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SEC Proposal Fails to Live Up to its "Best Interest" Label

Without Extensive Revisions, Inadequate Protections Would Leave Investors Vulnerable to Bad Advice; Proposed Disclosures Would Perpetuate Investor Confusion

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WASHINGTON, D.C. – In the guise of strengthening protections for retail investors, the Securities and Exchange Commission (SEC) has proposed a regulatory package that, despite its name, doesn't clearly require brokers to do what is best for their customers, doesn't clearly prevent them from placing their own interests ahead of their customers' interests, enshrines as policy the Commission's weak and ineffective approach to enforcing the Investment Advisers Act fiduciary standard, and requires disclosures by brokers and advisers that are more likely to mislead investors than to dispel investor confusion.

CFA outlined these and other weaknesses in the SEC proposal in a comment letter filed with the agency earlier today. The letter responds to the Commission's request for comment on three related regulatory proposals: (1) Regulation Best Interest, which purports to raise the standard of conduct that applies when brokers make

securities recommendations (Reg BI); (2) a new interpretive release regarding the standard of conduct for investment advisers (IA Guidance); and (3) a proposal to create a new relationship summary disclosure document for brokers and advisers (Form CRS).

"It is easy to be beguiled by the rhetoric surrounding Regulation Best Interest into thinking the SEC has done something meaningful to improve protections for average mom and pop investors, but a look beneath the surface quickly dispels that illusion," said CFA Director of Investor Protection Barbara Roper. "Unless the SEC undertakes extensive revisions, the proposal will put investors at greater risk, misled into expecting protections the proposed standard doesn't provide."

"Last year, SEC Chairman Jay Clayton set out principles to guide this rulemaking, his '4 Cs' – consistency, clarity, choice, and coordination. Unfortunately, this rulemaking fails to live up to his guiding principles," said CFA Financial Services Counsel Micah Hauptman. "It establishes different advice standards for different financial professionals, and many of the key differences are hazy at best. It preserves bad choices for investors but very profitable choices for the brokerage industry. And there's no evidence that the SEC coordinated with the Department of Labor or learned from experts who have extensively studied conflicts of interest in securities markets."

The following are among the most serious of the proposal's shortcomings detailed in CFA's comment letter.

1. **Reg BI is not a true "best interest" standard.** (Section II.A., pages 3-12)
   - The new standard does not define the term "best interest" at all, let alone in a way that matches investors' reasonable expectations.
   - It does not require brokers to recommend, from among the reasonably available investments, those that are the best match for the investor.

- Brokers would remain free to recommend higher cost investments that pay them more, except in the narrowest of circumstances.

- As a result, it is not clear that the so-called "best interest" standard imposes any obligations, except disclosure, that go beyond existing requirements under FINRA's suitability standard.

"There's a huge gap between what investors expect when they hear the term 'best interests' and what this rule actually delivers," Roper said. "If the SEC isn't prepared to require brokers to recommend the best of the reasonably available investments, they should stop calling this a best interest standard. It's misleading."

2. **Reg BI doesn't do enough to prevent brokers' conflicts from tainting their recommendations.** (Section II.B., pages 12-28)

- The rule includes a compliance safe harbor that doesn't contain the prohibition on placing the broker's interests ahead of the customer's interests.

- Some conflicts could be addressed through disclosure alone, with disclosures likely delayed until after the recommended transaction.

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

- It doesn't even prevent brokers from artificially creating incentives – like sales quotas and bonuses for recommending certain products – that encourage recommendations that put the firm's interests ahead of the customers' interests.

"Instead of cracking down on toxic incentives that firms use to encourage and reward brokers for giving bad advice, such as sales quotas and contests, it defers to the firms. As long as they go through the motions of mitigating conflicts, that appears to be good enough under the proposed standard," Hauptman said.

3. **The standard applies too narrowly.**

- Even brokers in long-term relationships with their customers would have no obligation to monitor the account to ensure that past recommendations continue to perform as intended and to be in the customer's best interests. (Section II.E., pages 39-43)

- Because recommendations regarding account type are not included, the rule wouldn't prevent dual registrant firms from steering customers toward the type of account that is most profitable for the firm, rather than the account that is best for the investor. (Section II.G., pages 44-45)

"Brokers market their services as ongoing relationships, but the rule applies only episodic protections. And for customers of dual registrant firms, those protections only kick in after the all-important recommendation of account type has been made," Roper said.

4. **The IA Guidance enshrines as policy the Commission's historically weak and ineffective enforcement of the Advisers Act fiduciary standard.** (Section II.C., pages 28-33)

- The guidance says investment advisers must always act in the client's best interests and put the client's interests first, but it goes on to make clear that this obligation could generally be satisfied through disclosure.

- It says advisers must "avoid" conflicts, but it doesn't even prohibit them from adopting incentives that conflict with their clients' best interests, as long as those incentives are disclosed.

- While it does suggest that disclosure alone might not to be adequate to address all conflicts, a positive step, it needs to apply that standard far more broadly than it does here for the standard's promised protections to be realized in practice.

"The SEC had an opportunity to strengthen the Advisers Act standard to match the rhetoric used to describe it, but it failed to do so," Roper said. "Instead, to the degree that the regulatory package reduces inconsistencies in the treatment of brokers and advisers, it achieves that primarily by adopting the weakest possible interpretation of

investment advisers' fiduciary duty rather than by raising the standard of conduct for brokers. Ironically, it adopts that approach despite broad support within the adviser community for a much stronger interpretation of their fiduciary obligations."

5. **The Form CRS disclosures are more likely to mislead investors than to reduce investor confusion.** (Section III, pages 50-81)

- The proposed disclosures would generally come only after the investor has chosen a provider, much too late to be factored into the choice of providers or accounts.
- The information firms would be required to provide about the nature of their services and the conflicts of interest present in their business model is too vague and generic to be useful.
- The information on the standard of conduct that applies would lead investors to expect protections that the standards do not, in practice, provide.

"The proposed Form CRS disclosure document for brokers and advisers fails every test of disclosure effectiveness. It is too dense and technical to be understood, too generic to be meaningful, and in some areas it is downright misleading. It needs to be totally revamped based on the results of cognitive usability testing and in consultation with disclosure design experts," Roper said.

6. **The Commission hasn't conducted an even remotely credible economic analysis to support its proposed regulatory approach.** (Section VI, pages 105-161)

- The Commission bases its "analysis" on a false characterization of the broker-customer relationships and fails even to acknowledge that a serious market failure exists that requires a regulatory response.
- It fails to consider the rich body of evidence suggesting that conflicts of interest have a harmful impact on investors, including evidence from its own regulatory oversight of the market, academic research, and audit studies.

- Instead, it draws unsupported conclusions based on unfounded assumptions, often simply echoing brokerage industry talking points designed to support adoption of the weakest possible standard.

- Because it provides no analysis of the tangible impact the proposed regulations would have on broker-dealer conduct, it doesn't clearly explain what regulatory problem it is attempting to solve or how its proposed approach would address that problem.

"Simply put, this is not serious economic analysis," Hauptman said.

7. **The Commission conducted a superficial and incomplete analysis of regulatory alternatives.** (Section V, pages 81-105, and Section VI.E., pages 147-150)

- Even though the Release makes clear that the Commission views brokers as just a different type of investment adviser, it doesn't even consider a regulatory approach based on regulating brokers' advisory activities under the Investment Advisers Act.

- It provides only a cursory analysis of the approach favored by Congress – adopting a uniform fiduciary standard for broker-dealers and investment advisers in reliance on the authority in Section 913(g) of the Dodd-Frank Act.

"This appears to be nothing more than a check-the-box exercise to justify the SEC's chosen approach," Roper said. "It doesn't include any serious analysis of regulatory alternatives that reflect the will of Congress and have broad support in the investor community,"

8. **The Commission should not finalize this deeply flawed proposal without extensive revisions.**

"The brokerage industry asked the SEC for a best interest standard in name only, and that is what the SEC has delivered. Investors deserve better," Roper said. "The SEC needs to go back to the drawing board to get this right."

"The strongest supporters of this proposal come from the brokerage industry. That tells you everything you need to know about it," Hauptman said. "The question is whether the SEC is willing to make the necessary changes to protect and serve investors or whether it is content with an approach that protects and serves the brokerage industry."

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