**Regulation Best Interest- It’s Not a Fiduciary Duty, but the Industry Hopes Investors Think It Is**

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The evidence is clear: Fiduciary, conflict-free portfolio management yields greater returns over time and results in less misconduct and fraud.[[2]](#footnote-3) It does not take an extraordinary logical leap to conclude that passive, fiduciary management leads to better returns and less fraud over time. What is considered true fiduciary management, as concluded by the authors of this piece to be passive management utilizing indexing, results in low fees, low costs, stops deleterious market timing, and the removal and avoidance of conflicts of interest which all lead to higher returns and less incentive for fraud and abuse. These facts are clear and cannot be cogently contradicted. Although retail brokerage firms and stock brokers argue that they provide myriad benefits to investors and that they regularly act in their clients’ best interests through advertising, the evidence establishes this is simply capitalism and profiteering at work.[[3]](#footnote-4) These firms want investors to believe they are fiduciaries that have their best interests at heart; clearly investors want to believe this or the firms wouldn’t spend billions of advertising dollars this way.[[4]](#footnote-5) But when challenged about this duty or when presented with the opportunity to mandate a universal fiduciary duty, Wall Street lashes out aggressively with a resounding screech.

It should be obvious therefore that a government entity that is charged with protecting investors would mandate that those managing other people’s money and providing investment advice to retail investors, be held to a fiduciary standard. The Securities and Exchange Commission’s (“SEC”) mission statement literally begins “to protect investors…”[[5]](#footnote-6) Not a watered-down version that parses words and redefines legal terms of art that have be defined for hundreds of years. But a clear, concise regulation that imposes on all financial advisors a uniform fiduciary duty. The SEC had almost ten years after the passage of the Dodd-Frank Act to study the myriad issues impacting retail investors. In fact, the SEC published several reports and made many findings about the retail investment advice industry. Yet for all of its studies and reports, the SEC still refused to submit regulations which would impose a fiduciary duty on financial advisors and investment advisers alike. Even when the Department of Labor submitted regulations imposing a fiduciary duty upon advisors providing advice to those accounts covered by the Department of Labor (DOL) regulations, like pension funds, 401(k)s, and IRAs, for example, the SEC continued to stand idly by. This refusal or apparent apathy by the SEC took place almost entirely under all administrations, so this inaction was not political on its face, not at least in the broader sense.

When a legitimate fiduciary duty is imposed on investment advisers, as has been the law under the Investment Advisers Act of 1940 since at least 1963, the statistical evidence establishes that investors make more money and the advisors take less money. This is one of the primary drivers of investor returns. The lag that fees, commissions, and costs create has a deleterious impact on returns over time. The fiduciary tag tends to reduce the urge for advisors or brokers to trade or churn accounts, and sell expensive annuities or high commissioned alternative investments. Instead, most fiduciaries, in accordance with their duties, adhere to fundamental investment tenets like Modern Portfolio Theory and utilize index-investing. This form of in-active management, results in less market-timing, which again evidence establishes that investors too frequently buy-high and sell-low, and relies on long term, low cost market performance to maximize investor returns.

When charged with the obligation to research, study, and draw-up regulations based on its findings pursuant to the Dodd-Frank law passed in 2010 after the banking industry melted down the world wide economy, the SEC came up with Regulation Best Interest on June 5, 2019, which does not impose a fiduciary duty on anyone under any circumstances. Regulation “Best Interest” is at best a vague, watered-down version of some standard; it’s neither the FINRA Suitability Rule and it’s certainly not a fiduciary duty rule. This all begs the elephant-in-the-room question: Why won’t the SEC impose a universal fiduciary duty upon all licensed professionals who provide investment, insurance, or financial advice?

The conclusion drawn by this piece, which will be accused by some of being jaded or partial, is that broker/dealers cannot drive revenue the way they’re used to if they are saddled with a real fiduciary duty. Revenues at brokerage firms are driven by annuities, active-management/trading, and alternative investments.[[6]](#footnote-7) These investment products or quantitative strategies are tougher to sell in a regime predicated on a true fiduciary standard, especially given the clear academic and empirical data and evidence indicating an investor is much better off with passive, index-style management than any other method. The best investment strategies simply cap revenue to a mere management fee, as opposed to far more lucrative commissions, fees, and trails brokers enjoy from selling alternative investments or variable annuities. Perhaps this is a jaded perspective; the authors have spent a combined 50 years advocating for investors. But if the dollars are followed, it becomes clear that the SEC is affected by the big bank lobby. Its paper tiger Regulation BI is the clearest evidence of this fact in at least a decade, probably going back to when Harvey Pitt famously advocated for a “kinder-gentler” SEC, only to have the Enron and WorldCom fiascos erupt months later.[[7]](#footnote-8)

The concept of a “fiduciary” traces its roots as far back as Hammurabi’s Code, which discusses the idea of the agency relationship, and the Holy Bible which famously warned “No man can serve two masters; for either he will hate one and love the other, or he will be devoted to one and despise the other.”[[8]](#footnote-9) Perhaps the most fundamental explanation of the definition of fiduciary duty was provided by Judge Cordozo in *Meinhard v. Salmon*:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (*Wendt v. Fischer,*243 N.Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[[9]](#footnote-10)

A mighty standard indeed. Courts nationwide have been applying this fundamental fiduciary concept to broker/dealers for decades in varying circumstances. For example, in *Vogel v. A.G. Edwards & Sons., Inc.* the Missouri court declared that under Missouri law, the “relationship between broker and customer is fiduciary and confidential.”[[10]](#footnote-11) In *Vogel,* the court distinguished between non-discretionary and discretionary accounts, ruling that the specific duties owed by brokers in non-discretionary accounts are more limited, but what duties they have are still fiduciary ones.[[11]](#footnote-12) Likewise, in discretionary accounts, regardless of what license the broker holds or what type of account is being managed, the courts have long held the broker-client relationship is a fiduciary one. *See, e.g. Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* which outlines a list of fiduciary duties brokers owe their clients in discretionary accounts.[[12]](#footnote-13) Also, in *Davis v. Merrill Lynch,* the court held stock-brokers are fiduciaries stating:

Securities brokers…at Merrill Lynch are licensed professionals who hold themselves out as trained and experienced to render a specialized service. Like the clients of real estate agents, securities customers rely on the agent’s expertise and expect the agent to act in their best interests. Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers a duty of utmost good faith, integrity, and loyalty.[[13]](#footnote-14)

This an interesting commentary to suggest that licensed professionals who hold themselves out as highly trained and experienced, be held to a fiduciary standard. These cases prove that the idea of applying fiduciary principles to the securities brokerage landscape fails for want of simplicity is false. Wall Street wants everyone to believe everything they do is so complicated. The last thing Merrill Lynch needs is their clients realizing they don’t need expensive asset management. None of this caselaw enforcing fiduciary obligations on stock brokers considered the cost or burden of this fiduciary duty. Instead it was rooted in common fiduciary sense. The brokerage firm business is not too complicated to apply a simple across the board fiduciary duty. That is what they want everyone to believe. Courts around the United States have done so for many years, albeit inconsistently. The conclusion therefore would be to introduce uniformity through legislation and regulation. However, like the old saying goes, nothing complicates simple matters like a committee.

Defining fiduciary duty is the Rubik’s Cube which has baffled the SEC, FINRA, and other regulators for what seems like generations. This is not for want of trying. FINRA, for example, has stated publicly that it supports a broad fiduciary duty for brokers, calling it a “best interest standard that “…would align the interests of intermediaries with those of their customers; better protect investors by providing a more consistent set of obligations across financial service providers; help ensure that intermediaries eliminate or manage conflicts of interest; and help ensure that intermediaries establish an ethical culture throughout their firms.”[[14]](#footnote-15) This comment letter from 2015 was written to the Department of Labor during its deliberations over the now dead DOL Fiduciary Rule, which sought to have a statutorily imposed fiduciary duty on all broker/dealers who managed retirement accounts.

This comment letter went so far as to bullet-point what FINRA believed any best-interest standard should require of brokerage firms:

* Act in their customers’ best interest;
* adopt procedures reasonably designed to detect potential conflicts;
* eliminate those conflicts of interest whenever possible;
* adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer’s best interest;
* obtain retail customer consent to any conflict of interest related to recommendations or services provided; and
* provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses.[[15]](#footnote-16)

One of FINRA’s core gripes with the DOL Rule seems to have been the inconsistencies and confusion it would create. So FINRA proposed uniformity, advocating that the DOL “best interest” rule apply to both retirement and non-retirement accounts equally, and that rules affecting brokers and registered investment advisors be “harmonized.”[[16]](#footnote-17) FINRA’s illustration points out that, under an all too common circumstance, the same advisor, client, account, and conduct could have multiple standards of conduct; the FINRA broker/dealer Suitability standard, the advisers act fiduciary standard, and the DOL fiduciary Rule – could all apply to the same situation. FINRA also advocated that the context and content of the FINRA suitability rule be used as the foundation for and be expressly incorporated into the DOL fiduciary nomenclature around the definition of “recommendation.”[[17]](#footnote-18) Essentially, what FINRA asked the Department of Labor to do was to adopt the suitability rule as part of the fiduciary standard of care. This seemed like a solid start down the road to a uniform fiduciary duty applicable to all brokers.

The Investment Advisers Act of 1940 imposes a fiduciary duty upon “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . .”[[18]](#footnote-19) 15 U.S.C. § 80b-l, *et seq. See, e.g., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc. et al.[[19]](#footnote-20)*. For years, the SEC has regulated Investment Advisers and adopted standards and duties in line with this fiduciary requirement. For example, investment advisers, like all fiduciaries, owe a duty of loyalty – the core of the “best interest” standard – and to disclose and eliminate conflicts of interest.[[20]](#footnote-21) The Advisers Act has been interpreted also to establish a duty of care “to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.”[[21]](#footnote-22) This duty of care means an investment adviser must have a reasonable and independent basis for its recommendations.[[22]](#footnote-23) Put another more simpler way, an investment adviser must perform due diligence on an investment, and understand it sufficiently, prior to advising its clients to invest. This is also the standard mere brokers are held to in FINRA RN 10-22 and reasonable basis suitability under FINRA Rule 2111.05(a).

In 2011, the SEC released its Staff Study that actually recommended a uniform fiduciary standard of conduct for all broker-dealers and investment advisers. What a watershed moment for retail investors. And yet, this uniform standard was never implemented and really never even made it up for a vote. The most, it seems, that the Obama Administration could hope for was to use its executive authority and shoehorn a Fiduciary rule for retirement accounts only through the Department of Labor. Even when FINRA publicly advocated for a more uniform fiduciary standard in 2015, it ultimately went nowhere. An unexpected result in the 2016 Presidential election vaulted one of the most anti-regulation Republicans since Herbert Hoover into office. It only took six weeks for the Trump administration to dismantle the DOL Fiduciary Rule.[[23]](#footnote-24) After the banks and brokerage firms nearly ended Capitalism in 2008, only to be bailed-out by Socialism in 2009, and after every regulator that matters – the SEC, the DOL, FINRA, and certainly dozens of state securities regulators – publicly advocated for a uniform fiduciary standard, and more than ten years later were on the cusp of passing this standard, it was ripped away. The banks and brokerage firms got their way. They gas-lighted their way to a new “uniform” standard called Regulation Best Interest which is now in full effect. This rule is not a fiduciary rule no matter what Wall Street’s salesmen say it is.

***How does active management persist despite its dismal results?***

“We recognized early on that very smart people do very dumb things, and we wanted to know why and who, so we could avoid them.” Charlie Munger, Berkshire Hathaway 2009 meeting via [Buffett FAQ](http://buffettfaq.com/).

Behavioral Finance explains how the naive investor is duped into believing in the efficacy of active management and how the industry is free to continue its duping so long as it avoids being a fiduciary.

**Modern Portfolio Theory (*MPT) and the brokerage industry today***

MPT and the inability of brokers to beat the market is well known within the industry, but amongst the retail customers, not so much. Brokers are not fiduciaries and fail to advise their clients that they would be better off, on a risk adjusted basis, buying a broad market index fund and not allowing the broker to actively manage their money. The situation is well summarized by Burton Malkiel in “The Random Walk Guide to Investing: Ten Rules for Financial Success”. Malkiel writes, “It’s true that when you buy an index fund, you give up the chance to boast at the golf course that you picked the best performing stock or mutual fund. That’s why some critics claim that indexing relegates your results to mediocrity. In fact, you are virtually guaranteed to do better than average. It’s like going out on the golf course and shooting every round at par. How many golfers can do better than that? Index funds provide a simple low-cost solution to your investing problems.”[[24]](#footnote-25) The lack of a fiduciary duty means that a broker never need tell his client of the superior results described by Malkiel, or inherent conflicts amongst its products.

Path Dependence[[25]](#footnote-26) and a history of caveat emptor helps explain why the brokerage industry feels no responsibility towards the retail customer, which is perpetuated thanks to its prodigious lobbying efforts.[[26]](#footnote-27) Over centuries The Prudent Man standard enshrined caveat emptor into law prior to the development of Modern Portfolio Theory in the 1950s. A feedback loop that well insulates Wall Street from change in regard to its obligations towards the retail investor, is obvious.[[27]](#footnote-28) Thus, the history of caveat emptor and the high fees associated with active management create a difficult gravity from which the retail client finds it almost impossible to escape. The SEC, FINRA and Congressional embrace of caveat emptor and the lobbying lucre from the industry keeps them from adopting a fiduciary duty rule.

***Behavioral Finance explains how retail investors are so susceptible to the Siren’s Song of active management***

More is needed to explain the persistence of active management by underperforming overcompensated conflicted salesmen. The Siren’s Song of active management, when not accompanied by the statistically grounded fiduciary advice that outsized returns are a statistical and very human behavioral finance mirage, are compelling fodder to the retail broker for his client. This is why a fiduciary obligation should be a bare minimum requirement for anyone that gives financial advice, just as it is for those who give medical or legal advice, teachers, executors, real estate agents, Boards of Directors, Liquidators, guardians, clergy and business partners. Behavioral Finance offers some clues as to why the siren’s song of the broker’s active management finds resonance in vulnerable investors.

The first useful principle of Behavioral Finance to explain the siren’s song of active management is that the human mind is incapable of comprehending randomness. ''We are hard-wired to overreact to coincidences,'' says Persi Diaconis. “It goes back to primitive man. You look in the bush, it looks like stripes, you'd better get out of there before you determine the odds that you're looking at a tiger. The cost of being flattened by the tiger is high.”[[28]](#footnote-29) “A funny example of this is when Apple CEO Steve Jobs had to change the programming behind the “shuffle” feature on iPods. Customers complained that when they used this feature the songs that played were often from the same album or by the same artist. Yet this is extremely possible with randomness, as it does not consider what has already been played. Steve Jobs responded to this feedback by altering the shuffle feature to make it less random, defying the point of randomness altogether!”[[29]](#footnote-30) Warren Buffet’s famous allegory of random people or chimps becoming heroes for winning coin tosses is a perfect example of an inability to comprehend randomness.[[30]](#footnote-31) The randomness of markets are counterintuitive to the human mind.[[31]](#footnote-32) The investor must be guided by counterintuitive competent statistical data. Lacking a fiduciary duty, the broker never shares this data and the teachings of Modern Portfolio Theory with his client. Anecdotally, it makes sense that the smartest most accomplished people would be most susceptible to the siren’s song because these people are well trained to identify patterns, though none exist in markets to observe for the retail investor. This makes the industry defense of “sophisticated investor understood the risks” because she had a graduate degree from an elite university in a totally different field, horribly egregious.

Humans including retail investors and their brokers who have an incentive to do so, also succumb to a second Behavioral Finance phenomenon, the Overconfidence Bias. This explains why retail investors and brokers intuitively embrace active management. “The overconfidence effect also applies to forecasts, such as stock market performance over a year or your firm’s profits over three years. We systematically overestimate our knowledge and our ability to predict on a massive scale. The overconfidence effect does not stop at economics: In surveys, 84 percent of Frenchmen estimate that they are above-average lovers (Taleb). Without the overconfidence effect, that figure should be exactly 50 percent—after all, the statistical “median” means 50 percent should rank higher and 50 percent should rank lower. In another survey, 93 percent of the U.S. students estimated to be “above average” drivers. And 68 percent of the faculty at the University of Nebraska rated themselves “in the top 25 percent for teaching ability.”[[32]](#footnote-33) Thus, the retail broker deludes his client and perhaps partially himself, with the broker having a financial incentive to do so, that the randomness and incomprehensible nature of markets as revealed by statistical methods, does not apply to them.

Finally, humans engage in the Hindsight Bias. “Hindsight bias is a psychological phenomenon in which past events seem to be more prominent than they appeared while they were occurring. Hindsight bias can lead an individual to believe that an event was more predictable than it actually was, and can result in an oversimplification in cause and effect.”[[33]](#footnote-34) Therefore, the broker and retail investor upon discovering contrary data to their “beat the market” discussions, engage in hindsight bias to explain away the contrary data and assure themselves they “won’t make that knowable mistake again”.

The cycle of incomprehensible randomness, overconfidence and hindsight bias is repeated and synergistically reinforcing until the losses are unsustainable. What is reprehensible in this scenario is that the broker knows or should know better, knows the statistical data and that Nobel Prizes were awarded for proving that outsized returns from active management are a Behavioral Finance mirage, but never tells his client!

***How the retail brokerage industry dupes the investor by avoiding a fiduciary duty rule***

Every broker who has taken a finance class has been instructed on Modern Portfolio Theory and understands that Nobel Prizes have been awarded for proving active management cannot “beat the market” on a risk adjusted basis. The Series 7 exam required to become a broker tests applicants on Modern Portfolio Theory.[[34]](#footnote-35) To become a broker a person must demonstrate to the examiners that they understand they cannot “beat the market” but once they obtain a license to sell stocks they have no obligation to reveal this information to their clients! Because there is no fiduciary duty owed to the investor, the broker is free to reap the profits of active management without ever telling the investor “look I am likely wasting your time and money and will underperform what you can obtain with 5 basis points fee in an Index Fund that tracks the market on a risk adjusted basis”. The broker never tells the investor that their all too human subjective false observations about stock market predictability as we explained with Behavioral Finance, are a mirage. Instead the industry standards set by the SEC, FINRA and Congress dance around being a fiduciary, but remain below that threshold of fiduciary, so as to preserve the ability of the broker to be an active manager without identifying to the investor the folly of their ever so human uninformed foolishness.

In any other profession with a fiduciary duty such as law or medicine, the doctor or lawyer has an obligation to “do no harm” and to explain to the client the folly of their ways, to burst the bubble of mirages afflicting the client and to not encourage the self-harm the client erroneously may unknowingly consent to inflict upon themselves after encouragement by the broker. So long as the brokerage industry avoids being a fiduciary, it can continue to prey upon the retail investor’s innate weaknesses explained by behavioral finance with no effort to disabuse the investor of their understandable folly and without any obligation to fully explain Modern Portfolio Theory. The broker has no duty to tell his client the outsized returns of active management are a compelling behavioral finance delusion.

***Regulation Best Interest: The Broker-Dealer Standard of Conduct***

On June 5, 2019, the SEC voted to adopt a new rule under the Securities Exchange Act of 1934 (“Exchange Act”) titled Regulation Best Interest: The Broker-Dealer Standard of Conduct.[[35]](#footnote-36) Regulation Best Interest establishes a standard of conduct for broker-dealers and associated persons when making a recommendation to a retail customer of any securities transaction or investment strategy involving securities.[[36]](#footnote-37) The package of rulemakings and interpretations implemented by the SEC included Regulation Best Interest, the new Form CRS Relationship Summary, and two separate interpretations under the Investment Advisers Act of 1940. The stated intention of the SEC in implementing the new rules was to heighten the obligations of broker-dealers when making a recommendation to a retail customer and to reduce the potential harm to retail customers from conflicts of interest that may affect the recommendation.[[37]](#footnote-38) Registered broker-dealers must be in compliance with Regulation Best Interest by June 30, 2020.[[38]](#footnote-39)

Regulation Best Interest was intended to improve investor protection by requiring (1) that broker-dealers act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interests of the broker-dealer ahead of the interests of the retail customer; and (2) addresses 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 it has been determined that disclosure is insufficient to reasonably address the conflict, to mitigate or eliminate the conflict.[[39]](#footnote-40) Regulation Best Interest imposes a new standard of conduct specifically for broker-dealers that is intended to regulate the standard of conduct for broker-dealers beyond the suitability standard.[[40]](#footnote-41) Regulation Best Interest includes disclosure provisions along with specific requirements imposed on the broker-dealer and client relationship.[[41]](#footnote-42)

One of the pillars of Regulation Best Interest is that when making a recommendation of a securities transaction or an investment strategy involving securities, a broker-dealer must act in the retail customer’s best interest and cannot place its own interests ahead of the customer’s interests.[[42]](#footnote-43)  Regulation Best Interest applies to broker-dealers and registered representatives at the point the securities transaction or investment strategy involving securities is made to the customer.[[43]](#footnote-44) Regulation Best Interest sets forth the following four (4) obligations on broker-dealers and their representatives:

***Disclosure Obligation:*** Broker-dealers must disclose material facts about the relationship and recommendations, including specific disclosures about the capacity in which the broker is acting, fees, the type and scope of services provided, conflicts, limitations on services and products, and whether the broker-dealer provides monitoring services.[[44]](#footnote-45) A broker-dealer must disclose, in writing, all material facts about the scope and terms of its relationship with the customer prior to or at the time the recommendation is made.[[45]](#footnote-46) The requirement includes disclosure that the firm or representative is acting in a broker-dealer capacity; the material fees and costs the client will be charged; and the type and scope of services to be offered, including any material restrictions on the recommendations that could be made to the retail customer.[[46]](#footnote-47) Additionally, the broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make an impartial recommendation, such as conflicts inherent to proprietary products, third party compensation, and payment arrangements.[[47]](#footnote-48)

***Care Obligation:*** A broker-dealer is obligated to use reasonable diligence, care, and skill when making a recommendation to a retail customer.[[48]](#footnote-49) The broker-dealer is required to consider potential risks, rewards, and costs associated with the recommendation offered. The broker-dealer must further contemplate those risks, rewards, and costs in relation to the customer’s investment profile. The broker-dealer must have a reasonable basis to believe that the recommendation is in the customer’s best interest and does not place the broker-dealer’s interest before the interests of the retail customer.[[49]](#footnote-50) When recommending multiple transactions, the broker-dealer must have a reasonable basis to believe that the sum of the transactions are not excessive, even if each is in the customer’s best interest when viewed singularly.[[50]](#footnote-51) The point of evaluation of whether or not a broker-dealer has fulfilled its duties under the Care Obligation is determined at the time of the recommendation (and not in retrospect).[[51]](#footnote-52)

***Conflict of Interest Obligation:***Broker-dealers are obligated to establish, maintain, and enforce reasonably created written policies and procedures addressing conflicts of interest related to its recommendations to retail customers.[[52]](#footnote-53) These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them.[[53]](#footnote-54) Essentially, conflicts of interests that generate an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer’s interest must be mitigated by the firm’s policies and procedures.[[54]](#footnote-55) Importantly, appropriate disclosures must be made to the retail client when a broker-dealer places material restrictions on recommendations that may be made to a retail customer to avoid the associated person’s or broker-dealer’s interests being put ahead of the customer’s interest.[[55]](#footnote-56) Lastly, firm’s policies and procedures must be reasonably designed to identify and remove sales contests, sales quotas, bonuses, and non-cash compensation that are premised on the sale of specific securities or specific types of securities within a certain time frame.[[56]](#footnote-57)

***Compliance Obligation:*** Broker-dealers are obligated to establish, maintain and enforce policies and procedures reasonably designed to attain compliance with Regulation Best Interest in its entirety.[[57]](#footnote-58) A broker-dealer’s policies and procedures must address conflicts of interest as well as compliance with its Disclosure and Care Obligations under Regulation Best Interest.[[58]](#footnote-59)

In addition to Regulation Best Interest, the SEC also implemented the requirement that broker-dealers and investment advisers utilize a *Form CRS Relationship Summary*. Under the regulation, advisors and broker-dealers are required to provide retail investors a relationship summary at the onset of their relationship.[[59]](#footnote-60) In the relationship summary, firms are required to summarize information about services, fees and costs, conflicts of interest, legal standard of conduct, and whether or not the firm and its financial professionals have disciplinary history.[[60]](#footnote-61)  The relationship summary will highlight the Commission’s investor education website, Investor.gov, which offers the investing public educational information.[[61]](#footnote-62)

Lastly, as part of the SEC’s package of new rules, the SEC provided two (2) interpretations. The first is the *Investment Adviser Interpretation* which clarifies that an investment adviser owes a fiduciary duty to its clients under the Advisers Act.[[62]](#footnote-63)  This duty is principles-based and applies to the entire relationship between an investment adviser and its client.[[63]](#footnote-64)  The second is the *Solely Incidental Interpretation* which confirms and clarifies the Commission’s interpretation of the “solely incidental” prong of the broker-dealer exclusion of the Advisers Act.[[64]](#footnote-65)  Specifically, the interpretation states that a broker-dealer’s advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the “solely incidental” prong of this exclusion if the advice is provided in connection with and is reasonably related to the broker-dealer’s primary business of effecting securities transactions.[[65]](#footnote-66)

***Regulation Best Interest Falls Short***

In the end, Regulation Best Interest: The Broker-Dealer Standard of Conduct, falls short of a fiduciary standard and fails to adequately protect investors. It is almost certain that broker-dealers and their representatives will extort the rule to attract investor clients only to later take advantage of the client’s confusion and deceitfully gained trust. The SEC touts that, "The enhancements contained in Regulation Best Interest are designed to improve investor protection by enhancing the quality of broker-dealer recommendations."[[66]](#footnote-67) Unfortunately, nothing in Regulation Best Interest requires an improvement in the recommendations of broker-dealers nor does it require the broker-dealer to act in the best interest of the client without regard for its own interests. Regulation Best Interest will likely result in only further confusing the public into implicitly trusting the broker-dealer industry to their detriment as they believe their brokers have a fiduciary duty to act in their best interests in the same manner as a fiduciary.

Regulation Best Interest falls short because “Best Interest” is not a fiduciary standard. The SEC made clear it "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)."[[67]](#footnote-68) Perhaps the bigger and more important issue is that the industry is not appropriately designed to conduct business in a fiduciary manner, but they are willing to make it appear as though they do to acquire clients and illicit trust from the investing public.

Furthermore, the SEC admits, "We do not believe that any rulemaking governing retail investor-advice relationships can solve for every issue presented."[[68]](#footnote-69) Ironically, however the SEC’s Regulation Best Interest is a rule-based concept instead of a principles based model like the fiduciary standard. Under Regulation Best Interest, broker-dealers are not required to give advice without regard to their own interests, instead the rule requires the interests of broker dealers not to be put ahead of the customers.[[69]](#footnote-70) Regulation Best Interest allows broker-dealers to keep their business model, including promoting their interests and conflicted recommendations, so long as the interests of the client are put ahead of the self-serving actions of the broker-dealer. Broker-dealers are not required to improve the recommendations they make to clients as a result of Regulation Best Interest. Instead, they are required to disclose material facts related to conflicts of interest associated with the recommendation that might incline a broker-dealer to make the recommendation. The warning to the broker-dealer’s client about the conflict will only be as good as the disclosure, and will only be effective if the client reads and understands the disclosure prior to taking the recommendation of the broker-dealer. An unlikely scenario indeed.

Perhaps, most importantly the disconnect between a fiduciary duty and Regulation Best Interest is that being a fiduciary requires ongoing responsibilities, including the duty of care and the duty to provide on-going advice resulting from the continued monitoring of client accounts in a manner and rate that is in the best interest of the client whereas Regulation Best Interest imposes no such duty. Instead, Regulation Best Interest requires no duties after the sale or investment recommendation is made.

In choosing to adopt Regulation Best Interest, the SEC allowed broker-dealers and financial professionals to avoid a fiduciary standard which would hold them to the highest legal and ethical standard to safeguard the client investor’s funds entrusted to their care. By implementing a rule misleadingly titled “Best Interest” the public will undoubtedly be deceived as most will relate “Best Interest” with the standard of a fiduciary because it is generally understood that a fiduciary must act in the client’s “best interest”. Furthermore, an advisor who is held to the fiduciary standard is generally expected to offer advice without regard to their own interests and to provide ongoing advice and monitoring. Regulation Best interest imposes no such duties. The SEC failed to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing investment advice to retail customers. Unfortunately, instead the SEC created a rule that will likely cause the investing public to believe broker-dealers are held to a fiduciary standard in instances when they are not.

1. Sara Hanley, Esq. is the founder of Hanley Law and Joe Wojciechowski, Esq. is a partner at Stoltmann Law Offices. [↑](#footnote-ref-2)
2. See President Obama, Council of Economic Advisors, *The Effects of Conflicted Investment Advice on Retirement Savings*, February 2015. [↑](#footnote-ref-3)
3. *See* Joseph C. Peiffer and Christine Lazaro, *Major Investor Losses Due to conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty*, Public Investors Arbitration Bar Association Report, March 25, 2015, https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf [↑](#footnote-ref-4)
4. PIABA: *Federal Action Needed To Stop U.S. Brokerage Firms Misleading Investors About Role As Fiduciaries, Which Firms Deny To Block Arbitration Claims*, March 25, 2015.

<https://piaba.org/in-the-media/piaba-federal-action-needed-stop-us-brokerage-firms-misleading-investors-about-role-0> (last viewed June 2, 2020). [↑](#footnote-ref-5)
5. *See* https://www.investor.gov/introduction-investing/basics/role-sec (last viewed July 29, 2019). [↑](#footnote-ref-6)
6. Securities and Exchange Commission, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 17 C.F.R. Part 240 [Release No. 34-86031; File No. S7-07-18] RIN 3235-AM35, at 410-412. [↑](#footnote-ref-7)
7. Bill Saporito, *Harvey’s Pittfalls,* Time Magazine, November 5, 2002 http://content.time.com/time/magazine/article/0,9171,386940,00.html [↑](#footnote-ref-8)
8. Mathew 6:24. [↑](#footnote-ref-9)
9. 249 NY 458, 464 (N.Y. Ct. App. 1928). [↑](#footnote-ref-10)
10. 801 S.W.2d 746, 752 (Mo. Ct. App. 1990). [↑](#footnote-ref-11)
11. *Id.* [↑](#footnote-ref-12)
12. 461 F. Supp. 951, 953 (E.D. Mich. 1978). [↑](#footnote-ref-13)
13. 906 F.2d 1206, 1215 (8th Cir. 1990). [↑](#footnote-ref-14)
14. Marcia E. Asquith, FINRA Senior Vice President and Corporate Secretary, Comment Letter, *Re: Proposed Conflict of Interest rule and Related Proposals*, July 17, 2015, at 2; https://www.finra.org/sites/default/files/FINRACommentLetter\_DOL\_07-17-15.pdf. [↑](#footnote-ref-15)
15. *Id.* [↑](#footnote-ref-16)
16. *Id.* at 3. [↑](#footnote-ref-17)
17. *Id.* at 13-14. [↑](#footnote-ref-18)
18. 15 U.S.C. § 80b-l, *et seq.* [↑](#footnote-ref-19)
19. 375 U.S. 180 (1963). [↑](#footnote-ref-20)
20. *See* U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011) at 112-13. [↑](#footnote-ref-21)
21. *Id.* at 120-21. [↑](#footnote-ref-22)
22. *In the matter of Alfred* C. *Rizzo,* Advisors Act Release No. 897, 1984 WL 470013 (Jan. 11, 1984). [↑](#footnote-ref-23)
23. Michael Hiltzin, *Trump’s Rollback of the Investment Conflict of Interest Rule is a Direct Attack on Middle-Class Savings,* Los Angeles Times, February 3, 2017. [↑](#footnote-ref-24)
24. Burton Malkiel, The Random Walk Guide to Investing: Ten Rules for Financial Success, 2003 at 137. [↑](#footnote-ref-25)
25. "Path dependence, the tendency of institutions or technologies to become committed to develop in certain ways as a result of their structural properties or their beliefs and values. As a theory, path dependence is based on the straightforward assumption that 'history matters’… First, it must be demonstrated that, at the creation of the institution or technology under study, a contingency or series of contingencies occurred that led to the selection of one outcome over another, which, given another set of initial conditions, might have led to another outcome having been selected instead…Second, it must be demonstrated how a new technology or organizational form becomes insulated to some extent from change. The factors involved in that insulation, or feedback mechanisms, may be positive (supporting advocates of the path-dependent institution or technology) or negative (interfering with attempts at change from advocates of alternative institutions or technologies). The feedback mechanisms that lock in the system under investigation along a particular path might be either cognitive or institutional.” Ian Greener, Path Dependence, Encyclopedia Britannica, https://www.britannica.com.topicpath-dependence. (last visited June 2, 2020). [↑](#footnote-ref-26)
26. E.g., Finance, Insurance and Real Estate was by far the largest donor amongst industry to political campaigns in the 2018 election cycle. Open secrets.Org, Totals by Sector 2018, https://www.opensecrets.org/overview/sectors.php. [↑](#footnote-ref-27)
27. E.g. Michael S. Edministon & Bradley R. Stark, The Financial Services Industry’s Historic Pattern of Opposition to Reform, “Wolf” is the only Cry, PIABA Journal Vol. 22. No.2 2015. [↑](#footnote-ref-28)
28. Lisa Belkin, N.Y Times, The Odds of That Aug. 11, 2002. [↑](#footnote-ref-29)
29. <https://blogs.glowscotland.org.uk/glowblogs/jceportfolio/2017/10/16/do-humans-really-understand-randomness> (last viewed May 28, 2020). [↑](#footnote-ref-30)
30. “Let’s assume we get 225 million Americans up tomorrow morning and we ask them all to wager a dollar. They go out in the morning at sunrise, and they all call the flip of a coin. If they call correctly, they win a dollar from those who called wrong. Each day the losers drop out, and on the subsequent day the stakes build as all previous winnings are put on the line. After ten flips on ten mornings, there will be approximately 220,000 people in the United States who have correctly called ten flips in a row. They each will have won a little over $1,000. Now this group will probably start getting a little puffed up about this, human nature being what it is. They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping. Assuming that the winners are getting the appropriate rewards from the losers, in another ten days we will have 215 people who have successfully called their coin flips 20 times in a row and who, by this exercise, each have turned one dollar into a little over $1 million. $225 million would have been lost, $225 million would have been won. By then, this group will really lose their heads. They will probably write books on “How I turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning.” Worse yet, they’ll probably start jetting around the country attending seminars on efficient coin-flipping and tackling skeptical professors with, “If it can’t be done, why are there 215 of us?’ By then some business school professor will probably be rude enough to bring up the fact that if 225 million orangutans had engaged in a similar exercise, the results would be much the same — 215 egotistical orangutans with 20 straight winning flips.

The Superinvestors of Graham-and-Doddsville [COLUMBIA BUSINESS](https://www8.gsb.columbia.edu/articles/columbia-business), [Warren Buffett](https://www8.gsb.columbia.edu/articles/authors/warren-buffett), May 17, 1984

https://www8.gsb.columbia.edu/articles/columbia-business/superinvestors. [↑](#footnote-ref-31)
31. Whether markets reflect randomness or a Chaotic System is irrelevant to the retail broker and his client. “Random behavior is non-deterministic: even if you knew everything that can be known about a system at a given time in perfect detail, you would still not be able to predict the state at a future time. Chaotic behavior on the other hand is fully deterministic *if* you know the initial state in perfect detail, but any imprecision in the initial state, no matter how small, grows quickly (exponentially) with time.” <https://www.quora.com/Chaos-Theory-What-is-the-difference-between-chaotic-behavior-and-random-behavior> (last viewed May 28, 2020). [↑](#footnote-ref-32)
32. Rolf Dobelli, *The Overconfidence Effect*, <https://www.psychologytoday.com/intl/blog/the-art-thinking-clearly/201306/the-overconfidence-effect> (last viewed May 28, 2020) [↑](#footnote-ref-33)
33. James Chen, *Hindsight Bias*, Updated Mar 19, 2018 <https://www.investopedia.com/terms/h/hindsight-bias.asp> (last viewed May 28, 2020). [↑](#footnote-ref-34)
34. Section 3.1 of the Series 7 Exam description by FINRA titled Provides customers with information about investment strategies, risks and rewards, and communicates relevant market, investment and research data to customers states “Portfolio or account analysis and its application to security selection (*e.g.*, diversification, asset allocation principles, concentration, volatility, potential tax ramifications) Portfolio theory (*e.g*., alpha and beta considerations, Capital Asset Pricing Model (CAPM )), https://www.finra.org/sites/default/files/Series\_7\_Content\_Outline.pdf. [↑](#footnote-ref-35)
35. Regulation Best Interest, Exchange Act Release No. 34-86031, 84 SEC Docket 134, (July 12, 2019). [↑](#footnote-ref-36)
36. *Id*. at 33318. [↑](#footnote-ref-37)
37. *Id.* at 33318. [↑](#footnote-ref-38)
38. *Id.* at 33400. [↑](#footnote-ref-39)
39. *Id*. at 33318. [↑](#footnote-ref-40)
40. *Id*. at 33319. [↑](#footnote-ref-41)
41. *Id*. at 33318. [↑](#footnote-ref-42)
42. *Id.* [↑](#footnote-ref-43)
43. *Id*. [↑](#footnote-ref-44)
44. *Id*. at 33321. [↑](#footnote-ref-45)
45. *Id*. [↑](#footnote-ref-46)
46. *Id.* [↑](#footnote-ref-47)
47. *Id*. [↑](#footnote-ref-48)
48. *Id.*  [↑](#footnote-ref-49)
49. *Id.* [↑](#footnote-ref-50)
50. *Id.* [↑](#footnote-ref-51)
51. *Id.*  [↑](#footnote-ref-52)
52. *Id.* [↑](#footnote-ref-53)
53. *Id.*  [↑](#footnote-ref-54)
54. *Id.* [↑](#footnote-ref-55)
55. *Id.* [↑](#footnote-ref-56)
56. *Id.* [↑](#footnote-ref-57)
57. *Id.*  [↑](#footnote-ref-58)
58. *Id.* [↑](#footnote-ref-59)
59. *Id*. at 33492. [↑](#footnote-ref-60)
60. *Id.* [↑](#footnote-ref-61)
61. *Id.* [↑](#footnote-ref-62)
62. *Id.* at 33320. [↑](#footnote-ref-63)
63. *Id.* at 33331. [↑](#footnote-ref-64)
64. *Id.* at 33336. [↑](#footnote-ref-65)
65. *Id.* [↑](#footnote-ref-66)
66. *Id*. at 33321. [↑](#footnote-ref-67)
67. *Id.* at 33322. [↑](#footnote-ref-68)
68. *Id.* at 33323. [↑](#footnote-ref-69)
69. *Id*. at 33318. [↑](#footnote-ref-70)