GROOM LAW GROUP

Publications

States Sue to Stop Regulation Best Interest

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On September 9, 2019, the States of New York, California, Connecticut, Delaware, Maine, New Mexico, Oregon, and the District of Columbia (the "States") sued the Securities and Exchange Commission ("SEC") asking the District Court for the Southern District of New York to strike down Regulation Best Interest. This sets up litigation not unlike the one that involving the Department of Labor's 2016 Fiduciary Rule. Financial institutions should watch this litigation as it could have an impact on their sales and other practices. Additionally, the litigation signals that the policy fight over the proper standard of care for brokers and other agents of financial institutions is not over.

In their complaint, the States focus largely on Section 913(g) of Dodd-Frank. Section 913(g) provided the SEC with authority to promulgate rules that provide for a uniform fiduciary standard for broker-dealers and registered investment advisers that would require that both act "in the best interest of [their] customers] without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The States make a number of arguments that Congress, in enacting Dodd-Frank, wanted the SEC to utilize that authority. The States briefly note that the SEC promulgated Regulation Best Interest pursuant to authority granted under Section 913(f) of Dodd-Frank. Section 913(f) granted the SEC authority to "commence a rulemaking, as necessary or appropriate to the public interest and for the protection of retail customers … to address the legal or regulatory standards of care for brokers, dealers … [and] persons associated with brokers or dealers … for providing personalized investment advice about securities to such retail customers."

The States make three main arguments. First, they argue that the legislative history of Dodd-Frank shows that Congress intended for the SEC to adopt regulations tracking Section 913(g)'s requirements. To make this argument, they note that an early House of Representatives precursor to Dodd-Frank would have required the SEC to impose a fiduciary standard. Next, they note that SEC staff, in 2013, recommended that the SEC use its Section 913(g) rulemaking authority. Finally, they argue that the best reading of Section 913 as a whole would be that Section 913(f) is not itself an independent grant of authority but is a grant of authority that would allow the SEC to issue a rule that tracks the language of Section 913(g).

An initial issue is whether the States have standing to bring the lawsuit against the SEC. To demonstrate standing, parties generally have to show that they have suffered an injury, there is a causal connection between the injury and the conduct complained of, and that a favorable decision will redress the injury. The States imply they have standing because Regulation Best Interest harms their residents because it "fails to impose a fiduciary standard" and because conflicted advice could continue to reduce their tax revenue. However, if the States received the remedy they are seeking – namely that Regulation Best Interest be struck down – broker-dealers would no longer be subject to a "best interest" standard but the standard would revert to "suitability." In other words, there is a question as to whether the relief sought would, in fact, redress the alleged harm.

Much like litigation surrounding DOL's Fiduciary Rule, litigation surrounding Regulation Best Interest could take years to play out. It is not clear whether or how this litigation may affect the new rules related to fiduciary investment advice, which are expected to be issued by DOL later this year. However, it is likely that this case merely represents the next step in the standard of care saga where DOL, the SEC, and the states have all been and are likely to continue to be major actors. This creates uncertainty financial institutions who continue to be frustrated by the lack of certainty and the costs of implementing compliance strategies.

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