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Regulation BI Challenged in Second Circuit

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As we reported in a ***previous alert***, the SEC and FINRA recently confirmed that Regulation Best Interest ("Regulation BI") will go into effect on the scheduled compliance date of June 30, 2020, despite the impact of the COVID-19 outbreak. The new rules regulating broker-dealers, however, must clear a last-minute hurdle: a lawsuit jointly filed by various states and a coalition of investment advisors challenging the SEC's authority to promulgate the new regulation. Last week, a panel of the Second Circuit Court of Appeals heard arguments and is expected to determine Regulation BI's fate before the end of the month.

Below, we outline the court challenge to Regulation BI.

Regulation BI

Regulation BI, adopted by the SEC on June 5, 2019, requires broker-dealers (and their associated persons) to act in the best interest of their retail customers when making a recommendation of any securities-related transaction or investment strategy. Importantly, broker-dealers are permitted to consider their own financial or other interests in making such recommendations, so long as they do not place these interests ahead of the customer's.

The general "best interest" obligation is satisfied only if a broker-dealer complies with four component obligations:[1]

- **Disclosure Obligation:** The broker-dealer must disclose material facts about the recommendation and the relationship with the customer, including specific disclosures about the capacity in which the broker is acting, fees, the type and scope of services provided, and any conflicts of interest.

- **Care Obligation:** The broker-dealer must exercise reasonable diligence, care and skill when making a recommendation to a retail customer, and consider any potential costs and risks associated with the investment in light of the customer's investment profile.

- **Conflict of Interest Obligation:** The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose or eliminate conflicts of interest.

- **Compliance Obligation:** Broker-dealers must establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole.

Regulation BI is scheduled to take effect after June 30, 2020.

Challenge to Regulation BI

In September 2019, a group of plaintiffs—consisting of seven states and the District of Columbia (represented by the New York Attorney General's Office), as well as two groups of investment advisors—filed petitions in the Second Circuit challenging the SEC's authority to promulgate Regulation BI.[2] The Second Circuit has original jurisdiction over the petitions for review of agency action.

The plaintiffs primarily challenge the dual regime preserved by Regulation BI in which broker-dealers may consider their own interests in making recommendations to clients, while Registered Investment Advisors (RIAs) remain held to the stricter fiduciary standard set out in the Investment Advisers Act of 1940. This inconsistency, plaintiffs argue, contravenes the Dodd-Frank Act's mandate authorizing the SEC to promulgate rules that "harmonize" the obligations of broker-dealers with those of RIAs. The plaintiffs also argue that Regulation BI is arbitrary and capricious due to the failure of the "best interests" standard—akin to FINRA's suitability rule—to adequately achieve the stated goal of customer protection.

Interestingly, the plaintiffs' position was supported by an amicus brief filed by various current and former members of Congress, including former Senator Chris Dodd and former Representative Barney Frank.

In response, the SEC maintained that its actions were within the sweeping authority granted to it by Dodd-Frank and that Regulation BI was not arbitrary and capricious. According to the SEC, Congress gave the SEC the choice to impose the standards set forth by the Investors Advisers Act on broker-dealers, to create its own standards, or to take no action at all. The SEC argued that it appropriately balanced its objectives, justified the reasons for its policy decisions, and took action to avoid investor confusion.

Conclusion

Caution is certainly warranted, given that the most recent attempt to impose new obligations on broker-dealers—the Department of Labor's "Fiduciary Rule"—was vacated by the Fifth Circuit in 2018.[3] That said, the SEC's Regulation BI appears to fit comfortably within the SEC's mandate and we expect it to go into effect on the scheduled June 30, 2020 compliance date. Either way, we will presumably have direction from the Second Circuit in the next several weeks, so stay tuned.

Bracewell attorneys are experienced with financial regulatory issues, and are ready and available to provide further information and discuss particular circumstances.

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[1] These obligations are set forth in full in Exchange Act Rule 15*l*-1(a)(2).

[2] *XY Planning Network, LLC v. SEC*, Nos. 19-2886 (2d Cir.).

[3] *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).