19-2886(L)

19-2893(CON)

In the United States Court of Appeals for the Second Circuit

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

Petitioners,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION and WALTER CLAYTON, IN HIS OFFICIAL CAPACITY AS CHAIRMAN OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Respondents.

On Petition for Review of a Final Rule of the Securities and Exchange Commission (File No. S7-07-18)

REPLY BRIEF OF XYPN PETITIONERS

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CORPORATE DISCLOSURE STATEMENT

XY Planning Network and Ford Financial Solutions have no parent corporations. No publicly held company owns 10% or more of their stock.

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INTRODUCTION

Consider the following scenario: Charles, a lawyer, runs a business that advertises "wealth management and financial planning services." He tells potential customers that he offers "objective and unbiased advice throughout the planning and investing process."[1] When clients sign on, Charles has a series of conversations with them about their financial goals and develops a financial plan for their investments; he collects a fee from them as well as a commission from the merchants whose products he recommends. He then assists his clients in executing their plan, signing contracts on his clients' behalf to open the various accounts recommended in the financial plan that they have paid him to draft.

It is this last step, Charles claims, that means he is not an investment adviser. Executing contracts is a legal service, which he says is his primary business. The financial advice he gives is merely incidental to this real service he provides: signing his clients' names on the paperwork that opens their investment accounts.

Under the approach established by the SEC in Regulation Best Interest and defended in its brief, Charles would be in the clear: He should not be considered an investment adviser subject to the consumer protections established in the Investment Advisers Act of 1940. SEC Br. 62-70. The SEC contends that the Investment Advisers

[1] *Cf.* Brief Amicus Curiae of Better Markets and Consumer Federation of America at 7-9.

Act's "solely incidental" exception (which applies in similar terms to lawyers and accountants as well as broker-dealers, *see* 15 U.S.C. § 80b-2(a)(11)) is satisfied so long as the provision of investment advice is "reasonably related" to a distinct "primary business," namely (for broker-dealers) the "business of effecting securities transactions." SEC Br. 63 (quoting Solely Incidental Interpretation, PA305). But that conclusion rests on the bizarre premise that the regulatory framework should not turn on "the quantum or importance of the advice" given by a business, *Id.* at 66. And the SEC never addresses the reality of how the broker-dealer industry is structured, in which the alleged "primary business" of "effecting securities transactions" is in fact often a ministerial task, frequently fully automated, that simply follows as a matter of course from the broker-dealer's recommendations. *See* XYPN Br. 6-8.

The result, as suggested by the hypothetical scenario described above, is an absurdity. Brokers can continue to emphasize to their customers that they provide long-term relationships based on trusted advice and argue that their advice does not "differ either in kind or quality" from that of registered investment advisers. Consumer Federation of America Br. at 10 (quoting Kenneth Bentsen, CEO, Securities Industry and Financial Markets Association, *Is it Time to Adopt a Uniform Fee-Only Standard for Financial Advice?*, Wall St. J. (Mar. 18, 2018)). Then, for regulatory purposes, brokers can portray themselves as "nothing more than mere order-takers,"

arguing that the ministerial execution of a transaction that follows the lengthy and expensive advice-giving process is really their primary business. *See* Brief Amicus Curiae of the Public Investors Arbitration Bar Association at 14-19. Regulation Best Interest explicitly permits this hat-switching, in spite of clearly contrary statutory language and the SEC's own evidence reflecting both that consumers do not understand the difference between broker-dealers and investment advisers and that they will not meaningfully be assisted by the new regulation's disclosure requirements. XYPN Br. at 53-60.

This regulatory scheme is neither required nor permitted by the Investment Advisers Act or the Dodd-Frank Act. When a broker-dealer advertises its services as providing personalized recommendations for how money should be invested, a consumer pays for those recommendations, and the execution of the recommendation occurs with the nearly costless click of a button, it is no longer plausible to say that the advice is "solely incidental" to the "primary business" of executing the transaction. The Investment Advisers Act therefore requires that such transactions be regulated under the standards governing registered investment advisers, not broker-dealers. The Dodd-Frank Act, meanwhile, provides the SEC with the authority to require broker-dealers and registered investment advisers to meet the same heightened fiduciary standard, but does not empower the SEC to make a distinct standard for broker-dealers. Regulation Best Interest is thus both

contrary to law and arbitrary and capricious, as it exceeds the authority granted to the SEC by the Dodd-Frank Act and is premised on an unreasonable interpretation of the Investment Advisers Act.

Regulation Best Interest is just the latest in a series of attempts by the SEC to exceed or misapply its regulatory authority in ways that have required judicial scrutiny. Since at least 1999, the SEC has fought the application of the Investment Advisers Act's standards to broker-dealers, attempting to write them out of the statute by regulation. *See Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). But in this latest round, the SEC has written a rule that cannot be squared with the plain text of the Dodd-Frank Act, has ignored evidence from its own empirical studies, and has even contradicted its own past interpretations of the Investment Advisers Act. Its response brief fails to rebut these problems, invoking rationales that were not relied on in Regulation Best Interest itself, contradicting the SEC's own past stances, relying on novel misinterpretations of Dodd-Frank, and misapplying the law of Article III standing. The SEC's latest "attempt to overcome the plain language" of Congress, *id.* at 490, in other words, is no more sound than the last one; it must therefore be set aside under the Administrative Procedure Act.

ARGUMENT

I. The petitioners have standing to bring this suit.

The SEC asserts that the XYPN petitioners lack Article III standing, both because Regulation Best Interest "increases the regulatory burdens" on broker-dealers and because the petitioners have inadequately proven causation and redressability. SEC Br. 40-45. Neither of these arguments succeeds.

First, the SEC argues that "XYPN cannot rely on competitor standing" because it is challenging a law that "increases the regulatory burdens and legal exposure for broker-dealers." SEC Br. 40 (citing *State National Bank of Big Spring v. Lew*, 795 F.3d 48 (D.C. Cir. 2015)). This argument misunderstands the requirements of Article III. It has never been the law that competitor standing is unavailable where a regulation imposes burdens on the relevant competitor. *See, e.g.*, *Am. Inst. of Certified Pub. Accountants v. I.R.S.*, 804 F.3d 1193, 1197-98 (D.C. Cir. 2015) (discussing *State National Bank*). When addressing questions of standing, courts "must … assume that on the merits the plaintiffs would be successful in their claims." *City of Waukesha v. E.P.A.*, 320 F.3d 228, 235 (D.C. Cir. 2003) (citing *Warth v. Seldin*, 422 U.S. 490, 502 (1975)). The relevant comparison is therefore not between the regulation as issued and a hypothetical pre-Dodd-Frank status quo; it is between the regulation that the SEC issued and what the law requires.

Here, the law requires that if the SEC issues a regulation governing the standard of care for broker-dealers' provision of personalized investment advice, it must hold broker-dealers to the same standard as investment advisers. XYPN Br. at 32-41. XYPN and its members suffer competitive harm because the SEC instead promulgated a rule creating fewer obligations for broker-dealers. *Id.* at 28-32. The SEC's theory to the contrary would lead to an absurd result: If a statute imposed a $100 transaction fee on broker-dealers, and the SEC promulgated a regulation levying only a $1 transaction fee, under its theory no competitors of broker-dealers would have standing to challenge that obviously unlawful regulation because it imposes a burden on broker-dealers. That is not how standing works.

In addition to misconstruing the general requirements of Article III, the SEC's argument is contrary to the established law of competitor standing in particular. That doctrine looks to whether a challenged action provides an unlawful benefit to competitors—and unlawful benefits can coexist in the same regulation as other provisions that impose burdens. *See, e.g.*, *Am. Inst. of Certified Pub. Accountants*, 804 F.3d at 1197-98. Or, as just discussed, the unlawful benefit can be the difference between a burden actually imposed and the burden required by law. The law of competitor standing thus means that "when regulations illegally structure a competitive environment—whether an agency proceeding, a market, or a reelection race—

parties defending concrete interests . . . in that environment suffer legal harm under Article III." *Id.*

Here, XYPN is defending a concrete interest: it derives revenue from members, who will have less incentive to do business as registered investment advisers if they can offer essentially the same advice and services as broker-dealers but face less of a regulatory burden. *See* XYPN Br. at 30-31.[2] And XYPN's members, including Ford Financial Solutions, suffer a competitive disadvantage under Regulation Best Interest because it will permit broker-dealers to say that they are acting in the consumer's "best interests" and use other language that has traditionally implied a fiduciary relationship, making it harder for registered investment advisers to compete by effectively communicating to consumers that their interests are better protected under the regulatory regime governing investment advisers than that governing broker-dealers. *Id.*

Next, the SEC challenges the XYPN petitioners' evidentiary showing on causation and redressability, arguing that "the competitive imbalance" that the

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[2] The SEC at one point mistakes XYPN's argument as being that the challenged rule "does not do enough to incentivize broker-dealers to register as investment advisers." SEC Br. at 41. XYPN has never argued that the law requires the SEC to incentivize broker-dealers to register as investment advisers. Instead, XYPN's argument is that Regulation Best Interest is unlawful and has the effect of decreasing the incentives for those providing financial advice to register as investment advisers and become XYPN's members. XYPN Br. at 28-31. This threat to XYPN's "financial or economic interests" is sufficient for standing. *Cottrell v. Alcon Labs.*, 874 F.3d 154, 164 (3d Cir. 2017).

XYPN petitioners describe "cannot tenably trace to Regulation Best Interest." SEC Br. 43. But this directly contradicts the SEC's own reasoning. The SEC explicitly stated in Regulation Best Interest that a reason it rejected a uniform rule was because such a rule might "increase the incentive to offer investment advice in the capacity of investment adviser" and "decrease the incentive to offer investment advice in the capacity of broker-dealer." 84 Fed. Reg. at 33,462. That is the core premise of the XYPN Petitioners' argument: that a lighter regulatory burden on broker-dealers unlawfully structures the competitive environment in a way that increases the incentives to offer investment advice as a broker-dealer, harming XYPN by financially decreasing the overall incentive for providers of financial advice to register as investment advisers. *See* XYPN Br. 30-31. The SEC cannot acknowledge this market-altering effect of its regulations only when it is convenient; it was true when Regulation Best Interest was being considered, and remains true today. The SEC's own analysis thus shows why its regulation causes an injury to the XYPN petitioners, and why enjoining that regulation will redress that injury at least in part. *See CREW v. Trump*, 953 F.3d 178, 191-94 (2d Cir. 2019).

The SEC is similarly at war with its own past conclusions about empirical reality when it creates an arbitrary evidentiary threshold for proving consumer confusion, faulting the XYPN petitioners for not providing "declarations from customers" to prove that consumers will have difficulty distinguishing between

broker-dealers and financial planners. XYPN Br. 41. The XYPN petitioners have produced declarations from experienced business owners explaining how customers will have difficulty differentiating between fiduciary duties and the "best interest" language permitted and required by the new regulatory scheme. XYPN Br. Add. 3-5. And the SEC's own detailed studies in this rulemaking demonstrate that consumer confusion regarding the duties owed by broker-dealers and financial advisers is a durable reality, and one that cannot be solved simply through disclosures. XYPN Br. 53-60.

Regulation Best Interest directly exacerbates this confusion. The Regulation uses language and concepts similar to fiduciary standards, such as "best interests," but puts in place a lower standard of care that relies heavily on ineffective disclosures, *id.* at 53-60, and allows broker-dealers to consider their own interests when making recommendations, *id.* at 33; *see also* Consumer Federation of America Br. at 20-31 (describing the weak protections of Regulation Best Interest relative to the status quo). As demonstrated by the SEC's own studies and the declarations submitted by the XYPN petitioners, there is a "substantial likelihood" that the rule will make it more difficult for investment advisers to compete based on their higher standard of care, satisfying Article III's requirement that the petitioners' injuries be "fairly traceable" to the SEC's action. *CREW*, 953 F.3d at 191-94.

II. Regulation Best Interest is not a permissible use of the SEC's regulatory authority under Dodd-Frank.

When it comes to the merits, the SEC's interpretation of the Dodd-Frank Act is critically flawed. Under the SEC's reading of the statute, there is no plausible rationale for the existence of Section 913(g). As the SEC sees it, Section 913(f) is a "separate rulemaking path[]" from Section 913(g). SEC Br. 50. This path involves "a broad grant of discretionary authority," which apparently authorizes the SEC to "address the legal or regulatory standards of care for brokers, dealers, investment advisers," and their associated persons with few or no substantive restrictions on the content of that rule. *Id.* at 46-47. As a result, says the SEC, Section 913(f) is enough to authorize it to promulgate Regulation Best Interest, and Section 913(g)'s substantive restrictions never come into play.

The SEC assures us that its reading does not render Section 913(g) superfluous because "[i]f the Commission decided to adopt a single fiduciary standard that would apply to both broker-dealers and investment advisers, that rulemaking" would be subject to Section 913(g)'s "mandatory constraints." SEC Br. 53-54. But this response is unmoored from the statute's text. There is no part of Section 913(g) that says "if" the SEC chooses to adopt a particular kind of rule—one that creates a single standard for both broker-dealers and investment advisers—then its terms kick in. Just a few pages earlier in its brief, the SEC says that Section 913(g) and 913(f) provide "separate rulemaking path[s]," both of which are "permissive." SEC Br. 48. The

SEC offers no reason why a "permissive," "separate" path for rulemaking would become a "mandatory constraint[]" if, and only if, the SEC decides to adopt a rule creating a single standard. *Id.* at 54.

To the contrary, as the SEC notes repeatedly, Section 913(g)'s use of "may" indicates a permissive, not mandatory, delegation of authority. *See* SEC Br. 46-50. Such a permissive authority is rendered redundant by the SEC's reading of Section 913(f). If Section 913(f) already provides the authority to create *any* general rule regarding the duties owed by broker-dealers and investment advisers, then there would be no reason to include specific authorization for a rule that applies the same standard to both kinds of entities.

Rather than defending the existence of 913(g), the SEC shows just how superfluous 913(g) really is under its view when it asserts that "[i]f the Commission decided to adopt a single fiduciary standard that would apply to both broker-dealers and investment advisers," then it would be subject to the constraints of 913(g). SEC Br. 53-54. The SEC is saying, in other words, that if it chose to promulgate a rule hewing to 913(g)'s requirements, then it would be subject to those requirements. Under this reading, 913(f) gives the discretion to the SEC to adopt any rule, including a rule that meets 913(g)'s requirements, and 913(g)'s requirements are mandatory only if the SEC issues a rule that complies with them. This approach is at worst nonsensical, and at best renders 913(g) entirely redundant.

The XYPN petitioners, in contrast, have provided a straightforward reading that makes sense of the statute as a whole. *See* XYPN Br. 32-41. Contrary to the SEC's assertion, this reading does not render Section 913(f) redundant. Section 913(f) contains a procedural authorization for a rulemaking, and also requires the SEC to consider the findings, conclusions, and recommendations of the report provided for earlier in Section 913. Section 913(g), meanwhile, provides for the substance of this rulemaking. *Cf. City of Willcox v. Fed. Power Comm'n*, 567 F.2d 394, 402 (D.C. Cir. 1977) (noting that Section 5 of the Natural Gas Act "provide[s] the substantive counterpart to section 16's procedural authority"). A natural reason for splitting the two provisions apart is because Section 913(g), the substantive provision, had to amend the substantive provisions of the Securities Exchange Act of 1934, and so was included under a separate heading of provisions amending that Act. *See* 124 Stat. 1828. In contrast, Section 913(f) was a grant of procedural authority to be exercised at the SEC's discretion after the steps taken in Sections 913(b) through (e), and so more naturally followed those sections and did not need to be inserted into the Securities and Exchange Act. *See* XYPN Br. 34-35.

The SEC appears to misunderstand the XYPN petitioners' reading of the statute. Under the petitioners' account, Section 913(g) does not provide "separate authority … for the agency to complete the rulemaking" provided for in Section 913(f). SEC Br. 51. Section 913(f) provides the authority to promulgate the rule, and

Section 913(g) provides the substantive standards that govern if the SEC chooses to exercise that authority. *Cf. City of Willcox*, 567 F.2d at 402. Under this reading, both 913(f) and (g) play a distinct and complementary role; neither is redundant.

Contrary to the SEC's assertion that "there is no textual link" between the two subsections, SEC Br. 50, the text of both subsections clearly addresses, with identical language, the same rulemaking authority: the authority to issue a rule governing the standard of care for those "providing personalized investment advice about securities to [a] retail customer[]." 124 Stat. 1827-28. There is no need for a cross-citation between the two sequential sections for this textual link to be clear. *See City of Willcox* 567 F.2d at 402 nn. 5-6 (no cross-citation between Sections 5 and 10 of the Natural Gas Act). And this reading is supported, not undermined, by the cross-reference in Section 913(c). *See* SEC Br. 52. Section 913(c) refers to factors that the SEC may consider "in determining whether to conduct a rulemaking under subsection (f)." 124 Stat. 1827. It does not say "subsection (f) or (g)," as one might expect if these two subsections provided parallel "paths" as the SEC asserts. This reinforces a common-sense understanding of subsection (f) as providing the authority to conduct a rulemaking, and subsection (g) as providing the authority that governs the substance of that rulemaking and makes the necessary changes to harmonize that authority with the Securities Exchange Act of 1934.

Finally, the SEC makes a clear mistake when it relies on the use of "[n]otwithstanding" in Section 913(g). The SEC asserts that the phrase "[n]otwithstanding any other provision of this Act" in Section 913(g) refers to other provisions "of Dodd-Frank," and so the use of the notwithstanding clause (in the SEC's eyes) "affirmatively decouple[s]" Section 913(g) from Section 913(f). SEC Br. 51. This is a misreading. The "Act" referenced in that clause is plainly the Securities Exchange Act of 1934—the SEC's organic statute—not the Dodd-Frank Act. *See* 124 Stat. 1828. Section 913(g) provides that "Section 15 of the Securities Exchange Act of 1934 . . . is amended by adding at the end the following:" *Id.* After the colon, quotation marks denote the beginning of the text to be inserted into the Securities Exchange Act. *Id.* That text begins with a subsection "(k)," and a new heading, "STANDARD OF CONDUCT." *Id.* The text of this subsection (k), also within quotation marks, is where the "notwithstanding" language is found: "Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940." *Id.* The placement after the colon and the quotation marks, in the subsection that is to be inserted in the Securities Exchange Act, make it clear that the phrase "this Act" within the inserted provision is a reference to the Securities Exchange Act and not the Dodd-Frank Act. *Id.*

Section 913(g) of the Dodd-Frank Act thus amends the Securities Exchange Act, and inserts its substantive limitation on the SEC's authority "[n]otwithstanding"

any other provision in the Securities Exchange Act or Investment Advisers Act. *Id.* The SEC is wrong to say that the "notwithstanding" clause means that those substantive limitations do not apply to Section 913(f) of the Dodd-Frank Act.

The SEC's various attempts to read Section 913(f) in isolation from 913(g) are thus unavailing. Its reading of the Dodd-Frank Act misinterprets the plain text of the statute and renders 913(g) wholly superfluous. The rule against reading one statutory provision to render another redundant "is strongest when an interpretation would render superfluous another part of the same statutory scheme." *See Marx v. Gen. Revenue Corp.*, 568 U.S. 371, 386 (2013). This interpretation of the Dodd-Frank Act is not "a permissible construction of the statute," and must be set aside under the Administrative Procedure Act. *City of Arlington, Tex. v. F.C.C.*, 569 U.S. 290, 307 (2013).

III. Regulation Best Interest is arbitrary and capricious.

The SEC makes two main responses to petitioners' arbitrary-and-capricious argument: First, that Regulation Best Interest does not "turn on" the challenged interpretation of the Investment Advisers Act, and, second, that its interpretation of the Investment Advisers Act is accurate. SEC Br. 59-70. Neither argument withstands scrutiny.

1. The "solely incidental" interpretation. First, the SEC appears to misunderstand the XYPN petitioners' argument regarding the relationship between Regulation Best Interest and the Solely Incidental Interpretation. The SEC argues

that the rule cannot "turn on" the application of the broker-dealer exclusion because "the rule presumes a firm fits within the exclusion when providing a recommendation subject to the rule." SEC Br. 60. But that is exactly the point. In promulgating this rule, the SEC's reasoning was based extensively on a particular understanding of which firms and activities the rule would cover. XYPN Br. 43 (collecting citations). And that understanding is wrong; the Solely Incidental Interpretation is an unreasonably broad interpretation of the broker-dealer exclusion in the Investment Advisers Act. *Id.* at 41-51. As a result, the SEC promulgated Regulation Best Interest based on a faulty understanding of the scope of activity to which it will apply. Therefore, even if the contents of the rule might otherwise be "permissible as an exercise of discretion," they are rendered arbitrary and capricious and "cannot be sustained" because the SEC's reasoning and weighing of the relevant interests was "based … on an erroneous view of the law." *Sea-Land Serv. v. Dep't of Transp.*, 137 F.3d 640, 646 (D.C. Cir. 1998).

It is no defense that the SEC couched this incorrect interpretation of the law in an interpretive rule. The SEC both faults the petitioners for not challenging the Solely Incidental Interpretation and then points out that interpretive rules cannot be challenged. SEC Br. 61-62. It does not matter *where* the SEC's incorrect interpretation of the law was published, or in what form. It is clear that Regulation Best Interest relies on it extensively, and a regulation that is "based on an incorrect view of

applicable law … cannot stand." *Prill v. N.L.R.B.*, 755 F.2d 941, 948 (D.C. Cir. 1985). If that were not the case, the SEC (or any agency) could simply place incorrect interpretations of the law in interpretive rules, base its regulations around the safely ensconced bad interpretations, and circumvent any possible challenge. Such a result cannot be reconciled with the "presumption favoring judicial review of administrative action" that is embodied in the APA, let alone administrative agencies' fundamental obligation to follow the law. *Sackett v. EPA*, 566 U.S. 120, 128 (2012).

Next, the SEC argues that its interpretation of the broker-dealer exception is reasonable. SEC Br. 62-70. The SEC faults the XYPN petitioners for their focus on the terms "solely incidental," arguing that the real meaning of the exception lies in what the advice must be solely incidental *to*: an entity's "conduct of his business as a broker or dealer." SEC Br. 62. The SEC says that this language is better captured by its interpretation: that the "solely incidental" exception is triggered by a broker-dealer who gives advice so long as "the advice is provided 'in connection with' and is 'reasonably related' to the 'primary business of effecting securities transactions.'" *Id.* at 63 (quoting Solely Incidental Interpretation, PA305). As a result, the SEC says, unless the broker-dealer's "primary business is giving advice" or the recommendation "is not reasonably related to [a] primary brokerage business," the exception applies. *Id.*

This argument fails entirely to respond to the XYPN petitioners' argument that the "reasonable relationship" and "primary business" standards effectively ignore the plain meaning of "solely incidental." *See* XYPN Br. 43-47. The XYPN petitioners do not ignore the words that come after "solely incidental"; their argument is that the phrase "solely incidental" indicates the nature of the relationship *between* advice that is eligible for the exception and a broker-dealer's primary business. The term "solely incidental" indicates that the investment advice at issue must be subordinate to a broker's transactional business because of its minor, contingent, or inessential nature. *Id.*

The SEC's test make vague gestures at this subordinate relationship by acknowledging in its "reasonable relationship" test that a broker-dealer's "business of effecting securities transactions" must be its "primary" business for the exception to apply. SEC Br. 63. But use of the word "primary" in its test is largely inconsequential, because the SEC—by its own admission—does not base its determination around "the amount or importance of" the advice given in an exchange, *see id.* at 65, in relation to the business of effecting securities transactions—which, again, will often be automated and ministerial. XYPN Br. 6-8. According to the SEC's definition, a broker-dealer can be eligible for the exception to the Investment Adviser's Act's requirements if giving advice is an essential element of its business model, is a component of every transaction, is a primary way the company

attracts and retains customers, and is responsible for a large fraction of the company's revenue. That is not a remotely reasonable reading of the phrase "solely incidental." XYPN Br. 43-48.

Nor is it consistent with stances that the SEC has taken in the past. In 2005, for instance, the SEC's final rule regarding the broker-dealer exception stated specifically that "a broker-dealer provides advice that is not solely incidental if it: holds itself out to the public as a financial planner or as providing financial planning services," or even if it simply "delivers to its customer a financial plan." 70 Fed. Reg. 20,424. This rule adopted a more reasonable understanding of the "solely incidental" exception, in which the scope of the advice that a company offers as well as how it "portrays itself to the public" was relevant—and could be dispositive—when considering whether that advice was solely incidental to its brokerage business. *Id.* at 20,439.

But now the SEC argues that such a stance "lack[s] any textual or historical basis," resorting to a series of straw-man arguments. SEC Br. 65. The SEC asserts, without justification, that focusing on the "quantum or importance" of the advice given would preclude considering whether a broker-dealer's advice is related to its transactional business. *Id.* at 66. That's not true. A reasonable interpretation of the "solely incidental" prong would, consistent with the text of the Investment Advisers

Act, examine both the significance of the investment advice given and whether it is related to a broker-dealer's transactional business.

Next, the SEC argues that there is no basis for examining "the significance of the advice *to the investor*," because the broker-dealer exclusion, so the SEC says, originally "turned on the relationship between the advisory function *to [a] brokerage business*." *Id.* at 65 (emphasis in original). But the XYPN petitioners have never suggested that the "solely incidental" test turns only on the significance of the advice to an investor or is otherwise divorced from examining the context of the broker-dealer's business. *See* XYPN Br. 43-48. It is the SEC, not the XYPN petitioners, that has put forward a narrow and unworkable definition: that one should disregard the quantum or significance of advice when applying a test that is designed to distinguish between advice-giving business models and transaction-executing business models. That makes no sense.

The SEC also argues that accountants and lawyers might be "swept within" the definition of "investment adviser" if a legal test were to examine the quantum or significance of the investment advice they gave. SEC Br. 66. But, again, the XYPN petitioners have never argued for a test that ignores a professional entity's business model, and have been clear that the quantum or importance of the advice given should be viewed in context of the revenue, business model, and public presentation of an entity claiming the "solely incidental" exception. *See*, *e.g.*, XYPN Br. 44. And if

someone trained as an accountant or lawyer actually creates an expansive business regime built around marketing financial advice to consumers in the way many broker-dealers have, they should be treated as an investment advisor just as the broker-dealers should be.

2. The "special compensation" prong. The SEC fares no better when it attempts to defend a stance regarding the "special compensation" prong that explicitly allows broker-dealers to receive compensation "directly or indirectly" for providing recommendations to investors as to how they should invest. 84 Fed. Reg. 33,344; XYPN Br. 48-51. The SEC argues that the word "special" in "special compensation" means compensation "received specifically in exchange for giving advice, as opposed to some other service." SEC Br. 69. But this is entirely consistent with the arguments made by the XYPN petitioners. *See* XYPN Br. 49. The SEC's argument does not rebut the fundamental problem with Regulation Best Interest—that the regulation explicitly covers "a variety of scenarios in which broker-dealers will receive compensation specifically for giving advice." *Id.* At several points, the rule and its explanatory text make clear that broker-dealers will be able to receive compensation specifically for advice and still be eligible for the broker-dealer exception—a clear violation of the special compensation prong. *Id.* at 48-51.

The SEC's response appears to be that compensation for a "recommendation" is not compensation for "advice" because the compensation for

a "recommendation" comes in the form of "traditional commissions or analogous transaction-based compensation." SEC Br. 68-69 (quoting *Thomas v. Metropolitan Life Ins. Co.*, 631 F.3d 1153, 1164 (10th Cir. 2011)). The SEC repeatedly invokes the notion that transaction-based compensation is a key differentiator between broker-dealers and investment advisers, because investment advisers often charge an ongoing fee. *See, e.g.*, SEC Br. at 3, 8, 14, 72. But neither the SEC nor the *Thomas* case on which it relies explains why compensation for investment advice cannot come in the form of a commission or other type of transaction-based compensation. *Id.*; *see also Thomas*, 631 F.3d at 1164-65. The opposite seems obviously true: a consumer can pay specifically for advice either in the form of an ongoing fee or as a one-time transactional payment for receiving a particular recommendation. The question of *how* the compensation is paid is a distinct question from *whether* the compensation is paid "specifically in exchange for giving advice." SEC Br. 69.

The SEC itself has previously taken the petitioners' stance—that the form of a payment does not determine whether it counts as compensation for advice—in this exact same context. In 1999, the SEC attempted to remove the "special compensation" prong from the broker-dealer exception by regulation—a rule that was eventually struck down by the D.C. Circuit in *Financial Planning Association.* The SEC said then that "[w]hile in 1940 the form of compensation a broker-dealer received may have been a reliable distinction between brokerage and advisory

services, development of … new brokerage programs suggest strongly that it is no longer." 64 Fed. Reg. 61,228.

The natural conclusion of that stance would be that much of broker-dealers' activity could no longer be excluded from the Investment Advisers Act on the basis of the form of compensation used in a given transaction. But the SEC sought to preclude the question of how to deal with this changed reality by exempting broker-dealers categorically from the "special compensation" prong to begin with. *See Financial Planning Association*, 482 F.3d at 485-92. That failed when the D.C. Circuit rejected the SEC's "attempt to overcome the plain language of the statute," *id.* at 490, and the SEC has now taken a different tack—contradicting its past analysis and saying that giving a recommendation for a transactional fee does not count as giving investment advice for special compensation.

This about-face highlights the fact that the SEC's brief never truly addresses the way that the broker-dealer industry has changed since the 1940s—changes that the SEC previously has acknowledged but now sweeps under the rug. The SEC writes that "petitioners seem to believe" that broker dealers "just recently start[ed] providing advice." SEC Br. 64. But the petitioners have never argued that broker-dealers' provision of advice is a recent phenomenon. What the petitioners have emphasized is that the *transactional* side of broker-dealers' businesses has changed radically. XYPN Br. 6-10. Executing financial transactions used to be a time-

intensive, specialized task involving expertise and discretion. But now it is frequently ministerial—often done automatically by computer, and in many circumstances done at little or no cost. *Id.*; *see also* Amicus Br. of The Public Investors Arbitration Bar Association, No. 64-2, at 22-23 ("As the cost to execute trades, the traditional service of brokerage firms, drops to zero, it seems the advice offered by brokers is no longer 'solely incidental' to their brokerage services."). Many major broker-dealers have cut trading commissions on all stocks, exchange-traded funds, and options in recent years—resulting in firms shifting "toward financial planning and advisory accounts that generate quarterly and annual advisory fees." Bruce Kelly, *What zero commissions means for B-Ds*, Investment News (Nov. 2, 2019), https://perma.cc/MQR7-EU24.

Broker-dealers realize that the key value they provide to customers is their advice; their advertising and marketing reflects that fact. *See*, *e.g.*, Micah Hauptman and Barbara Roper, *Financial Advisor or Investment Salesperson?*, Consumer Federation of America, at 2 (Jan. 18, 2017), https://perma.cc/Q3FZ-U8EX (surveying major brokerage firms and finding that they "typically describe their services as providing investment 'advice' and retirement 'planning,' not simply product sales"). As a result—and as the SEC has recognized—it is no longer plausible to simply view a fee payment as a payment that is "primarily" for a transaction's execution as opposed to compensation provided specifically for advice.

The case law that the SEC relies on is not to the contrary. *See* SEC Br. 68-69. The Tenth Circuit in *Thomas*—the only appellate court the SEC has cited on the issue—did not decide how to determine whether, in a given transaction, the "primary" conduct is the effectuation of a securities transaction or the provision of advice; and it never considers the wide swath of transactions in which the execution of the securities purchase is largely ministerial. *See Thomas*, 631 F.3d at 1164. And, as discussed above, *Thomas* does not consider why, in such a context, the form of compensation alone will not provide a reasonable means of identifying whether the compensation is provided for advice.

The court in *Wiener v. Eaton Vance Distributors*, meanwhile, specifically "find[s] no indication that Congress was more concerned with the form, as distinct from the purpose, of fees paid to broker-dealers." 2011 WL 1233131, *7 (D. Mass. March 30, 2011). The court reviewed the history of the SEC's own stance on "special compensation," noting that the SEC has not historically focused "on the *form* of the compensation" but instead looked to the relationship between "compensation paid by customers and any advisory services rendered." *Id.* (emphasis in original). Courts have followed suit, relying on "fact-based inquiries into the compensation paid, the services rendered, and evaluation of the connection between the two in determining whether the exemption applies." *Id.* at *10. This provides a stark contrast with the SEC's approach in Regulation Best Interest, which regularly assumes that broker-dealers

can make recommendations—i.e., advice—and receive compensation specifically *for those recommendations* while still not being subject to the Investment Advisors Act. *See, e.g.*, 84 Fed. Reg. at 33,331; 33,339 n.202; 33,344.

Regulation Best Interest is thus "based on misinterpretation" of the solely incidental exception in the Investment Advisers Act. *Kennecott Corp. v. E.P.A.*, 684 F.2d 1007, 1014 (D.C. Cir. 1982). The fundamental purpose of the rule is to carve up the market for investment advice and introduce new standards to govern the actions and disclosures of broker-dealers as distinct from registered investment advisers. *See* 84 Fed. Reg. at 33,318-27. But the rule is premised on an unreasonable understanding of the activities and laws separating those two kinds of entities. XYPN Br. 41-52. The result is that entire businesses will be subject to Regulation Best Interest as broker-dealers when they should be regulated as investment advisers. The regulation therefore "cannot stand as promulgated." *Prill*, 755 F.2d at 948.

3. Consumer confusion. Finally, the SEC's response regarding consumer confusion is a dodge. It first asserts, strangely, that the petitioners "offer nothing more than their opinion" that the disclosures in Regulation Best Interest "will be ineffective." SEC Br. 86. But the XYPN petitioners based their arguments primarily around *the SEC's own studies* on consumer confusion. XYPN Br. 53-60. The SEC's response brief, which does not discuss these studies at all in its two-page response to

petitioners on this issue, has simply doubled down on the strategy of ignoring the findings of its own reports. *See* SEC Br. 85-87.

Next, the SEC argues that the petitioners "focus on supposed problems with Form CRS, which is not at issue in this appeal." *Id.* at 86. But the XYPN petitioners have never singled out Form CRS as the basis for their challenge; they discussed evidence regarding Form CRS, and the inadequacies of Form CRS, alongside evidence regarding Regulation Best Interest's disclosure requirements and Regulation Best Interest more broadly. *See* XYPN Br. at 57 (discussing "the disclosure obligation and Relationship Summary form"); *id.* at 57-58 (discussing passages in both Regulation Best Interest and the Form CRS Final Rule); *id.* at 59 (discussing Regulation Best Interest). And the SEC's attempt to disentangle Form CRS from Regulation Best Interest is the height of formalism; Regulation Best Interest cites to Form CRS repeatedly and clearly relies on the SEC's perceived value of that form's disclosures throughout its discussion. *See, e.g.*, 84 Fed. Reg. at 33,320 & n.12; 33,327; 33,333 nn.138, 140; 33,342; 33,345; 33,346; 33,347 nn. 296–97; 33,349 n.312; 33,350; 33,351 & n.324; 33,352 n.343; 33,353 & n.353; 33,357 ("We believe the information included in the Relationship Summary may provide a useful starting point for the identification of the type and scope of services that must be disclosed pursuant to the Disclosure Obligation.").

The SEC's only other response is a tacit admission that the SEC has failed to "examine[] the relevant data and articulate[] a satisfactory explanation for its action." *NRDC v. FAA*, 564 F.3d 549, 555 (2d Cir. 2009). The SEC argues that the petitioners have misunderstood "how the Commission factored potential investor confusion into its decision to adopt Regulation Best Interest." SEC Br. 87. As the SEC now sees it, consumer confusion will still exist, but that confusion is "balanced" by benefits to "investor choice" created by the rule. *Id.*

But that is a revision of the SEC's actual justification for the rule, which relied heavily on the notion that disclosures would *facilitate* "informed choice" for consumers. *See* XYPN Br. 57-60. The SEC's original, core argument for adopting Regulation Best Interest rather than a uniform standard was that a uniform standard would reduce choice, 84 Fed. Reg. at 33,322, whereas the disclosure obligations created in Regulation Best Interest would "help retail customers better understand and compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs and circumstances." *Id.* at 33,321. The SEC's decision was not a balance of the benefits of preserving investor choice versus the costs of informing consumers—its reasoning was that consumer choice would be facilitated by the disclosures. And, as the XYPN petitioners demonstrated in their opening brief, this reasoning was contrary to the evidence before the SEC. XYPN Br. at 53-60. The evidence presented to the SEC,

much of which came from the SEC's own studies, demonstrated (in the SEC's own words) "robust...evidence that many retail investors do not understand or are confused by the different standards of care applicable to investment advisers and broker-dealers." *Id.* at 54. The evidence also showed that even where consumers reacted positively to disclosures, they misunderstood them, and the disclosures did not achieve the intended result of increasing consumer understanding. *Id.* at 56-57.

The SEC has failed entirely to respond to the substance of the XYPN petitioners' arguments here. The after-the-fact argument it makes in its brief—that consumer misunderstanding is outweighed by preserving choice—cannot justify the rule. In a challenge to a regulation as arbitrary and capricious, "courts may not accept appellate counsel's *post hoc* rationalizations for agency action. It is well established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *Islander E. Pipeline Co., LLC v. Connecticut Dept. of Environmental Protection*, 482 F.3d 79, 95 (2d Cir. 2006). The SEC has failed even to engage with the evidence regarding consumer confusion, much less demonstrate that it "examined the relevant data and articulated a satisfactory explanation for its action." *NRDC v. FAA*, 564 F.3d at 555 (cleaned up). As a result, its rule—premised heavily on the ability of consumers to differentiate between broker-dealers and investment advisers, contrary to the agency's own studies—must be struck down.

CONCLUSION

This Court should hold Regulation Best Interest to be unlawful and set it aside under 5 U.S.C. § 706.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Local Rule 32.1(a)(4) because this brief contains 6,982 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(f). This brief complies with the typeface requirements of Rule 32(a)(5) and the type-style requirements of Rule 32(a)(6) because this brief has been prepared in proportionally spaced typeface using Microsoft Word in 14-point Baskerville font.

April 14, 2020

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CERTIFICATE OF SERVICE

I hereby certify that on April 14, 2020, I electronically filed the foregoing brief with the Clerk of the Court for the U.S. Court of Appeals for the Second Circuit by using the CM/ECF system. All participants are registered CM/ECF users and will be served by the CM/ECF system.

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