

SEC Files Groundbreaking Reg BI Complaint

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On June 15, 2022, the SEC filed its first complaint alleging violations of the “care obligation” and the “compliance obligation” of Regulation Best Interest, Rule 15l-1(a) under the Securities Exchange Act of 1934 (Reg BI).

In *SEC v. Western International Securities Inc.*, the SEC alleges violations by Western International Securities Inc. and five of its registered representatives of Reg BI in connection with their recommendations to retail customers to purchase unrated debt securities, known as “L Bonds,” between July 2020 and April 2021. Unlike prior Reg BI settlements with the SEC involving alleged broker-dealer violations of the “disclosure obligation” associated with the new Form CRS, the Western complaint involves the first alleged broker-dealer violations of both the care obligation and the compliance obligation.

Specifically, the SEC alleges that Western and the registered representatives failed to exercise reasonable diligence, care, and skill to understand the risks, rewards, and costs associated with L Bonds. At the time they recommended L Bonds to retail customers, the registered representatives allegedly did not understand key risks associated with the bonds and the bonds’ issuer, GWG Holdings Inc. Further, the SEC alleges that Western and the registered representatives recommended L Bonds to at least seven retail customers without a reasonable basis to believe L Bonds were in those customers’ best interests. Notably, the SEC did not allege that recommendations for L Bonds were not in the best interests of Western’s customers.

The SEC also alleges that Western’s written policies and procedures were not reasonably designed to achieve compliance with Reg BI’s care obligation, i.e., that its written policies and procedures merely recited the objectives of Reg BI without offering registered representatives specific guidance tailored to Western’s operations. Western also allegedly had inadequate procedures for enforcing what limited policies it had regarding compliance with the care obligation of Reg BI.

As the regulation makes clear, the standard for evaluating compliance with the care obligation is whether the broker-dealer “exercises reasonable diligence, care, and skill” (as required by Rule 15l-

1(a)(2)(ii)) in making a recommendation. As the SEC made clear in its release adopting Reg BI, compliance is evaluated as of the time of the recommendation, not in hindsight. According to the release, it is an objective standard “turning on the facts and circumstances of the particular recommendation and the particular retail customer,” and “the factors that a broker-dealer should understand and consider when making a recommendation may vary depending upon the particular product or strategy recommended.” The rule and its adopting release are silent, however, on exactly what sources of information a broker-dealer should consider in the exercise of reasonable diligence to understand the risks, rewards, and costs of a product or to establish a reasonable basis for recommending the product.

On the other hand, Rule 15l-1(a)(2)(iv) provides that the standard for evaluating compliance with the compliance obligation is whether the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Reg BI. This is similar to language in FINRA’s supervision rule, Rule 3110(b).

This case will be instructive as to how future Reg BI cases will be brought and provides some insight into what broker-dealers can do to ensure compliance with Reg BI. See [“Takeaways for Broker-Dealers After SEC’s Reg BI Action.”](#)

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