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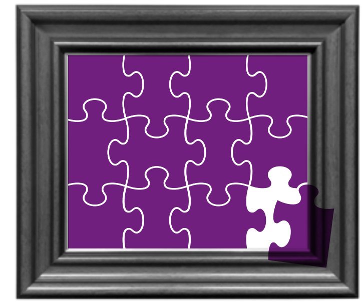

# Getting the full picture

The emerging best interest and fiduciary duty patchwork

**February 26, 2019**

## The best interest standard under FINRA's suitability rule

In connection with the US Securities and Exchange Commission's (SEC) proposed Regulation Best Interest, the Financial Industry Regulatory Authority (FINRA) has asserted (with some case law support from the SEC) that its suitability rule "implicitly requires a broker-dealer's recommendations to be consistent with customers' best interests. . . ."[1] This analysis explores the questionable foundation of that assertion.

### FINRA's Suitability Rule

FINRA's suitability rule, Rule 2111, provides that when broker-dealers or their salesforce make recommendations, they must "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."[2] This standard is often referred to as "reasonable basis suitability."[3] Note that the rule does not refer to a customer's "best interest." In contrast, under the Investment Advisers Act of 1940, registered investment advisers are fiduciaries and must act in their clients' best interest.

### FINRA's Support for its Assertion

In support of its assertion that its suitability rule "implicitly" requires a broker-dealer's recommendations to be consistent with a customer's best interest, FINRA's comment letter cited three authorities. First, FINRA cited its own Regulatory Notice 12-25 (May 2012), which is titled, "Additional Guidance on FINRA's New Suitability Rule."[4] That notice asserted that "[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."

The Notice cited nine cases for that proposition. Five cases were appeals to the SEC from FINRA disciplinary proceedings: *Raghavan Sathianathan,*[5] *Scott Epstein,*[6] *Dane S. Faber,*[7] *Wendell D. Belden,*[8] and *Daniel R. Howard*.[9] One case was an SEC Enforcement proceeding charging violations of the federal securities laws (not charging violations of FINRA or NASD rules): *Powell & McGowan*.[10] And three cases were appeals to FINRA's National Adjudicatory Council from Office of Hearing Officer proceedings: *Dep't of Enforcement v. Evans*,[11] *Dep't of Enforcement v. Cody*,[12] and *Dep't of Enforcement v. Bendetsen*.[13] In addition, FINRA's comment letter also directly cited *Raghavan Sathianathan* and *Scott Epstein*.

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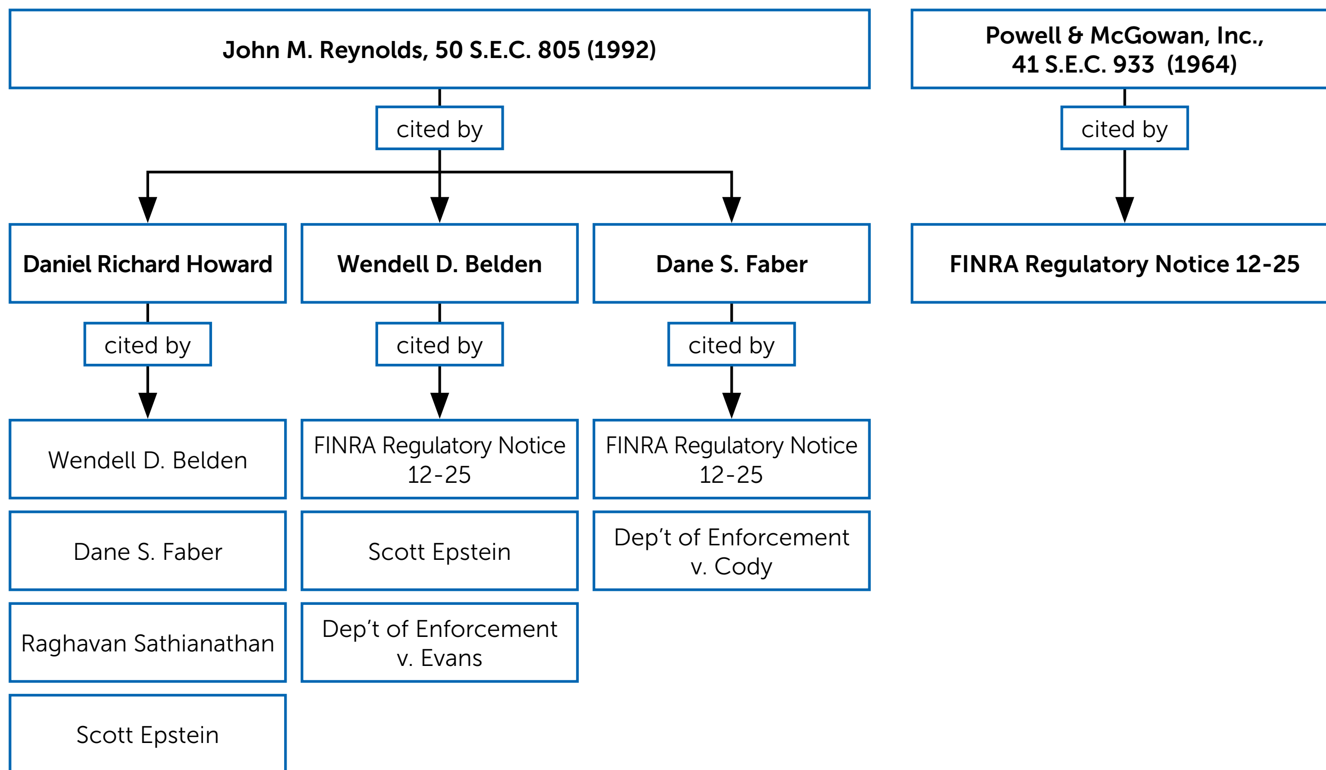
1 https://www.sec.gov/comments/s7-07-18/s70718-4268239-173131.pdf.
2 http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.
3 https://www.sec.gov/about/offices/investorad/letter-from-sec-investor-advocate-finra-regulatory-notice-18-13.pdf.
4 http://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf.
5 Exchange Act Rel. No. 54722 (Nov. 8, 2006), available at https://www.sec.gov/litigation/opinions/2006/34-54722.pdf.
6 Exchange Act Rel. No. 59328 (Jan. 30, 2009), available at https://www.sec.gov/litigation/opinions/2009/34-59328.pdf.
7 57 S.E.C. 297 (2004), available at https://www.sec.gov/litigation/opinions/34-49216.htm.
8 56 S.E.C. 496 (2003), available at https://www.sec.gov/litigation/opinions/34-47859.htm.
9 55 S.E.C. 1096 (2002), available at https://www.sec.gov/litigation/opinions/34-46269.htm.
10 41 S.E.C. 933 (1964).
11 *No. 20006005977901 (NAC Oct. 3, 2011), available at* https://www.finra.org/sites/default/files/NACDecision/p124603.pdf.
12 No. 2005003188901 (NAC May 10, 2010), available at http://www.finra.org/sites/default/files/NACDecision/p121479.pdf.
13 http://www.finra.org/sites/default/files/NACDecision/p012980.pdf.

## An Analysis of the Cited Cases

A close review of FINRA's cited cases and the precedent on which they are based shows that FINRA's assertion is misplaced. As the following chart indicates, all of the cases cited by FINRA that refer to "best interest" can be traced back to two cases: *John M. Reynolds* and *Powell & McGowan*.




The first discussion of a best interest standard for broker-dealers occurred in the 1964 *Powell & McGowan* case where the SEC suggested that, in certain circumstances, a broker-dealer cannot make recommendations "clearly contrary to the best interests of the customer." This case should not be cited as precedent for what FINRA's suitability rule "implicitly requires" because it was an SEC Enforcement action where the SEC charged the broker-dealer with committing fraud under the securities laws by making material misrepresentations or omitting material facts.

The facts involved a sympathetic customer who was a 79-year-old retiree whose health had deteriorated to the point that he likely could not understand investments or financial matters. Even though the broker-dealer's president knew the financial, physical and mental state of the customer, he nevertheless recommended that the customer enter into a loan agreement that would provide capital to the broker-dealer at substantial risk to the customer. The SEC found that this conduct willfully violated the anti-fraud provisions of securities regulations, specifically noting: "In the context of the circumstances here and the facts concerning this customer known to it and the special risks involved, [the broker-dealer] had an obligation not to recommend a course of action clearly contrary to the best interests of the customer, whether or not there was full disclosure." Although FINRA cited this case in Regulatory Notice 12-25 as a source of imposing a best interest standard on FINRA's suitability rule, the facts and the law applied in this SEC case show that FINRA's inflated definition is inappropriate.

The 1992 *John M. Reynolds* case is the other source for the best interest standard, although interestingly FINRA did not cite that authority in its comment letter regarding Regulation Best Interest. In *Reynolds*, the SEC affirmed an NASD disciplinary decision and articulated the best interest language related to suitability. While this case does state that a registered representative must make recommendations in his/her customer's best interest, it does so with a clear, crucial caveat—this heightened standard applies only when the representative also acts as a fiduciary. Reynolds, a registered representative, controlled trading in a church's account. He then traded the account excessively and disregarded the church's conservative strategy. The finding that Reynolds controlled the account made him a fiduciary, thereby heightening his duty of care. Indeed, the SEC explicitly qualified its language: "*As a fiduciary*, a broker is charged with making recommendations in the best interests of his customer even when such recommendations contradict the customer's wishes." (Emphasis added.)

Beginning in 2002, the cases that cited *Reynolds* unfortunately dropped the fiduciary qualification, and it was repeatedly cited for a proposition that it did not state. For example, *Daniel Richard Howard*, adopted the *Reynolds* language, but disregarded the fiduciary qualification. Solely citing *Reynolds* for authority, *Howard* sweepingly declared: "As we have frequently pointed out, a broker's recommendations must be consistent with his customer's best interests." The next year,

in *Wendell D. Belden*, the SEC used this same exact language, citing *Howard* and *Reynolds* as authority. This language was repeated again, with the same citations, in the 2004 *Dane S. Faber* case. In that matter, the SEC cited *Howard* and *Reynolds* and repeated the same "consistent with his customer's best interests" language. The SEC used this exact language again in 2006 in *Raghavan Sathianathan* and in 2009 in *Scott Epstein*.

As noted above, FINRA also cited its own cases as authority for its best interest pronouncement. Those cases, not surprisingly, relied on the above misguided SEC cases as precedent. For example, in 2010, in *Dep't of Enforcement v. Richard G. Cody*, the FINRA National Adjudicatory Council (NAC) cited *Dane S. Faber* for the proposition that "[a] broker's recommendations must be consistent with his customer's best interests, financial situation, and needs . . . ." Similarly, the next year, citing *Wendell D. Belden*, FINRA's NAC stated in *Dep't of Enforcement v. Evans* that "[a] recommendation must be consistent with the customer's best interests and tailored to the customer's financial profile and investment objectives."

## The Future of the Conflation of FINRA's Suitability Rule and the Best Interest Standard

The future of FINRA's approach to suitability appears bleak. In connection with Regulation Best Interest, the SEC considered FINRA's position and "implicitly" rejected it. The SEC stated in a footnote that "FINRA and a number of cases have interpreted the suitability rule as requiring a broker-dealer to make recommendations that are 'consistent with his customers' best interests' or are not 'clearly contrary to the best interest of the customer.'"[14] It is interesting to note that the SEC appears to have distanced itself from the cases. The SEC did not say that "FINRA and a number of *our* cases have interpreted . . . ." (Emphasis added.) In addition to distancing itself from prior SEC cases, the SEC also rejected this "interpret[ation]," by stating that this purported standard was "not an explicit requirement of FINRA's suitability rule." Finally, the SEC acknowledged that "under certain circumstances," a broker-dealer may have a fiduciary duty. Although the SEC didn't cite *Reynolds* for this proposition, it certainly could have. The SEC's conclusion was clear—despite FINRA's interpretation of its own rule, which would have negated the need for a new SEC regulation, the SEC decided to push ahead with its proposal.

What appears to have happened with these cases is that, somewhere along the way, the precedent was taken out of context and then misapplied. However, in the American legal tradition, once precedent is set, it is difficult to correct due to the doctrine of *stare decisis*. Indeed, late Justice Antonin Scalia once noted that the "whole function" of *stare decisis* is "to make us say that what is false under proper analysis must nonetheless be held to be true, all in the interest of stability."[15] The lesson here may be that the next time that FINRA (or the SEC) relies on precedent that sounds too good to be true and appears to be contrary to the plain reading of a rule, the regulator should review the cases and their antecedents thoroughly before citing them.

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14 https://www.sec.gov/rules/proposed/2018/34-83062.pdf.
15 https://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=4734&context=ndlr.

*An earlier version of this alert first appeared in Law360.*

## Contacts

For more commentary regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland's www.secfiduciaryrule.com.

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