

[Securities Regulation Daily Wrap Up, TOP STORY—8 attorneys general sue SEC over Regulation Best Interest, \(Sept. 10, 2019\)](#)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The lawsuit argues that the SEC's rule does not satisfy Dodd-Frank's authorization to harmonize standards of conduct between broker-dealers and investment advisers.

New York, along with the District of Columbia and six other states, filed suit in federal district and appellate courts challenging the SEC's adoption of Regulation Best Interest. The agency approved the rule in June by a 3-1 vote despite a considerable amount of pushback, including a [letter](#) from a coalition of state attorneys general. The lawsuit argues that Reg BI does not harmonize the standards of conduct applicable to broker-dealers and investment advisers, nor does it require that brokers act in their customers' best interests without regard to their own financial interests, as authorized by the Dodd-Frank Act ([New York v. SEC](#), September 9, 2019).

Origins and controversy. Dodd-Frank required the SEC to study the effectiveness of the existing standards of conduct for brokers and advisers when providing advice to retail customers, then recommend whether regulatory changes were needed to strengthen those standards. The statute also authorized the Commission to make rules harmonizing the standards of conduct between advisers and brokers and requiring the entities to act in customers' best interest "without regard to" the entity's own financial interest.

The agency completed its [study](#) in 2011 and [proposed](#) a rule in 2018, which immediately attracted criticism for failing to define "best interest," create a fiduciary standard, or ban the most egregious conflicts of interest. The SEC received thousands of [comments](#) and suggestions from industry groups including the [Investment Adviser Association](#), the [Investment Company Institute](#), [SIFMA](#), and [NASAA](#). The ranking members of four House and Senate committees, along with 31 other legislators, [urged](#) the SEC to make the rule more investor-friendly, and the proposal was panned by most witnesses at a House Financial Services subcommittee [hearing](#), with several opining that it would be better to have no rule at all.

The SEC pressed on, adopting on June 5 of this year a final rule that it [described](#) as an "enhancement" to the proposal, but which failed to appease many of the critics. Commissioner Robert Jackson, in dissent, [said](#) the rules "retain a muddled standard that exposes millions of Americans to the costs of conflicted advice." SEC Investor Advocate Rick Fleming gave the rule credit for improving the suitability standard for broker-dealers, but [said](#) it was otherwise a step in the wrong direction. But Chairman Jay Clayton [defended](#) the rule, calling out much of the criticism as "misleading, misguided, and unfortunately, in some cases, ... simply policy preferences disguised as legal critiques."

States' lawsuit. The lawsuit filed by the attorneys general of New York, California, Connecticut, Delaware, Maine, New Mexico, Oregon, and the District of Columbia takes issue with two main aspects of the rule. First, it fails to meaningfully evaluate broker-dealer standards beyond their existing suitability requirements. Second, it relies on a vague "best interest" standard while failing to actually require that brokers act in customers' best interests, which will leave investors even more confused about the duties of broker-dealers.

According to the complaint, the rule goes against the SEC's own study, which concluded that many retail investors are confused by the different standards of care applicable to investment advisers and broker-dealers. The study recommended a uniform fiduciary standard so that investors would receive the same protections whether they worked with an adviser or a broker. The complaint also observes that such a uniform fiduciary standard would be higher than the suitability standard applicable to broker-dealers.

The final rule also falls short of the standard contemplated by Dodd-Frank, the plaintiffs argue. While the statute authorizes a rule requiring brokers to act "without regard to" their own financial interests, the final rule provides that brokers must place clients' interests "ahead of" their own. The rule also fails to define key terms, including the term "best interest." The attorneys general worry that by failing to adopt a uniform fiduciary standard in favor of an "amorphous" best interest standard, the rule will exacerbate investor confusion and perpetuate the mistaken belief that broker-dealers must put aside their own financial interests.

Even as it fails to define the best interest obligation, the rule falls short of the fiduciary standard contemplated by Dodd-Frank, the complaint continues. The rule permits required disclosures of material facts to be made on a standardized, rather than individualized, basis and allows firms to develop their own compliance policies to address potential conflicts. Even sales contests are mostly allowed, unless they are under time-limited, high-pressure circumstances—terms that, the plaintiffs point out, are also undefined.

The plaintiffs also object that the SEC purported to act under the more general requirements of Dodd-Frank Section 913(f) and various Exchange Act provisions, which do not authorize the rulemaking, while disregarding the specific directives of Section 913(g), which does. As a principle of statutory interpretation, the specific controls over the general, and Section 913(f) does not stand alone as an alternative basis on which the SEC could promulgate the final rule.

Finally, the plaintiffs argue that the rule is arbitrary and capricious because it fails to adequately explain the SEC's departure from the recommendations of its own staff; runs counter to the evidence; and failed to consider important aspects of the problem. Furthermore, the SEC's explanations for its conclusion are internally inconsistent and contradictory—for example, the agency justified its decision to depart from Dodd-Frank's "without regard to" language by explaining that the language "would be inappropriately construed," while expressly acknowledging that any such misinterpretation would be unfounded and unreasonable.

The plaintiffs say that they will lose tax revenue if investors' taxable accounts are worth less because of conflicts of interest. They will also bear a greater burden to financially assist retirees and others with insufficient savings due to conflicted financial advice. Finally, the rule will harm the plaintiffs' quasi-sovereign interest in protecting their residents' economic well-being.

Statements. New York Attorney General Letitia James [said](#), "Instead of adopting the investor protections of Dodd-Frank, this watered-down rule puts brokers first. ... New York will continue to lead the charge to protect the millions of individuals investing in their futures, including the millions of Americans saving for retirement."

Better Markets' legal director Stephen W. Hall issued a [statement](#) giving the states "enormous credit" for filing their action. Hall said the rule "should be nullified so it can't lull investors into thinking they're getting protections that don't really exist. Then the SEC should start over and write a true fiduciary duty rule, one that requires advisers always to put the best interest of their clients ahead of their own interest."

The case is [No. 19-cv-08365](#).

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