Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: Judges query states, financial planners and SEC about scope of Regulation BI Congressional mandate, (Jun. 2, 2020)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

The panel asked for clarification about how to interpret lawmakers' use of "shall" and "may" in the Dodd-Frank Act provision authorizing the SEC to impose a fiduciary standard on broker-dealers.

A Second Circuit panel heard oral argument in consolidated cases brought by New York and several other states and by a financial planning firm that challenge the validity of the SEC's Regulation Best Interest. The SEC argued that it had wide latitude to determine what standard of conduct should apply to broker-dealers and that it in fact increased the standard of conduct via Regulation BI, while the state and financial planner petitioners argued that the SEC ignored its Dodd-Frank Act mandate to impose a fiduciary standard of conduct (*XY Planning Network, LLC v. SEC*, June 2, 2020).

The cases challenging Regulation BI were initially filed in the U.S. District Court for the Southern District of New York, but the state petitioners and the financial planning firm petitioner quickly filed petitions for review in the Second Circuit. The district court, on its own motion, later dismissed the cases for lack of subject matter jurisdiction. The parties and the Second Circuit panel never raised the issue of subject matter jurisdiction at oral argument, although the issue did play a role in previous Dodd-Frank Act challenges of SEC regulations brought before other federal district and appeals courts (See e.g., resource extraction issuers rule; credit risk retention rule). The petitioners asked for and received expedited oral argument in the Second Circuit. It is possible the Second Circuit panel will decide the cases before June 30, 2020, the compliance date for Regulation BI.

Advisers, Dodd-Frank, and brokers in a nutshell. The consolidated cases assert that Regulation BI exceeds the SEC's regulatory authority and is arbitrary and capricious in violation of the Administrative Procedure Act. Generally, broker-dealers are treated as investment advisers (i.e., provide investment advice about securities for compensation) unless the advice is solely incidental to the provision of traditional broker-dealer services and the broker-dealer receives no special compensation.

The state and financial planner petitioners argue that the broker-dealer business model has evolved, in large part because of modern technology, to one that emphasizes investment advice to the exclusion of more traditional, and now less profitable, broker-dealer order execution services. As a result, they argue that the current suitability standard of conduct for broker-dealers is no longer valid, at least in the context of personalized investment advice about securities provided to retail customers. The petitioners believe that Regulation BI, even though it raises the standard of conduct for broker-dealers, is just as confusing to retail investors as the suitability standard and that Regulation BI falls short of what is required by the Dodd-Frank Act (State Brief; State Reply Brief; XYPN Brief; XYPN Reply Brief). The SEC counters by relying heavily on its theory of broad discretionary authority under the Dodd-Frank Act to set a standard of conduct for broker-dealers (SEC Brief).

It is conceivable that the cases could be decided on the question of constitutional standing, which the SEC emphasized at oral argument. However, the bulk of oral argument dealt with the problems inherent in construing Dodd-Frank Act Section 913.

"Shall," "may," and other statutory issues. The state petitioners and XY Planning Network, LLC (XYPN) argued in their briefs that Dodd-Frank Act Section 913, the provision authorizing the SEC to impose a fiduciary standard on broker-dealers, should be interpreted as a series of steps in a process that leads to such standard for broker-dealers. That is, the SEC must conduct a study on broker-dealers and retail investors (Section

913(b)), subject to certain considerations (Section 913(c)), then the SEC may "commence" a rulemaking (Section 913(f)), then the SEC must give substance to the rulemaking by adopting a fiduciary standard that is equal to the standard for investment advisers (Section 913(g)). The state petitioners and XYPN evenly split their time for argument and rebuttal.

Ester Murdukhayeva, Assistant Solicitor General, State of New York, arguing on behalf of the several state petitioners, fielded questions about this process. One judge noted that if the SEC had done nothing, the status quo (the suitability standard) would have continued, but if the states win this lawsuit, then the standard of conduct goes back to suitability. Murdukhayeva said that once the SEC makes a predicate finding that factually determines broker-dealers no longer provide incidental advice, then the SEC must impose a fiduciary standard under either the Investment Advisers Act or Dodd-Frank Act Section 913(g). Under Section 913(g) broker-dealers would retain some flexibility regarding the sale of proprietary products, the receipt of commission- or fee-based compensation, and being relieved of any continuing duty of care or loyalty (i.e., account monitoring) after providing personalized investment advice about securities.

But Murdukhayeva emphasized that the Investment Advisers Act is both the default standard and an independent source of SEC authority. One judge asked if the Dodd-Frank Act is irrelevant. Murdukhayeva answered that the Dodd-Frank Act is material to the case because it reinforces the Investment Advisers Act approach. Murdukhayeva also said that the presence of "may" in Section 913(f) did not give the SEC total latitude to adopt a standard of conduct for broker-dealers and that the Investment Advisers Act must be read alongside the Dodd-Frank Act.

That reply prompted a judge to ask what "may" actually refers to. Here, Murdukhayeva replied that "may" as used in Section 913(f) refers to the considerations the SEC must address in the congressionally-required study of the broker-dealer industry (See Sections 913(c)(9) and (10)), including applying the Investment Advisers Act standard of conduct to broker-dealers wholesale, whether to impose a fiduciary duty on broker-dealers under Section 913(g), and whether to recommend to Congress that the broker-dealer exclusion be eliminated from the Investment Advisers Act definition of "investment adviser" (See Investment Advisers Act Section 202(a)(11)). The panel's questioning appeared to be directed at understanding if the SEC can invoke "may" in Section 913(f) as a discretionary basis to impose any standard of conduct it deems appropriate. Murdukhayeva closed this segment of the argument by noting that the SEC's Section 913 study never mentioned Section 913(f). In fact, the study recommended that the SEC use its authority under Section 913(g) to impose a uniform fiduciary standard for broker-dealers.

Deepak Gupta, of Gupta Wessler PLLC, arguing on behalf of XYPN, conceded the panel's observation that the SEC could have done nothing. But Gupta added that if the SEC chooses to act, it must abide by a floor; that is, the requirement in Section 913(h) that the SEC harmonize enforcement of broker-dealer and investment adviser standards of conduct. According to Gupta, however, the SEC "doubled down" on the existing confusion about the broker-dealer standard of conduct by adopting Regulation BI. Although not explicitly mentioned at oral argument, one of the arguments both the state petitioners and XYPN make is that while Regulation BI technically raised the standard of conduct for broker-dealers, it does so in a way that further confuses broker-dealers with investment advisers (e.g., by referring to "best interest," which can have different meanings under Regulation BI and the Investment Advisers Act).

Gupta also reiterated the process theory of the case in which Section 913 represents a series of steps toward adoption of a fiduciary standard for broker-dealers. Moreover, Gupta sought to counter the SEC's theory of broad regulatory discretion under Section 913(f). Gupta posited that when Congress indicates by statute that an agency has authority to adopt regulations, it tends to use words like "promulgate" or "provide," rather than the word "commence" in Section 913(f).

By contrast, Jeffrey Berger, Senior Litigation Counsel for the SEC, began the portion of his argument dealing with statutory construction by noting how both sides seem to agree that the plain text of the statute should resolve the case. Berger, however, rejected the petitioners' theory of Section 913 being procedural in character and instead argued that Section 913(f) contains "classic discretionary language" in the form of the word "may."

One of the judges then asked about the purpose Section 913(g). Berger replied that Section 913(g) has two purposes: (1) ensure the SEC can impose a fiduciary standard if the required study recommends against such standard; and (2) decrease the likelihood of a legal challenge to SEC rulemaking based on the broker-dealer exclusion contained in the Investment Advisers Act.

Berger also said that Section 913(g) provides "guardrails" if the SEC adopts a fiduciary standard for broker-dealers because it requires the agency to preserve some aspects of the broker-dealer business model (i.e., commissions/fees, proprietary products, and no account monitoring). Berger added that within Section 913, subsections (f) and (g) do not cross-reference each other, the use of "shall" and "may" was the product of a legislative compromise over the House and Senate versions of what would become Section 913, and that Congress had the opportunity to eliminate the broker-dealer exclusion and chose not to eliminate the provision.

On rebuttal, Murdukhayeva asserted that Congress did not have to repeal the broker-dealer exclusion because the Investment Advisers Act already contemplates scenarios in which broker-dealers are investment advisers. In her main argument, Murdukhayeva had noted that this was in fact the default scenario. Gupta noted on rebuttal that the SEC's Regulation BI relied heavily on its corresponding interpretive release explaining the meaning of "solely incidental," an interpretation that is insulated from court challenge.

Article III standing. Although much of oral argument was devoted to the panel's questions about the SEC's statutory mandate to impose a fiduciary standard of conduct on broker-dealers, the SEC urged the court to skip the merits of the case and instead dismiss the case for lack of constitutional standing. The SEC's Berger said the state petitioners and XYPN premise their cases on the SEC doing nothing, but that approach dooms their case on the issue of redressability because, if the SEC does nothing to enhance the broker-dealer standard of conduct, the states and XYPN would be hurt even more because broker-dealers would continue to operate under the old suitability standard. Berger also disputed that the petitioners could show causation because Regulation BI imposes more requirements on broker-dealers and the injuries asserted (for states tax revenues and for XYPN competitive harm) are too conjectural.

During his main argument, Gupta was asked about XYPN's assertion of competitor standing. According to Gupta, the baseline for evaluating standing should be the status quo ante (a confusing suitability standard of conduct) to which Regulation BI adds even more confusion. One of the judges sought clarification that the key to Gutpa's argument was that even if Regulation BI imposes more stringent rules on XYPN's competitors, there would still be ongoing confusion about what the broker-dealer standard of conduct is. Gupta replied that was correct, but that regulations can do different things and it was not necessary for XYPN to show that the entire regulation favored its competitors because all XYPN had to do was identify an injury traced to the regulation that arises from competing in the same marketplace as the firm's competitors.

Murdukhayeva addressed standing for the first time during rebuttal. She said if one assumes the states win on the merits, then the SEC would have to impose a fiduciary standard of conduct on broker-dealers. In other words, the relevant comparison for standing purposes is between the congressional mandate (impose a fiduciary standard) and what the SEC actually did (Regulation BI falls short of fiduciary standard of conduct) and not the status quo ante (broker-dealers adhere to suitability standard of conduct). With respect to the injury prong of constitutional standing, Murdukhayeva said the state petitioners could lose tax revenues if Regulation BI stands. Murdukhayeva also urged the panel to focus on the existence of an injury rather than the magnitude of that injury.

The case is No. 19-2886.

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Companies: XY Planning Network, LLC

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