

INSIGHTS

Second Circuit Upholds Regulation BI

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As we reported in a previous alert, Regulation Best Interest (“Regulation BI”) was recently challenged in the Second Circuit by seven states and the District of Columbia, as well as two groups of investment advisors. On Friday, June 26, 2020, the Second Circuit rejected this challenge, clearing the last hurdle for the implementation of Regulation BI and its mandatory compliance requirements for brokers and investment advisors.

Challenge to Regulation BI

In 2019, Petitioners challenged Regulation BI on several grounds. First, the Petitioners argued that promulgating Regulation BI was outside of the authority granted to the SEC by the Dodd-Frank Act. According to Petitioners, by creating obligations for broker-dealers that are arguably weaker than those for investment advisors, the SEC failed to “harmonize” the obligations of broker-dealers and the obligations of investment advisors. Second, the Petitioners argued that Regulation BI is arbitrary and capricious due to the failure of the “best interests” standard—akin to FINRA’s suitability rule—to adequately achieve the stated goal of customer protection.

Interestingly, Petitioners’ position was supported by an amicus brief filed by various current and former members of Congress, including former Senator Chris Dodd and former Representative Barney Frank.

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Just four days before Regulation BI would take effect, the Second Circuit rejected Petitioners’ arguments.

As a threshold matter, the Court held that the states did not have standing because there was no connection between Regulation BI and tax revenues. The Court held that the investment-advisor petitioners, however, did have standing based on their allegation that the “best interest” standard for broker-dealers would lead to potential investors mistakenly likening the “best interest” standard with the “fiduciary duty” standard and choosing broker-dealers over investment advisors. The Court accepted this argument, on the grounds that this could impair investment advisors’ ability to attract customers.

The Court rejected the Petitioners’ arguments that Regulation BI exceeded the scope of the Dodd-Frank Act’s mandate, holding that the SEC was within its statutory authority to promulgate the rule. The Court was not swayed by Petitioners’ argument that Dodd-Frank only gave the SEC authority to “harmonize” the obligations of broker-dealers with those of

investment advisors. According to the Second Circuit, Dodd-Frank instead gave the SEC a “broad grant of permissive rulemaking authority” that included the ability to create a standard like Regulation BI.

Finally, the Court rejected Petitioners’ argument that the SEC misinterpreted the Investment Advisers Act of 1940, holding that the Petitioners failed to explain why the SEC’s interpretation was arbitrary and capricious. Additionally, the Court reasoned that, though the SEC prioritized consumer choice and affordability over potential confusion, the SEC provided a reasoned explanation for its decisions, based on evidence.

Accordingly, the Second Circuit denied Petitioners’ challenge to Regulation BI.

Regulation BI

Regulation BI, adopted by the SEC on June 5, 2019, requires broker-dealers (and their associated persons) to act in the best interest of their retail customers when making a recommendation of any securities-related transaction or investment strategy. Importantly, broker-dealers are permitted to consider their own financial or other interests in making such recommendations, so long as they do not place these interests ahead of the customer’s.

The general “best interest” obligation is satisfied only if a broker-dealer complies with four component obligations:¹

- **Disclosure Obligation:** The broker-dealer must disclose material facts about the recommendation and the relationship with the customer, including specific disclosures about the capacity in which the broker is acting, fees, the type and scope of services provided, and any conflicts of interest.
- **Care Obligation:** The broker-dealer must exercise reasonable diligence, care and skill when making a recommendation to a retail customer, and consider any potential costs and risks associated with the investment in light of the customer’s investment profile.
- **Conflict of Interest Obligation:** The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose or eliminate conflicts of interest.
- **Compliance Obligation:** Broker-dealers must establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole.

Conclusion

The Second Circuit’s denial of Petitioner’s suit cleared the way for Regulation BI to take effect on June 30, 2020. Bracewell attorneys are experienced with financial regulatory issues, and are ready and available to provide further information and discuss particular circumstances.

^[1] These obligations are set forth in full in Exchange Act Rule 15c-1(a)(2).