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Regulation Best Interest (Reg BI): The SEC's Rule for Broker-Dealers

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SUMMARY

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Regulation Best Interest (Reg BI): The SEC's Rule for Broker-Dealers

On June 5, 2019, the Securities and Exchange Commission (SEC) voted to adopt Regulation Best Interest (Reg BI) under the Securities and Exchange Act of 1934 (P.L. 73-291). Reg BI reforms requirements for broker-dealers when they make investment recommendations to retail customers. According to the SEC, Reg BI is meant to "enhance the broker-dealer standard of conduct beyond existing ... obligations [by] requiring broker-dealers ... to: (1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and (2) address [various broker-dealer] conflicts of interest [with those clients]." Broker-dealers have until June 2020 to comply.

Broker-dealers execute securities trades and provide investment recommendations. They are licensed and regulated by state securities regulators, the SEC, and the Financial Industry Regulatory Authority (FINRA), a SEC-regulated entity that they must also join. Traditionally, broker-dealers provided transaction-specific discrete investment recommendations and were compensated via commissions for individual transactions.

Broker-dealers have generally made investment recommendations under the *suitability standard*, a FINRA rule requiring that recommendations are merely consistent with customers' interests. By contrast, investment advisers—another type of financial professional that typically offers more ongoing investment counsel (such as retirement planning) and is compensated by fixed fees or a percentage of total assets managed—have generally followed the *fiduciary standard*, a nonstatutory obligation derived from court rulings and decisions from SEC enforcement cases. It requires a more demanding level of financial professional client care than does broker-dealers' suitability standard: advisers are expected to serve their clients' best interests above their own.

Partly motivated by reporting on widespread investor confusion over the differences between broker-dealers and investment advisers and their respective client obligations, Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, P.L. 111-203) directed the SEC to evaluate gaps in existing regulations for advisers and broker-dealers. It gave the SEC authority to impose a fiduciary standard of care on broker-dealers akin to that already applied to advisers. Dodd-Frank also required the SEC to study this issue. The resulting 2011 staff study recommended that the SEC adopt a uniform fiduciary standard.

In 2016, the Obama Administration's Department of Labor (DOL) issued controversial regulations that subjected financial professionals who work with private-sector retirement plans governed by the Employee Retirement Income Security Act of 1974 (P.L. 93-406) to an elevated fiduciary level of customer duty. The largely unimplemented reform, which earned praise from investor advocates, was vacated in a 2018 court case brought by various business interests who successfully argued that it was statutory overreach. Currently, Trump Administration DOL officials are reportedly working on a new standard projected to align with Reg BI.

SEC officials and various business groups argue that Reg BI properly balances the need for an enhanced broker-dealer standard of care with the need to preserve the broker-dealer business model, a model deemed to have special appeal to less-affluent investors. Critics, including investor advocates, argue that it effectively preserves the inadequate suitability standard, exposing investors to harm from unaddressed broker-dealer conflicts of interest. In June 2019, the House passed H.R. 3351, the FY2020 Financial Services and General Government appropriations bill. It included an amendment sponsored by House Financial Services Committee Chair Maxine Waters that would forbid the SEC from using any of its congressional spending authority to implement, administer, enforce, or publicize the final rules and interpretations with respect to Reg BI. In September 2019, the Senate Appropriations Committee reported its version, S. 2524, which would not proscribe funding for SEC implementation of Reg BI. In late November 2019, H.R. 3055 was passed by the House and the Senate as a continuing resolution that would fund the government at current levels through December 20, 2019. On November 21, President Trump signed it into law as P.L. 116-69. It does not restrict agency funding for Reg BI implementation.

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Overview

On June 5, 2019, the commissioners of the Securities and Exchange Commission (SEC) voted to adopt Regulation Best Interest (Reg BI).[1] Reg BI is arguably the centerpiece and most controversial part of a set of regulatory reforms related to financial professionals adopted by the SEC on that day. A new rule under the Securities and Exchange Act of 1934 (P.L. 73-291), Reg BI changes broker-dealers' obligations in their relationships with retail customers. According to the SEC, the regulation is meant to "enhance the broker-dealer standard of conduct beyond existing ... obligations [by] requiring broker-dealers ... to: (1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and (2) address [various broker-dealer] conflicts of interest [with those clients]."[2]

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This report examines Reg BI in that it (1) provides background on the roles and the regulation of two types of financial professionals, broker-dealers and investment advisers; (2) provides background on the Obama Administration Department of Labor's 2016 fiduciary rule for broker-dealers under the Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406);[3] (3) describes the component obligations required to fulfill Reg BI's best interest broker-dealer standard; (4) examines state-based broker-dealer fiduciary regulatory and statutory developments; (5) examines congressional concerns and actions regarding Reg BI; (6) presents some key supportive and critical perspectives on Reg BI; and (7) examines research with potential relevance to the debate over the potential costs and benefits of Reg BI.

Background on Broker-Dealers and Investment Advisers

Broker-dealer firms or their affiliated persons act as brokers when they execute securities trades for their clients and as dealers when they trade their own securities for their own benefit. They are often discussed as a joint entity because most broker-dealers must register with the SEC, and must generally be members of and comply with the rules and guidance of a self-regulatory organization (SRO), the Financial Industry Regulatory Authority (FINRA, an SEC-regulated

[1] U.S. Securities and Exchange Commission (SEC), "Proposed Regulation Best Interest," *83 Federal Register* 21574, May 9, 2018, at https://www.federalregister.gov/documents/2018/05/09/2018-08582/regulation-best-interest. (Hereinafter SEC, "Proposed Regulation Best Interest.")

[2] SEC, "Proposed Regulation Best Interest."

[3] Department of Labor (DOL), Employee Benefits Security Administration (EBSA), "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice," 81 *Federal Register* 20945, April 8, 2016, at https://www.federalregister.gov/documents/2016/04/08/2016-07924/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice. (Hereinafter DOL, EBSA, "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice.")

nonprofit). In addition, broker-dealer sales personnel (called registered representatives) register with their state securities regulator.[4]

SEC-registered broker-dealers are largely regulated under the Securities Exchange Act of 1934 (P.L. 73-291) and comprise a small set of large and medium-sized broker-dealers and thousands of smaller broker-dealers who compete in small niche or regional markets. Broker-dealers, or simply brokers, have significant range in the kinds of services they provide and generally divide into two groups, full-service and discount brokerage firms.[5]

Broker-dealers typically provide discrete, transaction-specific investment recommendations and are compensated via the commissions they receive for each individual transaction. A broker-dealer's investment recommendations suite may include buying securities from or selling securities to retail customers on a principal basis or recommending the purchase of proprietary products.[6] In their investment recommendations, they are generally subject to what is known as the *suitability standard*, which requires them to "reasonably believe that a client recommendation is suitable given the client's investor profile."

Investment advisers are firms or persons who provide investment advice directly to their clients. Clients include individuals and institutional investors, such as mutual funds and hedge funds. Pursuant to the Investment Advisers Act of 1940 (IAA, which regulates key aspects of investment advisers; P.L. 76-768), advisers with more than $110 million in assets under management (AUM) must register with the SEC.[7] States generally register and regulate investment adviser firms with between $25 million and $110 million in AUM.

Investment advisers typically provide ongoing investment advice and services with respect to client portfolio management. Their compensation is generally determined by the client's account AUM size, a fixed fee, or other arrangements, such as a fee-based compensation model.

Although not expressly written in the IAA, court rulings and decisions from SEC enforcement cases have helped establish the *fiduciary standard,* the prevailing standard of retail customer care for investment advisers. Under this standard, advisers are generally expected to serve the best interests of their clients and are required to subordinate their own interests to those of their clients. Ideally, advisers are also expected to either eliminate material conflicts of interest or be fully transparent to the client about the existence of such conflicts.

By contrast, broker-dealers are generally subject to a less demanding standard of client care that is found in FINRA's Rule 2111, the *suitability standard*. Triggered when a broker-dealer makes an investment recommendation, the "standard requires that a firm or associated person have a reasonable basis to believe a recommended transaction or investment strategy involving a security or securities is suitable for the customer.... [It] is based on the information obtained through

[4] Financial Industry Regulatory Authority (FINRA), "Brokers," at https://www.finra.org/investors/brokers.

[5] Full-service firms typically charge more for each transaction and generally have large research units that their registered representatives can use to help them make recommendations. Such firms also have a wide range of investor services, which may include investment and retirement planning. Discount broker-dealer firms are usually not as expensive as full-service firms, but have traditionally lacked research operations.

[6] The former practice entails the sale of securities through brokers who initially bought a block of the securities for their own portfolios, whereas proprietary products are investment products that are managed, issued, or sponsored by the financial institution with whom a broker is associated.

[7] *Assets under management* refers to the total market value of the financial assets managed on behalf of a client. The Investment Advisers Act regulates key aspects of investment advisers. For more information on it, see SEC, "The Laws That Govern the Securities Industry," at https://www.sec.gov/Article/whatwedo.html#laws.

reasonable diligence of the firm or associated person to ascertain the customer's investment profile."[8]

Also, unlike investment advisers, brokers do not have an ongoing duty to monitor their clients' financial positions.[9]

Broker-dealers are, however, subject to a fiduciary standard (1) when they have control of a client's discretionary account (meaning that they have a client's authority to buy and sell securities on the client's behalf) generally, according to case law;[10] or (2) in a few states—California, Missouri, South Dakota, and South Carolina—where state courts have reportedly "imposed an unambiguous fiduciary standard" on them.[11]

The overall number of SEC-registered broker-dealers fell from more than 6,000 in 2005 to fewer than 4,000 in 2018, in contrast to an increase of SEC-registered investment advisers from about 9,000 in 2005 to more than 13,000 in 2018.[12]

Blurred Lines Between Broker-Dealers and Investment Advisers, the Dodd-Frank Act, and a Uniform Fiduciary Standard

During the late 1980s and early 1990s, the landscape for the delivery of investment advice began to shift as broker-dealers increasingly offered financial advisory services somewhat akin to investment advisers, including investment and retirement planning. The expansion was reportedly helped along by the brokers' reliance on the IAA's "solely incidental" exemption from compliance with the act, and the growth of dually registered firms (i.e., firms registered with FINRA and the SEC as both broker-dealers and investment advisers).[13]

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[8] FINRA, "Suitability," at https://www.finra.org/industry/suitability.

[9] Michael Finke and Thomas P. Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice," *Journal of Financial Planning*, vol. 25, no. 7 (July 2012), at https://www.onefpa.org/journal/Pages/The%20Impact%20of%20the%20Broker-Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx. (Hereinafter Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice.")

[10] For example, see Arthur B. Laby, "Fiduciary Obligations of Broker-Dealers and Investment Advisers," *Villanova Law Review*, vol. 55, no. 3 (July 2010), p. 708, at https://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1050&context=vlr.

[11] Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice." According to this study "Alabama, Alaska, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, New Hampshire, New Jersey, New Mexico, Nevada, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming impose either a limited fiduciary standard, or the courts have interpreted state law to impose duties that appear to be fiduciary in nature." The study calls these quasi-fiduciary states.

[12] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, June 5, 2019, p. 417, at https://www.sec.gov/rules/final/2019/34-86031.pdf. (Hereinafter SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*.)

[13] Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice." The solely incidental exception refers to Section 202(a)(11)(C) of the Investment Advisors Act, which excludes from the definition of an investment adviser, and thus exempts from Advisers Act compliance, broker-dealers "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" for those services (the "broker-dealer exclusion"). According to the SEC, the exemption reflected the fact that when the IAA was enacted, "Congress recognized broker-dealers commonly provided some investment advice to their customers in the course of their business as broker-dealers and that it would be

Compounding the potential retail customer perplexity over who is an investment adviser and who is a broker-dealer is the existence of "dozens of titles [in the broker world], including generic titles, such as financial advisor and financial consultant, as well as advertisements that reportedly claim that 'we do it all.'"[14]

As a consequence of these developments, various surveys report that retail customers are often confused over the distinctions between broker-dealers and advisers and the unique set of customer obligations attached to each of them.[15] This was encapsulated in an observation made in a Rand Corporation study: "[T]he industry is becoming increasingly complex, firms are becoming more heterogeneous and intertwined, and investors do not have a clear understanding of the different functions and fiduciary responsibilities of financial professionals."[16]

In 2009, the U.S. Department of the Treasury issued a white paper on potential financial reforms in the wake of the financial crisis, *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation*. A section of the report observed that for many investors there was little if any difference in the way they perceived brokers and advisers. It then argued that "retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same."[17]

The white paper then recommended the enactment of new legislation "requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers."[18]

On the heels of the Treasury report and driven in part by similar concerns regarding investor confusion over the roles of investment advisors and broker-dealers,[19] Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act, P.L. 111-203) did a number of things in this area. Among them was granting the SEC authority to impose fiduciary rules on broker-dealers subject to certain conditions and requiring the SEC to study various aspects of financial professionals' standards of retail customer care. Among other questions, the study was asked to evaluate "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute."[20]

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inappropriate to bring broker-dealers within the scope of the Advisers Act because of this aspect of their business." See "Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940," *Investment Advisers Act Release No. 2*, October 28, 1940.

[14] Rand Corporation, *Investment Advisers and Broker-Dealers*, Research Brief RB-9337, 2008, https://www.rand.org/pubs/research_briefs/RB9337/index1.html. (Hereinafter Rand Corporation, *Investment Advisers and Broker-Dealers*.)

[15] Rand Corporation, *Investment Advisers and Broker-Dealers*, p. 2.

[16] Rand Corporation, *Investment Advisers and Broker-Dealers*.

[17] U.S. Department of the Treasury, *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009, at https://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[18] U.S. Department of the Treasury, *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation*, June 17, 2009.

[19] For example, see Wolters Kluwer Law Firm, "Senior House Leaders Provide Legislative History on Sec. 913 of Dodd-Frank," *Dodd-Frank News Center* (blog) July 6, 2010, https://financialreform.wolterskluwerlb.com/2010/07/senior-house-leaders-provide-legislative-history-on-sec-913-of-dodd-frank.html.

[20] SEC, *Study on Investment Advisers and Broker-Dealers*, January 2011, https://www.sec.gov/news/studies/2011/913studyfinal.pdf. (Hereinafter SEC, *Study on Investment Advisers and Broker-Dealers*.)

Released in 2011, the staff study recommended that the SEC bolster investor protection and reduce investor confusion regarding the differences between brokers and investment advisers. The staff study then recommended "establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers."[21]

After the study, then-SEC Chair Mary Schapiro noted that the SEC staff had been tasked with considering the various ramifications of the recommended rulemaking.[22] No such rulemaking was proposed or adopted by the SEC under Chair Schapiro or her successor, Chair Mary Jo White, who in 2015 reportedly said that the agency should "implement a uniform fiduciary duty for broker-dealers and investment advisers where the standard is to act in the best interest of the investor."[23]

The 2016 DOL Fiduciary Rules

In April 2016, the Obama Administration's Department of Labor (DOL) adopted new rules under the Employee Retirement Income Security Act of 1974 (ERISA; P.L. 93-406). Previously, under ERISA, securities brokers-dealers who provided services to retirement plans and who were not fiduciaries were generally subject to a suitability standard.

The 2016 DOL rules represented a significant change from this. Under them, broker-dealers were generally deemed to be fiduciaries while providing recommendations to retirement plan participants. Major parts of the rules were not to be implemented until 2018.[24]

In making the case for the reform, the Obama Administration argued that the definition of investment advice needed to be revised given the changed nature of how Americans were readying themselves for retirement after ERISA's enactment in 1975. More specifically, the number of participants in traditional defined benefit (DB)[25] plans had significantly declined, whereas the number of participants in defined contribution (DC)[26] plans, such as 401(k) plans, had surged. The Administration argued that DC plan participants tend to confront more decision options, such as contribution amounts, investment allocations, rollovers, and withdrawals, than do DB plan participants. As such, it was argued that those in DB plans may have greater need for investment assistance and advice subject to the more strenuous fiduciary standard.[27]

Supporters of DOL's fiduciary rules, including investor advocates, argued that financial advisers (including broker-dealers) would no longer be able to direct clients to products that awarded them

[21] SEC, *Study on Investment Advisers and Broker-Dealers*.

[22] Testimony of SEC Chairman Mary L. Schapiro, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Continued Oversight of the Implementation of the Wall Street Reform Act*, hearings, 112th Cong., 1st sess., December 6, 2011, at http://www.sec.gov/news/testimony/2011/ts120611mls.htm.

[23] Mark Schoeff Jr., "SEC's Mary Jo White Says Agency will Develop Fiduciary Rule for Brokers," *Investment News*, March 17, 2015, at https://www.investmentnews.com/article/20150317/FREE/150319919/secs-mary-jo-white-says-agency-will-develop-fiduciary-rule-for.

[24] DOL, EBSA, "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice."

[25] A defined benefit pension plan is a type of retirement plan in which an employer/sponsor promises a specified pension payment, lump sum, or combination thereof on retirement that is predetermined by a formula based on the employee's earnings history, tenure of service, and age.

[26] A defined contribution plan is a type of retirement plan in which the employer, employee, or both make contributions on a regular basis. In such plans, the value of future benefits varies based on investment earnings.

[27] DOL, EBSA, "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice."

larger commissions at the client's expense. Detractors, including broker-dealers, financial planners, and various Members of Congress,[28] stressed that the rules would increase the cost of retirement accounts and would curtail various investors' access to investment advice.[29]

In February 2017, President Trump released a presidential memorandum ordering the Labor Department to reexamine the rule.[30] Later, between April and November 2017, DOL ordered a series of delays for key parts of the rule that stretched until July 2019.[31]

On March 15, 2018, the Fifth Circuit Court of Appeals vacated the DOL rules. It ruled that DOL had exceeded its statutory authority under ERISA in writing the rules. The decision formally halted implementation of the rules.[32] The adjudication was the result of a lawsuit brought by various business groups, including the U.S. Chamber of Commerce (a major business trade group), the Financial Services Roundtable (a group that represents the nation's largest firms in banking, insurance, and investment services), and the Securities Industry and Financial Markets Association (SIFMA, a major trade group for broker-dealers, investment banks and asset managers).

The Trump Administration's DOL has not challenged the Fifth Circuit's decision. However, in fall 2018, DOL officially announced that it was "considering regulatory options in light of the Fifth Circuit opinion" and projected a September 2019 date for the potential new final rules.[33]

In June 2019, various DOL officials, including then-DOL Secretary Alexander Acosta, reportedly said that the agency "was working with the SEC to promulgate new rules."[34]

The same month, Jeanne Klinefelter Wilson, deputy assistant secretary of the Employee Benefits Security Administration, the DOL unit that oversees ERISA, observed that although DOL and the SEC operate under different regulations, "the goal is to proceed under a raw common framework and propose Department of Labor rules [that] track as closely as possible with [the] SEC's best-interest regulations."[35]

In July 2019, President Trump nominated Eugene Scalia to succeed Alexander Acosta as Secretary of Labor. Scalia was later confirmed for that post by the Senate on September 26, 2019.

While a partner with the law firm Gibson, Dunn, & Crutcher, Scalia presented oral arguments on behalf of the plaintiffs in the aforementioned case in which the court vacated DOL's fiduciary

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[28] A number of bills were introduced in the 114th and 115th Congresses that would have prevented, delayed implementation of, or rescinded the DOL fiduciary rule. They can be found in CRS Report R44884, *Department of Labor's 2016 Fiduciary Rule: Background and Issues*, by John J. Topoleski and Gary Shorter.

[29] For example, see Oxford Economics (at the request of the Financial Services Institute), *Consequences of the U.S. Department of Labor's Proposed New Fiduciary Standard*, 2016, at https://www.oxfordeconomics.com/recent-releases/the-economic-consequences-of-the-us-department-of-labor-s-proposed-new-fiduciary-standard.

[30] White House, "Presidential Memorandum on Fiduciary Duty Rule," February 3, 2017, at https://www.whitehouse.gov/presidential-actions/presidential-memorandum-fiduciary-duty-rule/.

[31] DOL, "U.S. Department of Labor Extends Transition Period For Fiduciary Rule Exemptions," press release, November 27, 2017, at https://www.dol.gov/newsroom/releases/ebsa/ebsa20171127-0.

[32] The ruling is available at https://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[33] DOL, "Fiduciary Rule and Prohibited Transaction Exemptions," Fall 2018, at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=1210-AB82&operation=OPERATION_PRINT_RULE.

[34] Kurt Schacht, "Regulation Best Interest: Investors Are The Losers," Law360, June 26, 2019, at https://www.law360.com/articles/1172445/regulation-best-interest-investors-are-the-losers.

[35] Brian Croce and Hazel Bradford, "Scalia on Tap to Replace Scandal-Tainted Acosta at DOL," *Pensions & Investments*, July 22, 2019, at https://www.pionline.com/washington/scalia-tap-replace-scandal-tainted-acosta-dol.

rule. Scalia has reportedly described the rule as "an immensely controversial and burdensome rule that really pushed the envelope of the agency's regulatory authority."[36]

The possibility has been raised that Secretary Scalia may have to recuse himself from involvement in the development of a fiduciary rule because of government ethics rules that guard against conflicts of interest by prohibiting officials from participating in issues they were involved with in the private sector.[37]

The Reg BI Final Rule

On June 5, 2019, the SEC commissioners separately approved parts of a package of final rules related to the duty of care financial professionals owe to retail investors.[38]

The package contained

- Reg BI;
- the Form Customer Relationship Summary, a short-form disclosure that would identify key distinctions in the types of services offered by broker-dealers and investment advisers to their clients; applicable legal standards, and potential conflicts of interest;
- a clarification of the fiduciary duty owed by investment advisers to their clients under the Investment Advisers Act; and
- an interpretation of the "solely incidental" broker-dealer exclusion under the IAA aimed at clarifying when a broker-dealer's exercise of investment advisory activities redefines it as an investment adviser according to the IAA.

As observed earlier, in addition to its stated goal of requiring a broker-dealer to act in the best interest of a retail customer making recommendations, Reg BI also seeks to address some remaining conflict-of-interest concerns. Reg BI will do so by requiring broker-dealers to "address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where [the SEC] ... determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict."[39]

According to SEC officials, under Reg BI, which the SEC deliberately constructed to be a principles-based set of obligations rather than an expressly defined one,[40] when retail investor

[36] Law360, "MVP: Gibson Dunn's Eugene Scalia," November 27, 2018, at https://www.law360.com/articles/1094161/mvp-gibson-dunn-s-eugene-scalia.

[37] For example, see Andrew Ackerman, "Labor Pick Likely to Sit Out Fiduciary Rule Rewrite," *Wall Street Journal*, August 10, 2019, at https://www.wsj.com/articles/labor-nominee-would-likely-sit-out-financial-advice-rule-making-11565343120.

[38] A retail customer is defined as a natural person, or the legal representative of such natural person, who (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an association person of a broker or dealer; and (2) uses the recommendation primarily for personal, family or household purposes.

[39] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 1.

[40] For example, see SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors," speech delivered in Boston, MA, July 8, 2019, https://www.sec.gov/news/speech/clayton-regulation-best-interest-investment-adviser-fiduciary-duty. (Hereinafter SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors.")

clients receive and use a broker-dealer recommendation, the broker-dealer will be required to act in the retail customer's best interest without placing the broker-dealer's financial or other interests ahead of the retail customer's. The SEC interprets Regulation BI to apply to recommendations of (1) "any securities transaction" (purchase, sale, and exchange); and (2) any "investment strategy" involving securities (including account recommendations).[41]

In addition to investors receiving broker-dealer recommendations for non-retirement-based investment accounts, Reg BI also defines an *applicable retail investor* to include a "person receiving recommendations for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans." It also interprets applicable broker-dealer "account recommendations to include … recommendations to roll over or transfer assets from one type of account to another (e.g., converting a workplace retirement plan account to an IRA)."[42]

Broker-dealers will have until June 30, 2020, to comply with Reg BI.[43]

Officials at FINRA have reportedly characterized Reg BI as "sort of federalizing [broker-dealer] sales practice issues."[44] Noting that "most of the [broker-dealer] sales practice requirements historically have come from the FINRA rulebook," they indicated that FINRA will likely have to adjust its rules to align with Reg BI.[45]

The "Best Interest" Rule's Component Obligations

Under Reg BI, the dictate that a broker-dealer cannot place its financial or other interests ahead of its retail customers' interests is known as the *general obligation*. To satisfy the general obligation, a broker-dealer must comply with three underlying component obligations: (1) a duty of disclosure; (2) a duty of compliance; and (3) a duty of customer care. These obligations are described below.

In addition, a fourth component obligation—a duty to address certain conflicts of interests—is one of two broad mandates under Reg BI.[46] Given its significance, a separate section (see "The Conflict of Interest Obligation Under Reg BI") then discusses that obligation.

The Disclosure, Compliance, and Duty of Customer Care Obligations

- *The disclosure obligation.* Under this obligation, a broker must, prior to or at the time of the recommendation, provide to the retail customer, in writing, full and fair disclosure of all material facts related to the scope and terms of the relationship, including all material facts relating to conflicts of interest associated with the recommendation.[47]
- *The compliance obligation.* Reg BI requires broker-dealers to establish written policies and procedures reasonably designed to achieve compliance with Reg BI

[41] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 1.

[42] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* pp. 85-86.

[43] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 371.

[44] Jack Duval, "SEC Regulation Best Interest - The Final Rule," *The Securities Litigation Expert Blog*, Accelerant, June 13, 2019, at http://blog.accelerant.biz/blog/sec-regulation-best-interest-the-final-rule.

[45] Melanie Waddell, "FINRA's Cook: SEC Reg BI Compliance to Be a Heavy Lift," Think Advisor, May 8, 2019, at https://www.thinkadvisor.com/2019/05/08/finras-cook-two-issues-top-of-mind-regarding-sec-reg-bi-compliance/.

[46] The other broad mandate is that broker-dealers should act in their customers' best interests when making investment-related recommendations.

[47] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 130.

as a whole. This requirement reflected the SEC's decision to adopt certain commenters' suggestions that the proposed requirement to develop policies and procedures align with the conflict-of-interest obligation described below. The compliance obligation provides flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models. It does not enumerate specific requirements that broker-dealers must include in their policies and procedures. Instead, each broker-dealer should consider the scope, size, and risks associated with the firm's operations and the types of business in which the firm engages when adopting its policies and procedures. According to the Reg BI release, a reasonably designed compliance program generally would also include controls, remediation of noncompliance, training, and periodic review and testing.[48]

- *The duty of care obligation.* Under the duty of care obligation, a broker-dealer must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. As part of this, the broker-dealer must understand the potential risks, rewards, and costs associated with the recommendation. The broker-dealer must consider such factors in light of the retail customer's investment profile, while ensuring that an ensuing recommendation is in that customer's best interest.[49]

The Conflict of Interest Obligation Under Reg BI

The broad conflict of interest mandate under Reg BI says that broker-dealers must "address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where [the SEC] ... determined that disclosure is insufficient to reasonably address the conflict ... mitigate or, in certain instances, eliminate the conflict."[50]

Conflicts of interest occur when the interests of an entity working on behalf of a customer and the interests of that customer are misaligned. This dynamic informs the relationship between broker-dealers and customers because of various factors that potentially encourage broker-dealers to boost their compensation or to benefit in other ways to the possible detriment of their customers, such as the transaction-based commission compensation model.[51]

Federal securities laws and FINRA's rules address broker-dealer conflicts through three distinct approaches: (1) the *express prohibition* of certain actions; (2) *mitigation* through the client suitability requirement when giving investment advice; and (3) the *required disclosure* of material conflicts of interest when making client recommendations.[52]

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[48] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 357

[49] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 245.

[50] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* p. 1.

[51] SEC, *Study on Investment Advisers and Broker-Dealers,* p. 120. Investment advisers also have some conflicts of interest. A commonly held view is that "it is the treatment of conflicts of interest that largely separates investment advisers and broker-dealers under the fiduciary and fair dealing standards. An investment adviser must always seek to avoid conflicts of interest with clients and may not overreach or take unfair advantage of a client's trust." For example, see Kristina A. Fausti, "A Fiduciary Duty for All," *Duquesne Business Law Journal*, vol. 12, no. 2 (May 2012), p. 183, http://sites.law.duq.edu/blj/2012/05/18/a-fiduciary-duty-for-all/.

[52] SEC, *Study on Investment Advisers and Broker-Dealers,* pp. 1-5.

Expanding on these, the conflict of interest component obligation under Reg BI requires broker-dealers to have written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate conflicts of interest, including the following:

- Mitigating conflicts that may encourage them to place their interests, or their firm's interests, ahead of the customer's. Mitigation alters a broker-dealer's policies and procedures to "reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest."[53] Examples include (1) avoiding broker-dealer compensation targets that disproportionately expand compensation via certain sale increases; and (2) establishing a differential compensation based on neutral factors to minimize broker-dealer employee compensation incentives that incentivize the promotion of certain types of investment accounts over others. (This is similar to a provision in the 2016 DOL fiduciary rules.)[54]
- Establishing, maintaining, and enforcing written policies and procedures designed to "identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time." (This is similar to a provision in the earlier DOL fiduciary rule.)[55]
- Preventing customer offerings that have material limitations, including product menus that are very limited in scope or that solely offer proprietary products that can cause a broker-dealer to place his or her interests or the firm's interests ahead of the customer's.[56] (This is said to be a broader and more rigorous requirement than current FINRA rules on noncash compensation.[57])

The States' Requirements and Reg BI

Broker-dealers are subject to state securities laws, known as "Blue Sky Laws," state common laws, and judicial rulings from a state's highest court.[58]

As discussed earlier, reports indicate that the common law derived from judicial rulings in four states—California, Missouri, South Dakota, and South Carolina—imposes an "unambiguous fiduciary standard" for broker-dealers who do business in the states.[59] State common laws, however, lack the authority of state regulations and statutes.[60]

[53] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, pp. 321-328.

[54] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, pp. 321-328.

[55] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, pp. 321-328.

[56] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, pp. 321-328.

[57] Tom Bohac, et al., "Regulation Best Interest: What You Need to Know to Prepare for the June 30, 2020 Compliance Date," JD Supra, July 11, 2019, at https://www.jdsupra.com/legalnews/regulation-best-interest-what-you-need-86010/.

[58] Annie Decker, "A Theory of Local Common Law," *Cardozo Law Review*, vol. 35, no. 5 (June 2014), p. 1939, at http://cardozolawreview.com/wp-content/uploads/2018/08/DECKER.35.5.pdf.

[59] Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice."

[60] Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice."

Under state Blue Sky laws, it is generally unlawful for any person to transact business in a state as a broker-dealer or agent unless they are registered with the state's securities regulatory authority.[61]

During the past few years, several states have been attempting to impose either state statutory or regulatory requirements stipulating that state-registered broker-dealers have a fiduciary duty to their retail customers. And as of September 2019, New Jersey, Nevada, Massachusetts, and New York reportedly had ongoing initiatives that would impose fiduciary requirements on broker-dealers in various stages of development.[62]

Of these state initiatives, only Massachusetts' (proposed in June 2019) began after the Reg BI proposal and final rule. Explaining the rationale for the Massachusetts initiative, Secretary of the Commonwealth William Galvin blamed the inadequacies of Reg BI: "We are proposing this standard, because the SEC has failed to provide investors with the protections they need against conflicts of interest in the financial industry, with its recent 'Regulation Best Interest' rule."[63]

Barbara Roper, director of investor protection at the Consumer Federation of America, a consumer advocacy group, has raised concerns that the state-based fiduciary laws could create loopholes to the detriment of broker-dealer customers. She noted that the Nevada initiative would not recognize insurance agents as financial planners, excluding them from the fiduciary regulation, which she argued could significantly disadvantage consumers within the state.[64]

Meanwhile, the brokerage industry and its trade groups have reportedly been lobbying states, such as New Jersey, to halt state-based fiduciary actions. Their arguments are two-pronged: (1) states should reconsider their fiduciary efforts in light of Reg BI; and (2) if adopted, multiple state-based fiduciary broker-dealer standards will result in a messy patchwork of "laws that would be duplicative of, different than, and possibly in conflict with federal standards."[65]

Jay Clayton, the SEC chair, has raised related concerns; he identified "the potential patchwork of inconsistent state-level standards [as a development that he] and many others believe ... will increase costs, limit choice for retail investors and make oversight and enforcement more difficult."[66]

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[61] Robert L.D. Colby, Lanny A. Schwartz, and Zachary J. Zweihorn, "What Is a Broker-Dealer?," Davis Polk Law Firm, July 25, 2016, https://www.davispolk.com/files/whats_a_broker_dealer_2.pdf.

[62] For example, see The Stradley Ronan Law Firm, "Why States have Opted to 'Go Your Own Way' on Fiduciary Standards re. Broker-Dealers and Investment Advisers," *Fiduciary Governance Blog*, September 9, 2019, at https://fiduciarygovernanceblog.com/2019/09/09/why-states-have-oped-to-go-your-own-way-on-fiduciary-standards-re-broker-dealers-and-investment-advisers/; and Mark Schoeff, Jr., "New York Lawmaker Works on Bill to Establish Fiduciary Duty for Advisers in State," *Investment News*, July 3, 2019, at https://www.investmentnews.com/article/20190703/FREE/190709974/new-york-lawmaker-works-on-bill-to-establish-fiduciary-duty-for.

[63] Greg Iacurci, "Galvin to Propose Fiduciary Rule for Massachusetts Brokers," *Investment News*, June 14, 2019, at https://www.investmentnews.com/article/20190614/FREE/190619944/galvin-to-propose-fiduciary-rule-for-massachusetts-brokers.

[64] Rita Raagas De Ramos, "State Fiduciary Laws Seen Adding to Chaos, Confusion," Financial Advisor IQ, October 19, 2017, at https://financialadvisoriq.com/c/1769813/205303/state_fiduciary_laws_seen_adding_chaos_confusion.

[65] Letter to Christopher W. Gerold, Bureau Chief, New Jersey Bureau of Securities, Regarding the Fiduciary Duty of Broker-Dealers and Investment Advisers Proposed New Rule from Securities Industry and Financial Markets Association, the Insured Retirement Institute, the National Association for Fixed Annuities, et al., June 14, 2019, at https://www.sifma.org/wp-content/uploads/2019/06/Fin-Services-Trade-Association-Comments-on-NJ-Fiduciary-Rule-Proposal.pdf.

[66] SEC Chairman Jay Clayton, "Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors," June 5, 2019, at https://www.sec.gov/news/

By contrast, SEC Commissioner Robert Jackson, who provided the sole dissenting vote on Reg BI, has characterized the state fiduciary effort as a potentially encouraging fix to the perceived inadequacies of Reg BI.[67]

The National Securities Markets Improvement Act (NSMIA; P.L. 104-290) is often cited as being in potential conflict with the state fiduciary proposals. Aimed at increasing financial services industry efficiency, the act expanded federal regulators' authority by taking some authority away from state securities regulators. Among other things, it also prohibited states from imposing additional or different books and records requirements on broker-dealers outside of federal requirements. The provision is often cited as a potential source for a legal challenge in the event that any of the state broker-dealer fiduciary regimes are adopted.[68]

Before the SEC's adoption of Reg BI, SIFMA, a critic of the state fiduciary proposals, asked the agency to consider inserting language into Reg BI noting that NSMIA provides for federal preemption of such actions.[69] The final rule does not contain any such language, a position advocated by an association of state and provincial securities regulators, the North American Securities Administrators Association.[70] Instead, the commentary accompanying the rule notes that "the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law."[71]

Action by Eight Attorneys General

On September 9, 2019, Attorneys General (AGs) from California, Connecticut, Delaware, Maine, New Mexico, New York, Oregon, and the District of Columbia filed a suit in the United States District Court, Southern District of New York, asking the court to vacate Reg BI. In arguing that it should be vacated, the AGs alleged that the regulation injures retail investors in two significant ways: (1) it fails to restrict the provision of conflicted advice as directed by Section 913(g) of the Dodd-Frank Act, which permits the SEC to promulgate rules to provide for a uniform fiduciary standard; and (2) it increases the potential that retail investors will receive conflicted information because it compounds previously existing investor confusion with respect to the duties that broker-dealers owe such investors in the provision of investment advice. The AGs also argued that the standard of customer care provided by Reg BI fails to meaningfully go beyond FINRA's existing "suitability obligation."[72]

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public-statement/statement-clayton-060519-iabd.

[67] SEC Commissioner Robert J. Jackson, Jr., "Statement on Final Rules Governing Investment Advice," June 5, 2019, at https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd. (Hereinafter SEC Commissioner Robert J. Jackson, Jr., "Statement on Final Rules Governing Investment Advice.")

[68] Melanie Waddell, "Nevada Oversteps Its Authority on Fiduciary Reg: Trade Groups Advocacy Groups on All Sides of the Fiduciary Debate Offered Constructive criticism of the Rule," Think Advisor, March 1, 2019, at https://www.thinkadvisor.com/2019/03/01/nevada-overstepping-its-authority-on-fiduciary-reg-trade-groups/.

[69] Kevin M. Carroll, "Comments to the SEC from SIFMA Regarding Federal Preemption of State Regulation under NSMIA," SIFMA, March 29, 2019, https://www.sec.gov/comments/s7-07-18/s70718.htm.

[70] Mark Schoeff, Jr., "NASAA Doesn't Want Regulator to Assert Federal Preemption in Advice Rule," *Investment News*, April 30, 2019, at https://www.investmentnews.com/article/20190430/FREE/190439992/state-regulators-urge-sec-not-to-try-to-block-state-fiduciary-laws.

[71] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 43.

[72] The suit is available at https://ag.ny.gov/sites/default/files/doc_01_complaint.pdf.

Congressional Concerns and Actions

In September 2018, 35 House and Senate Democratic Members—including House Committee on Financial Services then-ranking member Maxine Waters, who now chairs the committee, and Senate Committee on Banking, Housing, and Urban Affairs ranking member Sherrod Brown—sent a letter to SEC Chair Jay Clayton criticizing the then-proposed Reg BI. The letter stated the following:

> Regulation BI falls woefully short… We urge the SEC to revise its proposal consistent with [the Dodd-Frank law] and require brokers to abide by the same high standard that currently applies to investment advisers so that their advice to retail investors is provided without regard to their financial and other interests. Regulation BI for brokers and the SEC's interpretation of the "fiduciary" obligation owed by investment advisers fail to clearly do this, enabling investors to 'consent' to harmful conduct in complex and legalistic disclosures that most will never read and would not understand if they did.[73]

In March 2019, in advance of the SEC's adoption of Reg BI, Chair Waters[74] reportedly said the following:

> [W]e have to be concerned about best interests of our consumers and our seniors in particular. When you have investment advisors who are not acting in [consumer's] best interest, but are acting in their own best interest, it does not bode well for our senior investors in particular. So we are going to continue to pay attention to that. I don't know what the SEC has decided about what their role should be in this [fiduciary realm], but it's of interest to us.[75]

On June 26, 2019, the House passed H.R. 3351, the Financial Services and General Government Appropriations Act for FY2020. The bill included an amendment sponsored by Chair Waters that would prohibit the SEC from using any of its congressional spending authority "to implement, administer, enforce or publicize the final rules and interpretations" with respect to Reg BI.

Responses to the congressional action generally reflect where observers stand on the merits of Reg BI itself.

For example, Barbara Roper has been critical of Reg BI. She reportedly observed: "Rewriting this rule will be a top priority in the next Democratic administration. [Ms. Waters'] amendment [enables us] to hit the pause button on Reg BI until after the election [which] would spare firms unnecessary compliance costs and protect investors from a bad rule."[76] By contrast, Kenneth E. Bentsen, Jr, chief executive of SIFMA, which praised Reg BI, argued "Reg BI is the most comprehensive enhancement of standard-of-conduct rules governing broker-dealers since the enactment of the Securities Exchange Act of 1934.... It makes no sense to halt the orderly

[73] Letter from Rep. Maxine Waters and Sen. Sherrod Brown, et al., to the Honorable Jay Clayton, SEC chairman, September 12, 2018, https://democrats-edworkforce.house.gov/media/press-releases/waters-scott-brown-and-murray-call-on-sec-to-increase-investor-protections.

[74] "If House Flips, What Will Happen to SEC Broker Rule, Retirement Policy?," *The Wealth Advisor*, October 17, 2018, at https://www.thewealthadvisor.com/article/if-house-flips-what-will-happen-sec-broker-rule-retirement-policy.

[75] Melanie Wadell, "Rep. Waters Comments on SEC's Regulation Best Interest," Think Advisor, March 6, 2019, at https://www.thinkadvisor.com/2019/03/06/rep-waters-comments-on-secs-regulation-best-interest/.

[76] Mark Schoeff, Jr., "House Passes Maxine Waters' Amendment to Stymie SEC Advice Reform Rules; Measure Prevents Funding for Reg BI but Could Die in Senate," *Investment News*, June 26, 2019, at https://www.investmentnews.com/article/20190626/FREE/190629942/house-passes-maxine-waters-amendment-to-stymie-sec-advice-reform.

implementation of this important new set of regulations that would provide strong investor and consumer protections for 43 million households."[77]

In September 2019, the Senate Appropriations Committee reported S. 2524, the FY2020 Financial Services and General Government Appropriations. Unlike H.R. 3351, it does not contain a proscription on funding SEC implementation of Reg BI.

In November 2019, the House and the Senate passed H.R. 3055, the Further Continuing Appropriations Act, 2020, and Further Health Extenders Act of 2019, a stopgap budget bill that extends current government funding levels through December 20, 2019. On November 21, President Trump signed it into law as P.L. 116-69. The continuing resolution does not restrict SEC funding for the implementation of Reg BI.

Various Perspectives on Reg BI

Like the wide-ranging comments that followed the release of the proposed Reg BI in 2018, the adoption of the final 2019 rule also elicited an expansive range of responses. This section first identifies the three broad reactions to the reform. It then provides quoted excerpts from various observers and stakeholders that either (1) provide support for or (2) are critical of several concerns regarding Reg BI, including its failure to provide for a broker-dealer fiduciary standard.

The Division of Views on Reg BI

The three broad divisions with respect to overall views on Reg BI are as follows:

- those who have given it qualified support, such as Rick Fleming, the SEC's investor advocate, who characterized it as "not as strong as it could be" but "a step in the right direction";[78]
- those who broadly support it, including the U.S. Chamber of Commerce, a major business trade group, and SIFMA; and
- those who are broadly critical, including the Consumer Federation of America and the Public Investors Arbitration Bar Association (PIABA, a bar association whose members represent investors in disputes with the securities industry).

Significant Supportive and Critical Perspectives on Debated Assertions About Reg BI

This section provides excerpts of quotes from various stakeholders and observers, which provide contrasting supportive and critical views on policy concerns integral to the debate surrounding Reg BI. Framed as debatable assertions, they are as follows: (1) Reg BI represents meaningful progress over the suitability requirement; (2) Reg BI's failure to define best interest is a problem; (3) the absence of a uniform fiduciary standard is not a problem; (4) the absence of a Reg BI fiduciary standard is not a problem; and (5) Reg BI meaningfully addresses outstanding conflict of interest issues.

[77] Mark Schoeff, Jr., "House Passes Maxine Waters' Amendment to Stymie SEC Advice Reform Rules; Measure Prevents Funding for Reg BI but Could Die in Senate," *Investment News*, June 26, 2019.

[78] SEC Investor Advocate Rick Fleming, "Statement Regarding the SEC's Rulemaking Package for Investment Advisers and Broker-Dealers" SEC, June 5, 2019, at https://www.sec.gov/news/public-statement/statement-regarding-sec-rulemaking-package-investment-advisers-broker-dealers.

Reg BI Represents Meaningful Progress over the Suitability Requirement

Supportive Comments

In a letter to Members of the House, SIFMA said the following in support of Reg BI:

> Reg BI is the most comprehensive enhancement of the standard of conduct rules governing broker-dealers since the enactment of the Securities Exchange Act of 1934. The new SEC rules dramatically and undeniably exceed the previous suitability standard by requiring a duty of loyalty, meaning that a broker's recommendations must be in the customer's best interest and that the broker cannot place its own interests ahead of its customer. The regulations impose a duty of diligence, care and skill in making the recommendations, thereby holding the broker accountable for failures of knowledge or skill.[79]

SEC Chairman Jay Clayton said the following in a July 2019 speech:

> Regulation Best Interest—or "Reg. BI"—imposes a new standard of conduct specifically for broker-dealers that substantially enhances their obligations beyond the current "suitability" requirements…. Reg. BI is satisfied only if the broker-dealer complies with four specified component obligations: Disclosure, Care, Conflict of Interest, and Compliance. Each of these obligations includes a number of prescriptive requirements, all of which must be satisfied to comply with the rule.[80]

The U.S. Chamber of Commerce said the following in a press release supporting Reg BI:

> The new best interest standards create strong new protections for investors against bad actors, provide clearer information that will help Americans invest and save for their futures, allow investors to choose the right type of advice to fit their needs, and help small businesses provide retirement benefits for their employees. We hope that the Department of Labor moves forward on similar protections for ERISA plans that dovetail with the SEC's approach.[81]

Critical Comments

SEC Commissioner Robert Jackson, who provided the sole dissenting vote on Reg BI, said the following in a statement after the rule's adoption:

> As to brokers, today's rule, like the proposal, fails to require that investor interests come first. Congress expressly authorized us to take that step in Dodd-Frank—authority we should have used today. Instead, the core standard of conduct set forth in Regulation Best Interest remains far too ambiguous about a question on which there should be no confusion. As a result, conflicts will continue to taint the advice American investors receive from brokers.[82]

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[79] Letter from Kenneth Bentsen, Jr., president and CEO of SIFMA, to Members of the U.S. House of Representatives, "Waters Amendment Amendment #78 on Reg BI," SIFMA, June 25, 2019, https://www.sifma.org/resources/submissions/waters-amendment-78-on-reg-bi/.

[80] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[81] "U.S. Chamber Statement on the SEC's Final Best Interest Standards," U.S. Chamber of Commerce, press release, June 5, 2019, https://www.uschamber.com/press-release/us-chamber-statement-the-sec-s-final-best-interest-standards.

[82] SEC Commissioner Robert J. Jackson, Jr., "Statement on Final Rules Governing Investment Advice."

Micah Hauptman, financial services counsel at the Consumer Federation of America, reportedly said the following:

> [Reg BI is] a bait and switch on investors. The SEC claims to be imposing a new best interest standard on brokers, but it won't change any practices in the brokerage industry. Instead, Reg BI simply codifies the existing standard under FINRA rules, just like the brokerage industry asked them to. [The investing public is] getting hoodwinked.[83]

Barbara Roper, director of investor protection for the Consumer Federation of America, reportedly said the following:

> [The SEC is saying] we'll let you have the conflict and then just mitigate it. Two different advisors both can call what they do financial planning or retirement planning, and one could have a duty to you for the whole relationship, but for the other—a broker—it's transaction by transaction.[84]

Reg BI's Failure to Define Best Interest is a Problem

Supportive Comments

Barbara Roper, of the Consumer Federation of America, said the following in testimony before the House Committee on Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets:

> If the goal behind Reg BI truly is to enhance protections for investors, and not simply to preserve the status quo, the Commission must start by clarifying what it means by "best interest," and it must do so in a way that offers protections beyond those already afforded under FINRA rules.... The Commission must adopt a principles-based definition of best interest clarifying that a broker acts in a customer's best interest when she recommends, from among the reasonably available suitable options, those investments, investment strategies, services, or accounts that she reasonably believes are the best available match for that investor, taking into account both the investor's needs and the investments' material characteristics. While there will often not be a single "best" option, satisfying a best interest standard should require the broker to narrow down the acceptable options beyond the dozens or even hundreds of investments that would satisfy the existing suitability standard in a given situation."[85]

Massachusetts Secretary of the Commonwealth William Galvin reportedly said the following:

> Crucially, the term "best interest" is not defined in the rulemaking package. This ambiguity will lay the groundwork for the same debates and litigation that exist today under the "suitability" standard that applies to broker/dealers.[86]

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[83] Rita Raagas De Ramos "It's Official! SEC Pushes Through with Regulation Best Interest Standard for Broker-Dealers," Financial Advisor IQ, June 5, 2019, https://financialadvisoriq.com/c/2325333/284563/official_pushes_through_with_regulation_best_interest_standard_broker_dealers?referrer_module=mostPopularRead&module_order=0.

[84] Sarah O'Brien, "SEC's New Investor Protection Rule Won't End the Fiduciary Debate," July 30, 2019, CNBC, https://www.cnbc.com/2019/07/30/sec-new-investor-protection-rule-wont-end-the-fiduciary-debate.html..

[85] Testimony of Barbara Roper, director of investor protection, Consumer Federation of America, in U.S. Congress, House Committee on Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, *Putting Investors First? Examining the SEC's Best Interest Rule*, hearings, 116th Cong., 1st sess., March 14, 2019, https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-roperb-20190314.pdf.

[86] John Manganaro, "It's Not Déjà Vu, It's a Brand New Best Interest Rulemaking Debate," *Plan Advisor*, April 19, 2018, https://www.planadviser.com/not-deja-vu-brand-new-best-interest-rulemaking-debate/.

Critical Comments

SEC Chairman Jay Clayton said the following in a July 2019 speech:

> [Some commenters to the Reg BI proposal asked whether the SEC should] provide a detailed, specific, situation-by-situation definition of "best interest" in the rule text.... Our view was that the best approach would be to apply the specific component obligations of Reg. BI, including the "best interest" requirement in the Care Obligation, in a principles-based manner. Under Reg. BI, whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of the rule are satisfied. This principles-based approach is a common and effective approach to addressing issues of duty under law, particularly where the facts and circumstances of individual relationships can vary widely and change over time, including as a result of innovation. [The] approach is … similar to an investment adviser's fiduciary duty, which has worked well for advisers' retail clients and our markets. Indeed, there is no definition of "best interest" under the Advisers Act.[87]

Thomas Wade, director of financial services policy at the American Action Forum, said the following:

> [With respect to Reg BI's lack of a clear definition] the SEC provides for a spectrum of advisor-investor obligation, allowing investors to choose their desired level of protection based on their risk appetite and finances. The criticism of allowing this fluidity—that investors may not understand the duty of care provided by their advisor—has been mitigated by the SEC requirement that brokers at stand-alone broker-dealerships not be able to use the word "advisor" in their title.[88]

Financial news summary service FINSUM said the following regarding Reg BI's lack of a "best interest" definition:

> Having a highly defined rule leaves it more vulnerable to loopholes. With the current contextual structure, one has to worry whether their behavior could be considered "best interest" depending on an amorphous standard. It seems like a better way to keep bad actors in line.[89]

The Absence of a Uniform Fiduciary Standard in Reg BI is not a Problem

Supportive Comments

In the text of Reg BI, the SEC said the following regarding a uniform fiduciary standard:

> We have also declined to craft a new uniform standard that would apply equally and without differentiation to both broker-dealers and investment advisers. Adopting a "one size fits all" approach would risk reducing investor choice and access to existing products, services, service providers, and payment options, and would increase costs for firms and for retail investors in both broker-dealer and investment adviser relationships.[90]

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[87] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[88] Thomas Wade, "Is the Proposed Regulation in the Best Interest of Investors?" American Action Forum, August 8, 2018, https://www.americanactionforum.org/insight/is-the-sec-proposed-regulation-in-the-best-interest-of-investors/#ixzz5v6blT1VI.

[89] FINSUM, "The SEC Says its BI Rule is Perfect as it is," July 11, 2019, https://www.finsum.com/index.php/markets/wealth-management/item/8037-the-sec-says-its-bi-rule-is-perfect-as-it-is.

[90] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 18.

In a July 2019 speech, SEC Chairman Jay Clayton said the following regarding the decision to not adopt a uniform fiduciary standard:

> A number of commenters expressly or impliedly advocated for regulation that would collapse the distinction, with a substantial majority of those commentators favoring the generally applicable investment adviser model where clients pay an asset-based fee or a flat fee for generally broad-based financial advice from a fiduciary…. [T]his is a good model, and for many investors, this type of investment adviser relationship may better match their needs than the typical broker-dealer relationship. However, for many other investors, the broker-dealer model, particularly after the implementation of Reg. BI—either alone or in combination with an investment adviser relationship—provides the better match. For example, a retail customer that intends to buy and hold a long-term investment may find that paying a one-time commission to a broker-dealer is more cost effective than paying an ongoing advisory fee to an investment adviser to hold the same investment. That same investor might want to use a brokerage account to hold those long-term investments, and an advisory account for other investments.[91]

SIFMA described the following findings from a study in support of the idea that a uniform fiduciary standard could negatively impact customer choice:

> SIFMA has released a study conducted by Oliver Wyman for the Securities and Exchange Commission that examines the impact of unifying the fiduciary standard of care that retail investors receive from financial advisers and broker-dealers.... Oliver Wyman collected data from a broad selection of retail brokerage firms that serve 33% of households and represent 27% of all retail financial assets. The key insight from the survey is that broker-dealers play a critical role in the financial services industry that cannot be easily replicated with alternative services models. Therefore, if the proposed standardization is adopted, retail investors (particularly small investors) could see a negative impact on the choice of advisory model, product access, and affordability of advisory services.[92]

Critical Comments

The Financial Planning Coalition, an industry group, said the following:

> Adoption of a uniform fiduciary standard of care will not affect the availability of investment advice or the range of products for moderate- or low-income consumers.... Research shows that the costs to broker-dealers to implement a fiduciary standard would be minimal.[93]

Duane Thompson, senior policy analyst at Fi360, reportedly said the following:

> Instead of having a uniform fiduciary standard for identical advisory services, there will continue to be two somewhat different market conduct standards to what can be identical advisory services. It's another tangible sign that the broker-dealer business model has changed dramatically in recent years, where advice is a dominant feature of what they provide.[94]

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[91] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[92] "SIFMA Releases Oliver Wyman Study on Impact of Uniform Fiduciary Standard on Retail Investors," Oliver Wyman, 2010, https://www.oliverwyman.com/our-expertise/insights/2010/nov/sifma-releases-oliver-wyman-study-on-impact-of-uniform-fiduciary.html.

[93] Financial Planning Coalition, "Fiduciary Standard of Care," 2019, at http://financialplanningcoalition.com/issues/fiduciary-standard-of-care/.

[94] Jeff Benjamin and Mark Schoeff, Jr., "SEC Advice Reform: What's in the Final Reg BI, Form CRS and Agency Interpretations," *Investment News*, June 20, 2019, at https://www.investmentnews.com/article/20190620/FREE/

According to a media report, the AARP's Reg BI comment letter to the SEC said the following:

> [AARP is asking the SEC to] adopt a uniform fiduciary standard for financial professionals that applies to all types of retail accounts. There is no question that there is confusion among retail investors in the marketplace as a result of standards that are not uniform and do not address the perpetually evolving universe of investment products and industry practices.[95]

The Absence of a Reg BI Fiduciary Standard is not a Problem

Supportive Comments

In a 2015 speech, SEC Commissioner Daniel M. Gallagher said the following regarding the fiduciary duty:

> Much of the debate on these issues seems to assume that the "fiduciary duty" is some sort of talismanic protection that can overcome any competing regulatory concerns. All too often, this is the approach taken by those who simply do not know how the fiduciary duty works in practice. They do not understand or choose to ignore the limitations of the fiduciary duty.[96]

In a 2018 speech, SEC Commissioner Hester Peirce said the following:

> The word "fiduciary" hangs heavily over any discussion about standards for financial professionals. The word carries a lot of different meanings, and legal context matters…. Never mind that it took many pages of regulation and lots of interpretation to explain what "fiduciary" meant in the new DOL iteration. Never mind that even lawyers and financial professionals do not have a universal understanding of what the term means.[97]

The SEC addressed the fiduciary standard in the text of Reg BI as follows:

> We have declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Advisers Act because it is not appropriately tailored to the structure and characteristics of the broker-dealer business model (i.e., transaction-specific recommendations and compensation), and would not properly take into account, and build upon, existing obligations that apply to broker-dealers, including under FINRA rules. Moreover, we believe (and our experience indicates), that this approach would significantly reduce retail investor access to differing types of investment services and products, reduce retail investor choice in how to pay for those products and services, and increase costs for retail investors of obtaining investment recommendations.[98]

In a July 2019 speech, SEC Chairman Clayton said the following:

> Reg. BI—imposes a new standard of conduct specifically for broker-dealers that substantially enhances their obligations beyond the current "suitability" requirements.... [I]t establishes a general obligation that draws from key fiduciary principles, requiring

190609951/sec-advice-reform-whats-in-the-final-reg-bi-form-crs-and-agency.

[95] Lee Barney, "Groups Say SEC's Best Interest Proposal Fails to Provide Uniform Fiduciary Standard," *Plan Advisor*, August 9, 2018, at https://www.planadviser.com/groups-say-secs-best-interest-proposal-fails-provide-uniform-fiduciary-standard/.

[96] SEC Commissioner Daniel M. Gallagher, "Remarks at The SEC Speaks in 2015," speech, February 20, 2015, at https://www.sec.gov/news/speech/022015-spchcdmg.html.

[97] SEC Commissioner Hester M. Peirce, "What's in a Name? Regulation Best Interest v. Fiduciary," speech at NAPA DC Fly-in Forum, Washington, DC, July 24, 2018, at https://www.sec.gov/news/speech/speech-peirce-072418.

[98] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 28.

> broker-dealers to act in the best interest of their retail customers and not place their own interest ahead of the retail customer's interest.[99]

In the same speech, Chairman Clayton also said the following:

> This [principles-based] approach is similar to an investment adviser's fiduciary duty, which has worked well for advisers' retail clients and our markets.... [And the determination of whether a broker-dealer is acting in a retail customer's best interests, will be based on] an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest are satisfied at the time that the recommendation is made (and not in hindsight).[100]

In a June 2019 statement, SEC Commissioner Elad L. Roisman said the following:

> Regulation Best Interest also will impose heightened disclosure requirements about brokers, their investment offerings, and associated conflicts of interest in order to better inform retail customers about their service provider and investing options. Not even the so-called fiduciary standard under the Investment Advisers Act includes the obligation to eliminate or mitigate conflicts.[101]

In the same statement, Commissioner Roisman also said the following:

> In 2016, for example, the DOL acted unilaterally to adopt its so-called "Fiduciary Rule" that would have applied to providers of retirement investment accounts—a significant proportion of the registrants under the SEC's jurisdiction. DOL's rule quickly proved unworkable for many, if not all, providers of pay-as-you-go financial services, raising compliance costs, exposing firms to new litigation risks, and in some cases forcing them to choose whether to continue serving some of their smallest customers. According to some, the rule resulted in huge swaths of U.S. investors losing access to affordable financial advice and others paying much higher fees on their retirement accounts, without receiving any increases in service or other discernable benefits. I am glad that this rule is not in effect.[102]

Representative Trey Hollingsworth reportedly said the following:

> I am very upset that we continue to talk about polls that ask: Do you believe that this fiduciary rule is a good idea? People say yes. What's not disclosed in that is that you, lower and middle income America, won't get the benefit of that because you don't have an account size that's enough to ensure that those people will continue to give you advice.[103]

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[99] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[100] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[101] SEC Commissioner Elad L. Roisman,, "Statement at the Open Meeting on Regulation Best Interest, the Interpretation of the Standard of Conduct for Investment Advisers, the Form CRS Relationship Summary, and the Interpretation of 'Solely Incidental,'" June 5, 2019, https://www.sec.gov/news/public-statement/statement-roisman-060519. Dalia Bass, director of the SEC Division of Investment Management, reportedly refuted this assertion that the IAA does not require advisers to mitigate of conflicts of interest in "Regulation Doesn't Trump Fiduciary Standard, Reg BI Author Insists," Financial Advisor IQ, July 12, 2019, https://financialadvisoriq.com/c/2435233/283053.

[102] SEC Commissioner Elad L. Roisman,, "Statement at the Open Meeting on Regulation Best Interest, the Interpretation of the Standard of Conduct for Investment Advisers, the Form CRS Relationship Summary, and the Interpretation of 'Solely Incidental,'" June 5, 2019

[103] Ian Wenik, "A Horrible Choice: Reg BI Comes Under Fire at Congressional Hearing," *City Wire*, March 14, 2019, at https://citywireusa.com/registered-investment-advisor/news/a-horrible-choice-reg-bi-comes-under-fire-at-congressional-hearing/a1210407.

Critical Comments

The Financial Planning Coalition said the following:

> Adoption of a fiduciary standard of care will not negatively affect the availability of investment advice or the range of products for moderate- and low-income consumers.... Research shows that the costs to broker-dealers to implement a fiduciary standard would be minimal, and that broker-dealers and investment advisers who provide financial services under a fiduciary standard experience stronger asset and revenue growth than those under a suitability standard.[104]

In comments to the SEC, the CFA Institute, an investment profession industry group, said the following:

> [B]rokers who are providing non-incidental advice must, by virtue of the Advisers Act, adhere to a fiduciary standard of care and therefore refrain from putting their own interests ahead of their clients' interests. Imposing a fiduciary standard on broker-dealer recommendations, therefore, would still be in keeping with these investor expectations.[105]

Representative Carolyn Maloney reportedly said the following during a House subcommittee hearing on Reg BI:

> [Under Reg BI] brokers have to act in the "best interest of customers," which sounds good, but the rule does not even define what this means. In fact, the rule allows brokers to continue to take their own financial interest into account when making client regulations. They can remain conflicted as long as they offer some basic amount of disclosure. This is dangerous for investors.[106]

An industry observer wrote the following regarding the absence of a fiduciary standard:

> [This rulemaking] presented a perfect opportunity to firm up what "best interest" means, but the SEC declined to do so. I have mixed feelings about this, because best interest can vary from client to client, and this allows flexibility when needed. However, the grey area has proven to be problematic, because, as you can imagine, it's hard to hold someone accountable to a flexible and unclear standard of care.[107]

John Britt, a retired SEC enforcement attorney, reportedly said the following:

> If a securities professional recommends that his client purchase a particular stock, he is giving investment advice. And if he's giving investment advice, he should have a fiduciary duty to his client—nothing less.... [This is] fake regulation.[108]

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[104] Financial Planning Coalition, "Fiduciary Standard of Care."

[105] Letter from Kurt N. Schacht, CFA managing director, to SEC Secretary Brent J. Fields, "Comments Re: Regulation Best Interest" Chartered Financial Analyst Institute, August 7, 2018, https://www.sec.gov/comments/s7-07-18/s70718.htm.

[106] John Manganaro, "House Subcommittee Witnesses Bash SEC's Regulation Best Interest," *Plan Adviser*, March 14, 2019, https://www.planadviser.com/house-subcommittee-witnesses-bash-secs-regulation-best-interest/.

[107] Jamie Hopkins, "SEC Brings Increased Confusion For Investors With New 'Best Interest' Rule," *Forbes*, June 5, 2019, at https://www.forbes.com/sites/jamiehopkins/2019/06/05/sec-brings-increased-confusion-for-investors-with-new-best-interest-rule/#65b6e28f270b.

[108] Ben Bain and Robert Schmidt, "SEC Says Securities Brokers Must Act in Clients' Interest. Is it an Improvement?" *Los Angeles Times*, June 5, 2019, https://www.latimes.com/business/la-fi-broker-conflict-of-interest-rules-20190605-story.html.

Reg BI Meaningfully Addresses Outstanding Broker-Dealer Conflict of Interest Issues

Supportive Comments

The SEC addressed conflicts of interest in the text of Reg BI as follows:

> The conflicts of interest associated with incentives at the associated person level and limitations on the securities or products that may be recommended to retail customers have raised particular concerns in the context of the broker-dealer, transaction-based relationship. Accordingly, the Commission believes specific disclosure and additional mitigation requirements are appropriate to address those conflicts. Sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities within a limited period of time create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities within a limited period of time and thus compromise the best interests of their retail customers. The Commission does not believe such conflicts of interest can be reasonably mitigated and, accordingly, they must be eliminated.[109]

In a written statement to Congress, former SEC Chairman Harvey L. Pitt said the following:

> [N]othing ... requires broker-dealers to recommend the least expensive or least remunerative securities or investment strategies, as long as the firm and its associated individuals comply with the disclosure, care and conflict of interest obligations that would be created by the Regulation. This is significant, because the mere fact that a brokerage firm, or an account executive, receive additional remuneration for pursuing certain strategies or securities does not, ipso facto, make the recommendation improper, unsuitable, or contrary to the best interests of the retail customer.[110]

In a July 2019 speech, SEC Chairman Jay Clayton said the following:

> Some critics have gone so far as to fault Reg. BI for failing to require elimination of all conflicts of interest. This criticism is misguided—there are conflicts of interest inherent in all principal-agent relationships, and the broker-customer relationship and the investment adviser-client relationship are no exception. Reg. BI recognizes that these conflicts exist, and requires that firms address those conflicts and provide recommendations that are in the best interest of their retail customers.[111]

Thomas Wade, of the American Action Forum, said the following:

> [It has been argued] that the best interest standard is a greater protection than fiduciary, as brokers must mitigate and eliminate conflicts of interests, where under the fiduciary duty all that was required was disclosure.[112]

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[109] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, pp. 55-56.

[110] Written Statement of Harvey L. Pitt, founder, CEO, and managing director, Kalorama Partners, LLC and Kalorama Legal Services PLLC, in U.S. Congress, House Committee on Financial Services Committee, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, *Putting Investors First? Examining the SEC's Best Interest Rule*, hearings, 116th Cong., 1st sess., March 14, 2019, https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402388.

[111] SEC Chairman Jay Clayton, "Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors."

[112] Thomas Wade, "Is the Proposed Regulation in the Best Interest of Investors?" American Action Forum, August 8, 2018.

Critical Comments

The Consumer Federation of America said the following in a fact sheet criticizing Reg BI:

> The rule's conflict obligations don't prohibit firms from creating incentives that encourage and reward advice that is not in customers' best interests. Nor does the rule require firms to manage any conflicts to the benefit of the customer. For example, policies and procedures to "mitigate" financial conflicts don't have to be reasonably designed to prevent the broker from placing its interests ahead of the customer's interests.[113]

A media report detailed SEC Commissioner Jackson's criticism of Reg BI's approach to conflicts of interest as follows:

> The rule would be much improved with the addition of provisions that "limit or ban compensation practices that lead brokers to engage in conflicted activities," he says. "[Y]ou can expect people in the marketplace to do that which they're paid to do," he says. "If you pay them extra to put people in in-house products that are bad for the people, you can expect that there will be conflicts that will be difficult to mitigate, so I've urged for changes there as well."[114]

Commissioner Jackson also said the following in his statement on Reg BI:

> Troubling broker compensation practices that put investors at risk are addressed [in a very limited fashion] when they are "based on the sales of specific securities within a limited period of time," or "create high-pressure situations." These restrictions merely mimic those in longstanding FINRA proposals, and I cannot see why our rules should permit pay practices that create *any* pressure for brokers to harm investors."[115]

An industry observer wrote the following regarding Reg BI and conflicts of interest:

> The SEC fact sheet [as part of the press release accompanying Reg BI] ... did take positive steps from the proposed rule, but still left significant worries. For instance, sales competitions with award trips, bonuses and other rewards tend to prioritize growth over customer care (think Wells Fargo) were to some degree shot down in the rule, but not entirely. While specific product sales leading to bonuses appear to be shot down, an overall competition or bonus system for selling a suite of products is not clearly prohibited. This could really just cause companies to redo their bonus and competition models and allow them to continue.[116]

The Consumer Federation of America said the following in a press release:

> Even where conflicts would have to be "mitigated," the Commission doesn't make clear that mitigation has to be designed to support compliance with the best interest standard.[117]

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[113] "The SEC's 'Best Interest' Bait and Switch," *Consumer Federation of America Fact Sheet*, June 3, 2019, at https://consumerfed.org/in_the_media/the-secs-best-interest-bait-and-switch/.

[114] Kenneth Corbin, "SEC Commissioner Calls for Major Changes to Reg BI," *Financial Planning*, April 22, 2019, at https://www.financial-planning.com/news/sec-commissioner-jackson-calls-for-stricter-reg-bi.

[115] SEC Commissioner Robert J. Jackson, Jr., "Statement on Final Rules Governing Investment Advice."

[116] Jamie Hopkins, "SEC Brings Increased Confusion For Investors With New 'Best Interest' Rule," *Forbes*, June 5, 2019.

[117] Consumer Federation of America, "SEC Proposal Fails to Live Up to Its 'Best Interest' Label Without Extensive Revisions, Inadequate Protections Would Leave Investors Vulnerable to Bad Advice; Proposed Disclosures Would Perpetuate Investor Confusion," Consumer Federation of America, press release, August 7, 2018, https://consumerfed.org/press_release/sec-proposal-fails-to-live-up-to-its-best-interest-label/.

An Analysis of Reg BI Reform

In its 700-page Reg BI release, the SEC spoke of its inability to employ data-based research to gain insight into the reform's probable impact:

> Because the Commission does not have, has not received, and, in certain cases, does not believe it can reasonably obtain data that may inform on certain economic effects, the Commission is unable to quantify certain economic effects.... [E]ven in cases where it has some data or it has received some data regarding certain economic effects, the quantification of these effects is particularly challenging due to the number of assumptions that it would need to make to forecast how broker-dealers will respond to Regulation Best Interest, and how those responses will, in turn, affect the broader market for investment advice and the retail customers' participation in financial markets.[118]

The release, however, included a discussion of theoretical costs and benefits from an alternative to Reg BI that would have imposed fiduciary standards on broker-dealers akin to those that generally apply to investment advisers.

The release asserted that a major theoretical benefit to such a uniform fiduciary standard would be reduced customer confusion surrounding what obligations both brokers and investment advisers have toward them. Moreover, the release argued that such a change could also reduce potential customer costs associated with choosing a financial professional who is not a good fit since both brokers and investment advisers would be subject to the same standard of customer care.

The release noted, however, that a uniform fiduciary standard could result in a standard of care for brokers "that is not appropriately tailored to the structure and characteristics of the broker-dealer model (i.e., transaction specific recommendations and compensation)." Because of this possibility, it argued that the range of options in the financial advice market would shrink. It contended that at least in the short run, brokers would face greater compliance costs, possibly encouraging them to transition into offering advice in an investment adviser capacity and discouraging them from continuing to offer advice in a broker capacity.[119]

In turn, the release observed that brokers formally exiting their roles as broker-dealers could limit retail customers' access to particular securities or investment strategies as well as how they would pay for such advice. As a result, customers' costs for such advice could increase. The release then examined the potential fallout from a hypothetical scenario in which brokers operate under a new fiduciary standard but uniformly remain broker-dealers. According to the release, this could result in increased compliance costs for brokers that could be fully or partially passed on to their clients. That possibility, it argued, could lead to some customers problematically engaging less expensive investment advice providers outside of the regulated world of investment advisers and broker-dealers.[120]

Some data-based research has also examined the implications of a hypothetical final rulemaking that imposed a fiduciary standard on brokers. Several examples of this research are examined below, illustrating that research has resulted in disparate views on the nature of such impact.

The Deloitte-SIFMA Study. In 2017, the business consultant Deloitte and SIFMA, the broker-dealer trade group, released the results of a collaborative survey conducted by Deloitte on SIFMA

[118] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 844.

[119] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 634.

[120] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, p. 647.

members. The study yielded results from the responses of 21 large national corporate SIFMA members on their reactions to the partially implemented DOL fiduciary rule, which the members had responded to by making plans to modify their retail customer-based services and products. Of the 21 respondents, 53% reported that they had either eliminated or limited access to brokerage advice services and 67% had migrated away from open choice[121] to fee-based or limited brokerage services.[122] The study also found that a "trend towards fee-based accounts was likely accelerated by the rule." It noted that "[t]ypically, fee-based accounts offer a higher level of service than brokerage accounts and often include automatic rebalancing of accounts, comprehensive annual reviews, enhanced reporting to account holders, and access to third party money managers. The fees are generally an 'all-in' asset-based fee that is generally higher than the fees paid in an advised brokerage account."[123]

Finke and Langdon. As indicated earlier, some states have common laws that impose a fiduciary standard of care on brokers, but many do not. By surveying broker-dealer registered representatives subject to differing state common law-based fiduciary requirements, Finke and Langdon, two academics, exploited those differences to ascertain whether a relatively stricter fiduciary standard of care affected brokers' willingness to provide advisory services to retail consumers. Among other things, the 2012 research found that the number of registered representatives conducting business within a state as a percentage of total households did not significantly change whether or not a state had a stricter fiduciary standard. It also found no significant differences among such financial professionals in states with a strict fiduciary standard compared with states that did not have a fiduciary standard with respect to (1) whether they were limited in their ability to recommend certain products or to serve clients with limited wealth; (2) the percentage of clients with lower incomes and higher levels of wealth; (3) their ability to provide a broad range of investment products including those that involve commission-based compensation; and (4) the ability to provide tailored customer advice.[124]

Bhattacharya, Padi, and Illanes. The researchers analyzed patterns of sales behavior for annuities[125] issued by a large national financial company sold between 2013 and 2015 by broker-dealers based in adjacent counties separated by state lines. Released in 2019, the analysis hinged on the fact that some of the counties were in states with common law-based broker fiduciary standards, but adjacent counties were in states without such standards. Among other things, they found that subjecting brokers to a fiduciary duty shifted the suite of investment products that they sell to retail investors. Relative to counties without broker fiduciary obligations, brokers in counties with fiduciary standards saw increased costs of doing business, but the jurisdictions also witnessed direct improvements in the quality of the financial advice.[126]

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[121] Open choice policies give investors broad access to advised brokerage and fee-based platforms.

[122] Deloitte, "The DOL Fiduciary Rule: A Study on How Financial Institutions have Responded and the Resulting Impacts on Retirement Investors," SIFMA, August 9, 2017, https://www.sifma.org/resources/submissions/deloitte-study-on-the-dol-fiduciary-rule-august-2017/.

[123] Deloitte, "The DOL Fiduciary Rule: A Study on How Financial Institutions have Responded and the Resulting Impacts on Retirement Investors," SIFMA, August 9, 2017, p. 21.

[124] Finke and Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice."

[125] An annuity is a financial product that pays out a fixed stream of payments to an individual. They are primarily used as an income stream for retirees. Annuities are created and issued by financial institutions, which accept and invest funds from individuals. When an annuity is annuitized, the institution that holds it will then issue a stream of payments at some later date.

[126] Vivek Bhattacharya, Gaston Illanes, and Manisha Padi, "Fiduciary Duty and the Market for Financial Advice," National Bureau of Economic Research, NBER Working Paper no. 25861, May 2019, available at https://www.nber.org/papers/w25861.pdf.

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