

June 24, 2022

## SEC Files First Enforcement Action Alleging Violations of Best Interest Rule's Care and Compliance Standards

In the first action of its kind, the Securities and Exchange Commission (“SEC”) recently charged registered broker-dealer Western International Securities, Inc. (“Western”) and five of its associated persons (the “APs”) with violations of Regulation Best Interest, Rule 15l-1(a) under the Securities Exchange Act of 1934 (“Reg BI”). In *SEC v. Western Int'l. Sec. et al.*, Case No. 2:22-cv-04119 (C.D. Cal. June 15, 2022), the SEC claims that Western and the APs violated Reg BI by recommending certain unrated bonds to retail investors despite failing to understand key risks associated with the bonds, and without a reasonable basis to believe that investments in the bonds were in the investors’ best interests. The SEC also asserts that Western violated Reg BI by failing to have sufficient policies and procedures in place to ensure compliance with the rule. The complaint marks the SEC’s first case pursuing violations of Reg BI’s best interest standard and previews how regulators might conceptualize Reg BI violations going forward.

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### Background on Reg BI

Reg BI arose out of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), which called for the SEC to study the effectiveness of then-existing standards of care and whether any gaps existed. After a number of years, the SEC proposed Reg BI in April 2018 and enacted the final rule in June 2019. Reg BI took effect in June 2020 and placed an obligation on broker-dealers and their associated persons to act in the best interests of a retail customer at the time a recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the retail customer. To comply with Reg BI, broker-dealers must comply with four component obligations identified in the rule: the Disclosure Obligation, the Care Obligation, the Conflict of Interest Obligation, and the Compliance Obligation.

### *SEC v. Western International Securities, Inc.*

In its complaint, the SEC alleges that Western and the APs recommended and sold L Bonds to various retail investors and received commissions on those sales. The L Bonds were unrated corporate bonds offered by GWG Holdings, Inc. (“GWG”) in four separate offerings in 2012, 2016, 2017, and 2020. The L Bonds at issue in the SEC’s action are from the 2020 offering.<sup>1</sup> In the materials for the 2020 offering, GWG identified that the L Bonds involved a high degree of risk, that investing in the L Bonds could be considered speculative, and that the L Bonds were only suitable for people with substantial financial resources and no need for liquidity.

The SEC charged Western and the APs with violating Reg BI’s Care Obligation by failing to use reasonable diligence, care, and skill in recommending the L Bonds and recommending the L Bonds without a reasonable basis to believe that the products were in the retail customers’ best interest. For example, the APs allegedly did not know about or adequately understand publicly disclosed changes to GWG’s corporate structure and business model, did not know if GWG was profitable or how the L Bonds were collateralized, and/or believed the L Bonds were relatively safe or otherwise disregarded the risks. Western and the APs also allegedly sold the L Bonds to retail investors whose investment goals did not match with the bonds’ risks. For example, the APs allegedly recommended the L Bonds to investors with moderate to

<sup>1</sup> Prior to 2018, GWG’s business model consisted of acquiring life insurance policies on the secondary market, continuing to pay the premiums, and collecting the policy benefits upon the insured’s death. In 2018 and 2019, GWG and Beneficent Company Group, L.P. (“Beneficent”) engaged in a series of transactions that placed Beneficent’s management in control of GWG, after which GWG stopped purchasing life insurance policies and shifted its business model to providing liquidity to holders of illiquid and alternative investments. The SEC notes that GWG had a history of net losses and ultimately filed for bankruptcy in April 2022.

moderate-conservative risk tolerances, investors who did not identify speculation as an investment objective, investors who had limited financial resources, and/or investors who were retired and seeking to preserve capital.

The SEC also charged Western with violating Reg BI's Compliance Obligation, alleging that Western's policies and procedures were substantially copied from the SEC's Small Entity Compliance Guide and contained no specific tailoring to Western's business. Western's policies also did not include guidance on how to determine if an investment was in an investor's best interest, what it meant to recommend reasonably available alternative investments, or how to take "particular care" in regard to complex or risky products. In regard to the L Bonds specifically, the SEC alleged that Western's compliance function did not require updated trainings on L Bonds in connection with the changes to GWG's business model following the Beneficent transactions, did not require review of an updated due diligence report on GWG despite its availability to the Chief Compliance Officer, and did not set a minimum net worth to invest in L Bonds.

The facts as alleged by the SEC do not appear to be a reach for the application of Reg BI; based on the conduct set forth in the SEC's Complaint, it is possible a regulator might have brought a similar case under a preexisting suitability regime. While the case leaves many open questions regarding the specifics of Reg BI, such as what communications constitute a recommendation and when an investor will be deemed to have used a recommendation, the SEC's complaint previews what future applications of Reg BI may entail. The SEC's focus on Western's alleged compliance failures indicates the importance the SEC places on supervisory procedures and the requirements for a compliance function to be considered "reasonably designed to achieve compliance" with Reg BI, including tailored and up-to-date policies, active monitoring and enforcement efforts, and continuous diligence on investments that are being offered to investors. The charges against the APs also indicate the SEC's willingness to pursue individuals for violating their Reg BI obligations.

### Related State Regulation

The SEC's action against Western comes amid state-level activity on fiduciary standards. In late March 2022, a Massachusetts state Superior Court invalidated the state's Fiduciary Duty Rule in *Robinhood Fin. Inc. v. Galvin*, 2022 WL 1720131 (Mass. Super. Ct. Mar. 30, 2022). The Superior Court held that Massachusetts Secretary of State William Galvin went beyond his authority in enacting the Fiduciary Duty Rule, which imposed a general fiduciary duty on broker-dealers like Robinhood. The Superior Court invalidated the rule as contrary to Massachusetts state common law defining the scope of broker-dealer fiduciary duties, citing the Massachusetts legislature's directive that its securities laws harmonize with federal and other states' securities laws, without reaching constitutional or federal preemption issues. The matter is now on appeal.

Several other states have attempted to enact similar fiduciary rules for broker-dealers. Nevada's Securities Division reportedly resumed efforts earlier this year to enact regulations under the state's 2017 uniform fiduciary duty statute. Nevada previously proposed regulations under the statute in 2019 that received heavy criticism from the brokerage industry in the public comment period, and its regulatory efforts went quiet following the emergence of the COVID-19 pandemic. Similar efforts for a general fiduciary duty rule in New York, New Jersey, and Maryland have stalled. As of yet, there has not been a definitive ruling on federal preemption for state laws purporting to impose a standard different than Reg BI's.