

As Regulation Best Interest Enforcement Cases Accelerate, It's Time to Shift Strategy

September 9, 2024 | Client Alert

Western International Securities (Western), a registered broker-dealer, on July 29 settled all charges brought against it in the first litigated enforcement action filed in federal district court by the U.S. Securities and Exchange Commission (SEC) alleging violations of Regulation Best Interest (Reg BI), 17 C.F.R. §240.15l-1.¹ Pursuant to a consent order filed in the U.S. District Court for the Central District of California in *SEC v. Western International Securities*, Western agreed to an injunction, disgorgement of \$34,468, prejudgment interest of \$2,000, and a civil penalty of \$160,000.² Five of Western's registered representatives also agreed to injunctions, disgorgement and prejudgment interest between \$5,808 and \$31,699 and a civil penalty of \$12,500 each.

Separately, the SEC [settled an administrative proceeding](#) against Western involving an additional violation of Reg BI based on allegations of improper excessive trading on July 30. Pursuant to the settled order, Western agreed to cease and desist its violative conduct, a censure and a civil penalty of \$140,000.³

While the recent settlements put an end to the SEC's first litigated Reg BI enforcement action, federal court actions to enforce Reg BI may be just beginning. As noted in our prior [client alert](#), Reg BI provides a tool for the SEC to charge broker-dealers related to securities recommendations to retail clients. Given the U.S. Supreme Court's recent decision in [SEC v. Jarkesy](#), the SEC's Reg BI enforcement cases are likely headed to federal court. Although the monetary penalties against Western were relatively modest in comparison to the fanfare that accompanied the filings, federal court actions typically involve injunctive relief, which may have serious implications for industry participants.

Reg BI

Reg BI heightens the standard of conduct for broker-dealers and individual registered representatives at the time they make securities recommendations to retail customers. The rule imposes specific obligations relating to disclosure, care, conflicts of interest and compliance.

The care obligation requires broker-dealers to have a reasonable basis for recommendations that are in the best interests of the customer, based on the customer's investment profile and

¹ *SEC v. Western International Securities*, Case No. 2:22-cv-04119-WLH-JCx (C.D.C.A. July 29, 2024).

² *Id.*

³ *In the Matter of Western International Securities*, Administrative Proceeding File No. 3-21986 (July 30, 2024).

the potential risks, rewards and costs associated with the recommendation. In addition, Reg BI requires broker-dealers to disclose or mitigate all conflicts of interest. Finally, Reg BI's compliance obligation requires a broker-dealer to implement and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. All four of these requirements are subject to a wide range of interpretations and therefore present varying degrees of regulatory risk.

The District Court Action

The SEC's district court enforcement action against Western was product-based and focused on the sale of more than \$13.3 million worth of high-yield L bonds issued by GWG Holdings (GWG), a financial services company to retail customers (notably fixed-income retirees or low-net-worth individuals). According to the SEC, GWG initially issued the L bonds to finance its business of purchasing life insurance policies from insured individuals at a discount and later collecting on the policies' death benefits. However, GWG changed its business model to focus on providing loans and other liquidity to acquirers of alternative and certain distressed assets while continuing to issue new L bonds.⁴

The SEC alleged that the individual registered representatives received more than \$70,000 in sales commissions but did not adequately understand important aspects of the L bonds and therefore could not have fulfilled their obligations pursuant to Reg BI.⁵

Relatedly, the SEC alleged compliance failures as the registered representatives were not properly trained on the sale of the specific bonds; the firm did not provide them with due diligence reports regarding the bonds; and the firm failed to set any sales criteria, thresholds or restrictions with respect to sales of the bonds to certain customers based on their risk profiles and investment objectives.⁶

The Administrative Action

In the administrative action, the SEC alleged that during the same time period, a Western independent contractor registered representative was engaged in an excessive options trading strategy in the accounts of retail customers.⁷ Although the accounts had an average monthly equity of approximately \$700,000, the registered representative executed an average of more than \$2 million in trades per month in each investor account.⁸ These trades generated \$1.27 million in commissions and more than \$62,000 in other transaction fees. The accounts also suffered significant losses from the options trading strategy, with one account losing \$525,000 in a single month.⁹

According to the SEC, Western's retail customers had little, if any, prior trading experience in stocks, had no experience trading options, and preferred a moderate or conservative risk profile. However, Western's registered representative continued to engage in the high-risk trading strategy, generating excessive commissions that were not in his retail customers' best

⁴ *SEC v. Western International Securities*, Case No. 2:22-cv-04119-WLH-JCx (C.D.C.A. July 29, 2024).

⁵ *Id.*

⁶ *Id.*

⁷ *In the Matter of Western International Securities* (July 30, 2024).

⁸ *Id.*

⁹ *Id.*

interests.¹⁰ Further, after Western's chief compliance officer learned of the excessive trading and significant losses, contrary to the firm's policies and procedures, Western continued to trade in these accounts and failed to take action to curtail the representative's trading authority.¹¹

SEC's Increasing Enforcement Activity Under Reg BI

The SEC's enforcement action against Western may have been the first litigated matter, but since its filing in June 2022, the SEC has filed and settled a handful of additional matters alleging substantive violations of Reg BI.¹² The SEC alleged LifeMark Securities Corp. and one of its registered representatives violated their duty of care for transacting in the same GWG-issued L bonds as Western.¹³ To [settle the matter](#), LifeMark agreed to a cease-and-desist order and to pay \$4,410 in disgorgement plus \$705 in prejudgment interest and a civil penalty of \$85,000.¹⁴ The administrative order requires the representative to pay a \$15,000 civil penalty and approximately \$28,400 in disgorgement and prejudgment interest.¹⁵ On July 29, the SEC filed a [complaint in federal court](#) against a GWG registered representative for their role in the sale of GWG's L bonds.¹⁶

Similarly, the SEC announced the [settlement of a recent action](#) against Laidlaw & Company (UK) Ltd. and two of its registered representatives on November 20, 2023, for excessive trading in violation of Reg BI. The SEC alleged that several of Laidlaw's representatives failed to consider the costs associated with employing a high-risk, excessive trading strategy, which placed their interests ahead of their customers.¹⁷ Laidlaw agreed to pay approximately \$822,884, which includes disgorgement of \$547,712, prejudgment interest of \$51,844, and a civil penalty of \$223,328.¹⁸ One of Laidlaw's registered representatives agreed to a six-month suspension and to pay approximately \$137,019, which includes disgorgement of \$88,506, prejudgment interest of \$4,260, and a civil penalty of \$44,253.¹⁹ Laidlaw's second registered representative agreed to pay approximately \$45,558, which includes disgorgement of \$24,414, prejudgment interest of \$1,143, and a civil penalty of \$20,000.²⁰

¹⁰ Id. (For reference, "the retail customer's account performance would need to return over 20% of the average monthly value of their account to pay the commissions and fees charged by Western and its representatives.")

¹¹ *In the Matter of Western International Securities* (July 30, 2024).

¹² *SEC v. Blumer*, 1:23-cv-07250 (E.D.N.Y. September 28, 2023); *In the Matter of Salomon Whitney*, Administrative Proceeding File No. 3-21762 (September 28, 2023) (SEC alleges that Salomon Whitney and five of its registered representatives violated Reg BI's care obligation for employing an excessive trading strategy, which generated over \$660,000 in commissions and fees but produced over \$1 million in losses for those retail customer accounts); *In the Matter of Citigroup Global Markets*, Administrative Proceeding File No. 3-21753 (September 28, 2023) (SEC alleges that Citigroup violated the disclosure obligation of Reg BI for failing to mail the required Reg BI disclosures to its existing retail customers).

¹³ *In the Matter of LifeMark Securities Corp.*, Administrative Proceeding File No. 3-21984 (July 29, 2024).

¹⁴ Id.

¹⁵ Id.

¹⁶ *SEC v. Moretz*, No. 5:24-cv-00171 (W.D.N.C. July 29, 2024).

¹⁷ *In the Matter of Laidlaw and Company (UK) Ltd.*, Administrative Proceeding File No. 3-21800 (November 20, 2023).

¹⁸ Id.

¹⁹ *In the Matter of Richard Michalski and Michael Murray*, Administrative Proceeding File No. 3-21801 (November 20, 2023).

²⁰ Id.

Finally, the SEC announced on September 22, 2023, the [settlement of Reg BI charges](#) against Carl M. Hennig Inc. (Hennig) for alleged violations that were discovered following a broker-dealer examination of the firm.²¹ The SEC alleged that Hennig violated Reg BI's compliance obligation for (1) failing to require its representatives to evaluate the risks, rewards and costs associated with its recommendation to retail customers; (2) not providing its customers with information regarding fees beyond the hypothetical fees disclosed in its Form CRS; and (3) adopting policies and procedures that fail to address the identification, disclosure and remediation of conflicts of interest.²²

Key Takeaways

- **SEC Enforcement Trend:** The SEC's enforcement of Reg BI appears to be a permanent addition to both its enforcement and examination programs. While the agency's early enforcement matters focused on technical violations of the regulation, its current priorities are more centered on substantive violations regarding specific products, conflicts of interest and compliance programs. These violations and the facts that support them resemble routine SRO suitability cases; only now, following the Supreme Court's decision in *Jarkesy*, such matters are likely to be filed in federal court and can carry significant fines and potential industry bars. Clients should consider consulting enforcement and litigation counsel to assist with regulatory examinations pursuant to Reg BI as well as navigating the litigation and settlement process in federal court.²³
- **Care Obligation:** The SEC's actions have largely been focused on specific products sold to retail investors and trades made on their behalf. Firms offering new or unique investment products or trading strategies should ensure that their registered representatives have a full understanding of such products and strategies and that the firms are providing the necessary information to keep their representatives appropriately informed of any and all changes involving the products and strategies and the obligations that result from those changes.
- **Compliance Obligation:** Reg BI requires firms to implement policies and procedures reasonably designed to achieve compliance with the regulation. The SEC's recent enforcement actions highlight the importance of implementing policies and procedures tailored to the specific products and strategies offered as well as the investment objectives of the firm's clientele. Finally, firms should consider frequent reviews of the content and implementation of such policies and procedures to ensure continued compliance with Reg BI.

²¹ *In the Matter of Carl M. Hennig Inc.* Administrative Proceeding File No. 3-21699 (September 22, 2023).

²² *Id.*

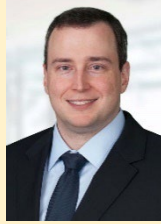
²³ *SEC v. Jarkesy*, 34 F.4th 446 (2024).

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