BETTER MARKETS

FACT SHEET

A Capital Markets Agenda that Puts Investors First

By Benjamin Schiffrin | *Director of Securities Policy*

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Introduction

Big banks' profits are surging. Yet over half of Americans struggle to afford groceries and gas. One of the reasons for this problem is that our financial system extracts wealth from Main Street to give to Wall Street. So the solution is to adopt rules that prevent financial firms from taking advantage of ordinary investors. Unfortunately, our policymakers seem poised to do the opposite.

Today, Congress will hold a hearing entitled "Empowering Main Street by Unlocking Access to Capital." Although the name implies the focus will be on unlocking access to funding for the needs of everyday Americans, the focus instead is likely to be on empowering the financial industry to unlock access to the savings of Main Street investors for its own financial benefit. That is because, under this administration, regulators have endlessly championed deregulation, which makes it easier for Wall Street to prey on investors, consumers, and all hard-working Americans.

The record profits at Wall Street firms demonstrate that the last thing we need is more ways for the financial industry to benefit at the expense of the investing public. Indeed, one reason for these record profits is the deregulation that has taken place over the last few years, if not decades. Instead, what we need are reforms that will put money in the pockets of Main Street rather than Wall Street.

Our Financial System Should Serve Main Street, Not Wall Street

Numerous commonsense rules would protect ordinary investors and allow them to keep more of their own money. We need rules that require financial professionals to put investors' interests first; ensure investors receive the best prices on their securities trades; eliminate the fragmentation of trading venues that harm our markets; revitalize transparent public markets and curtail opaque private markets; and limit the gamification of trading that blurs the line between investing and gambling. Enacting these reforms is the real way to empower Main Street investors.

The Fiduciary Duty

We need a financial system that puts the interests of investors first instead of one that allows Wall Street to profit at investors' expense. That itself should be a rule: broker-dealers, no less than investment advisers, should be subject to a fiduciary duty that requires them to put customers' interests first. That means when a broker or adviser recommends a particular investment, it's because that investment can best meet the needs of their customer—not because compensation structures give them higher fees to steer investors into certain products.

- The SEC should adopt the strongest possible fiduciary duty rule. It should require that a broker or adviser always act in the best interests of the client. The rule should require further that, at all times, a broker or adviser must observe the duties of loyalty and care and manage any conflicts of interest so that the interests of the client always come first.
- The SEC should revise Regulation Best Interest so that it imposes a uniform fiduciary standard on brokers and advisers. Brokers, no less than advisers, should not be able to rely simply on disclosure of conflicts. The rule should require that brokers always act in the best interest of their customers without regard to the financial or other interest of the broker.
- The Department of Labor should close the loopholes in the definition of an investment advice fiduciary. These loopholes exempt a great deal of investment advice from the requirements Congress established to protect retirement savers from conflicts of interest. Financial advisers should not be allowed to saddle retirement savers with overpriced, underperforming, and risky investments that harm retirees but enrich the advisers.

A Duty of Best Execution

Brokers should be required to try to obtain the best prices for their customers' trades. It would probably shock most customers to discover that no federal law or SEC rule requires brokers to execute trades for their customers at the best possible price. Although the SEC recognized the importance of imposing a duty of best execution on brokers in 1972, it has never done so.

- The SEC should adopt a rule saying that brokers must attempt to ensure that investors receive the best prices for their trades. The rule should apply on an order-by-order basis. The SEC would be able to enforce this rule and thus provide this protection to investors.
- A best execution rule would also protect our markets. Markets in which orders are executed at the best possible price promote the efficient allocation of capital. Best execution also promotes capital formation by instilling investor confidence in the fairness of the markets.
- The fact that FINRA, a self-regulatory organization, has a best execution rule is insufficient. FINRA's rule allows brokers to satisfy their best execution obligations through periodic, quarterly reviews of execution quality. This means that brokers do not have to try to obtain the best price for each trade but simply have to show that, in the aggregate, they have order routing practices that offer their customers favorable terms on their trades.

Reducing Market Fragmentation and Its Perils

Policymakers must take steps to increase trading on "lit" exchanges rather than on "dark" alternative trading venues and to reduce the fragmentation that currently plagues our markets. The consequence of the complexity that results from our fragmented markets has been the transformation of our financial markets from a wealth creation system for the many to a wealth extraction system for the few. This market fragmentation has created conflicts for brokers and opportunities for predatory market participants, including high-frequency trading firms, to take advantage of retail investors by arbitrating slight price differentials across trading venues.

- The SEC should level the playing field between exchanges and alternative trading systems (ATSs), an exemption from the exchange framework created in the late 1990s. The current regulatory framework for ATSs allows them to perform all of the essential functions of exchanges with substantially less oversight. Almost as much trading now occurs off-exchange as on-exchange, and the evolution of our securities markets from trading conducted on well-regulated national securities exchanges to trading conducted on less regulated trading platforms has materially harmed investors and the public interest.

- The SEC should ban the practice of payment for order flow (PFOF). PFOF is the practice of high-frequency trading firms paying for the order flow of retail investors. They then execute the orders at one price and engage in offsetting trades at better prices for their own gain. This creates a clear conflict of interest for brokers, who have an incentive to route the orders to these firms in return for payment even if those firms do not offer their customers the best execution. PFOF also contributes to market fragmentation by routing orders to high-frequency trading firms who either execute the trades against their own inventory or on dark pools, so those orders never interact with orders on the lit public securities exchanges.

- High-frequency trading firms (HFTs) also profit by taking advantage of latency arbitrage—exploiting the gaps in the time it takes to collect and collate quotes from the various exchanges and then disseminate a national best bid and offer (NBBO) to the market. HFTs are able to obtain quotes directly from the exchanges and figure out what the NBBO is going to be before it is disseminated to the market. This enables HFTs to essentially front-run other orders. The SEC should stop this by implementing a central limit order book (CLOB).

Revitalizing Public Markets

Policymakers must also curtail the exemptions from registered securities offerings that have allowed the private markets to proliferate. The financial industry favors private market assets because it can earn high fees from those assets, but private assets are opaque, illiquid, and hard-to-value. So policymakers should instead focus on revitalizing our public securities markets.

- Studies show that capital is raised more efficiently in public markets than private markets. That is because the disclosure requirements that ensure investors have the information that they need to get capital to its most productive uses exist in the public markets but not in the private markets. So the consequences of raising capital through the private rather than public markets extend beyond the risks to retail investors to real capital formation.

- The number of ways to raise money privately, without the protections of the federal securities laws, has exploded. The exemptions from the registration requirements are now so numerous that the SEC has an 8x10 chart to explain all the different ways companies can raise money privately. The problem is that even institutional investors have suffered huge losses in the private markets. And now investors in the private markets can't get out fast enough. This is hardly the time to expose retail investors to the private markets.

- Instead, policymakers should return to the framework Congress originally envisioned when it enacted the federal securities laws—registered public offerings as the default and exemptions available in only narrow circumstances. The decline in the number of initial public offerings and the number of public companies over the last few years and decades has coincided with the rise of the private offering exemptions. Returning the private markets to their proper role will ensure the vibrancy of our public markets, which will provide investors with sound investment opportunities and enable efficient capital formation.

Reinforcing the Line Between Investing and Gambling

Policymakers should further insulate our capital markets from the gamification of finance, which is being supercharged by artificial intelligence. Five years after the GameStop trading saga, regulators have done nothing to protect retail investors from the gamification of investing. Instead, regulators have allowed or even encouraged the dangerous gamification of investing. As a result, despite participating in the stock market in record numbers, retail investors are more vulnerable than ever. Turning finance into a game blurs the line between investing and gambling.

- The use of AI in the securities industry allows firms to exploit predictive data analytics, digital engagement practices, and gamification features to induce investors to trade excessively. Firms use the data that they gather on investors to deliver prompts, nudges, and cues that are designed to keep investors trading. Although AI may have many benefits in the financial industry, it should not be used as a tool to cause investors to employ a trading strategy that is excessive, risky, and inconsistent with their investment objectives.
- Expanding trading hours also risks turning stock exchanges into casinos. One of the reasons for the gambling addiction epidemic in the United States is the ability to place bets 24 hours a day. 24/7 stock exchanges might be lucrative for the exchanges but would pose risks for retail investors, from excessive trading to speculative trading to impulsive trading. The ability to trade from a smartphone at 3 am is unlikely to be in investors' best interests. It is likely to cause retail investors to treat the stock market more like gambling.
- Policymakers should also guard against products that are really for speculation and gambling under the guise that they are investments. Most investors consider exchange-traded funds to be low-cost, index fund investments that cover broad markets like the S&P 500. But newer products like single-stock ETFs that use leverage are almost always inappropriate for retail investors and more closely resemble portfolio gambling. Now, the SEC is considering ETFs tied to prediction markets, which would serve no economically productive purpose and would instead be a gambling product. Policymakers should ensure that the stock market is for investment opportunities and capital formation, not gambling.

Conclusion

Our capital markets are not a tool for the financial industry to extract wealth from everyday Americans. They are a means to save for a house, pay for college, or prepare for retirement. Yet all too often Wall Street preys on Main Street for its own financial gain. And, currently, the officials in charge of stopping these predatory practices are instead encouraging them. This needs to stop. Instead, policymakers must pursue a capital markets agenda that puts investors first.

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Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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