Multiple Plaintiffs Take Shot at SEC Regulation Best Interest

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The Securities and Exchange Commission's Regulation Best Interest faces a bumpy road in the wake of recent lawsuits challenging the appropriateness and effectiveness of the rule.

On September 9, 2019, seven states and the District of Columbia filed suit against the SEC in the U.S. District Court for the Southern District of New York seeking to invalidate Regulation Best Interest, or Reg BI, claiming that the rule is too weak. The plaintiffs — including New York, California, Connecticut, Delaware, Maine, New Mexico, and Oregon — alleged that the final rule is arbitrary and capricious and that the SEC exceeded its authority in violation of the Administrative Procedure Act in issuing it. The states claimed that Reg BI undermines critical consumer protections for retail investors, increases investor confusion about the standards of conduct that apply when investors receive recommendations from brokers or investment advisers, and makes it easier for brokers to market themselves as trusted advisers while still being able to provide conflicted advice.

The states also contended that the adoption of Reg BI contradicts Congress' express direction under the Dodd-Frank Act to implement uniform standards of conduct between brokers and investment advisers. Brokers currently adhere to a suitability standard of care with their clients, while investment advisers are fiduciaries who must act in their clients' best interests. The states alleged that section 913(g)(1) of the Dodd-Frank Act authorizes the SEC to harmonize the standards of conduct for brokers and investment advisers and promulgate rules to ensure that brokers are subject to the same standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940. The states also alleged that section 913(g)(2) directs that any SEC rules establishing a best interest obligation for brokers must provide that the standard of conduct "shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The states alleged that, taken together, these provisions make clear that any rules promulgated by the SEC regarding the standard of conduct for brokers must be the same as the standard of conduct applicable to investment advisers. While the SEC contends that Reg BI elevates the standard of care for brokers, the states argued that the rule falls short of the uniform standard of conduct contemplated by the Dodd-Frank Act and fails to even meaningfully elevate existing suitability obligations.

On September 10, 2019, XY Planning Network, a coalition of fee-only financial planners, also filed suit against the SEC in the U.S. District Court for the Southern District of New York. The organization claimed that Reg BI puts investment advisers at a competitive disadvantage to broker-dealers and makes it more difficult to differentiate an investment adviser's fiduciary standard of conduct from the lower standard of conduct applicable to broker-dealers. The suit largely mirrored the lawsuit by the states and contended that the SEC ignored section 913(g) of the Dodd-Frank Act, which states that regulations for broker-dealers should be no less stringent than those for investment advisers when it comes to providing financial advice. XY Planning Network also argued that Reg BI is inconsistent with the Investment Advisers Act, which exempts broker-dealers from the fiduciary standard imposed on investment advisers only if the broker-dealers give advice that is "solely incidental to" the conduct of their business as brokers or dealers. XY Planning Network contends that Reg BI's focus on the episodic nature of the advice provided by broker-dealers ignores whether the advice is "solely incidental" to the provision of brokerage

services as set forth in the Investment Advisers Act.

On the same days that these cases were filed in the district court, the states and XY Planning Network simultaneously filed petitions for review of Reg BI in the U.S. Court of Appeals for the Second Circuit.

The Southern District of New York consolidated the two district court cases on September 12, 2019, noting that "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." On September 27, 2019, the district court entered a sua sponte order examining its jurisdiction, concluding that it lacked subject-matter jurisdiction because jurisdiction to review the agency decision was statutorily granted to the court of appeals. The district court, thus, dismissed the consolidated action "in favor of further litigation pursuant to the petitions for review filed in the Second Circuit."

It remains to be seen whether the states and XY Planning Network will pursue allegations comparable to those discussed above before the Second Circuit or take other action following the district court's dismissal. Carlton Fields will continue to monitor and report on further developments in these challenges to Reg BI.