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POLICY BRIEF

Will SEC Regulation Best Interest Protect Investors?

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The Securities and Exchange Commission (SEC) has proposed to hold securities brokers to a stricter regulatory standard when they provide their clients with investment advice "incidental" to their primary function as securities traders. The ostensible goal of the proposal is to ameliorate conflicts of interest. Regulation Best Interest would require brokers to act "solely in the best-interest" of their clients when making investment recommendations.[1] This would require brokers to recommend the securities within a given category that minimize their compensation or else risk regulatory sanctions and civil liability for securities fraud.

Brokers should of course seek to act in their clients' best interest at all times, but imposing a legal obligation to do so is ill advised. It may end up hurting investors rather than protecting them by making incidental advice more expensive or driving it out of retail brokerage accounts entirely.

BROKERS VS. ADVISERS

The best interest rule would impose a fiduciary standard of liability on brokers similar to what investment advisers—their market rivals—have long faced. But brokers and advisers do different things and are governed under different statutes. The Securities Exchange Act of 1934 regulates brokers, defined as those "engaged in the business of effecting transactions in securities for the account of others."[2] Brokers' primary function is to trade securities, for which they receive trading commissions or other transaction-based fees, including sales loads on mutual funds shares—commissions directly deducted from investors' deposits.

When trading, brokers owe their clients a fiduciary duty of best execution. When providing incidental investment advice, they have long been bound by the suitability rule (now FINRA Rule 2111).

After a reasonable investigation of a client's financial circumstances, the suitability rule allows brokers to recommend any security they reasonably believe to be appropriate for that client and to earn reasonable compensation for doing so. For decades—until now—the SEC has considered the suitability rule consistent with the 1934 act's requirement to regulate "for the protection of investors."[3]

Congress has spoken clearly on the differences between advisers and brokers. The Investment Advisers Act of 1940 defines an adviser as "any person who, for compensation, engages in the business of advising others [about] investing in, purchasing, or selling securities . . . as part of a regular business."[4] The 1940 act applies to those who provide investment advice for compensation, specifically excluding those whose advice is "incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[5]

As the 1940 act makes clear, investment advisers' primary function is to give their clients investment advice—normally via comingled accounts, or common "portfolios"—for which they earn a recurring fee, often calculated as a share of clients' assets under management. Active advisers promise to provide their clients with ongoing account supervision, research, and stock picking, and they normally have discretion to buy and sell portfolio securities without specific client consent as long as they adhere to their declared investment style. One likely response to the best interest rule is for brokers to migrate their clients to advisory accounts.[6] Yet some investors who prefer a buy-and-hold strategy (widely considered prudent) may find the added cost of advisory accounts too high a price to pay for fiduciary protection.

MARKET SEGMENTATION: FEWER OPTIONS FOR INVESTORS

In my reading, the SEC's motivation for proposing the best interest rule is to eliminate the conflict of interest brokers face in the sale of newly issued mutual fund shares carrying front-end sales loads. With a traditional front-end load, brokers take their commissions directly from clients' deposits and remit the balance for investment with the fund. For instance, a broker will take $5 from a $100 deposit and remit $95 to the fund on behalf of the client.[7] This front-end load is required by the issuing fund and is clearly stated in the fund's prospectus. Nevertheless, the best interest rule would cast suspicion on any broker who recommends a managed fund carrying a load rather than a no-load fund with similar investment objectives and past performance.

By threatening legal sanctions against brokers for recommending load funds, a best interest rule will narrow the supply of mutual fund advice. To avoid the risk of falling afoul of the rule, brokers will refer clients either to expensive advisory accounts or limit themselves to providing trade execution. This is likely to result in inferior market outcomes—in economic jargon, a suboptimal allocation of resources—because it forecloses options for investors who benefit from investing in managed funds. For instance, take investors nearing retirement who are more interested in hedging against downturns than in matching long-run market index performance. Many of those investors cannot afford advisory accounts but could benefit from the rebalancing and hedging provided by managed funds.

In this sense, managed funds' load fees are a pricing strategy to signal quality. Funds that survive the dual test of time and competition by delivering on their promises to investors can afford to charge loads and remain in business. One consequence of the proposed best interest rule is that these high-quality managed funds would no longer be available to investors without expensive advisory accounts.

THE ECONOMICS OF "BEST" CONDUCT

The proposed best interest rule is not the first time the SEC has attempted to impose "best" conduct on securities brokers. At least as early as 1962, it took the position that securities brokers have a fiduciary duty of best execution when trading on their clients' behalves. By way of example, it declared that a broker who accepts a customer's market sell order has a fiduciary duty to sell the stock at "the highest possible price."[8] Superlatives such as "best" are designed to sound uncompromising and solemn, obviously in hopes of getting brokers (and other agents) to look beyond their narrow self-interest. This is appropriate to the extent that it encourages brokers to avoid shirking by neglecting to perform due diligence. But if taken literally, the "best" admonition risks pushing brokers too far in the other direction and will invariably collide with the economic fact that brokers and their clients face tradeoffs.

Since clients must compensate brokers for their effort in competitive markets, rational clients would not want their brokers to spend an extra dollar to find a price likely to add only a dime to the gross proceeds from sale (i.e., the "best" price). Nor would clients want their broker to spend a dollar in time, effort, and other resources to serve clients' "best" interest to the tune of only a dime when seeking incidental investment advice. Yet this is exactly what a strict application of the best interest rule would require. Past some point, it would waste time and resources. Transacting parties need rules expressed in pragmatic language rather than superlatives.[9]

It was inevitable that the best execution rule would bend to economic reality. Eventually the SEC retreated, conceding that the rule merely requires a broker to seek "the most favorable terms *reasonably* available under the circumstances for a customer's transaction."[10] What is reasonable? A practical approach is to direct the broker to execute orders as if he were trading for his own account, which economic theory instructs is the point at which the marginal benefit from search equals the marginal cost. Anything past that point is both economically inefficient and intuitively unreasonable.

The SEC and civil courts will eventually be forced to confront economic reality when evaluating broker conduct under the best interest rule. It is thus likely that some kind of reasonableness qualifier will be inserted into the text of the rule. But why go through all this when the existing suitability rule already establishes a standard of review based on what is reasonable?

AN ALTERNATIVE TO BENEFIT-COST ANALYSIS: TRANSACTION COSTS

Statutory amendments dating back to the National Securities Market Improvement Act of 1996 require the SEC to consider, in addition to investor protection, whether a proposed rule will promote "efficiency, competition, and capital formation."[11] Recent federal circuit court case law interpreting this language requires the SEC to perform an economic analysis of proposed rules to ensure that the benefits are likely to exceed the costs.[12]

Quantifying and comparing the costs and benefits of a proposed rule is extremely difficult, but there is an alternative. As Nobel laureate Ronald Coase famously showed, if the costs of transacting are zero, the parties will make the value-maximizing bargain regardless of the rule of liability, all of which requires efficient economic organization. The SEC could justify the best interest rule by showing how it reduces transactions costs. In particular, the SEC needs to falsify the aforementioned hypothesis that the proposed rule would narrow the market for mutual fund advice to the detriment of investors, brokers, and likely managed funds as well. If the hypothesis is supported, however, the proposed rule is likely to increase transaction costs and leave the parties worse off.

The economic analysis section of the proposed best interest rule suggests a transaction-costs analysis without delivering one, and summarily concludes that in some cases transaction costs (the SEC uses the term "agency costs") can best be reduced by imposing a uniform rule across the entire market rather than leaving the parties to private ordering. Indeed, this could be true of the best interest rule. Still, the SEC must show that the proposed best interest rule will reduce transaction costs compared to the baseline suitability rule.[13]

CONCLUSION

The best interest rule could provide a measure of investor protection by constraining unscrupulous brokers intent on self-enrichment, but it could also hurt retail investors by driving incidental advice out of the brokerage market and forcing retail investors into more expensive advisory accounts. Which effect dominates is an empirical question, one the SEC has the burden of resolving before the proposed rule comes into force.

Properly managing conflicts of interest involves balancing tradeoffs rather than setting superlative rules of conduct. That some residual conflicts persist, as they will under any rule of liability, is no reason to rewrite the regulations governing incidental investment advice.

ABOUT THE AUTHOR

D. Bruce Johnsen is a professor at Antonin Scalia Law School at George Mason University, a leading center for law and economics scholarship. Johnsen holds a BA, MA, and PhD in economics from the University of Washington and a JD from Emory University. He has held positions in the Department of Management at Texas A&M University, the Office of Economic Analysis at the US Securities and Exchange Commission, and the Department of Legal Studies in the Wharton School at the University of Pennsylvania. He has published widely in peer-reviewed social science journals, law reviews, and the popular press.

NOTES

1. Regulation Best Interest, 83 Fed. Reg. 21574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).
2. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4)(A) (2018).
3. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(11) (2018).
4. Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2018).
5. Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2018).
6. This is exactly what happened in anticipation of the US Department of Labor's (DOL's) recent attempt to impose a fiduciary duty on securities brokers when handling their clients' *retirement* accounts. Challenged in the Fifth Circuit by the US Chamber of Commerce, the court found the DOL's fiduciary rule outside its statutory authority under the Employee Retirement Income Security Act of 1974. See Chamber of Commerce of the U.S. v. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018).
7. Front-end loads were the original form of load fee. There are now many variations on the theme, including back-end or deferred loads assessed only when the client sells the fund shares, contingent loads that disappear entirely if the client holds them for a minimum time, etc. These differences are reflected in different mutual fund share "classes" issued against a common fund.
8. Kenneth D. Garbade and William L. Silber, "Best Execution in Securities Markets: An Application of Signaling and Agency Theory," *Journal of Finance* 37, no. 2 (1982): 493. A "market order" is a request by the client that the broker execute the trade at the prevailing market price at the next available opportunity. Alternatively, the client might give more elaborate instructions, such as requiring the client to sell only at a specified price or higher (called a "limit order").
9. By any structural metric, concentration in the securities brokerage industry is extremely low, suggesting it is highly competitive.
10. Office of Investor Education and Advocacy, "SEC Bars Brokers Who Played Favorites to Double Their Commissions," press release no. 2015-248, October 28, 2015, https://www.investor.gov/additional-resources/news-alerts/press-releases/sec-bars-brokers-who-played-favorites-double-their.
11. National Securities Market Improvement Act of 1996, 15 U.S.C. § 77b(b) (1996); National Securities Market Improvement Act of 1996, 15 U.S.C. § 78c(f) (1996).
12. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 136 (D.C. Cir. 2005); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 178 (D.C. Cir. 2010); Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).
13. Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 178 (D.C. Cir. 2010).