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REGULATION "BEST INTEREST'S" REDUCTION OF

CONSUMER ACCESS TO INVESTMENT ADVICE

Justin Deffenbacher

I. INTRODUCTION

The United States Securities and Exchange Commission's ("SEC") release of Regulation Best Interest (Reg BI) was promulgated to enhance the protections afforded to retail investors. Aptly named, Reg BI requires broker-dealers to act in the "best interest" of their retail customers: natural persons acting for their own account rather than for commercial purposes.[1] The best interest objective is achieved through four more specific obligations: the Disclosure Obligation, the Care Obligation, the Conflict Obligation, and the Compliance Obligation.

To better facilitate Reg BI, the SEC adopted another rule requiring that advisers send a "Client Relationship Summary" to both their retail customers and the SEC.[2] This summary helps the SEC determine whether advice given is "solely incidental" to a transaction, which is the standard by which broker-dealers must adhere to avoid violating the regulation.

Due to an overly cumbersome reporting standard, conflict with statutes and common law rulings that protect retail investment clients, and vague guidance, Reg BI has created an environment where brokers are rapidly exiting the investment advice business. Retail investment clients, who were meant to be protected by Regulation BI now face limited options for brokerage, signaling that Reg BI is entirely

[1] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 C.F.R. § 240 (2019).
[2] Securities and Exchange Commission, Form CRS Relationship Summary; Amendments to Form ADV, 17 C.F.R §§ 200, 240, 249, 275, and 279 (2019).

incompatible with the incidental investment advice model that had been a hallmark of full-service brokerage. [3]

The high level of attention and reporting required of broker dealers, overly encumbers interactions with retail investors. With most retail investors trading only occasionally and in small dollar amounts, broker traders are unable to provide individualized attention. The SEC has even acknowledged this issue in its adopting release of Reg BI.[4] Three specific areas drastically reduce access to investment advising services: (1) dramatic cost increases for broker-dealers, which are pushing them out of the full service business, (2) conflicts with state and federal regulation, causing confusion and a complete desire to avoid interacting with "best interest" standards, and (3) vague guidance regarding the threshold for what constitutes a "recommendation."

II. SEC INVESTOR PROTECTION OVERVIEW

With many investors lacking the time or understanding to make their own investment decisions, the broker-dealer or advisor is the trusted source for investment strategy. Once dominated by the wealthiest segment of the population, more and more individuals are turning to the markets to protect their futures, cover education costs, and finance major purchases.[5] This growth has caused the SEC to prioritize investor protection by enacting new market regulations.

One could rationally assume that these inexperienced market participants enter with an expectation that brokers will follow through on the claims they make and that brokers will act in participants' best interest.[6] Furthermore, given that broker-client relationships are long-term, that client could expect their interest to be protected in all future transactions rather than just the first purchases made.

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[3] Jill I. Gross, *Position Paper on the SEC's Proposed Regulation Best Interest,* New York City Bar Center for Continuing Legal Education, 20190521A NYCBAR 58 (May 21, 2019).

[4] *Choose One: Best Interest or Full Service*, CADWALADER (Apr. 26, 2018), https://www.cadwalader.com/resources/clients-friends-memos/choose-one-best-interest-or-full-service (last visited Sept. 12, 2019).

[5] *SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals*, SEC, (June 5, 2018), https://www.sec.gov/news/press-release/2019-89 (last visited Nov. 24, 2019).

[6] Heather Slavkin Corzo et al., *Comment Letter on Regulation Best Interest,* SEC, (Apr. 26, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5417927-184568.pdf (last visited Sep 12, 2019).

These expectations coupled with very few transactions being conflict-free have created a space that the SEC views as reparable only by market regulation. The conflict-of-interest problem is further exacerbated in the broker-dealer relationship as they act on behalf of their clients.

Broker Dealers vs. Advisers

The distinction between broker-dealers, executors of trades, advisors, and analysts certified to provide investment advice, has blurred in the last decade due to changes in the broker-dealer model.[7] With brokers starting to make inroads into the advisement business, Reg BI clearly delineates the limited advisement role they can play. Brokers are now restricted in using the term adviser or advisor unless they are appropriately registered.[8] This has not stopped conflicts of interest from proliferating to both business models due to the fact both brokers and advisors are paid on a commission basis, which seemingly doesn't coincide with investors' best interest. Advocacy groups such as the Consumer Federation of America have pushed the SEC to clarify the broker-dealer/advisor division by drafting guidance or writing a new exclusion for broker-dealers under the Adviser's Act ("the Act").[9]

This Act is the foundation of financial adviser duties, carving out a specific role that excludes brokers. Under this rule, advisors adhere to a fiduciary duty, which "includes an affirmative duty of utmost good faith and full and fair disclosure of all material facts."[10] With the release of Reg BI, advisors now hold a clear competitive advantage. They do not face the same stringent guidelines as brokers, such as not being required to avoid conflicts of interest or remaining free to recommend investments that pay them more if these practices are disclosed.[11] To remedy this new regulatory advantage, the SEC does have the potential to create a best interest standard applicable to both brokers and advisors under Dodd-Frank.[12]

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[7] Letter from Roper to SEC Secretary Jonathan G. Katz, Certain Broker-Dealers Deemed Not to Be Investment Advisers, CFA (Feb. 7, 2005), https://bit.ly/2ISPTer, at 8-11.

[8] Corzo et al., *supra* note 6.

[9] *Id.*

[10] *Transamerica Mortg. Advisors, Inc. v. Lewis,* 444 U.S. 11, 17 (1979) (stating that "§ 206 [of the Advisers Act] establishes 'federal fiduciary standards' to govern the conduct of investment advisers").

[11] Corzo et al., *supra* note 6.

[12] *Id.*

III. RULE 15*L*-1 AKA REGULATION BEST INTEREST

On June 5, the SEC announced the release of Reg BI after lengthy consideration. The goal was to develop standards based on what investors would reasonably expect from investment professionals, while preserving access to a variety of investment services and products. [13] The regulation, which is only three pages in length, is accompanied by an adopting release and guidance that is over 700 pages in total.

Throughout the release the SEC reiterates that the general obligation of Reg BI was not to require brokers to make conflict-free recommendations, but to create an incentive for brokers to put their customers' interests ahead of their own. While a broker can recommend products that involve higher risks or costs, it will have to satisfy at a minimum four specific obligations.

I. The Disclosure Obligation

Before or concurrent with retail investor recommendations, broker dealers must provide a written report of all "material facts" and conflicts as to its' relationship with the customer. The standard for "material fact" is whether there is "a substantial likelihood that a reasonable retail investor would consider [the information] important."[14] For example, the benefit that a broker received in a transaction would qualify as a material fact.

The written report must include (i) disclosure that the firm is acting as a broker-dealer (and not as an investment adviser); (ii) the material costs to the Retail Customer; (iii) the type and scope of services that the Retail Customer will be provided, including any "material limitations" involving the securities or investment strategies that may be recommended to the Retail Customer; and (iv) all material facts relating to conflicts of interest that are associated with a recommendation.[15] Supplemental oral disclosures are allowed as long as they are subsequently added to the written record.

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[13] Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals (June 5, 2019).

[14] Bradley Berman, Anna Pinedo & Michael Russo, *Regulation Best Interest*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION 1, 9 (2019).

[15] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or

As brokers move forward in the compliance process, disclosure obligations will largely dictate which recommendations they will make. For instance, a firm may choose to limit its recommendations to exchange-traded options or investment grade debt based on the required disclosures.

II. The Care Obligation

In recommending a transaction a broker must act with reasonable "diligence, care, and skill."[16] To fulfill this obligation a broker must have a proper understanding of the risks associated with the recommendation, have a "reasonable basis" for determining that it was in the best interest of a customer, and finally a belief that the transaction was not excessive.[17] Whether customer information provides a reasonable basis will be determined by the circumstances surrounding the transaction.

Effectively the care obligation fulfills the requirements of FINRA's suitability rule but goes a step beyond by requiring that brokers exercise "prudence," thereby indicating a preference for conservative recommendations. The adopting release highlights the importance of this obligation in "complex or risky" transactions, in which the broker's knowledge of a product is essential to establish a proper basis for a recommendation.[18]

III. The Conflict Obligation

In the lifetime of a transaction, it is likely that an experienced broker will have some conflict of interest. Under Reg BI, a broker must establish, maintain, and enforce procedures to disclose and mitigate "material facts" related to conflicts of interest.[19] Reg BI defines these conflicts as "an interest that might incline a person . . . consciously or unconsciously . . . to make a recommendation that is not disinterested."[20]

Titles, 84 Fed. Reg. 33492 (proposed July 12, 2019) (to be codified at 17 C.F.R. pts. 240, 249, 275, 279).

[16] Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals (June 5, 2019).

[17] *Id.*

[18] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 C.F.R. § 240.151–1 (2019).

[19] *Id.* at 1.

[20] *Id.* at 36.

Firms must monitor and mitigate all conflicts that create the potential for a broker's interest to supersede a customer's interest. For example, a firm that has proprietary products must refrain from exclusively or primarily offering those products unless they are truly in the best interest of the customer.

Sales contests, quotas, bonuses, and other compensation for the sale of specified products were initially outlawed due to their impact on broker impartiality.[21] However since its initial release, the SEC has modified and relaxed restrictions on financial incentives to maintain existing product choices for retail customers. The elimination of transaction-based compensation was also discontinued. Moreover, the adopting release states: "[w]e continue to believe that where a broker-dealer cannot fully and fairly disclose a conflict of interest in accordance with the Disclosure Obligation, the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure in accordance with the Disclosure Obligation is possible."[22]

IV. The Compliance Obligation

The final and simplest obligation under Reg BI, the compliance obligation, is satisfied by establishing, maintaining, and enforcing written policies and procedures that comply with the other obligations. The final compliance date is set for June 30, 2020.

IV. INVESTMENT ADVICE PROCEDURES

I. Retail Customers and Recommendations

The main objective of Reg BI is to protect the average investor: Mr. or Mrs. 401(k). To do that, the regulation defined an average investor more clearly with the term "retail customer." This retail customer is a natural person (or the legal representative of such natural person) acting for his or her own account who receives a recommendation regarding investment strategy and uses it for personal purposes only.[23]

If an individual acts through a legal representative that representative cannot qualify as a professional, which therefore means that regulated financial services industry professionals retained by

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[21] *Id.* at 16.

[22] *Id.*

[23] *Id.* at 108.

customers do not meet the Reg BI standard. This broad definition is designed to encompass a range of retail services such as retirement accounts, in which an individual receiving a recommendation on how to invest funds into a 401(k) plan would be considered a "retail customer."

Furthermore, a recommendation follows an entire transaction. Implicit recommendations to hold stock do not result in a transaction, but still impact a customer's decision making. Rather than develop a concurrent on separate definition of "recommendation," the SEC relied on FINRA guidance to avoid confusion.[24]

In the adopting release, the SEC gave few specifics beyond a referral to the FINRA definition. However, the release did provide examples of items that would not constitute a recommendation, which included general financial and investment information, descriptive information about a retirement plan, certain asset allocation models, and interactive investment materials.[25] The SEC addressed this lack of specificity, reasoning that "what constitutes a recommendation is highly fact-specific and not conducive to an express definition in the rule text," and that "being more prescriptive could result in a definition that is over inclusive, under inclusive, or both."[26]

II. The Client Relationship Survey

To facilitate the disclosures that Reg BI requires, the SEC released a sister regulation, Rule 17a-14 (Form CRS) under the Exchange Act.[27] Under this regulation, brokers are required to provide retail investors with a Client Relationship Summary (CRS). The CRS is an overview of the services provided by the firm and the standard of conduct associated with those services. The main objectives of the summary are to simplify comparisons between different types of financial firms and improve financial literacy among investors. Delivery of this summary is required before or concurrent with an advisory agreement. Redelivery will occur every time an appreciable change is made to an account, or a new account is opened. [28]

Since CRSs would not be disclosed until May 1, 2020, the SEC's investment advisory committee has pushed for the disclosures

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[24] *Id.* at 80.
[25] *Id.* at 88.
[26] *Id.* at 81.
[27] *Id.* at 122.
[28] Form CRS Relationship Summary, File No. S7-08-18, SEC (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/34-83063.pdf

to undergo usability testing to determine their effectiveness.[29] If disclosures are found to not achieve their intended purpose of reducing investor confusion, the SEC will rectify such shortcomings before a final Form CRS is released.

V. IMPACT ON FULL-SERVICE BROKERAGE

I. Associated Costs Pushing Broker Dealers Out of the Full-Service Business

The creation of the "best interest" standard requires every broker to provide detailed attention and oversight for every recommendation made, even when incidental. This level of consideration coupled with the facts that retail investors trade infrequently and in low denominations has made it financially infeasible for brokers to stay in the advising business without inflating compensation.[30] Investors will either need to shell out additional funds for advisor services, often at a greater expense than worthwhile, or go without the attention received in the unregulated market.

In its drafting, the SEC prioritized the preservation "to the extent possible, [of] retail investors access, in terms of choice and cost, to differing types of investment services."[31] However the standard has been virtually incompatible with the full-service brokerage model and the incidental investment advice that is associated with it. To understand the full extent of a retail customer's "risk profile," would require funds well beyond the commission earned on a ten-to-twenty-thousand-dollar investment. Analysis by the law firm Cadwalader, Wickersham & Taft explained the situation simply, stating: "Suppose you go into a restaurant and ask the waiter "what's good?" It's one thing to recommend what is good on the menu, but it's another thing if the waiter is required to know your health profile before making a recommendation."[32]

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[29] SEC, Recommendation of the Investor Advisory Committee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance 1,8 (2018).
[30] D. Bruce Johnsen, *A Transaction Cost Assessment of SEC Regulation Best Interest*, 2018 Colum. Bus. L. Rev. 695 (2018).
[31] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 C.F.R. § 240 (2019) at 18.
[32] Steven Lofchie et al., *SEC Adopts Regulation Best Interest*, THE NAT'L L. REV. (2019), https://www.natlawreview.com/article/sec-adopts-regulation-best-interest (last visited Sep 13, 2019).

SEC Commissioners continue to be concerned about investors being cut off from advice. In an interview nearly two months after the final release of Reg BI, Commissioner Hester Peirce said, "at a minimum, their costs of obtaining such assistance might rise markedly. Although we tried to be cognizant of these access concerns, given the relative balance of the two standards, I fear that more and more broker-dealers will decide to become advisers that offer only fee-based accounts."[33]

The brokerage industry is no stranger to regulations that dampen investor access. Before the implementation of Reg BI, the Department of Labor (DOL) conducted its own inquiry into adopting a fiduciary standard for brokers. The fiduciary study conducted by SIFMA and the DOL, revealed that 53% of firms eliminated or reduced access to brokerage advice services and 67% migrated away from open choice to fee-based services.[34] SEC Commissioner Jay Clayton was so concerned about the DOL regulation that he pushed through the adoption of Reg BI, despite the fact that he admitted Reg BI discouraged full service brokerage.[35] The adopting release echoed this sentiment: "Our concerns about the ramifications for investor access, choice, and cost are not theoretical... With the adoption of the now vacated [Department of Labor] 'Fiduciary Rule,' there was a significant reduction in retail access to brokerage services, and we believe that the available alternative services were high priced in many circumstances."[36]

II. Redundancy with State and National Regulation Causing Investor Confusion

The adoption of Reg BI was supported by additional calls to eliminate investor confusion regarding the requisite standard of care for broker-dealers providing investment advice. Before the adoption of Reg BI, it was often believed that brokers were already mandated to act in a customer's best interest. However, federal law only required

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[33] SEC member says broker standard could shut out Americans from advice, 2018 WL 3616968

[34] Lofchie, et al., *supra* note 32,at 5.

[35] Jay Clayton, *Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors*, SEC (June 5, 2019), https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd (last visited Sept. 15, 2019).

[36] *Id.*

broker recommendations to be "suitable" for investor goals.[37] This meant that a broker was able to sell a product to a retail customer that resulted in a higher commission and lower performance as long as it met the customer's investment objectives.

Investment Advisors, on the other hand, have long been subject to a fiduciary standard, requiring them to put their client's interest ahead of their own by recommending suitable investments and disclosing conflicts of interest.[38] This standard was met through duties of loyalty and care.

The varied standards that financial professionals owed to their clients spurred Congress to act. The 2010 Dodd-Frank Act authorized the SEC to clear up discrepancies by imposing a uniform fiduciary duty on both advisors and brokers.[39] However, despite these efforts, investor confusion has remained a prominent fixture in choosing a financial professional. The states, judiciary, and federal regulators have all made strides to establish their own investor protection guidelines. These disconnected guidelines have resulted in an overlapping and complex regulatory scheme.

Interaction with Reg BI has only complicated matters, making it nearly impossible for brokers to correctly comply. It is reasonable to expect a large increase in litigation as investors test the bounds of the conglomeration of case law and regulation on a state-by-state basis.

III. State Action

Due to low levels of financial literacy and heightened dependence on brokers for access to the markets, states have already begun stepping in to protect investors through the creation of a fiduciary duty for brokers, specifically including a duty to monitor accounts.[40] These standards exist on a state-by-state basis and conflict with Reg BI as

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[37] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Federal Register (2019) at 33332, https://www.federalregister.gov/d/2019-12164 (last visited Sept. 16, 2019).

[38] The Investment Advisers Act of 1940, 15 U.S.C. § 80b-1-21 (1940).

[39] Recommendation of the Investor Advisory Committee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance at 7, https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-on-proposed-reg-bi.pdf.

[40] U.S. Chamber Staff, *Quick Take: Your Primer on SEC's Best Interest Regulations*, Center for Capital Markets Competitiveness (last updated June 10, 2019), https://www.centerforcapitalmarkets.com/quick-take-your-primer-on-secs-best-interest-regulations/

well as other states. The inherent inconsistency creates an investment environment that both brokers and advisers cannot navigate.

The patchwork of regulation has increased confusion, compliance burdens and investor risk, as well as reduced access for small account customers. The Center for Capital Market Competitiveness addressed this issue in a comment letter to the SEC noting, "such a patchwork of conflicting standards will run counter to the reasoned judgments and determinations that the SEC makes in adopting its final rules."[41]

Nevada and New Jersey are the first states to release uniform fiduciary standards for both brokers and advisors. Neither regulation is expressly permitted by federal securities law, going a step beyond what is allowed by anti-fraud statutes and the National Securities Markets Improvement Act of 1996 (NSMIA).[42] NSMIA was enacted specifically to preempt regulatory requirements imposed by states on SEC registered broker and advisors, except for regulation relating to anti-fraud prohibitions.[43] Instead, these new regulations attempt to supersede SEC regulation through comprehensive record keeping requirements and compliance standards.

The newest fiduciary regulation proposal comes from Nevada where a fiduciary duty for brokers and investment advisors is imminent. Section 10.6 of the proposal aims to comply with federal preemption stating that it is to be "interpreted and applied in harmony with NSMIA."[44] However, by instituting a new standard of care, Nevada surpasses its authority under NSMIA as fraud is already prohibited no matter the standard in use.

The Nevada proposal would require record keeping requirements well beyond what is expected under Reg BI. Furthermore, companies will have to purchase insurance and professional responsibility coverage to comply.[45] Virtually all recommendations fall under the Nevada proposal, resulting in an obligation to monitor and advise clients perpetually. For example, a one-time recommendation made by a broker would require a full risk workup of the client, ongoing monitoring of that client, and an analysis of how the recommendation

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[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*

impacted the client. [46] Even when a broker dealer is not subject to the proposal, they are required to maintain records indicating why they are exempt as noted in Section 9.[47]

Meanwhile in April 2019, New Jersey's Bureau of Securities released its own proposal to establish a uniform fiduciary duty. The issues with New Jersey's proposal are the same as those for Nevada, as captured by the following comment: "should the SEC adopt Regulation Best Interest, the Bureau's proposed new rule will exceed this standard."[48]

IV. Common Law Rulings

The lack of clarity has led the courts to make their own inferences about advisor and broker duties. Courts already recognize that a broker and advisor making recommendations to a customer have enhanced obligations including acting in the customer's best interest and giving ongoing advice. Furthermore, a fiduciary duty is applied under existing case law in the typical broker relationship. While customers may not explicitly grant the discretion needed for a fiduciary relationship, courts find that brokers have implicit control. Conflict will likely arise when a court must decide whether a particular broker owes its customer an ongoing duty. It is reasonable to assume that the SEC standard should take precedent; however, Reg BI often fails to apply a fiduciary duty in most circumstances where case law would.

The controlling case on broker obligations under common law is *Leib v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.* In *Leib,* the U.S. District Court for the Eastern District of Michigan held that discretion is the single most important factor in determining if a broker owes a fiduciary duty to their client.[49] Additionally, the court found that regardless of a fiduciary relationship, a broker owes his client six specific duties: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial

[46] *Fiduciary Duty of broker-dealer and sales representatives (NRS 90.575)*, NVSOS, https://www.nvsos.gov/sos/home/showdocument?id=6156 (Last visited 16 Sep. 2019).
[47] *Id.*
[48] Tom Quaadman, *Comment on Regulation Best Interest,* SEC (May 16, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5528937-185232.pdf
[49] *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 461 F. Supp. 951 (E.D. Mich. 1978), (E.D. Mich. held that discretion is the single most important factor in determining if a broker owes a fiduciary duty to their client), *aff'd,* 647 F.2d 165 (6th Cir. 1981).

prognosis ...; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests ...; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security ...; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security ...; (5) the duty not to misrepresent any fact material to the transaction ...; and (6) the duty to transact business only after receiving prior authorization from the customer.[50]

More recently, the U.S. Court of Appeals for the Second Circuit found that a broker may owe a duty to a client that is broader than purely transactional in certain special circumstances.[51] These special circumstances include those in which individuals have closer "than arms-length" relationships with their broker and are enumerated to prevent brokers from taking unfair advantage of a customer's incapacity or simplicity.[52]

V. FINRA "Suitability"

Before the introduction of Reg BI, the Financial Industry Regulatory Authority (FINRA) held brokers accountable. FINRA managed broker duties through its "Suitability Standard," much of which overlaps with Reg BI.[53] In fact, the SEC acknowledges the Suitability Standard in Reg BI by stating its intention to codify rather than enhance FINRA's standards.[54] Furthermore, the same terminology and obligations have been used throughout regulations released by not only FINRA and the SEC, but also the Department of Labor.[55]

The only appreciable difference between the two regulations is that Reg BI requires the broker, advisor, and their associates to narrow investment options beyond what is suitable to the most favorable.[56] However unlike the suitability standard, Reg BI fails to define how narrow these recommendations should be. Beyond that, the SEC has failed to provide other concrete examples of how Reg BI is a logical next step, rather than a confusing addition to the regulatory landscape. In fact, FINRA already requires many of the duties touted in the release

[50] *Id.*
[51] *See* Gross, *supra* note 3.
[52] *Id.*
[53] FINRA, Rule 2111 (2019).
[54] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Final Rule, 17 CFR 240 p. 33319 (July 12, 2019).
[55] *Leib,* 647 F.2d at 165.
[56] Johnsen, *supra* note 30, at 739.

of REG BI, such as the duty to weigh costs in transaction recommendations.[57]

VI. Vague Guidance on "Recommendations"

The determination of what qualifies as a recommendation has usually been based on the circumstances of a particular case. FINRA has refused to define the term recommendation in past releases, calling it "unnecessary" and stating that "it would raise many complex issues."[58] For the suitability standard, it went only as far to define it as a "transaction when the member brings a specific security to the attention of the customer through any means."[59] The SEC deferred to this definition in its release of Reg BI, but failed to specify many other areas where a recommendation might occur. For example, the regulation does not address whether a recommendation to open an account or to separate assets between a brokerage and advisory firm falls under the purview of Reg BI. More importantly, it is difficult to determine if the FINRA definition would apply to every single mention of a security to a client, even those that occur in passing.

VI. A NEW DIRECTION

While Reg BI concedes that the advice-providing broker exists, the question remains if it's stringent requirements will leave brokers in a bind, whether they must charge extra commission to comply. As it

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[57] *See, e.g.,* Press Release, FINRA, FINRA Settles with Five Firms for Supervisory Failures, Improper Mutual Fund Sales to More than 5,300 Households; Tens of Millions of Dollars to be Returned to Customers, (February 28, 2008), https://www.finra.org/media-center/news-releases/2008/finra-settles-five-firms-supervisory-failures-improper-mutual-fund; NASD fines firms $19.4 Million for improper sales of Class B and C mutual fund shares, INVESTMENT EXECUTIVE (December 19, 2005), https://www.investmentexecutive.com/news/from-the-regulators/nasd-fines-firms-us19-4-million-for-improper-sales-of-class-b-and-c-mutual-fund-shares/; Jill Gregorie, FINRA Censures Voya Over Share Class Sales, Ignites, (April 25, 2019), https://www.ignites.com/c/2262013/277743/finra_censures_voya_over_share_class_sales?referrer_module=issueHeadline&module_order=2.

[58] FINRA, Regulatory Notice 11-02 (July 9, 2012), https://www.finra.org/rules-guidance/notices/11-02 (last visited Sep 16, 2019).

[59] NASD, Notice to Members 96-60, Clarification Of Members' Suitability Responsibilities Under NASD Rules With Special Emphasis On Member Activities In Speculative And Low-Priced Securities, (Sept. 1996), https://www.finra.org/sites/default/files/NoticeDocument/p016905.pdf (last visited Sep 16, 2019).

stands, the ever-expanding web of case law and regulations coupled with these increased costs smothers the viability of the incidental advice business. The easy but highly unlikely solution is to get the retail customer to buy in and believe that regulated brokerage services are worth it.

However, few customers will be financially able, let alone willing, to "chip in" for the costs of "best interest" compliance. Instead, the SEC should resort to more creative methods to achieve broker accountability, such as requiring detailed account statements that glimpse performance or subjecting brokers to binding arbitration. These tactics, as well as classic market mechanisms, including contracting out of a best interest standard, are likely to push contract terms towards equilibrium.[60] Jensen and Meckling support the private contracting mechanism as a superior alternative to mandatory regulations in averting market failures.[61] This is especially likely in broker and advisor relationships as an extremely competitive market dictates who manages investors' money. Many retail clients hold assets in both brokerage and advisory accounts and can easily shift money between them.[62]

What Reg BI truly fails to grasp is that when brokers capture value, they are not doing so at their client's expense. The advice provided to clients is only beneficial to brokers when it generates income for the client. As noted in a cost benefit analysis of Reg BI, the "problem, if one exists at all, is that the broker will have too little incentive to make informed recommendations."[63]

Alternatively, the SEC could simplify the varying standards for brokers and advisors to one fiduciary duty. Clarification that both groups are working under the same standard tailored to their particular business would eliminate confusion and end the debate over comparative advantages in the financial professional industry.[64]

Instead, the SEC has failed to empirically identify the benefits that would accrue to investors, even if a buy-in to Reg BI was to occur. Despite a lack of empirical proof and an overwhelming confusion over

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[60] Johnsen, *supra* note 30, at 734.

[61] Scott E. Masten, James W. Meehan, Jr. & Edward A. Snyder, *The Costs of Organization*, 7 J.L. ECON. & ORG. 1 (1991).

[62] Johnsen, *supra* note 30, at 735.

[63] *Id.* at 748.

[64] Recommendation of the Investor Advisory Committee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance (Nov. 7, 2018), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-on-proposed-reg-bi.pdf.

investment representative duties, the SEC continues to champion a standard that accomplishes essentially what its FINRA predecessor already did. It simply does not suffice for the SEC to argue that "any rule could promote efficiency and competition." The Commission must make a "plausible showing that the specific rule" will promote efficiency and competition relative to the current baseline.[65]

[65] *Am. Equity Inv. Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 178 (D.C. Cir. 2010).