

Takeaways for Broker-Dealers After SEC's Reg BI Action

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In June, the U.S. Securities and Exchange Commission filed its first complaint alleging violations of the care obligation and the compliance obligation of Regulation Best Interest, or Reg BI.

In SEC v. Western International Securities Inc., the SEC [alleges 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.

Analysis of the complaint provides some insight as to how to facilitate compliance with the rule and how to defend such claims going forward.

The Care Obligation — Failure to Understand L Bonds

The SEC first 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.

Specifically:

- The firm did not provide a copy of its third-party due diligence report to the registered representatives for their review before making recommendations. Western's chief compliance officer received the report, but did not share it with the registered representatives.
- The firm did not provide specific training to the registered representatives about the current L bond offering. Although the registered representatives were trained on L bonds, the training was on prior issuances, not those sold during the relevant period.
- The registered representative misunderstood important issues regarding GWG Holdings Inc. and L bonds. Each issue was disclosed by GWG in its 2020 prospectus or the filings incorporated therein.

Analysis

First, the SEC's Reg BI does not require that firms provide copies of due diligence reports to registered representatives. The reports are typically used by the firm's investment committee to determine whether to place a product on the firm's approved product list.

After the information is used for that purpose, the firm may incorporate relevant information from the report into training courses or otherwise provide it to registered representatives, but there is no requirement to provide the actual report to registered representatives.

In practice, the firm, in placing a product on its approved product list, makes the first determination, whether there is a reasonable basis to believe that the product could be in the best interests of at least some retail customers of the firm.

The registered representatives make the second determination, whether there is a reasonable basis to believe that the product is in the best interests of a particular retail customer.

To do so, the registered representatives must exercise reasonable diligence to understand the products' risks, rewards and costs, as well as reasonable alternatives. The registered representatives must consider the information and training provided by the firm, as well as customer investment profiles and communications.

Second, the regulation does not require that firms provide training specific to every bond issue. As with due diligence reports, the firm determines what to provide to the registered representative. There is no requirement that it provide training specific to a particular bond issue.

Third, the SEC cites statements made by the registered representatives that appear to support the allegations that they lacked an understanding of the risks, rewards and costs of the offering. While some statements do not pertain to the risks, rewards or costs of the offering, other statements do.

Most damaging are those statements where the registered representatives do not admit that the bonds involved a high degree of risk or that they may be considered speculative, even when the prospectus expressly indicates that the bonds are risky. Similarly damaging are statements where the registered representatives do not demonstrate an awareness of whether there was sufficient collateral to secure the bonds, even when the prospectus indicates it may be insufficient.

Takeaways

For the care obligation, it appears the SEC assumes the universe of information available to the registered representatives should be limited to prospectuses and approved offering materials.

But registered representatives, in the exercise of reasonable diligence, may consider information provided by the issuer through other means, such as webinars, emails, product meetings and phone calls. Further, whatever information is provided by the issuer may contain material misrepresentations or omissions.

As a result, registered representatives may have had a reasonable basis to believe that their recommendations were in the best interests of their customers at the time they were made, as opposed to the SEC's assessment made years later, in hindsight, by considering only the prospectus and incorporated documents.

For products such as L bonds, the SEC considers them to be high risk and speculative. Thus, the SEC expects that the reasonable diligence exercised to understand their risks, rewards and costs should be more than for other products.

Thus, firms may consider establishing policies and procedures to ensure they provide registered representatives with all the latest material information available from their investment committee that is relevant to registered representatives' determinations and not simply rely upon the issuer's offering materials.

In some circumstances, this could include information culled from due diligence reports, if relevant and not already included in the prospectus. Such information could also be included in the initial product training for the registered representatives.

But restraint appears to be necessary to avoid overloading the registered representatives with information more appropriate to the investment committee and its determination to place the product on the approved product list.

In any event, firms should document the information and training that is provided to the registered representatives.

Firms may also consider establishing policies and procedures to ensure registered representatives, throughout a continuous offering, receive all relevant, material information or training regarding changes in the issuer's business operations or finances.

A firm's investment committee, for example, could periodically review ongoing offerings and provide additional relevant, material information to the registered representatives as necessary.

The Care Obligation — Reasonable Basis for Recommendation

The SEC alleges that the registered representatives recommended L bonds to retail customers without a reasonable basis to believe they were in those customers' best interests.

Significantly, in each instance, the SEC alleges that the basis set forth for believing the recommendation was in the best interests of the customer was unreasonable, vague and unsupported.

Notably, the SEC does not allege that the recommendations made were not in the best interests of the customers.

Analysis

Generally, Reg BI says a broker-dealer "should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers' best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer." The SEC complaint, however, raises certain concerns.

First, as previously discussed, the SEC did not consider the entire universe of information available to the registered representatives. As a general proposition, it is arguable that the registered representatives had more information at the time and more reason to believe that recommendations were in the best interests of particular retail customers than a belief derived by the SEC in hindsight, years later, solely from the prospectus.

Second, retail customers are provided a copy of the prospectus before firm approval of the sale. Thus, potential customers would have the prospectus before the transaction regardless of any other information.

Third, firms selling alternative investments in continuous offerings typically do so underselling agreements with the issuer or managing broker-dealer in which the seller agrees not to provide any information to potential customers other than that which is set forth in the issuer's latest prospectus or approved sales materials.

As such, the registered representatives may have considered additional information but would be precluded from providing it to potential customers if it does not appear in the prospectus.

Fourth, the SEC cites potential violations by five registered representatives who collectively handled only 16% of Western's total sales of L bonds during the relevant time, and cites only one or two transactions for each registered representative. This suggests the SEC does not have evidence of widespread actual violations by the firm.

Fifth, the SEC notes that the firm did not set any criteria or thresholds for its customers to invest in L bonds, and did not restrict sales to customers with certain risk profiles or investment objectives. Presumably, the SEC thinks the firm should have done so.

Reg BI, however, does not require criteria or thresholds. It simply requires a reasonable basis to believe that a recommendation is in the best interests of the customer.

It is possible, for instance, that a customer's best interests may be served by a limited purchase of a product that might be facially inconsistent with the customer's preestablished risk profile or investment objectives, but which is part of a broader investment strategy that is in the best interests of the customer. The adopting release contemplates this possibility.

Sixth, the SEC is not alleging that the recommendations were not in the best interests of customers but rather that the registered representatives failed to exercise reasonable diligence to have a reasonable basis to believe they were in the best interests of customers.

This distinction means that the SEC is declining to substitute its judgment for that of the registered representatives in terms of the recommendations made, but is instead requiring the registered representatives to have a reasonable basis for each recommendation.

Takeaways

First, although not required by Reg BI, firms may wish to consider establishing criteria and thresholds for any alternative investments in terms of risk profiles and investment objectives, including net worth and liquid net worth requirements.

While establishing criteria and thresholds may restrict the flexibility of registered representatives in making certain recommendations, their inclusion shows regulators that the firm is aware of the risks posed by certain products and is taking steps to manage those risks.

Second, while the regulation does not require documenting every recommendation, a risk-based approach suggests that firms should ensure that the bases for all recommendations for alternative investments are documented, particularly any recommendation that appears inconsistent with the customer's investment objectives.

These bases should be reasonable, specific and supported by the facts. Should a firm contemplate allowing exceptions to established criteria or thresholds, the firm should document both the process for, and approval of, such exceptions.

Finally, firms charged with alleged violations regarding the bases for recommendations should, when defending their actions, consider all information considered by the registered representatives, not just the information cited by the SEC from the latest prospectus. They should also consider whether there may have been material misrepresentations or omissions in the information provided by the issuer.

The Compliance Obligation

The SEC also alleges that Western's policies and procedures in its written supervisory procedures lacked enforcement mechanisms and explanations as to how to comply with various requirements of Reg BI.

The adopting release indicates a firm's written supervisory procedures should include procedures regarding firm controls, remediation of noncompliance, training, periodic reviews and testing.

It may also be useful to refer to Financial Industry Regulatory Authority guidance regarding requirements for reasonably designed written procedures — e.g., that they include specific procedures to identify the individuals responsible for supervision, the supervisory steps and reviews to be taken, the frequency of such reviews, and how such reviews shall be documented.

Takeaways

Firms should review their written policies and procedures for ensuring compliance with Reg BI. This should include procedures to address training, controls, how registered representatives are to perform their duties, enforcement and remediation, supervisory reviews, and testing.

Further, the review should include procedures that identify who is to perform the supervisory reviews, how the reviews are to be conducted, and how they are to be documented.

In addition, firms may wish to consider establishing, maintaining and enforcing policies and procedures to ensure all relevant and material information from the investment committee not contained in the latest prospectus is also provided to registered representatives on an ongoing basis to ensure that registered representatives understand all the risks, rewards and costs of the alternative investment.

Finally, firms may wish to consider policies and procedures regarding the use of specific criteria and thresholds as controls for recommending alternative investments to ensure that all recommendations in alternative investments are in the best interests of the customer.

Disgorgement

As set forth above, the SEC alleges ancillary violations of the care obligation, not that Western or the registered representatives recommended products that were not in the best interests of the customers. Nevertheless, the SEC seeks disgorgement of any unjust enrichment received as a result of the ancillary violations.

The ancillary violations, if proven, will surely merit penalties. But they should not merit disgorgement. To get legal disgorgement, unjust commissions received by the firm must be attributable to the violation. And, at a minimum, "but-for" causation must be shown between the violation and the unjust enrichment.

Thus, the commission received by the firm from each transaction would not likely be considered unjust enrichment if the recommendation for which it was received was nevertheless in the best interests of the customer. Second, the ancillary violations would not necessarily be the "but-for" cause of the enrichment, unjust or not, because the transactions may have occurred regardless of the ancillary violations.

One cannot say, for example, that the commissions received would not have been received but for the registered representative's failure to understand the product, or but for the failure to have a reasonable basis for the recommendation. On the other hand, if the registered representative's failure to understand the product resulted in a material misrepresentation or omission to the customer, then disgorgement may be appropriate.

Thus, unless the SEC can establish that the recommendations made were not in the best interests of the customers at the time they were made — or involved material misrepresentations or omissions — the commissions the firm received from the transactions would not likely be considered either unjust or the "but-for" cause of the alleged violations to support a claim for disgorgement.

Takeaways

Firms should carefully consider the actual allegations set forth regarding the purported Reg BI violations. If they do not include allegations and evidence that the recommendations were not in the best interests of the customer, claims for disgorgement should be considered untenable.

Given that there were more than 140 broker-dealers that sold L bonds, readers can expect more Reg BI cases to come.

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