

Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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Securities Enforcement and Regulation

Regulation BI: Updates and Developments

INTRODUCTION

It's been nearly five months since the Securities and Exchange Commission ("SEC") approved Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg BI"). As discussed in our June 27, 2019 Client Alert,¹ Reg BI requires broker-dealers and their associated persons to "act in the best interest" of retail customers when recommending securities transactions or strategies to retail customers. Our previous alert summarized Reg BI, described its impact on broker-dealers, and highlighted how the new rule falls short of the fiduciary standard of conduct that investment advisers owe their clients.

The SEC's decision not to adopt a uniform fiduciary standard for both investment advisers and broker-dealers has resulted in some confusion and criticism. In this alert, we provide an update on several recent developments relating to Reg BI's implementation:

- A few weeks after Reg BI was adopted, the U.S. House of Representatives passed legislation prohibiting the SEC from requiring broker-dealers to comply with the new regulation.
- Last month, eight state attorneys general and an organization of investment advisers initiated litigation against the SEC seeking to vacate Reg BI and permanently enjoin its implementation.
- In addition, various state legislatures and state securities regulators are taking steps to adopt uniform fiduciary standards for broker-dealers and investment advisers at the local level.
- The Chief Executive Officer and Chief Legal Officer of the Financial Industry Regulatory Authority ("FINRA") have indicated that interpretation of Reg BI will remain the responsibility of the SEC; FINRA is closely coordinating with the SEC on how best to enforce the new rules; FINRA will not eliminate its suitability rule; and FINRA will



begin to conduct “preparedness reviews” of member firms in advance of the June 2020 Reg BI compliance deadline. As these developments unfold, the SEC and FINRA remain committed to the existing June 2020 Reg BI compliance deadline.

HOUSE BILL TO BLOCK REG BI

In June 2019, the House approved an amendment to an annual appropriations bill that would prohibit the SEC from using funds to implement and enforce Reg BI.² This prohibition, however, is unlikely to pass in the Senate. Recently, the ranking members of the Senate’s Committee of Banking, Housing, and Urban Affairs sent a letter to SEC Chairman Jay Clayton commending the agency’s promulgation of Reg BI and describing the new rule as striking “the appropriate balance of increasing transparency in investors’ relationships, while preserving access to advice relationships and investment products.”³

LITIGATION SEEKING TO BLOCK REG BI IMPLEMENTATION

In September 2019, a coalition of attorneys general from seven states plus the District of Columbia commenced litigation to challenge Reg BI in both the United States District Court for the Southern District of New York and the United States Court of Appeals for the Second Circuit.⁴ A day later, an industry organization of fee-only investment advisers filed similar proceedings.⁵

In their district court complaints and Second Circuit petitions, these litigants seek to vacate Reg BI and to enjoin its enforcement on the grounds that the SEC exceeded its statutory authority and acted arbitrarily and capriciously. More specifically, they allege that the SEC’s failure to implement a uniform standard of conduct creates increased risk of harm to retail investors who cannot always differentiate between the roles of broker-dealers and investment advisers, nor between the different standards of care that may apply.⁶ The state attorneys general argue that Reg BI fails to “meaningfully elevate” existing suitability rules and would cause economic injury to their respective states through that harm to retail investors.⁷ The investment adviser industry group also alleges that Reg BI gives broker-dealers a competitive advantage over investment advisers who are held to more stringent fiduciary standards. They contend that under the new rule, broker-dealers would be less inclined to register as investment advisers, directly harming the advisory industry, and would be able to provide the same financial-planning services as registered investment advisers at an unfairly reduced risk of legal exposure.⁸

On September 27, 2019, the district court dismissed the complaints *sua sponte*, concluding that jurisdiction properly lies in the Second Circuit.⁹ As of the time of this client alert, the parties had reported that they are in discussion about a procedure to resolve the jurisdictional issues and anticipate filing papers soon.¹⁰

UPDATE ON STATE LEGISLATION

Even before the SEC adopted Reg BI in June 2019, multiple states were working at the local level toward imposing fiduciary duties and increased disclosure requirements on broker-dealers. The announcement of the final Reg BI rule has triggered additional interest by state legislators and securities regulators in the adoption of more stringent broker-dealer conduct standards. Thus far, Massachusetts, Nevada, New Jersey, and New York have all taken steps toward requiring greater levels of disclosure or imposing uniform fiduciary standards on all investment professionals:

- In July 2017, Nevada amended its securities laws to make clear that all financial planners, including broker-dealers and investment advisers who provide financial advice for compensation, owe a fiduciary duty to their customers.¹¹ In January 2019, the Nevada Securities Division proposed draft regulations which would further outline the fiduciary duties owed by broker-dealers and investment advisers to their clients, including any exemptions that might apply.¹²



- In January 2019, the New York State Assembly introduced legislation that would require all investment professionals not currently subject to a fiduciary standard to disclose to clients that they are not fiduciaries, and therefore not required to act in their clients' best interests.¹³ This bill is in committee.
- In April 2019, the Massachusetts Securities Division proposed a regulation that would require investment advisers registered therewith to create and provide annually a table of fees and services to advisory clients in order to increase transparency for retail investors.¹⁴ In June 2019, the Division issued a preliminary solicitation of public comment for a proposed regulation that would apply a fiduciary standard to broker-dealers, agents, investment advisers, and investment adviser representatives.¹⁵
- In April 2019, the New Jersey Bureau of Securities proposed a rule that would require all investment professionals registered with the state's Division of Consumer Affairs' Bureau of Securities to place customers' interests above their own when recommending securities or providing investment advice.¹⁶ This rule, if adopted, would impose a fiduciary duty of care and loyalty on broker-dealers.

FINRA DEFERENCE TO SEC INTERPRETATIONS OF REG BI

On August 7, 2019, FINRA issued Regulatory Notice 19-26, which informed its members of the SEC's adoption of Reg BI.¹⁷ In the notice, FINRA announced the establishment of a committee to assist firms with planning for Reg BI implementation. The committee will be comprised of both FINRA staff and representatives of the SEC's Division of Investment Management, Division of Trading and Markets, Division of Economic and Risk Analysis, Office of Compliance Inspections and Examinations, and Office of the General Counsel. FINRA directed firms to send any questions they have to a dedicated SEC email address (IABDQuestions@sec.gov). In addition, FINRA committed to producing guidance and workshops to assist firms with their Reg BI compliance efforts. It has since issued a new Reg BI and Form CRS Checklist¹⁸ and agreed to host several events, including an Advertising Regulation conference, a small firm conference, and a Regulation Best Interest Conference designed to "bring regulators, executives and industry practitioners together to learn more about [Reg BI]."¹⁹

As the primary regulator for broker-dealers, FINRA will be tasked with the responsibility of ensuring that member firms and associated persons comply with Reg BI. However, FINRA has acknowledged that interpretation of Reg BI remains primarily the responsibility of the SEC. FINRA can therefore be expected to follow the SEC's lead on interpretation and enforcement of the new rules. Indeed, at a recent North American Securities Administrators Association conference, FINRA's CEO told state regulators: "It's not our rule. It's an SEC rule," and in a more recent interview, he said that FINRA is "collaborating closely with [the SEC], including working with their examination team to think about how we approach the task of overseeing compliance in a consistent, coordinated way."²⁰

Previously, FINRA indicated that its suitability rule (FINRA Rule 2111) would become moot with Reg BI in place. However, it now appears that the SRO is leaning towards keeping its suitability rule, with potential amendments to a rule proposal on sales contests. When asked about Reg BI's impact on FINRA's long standing suitability rule, FINRA's CLO recently stated, "we're not going to get rid" of Rule 2111,²¹ and that "[o]ur thinking at this point is to say that with respect to [brokers servicing] retail persons, if you comply with Reg BI, you comply with our Suitability Rule."²² Most recently, FINRA's Northeast Regional Director for sales practice exam and surveillance programs indicated FINRA will begin to conduct "preparedness reviews" of its member firms for Reg BI compliance, to see "where firms stand in advance of the June 30, 2020 compliance date."²³



CONCLUSION

While Regulation BI continues to be tested and challenged, broker-dealers should remain focused on achieving Reg BI and Form CRS compliance by the existing June 2020 deadline. In addition, broker-dealers should continue to monitor state law amendments to broker-dealer standards of conduct. While the outcomes of pending litigation, legislation, and state regulatory developments are yet to be determined, the relationship between broker-dealers and their customers is unlikely to remain business as usual going forward.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

ABU DHABI	BRUSSELS	DUBAI	HOUSTON	MOSCOW	RIYADH	SINGAPORE
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AUSTIN	CHICAGO	GENEVA	LOS ANGELES	PARIS	SILICON VALLEY	WASHINGTON, D.C.



- ¹ King & Spalding Client Alert, *The SEC Approves Regulation Best Interest: The Broker-Dealer Standard of Conduct*, (June 27, 2019), <https://www.kslaw.com/news-and-insights/the-sec-approves-regulation-best-interest-the-broker-dealer-standard-of-conduct>.
- ² The amendment was made to the Financial Services and General Government Appropriations Act of 2020, H.R. 3351. See <https://amendments-rules.house.gov/amendments/SECMAJA6--REVISED%20AMENDMENT624190937483748.pdf>; see also Brian Croce, *House passes amendment to block Reg BI, but Senate not likely to follow*, Pensions & Investments (June 26, 2019), <https://www.pionline.com/legislation/house-passes-amendment-block-reg-bi-senate-not-likely-to-follow>.
- ³ <https://www.investmentnews.com/assets/docs/CI120305719.PDF>.
- ⁴ *State of New York, et al., v. United States Securities and Exchange Commission, et al.* No. 1:19-cv-08365-VM (S.D.N.Y. Sept. 9, 2019).
- ⁵ *XY Planning Network, LLC and Ford Financial Solutions v. United States Securities and Exchange Commission et al.*, No. 1:19-cv-08415-VM (S.D.N.Y. Sept. 10, 2019); Consolidation Order, *State of New York, et al., v. United States Securities and Exchange Commission, et al.* No. 1:19-cv-08365-VM, Docket No. 13, (S.D.N.Y. Sept. 12, 2019) (“[I]n all material respects the complaints describe the same or substantially similar underlying events arising out of the same or substantially similar operative facts, and assert the same or substantially similar claims against the same defendants.”).
- ⁶ Complaint, *State of New York v. United States Securities and Exchange Commission*, No. 1:19-cv-8365-VM, Docket No. 1, (S.D.N.Y. Sept. 9, 2019) at ¶ 25 (“Over time, brokers’ roles blurred with advisers’ roles, with brokers increasingly functioning as financial advisers without being regulated accordingly. This development has created confusion and caused harm in the marketplace because investors rely on brokers’ recommendations as if those recommendations were trustworthy advice, when in fact they are often highly-conflicted sales recommendations.”); see also *id.* at ¶ 31 (“The lack of clear distinctions between investment advisers and broker-dealers has left investors confused and at increased risk of being harmed as a result of the different level of protections they receive based on the different accounts they have...The Section 913 Study concluded that ‘in light of this confusion and lack of understanding, it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer.’”).
- ⁷ *Id.* at ¶¶ 76 and 116-18.
- ⁸ Complaint, *XY Planning Network, LLC, et al.*, Docket No. 1, (S.D.N.Y. Sept. 10, 2019) (at ¶ 7 (“The SEC’s ‘best interest’ rule presents a significant threat to XYPN’s business and to the businesses of its members By failing to impose a standard of conduct for broker-dealers that is the same as the standard for investment advisers, as required by Dodd-Frank section 913(g), the SEC’s rule reduces the likelihood that broker-dealers will register as investment advisers, resulting in a loss of business for XYPN. Second, the SEC’s rule poses a competitive threat to XYPN’s members. In subjecting broker-dealers to a lower standard of conduct than RIAs, the rule allows broker-dealers to pursue their own financial interests even when providing the same financial-planning services as RIAs, while also reducing their legal exposure.”).
- ⁹ Decision and Order, *State of New York, et al., v. United States Securities and Exchange Commission, et al.*, No. 1:19-cv-08365-VM, Docket No. 27 (S.D.N.Y. Sept. 27, 2019), (dismissing the action “on the Court’s own motion for lack of subject-matter jurisdiction and in favor of litigation pursuant to the petitions for review filed in the United States Court of Appeals for the Second Circuit.”).
- ¹⁰ United States Court of Appeal for the Second Circuit Agency Appeal Pre-Argument Statement Form C-A Addendum B, *State of New York, et al., v. United States Securities and Exchange Commission, et al.*, No. 19-2893, Docket No. 20-3, (2d Cir. Sept. 23, 2019).
- ¹¹ State of Nevada, Senate Bill No. 383, https://www.leg.state.nv.us/Session/79th2017/Bills/SB/SB383_EN.pdf.
- ¹² State of Nevada Office of the Secretary of State, Notice of Draft Regulations and Request for Comment, (Jan. 18, 2019), <https://www.nvsos.gov/sos/home/showdocument?id=6156>.
- ¹³ New York State Senate Assembly Bill A2476A (2019-2020 Regular Session) (Jan. 22, 2019) <https://www.nysenate.gov/legislation/bills/2019/a2476>.
- ¹⁴ Massachusetts Secretary of State, *Request for Public Comment on Proposed Amendments to Investment Adviser Disclosure Regulations* (April 3, 2019), <http://www.sec.state.ma.us/sct/scfetable/feetableidx.htm>.
- ¹⁵ Massachusetts Secretary of State, *Preliminary Solicitation of Public Comments: Fiduciary Conduct Standard for Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives* (June 14, 2019), <http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryconductstandardidx.htm>.
- ¹⁶ New Jersey Div. of Consumer Affairs Alert: Rule Proposal, 51 N.J.R. 493 (a), Vol. 51, Issue 8, (April 15, 2019), <https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx>; see also, Suzette Pamley, *Proposed NJ Rule Would Impose Fiduciary Duty on All Financial Service Professionals*, Law.com – New Jersey Law Journal (April 15, 2019 at 5:40 pm), <https://www.law.com/njljournal/2019/04/15/proposed-nj-rule-would-impose-fiduciary-duty-on-all-financial-service-professionals/> (“If the federal government won’t act to protect investors, then we will,” N.J. Attorney General Grewal said in a statement. “Today, we are fulfilling Governor Murphy’s promise to strengthen financial protections for New Jersey residents.”).
- ¹⁷ FINRA Regulatory Notice 19-26, *Regulation Best Interest: SEC Adopts Best Interest Standard of Conduct* (Aug. 7, 2019), <https://www.finra.org/sites/default/files/2019-08/Regulatory-Notice-19-26.pdf>.
- ¹⁸ FINRA Reg BI and Form CRS Checklist, *Compliance Date is June 30, 2020*, <https://www.finra.org/sites/default/files/2019-10/reg-bi-checklist.pdf>; see generally FINRA Rules & Guidance, *SEC Regulation Best Interest (Reg BI)* at <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest>.
- ¹⁹ <https://www.finra.org/events-training/conferences-events/2019-Regulation-BI-Conference>.
- ²⁰ Mark Schoeff, Jr., *Finra moves forward after 360 appraisal*, Investment News.com, (Oct. 12, 2019 at 6:00 am), <https://www.investmentnews.com/article/20191012/FREE/191019990/finra-moves-forward-after-360-appraisal> (When asked how big of a change Reg BI would be for FINRA’s mission, the CEO said, “It’s entirely consistent with FINRA’s mission. We will now be examining for compliance with Reg BI as opposed to FINRA’s suitability rule.”).
- ²¹ Melanie Waddell, *FINRA Won’t Nix Suitability Rule in Light of Reg BI*, ThinkAdvisor.com (Oct. 21, 2019 at 11:48 am), (<https://www.thinkadvisor.com/2019/10/21/finra-wont-nix-suitability-rule-in-light-of-reg-bi/?sreturn=20190930155221>).
- ²² Rita Raagag De Ramos, *Finra Wants to Keep Suitability Rule: Legal Chief Explains How That Would Work*, Financial Advisor.com (Oct. 14, 2019), https://financialadvisoriq.com/c/2543113/299393/finra-wants-keep-suitability-rule-legal-chief-explains-that-would-work?referrer_module=issueHeadline&module_order=3.
- ²³ Rita Raagag De Ramos, *Finra Reveals Reg BI ‘Preparedness Reviews’ Starting in November*, Financial Advisor.com (Oct. 23, 2019), <https://financialadvisoriq.com/c/2552133/299463/finra-reveals-preparedness-reviews-starting-november>.