If she decides to passively invest the assets and leave them untouched for the next ten to fifteen years, she secures substantially lower returns with little benefit by paying an investment adviser 1.5% per year.

### 4. *The Regulatory Arbitrage Problem*

The proposal also solves the arbitrage problem.[239] Retail financial intermediaries may now even engage in a form of regulatory arbitrage to exploit differences between current regulatory structures to their own advantage.[240] Regulatory arbitrage occurs when parties shift similar transactions from one regulatory regime to another to maximize their own profits.[241] For example, some reverse churning may be regulatory arbitrage—when a financial advisor registered as both a broker and an investment adviser has secured substantial commission-based revenue from a brokerage client, she may persuade the client to transfer her account to an investment adviser's assets under management fee structure, allowing the financial advisor to collect additional compensation from a client account that does not need assistance.[242] Similarly, a broker who is also registered as an insurance salesperson may decide to sell the client an insurance product to secure a higher fee than could be secured by a securities product.[243] Regulating

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[238] *See* FIDUCIARY STUDY, *supra* note 7, at 152 (describing reverse churning).

[239] *See, e.g.*, Lily Batchelder & Jared Bernstein, *Is Your Financial Adviser Making Money Off Your Bad Investments?*, N.Y. TIMES (Sept. 29, 2015), http://www.nytimes.com/2015/09/30/opinion/is-your-financial-adviser-making-money-off-your-bad-investments.html [https://perma.cc/44P2-7NZK] (explaining that the SEC "doesn't have authority over all retirement investments," "[f]or example, it can't protect you if your broker recommends one fixed annuity over a similar but better one because he is receiving a side payment from the first provider").

[240] For definitions of regulatory arbitrage and examples in other contexts, see Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230 (2010), which defines "regulatory arbitrage as the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment"; Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 849 (2015), which explains that corporate inversion transactions are a form of transnational regulatory arbitrage; and Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997), which states that "[r]egulatory arbitrage consists of those financial transactions designed specifically to reduce costs or capture profit opportunities created by differential regulations or laws."

[241] *See* BIRDTHISTLE, *supra* note 4, at 149 (explaining that brokers giving financial advice may be a form of regulatory arbitrage with brokers marketing themselves as advice-givers without the accompanying burdens of loyalty imposed by the Advisers Act).

[242] *See* FIDUCIARY STUDY, *supra* note 7, at 152.

[243] Similarly, registered investment advisers have been known to construct retirement plans before transitioning to a role as a broker for purchasing the assets for those plans.

commission compensation across these domains will create a consistent standard.[244]

## IV. IMPLICATIONS FOR STAKEHOLDERS AND ALTERNATIVES

Implementing a blanket prohibition on commission compensation for retail financial advice will have significant implications for the financial markets. This Part considers these implications and weighs alternative proposals, ultimately concluding that a blanket prohibition does the most to get to the root of the problem.

### A. *Implications*

#### 1. *Retail Investors and Financial Advisors*

Some have argued that altering the current commission-based compensation system might reduce the public's access to financial advice.[245] That is, those who would have received the attention of a financial advisor may find themselves making financial decisions without that assistance.[246]

This argument assumes that access to a conflicted financial advisor would be better than a situation where the market did not provide a financial advisor.[247] Some evidence indicates that many persons would make better decisions without the self-serving assistance of commission-compensated financial advisors.[248] A study of one state retirement system found that portfolios of persons that used a broker for assistance were substantially worse

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*See, e.g.*, Ron A. Rhoades, *Fiduciary Duties: What Policymakers and the Public Need to Know*, BROKE & BROKER BLOG (June 22, 2009), http://www.brokeandbroker.com/index.php?a=blog&id=203 [https://perma.cc/822Z-8S94] ("There is at least one large broker-dealer / RIA firm which primarily markets . . . 'financial plans' for its clients. Yet, when it comes to implementation of the plan, many . . . representatives of this firm 'switch hats' to a non-fiduciary role and sell products (which are often proprietary mutual funds).").

[244] Anne Tucker has recognized this problem and noted that issues addressed within agency silos impact behavior before other agencies. *See* Tucker, *supra* note 94, at 217 ("The issues addressed in each agency's silo—workplace, tax, or securities—have implications in the other arenas as well.").

[245] *See, e.g.*, Batchelder & Bernstein, *supra* note 239 ("Critics of the proposal argue that it would hurt the retirement security of low- and middle-income Americans by reducing access to financial advice, as if more advice equals good advice.").

[246] *Id.*

[247] Indeed, many retirees would be better off without the assistance they now receive in free-lunch seminars. *See* SEC. & EXCH. COMM'N ET AL., *supra* note 164, at 11 (discussing free-lunch sales seminars).

[248] *See* Russell, *supra* note 108, at 64 ("Financial advisers, including brokers (who have no fiduciary duty to their clients), make the problem worse. Most of them are compensated based on (entirely legal) kickbacks.").

than portfolios that were constructed without a broker's assistance.[249] Another recent audit study presented financial advisors, here brokers, with client portfolios to see what changes they would recommend, if any.[250] Unsurprisingly, the brokers showed a strong bias toward recommending changes that would move client assets to high-fee mutual funds that would pay the brokers more money and deliver lower expected returns for their clients.[251]

Furthermore, small investors will not be without options. The proposal would likely accelerate the growth of so-called robo-advisers.[252] Financial technology may disrupt much of the traditional investment advice business by allowing algorithms to select appropriate portfolios for persons that meet particular characteristics. For example, one leading firm, Wealthfront, manages over $2 billion in assets and supports accounts as small as $500.[253] It does not even charge an advisory fee on accounts below $10,000.[254] For accounts over $10,000, investors pay 0.25% of the assets under management.[255]

On the whole, the proposal will likely reduce the total amount of capital flowing to financial advisors for their services. While the size of the reduction cannot be predicted with precision, one recent report conservatively estimated that the total costs imposed on account of conflicted investment advice now run to about $17 billion annually.[256] Implementing the proposal would result in investors allocating that $17 billion dollars to other uses.[257]

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249 *See generally* John Chalmers & Jonathan Reuter, *Is Conflicted Investment Advice Better Than No Advice?* (Nat'l Bureau of Econ. Research, Working Paper No. 18158, 2012), http:// www.nber.org/papers/w18158 [https://perma.cc/U5D3-EQQ3].

250 *See generally* Sendhil Mullainathan et al., *The Market for Financial Advice: An Audit Study* (Nat'l Bureau of Econ. Research, Working Paper No. 17929, 2012), http:// www.nber.org/papers/w17929.pdf [https://perma.cc/GXL8-B9M4].

251 *Id.*

252 *See* Anne Tergesen, *Robo Advisers Seen Exploding in Popularity*, WALL STREET J. (Dec. 11, 2015), http://www.wsj.com/articles/robo-advisers-seen-exploding-in-popularity-1449860367 [https://perma.cc/Z3AE-JRQ6] (explaining that robo-advice "firms typically use algorithms to recommend and manage portfolios of low-cost funds for investors, including implementing tax-saving trades").

253 *See* Alessandra Malito, *Betterment Catches Up to Wealthfront in AUM as Robo Competition Reaches Boiling Point*, INVESTMENTNEWS (July 30, 2015), http://www.investmentnews.com/article/20150730/FREE/150739992/betterment-catches-up-to-wealthfront-in-aum-as-robo-competition [https://perma.cc/J8MB-QPZM].

254 *Fee: How Much Does Wealthfront Charge for Its Service*, WEALTHFRONT, https://support.wealthfront.com/hc/en-us/articles/211003683-Fee-How-much-does-Wealthfront-charge-for-its-service- [https://perma.cc/PG76-ZBJZ] (last updated Mar. 24, 2017).

255 *Id.*

256 COUNCIL OF ECON. ADVISERS, *supra* note 12, at 2.

257 This could also have other effects, perhaps reducing consumption in the market for luxury goods. *Cf.* FRED SCHWED, JR., WHERE ARE THE CUSTOMERS' YACHTS? (John Wiley & Sons, Inc. 2006) (1940) (pointing out that while certain financial intermediaries had yachts, their customers did not).

### 2. *Asset Managers*

The proposal also has significant implications for asset managers seeking to gather capital to manage. At the least, it will mean that funds will no longer be able to attract retail capital by paying financial intermediaries to recommend the funds to their retail clients. This may force asset managers to incur other expenses to advertise their funds to financial advisors. It will also remove any incentive to pay fees to financial advisors to keep pace with other funds.

In the alternative, asset managers may move away from the retail market and focus their offerings on accredited investors.[258] This, of course, does not mean that retail investors would be prohibited from participating in these funds, but simply that their decision to invest in these funds would not be affected by incentive fees paid to their financial advisor.

## B. *Alternatives*

The proposal is not the only means to address the problem. Policymakers have pursued several different interventions. But, while many of these alternatives seem likely to yield benefits worth the costs, none seem as effective as simply banning commission compensation in connection with the provision of personalized investment advice.

### 1. *Financial Literacy Education*

One oft-proposed solution to the problem is to give retail investors better financial education so that they may better protect their interests.[259] Because financial advisors and financial services firms often exploit the sophistication gap between them and their clients, financial literacy education aims to reduce the size of the gap by improving retail investors' financial sophistication, enabling retail investors to protect themselves.[260] Yet, overemphasis on financial literacy education risks victim blaming by portraying the investor as

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[258] For a discussion of how retail investors are already largely excluded from many private funds now, see Cary Martin Shelby, *Privileged Access to Financial Innovation*, 47 LOY. U. CHI. L.J. 315, 367 (2015), who argues that "antiquated regulations have excluded retail investors from many of the [financial innovation's] benefits."

[259] In a sense, this is an agency cost solution, designed to improve the ability of investors to monitor their financial advisors. *Cf.* Black, *supra* note 32, at 772 ("The ability of the retail customer (the principal) to monitor the performance of her registered representative, to assure that he is making decisions consistent with her investment objectives, is minimal."); Benjamin P. Edwards, *Disaggregated Classes*, 9 VA. L. & BUS. REV. 305, 320 (2015) (discussing how agency cost analysis has informed securities class action litigation reforms by seeking to improve monitoring); Tucker, *supra* note 94, at 224–25 (discussing the need for improved investor education).

[260] *See* Tucker, *supra* note 94, at 224–25.

somewhat at fault for being taken in by manipulation and deception.[261] It does not focus on the force driving the manipulation and deception—the incentive to collect a commission.

Not all problems should be solved by recommending that the victims better learn to protect themselves. Consider the wisdom of a sheriff warning travelers that bandits lurk in the forests ahead and offering them free materials to learn more information about self-defense techniques. This type of protection from a public regulator seems less effective than having the sheriff provide a warning while spending more resources to saddle up and clear the woods. Worse, persons may review a few glossy pamphlets and mistakenly believe themselves capable. To the extent that regulators allocate funds to investor education initiatives, they should be effectively designed and based on research showing a likelihood of effectiveness.[262]

Pursuing financial literacy education as a strategy to improve capital allocation appears to be a game that is not worth the candle: the cost of effectively educating retail investors to understand modern financial innovation would outweigh any benefits.[263] To begin, retail investors generally exhibit low levels of financial literacy.[264] Adding to the difficulty, many investors make significant decisions when they enter retirement—a period when many may be experiencing cognitive decline.[265] Given the demands that most retail investors already face on their time, it seems unlikely that a critical enough mass would actually take advantage of financial literacy programs, even if they were available. And, if this confluence of unlikely events were to occur, financial innovation would likely create new products that had not been covered by prior education programs.

To a large extent, this approach has already been tried and appears to be a failure.[266] This is not to say that resources should not be devoted to investor education; rather, financial literacy should not be promoted as a means of

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261 *See* Barbara Black, *Introduction: Working Toward Fair Treatment for Retail Investors*, 76 U. CIN. L. REV. 375, 380 (2008) ("[R]easonable investors are expected to possess a certain level of understanding and sophistication to withstand broker-dealer conduct.").

262 *See* Tucker, *supra* note 94, at 225 ("[I]nvestor education is not a cost-free proposition, and resources dedicated to education reform must be allocated to effective measures based upon current behavioral economic research.").

263 *See generally* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008) (arguing that literacy education's costs outweigh its benefits).

264 Studies show that "investors do not understand the most elementary financial concepts, such as compound interest and inflation." SEC, FINANCIAL LITERACY STUDY, *supra* note 193, at vii–viii ("[M]any investors do not understand other key financial concepts, such as diversification or the differences between stocks and bonds . . . .").

265 *See* Christina M. Costa, *Preparing for the Senior Tsunami: Cognitive Decline in Aging Lawyers*, 28 GEO. J. LEGAL ETHICS 471, 473 (2015) ("Normal cognitive aging occurs when the brain and central nervous system undergo predictable decline over time.").

266 *See* Willis, *supra* note 263, at 197 ("[B]elief in the effectiveness of financial-literacy education lacks empirical support.").

avoiding more difficult regulatory initiatives, allowing policymakers to claim that they are addressing a problem without directly confronting well-funded industry lobbyists.

### 2. *Subsidizing Financial Advice*

Another possible intervention would be for the government to subsidize unbiased financial advice. Indeed, Robert Shiller has argued that a government subsidy for "financial and legal advice" could be "justified on the basis of the externality provided by having a society that functions well."[267] While providing unbiased, expert assistance to retail investors allocating assets could certainly improve overall capital allocation, funding such a project would be quite costly. If the market failed to provide adequate financial advice to improve capital allocation after prohibiting commission compensation, the strategy might be worth pursuing because even high costs might be justified to the extent that it could reduce the likelihood of additional financial crises.[268] This alternative should be considered as a complement to banning commission compensation.

### 3. *Imposing Fiduciary Duties*

One promising additional mechanism to address the problem might be to require financial advisors to act in the best interests of their clients without regard to their personal financial interests. This mechanism would likely also function well with a flat ban on commission compensation. Here, the cost of additional liability from an enforceable fiduciary obligation to provide advice in the best interests of customers would more firmly bond financial advisors to their clients' interests. If an advisor gave self-serving advice, an enforceable fiduciary obligation would allow the investor to seek damages.

At present, there are two different regulatory levers available to impose fiduciary duties: (i) the SEC; or (ii) the Department of Labor (DOL). As to the first, Dodd-Frank authorized the SEC to impose fiduciary duties on a subset of financial advisors by harmonizing broker obligations with those of registered investment advisers.[269] For reasons that remain unclear, the SEC has not yet acted under this authority. One former SEC Chairman has remarked that delay

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[267] SHILLER, *supra* note 132, at 84.

[268] *Id.* at 85 ("Avoidance of a financial crisis such as the one which we now find ourselves offers a perfect example of the kind of externality that justifies government subsidy of financial, as well as legal, advice for everyone.").

[269] For a discussion of this possibility and the extent to which brokers are already subject to fiduciary duties, see Edwards, *supra* note 9, at 112–18, and FIDUCIARY STUDY, *supra* note 7, at vi, which recommends that the SEC use its authority under Dodd-Frank to make a rule to require brokers to "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."

appears to be driven by philosophical divisions that will cause SEC Commissioners to remain "locked in conflict on this issue for a long, long time."[270]

While the SEC has the power to impose a fiduciary duty on brokers and registered investment advisers, its power is still limited. While Dodd-Frank authorized the imposition of a fiduciary duty, it also included a provision stating that the "receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser," seemingly limiting the SEC's ability to target commission compensation directly.[271] Moreover, even if the SEC were to act to impose a fiduciary duty on brokers and registered investment advisers, that duty would not stretch to reach insurance producers—persons now providing the same sorts of services as brokers and investment advisers.[272]

In the absence of action from the SEC and over extensive industry opposition,[273] the DOL has proposed to use its authority under the Employee Retirement Income Security Act to impose a fiduciary duty on all persons providing advice in connection with retirement accounts.[274] While the new DOL rule has not yet been fully implemented, if it survives, it seems likely to affect nearly all capital-allocation decisions involving retirement accounts, including instances where retail investors receive advice from insurance producers.[275] From a capital-allocation perspective, imposing a fiduciary duty

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[270] *See* INST. FOR THE FIDUCIARY STANDARD, INVESTMENT ADVISERS ACT 74TH ANNIVERSARY – STATEMENTS FROM INDUSTRY LEADERS AND EXPERTS (Sept. 2015), http://www.thefiduciaryinstitute.org/wp-content/uploads/2015/09/Arthur_Levitt_and_David_Tittsworth_on_IAA_at_75.pdf [https://perma.cc/U33Y-2HR4] (statement of Arthur Levitt, former Chairman, Securities and Exchange Commission).

[271] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 913(g)(2), § 211, 124 Stat. 1376, 1828–29 (2010) (codified at 15 U.S.C. § 80b-11(g)(1) (2012)).

[272] *See* Lazaro & Edwards, *supra* note 9, at 74–84 (describing limits on the SEC's ability to regulate insurance producers selling equity-indexed annuities).

[273] *See* Letter from Elijah E. Cummings, Ranking Member, U.S. House of Representatives Comm. on Oversight & Gov't Reform & Elizabeth Warren, Ranking Member, U.S. Senate Subcomm. on Econ. Policy, Comm. on Banking, Hous., & Urban Affairs, to Thomas Perez, Sec'y, Dep't of Labor & Shaun Donovan, Dir., Office of Mgmt. & Budget (Feb. 11, 2015) [hereinafter Letter from Cummings & Warren], http://www.warren.senate.gov/files/documents/2016-2-11_Letter_to_DOL_and_OMB.pdf [https://perma.cc/UYG5-Q2HX] (describing intense industry opposition to the Department of Labor's proposed fiduciary rule).

[274] *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 10, 2016) (codified at 29 C.F.R. pts. 2509, 2510, 2550).

[275] In a changing political climate, some observers believe that Congress may move to block the DOL's fiduciary rule. Michael Wursthorn & Lisa Beilfuss, *Donald Trump Victory Casts Clouds Over Fiduciary Rule*, WALL STREET J. (Nov. 11, 2016), http://www.wsj.com/articles/donald-trump-victory-casts-clouds-over-fiduciary-rule-1478709489 [https://perma.cc/U3LD-KLAV].

on advisors may offer significant benefits for the economy by reducing the likelihood that advisors will misallocate client assets in exchange for commissions.

While a fiduciary rule promulgated by the DOL might provide significant benefits, this Article's proposal seeks an even broader reform—one that would affect all retail investor assets, not merely assets held within the retirement accounts that give rise to the DOL's jurisdiction. While the DOL's approach will likely do much good, broader benefits could be achieved by creating a consistent standard for retirement and non-retirement funds. This is not to say that the DOL's proposal does not deserve enthusiastic support simply because it would be better to have Congress enact more far-reaching legislation.

The vociferous opposition raised by certain issuers of high-commission products provides evidence that the DOL's fiduciary rule may significantly affect the allocation of retirement account capital.[276] Put simply, certain issuers will likely see their capital inflows reduced in a fiduciary environment—forcing them to develop some other strategy to attract capital—perhaps by improving their returns.[277] Consider, for example, the objections raised by non-traded REITs, a sector that has generally fought against the implementation of a fiduciary standard.[278] Spokespersons for the interests of non-traded REITs have argued that under an early iteration of the DOL fiduciary rule, investors could lose their ability to diversify by adding non-traded REITs to their investment portfolios, an unpersuasive argument because retail investors could achieve real estate exposure by buying a publicly traded REIT.[279]

## V. CONCLUSION

This Article shows that the economic interests of financial advisors play a significant role in shaping capital allocation decisions, and that the misalignment of those incentives and the interests of retail investors generates cascading harms for ordinary investors and the capital markets. The current commission compensation structure for many financial advisors means that corrosive conflicts of interest undermine efficient capital allocation. This Article aims to improve capital allocation, by focusing regulatory attention on the source of much capital misallocation—commission compensation structures that encourage financial advisors to induce investors to make unwise decisions.

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[276] *See* Letter from Cummings & Warren, *supra* note 273, at 2.

[277] *Id.* at 4.

[278] Along with letters submitted by many others, the Public Non-Listed REIT Council of the National Association of Real Estate Investment Trusts (the "Non-Listed REIT Council") submitted an eight-page letter seeking changes to the DOL's proposed fiduciary rule for retirement accounts. *See* Letter from Exec. Comm., NAREIT PNLR Council, to the Office of Regulations & Interpretations, U.S. Dep't of Labor (July 21, 2015), https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-ZA25/00245.pdf [https://perma.cc/MT3C-YKA3].

[279] *Id.*