Second Circuit Rejects Challenge to SECs Regulation Best Interest

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A collection of federal and state statutory and regulatory requirements governs the standards of care owed by broker-dealers and investment advisers to their clients. Traditionally, investment advisers have been held to a higher legal standard of care than broker-dealers. In recent years, the traditional distinctions between these two types of entities have blurred, and, in an effort to harmonize the standards, the Securities and Exchange Commission (the "SEC" or the "Commission") issued Regulation Best Interest, 17 C.F.R. § 240.15l-1 (2019), which requires broker-dealers to act in the best interest of their retail customers but does not bar broker-dealers from taking their own financial interests into account, as long as they do not place them ahead of customers' interests. Regulation Best Interest went into effect on June 30, 2020. Although the regulation imposes obligations on broker-dealers greater than those historically required, it does not require broker-dealers to match the fiduciary duties owed by investment advisers.

On June 26, 2020, shortly before Regulation Best Interest went into effect, the United States Court of Appeals for the Second Circuit considered the validity of the SEC's Regulation Best Interest. In *XY Planning Network, et al.* v. *SEC,* 2020 WL 3482869 (2d Cir. June 26, 2020) (the "Opinion"), a group of plaintiffs comprised of an organization of investment advisers, an individual investment adviser, seven states, and the District of Columbia challenged Regulation Best Interest as unlawful under the Administrative Procedure Act (the "APA"). The plaintiffs argued that the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824-30 (the "Dodd-Frank Act"), required the SEC to adopt a rule that subjected broker-dealers to the same fiduciary standard as investment advisers.

The Second Circuit rejected the challenge, holding that Dodd-Frank Act authorized the SEC to promulgate the regulation and that the regulation was neither arbitrary nor capricious. As discussed *infra,* among other things, the Court reasoned that (i) the SEC's interpretation of the broker-dealer exemption under the Investment Advisers Act, even if incorrect, was not "fundamental" to the regulation, and (ii) even if contrary to the petitioners' preferred policy on the subject, the Commission followed a "reasoned and lawful" process in adopting the regulation. Judge Richard J. Sullivan dissented in part, arguing that none of the petitioners had standing under Article III of the United States Constitution ("Article III"), but agreeing "with the majority's analysis of Regulation Best Interest and its rejection of the investment advisers' challenge on the merits."

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