The Asset Management Industry
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Second Circuit Rejects States' Bid to Invalidate Reg BI

[32564]

June 29, 2020 TO: ICI Members
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Pension Operations Advisory Committee
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Compliance
Derivatives
Disclosure
Distribution
Exchange-Traded Funds (ETFs)
Fees and Expenses
Investment Advisers
Litigation & Enforcement
Operations
Pension
State Issues RE: Second Circuit Rejects States' Bid to Invalidate Reg BI

On June 26, 2020, just days before the June 30th compliance date for Regulation Best Interest (“Reg BI”), a three-judge panel of the US Court of Appeals for the Second Circuit ruled to uphold Reg BI, holding that the SEC acted within its authority when it promulgated Reg BI.

Background

On September 9, 2019, the attorneys general of seven states[1] and the District of Columbia filed a lawsuit against the SEC in the US District Court in the Southern District of New York.[2] The states sought to invalidate Reg BI and claimed standing to bring the lawsuit because Reg BI harms their "sovereign, quasi-sovereign, economic, and proprietary interests" and causes ongoing harm to their residents.

The complaint alleged multiple claims, including that the rulemaking:

1. exceeds SEC's statutory authority;
2. is not in accordance with section 913(g) of the Dodd-Frank Act[3] because the broker-dealer standard of conduct established under Reg BI is not "the same as" the standard that applies to investment advisers under the Advisers Act; and
3. is arbitrary and capricious because it runs counter to the evidence before the SEC and is based on a flawed cost-benefit analysis.

The states requested that the court vacate Reg BI and enjoin the SEC from implementing or taking any action under the rule.

The same week the states filed their lawsuit against the SEC, an organization of financial planners and one of its members[4] filed a separate lawsuit against the SEC that also claimed Reg BI is inconsistent with the SEC's rulemaking authority under the Dodd-Frank Act.[5] The two lawsuits were consolidated, and the case was moved to the Second Circuit for jurisdictional reasons. The Second Circuit heard oral arguments on June 2, 2020.

Second Circuit's Decision

In the opinion (attached below), the court first addressed the question of whether any of the petitioners had standing to challenge Reg BI. It held that the states do not have standing "because their claim that [Reg BI] will cause a decline in state revenue is entirely speculative."[6]

The court found that Ford Financial Solutions does have standing because "by enabling broker-dealers to advertise their new best-interest obligation, [Reg BI] will put Ford and other investment advisers at a competitive disadvantage compared to the status quo."[7] One of the three judges disagreed on this point, writing in a separate opinion (concurring in part and dissenting in part) that *all* petitioners lack standing and that the lawsuit therefore should be dismissed without addressing the merits of the case.

The judges were unanimous, however, in their decisions (1) that the SEC lawfully promulgated Reg BI pursuant to Congress's permissive grant of rulemaking authority under Section 913(f) of the Dodd-Frank Act, and (2) that Reg BI is not arbitrary and capricious under the APA because the SEC gave "adequate reasons for its decision" and supported its findings with "substantial evidence."[8]

The court wrote in its opinion, "[a]lthough Regulation Best Interest may not be the policy that Petitioners would have preferred, it is what the SEC chose after a reasoned and lawful rulemaking process."[9]

The court further explained, "[a]t bottom, Petitioners' preference for a uniform fiduciary standard instead of a best-interest obligation is a policy quarrel dressed up as an APA claim. The SEC carefully considered and rejected a fiduciary rule based on its findings that the

fiduciary duties owed by investment advisers are “not appropriately tailored to the structure and characteristics of the broker-dealer business model (i.e., transaction-specific recommendations and compensation).”[10]

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Attachment

endnotes

[1] The states include New York, California, Connecticut, Delaware, Maine, New Mexico and Oregon.

[2] *See* ICI Memorandum No. 31957, dated September 10, 2019, *available at* https://www.ici.org/my_ici/memorandum/memo31957.

[3] As the complaint acknowledges, the SEC relied in part on Dodd-Frank Act Section 913(f) as its authority for promulgating the rulemaking. However, the states argue that the SEC was obligated, instead, to rely on Section 913(g), which authorizes the SEC to establish a harmonized fiduciary duty for broker-dealers and investment advisers.

[4] The suit was filed by XY Planning Network, LLC and its member, Ford Financial Solutions, LLC.

[5] *See* XY Planning Network, LLC v. SEC, No. 1:19-cv08415 (SDNY filed Sept. 10, 2019).

[6] *See* page 13 of the attached opinion.

[7] *Id.*

[8] *Id.* at page 28.

[9] *Id.* at page 5.

[10] *Id.* at page 24.