CFA Consumer Federation of America

The SEC's "Best Interest" Bait and Switch

The SEC and its Broker Industry Allies Claim Reg BI Strengthens Investor Protections; It Doesn't. That's Why Industry Supports It.

Taking a page out of the Trump Administration playbook, the Securities and Exchange Commission (SEC) is scheduled to finalize a regulatory package June 5th that sounds like it's designed to "enhance protections" for Mr. and Ms. 401(k), but doesn't. In reality this cynically labeled "best interest" standard is a craven giveaway to Wall Street, according to CFA Director of Investor Protection Barbara Roper and Financial Services Counsel Micah Hauptman.

Instead of strengthening protections for investors, it will preserve and protect broker-dealers' ability to rip off their clients, water down the standard that applies to investment advisers, and abandon investors to sort out the differences between brokers and advisers based on confusing and misleading disclosures.

That's why the chief supporters of this rulemaking are not the investors who want and need to be protected against conflicted investment advice, or state securities regulators who are the front line on retail investor protections, or fiduciary advisers who have long embraced a higher standard, but the broker-dealers that make tens of billions of dollars annually steering investors into high-cost, risky investments that are highly profitable for the firm, rather than those that are best for the investor.

A comparison of SEC Chairman Jay Clayton's trumped-up claims about the rule's supposed benefits with the actual rule text makes it clear that the regulatory package is in brokers' best interest, not investors'.

Chairman Clayton's Trumped-Up Claim	Reality…
Regulation "Best Interest" imposes a new "best interest" standard on brokers that is significantly higher than the suitability standard that currently governs brokers' sales recommendations.	FINRA rules, at least on paper, already require brokers' recommendations to be "consistent with their customers' best interests" and Reg BI doesn't raise that standard. 1) Footnote 7 of the proposing release states that many of Reg BI's requirements "reflect obligations that already exist under the FINRA suitability rule or have been articulated in related FINRA interpretations and case law," including the "requirement to make recommendations that are 'consistent with his customers' best interest.'"

	2) The SEC has failed to provide a single example of a practice that is permitted under existing FINRA suitability rules that would be impermissible under Reg BI. The examples it has provided – such as requiring brokers to recommend the lower cost share class of two otherwise identical securities or the fact that the best interest standard can't be satisfied through disclosure – reflects current FINRA practice. 3) The brokerage industry that now echoes the Chairman's misleading claim that best interest is a much higher standard than suitability previously pointed to FINRA suitability and related case law to support the proposition that "broker-dealers already have an obligation to act in a customer's best interest" and that the "existing suitability standard is a highly effective best interest standard of conduct" that is "tailored to the broker-dealer business model."
Chairman Clayton's Trumped-Up Claim Under Reg BI, brokers will be required to act in their customers' best interests.	**Reality…** The "best interest" standard doesn't require brokers to recommend the investments they reasonably believe are the best match for the investor from among the reasonably available options. Most investors reasonably believe that's what a "best interest" standard requires. As a result, this will defeat investors' legitimate expectations.
Chairman Clayton's Trumped-Up Claim Under Reg BI's "best interest" standard, brokers will be prohibited from placing their own interests ahead of their customers' interests.	**Reality…** Brokers can fully comply with the standard by satisfying its care, conflict, and disclosure obligations. The requirement that brokers not place their interests ahead of their customers' interests doesn't even make it into this compliance safe harbor. As a result, this "requirement" is unenforceable.
Chairman Clayton's Trumped-Up Claim The rule's conflict obligations – which require firms to adopt and enforcement policies and procedures to "mitigate" financial conflicts of interest – will offer strong new protections against the most harmful conflicts.	**Reality…** The rule's requirements, as described in the proposing Release, are not adequate to prevent conflicts of interest from tainting brokers' recommendations.

	1) The rule's conflict obligations don't prohibit firms from creating incentives that encourage and reward advice that is not in customers' best interests. 2) 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. 3) FINRA Rule 3110 already requires broker-dealers to adopt policies and procedures reasonably designed to prevent violations of securities laws and FINRA rules, including FINRA suitability rules. It is not clear to what extent Reg BI's conflict mitigation requirements will exceed that existing obligation. 4) The SEC has failed to provide any examples of conflicts that are permissible under FINRA rules that would be impermissible under Reg BI. The one example it has offered – cracking down on product-specific sales contests – is already largely addressed under FINRA rules, which generally ban such contests with regard to the sale of mutual funds, variable annuities, and direct participation programs, such as non-traded REITs.
Chairman Clayton's Trumped-Up Claim Reg BI would require brokers to give greater consideration to costs when determining which investments to recommend.	**Reality…** Reg BI applies this obligation to consider costs in only the narrowest of circumstances, when a broker chooses between "otherwise identical" securities, in other words between different share classes of the same mutual fund. 1) FINRA already enforces this standard with regard to share class recommendations. For example, in the early 2000s, FINRA brought several enforcement actions for inappropriate sales of B share mutual funds. More recently, FINRA announced it was targeting inappropriate share class sales in the 529 context.

	2) Reg BI does not require brokers to consider costs when determining what investment strategies or types of investments to recommend. As a result, brokers will remain free to recommend higher cost investments when better, lower cost alternatives are available. For example, the rule would not stop a broker from recommending a large cap mutual fund that costs more for the investor and pays the broker significantly more when a lower cost, higher performing large cap mutual fund is available. Similarly, the rule would not stop a broker from recommending a much more expensive variable annuity that pays the broker significantly more when the investor could achieve the same investment goal at a lower cost and with greater liquidity through a portfolio of low-cost mutual funds.
Chairman Clayton's Trumped-Up Claim Brokers are advisers who just happen to charge for their advice on a "pay as you go" basis.	**Reality…** In their 5th Circuit challenge to the Department of Labor fiduciary rule, brokers insisted that they are merely salespeople engaged in arm's length commercial sales transactions, no different from car dealers who solicit interest in their inventory. If the industry's court argument was valid, then the SEC is helping to mislead investors about the nature of those services. If the SEC's characterization is the correct one, than the Commission has an obligation to consider whether brokers can legitimately claim that their advice is solely incidental to product sales for the purposes of determining their regulatory status. The SEC never conducted that analysis.
Chairman Clayton's Trumped-Up Claim The SEC's interpretation that the Investment Advisers Act fiduciary duty can be fully satisfied by disclosure alone represents the full extent of the SEC's authority.	**Reality…** Congress gave the SEC all the authority it needs in Section 913(g) of the Dodd-Frank Act to hold both investment advisers and brokers to a true best interest standard backed by tough restrictions on conflicts of interest.

	1) Dodd-Frank authorizes the SEC to adopt an explicit obligation for investment advisers and broker-dealers alike to act in the best interests of their customers, without regard to their own conflicting interests. 2) Dodd-Frank specifically directs the SEC to examine conflicts of interest present in both broker-dealers and investment advisers and authorizes the agency to adopt rules banning or limiting practices that are not in the public interest. 3) The SEC made a deliberate and conscious choice to ignore that authority to adopt new rules for advisers and instead adopt the weakest possible interpretation of its existing authority.
Chairman Clayton's Trumped-Up Claim The new Customer Relationship Summary (Form CRS) will enable investors to choose the type of relationship and account that is best for them.	**Reality…** A wealth of investor testing, including testing commissioned by the SEC and conducted by the RAND Corporation, clearly shows that investors don't understand the most basic aspects of Form CRS and are therefore unable to make an informed decision. 1) Investors didn't understand basic differences in the nature of services offered by brokers and advisers, let alone important information about their conflicts of interest and legal obligations. 2) The SEC is expected to extensively revise the required disclosures but without doing any additional testing to ensure that the disclosures serve their intended function. 3) If, as industry has requested, the SEC gives firms greater "flexibility" to develop and design their own disclosure documents, this will both undermine comparability and make it easier for firms to characterize their services in ways that are most beneficial to them, decreasing the likelihood that investors will be adequately alerted to risks related to harmful conflicts.

Chairman Clayton’s Trumped-Up Claim	Reality…
The proposal is based on an exhaustive and highly credible economic analysis.	The SEC has failed to identify a market failure that its rules are intended to address, let alone carefully analyze evidence and causes of investor harm. In particular, it has failed to consider the many and varied harms that can result from conflicted investment advice or how the proposal would adequately address those harms, to investors’ benefit. In what is, to our knowledge, an unprecedented act, 11 former senior SEC economists wrote to the Commission to voice the concern that it has failed to meet even the most basic of standards for credible economic analysis, leading them to speculate that the rule was intended to solve a political problem, not a serious attempt at addressing a market failure.