

Regulation Best Interest sees its first enforcement action

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The financial industry is getting its first look at how the new regulations governing broker-dealer professional conduct and investment recommendations will be enforced by the Securities and Exchange Commission (SEC). The financial world has been wondering how strictly the SEC will interpret and enforce Regulation Best Interest (Reg BI) and where the Commission will draw the line when determining what counts as “reasonable” effort toward achieving compliance. We’re now getting a glimpse of what this regulatory landscape could look like going forward.

In previous years, broker-dealer investment recommendations were subject to the suitability requirements found in FINRA Rule 2111. These requirements were composed of three general obligations.

- The **reasonable-basis obligation** required broker-dealers (through reasonable diligence) to understand the risks and rewards involved with a particular investment and to have a reasonable basis to believe that an investment was suitable for at least some investors.
- The **customer-specific obligation** required broker-dealers to have a reasonable basis to believe an investment was suitable for a specific customer based on that customer’s investment profile.
- The **quantitative suitability obligation** required broker-dealers to reasonably believe that a series of individually suitable recommendations, when considered in concert, would not become excessive and therefore unsuitable for an investor.

However, in June 2019, this standard for broker-dealers was supplanted by the SEC’s new Regulation Best Interest rule, also known as Rule 15l-1(a) of the Securities Exchange Act of 1934. The new rule was touted by the SEC as an improvement in protections for everyday Main Street investors, creating heightened obligations on broker-dealers and their registered representatives.

In a press release issued on June 5, 2019, the Commission summed up the new rule:

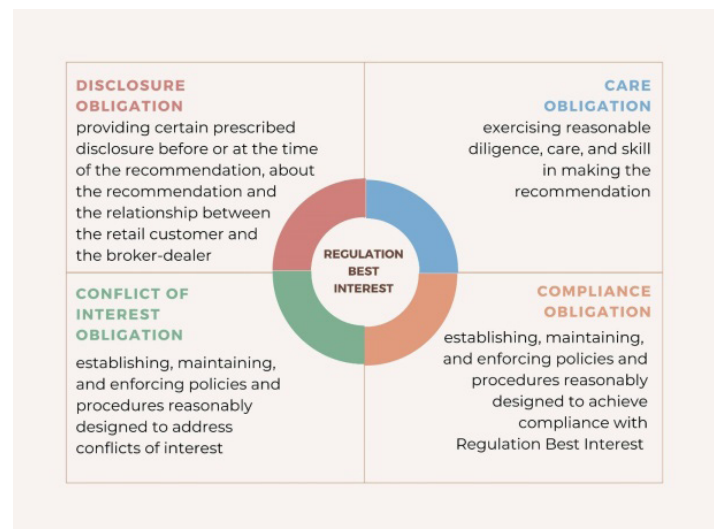
“Under Regulation Best Interest, broker-dealers will be required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. Regulation Best Interest will enhance the broker-dealer standard of conduct beyond existing suitability obligations

and make it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer when making recommendations.”

No longer was “suitable” to be the threshold for broker-dealers — recommendations would need to meet a higher standard and be in the best interest of any given client. Specifically, Reg BI is composed of four component obligations: the 1) Disclosure Obligation; 2) Care Obligation; 3) Conflict of Interest Obligation; and 4) Compliance Obligation.

It’s important to note that these obligations only apply to broker-dealers when they are making a financial recommendation to a retail investor, not simply providing a description or information. Recommendations can relate to types of accounts (e.g., Do I open a brokerage or an advisory account?), the transfer of assets (e.g., Do I roll my 401k over to an IRA?), or actually investing in securities (e.g., What stocks or bonds should I purchase?).

Regardless of the nature of the recommendation, broker-dealers and their firms have a duty to meet each of the Reg BI obligations in accordance with individual investors’ profiles, while also making best efforts to ideally eliminate and, at a minimum, disclose conflicts of interest and incentives that may run contrary to a customer’s best financial interests.



Definitions taken from 17 CFR Part 240 Regulation Best Interest: The Broker-Dealer Standard of Conduct (p.13). Graphic developed by the authors' firm.

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After Reg BI was adopted, the deadline for compliance was set for June 30, 2020. In the two years since then, there have been no major Reg BI enforcement actions brought by the SEC until recently. In a document filed in the Central District of California on June 15, 2022, the SEC brought its first substantial Reg BI complaint, alleging that Pasadena-based advisory firm Western International Securities, Inc. and five of its registered representatives had violated the best interest rule (*SEC v. Western International Securities, Inc.*, 2:22-cv-04119).

According to the complaint, five of Western's broker-dealers recommended the purchase of "L Bonds" — unrated debt securities offered by GWG Holdings, Inc. — to certain retail customers. Between July 2020 and April 2021, Western sold \$13.3 million worth of L Bonds. However, as the SEC pointed out, the prospectus for L Bonds described them as high-risk and speculative securities. The SEC also noted that the L Bonds were illiquid (there is currently no market on which to trade L Bonds), the bonds were unrated by a third party regarding the issuer's credit risk, and GWG Holdings had a history of net losses. In short, the SEC concluded that the L Bonds were "high risk, illiquid, and only suitable for customers with substantial financial resources" (Complaint, p. 2).

The SEC subsequently alleged that Western's broker-dealers recommended L-Bonds to retail investors whose investor profiles didn't match the highly speculative nature of the L Bonds, such as customers that had "moderate-conservative or moderate risk tolerances, investment objectives that did not include speculation, limited investment experience, limited liquid net worth, and/or they were retired" (Complaint, p. 4).

The complaint claims that the broker-dealers violated the Care Obligation of Reg BI by not using reasonable care and diligence to adequately assess and understand the risks involved with the L Bonds. They went on to recommend these L Bonds to customers with risk-sensitive profiles, with no reasonable basis to believe this recommendation was in those individuals' best interests.

The SEC also purported that Western did not meet the Compliance Obligation. Although Western's written policies included verbiage related to Reg BI, the SEC noted that the language was overly general and substantially copied from a compliance guide the Commission had previously issued to the public; that is to say, Western had not tailored its Reg BI written policies to its business operations, nor did it provide explanations or guidelines that could have assisted representatives in better complying with the rule.

Additionally, the complaint highlights the conspicuous lack of mechanisms in place to actually enforce any of the Reg BI policies and procedures. These circumstances led the SEC to conclude that Western had failed in its obligation to "establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI."

The SEC is seeking permanent injunctions, disgorgement and prejudgment interest, and civil penalties against both Western and the broker-dealers involved. However, Western has so far denied any wrongdoing. As reported by "Investment News" on June 16, 2022, a spokesperson for Western said in a statement, "The firm takes its clients' best interests very seriously and believes it complied with Reg BI and the regulatory guidance available during the pertinent timeframe. The firm intends to actively defend the claims asserted by the SEC and will not provide additional comments on this pending litigation at this time."

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Although still early in Reg BI's lifetime, the Commission's recent actions and the details of this complaint indicate that compliance with Regulation Best Interest cannot be left as an afterthought. Of additional note is the fact that Reg BI is now among the top 15 controversy types for FINRA customer arbitration. According to statistics released by FINRA, there have been 37 cases involving breach of Reg BI as of May 2022, making it the authority's 14th most common controversy type in customer arbitrations (<https://bit.ly/3ANMIFs>).

These trends indicate that both firms and their representatives must put a true "good faith" effort behind implementing the Reg BI standard or else face potential enforcement actions and customer disputes. At the end of the day, complying with Regulation Best Interest will be in broker-dealers' best interest as well.

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