XY Planning v. SEC: Regulation Best Interest

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Note: *This Client Alert updates a Client Alert AGG's (Securities Enforcement Group) issued in June 2019.*

The U.S. Court of Appeals for the Second Circuit has before it an appeal from a consolidated action that challenges Regulation Best Interest, a new regulation that the Securities and Exchange Commission ("SEC") released last June, 2019. A key question is whether, and how, the Regulation harmonizes the standards of care imposed on investment advisers and broker-dealers, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The case, *XY Planning Network LLC v. SEC* (Docket No: 19-2886), appeals a final order from the US District Court for the Southern District of New York (SDNY), that had consolidated and dismissed the original cases and directed the plaintiffs to submit their common issues to the Second Circuit for review.

Issues with Regulation Best Interest

Before Congress passed the Dodd-Frank Act in 2010, the standard of care regulating investment advisers required them to act in their clients' best interests without regard to their own financial interests, while the standard of care regulating broker-dealers, the suitability rule, implicitly requires a broker-dealer's recommendations to be consistent with a customer's best interest. The Financial Industry Regulatory Authority's (FINRA) Regulatory Notice 12-25 (May 2012), publishing guidance on FINRA's suitability rule adopted in November 2010,[2] asserted that "[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."

Given financial market instability, thought to have been contributed to in part by the inconsistent standards of care for broker-dealers and investment advisers, Section 913 of the Dodd-Frank Act directed the SEC to study this problem and adopt a uniform standard that required entities "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The resulting rule, Regulation Best Interest, requires broker-dealers to act in their clients' "best interest," but allows them to provide services traditionally associated with investment advisers without the corresponding standard of care required of investment advisers under the Investment Advisers Act of 1940.[3] In essence, it can be argued that Regulation Best Interest awkwardly grafts the "best interest" standard onto the old suitability rule, thus either enshrining the inherent conflict of interests we discussed in our June 2019 Client Alert or, alternatively, it could be argued that Regulation Best Interest is narrowly designed to address the financial conflicts of interest motivated by self-interest while allowing broker-dealers to provide the financial advice needed to understand and use their products.

The likelihood of confusion resulting from the similarities between FINRA's well-known suitability rule and the SEC's Regulation Best Interest was one of the several potential problems identified in our June 2019 Client Alert. One legal issue on appeal in *XY Planning Network LLC v. SEC* is whether the SEC's Regulation Best Interest harmonizes the standards of care for investment advisers and broker-dealers, as required by the Dodd-Frank Act. Appellants argue that Regulation Best Interest

1 Pub. L. 111-203 (2010).

2 Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b)(1), rules proposed by self-regulatory organizations (defined as any national securities exchange, registered securities association, or registered clearing agency), including FINRA, must be approved by the SEC before becoming effective.

3 15 U.S.C. § 80b-1, *et seq*.

violates the Dodd-Frank Act by requiring a less demanding standard of care than that required by investment advisers' fiduciary duties, which prohibits investment advisers from considering their own financial interests when advising clients.

XY Planning, the lead appellant, argues that Regulation Best Interest allows broker-dealers to prioritize their own interests over that of their clients in two ways. First, Regulation Best Interest does not require broker-dealers to eliminate their conflicts of interest to act in the "best interests" of customers when providing advice or making a recommendation. Instead, broker-dealers need only disclose their conflict. Appellants argue that, rather than requiring broker-dealers to act with the same standard of care as investment advisers, Regulation Best Interest simply enshrined the conflicted interests that existed when Congress passed the Dodd-Frank Act, thereby allowing broker-dealers to continue considering their own interests when providing financial advice.

Second, appellants argue that, in allowing dual registration as both investment adviser and broker-dealer, the SEC has created additional ambiguity concerning in which role an entity is acting when making investment recommendations. Identifying whether an entity is acting as an investment adviser providing financial advice or a broker-dealer selling financial instruments can be difficult to determine. Regulation Best Interest, appellants argue, does not harmonize the standard of care for a broker-dealer's advice versus an investment adviser's advice as mandated by Section 913 of the Dodd-Frank Act, and instead expanded the broker-dealer exemption, allowing broker-dealers to provide comprehensive financial planning advice without registering as investment advisers and, therefore, without being subject to the appropriate standard of care for the service provided. As a result, rather than more clearly delineating the respective services that broker-dealers and investment advisers provide, Regulation Best Interest creates greater ambiguity and confusion by eroding the distinction between the services broker-dealers provide. Ultimately, the lawsuit seeks either heightened standards for broker-dealers providing financial advice or a requirement that all entities providing such advice register as investment advisers.

Analysis

XY Planning argues that Congress provided two corrective solutions: (1) enforce the provision of the Dodd–Frank Act that requires broker-dealers to be held to the same fiduciary standard as financial advisers when providing advice; or (2) enforce the Investment Act of 1940 provision, which prohibits broker-dealers from providing financial advice and, if they wish to provide such advice, require them to register as investment advisers. The first corrective would either invalidate Regulation Best Interest, requiring a new rule, or require an amendment to the current rule. The second corrective is simple in theory but may be difficult to effectuate. Although broker-dealers often provide investment advice to their clients, they are largely exempt from registration under the Investment Advisers Act of 1940, so long as the investment advice is "solely incidental" to brokerage activities; and the broker-dealer does not receive "special compensation" for providing the investment advice.

Conclusion

Perhaps the simplest solution is for broker-dealers not to give advice. Broker-dealers should perform the services for which they have expertise: conducting trades and market making. Keeping the respective roles of broker-dealers and investment advisers distinct removes the confusion inherent to dual-registration: they should not be held to a fiduciary standard. Investment advisers traditionally stand in a fiduciary relationship with their clients, whereas brokers traditionally market and communicate their services as such to the public at large. While investment advisers provide comprehensive financial planning that accounts for a client's specific needs and objectives, the very concept of comprehensive financial planning is incompatible with the "solely incidental" financial advice broker-dealers provide when selling their financial products. Ideally, as the services provided by broker-dealers and investment advisers converge, the need increases for a standard of care that adequately applies to the range of services each provide, but this is simpler in theory than in practice.

Some industry experts have advocated that the SEC revive Rule 202(a)(11)-1, a rule that had permitted brokers to receive fee-based compensation without also registering as investment advisers that was vacated in *Financial Planning*

Association v. Securities and Exchange Commission, 482 F.3d 481 (D.C. Cir. 2007)("FPA v. SEC").[4] Rule 202(a)(11)-1 raised similar questions now raised by Regulation Best Interest: how does a broker-dealer assure regulators that any advice provided is "solely incidental" to the brokerage services provided such that the broker need not register as an investment adviser under Section 202(a)(11) of the Advisers Act?[5] The contours of the "solely incidental" limitation are unclear, both in the context of the due diligence surrounding a broker-dealer's suitability review and recommendation as well as in commission-based discretionary accounts following *FPA v. SEC*. This uncertainty favors the clarity provided by sharply separated roles.

A viable solution to this issue requires some policy decisions on the part of the SEC. A primary, important question is clearly delineating what it means to provide "comprehensive planning advice" and what it means to provide advice related to the brokerage services that is "solely incidental." The current Regulation Best Interest fails to provide the necessary clarity.

4 The rule was vacated in *Financial Planning Association v. Securities and Exchange Commission*, 482 F.3d 481 (D.C. Cir. 2007) because the court concluded that the SEC had exceeded its statutory authority in enacting the rule—that would seem to no longer be the issue due to the mandate to address this issue under Dodd-Frank, enacted three years after that case.

5 Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" for broker-dealers whose advisory services are "solely incidental" to the brokerage services provided ***and*** who receive no "special compensation" for the advisory services.

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