

# Enforcement and Litigation Risks

The US Securities and Exchange Commission's (SEC) comprehensive rulemaking package involving the standards of conduct applicable to broker-dealers, investment advisors and their associated persons pose new enforcement and litigation risks. Specifically, under Regulation Best Interest (Reg BI), broker-dealers will be subject to an enhanced standard of conduct. In addition, the SEC's Interpretation Regarding Standard of Conduct for Investment Advisors and Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Advisor provide guidance for complying with the Investment Advisers Act of 1940 (Advisers Act) and address various requirements and prohibitions under this statute. Finally, the Form CRS Relationship Summary imposes new disclosure obligations on broker-dealers and investment advisors.

This article provides a high-level overview of how the SEC enforces the federal securities laws and the rules thereunder, and the enforcement and litigation risks presented by the rulemaking package.

## Overview of Enforcement

The SEC is responsible for civil enforcement of the federal securities laws and the rules thereunder. The SEC may bring enforcement actions in federal court or through administrative proceedings. Most enforcement actions against regulated entities such as broker-dealers and investment advisors are brought administratively, and most enforcement actions are settled through Orders Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and- Desist Order, rather than through litigation in federal court. In civil enforcement actions, the SEC files suit in federal court and may obtain a court order enjoining a person from further violating the securities laws, ordering disgorgement of funds obtained from illegal conduct, or ordering the payment of civil monetary penalties.

Administrative proceedings differ from civil court actions in that they are initially heard by an administrative law judge. Both the SEC Enforcement staff and the

respondent may appeal all or any portion of the initial decision to the SEC.

Administrative sanctions may include Cease-and-Desist Orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties and disgorgement. Decisions from federal courts and from the SEC may be appealed to the federal court of appeals.

The Financial Industry Regulatory Authority, Inc. (FINRA) is responsible for ensuring that broker-dealer member firms and their associated persons comply with the federal securities law and FINRA rules. As with the SEC, the majority of FINRA enforcement actions are resolved through a settlement, called a Letter of Acceptance, Waiver and Consent, or AWC. If FINRA litigates, it files a complaint with its Office of Hearing Officers (OHO). A three-person panel comprising



a FINRA Hearing Officer and two industry members hear the case. In FINRA's enforcement actions, FINRA may impose industry expulsions, suspensions, censures, fines, restitution, rescission or institute procedures to prevent further violations. Any appeal of the OHO decision may be made to FINRA's National Adjudicatory Council (NAC), and any appeal of FINRA's final decision may be appealed to the SEC and then to a federal court of appeals.

## Enforcement Implications of Regulation Best Interest

Broker-dealers and dual registrants (with respect to their brokerage activities) must comply with Reg BI by **June 30, 2020**.

FINRA is expected to take the lead in examining broker-dealers for their compliance with Reg BI, although the SEC also will, from time to time, examine firms with respect to their Reg BI compliance. The SEC has noted that Reg BI applies in addition to the general antifraud provisions of the federal securities laws and other obligations arising under the Securities Exchange Act of 1934. FINRA is expected to modify its suitability rule and certain other rules to be consistent with Reg BI.

Under Reg BI, broker-dealers and their associated persons will be subject to an enhanced standard of conduct. In determining whether a violation has occurred, it will be irrelevant whether a broker-dealer or associated person intended to violate Reg BI. Broker-dealers' and associated persons' conduct that falls short of the obligation to act

in a retail customer's best interest, as measured by compliance with the component obligations (the "Care Obligation," the "Disclosure Obligation," the "Conflict of Interest Obligation" and the "Compliance Obligation" discussed below), constitute violations of the rule. Firms may be charged with each of the obligations as well as the new books and records requirements, while individuals are subject to the Care Obligation and Disclosure Obligation.

We expect violations under Reg BI to fall into the following categories:

**The Care Obligation.** Broker-dealers' and their associated persons' compliance with the Care Obligation will be measured against a standard of reasonableness. FINRA and the SEC will likely bring enforcement actions against broker-dealers and associated persons that fail to exercise reasonable diligence, care and skill in compliance with Reg BI when making recommendations.

**The Disclosure Obligation.** Broker-dealers' and their associated persons' compliance with the Disclosure Obligation will be measured against a negligence standard. FINRA and the SEC will likely bring enforcement actions against broker-dealers and associated persons that fail to make full and fair disclosure of (i) material facts relating to the scope and terms of the brokerage relationship, or (ii) material facts relating to conflicts of interest faced by the broker-dealer or associated person.

**The Conflict of Interest Obligation.** A broker-dealer's design of policies and procedures under the Conflict of Interest Obligation will be measured against a standard of reasonableness. FINRA and the SEC will likely bring enforcement actions against broker-dealers that fail to identify, mitigate, disclose or eliminate certain conflicts of interest in accordance with the obligations of Reg BI.

**The Compliance Obligation.** A broker-dealer's compliance with the Compliance Obligation will be measured against a standard of reasonableness. FINRA and the SEC will likely bring enforcement actions against broker-dealers that fail to adopt or enforce policies and procedures reasonably designed to achieve compliance with Reg BI.

**Recordkeeping Requirements.** Reg BI also requires broker-dealers to make and maintain certain records relating to the recommendations made to retail customers. FINRA and the SEC will likely bring enforcement actions against broker-dealers that fail to make or maintain records in compliance with Reg BI. In this respect, the records maintained by broker-dealers under the rule may demonstrate compliance with the Component Obligations. For example, broker-dealers that record the basis for their recommendations, which is especially important for securities that are complex, risky or expensive, may use such records to demonstrate compliance with the Care Obligation. In addition, when making oral disclosures in compliance with

Reg BI, broker-dealers may want to create a record that the registered representative provided an oral disclosure.

## Enforcement Implications of the Form CRS Relationship Summary

Broker-dealers and investment advisors who are registered with the SEC, and investment advisors who have an application for registration pending with the SEC prior to June 30, 2020, will be required to file their initial relationship summary **beginning on May 1, 2020, but no later than June 30, 2020.**

As noted above, the SEC and FINRA have jurisdiction over broker-dealers, while the SEC has jurisdiction over investment advisors registered under the Advisers Act.

The Form CRS Relationship Summary requires broker-dealers and investment advisors to provide additional disclosure documents to their retail customers and clients. The SEC will likely bring enforcement actions against investment advisors and broker-dealers for a failure to provide adequate disclosure of the information required under the Form CRS Relationship Summary. FINRA will likely bring similar enforcement actions against broker-dealers.

## Interpretation Regarding Standard of Conduct for Investment Advisors

The SEC's Interpretation Regarding Standard of Conduct for Investment Advisors (Advisor Interpretation) has been effective as of **July 12, 2019.**

The Advisor Interpretation slightly altered the investment advisory fiduciary landscape. Investment advisors may want to consider enhancing their policies and procedures in anticipation of the SEC's enforcement of this interpretation.

Future SEC enforcement actions may focus on:

**An advisor's basis for providing advice:** For retail clients, the Advisor Interpretation stated that a reasonable basis for understanding a retail client's objectives generally includes understanding the investment profile of the retail client. Comparatively, for institutional clients, the Advisor Interpretation states that a reasonable basis for understanding an institutional client's objectives generally includes understanding the investment mandate of the institutional client. The Advisor Interpretation also elaborated on an investment advisor's duty of care in providing investment advice. As a result, the SEC may in the future bring enforcement actions based on a failure

by an investment advisor and its supervised persons to provide investment advice that is in the best interests of clients. In particular, the SEC may focus on the processes used by investment advisors in formulating and documenting the rationale for the investment advice provided. For instance, a retail investment advisor that has arrangements with multiple investment advisory programs (and multiple "spokes" or "sleeves" within such advisory programs) may want to consider implementing policies and procedures (including providing adequate guidance, training and supervision) concerning the recommendation of particular advisory programs (and particular spokes and sleeves within such advisory programs) by its supervised persons.

**Hedge clauses in advisory agreements:** The Advisor Interpretation rescinded the Heitman Capital Management no-action letter concerning hedge clauses. Under the Advisor Interpretation, whether a hedge clause violates the antifraud provisions of the Advisers Act depends on the surrounding facts and circumstances, including the client's sophistication. Importantly, however, the Advisor Interpretation states that there are few instances in which a hedge clause, that purports to relieve an adviser from liability for conduct as to which a retail client has a non-waivable cause of action against the advisor provided by state or federal law, would be consistent with the antifraud provisions of the Advisers Act. Therefore, the SEC, may, in the future, bring enforcement actions against investment advisors regarding these issues.

**Advice about account types:** The Advisor Interpretation also noted that Section 206 of the Advisers Act applies to advice about whether to open or invest through a certain type of account (e.g., a brokerage account or an investment advisory account), rollovers from one account to a new or existing account that the advisor or an affiliate of the advisor manages, and whether to engage a sub-advisor. The SEC may, in the future, bring enforcement actions regarding such advice.



## Interpretation of the Solely Incidental Prong

The SEC's Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Advisor (Solely Incidental Interpretation) has been effective since July 12, 2019 and focuses on when a broker-dealer's activities would cause it to be acting as an investment advisor:

**Limited/temporary discretion and unlimited discretion:** The Solely Incidental Interpretation states that unlimited discretion is not solely incidental to a broker-dealer's business. However, discretion that is temporary or limited in terms of time, scope or other manner lacks the "comprehensive and continuous character" that would suggest an advisory relationship. Such temporary or limited investment discretion includes discretion: (i) as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security, (ii) on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time, (iii) to purchase or sell securities to satisfy margin requirements, and (iv) to purchase or sell a security or type of security limited by specific parameters established by the customer.

**Policies and procedures governing agreed-upon account monitoring:** The SEC advised broker-dealers to consider adopting policies and procedures that, if followed, would help demonstrate that agreed-upon account monitoring is "in connection with and reasonably related to" the broker-dealer's primary business of effecting securities transactions. The SEC also noted that continuous monitoring is not within the broker-dealer exclusion and would cause a broker-dealer to be acting as an investment advisor.

Broker-dealers (and dual registrants with respect to their brokerage activities) can expect FINRA and the SEC to focus their examination efforts on ensuring that broker-dealers do not exercise unlimited discretion over customers' accounts, including with respect to "friends and family accounts" and accounts where a registered representative serves as a trustee. Similarly, broker-dealers must ensure that registered representatives do not set out to provide continuous monitoring over accounts that are treated solely as brokerage accounts. Such accounts must be treated as being subject to the Advisors Act and comply with the Advisor Interpretation and the other requirements of the Advisors Act. Enforcement actions may arise from failures with regard to these issues.



## Litigation Implications of Regulation Best Interest

It is well-settled that violations of FINRA rules and regulations do not create a private cause of action nor provide a remedy of rescission. Reg BI in general, and the Form CRS Relationship Summary, in particular, do not create new private rights of action, nor do they impose a continuing duty to monitor brokerage accounts. In private litigation cases, however, the plaintiff or claimant often will argue that FINRA rules and regulations establish, or are evidence of, the standard of care that forms the basis for a negligence claim, or that these rules and regulations are incorporated into the contracts between broker-dealers and their customers. Moreover, experts retained by the plaintiff or claimant will often base their opinions on FINRA rules and regulations, along with the interpretations of those rules set forth in Notices to Members and Regulatory Notices. Thus, we can expect to see the Care, Disclosure, Conflict of Interest and Compliance Obligations to be cited in future court cases and arbitrations as the basis for a variety of claims, including; negligence, breach of contract and breach of fiduciary obligations. It will be up to the courts and arbitration panels to determine whether Reg BI imposes new legal duties, and if so, whether a violation of such duties creates a claim for damages.

The Interpretation Regarding Standard of Conduct for Investment Advisers likely will be cited as the basis for triggering application of the Advisors Act to some brokerage accounts and thus, recognizing fiduciary duties in particular relationships. Such fiduciary standards may impose duties well beyond the reach of FINRA rules and regulations.

At this juncture, it is not entirely clear whether Reg BI will expand the potential liability of broker-dealers and investment advisors in future litigation and arbitration matters, nor is it settled whether Reg BI will expand or restrict the scope of parallel state law statutes and regulations. The SEC notes in the release adopting

Reg BI that the preemptive effect of Reg BI, including its effect on state law governing the relationship between broker-dealers and their customers, must be determined in future judicial proceedings based on the specific language and effect of state law. Such decisions will shape the impact of Reg BI on the potential liability of broker-dealers, investment advisors and registered persons in future litigation matters.

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