The Implications of "Regulation Best Interest: The Broker-Dealer Standard of Conduct" in an Increasingly Regulated Industry

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I. INTRODUCTION TO "REG. BI"

The recently published SEC policy entitled "Regulation Best Interest: The Broker-Dealer Standard of Conduct" imposes—among other changes—a heightened standard of care upon broker-dealers, requiring all registered broker-dealers to act in the best interest of their clients when making a recommendation on any securities transaction or investment strategy involving securities.[1] This new standard sets a higher bar than the previous "suitability standard," although it does not yet seem to impose the higher "fiduciary standard" required of registered investment advisers.

To comply with the best-interest standard, which the SEC calls a "general obligation," a broker-dealer must satisfy four "component obligations," consisting of heightened obligations of disclosure, care, conflict of interest, and compliance.[2] The disclosure obligation requires broker-dealers to provide certain disclosures before or during a financial recommendation regarding the relationship between the broker-dealer and the client.[3] The care obligation requires the broker-dealer to "exercise reasonable diligence, care, and skill in making [a] recommendation."[4] The conflict of interest obligation requires broker-dealers to "establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest."[5] The compliance obligation requires broker-dealers to "establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest."[6]

This Note will critically discuss the consequences of the heightened regulation in an evolving system and propose steps toward clearer, less burdensome regulation on broker-dealers. This Note argues less burdensome regulation can reduce market costs for broker-dealers and consumers without sacrificing meaningful consumer protection. Part II of this Note will examine the historical regulation imposed on financial advisers and broker-dealers, as well as the impacts of the current regulatory system, concluding with an overview of the newly implemented regulation—Regulation Best Interest: The Broker-Dealer Standard of Conduct (Reg. BI). Part III will analyze the major changes Reg. BI brings by exploring the potential benefits and drawbacks of the additional layer of regulation. Part III will conclude by identifying and discussing specific criticisms voiced by two prominent lawsuits filed in opposition to Reg. BI. Part IV of this Note responds to the criticisms of Reg. BI by suggesting two amendments to Reg. BI designed to decrease unnecessary compliance costs while preserving robust levels of consumer protection.

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1. Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33318 (July 12, 2019) (codified at 17 C.F.R. pt. 240) [hereinafter *Regulation Best Interest*].
2. *Regulation Best Interest: A Small Entity Compliance Guide*, SEC, https://www.sec.gov/info/smallbus/secg/regulation-best-interest (Sept. 23, 2019) [https://perma.cc/QMR3-3GAV] [hereinafter *SEC Reg. BI Compliance Guide*].
3. *Id.*
4. *Regulation Best Interest*, *supra* note 1.
5. *Id.*
6. *Id.*

II. Financial Adviser Regulation Background

The term "financial adviser" is a broad one, and can encompass many different roles, but the term is generally used to describe "[a] person who is employed to provide financial services or guidance to clients."[7] Two important and distinct positions exist under the umbrella of the term financial adviser: broker-dealers ("BDs") and registered investment advisers ("RIAs"). For the purposes of this Note, a broker-dealer can be thought of as a person or company in the business of buying and selling securities, while an RIA can be thought of as a person or company who provides financial advising services such as portfolio management, financial planning, and investment advice.[8] An RIA is held to a fiduciary standard, and regulated under the SEC and the Investment Advisers Act of 1940, whereas a broker-dealer is held (only recently) to a best-interest standard, and regulated under the Financial Industry Regulatory Authority and the Securities Act of 1934.[9]

This Section will first examine the current and historical regulatory environment under which these two advisers operate, and then discuss further the differentiating characteristics of these two types of advisers. This Section will conclude with a detailed look at the newest piece of regulation in the financial adviser space, and the main topic of this Note: Reg. BI.

A. Timeline of Legislation

Since the passage of the 1933 Securities Act—in response to the stock market crash of 1929—the regulatory climate of financial advisers has grown increasingly large and complex.[10] Prior to this landmark legislation, there was relatively little meaningful regulation imposed on the trade of securities, and thus, very little regulation restricting those in the business of advising customers on the trading of securities.[11] Since 1929, several pieces of regulation and legislation were introduced to regulate the sale of securities, as well as the professionals working in the industry.[12] The implementation of the following regulations eventually formed the current system of regulation for investment advisers that is in place today.

1. The Securities Act of 1933

After the crash of the stock market in 1929, the Securities Act of 1933 (the 1933 Act) was

7. *Financial Adviser*, LEXICO, https://www.lexico.com/en/definition/financial_adviser [https://perma.cc/J8EJ-EDA6] (last visited Sept. 23, 2020).

8. *See Broker-Dealers vs. Registered Investment Advisers ('RIAs'): Which Is Which?*, NASDAQ (Jan. 16, 2019, 10:27 AM), https://www.nasdaq.com/articles/broker-dealers-vs-registered-investment-advisers-rias-which-which-2019-01-16 [https://perma.cc/2GBH-H4LW] (differentiating RIAs and BDs).

9. *See infra* Section II.B (describing the distinguishing characteristics between RIAs and BDs).

10. *See generally* Larry Bumgardner, *A Brief History of the 1930s Securities Laws in the United States—And the Potential Lesson for Today*, 4 J. GLOB. BUS. MGMT. 39 (2008) (examining the growth of regulation in the financial industry post-1929).

11. *Federal Securities Laws*, SEC (May 4, 2017), https://www.sec.gov/page/federal-securities-laws?auHash=B8gdTzu6DrpJNvsGlS1-JY1LnXDZQqS-JgJAgaSXimg [https://perma.cc/P4GT-XXFH] (describing the process of selling stocks and bonds in the 1920s "on the basis of glittering promises of fantastic profits and without disclosing meaningful information to investors").

12. *Id.*

created to protect investors.[13] Appropriately, the legislation is often referred to as the "truth in securities law" because the legislation requires disclosure of financial information through the registration of securities, thereby creating a more transparent landscape for investors.[14] The 1933 Act laid the foundation for the regulation of securities in the United States, and, therefore, the regulation of broker-dealers and RIAs. The Securities Act of 1933 has two main objectives: "require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities."[15]

While securities regulation has continued to expand after the 1933 Act, the basic idea of protecting investors through transparency remains at the center of regulation in this area.[16]

2. The Securities Act of 1934

The next major piece of financial legislation came in the following year in the form of The Securities Exchange Act of 1934 (the 1934 Act).[17] As the 1933 Act regulates the issuance of securities offered on the public market, the 1934 Act regulates the secondary market for securities.[18] To lead this endeavor, the 1934 Act established the Securities and Exchange Commission to "govern[] the way in which the nation's securities markets and its brokers and dealers operate."[19]

The 1934 Act grants the SEC broad power and authority to regulate the securities industry.[20] This Act also identifies prohibited conduct in the industry and empowers the SEC with disciplinary authority to further regulate both persons and entities operating in the securities industry.[21] The 1934 Act also grants the SEC power to "register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's self-regulatory organizations."[22] Perhaps the most notable self-regulatory organization (SRO) in the financial adviser world is the Financial Industry Regulatory Authority (FINRA). FINRA was created through the merger of the National Association of Securities Dealers (NASD) and the regulatory branch of the New York Stock Exchange (NYSE) in

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13. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C § 77a et seq.); *The Laws that Govern the Securities Industry*, SEC (Oct. 1, 2013), https://www.sec.gov/answers/about-lawsshtml.html#secexact1934 [https://perma.cc/54T4-N2U9].

14. *The Laws that Govern the Securities Industry*, *supra* note 13.

15. *Id.*

16. *See The Nature of Securities Regulation*, LEGAL ASPECTS OF CORP. MGMT. AND FIN. (Saylor Academy, 1st ed. 2012), https://saylordotorg.github.io/text_legal-aspects-of-corporate-management-and-finance/s20-01-the-nature-of-securities-regul.html [https://perma.cc/V3R4-QK9M] (describing the goals of securities regulation).

17. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq.).

18. *Id*. *See also* Will Kenton, *Secondary Market*, INVESTOPEDIA (Sept. 24, 2020), https://www.investopedia.com/terms/s/secondarymarket.asp [https://perma.cc/BU4Y-W8FS] (explaining the secondary market of securities as "what most people typically think of as the 'stock market'").

19. *Guide to Broker-Dealer Registration*, SEC (Dec. 12, 2016), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#II [https://perma.cc/8A6K-SFL8].

20. *The Laws that Govern the Financial Industry*, *supra* note 13.

21. *Id.*

22. *Id.* Notable self-regulatory organizations, or SROs, in the industry include the NASDAQ Stock Market, the New York Stock Exchange, the Chicago Board of Trade, and the Financial Industry Regulatory Authority.

2007 and is now the official self-regulatory organization for the U.S. securities industry.[23] While the SEC and the 1933 and 1934 Acts serve as the source of law for broker-dealers, in practice, FINRA oversees most ongoing regulatory duties involving broker-dealers.[24]

3. The Investment Advisers Act of 1940

Six years after the implementation of the 1934 Act, Congress passed the 1940 Investment Advisers Act (the Advisers Act) in response to concern regarding the quality of investment advice given by investment advisers.[25] The Advisers Act is thus the primary source of law for registered investment advisers, requiring "firms or sole practitioners compensated for advising others about securities investments [to] register with the SEC and conform to regulations designed to protect investors."[26] The Supreme Court later interpreted the Advisers Act to impose a fiduciary duty upon advisers acting for their clients.[27] Today, the Advisers Act and the 1934 Act—backed by the 1933 Act—serve as the framework of regulation used to govern investment advisers.

B. Registered Investment Advisers and Broker-Dealers

Financial advisers can be subcategorized into two groups: registered investment advisers and broker-dealers.[28] The two categories can be differentiated by three distinguishing characteristics: compensation, regulation, and standard of care.[29] RIAs generally use fee-based compensation, are regulated under the SEC through the 1940 Act, and have a fiduciary obligation to their clients.[30] Broker-dealers, on the other hand, are regulated under the 1934 Act through FINRA, use commission-based compensation, and were long held to a suitability standard—now a best-interest standard.[31]

1. The Registered Investment Adviser

The Advisers Act defines an RIA as "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, or who, for compensation . . . issues or promulgates analyses or reports concerning securities."[32] RIAs are regulated primarily by the SEC under the Advisers Act.[33] A clear

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23. *The Laws that Govern the Securities Industry*, *supra* note 13.

24. FINRA describes their purpose on their website, stating: "[w]orking under the supervision of the Securities and Exchange Commission, we: (1) Write and enforce rules governing the ethical activities of all registered broker-dealer firms and registered brokers in the U.S., (2) Examine firms for compliance with those rules, (3) Foster market transparency, and (4) Educate investors." *What We Do*, FINRA, https://www.finra.org/about/what-we-do [https://perma.cc/9689-JQR3] (last visited Sept. 7, 2020).

25. Investment Advisers Act of 1940, Pub. L. No. 76–768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80b-1– 80a-64).

26. *The Laws that Govern the Securities Industry*, *supra* note 13.

27. SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 181–82 (1963); *see also infra* Section II.B.4.a (describing a fiduciary duty as the highest duty of care owed to an investor).

28. *Regulation Best Interest*, *supra* note 1, at 5–6.

29. *Infra* Section II.B.

30. *Infra* Section II.B.1.

31. *Infra* Section II.B.2.

32. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(11) (2010).

33. *Id.*

distinction between an RIA and broker-dealer can be found by examining the scope of the relationship: RIAs engage in regular and ongoing investment advice and analysis, whereas the role of the BD is often more disconnected and transactional.[34]

2. The Broker-Dealer

Section 3 of the 1934 Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," and a "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise."[35] The difference here is a broker acts as an agent, while a dealer acts as principal.[36] While a broker and a dealer are technically two different actors, the terms are generally lumped together to describe any person or institution engaged in these activities.[37] As mentioned above, broker-dealers are primarily regulated by FINRA under the 1934 Act.[38]

3. Compensation

One key difference between broker-dealers and RIAs lies in the compensation model. Generally, RIAs use a fee-based system, while broker-dealers use a commission-based system. In a fee-based model, an RIA offers ongoing advice and services for their clients and is typically paid either through a percentage of their assets-under-management (AUM) or by an hourly rate.[39] Broker-dealers typically provide less financial planning and advice and focus more on buying and selling investment products.[40] BDs, then, are typically paid by earning a commission on each transaction.[41]

A growing trend in the financial adviser industry is the "hybrid model," whereby a financial adviser operates both a fee-based RIA service and a BD service.[42] Such an adviser could offer different services to different clients or offer both services to a single client.[43] As one can imagine, the different transactions involved in managing the capital of a single high-net-worth client can often blend between the two models.[44] This can lead to significant confusion—both to the adviser and the client—when identifying the appropriate

34. *A Brief Overview: The Investment Adviser Industry*, N. AM. SEC. ADMIN. ASS'N, https://www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide/ [https://perma.cc/WA3E-Y85B] (last visited Sept. 6, 2020).

35. *Guide to Broker-Dealer Registration*, *supra* note 19.

36. For a detailed examination of principal and agent roles in the context of broker-dealer regulation, see Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Exchange Act Release No. IA-1732 (July 17, 1998), https://www.sec.gov/rules/interp/ia-1732.htm [https://perma.cc/W79D-CR5C].

37. In reality, the financial industry is filled with so-called "broker-dealer firms" that sell only third-party securities, making them technically just a broker.

38. Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq.

39. *See Broker-Dealers vs. Registered Investment Advisers ('RIAs'): Which is Which?*, *supra* note 8 (comparing RIAs and BDs).

40. *Id.*

41. *Id.*

42. *See* Lukas R. Dean et al., *Examining Asset Flows and Type of Adviser Compensation After an Economic Downturn*, 32 J. FIN. PLAN., 48, 48 (2019) (analyzing changes in compensation models among financial advisers).

43. *Id.*

44. For example: a client with high AUM may simultaneously require: (1) ongoing financial management and planning advice to maintain and grow their assets (an RIA service) and (2) recommendations for investment opportunities and assistance in executing such purchases (a BD service).

standard of care to which an adviser should be held.[45]

4. Standard of Care

Perhaps the most important difference between RIAs and broker-dealers is the standard of care the broker-dealer or RIA owes to their client. RIAs are held to a fiduciary standard, while broker-dealers—up until the passage of Reg. BI—were held to a suitability standard.[46]

a. Fiduciary Standard

The fiduciary standard of care originates at common law, and courts have consistently held that an RIA owes a fiduciary standard of care to their clients under the Advisers Act.[47] While the legislation never explicitly states this, the Supreme Court interpreted the Advisers Act to imply a common law fiduciary duty in the landmark Supreme Court case *SEC vs. Capital Gains Research Bureau*.[48] An RIA—being held to a fiduciary standard—may not put their interests ahead of the interests of the client.[49] The fiduciary standard is comprised of a duty of care and a duty of loyalty towards a client. This duty requires an RIA to "adopt the [client's] goals, objectives, or ends."[50]

RIAs consider not just the transaction at hand, but all their client's interests that may influence a financial decision.[51] A comprehensive understanding of the fiduciary standard—as applied to RIAs—is illustrated in a speech by SEC Director of Compliance Inspections and Examinations, Lori A. Richards:

> Fiduciary comes from the Latin word for 'trust.' A fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest . . . [and] investment advisers are fiduciaries with an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients. . . . I would suggest that an adviser, as that trustworthy

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45. *See* Dean et al., *supra* note 42, at 49–50 (discussing the potential for dual standards of care in the hybrid model: "At a hybrid firm the financial adviser can choose client-by-client how much to charge in fees and how much to charge in commissions, providing flexibility [for the adviser] to select when to act as an RIA with a fiduciary obligation to clients, and when to act as a broker with a suitability standard. . . . [I]t also requires the consumer to more closely monitor costs to discern when their adviser is acting as a[n] [RIA] fiduciary . . . and when they are operating under the [BD] suitability standard").

46. *Infra* Section II.B.4.

47. Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1052–53 (2011) (critically discussing the development of the fiduciary standard).

48. SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 191 (1963).

49. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Exchange Act Release No. IA-5248, 2019 WL 3779889 (July 12, 2019).

50. Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 BUFF. L. REV. 99, 103 (2008); RESTATEMENT (THIRD) OF AGENCY § 2.02 (AM. L. INST. 2006).

51. A good financial planner will consider as much information as possible to best serve their client as a fiduciary. These considerations may include, but are certainly not limited to, a client's comprehensive portfolio of assets, retirement plans, personal goals, debt obligations, risk tolerance, estate plans, succession plans, tax benefits, real estate holdings, and market trends and forecasts. Ryan Barnes, *What is a Registered Investment Advisor?*, INVESTOPEDIA (June 15, 2020), https://www.investopedia.com/articles/financialcareers/06/whatisaria.asp [https://perma.cc/E7HF-RJUR] (describing the role of an RIA and describing the position as a "financial quarterback").

> fiduciary, has five major responsibilities when it comes to clients. They are: (1) to put clients' interests first; (2) to act with utmost good faith; (3) to provide full and fair disclosure of all material facts; (4) not to mislead clients; and (5) to expose all conflicts of interest to clients.[52]

While there is no definitive language to conclusively define this standard, it is clear the fiduciary standard is the apex on the scale of duty of care in the financial industry.

b. Suitability Standard

The now-abolished suitability standard required broker-dealers' investment recommendations to be "suitable for their customers."[53] The suitability standard is less stringent than the fiduciary standard in the degree to which an adviser is obligated to put the client's interests before their own.[54] Under a suitability standard, a BD was only obligated to present an investment product that was suitable for the client at the time of investment.[55] This standard also required the BD to have an "adequate and reasonable basis" for their recommendation.[56] Investment recommendations have been considered unsuitable under this standard when they were "inconsistent with the customer's investment objectives."[57] When compared with a fiduciary standard, the suitability standard sets a relatively low bar for the broker-dealer.[58]

The suitability standard has been widely criticized for allowing BDs to only show clients those investment products which—while technically suitable—would generate high commission. This standard allowed BDs to ignore other suitable products that may have lower commissions for the BD but better returns for the consumer. This criticism has been largely curtailed through the implementation of Reg. BI.[59]

c. Best Interest Standard

The suitability standard has long been the standard to which broker-dealers have been held.[60] The suitability standard—as this Section will conclude—was raised significantly in the new Regulation Best Interest regulation. While the SEC has declined to offer a specific

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52. Lori A. Richards, Dir., Off. of Compliance Inspections and Examinations, SEC, Speech at the Eighth Annual Investment Adviser Compliance Summit: Fiduciary Duty: Return to First Principles (Feb. 27, 2006) (quoting from Supreme Court decision in SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180 (1963)).

53. *Guide to Broker-Dealer Registration*, *supra* note 19.

54. *RIA vs. Broker-Dealer: What's the Difference?*, FRONTIER WEALTH MGMT., https://frontierwealth.com/ria-vs-broker-dealer-whats-the-difference/ [https://perma.cc/FJQ9-7H2A] (last visited Sept. 26, 2020).

55. *See Guide to Broker-Dealer Registration*, *supra* note 19 (explaining the suitability standard under SRO rules such as NASD Rule 2310: a broker-dealer must have an "adequate and reasonable basis for any recommendation that it makes . . . [T]he reasonable basis test[] relates to the particular security or strategy recommended . . . . [T]he broker-dealer has an obligation to investigate and obtain adequate information about the security it is recommending . . . [and to] determine customer-specific suitability . . . based on a customer's financial situation, needs, and other security holdings.").

56. *Id.*

57. *Id.*

58. *See supra* Section II.B.4.a (analyzing the fiduciary standard).

59. *Infra* Section II.B.4.c.

60. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 59 (2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf [https://perma.cc/U5FS-XCWX].

definition of the "best interest" standard of care—especially concerning its relationship to the fiduciary standard—a tentative definition would likely state a broker-dealer must act in the best interest of their client by satisfying the four requirements outlined in Reg. BI, consisting of disclosure, care, conflict of interest, and compliance obligations.[61] The next Section will examine these requirements and the new regulation as a whole.

C. The Newest Addition-Regulation Best Interest: The Broker-Dealer Standard of Conduct

Regulation Best Interest: The Broker-Dealer Standard of Conduct was adopted on June 5, 2019, after a 3-1 vote by SEC commissioners.[62] All applicable persons and companies were required to comply with Reg. BI by June 30, 2020.[63] The lengthy document—weighing in at 771 pages—is undoubtedly one of the most influential legislative acts upon broker-dealers in recent history. The new regulation is comprised of four sections, titled—for the purposes of this analysis—Regulation Best Interest, Form CRS, RIA Standard of Conduct, and Solely Incidental Clarification.[64]

The new "best-interest" standard of care is clearly the focal point of this regulation. This portion of the regulation, broadly speaking, requires brokers to act in a client's "best interest."[65] BDs must do this by adhering to four obligations of disclosure, care, conflict of interest, and compliance as described in this section of Reg. BI.[66] The SEC summarizes these obligations—in a published compliance guide—as follows:

> Disclosure Obligation: provide certain required disclosure before or at the time of the recommendation, about the recommendation and the relationship between you and your retail customer; Care Obligation: exercise reasonable diligence, care, and skill in making the recommendation; Conflict of Interest Obligation: establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest; and Compliance Obligation: establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[67]

The other three sections of Reg. BI—while not the focus of this Note—provide additional guidance in support of the new "best-interest" standard as well as clarifications of existing regulations.[68] Form CRS—delivered to the client at the beginning of a relationship—is meant to clarify the relationship between the client and the BD or RIA by providing information and clarification regarding the scope of the relationship and services, the structure of fees, disclosure of any and all possible conflicts of interest, and the BD's disciplinary history.[69] The RIA Standard of Conduct portion of Reg. BI further interprets the standard of conduct surrounding Registered Investment Adviser firms regarding their

61. *SEC Reg. BI Compliance Guide*, *supra* note 2.
62. *Regulation Best Interest*, *supra* note 1.
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *SEC Reg. BI Compliance Guide*, *supra* note 2.
68. *See generally Regulation Best Interest*, *supra* note 1 (adopting a final rule regarding recommendations from broker-dealers to retail customers).
69. *Id.*

position as fiduciaries.[70] Lastly, the Solely Incidental Clarification is included in Reg. BI to resolve ongoing industry confusion regarding the SEC's position on a BD exception under the Advisers Act.[71] The Solely Incidental Clarification section in Reg. BI is designed to provide an interpretation of what investment advice is considered "solely incidental" under the Advisers Act.[72]

III. Analysis of Reg. BI and Its Implications

A. Best Interest vs. Fiduciary—How Big Is the Shift?

The largest and most ambiguous change in Reg. BI is arguably the heightened standard of care for broker-dealers, raising a broker's obligation from a "suitability" standard to a "best interest" standard.[73] A common question amongst industry professionals is—understandably—"what does this mean?" The SEC has provided a loose and arguably unhelpful definition of best interest, stating that, while making a recommendation to a retail customer, a broker-dealer must "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer."[74] The SEC goes on to clarify the best interest obligation—a "general obligation"—is only met if a broker-dealer follows four "component obligations" outlined in Reg. BI.[75] All four component obligations—the Disclosure Obligation, the Care Obligation, the Conflict-of-Interest Obligation, and the Compliance Obligation—seem to impose heightened regulation compared to previously imposed BD regulations.

New guidance regarding the broker-dealer's Disclosure Obligation requires broker-dealers to disclose all material facts about the relationship; this includes all material facts relating to "the scope and terms of the relationship with the retail customer, and . . . conflicts of interest that are associated with the recommendation."[76] These disclosure requirements are extremely detailed and potentially cover a huge amount of information due to the broad language in the regulation. For example, Reg. BI defines "conflict of interest" as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[77] Considering the basic nature of a broker-dealer—to provide BD financial services in exchange for payment—the obligation to

70. *Id.*

71. *Id.*

72. Note that, under the Advisers Act, advisory activities considered "'solely incidental' to the conduct of the broker or dealer's business" are not subject to the same level of regulation as standard BD activities. *See generally* Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, 84 Fed. Reg. 33681-01 Release No. IA-5249 (July 12, 2019) (codified at 17 C.F.R. pt. 276) (interpreting the "solely incidental" exception for advisers under the Advisers Act); Jamie Hopkins, *SEC Brings Increased Confusion for Investors with New 'Best Interest' Rule*, FORBES (June 5, 2019, 3:55 PM), https://www.forbes.com/sites/jamiehopkins/2019/06/05/sec-brings-increased-confusion-for-investors-with-new-best-interest-rule/#49563cc2270b [https://perma.cc/9WHK-WMV7] (listing key takeaways from the Best Interest Rule).

73. *See supra* Section II.B.4.

74. *Regulation Best Interest*, *supra* note 1, at 1.

75. *SEC Reg. BI Compliance Guide*, *supra* note 2.

76. *Id.* (emphasis removed).

77. *Id.*

disclose any and all interests fitting the above definition is quite burdensome. Even more burdensome, however, is the requirement to mitigate or eliminate these conflicts.

New guidance regarding the broker-dealer's Care Obligation requires a broker-dealer to "exercise reasonable diligence, care, and skill when making a recommendation."[78] To comply with this obligation under Reg. BI, a BD making a recommendation must "understand potential risks, rewards, and costs . . . have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile . . . not place the interest of the broker-dealer ahead of the interest of the retail customer; and have a reasonable basis to believe that . . . [the recommendation] is not excessive . . . [and] is in the retail customer's best interest."[79]

While introducing new "best-interest" language, this obligation does not significantly alter the previous regulation. The primary source of industry feedback in the context of this obligation comes from the lack of a comprehensive definition of "Reg. BI."[80]

The new Reg. BI guidance regarding the broker-dealer's conflict of interest obligation requires that: "[the] broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to . . . identify and at a minimum disclose . . . or eliminate conflicts of interest."[81] To comply with Reg. BI, these procedures must identify and disclose or mitigate all conflicts of interest associated with a BD's recommendation and relationship to the client. These conflicts are quite expansive and can include any incentives for the BD to place their own interest ahead of the clients.[82] Examples that were—up until now—common in the BD space, include: financial incentives for a BD to recommend certain products, recommendation of products owned or promoted by the BD firm, the existence of other, possibly better products not available through the BD, or any form of sales contests, quotas, or bonuses to incentivize the sale of certain investment products.[83]

The Reg. BI Compliance Obligation requires all registered broker-dealer firms to "establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole."[84] Although firms were supposed to be in compliance by June 30, 2020, the language in the Compliance Obligation creates flexibility for BDs to create compliance procedures that—while still adhering to Reg. BI—work with the individual business model of the BD.[85]

Putting these four obligations together creates compliance with a new standard of care that starts to look more and more like a fiduciary standard.[86] While the SEC has not commented on the specific differences between "best interest" and "fiduciary," they have made it clear that best interest is a significantly higher standard than the previous suitability standard, but not equal to a fiduciary standard as applied to advisers.[87] This purposeful

78. *Regulation Best Interest*, *supra* note 1, at 13–14.

79. *Id.*

80. *Supra* Section II.C (discussing the lack of a comprehensive definition for Reg. BI).

81. *SEC Reg. BI Compliance Guide*, *supra* note 2 (emphasis removed).

82. *Id.*

83. *Id.*

84. Press Release, SEC, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals (June 5, 2019), https://www.sec.gov/news/press-release/2019-89 [https://perma.cc/3B3J-7NNR].

85. *SEC Reg. BI Compliance Guide*, *supra* note 2.

86. *Id.*

87. *See* SEC, *supra* note 84 (stating Reg. BI "substantially enhances the broker-dealer standard of conduct

ambiguity has not been lost on the public, and financial institutions are scrambling to interpret the difference. SEC Chairman Jay Clayton recently gave an interview with CNBC to—among other things—address this question, saying:

> Best interest on the broker side has many of the same elements, but we want people to understand that the investment advisor space, and the broker-dealer space, are different . . . . They're very different in the way people get paid. In the broker-dealer space, you get paid usually a commission on a transaction by transaction basis. In the investment advisor space, it's more of a long-term relationship, where you get paid on a quarterly fee, yearly fee, and the advisor has a more portfolio lifetime relationship with you. Those are two very different relationships and we want to be clear.
>
> . . . We're raising the standard of conduct for broker-dealers—the obligations that they owe to their clients.
>
> . . . [W]e're covering more of the advice spectrum, and one of the things we're covering that's key is account type—when you're rolling over your 401(k) into a different type of account that advice is now covered by our standards of conduct, whether you're a broker-dealer or an investment advisor.[88]

While Jay Clayton's comments are by no means the missing piece to the puzzle, it gives us subtle insight into the mindset of the SEC. It seems the SEC prefers to regulate the fiduciary and best interest standards separately, rather than as two points on the same scale. Robert Colby, FINRA's chief legal officer, has said FINRA will either revamp its current suitability rule or eliminate it: "There's a lot of overlap between the existing suitability rule and the direction that Reg. BI is going in order to mitigate conflicts."[89] The explanations given by Mr. Clayton and Mr. Colby further suggest the differences between the two standards should not be interpreted as incremental—like one might interpret a legal standard of review—but instead should be interpreted as two points on different scales meant to regulate two different actions. While attempting to compare the fiduciary and best interest standards side-by-side may be inappropriate, it is also necessary, as broker-dealers increasingly act as both a "fiduciary RIA" and a "best-interest BD."[90]

B. Pros and Cons

As one can expect from such a significant regulation, there has been a plethora of industry feedback on Reg. BI. "Since the issuance of the proposals on April 18, 2018, the SEC received over 3,000 unique comment letters (over 6,000 comment letters in total) from individuals, consumer advocacy groups, financial services firms, investment professionals,

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beyond existing suitability obligations").

88. Melanie Waddell, *SEC's Clayton Explains 'Best Interest' vs. 'Fiduciary' Duty*, THINKADVISOR (June 6, 2019, 4:42 PM), https://www.thinkadvisor.com/2019/06/06/secs-clayton-explains-best-interest-vs-fiduciary-duty/ [https://perma.cc/4T9C-Z6CE].

89. *Id.*

90. *See supra* Section II.B.3 (discussing the growth of the "hybrid" model). Also note that the SEC has recently updated their Reg. BI FAQ page to address some concerns regarding the increasing overlap between BDs and RIAs. *Frequently Asked Questions on Regulation Best Interest*, SEC (Aug. 4, 2020), https://www.sec.gov/tm/faq-regulation-best-interest#disclosure [https://perma.cc/MUX6-HC3F]. While this is a good start, confusion is still likely as advisors settle into the new regulatory landscape.

industry and trade associations, state securities regulators, bar associations, and others."[91] The industry feedback—both for and against Reg. BI—can be compiled into several key arguments.[92]

1. Pro-Reg. BI Argument

At first glance, Reg. BI is a step in the right direction. The U.S. Chamber of Commerce identifies three important benefits in the regulation.[93] First, the "explicit requirement to act in customers' best interest" substantially raises the standard of care owed to a client and would undoubtedly benefit the average retail investor.[94] Under the previously existing suitability standard, a BD could be disincentivized to recommend the best investment product for a consumer in favor of a less beneficial investment product that—while still technically suitable for the investor—offers the BD greater commission rates.[95]

Second, the regulation provides for a clearer set of national standards for investment advisers. By raising the duties of BDs and providing additional clarification for all investment advisers, Reg. BI effectively preempts many state laws with weaker consumer protection, providing investors with added protection.[96] Additionally, the more uniform standard benefits the broker-dealer by streamlining some compliance issues by reducing the variations between the "patchwork of state regulations."[97] Lastly, the new form, CRS, provides better disclosure for investors. The U.S. Chamber of Commerce commented that this added disclosure is "investor-friendly and will allow individuals to make informed decisions when working with a financial professional."[98] Increased disclosure requirements will—in theory—create a more transparent environment for retail investors.[99]

2. Criticisms

While criticisms of Reg. BI are both plentiful and diverse, the most meritorious concerns can be subcategorized into three complaints: (1) Reg. BI is too complex and too ambiguous, (2) Reg. BI does not adequately protect retail investors, and (3) the conflict of interest disclosure requirements are unnecessarily burdensome.[100]

a. Complexity and Ambiguity

Regulation Best Interest tips the scales at 770 pages, and yet refrains from offering a

91. James G. Lundy et al., *The Final Reg BI Package: What to Know and What's Next*, FAEGRE DRINKER (June 12, 2019), https://www.faegredrinker.com/en/insights/publications/2019/6/the-final-reg-bi-package-what-to-know [https://perma.cc/LW8S-LKLK].

92. *See infra* Section III.B.1 (summarizing general arguments for and against Reg. BI).

93. Tom Quaadman, *Why Sticking with the SEC's New Regulation Best Interest Rule Is a Win for Investors*, U.S. CHAMBER OF COM. (Sept. 23, 2019, 11:15 AM), https://www.uschamber.com/series/above-the-fold/why-sticking-the-sec-s-new-regulation-best-interest-rule-win-investors [https://perma.cc/EG9X-VQEB].

94. *Id.* (emphasis removed).

95. *Id.*

96. *Id.*

97. *Id.*

98. Quaadman, *supra* note 93.

99. *See infra* Section III.B.2.c (criticizing the added disclosure requirements as unnecessarily burdensome).

100. *Infra* Section III.B.2.

comprehensive definition of what a "best-interest standard" entails. If the intended effect of raising the broker-dealer standard was to further protect investors, surely this protection is at least partly eroded by the lack of clarity in defining the duty of care owed. A similar statement was made by Jon Stein—founder and CEO of Betterment, a digital adviser:

> Regulation Best Interest will likely hurt retail investors who need quality advice that puts their interests first. Unfortunately, this misleadingly titled rule may best serve the marketing interests of large financial corporations to the detriment of individual investors. It is a gift of sheep's clothing to the wolves of Wall Street.[101]

Mr. Stein's comments exemplify the sentiment that Reg. BI will diminish transparency among retail investors and lead to further confusion regarding the standard of care one is owed by their financial adviser.

While it is likely confusion among retail investors will increase with Reg. BI, this confusion may extend to broker-dealers as well—clouding the rule of how BDs must conduct themselves—and raising compliance costs in the process. The SEC chairman has addressed these complaints, saying "I think investors need to know how much of their money is going to work for them. And the key part of this rule package is whether you're an investment adviser or a broker-dealer, you're going to have to be very candid with how you're making your money."[102] The chairman's comments fit nicely with the SEC's history of vague and broad regulation to further compliance efforts. Financial regulation has often taken the form of broad guidelines open to interpretation by the regulatory body, ensuring the regulatory body has ample discretion to penalize firms while simultaneously creating heightened compliance within a firm.[103] Simply put: ambiguous guidelines force firms to proceed cautiously to avoid sanction.[104] While the increase of compliance efforts in the financial industry is certainly not without benefit, it is concerning that ambiguous regulation is the chief tool used to accomplish this.

b. Reg. BI Does Not Adequately Protect Retail Investors.

Another common complaint of Reg. BI is it does not require enough consumer protection, as it does not explicitly require a BD to recommend the best investment product. Theoretically, a simple solution to this complaint would be the promulgation of a clear rule requiring brokers to conform to a fiduciary standard, or at least to recommend the best product available. SEC Chairman Jay Clayton effectively rebuts this sentiment, saying, "[n]either investment advisers nor broker-dealers are required to recommend the single 'best' product . . . [m]any different options may in fact be in the retail investor's best interest, and what is the 'best' product is likely only to be known in hindsight."[105] This statement does not, however, address what is arguably the primary reason for avoiding this

101. Caleb Silver, *Regulation Best Interest (BI)*, INVESTOPEDIA (Oct. 11, 2019), https://www.investopedia.com/what-is-the-sec-s-regulation-bi-best-interest-rule-4689542 [https://perma.cc/WG6Z-NLSX].

102. Waddell, *supra* note 88.

103. For a discussion of how vague financial regulations can criminalize arguably innocent behavior, see generally HARVEY A. SILVERGLATE, THREE FELONIES A DAY: HOW THE FEDS TARGET THE INNOCENT (2011).

104. *Id.*

105. Jay Clayton, Chairman, SEC, Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors (July 8, 2019).

kind of regulation: there would be an enormous revenue decline among broker-dealers. Losing the ability to sell more profitable products would drive many broker-dealers out of business. Short-sighted regulation of this nature could hugely disrupt the financial services industry and potentially decrease or even extinguish a future investor's access to qualified advisers in favor of short-term consumer protections.

c. Unnecessary Conflict of Interest Regulation

The conflict of interest provisions of Reg. BI can be criticized for being both too lenient and too strict. Proponents of the "too lenient" side of the argument would say the provisions fail to require all conflicts of interest to be eliminated. This is a fairly uninformed criticism, because it would be virtually impossible to eliminate all conflicts of interest. This is due, in part, to the differing roles of the broker and the investor, and in part to the huge amount of transactions involved in the broker-dealer space. A more appropriate criticism is the new conflict of interest regulation in Reg. BI creates a burdensome and often unnecessary process. This update constitutes more burdensome conflict of interest regulation than existing regulation by requiring broker-dealers to identify, disclose, and—where possible—mitigate all potential conflicts of interest to a transaction.[106]

Often, in the broker-dealer space, conflicts exist that would have no effect upon the transaction at hand and would have inconsequential effects on the investor.[107] These types of conflicts must now be disclosed and mitigated before a transaction can proceed. This leads to enormous efficiency costs for the broker-dealer and added levels of complexity for the retail investor. In a press release, Kenneth Bentsen, President and CEO of the Securities Industry Financial Markets Association (SIFMA), illustrated the burdensome disclosure requirements, saying, "[n]ot even the so-called fiduciary standard under the Investment Advisers Act includes the obligation to eliminate or mitigate conflicts."[108] While some might celebrate the sizable conflict of interest obligations of Reg. BI as a win for consumers, the complex disclosure requirements could pose an extensive burden on broker-dealers while providing little real protection for investors.[109]

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106. *SEC Reg. BI Compliance Guide*, *supra* note 2.

107. Consider, for example, a trusted broker-dealer ("BD") helping a long-time client invest in a safe, slow growth investment product for which Client will earn 4% annually. BD must choose to recommend either Product A or Product B, two nearly identical products that both carry the same level of risk and the same expected return of 4%. With Product A, BD will earn a $20 transaction fee billed to Client and a 1% commission bonus from her firm; by selling Product B, however, BD will earn the same $20 transaction fee but a much higher commission bonus from her firm, at 3.5%. Under Reg. BI, BD is now required to inform Client of this commission difference and either (1) "mitigate and eliminate" this conflict or (2) ask Client to sign a disclosure consent form. *Id.* at 1. BD may also have a duty to inform Client that Product B is sold through BD's firm, and that a similar product, Product W, is available at a different firm for a $19.75 transaction fee. Whether Client will care—or even bother to read these disclosures—is a question that Reg. BI seems to disregard.

108. *SIFMA Statement on the SEC's Final Regulation Best Interest Rule*, SEC. INDUS. & FIN. MKTS. ASS'N (June 5, 2019), https://www.sifma.org/resources/news/sifma-statement-on-the-secs-final-regulation-best-interest-rule/ [https://perma.cc/S93T-SRVP]. SIFMA is an association that represents the brokerage industry, advocating for "effective and resilient capital markets." SEC. INDUS. & FIN. MKTS. ASS'N, https://www.sifma.org/ [https://perma.cc/736R-MQ4D] (last visited Sept. 22, 2020).

109. *See infra* Section IV.A.3 (arguing the heightened conflict of interest requirements of Reg. BI are unnecessarily burdensome).

C. Lawsuits

Seven states—including New York, New Mexico, California, Oregon, Maine, Connecticut, and Delaware, and the District of Columbia—filed a suit in the Southern District of New York on September 10, 2019, against Reg. BI for failing to institute a uniform fiduciary standard and failing to "meet basic investor protections" which were laid out in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[110] On the same day, a similar suit was filed: XY Planning Network (XYPN) filed a lawsuit alleging the new regulation creates an anticompetitive environment between BDs and RIAs, limiting the firm's ability to provide comprehensive financial planning services.[111] The first lawsuit is notable because challenges to financial regulation are typically led by industry organizations. These suits from both the public and private sectors exemplify the frustrations with the new legislation coming from both sides of the issue.

After both suits were dismissed by federal judges for lack of subject matter, they were combined and appealed jointly to the Second Circuit U.S. Court of Appeals.[112] In June of this year, the Second Circuit denied the joint operation, finding that the petitioner states lacked Article III standing and the investment adviser firms failed to show that the SEC acted unlawfully in the promulgation of Reg. BI.[113]

1. Attorneys General Suits

The lawsuits filed by the Attorneys General of seven states and the District of Columbia argue the SEC violated the Administrative Procedure Act by promulgating a broker requirement that doesn't follow lawmakers' direction in the Dodd-Frank financial reform law.[114] Dodd-Frank, according to the petitioners, directs the SEC to "formulate a uniform standard of conduct that is no less stringent than the fiduciary duty that currently applies to advisers."[115] The AGs' complaint relies heavily on this particular provision of

110. Melanie Waddell, *SEC's Regulation Best Interest Comes Under Attack*, THINKADVISOR (Sept. 24, 2019, 12:00 PM), https://www.thinkadvisor.com/2019/09/24/secs-regulation-best-interest-comes-under-attack/ [https://perma.cc/7W32-8UWE]; Andrew Welsch, *In Whose Best Interest? State AGs Challenge SEC's Reg BI*, FIN. PLAN. (Sept. 10, 2019, 3:27 PM), https://www.financial-planning.com/news/states-sue-sec-over-regulation-best-interest [https://perma.cc/6969-ZQZY]; W. Scott Simon, *Litigation Against the SEC's Regulation Best Interest? Not Surprised*, MORNINGSTAR (Oct. 3, 2019), https://www.morningstar.com/articles/947744/litigation-against-the-secs-regulation-best-interest-not-surprised [https://perma.cc/5VUZ-GAEW].

111. Complaint for Declaratory and Injunctive Relief at 2, XY Plan. Network, LLC v. SEC No. 1:19-CV-08415 (S.D.N.Y. filed Sept. 10, 2019) 2019 WL 4334322 [hereinafter *XY Planning Complaint*].

112. XY Plan. Network, LLC v. SEC, 963 F.3d 244, 253 (2d Cir. 2020); Carl Ayers, *An Update on Reg BI Lawsuits*, REGUL. COMPLIANCE WATCH (Jan. 23, 2020), https://www.regcompliancewatch.com/an-update-on-reg-bi-lawsuits/ [https://perma.cc/4Q8G-XVDY].

113. *See XY Plan. Network*, 963 F.3d at 248 (holding that "(1) investment adviser had Article III standing to assert claim; (2) states lacked Article III standing; (3) SEC lawfully promulgated regulation pursuant to Congress's permissive grant of rulemaking authority; (4) SEC's interpretation of scope of Investment Advisers Act's . . . broker-dealer exemption was not arbitrary and capricious; and (5) SEC adequately addressed evidence that consumers were not meaningfully able to differentiate between standards of conduct owed by broker-dealers and investment advisers").

114. Complaint for Declaratory and Injunctive Relief at 3, New York v. SEC, No. 1:19-CV-08365 (S.D.N.Y. filed Sept. 9, 2019) 2019 WL 5203751.

115. Mark Schoeff, Jr., *Reg BI Suits Promise Long Legal Fight over Whether SEC Did Enough to Protect Investors*, INVESTMENTNEWS (Sept. 18, 2019), https://www.investmentnews.com/article/20190918/FREE/190919914/reg-bi-suits-promise-long-legal-fight-over-whether-sec-did-enough-to [https://perma.cc/PF4A-WKAT].

Dodd-Frank.[116] The heart of the dispute lies in whether Dodd-Frank actually imposes the requirements that the petitioners claim. The SEC takes the position that Dodd-Frank authorized, but did not explicitly require, the imposition of a fiduciary RIA standard of care on broker-dealers.[117] It is no surprise that—due to the ambiguous language in Dodd-Frank and the SEC's rulemaking process—the court sided with the regulator in this action.[118]

2. XYPN Suit[119]

The suit filed by XY Planning Network and Ford Financial Solutions ("the XYPN suit") also argues the SEC sidestepped Dodd-Frank.[120] In addition, it claims Reg. BI puts investment advisers at a competitive disadvantage because it "makes it more difficult to differentiate their fiduciary standard of conduct from the lower standard of conduct now applicable to broker-dealers."[121] XYPN alleges Reg. BI presents "a significant threat" to its business in several ways.[122] First, XYPN claims their business model depends substantially on incentivizing financial planners to register as RIAs.[123] By refusing to create a standard of conduct for both BDs and RIAs, Reg. BI effectively disincentivizes BDs to register as RIAs, thus resulting in business losses.[124] XYPN bases their claim on the argument that Dodd-Frank[125] requires the SEC to create a uniform standard of conduct among BDs and RIAs and has failed to do so with Reg. BI.[126]

Second, XYPN argues Reg. BI "poses a competitive threat" to XYPN's members, stating: "[i]n subjecting broker-dealers to a lower standard of conduct than RIAs, the rule allows broker-dealers to pursue their own financial interests even when providing the same financial-planning services as RIAs, while also reducing their legal exposure."[127] The complaint further states the rule does so "while using the label 'best interest' to refer to the lower standard of care applicable to broker-dealers, making it more difficult for RIAs to differentiate [their] fiduciary duty . . . from the duty owed by broker-dealers under the rule."[128] This problem illustrates the potential for anti-competitive behavior among BDs and RIAs.[129]

Although the appellate court found the adviser firms had standing to assert the claim,

116. *See generally* Complaint for Declaratory and Injunctive Relief, New York v. SEC, *supra* note 114 (citing repeatedly the fiduciary duty and standard).

117. *XY Plan. Network*, 963 F.3d at 253.

118. *Id*. at 257. *See also* Waddell, *supra* note 110 (correctly predicting the regulator's success).

119. *XY Planning Complaint*, *supra* note 111.

120. *Id.*

121. *Id. See* Schoeff, *supra* note 115(analyzing XYPN Suit); *see also* Ryan W. Neal, *XY Planning Network Sues SEC Over Reg BI*, INVESTMENTNEWS (Sept. 10, 2019), https://www.investmentnews.com/xy-planning-network-sues-sec-over-reg-bi-81245 [https://perma.cc/9CCF-87FQ] (discussing the case's take on competitive advantage).

122. *XY Planning Complaint*, *supra* note 111.

123. *Id.*

124. *Id.*

125. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 913(g) (2010) (articulating: "formulate a uniform standard of conduct that is no less stringent than the fiduciary duty that currently applies to advisers").

126. *XY Planning Complaint*, *supra* note 111.

127. *Id.*

128. *Id. See also* Waddell, *supra* note 110 (analyzing XY Planning's Complaint allegations).

129. *See XY Planning Complaint*, *supra* note 111; Waddell, *supra* note 110 (setting forth arguments by Reg. BI opponents that the policy will result in "diminished value of . . . accounts beset by conflicts of interest").

they nevertheless decided that the SEC acted lawfully in their promulgation of the new rule.[130]

IV. RECOMMENDATION

An analysis of the broker-dealer regulatory space shows a more economical solution to the SEC's regulation question lies not in additional regulation, but in deregulation, or, at the very least, in maintaining the current levels of regulation and duty of care.

A. Deregulation in the Broker-Dealer Space

A careful examination of the SEC's new Regulation: Best Interest suggests—despite the vocal opinions of several interested groups[131]—the best resolution lies in a modest decrease in current levels of broker-dealer regulation. The deregulation of the four pieces of Reg. BI—Regulation Best Interest, Form CRS, RIA Standard of Conduct, Solely Incidental Requirement—should occur through two amendments to the "Best-Interest" portion of the regulation. First, the "Best-Interest" duty of care should be clarified to instruct the broker-dealer in exactly where their duty to the client starts and ends. This would decrease both broker and investor confusion as well as set clear standards that an investor can both understand and expect.[132] Second, conflict of interest mitigation requirements should be reduced so a broker is only obligated to mitigate or eliminate conflicts when the conflict could reasonably be expected to affect the investment decision.

While deregulation in these two areas might be construed, at least facially, as a reduction in consumer protection—such as alleged in the AG lawsuit[133]—a closer analysis considering market efficiency, cost pass-through theory, and actual conflict of interest risk, indicates deregulation in these areas would in fact provide more value to the broker-dealer and investor alike.

1. Market Efficiency

The most basic—and arguably most persuasive—argument for deregulation lies in market efficiency. Simply put, the market is in a better position to regulate many of the issues Reg. BI was created to address. This is demonstrated largely by the investor's ability to choose his or her broker. Broker fees, return rates, and recommendations make up just a fraction of the information readily available to investors. Such investors can switch from broker to broker with relative ease, incentivizing all brokers in the market to provide the

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130. *See* XY Plan. Network, LLC v. SEC, 963 F.3d 244, 248 (2d Cir. 2020) (finding the SEC gave "adequate reasons for its decision" and supported its findings with "substantial evidence").

131. Significant opposing parties to Reg. BI include State AGs, broker-dealer firms, and state and federal representatives; Complaint for Declaratory and Injunctive Relief, New York v. SEC, *supra* note 114; *XY Planning Complaint*, *supra* note 111.

132. The current version of Reg. BI contains no comprehensive definition of the standard. While this creates room for the SEC to regulate and punish firms, it drastically increases compliance costs. This common criticism in the financial industry is often called "regulation by enforcement." *See generally* Matt Levine, *Rules Make for Better Rules than Lawsuits Do*, BLOOMBERG (Jan. 30, 2018, 1:00 AM), https://www.bloomberg.com/opinion/articles/2018-01-30/the-cfpb-approach-to-regulation-has-it-backward [https://perma.cc/9T23-MSF5] (arguing against the regulation by enforcement approach).

133. Complaint for Declaratory and Injunctive Relief, New York v. SEC, *supra* note 114.

best recommendation at the lowest cost.[134] To put it another way: it is not the role of the SEC, but that of the market, to set prices for broker-dealer compensation and investment products. While some governmental oversight is necessary, the market should be permitted to regulate when possible.[135]

2. Cost Pass-Through Theory

As discussed above, numerous aspects of Reg. BI serve to create new or increase existing business and compliance costs. Changes that bring significant cost increases include, but are not limited to:

(1) the requirement that broker-dealers must clearly document the bases for *each* of their recommendations, as well as how *each* of their recommendations were in the customer's best interest,

(2) the requirement that all conflicts must be mitigated or eliminated, and

(3) the enormous compliance costs of conforming to a frustratingly vague regulation that does not succinctly define the standard of care to which a broker is held.[136]

"'Cost pass-through' describes what happens when a business changes the price of the products or services it sells following a change in the cost of producing them."[137] Some, if not most, of the additional business and compliance costs brought on by Reg. BI could be "passed through" to the investor through various fees, lessening the appeal of the increased investor protection that Reg. BI claims.

3. Actual Risk of Conflict-of-Interest

As discussed in Part II, Reg. BI now obligates broker-dealers to eliminate, or disclose and mitigate, certain conflicts of interest.[138] This standard sets a very high bar that is relatively unprecedented, and not even applied to registered investment advisers under the fiduciary standard.[139] While the elimination or mitigation of conflicts seems like a promising way to protect investors, the reality is conflicts in the broker-dealer space are extremely common, and often irrelevant to a transaction; regulating these inconsequential conflicts creates huge compliance and business costs that are largely unnecessary.[140]

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134. Leaving one broker-dealer for another is relatively common and typically does not require significant costs to the investor. Furthermore, metrics used to measure brokers are also readily available. Thus, unsatisfied investors have both the information and ability to switch broker-dealer firms if they so choose.

135. For an in-depth discussion of market efficiency in the financial sector see generally Mario I. Blejer, *Economic Growth and the Stability and Efficiency of the Financial Sector*, 30 J. BANKING & FIN. 3429 (2006) (arguing financial efficiency leads to financial stability).

136. *See supra* Section II.C (describing additional obligations imposed under Reg. BI).

137. IESTYN WILLIAMS ET AL., COST PASS-THROUGH: THEORY, MEASUREMENT, & POTENTIAL POLICY IMPLICATIONS 1 (2014), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/320912/Cost_Pass-Through_Report.pdf [https://perma.cc/HJ9X-TFYZ].

138. *Supra* Part II.

139. John D'Antona, *Reactions Mixed to Reg BI Passage*, MKTS. MEDIA (June 14, 2019), https://www.marketsmedia.com/reactions-mixed-to-reg-bi-passage/ [https://perma.cc/GQ73-YBW7]; Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C § 77a et seq) (1933).

140. *See supra* note 107 (illustrating a common example of an irrelevant conflict of interest that creates enormous compliance costs with little increased consumer protection).

B. If Not Deregulation—Resist Raising the Duty of Care[141]

The SEC will be reluctant to significantly amend or repeal a regulation that has been developing for the better half of a decade, so it is likely that no significant changes will be applied to Reg. BI in the near future.[142] If this is the case, the SEC should refrain from conceding to the vocal critics of Reg. BI by applying a fiduciary standard to both the broker-dealer and the investment adviser. If a better solution cannot be promulgated through deregulation, then a retention of current regulation (Reg. BI) is far better than applying a fiduciary standard—as recommended by the AG lawsuit—to broker-dealers and investment advisers alike.

Applying a fiduciary standard to broker-dealers would greatly increase the compliance and business costs outlined in Part III. Additionally, a fiduciary standard is not necessary for broker-dealers. As summarized above, a broker-dealer and a registered investment adviser hold two very different roles. An investment adviser fiduciary must look beyond individuals and their investments, considering their clients' entire financial life.[143] This level of involvement simply is not necessary for a broker, whose role may simply be to acquire a specified number of shares in a mutual fund. Further, the added costs associated with imposing a fiduciary standard on a broker-dealer is not worth the benefits of fiduciary protection, especially when said fiduciary protection was likely not necessary in the first place.

Admittedly, the argument for lowering or retaining the current level of broker-dealer regulation is not without its flaws. The increased opportunity for exploitation of investors is a persuasive drawback of deregulation. However, in this case, the actual risk of decreased investor protection is relatively low and can be mitigated through several factors:

(1) The investor is not tethered to one broker-dealer or even to one brokerage firm; dissatisfaction in either profit or service can easily be resolved by walking across the street to a different broker.

(2) The customer has access to multiple channels already available (with options for financial restitution) to report or bring legal action against a broker-dealer whom they suspect to have breached a duty; the process is as simple as filing a complaint with FINRA.

(3) The financial and economic savings through reduced fees, confusion, and time, partially mitigate the risk of investor exploitation.

Arguments for and against deregulation have existed since the dawn of financial regulation and will very likely continue long after Reg. BI is implemented. However—

141. Note that this author recommends that the SEC also resist increasing their conflict-of-interest mitigation requirements, but it is unlikely that this will present a problem, as the current Reg. BI conflict mitigation policy is arguably the most stringent in the history of the industry. *See supra* Part IV (recommending less intrusive conflict mitigation requirements).

142. Note that, as with many newly-passed SEC regulations, feedback is accepted and encouraged and often leads to future changes in the regulation.

143. A financial adviser under the fiduciary standard is "beholden to monitor their [clients'] investments and meet with them on a regular basis . . . tak[ing] into consideration their clients' entire financial life, including investments, tax planning, debt management, cash flow, insurance, college costs, estate planning and more." *Fiduciary vs. Non-Fiduciary, Does It Really Matter?*, BRILLIANT ADVICE (Sept. 12, 2016), https://www.brilliantadvice.net/2016/09/12/fiduciary-vs-non-fiduciary-really-matter/ [https://perma.cc/T4BW-42F9].

whenever possible—we should consider alternatives to the promulgation of increased regulation. The suggestions above provide examples of incremental decreases in regulation that could create net benefits for both the broker-dealer and their clients.

V. CONCLUSION

"Regulation Best Interest: The Broker-Dealer Standard of Conduct" marks the passage of another in a long list of regulations designed to further constrain financial advisers and thereby increase consumer protection. The new regulation imposes a heightened standard of care upon broker-dealers, requiring all registered broker-dealers to act in the best interest of their clients when making a recommendation on any securities transaction or investment strategy involving securities. This standard is significantly higher than the previous "suitability" standard, although separate and distinguishable from the higher "fiduciary" standard applied to registered investment advisers.

While crafted with good intentions, Reg. BI imposes enormous compliance burdens—both financial and economic—through complex and ambiguous language as well as through unnecessary and lengthy disclosure requirements. A scaling-back of the regulation in these areas would ease the compliance burden on the industry while sacrificing very little consumer protection. The results of such changes would benefit all parties involved, providing greater clarity and lower investment costs for the consumer, and decreased compliance costs for the broker-dealer. Furthermore, future regulation in this area should more carefully consider the effects of unclear governance and aim to better protect both the client and the adviser, not by enacting ambiguous and complex language but by promulgating clear and understandable regulation.