CARLTON FIELDS

The SEC's First Regulation Best Interest Action and the Challenges of Regulating By Enforcement

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This article was originally published by the American Bar Association Litigation Section Securities Litigation Committee on January 31, 2023. It also appeared in Law360. In June 2022, the U.S. Securities and Exchange Commission (SEC) filed its first complaint alleging violations of both the care and compliance obligations of Regulation Best Interest, or Reg BI. In SEC v. Western International Securities Inc., the SEC alleged violations by Western and five of its registered representatives in connection with recommendations to retail customers to purchase unrated debt securities, known as L bonds, between July 2020 and April 2021. In their answers, the defendants denied the allegations and asserted various affirmative defenses, including lack of fair notice and vagueness regarding the requirements of Reg BI. The SEC then filed a motion to strike the affirmative defenses, the defendants filed oppositions, and in November, the SEC filed its reply. The pleadings highlight a number of problems for the SEC as it prosecutes its first Reg BI case. The problems arise from a regulation accompanied by a 770-page adopting release that not only does not define "best interest" but also does not prohibit much of the conduct cited in the complaint; does not specify the requirements of "reasonable diligence, care, and skill"; and does not differentiate between the obligations of broker-dealer firms and their registered representatives. As a result, it is not clear what the regulation actually requires. It leads to claims that "Reg BI" might be better described as "Reg BE" for "Regulation By Enforcement." **Reg BI Does Not Prohibit Certain Conduct Cited in the Complaint** The first affirmative defense–lack of fair notice–argues that certain alleged violations involve standards that are not set forth anywhere in Reg BI or related guidance, failures to engage in conduct that is not required by Reg BI or related guidance, and interpretations of Reg BI that are erroneous or inconsistent with the regulation or related guidance. For example, the SEC

alleges in the complaint that

- "the Chief Compliance Officer did not provide the Due Diligence Report to Western registered representatives, supervisors, or other compliance personnel."
- "Western did not set any criteria or thresholds for its customers to invest in L Bonds. Western also did not restrict the sale of L Bonds to customers with certain risk profiles or investment objectives."
- "Western did not require registered representatives to take L Bond training on the current L Bond offering if they had already taken a training for one of the prior issuances of L Bonds, notwithstanding the significant changes in GWG's business and finances following its [merger] transactions with Beneficient."

But none of the "failures" cited by the SEC involve conduct that is expressly required by Reg BI or even referenced in the adopting release; that is, there are no specific requirements or even references suggesting a broker-dealer ought to provide its due diligence reports to the registered representatives, set specific criteria or thresholds for investing in certain products, or provide training for *every* issuance of a product. Nor do the practices in the industry appear to include such activities. Thus, this is fertile ground to argue lack of notice. **Reg BI Does Not Specify the Requirements of Reasonable Diligence, Care, and Skill** The second affirmative defense–void for vagueness–argues that Reg BI is unconstitutionally vague because it fails to provide "sufficient concrete, practical guidance" for compliance with the regulation when making a recommendation. For example, the SEC alleges that each of the registered representatives "misunderstood important issues regarding GWG and L Bonds" as set forth below:

- "several [registered representatives] Defendants failed to use reasonable diligence, care, and skill to understand the business combination with Beneficient, Beneficient's business, or the impact of that business combination on the L Bonds' risk";
- "did not understand the risk of L Bonds";
- "did not understand the nature of the collateral for L Bonds"; and
- "knew little, if anything, about Beneficient's finances, including its history of operating losses, and did nothing to educate themselves."

But Reg BI does not specify the requirements of "reasonable diligence, care, and skill" as it relates to understanding a recommendation, other than it requires the broker, dealer, or associated person to "understand the potential risks, rewards, and costs associated with the recommendation…" The adopting release provides little helpful guidance, except to state that, "reasonable diligence, care, and skill . . . will vary depending on, among other things, the complexity of and risks associated with the recommended security … and the broker-dealer's familiarity with the recommended security." It

also states that the broker-dealer should develop a sufficient understanding of the security by considering "important factors" such as the security's "investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security… Together, this inquiry should allow the broker-dealer to develop a sufficient understanding of the security … and to be able to reasonably believe that it could be in the best interest of at least some retail customers." SEC Release No. 34-86031, at 262. Notably, the factors that the SEC states are "important" to develop a sufficient understanding of the product *do not include factors specific to the issuer or its business partners*. Further, Reg BI does not define how deeply broker-dealers and their registered representatives, in the exercise of reasonable diligence, must delve into the issuer's financial history, collateral, or business model (or changes to its business model) to understand sufficiently the risks, rewards, and costs associated with the recommendation. Nor does the regulation specify how far broker-dealers and their registered representatives, in the exercise of reasonable diligence, must look back to sufficiently understand the risks, rewards, and costs associated with the recommendation. This lack of specificity in Reg BI renders SEC enforcement actions susceptible to the affirmative defense of "void for vagueness," as well as claims of regulation by enforcement. It also may present proof problems for the SEC because there are no prior Reg BI cases or interpretive guidance (other than the adopting release) to illuminate the contours of the regulation. While there are older suitability cases that may serve as precedent for various propositions, it is not clear that any would stand for the proposition that broker-dealers and their registered representatives must, in the exercise of reasonable diligence, understand the finances and transactional history of the issuer and its business partners as suggested in the *Western* complaint. With respect to *Western*, it is too easy to say, in retrospect years later, that a broker-dealer and its registered representatives should have exercised more diligence to develop a better understanding of the issuer's financial condition, that of its business partner, and the consequences of their merger simply because the new entity, years later, enters bankruptcy. That is why the traditional test of reasonableness is at the time of the recommendation. Given all the above, the SEC may have difficulty establishing that the broker-dealer's and registered representatives' due diligence was unreasonable at the time of the recommendation. **Reg BI Does Not Distinguish Between the Obligations of the Broker-Dealer and its Associated Persons** More problematic for the SEC is that Reg BI does not differentiate between the obligations of broker-dealer firms and those of its associated persons (here, the registered representatives). For example, the subsection of Reg BI setting forth the care obligation applies equally to both broker-dealer firms and their associated persons: "The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises . . ." Further, the adopting release, on page 5, states that the term "broker-dealer" is inclusive of "associated persons" unless otherwise indicated. Thus, where the adopting release provides guidance regarding the reasonable diligence, care, and skill required of broker-dealers, it includes the registered representatives. While conflating the obligations of firms and their registered representatives may be useful for rulemaking purposes, it does not appear to reflect the actual

practices in the industry. For example, all but the smallest broker-dealer firms will have an investment or product committee or supervisory principal or principals who exercise reasonable diligence, care, and skill in performing due diligence reviews of available investment products. The reviews are typically extensive, involving due diligence reports from third parties, reviews of public information, reviews of financial filings of the issuer and offering materials, meetings with management, and possibly on-site visits. The due diligence reports typically include in-depth analysis by attorneys and accountants regarding the issuer's corporate history, business plan, management, financial condition, portfolio, organizational structure, and risk factors, as well as details about the offering, its use of proceeds, and plan of distribution. Upon completing its review, the firm determines whether the product could be in the best interest of at least some customers. If so, the product may be placed on the firm's approved product list (APL). Once the product is placed on the APL, the registered representatives, relying on the product due diligence of the firm, take product training and review the approved offering materials to determine whether there is a reasonable basis to believe that the product is in the best interest of a particular retail customer in light of the customer's investment profile. In practice, the registered representatives do not receive and do not need all the information the firm may have regarding product due diligence, and the firm does not receive or need all the information the RRs may have regarding their particular customers' investor profiles. The obligations of due diligence are, in practice, bifurcated. Firms, with their greater resources, are primarily responsible for product due diligence, while registered representatives are primarily responsible for customer due diligence. Registered representatives rely on the firm's product due diligence when the firm approves the product for the APL and provides training and offering materials to the registered representatives. And when firms provide final approval of a recommendation, they rely on the registered representatives to provide a form summarizing their customer due diligence. This is not to say that registered representatives do not need to understand the risks, rewards, and costs of the product–they do, through the training and offering materials–but they also may rely on the firm to perform more extensive product due diligence. Thus, it is not surprising that registered representatives may not have the same understanding of a product as the firm. *See, e.g.,* FINRA Suitability Rule FAQ A5.2 and FINRA NTM 11-25 Q11 (registered representatives "may rely on a firm's fair and balanced explanation of the potential risks and rewards of a product"). But you would not know this from *Western*, where the SEC alleges the registered representatives failed to understand GWG Holdings' business combination with Beneficient or its business, the impact of the business combination on the L Bonds' risk, or the nature of the collateral for the L Bonds. Such information, however, might have been known and understood by the firm through the product due diligence conducted by its committee. Arguably, if the firm knows and understands all the material information about the product and issuer that was provided by its experts before placing the product on the APL, there is no need for the firm's registered representatives to understand it to the same degree. After all, "[t]he standard for reasonable diligence does not require an overzealous or extreme pursuit of any and every avenue of relief. . . Rather, diligence requires only the effort that a reasonable person might be expected to deliver under his or her particular circumstances.'" *Simmonds v. Credit Suisse Securities (USA) LLC*, 2013 WL 12090085 (W.D. Wash. 2013). Under the circumstances in *Western,*

and even assuming that the registered representatives did not know and understand all the information in the firm's possession about the product and issuer, the SEC may have difficulty establishing that such a lack of understanding on their part necessarily violates Reg BI. **Conclusion** In sum, Reg BI is emblematic of the phrase "regulation by enforcement" because of its lack of clarity. This same lack of clarity, however, may make litigation problematic for the regulator.

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