

Second Circuit Rejects Challenge to SEC's Regulation Best Interest

I. Overview

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. § 240.151-1 (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.¹ 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.² 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."³

¹ It is rare for the Second Circuit to consider the validity of an SEC regulation because most challenges to SEC rules and regulations occur in the United States Court of Appeals for the District of Columbia Circuit.

² The arbitrary and capricious standard, applied for the review of agency or administrative decisions, is a deferential standard in which the court "must be reluctant to reverse results supported by a weight of considered and carefully articulated expert opinion." *County of Westchester v. United States Department of Housing & Urban Development*, 802 F.3d 413, 430-31 (2d Cir. 2015) ("Under this deferential standard of review, we may not substitute our judgment for that of the agency" (internal quotation marks omitted)); *see also Natural Resources Defense Council, Inc. v. FAA*, 564 F.3d 549, 555 (2d Cir. 2009) ("[W]e will set aside the agency's decision only if it is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." (internal quotation marks omitted)).

³ Opinion at *9.

II. Background

Although broker-dealers and investment advisers both offer financial services to retail customers, the regulatory framework and standards of care that govern them are different. Broker-dealers generally are governed by the Securities Exchange Act of 1934, the SEC rules promulgated thereunder, and the rules of the Financial Industry Regulatory Authority (“FINRA”). Under the FINRA rules, broker-dealers historically have been held to a “suitability” standard of care that requires them to “have a reasonable basis to believe that a recommended transaction or investment strategy . . . is suitable for the customer.”⁴ By contrast, investment advisers are governed by the Investment Advisers Act of 1940 (the “IAA”) and the SEC rules promulgated thereunder. Investment advisers generally owe a fiduciary duty to clients and are obliged to “employ reasonable care to avoid misleading . . . clients.”⁵

The Dodd-Frank Act authorized the SEC to develop additional rules regarding the standards of conduct for both broker-dealers and investment advisers. Section 913(f) of the Dodd-Frank Act states that the SEC “may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers . . . to address the legal or regulatory standards of care for brokers, dealers, [and] investment advisers.” Similarly, Section 913(g) states that the SEC to “may promulgate rules to provide that, with respect to [broker-dealers], when providing personalized investment advice about securities to a retail customer[,] . . . the standard of conduct for such [broker-dealers] . . . shall be the same as the standard of conduct applicable to an investment adviser” Section 913(g) further provides that the SEC “may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers[,] . . . shall be 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 [S]uch standard of conduct shall be no less stringent than the standard applicable to investment advisers under [the IAA].”

The Commission adopted Regulation Best Interest in 2019, establishing a heightened standard of care for broker-dealers’ service of retail customers. The regulation requires broker-dealers to “act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the [broker-dealer] . . . ahead of the interest of the retail customer.”⁶ The regulation outlined four obligations applicable to broker-dealers:

(i) a disclosure obligation, requiring the disclosure of all material facts regarding the relationship between the broker-dealer and customer, including any material conflicts of interest relating to investment advice; (ii) a care obligation, requiring broker-dealers to make only those recommendations it believes are in the best interest of the customer; (iii) a conflict of interest obligation, requiring broker-dealers to prevent any conflicts of interest that might cause them to put their own interests ahead of customers in the context of investment recommendations; and (iv) a compliance obligation, requiring broker-dealers to adopt policies “reasonably designed” to achieve compliance with the regulation.⁷

⁴ FINRA Rule 2111(a).

⁵ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (articulating an investment adviser’s obligations as an “affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading . . . clients”).

⁶ 17 C.F.R. § 240.151-1(a)(1).

⁷ *Id.* § 240.151-1(a)(2).

Multiple petitioners sued the SEC in September 2019 in the United States District Court for the Southern District of New York, alleging that Regulation Best Interest failed to sufficiently protect retail customers and seeking to invalidate the rule. Petitioners were an investment adviser interest group, XY Planning Network, LLC (“XY Planning”), and one of its members, Ford Financial Solutions, LLC (“Ford” and, together with XY Planning, the “Network Petitioners”), and the Attorneys General of California, Connecticut, Delaware, Maine, New Mexico, New York, Oregon, and Washington, D.C. (together, the “States” or the “State Petitioners”). The Network Petitioners argued that Regulation Best Interest would make it more difficult for investment advisers to differentiate their services from those offered by broker-dealers because the investment advisers’ heightened standard of care was a selling point to grow business. According to the Network Petitioners, Regulation Best Interest muddled the obligations of investment advisers and broker-dealers, thus placing investment advisers at a material disadvantage to broker-dealers in attracting clients, particularly given the “comparatively fewer regulatory obligations, lower compliance costs, and less legal exposure” that broker-dealers enjoy.⁸ The State Petitioners argued that Regulation Best Interest undermined protections for retail customers and, as a result, would increase conflicted investment advice and decrease state tax revenues as a result of lost investment income.

III. Holding

The Second Circuit addressed three issues, holding that: (i) Ford,⁹ but not the State Petitioners, had standing under Article III; (ii) Section 913(f) of the Dodd-Frank Act authorized Regulation Best Interest; and (iii) Regulation Best Interest was not arbitrary or capricious and was validly promulgated by the SEC.

A. Standing

As to the threshold issue of Article III standing, the majority held that Ford carried its burden to establish a competitive disadvantage necessary to invoke Article III.¹⁰ Competitors’ standing, a widely accepted basis for standing, recognizes “that economic actors ‘suffer an injury in fact when agencies . . . allow increased competition’ against them.”¹¹ Having articulated an “actual or imminent increase in competition,” a plaintiff may sue to restrict a regulation that unlawfully “bestows upon their competitors ‘some competitive advantage.’”¹² The Court found that Ford had shown that it was likely to suffer financial injury from Regulation Best Interest because the regulation will create “a significant risk that clients will not be able to effectively differentiate the fiduciary duty that [Ford] owe[s] them from the lower duty that broker-dealers owe their clients,” which ultimately will “harm [Ford’s] ability to attract customers through . . . highlighting the increased standard of loyalty and care” that it owes its clients.¹³

Judge Sullivan dissented from the majority regarding standing because he did not agree that Regulation Best Interest caused the harm that Ford alleged, reasoning that Ford failed to establish the alleged injuries could be

⁸ Opinion at *3.

⁹ The Court stated that, having determined that Ford had standing to challenge the regulation, it did not need to determine if XY Planning had standing to sue on behalf of its members.

¹⁰ Petitioners bear the burden of demonstrating that they have “(1) suffered an injury in fact, (2) that is fairly traceable to the challenged conduct of the defendant, and (3) that is likely to be redressed by a favorable judicial decision.” *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540, 1547 (2016); see also *Sierra Club v. EPA*, 292 F.3d 895, 899 (D.C. Cir. 2002) (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992)).

¹¹ *Sherley v. Sebelius*, 610 F.3d 69, 72 (D.C. Cir. 2010).

¹² *Citizens for Responsibility & Ethics in Washington v. Trump*, 953 F.3d 178, 190 (2d Cir. 2019) (quoting *Fulani v. League of Women Voters Education Fund*, 882 F.2d 621, 626 (2d Cir. 1989)).

¹³ Opinion at *4.

“tenably traced” to the regulation.¹⁴ According to the dissent, Regulation Best Interest would instead *lessen* the competitive imbalance between investment advisers and broker-dealers — an imbalance that favored broker-dealers and that Ford conceded had existed before the regulation — because it would necessarily increase the regulatory scrutiny, compliance burden, and legal risk to broker-dealers.¹⁵ Further, in the dissent’s view, a favorable judicial determination would not redress the harms of which Network Petitioners complained, as any outcome in favor of the Network Petitioners would leave broker-dealers with less regulation and, therefore, a competitive advantage over investment advisers.

The full panel rejected standing for the State Petitioners under Article III because none of the State Petitioners had established a “direct link” between Regulation Best Interest and the alleged loss of tax revenue.¹⁶ Instead, the States relied on a causal chain that was “too attenuated and speculative” to meet the standing requirements. Recognizing that the pool of annual taxable capital gains depends upon “countless variables,” the Court reasoned that the claimed harm leaned too heavily on “conclusory statements and speculative economic data.”¹⁷

B. Authority To Regulate

The Network Petitioners challenged Regulation Best Interest on the grounds that it did not comply with the parameters set out in Section 913(g) of the Dodd-Frank Act regarding the standard of care required of broker-dealers. Specifically, the Network Petitioners argued that Section 913(g) required that any rule the SEC promulgated regarding the standard of care for broker-dealers must “be no less stringent” than the standard applicable to investment advisers.¹⁸ The Network Petitioners contended that, because Regulation Best Interest failed to establish a fiduciary duty for broker-dealers — a standard to which investment advisers already are held under the IAA — the regulation did not satisfy the requirements of Section 913(g). In support of this argument, the Network Petitioners pointed to Section 913(f), which permits the SEC to generally promulgate rules to “address the legal or regulatory standards of care for brokers, dealers, [and] investment advisers.” The Network Petitioners argued that Section 913(g) necessarily narrows the extent and nature of the SEC’s broader rule-making powers described in Section 913(f), and that to hold otherwise would render the latter superfluous.

The Second Circuit rejected the Network Petitioners’ position and concluded that Section 913(g), which permits but does not require the SEC to establish a heightened fiduciary duty for broker-dealers, in no way restricts the broader provision of Section 913(f), “but rather provides a separate grant of rulemaking authority.”¹⁹ The SEC was not obliged to establish a standard of care for broker-dealers equal to that of investment advisers due to the word “may,” which was the key language in both Sections 913(f) and (g), the Court held. Simply put, the Court said, the SEC *may* promulgate rules establishing protections for retail customers, but it need not; and if it elects to do so, those rules *may* articulate a fiduciary duty for broker-dealers equivalent to that of investment advisers, but they need not. In crafting Regulation Best Interest, the SEC proceeded with rule-making under Section 913(f), rather than Section 913(g), and thus permissibly established a standard of care for broker-dealers that was not

¹⁴ *Id.* at *9.

¹⁵ *Id.*

¹⁶ A “fairly direct link” is required because “the unavoidable economic repercussions of virtually all federal policies . . . suggest to us that impairment of state tax revenues should not, in general, be recognized as sufficient injury in fact to support state standing.” *Pennsylvania v. Kleppe*, 533 F.2d 668, 672 (D.C. Cir. 1976).

¹⁷ Opinion at *5.

¹⁸ Section 913(g)(1); *see also* Complaint ¶¶ 30, 33, 35, 37-38 (quoting the language in Section 913(g) and alleging that any standard of care set for broker-dealers should have met that of investment advisers).

¹⁹ Opinion at *6.

identical to that of investment advisers. The Court rejected the Network Petitioners' argument that Section 913(f) was a mere procedural authorization for Section 913(g)'s substantive rule-making framework. The Court concluded that the overlap in authority provided in Section 913(g) and Section 913(f) did not render the latter section superfluous or invalid.²⁰

C. Arbitrary and Capricious Standard

The Second Circuit also addressed the Network Petitioners' APA challenge to Regulation Best Interest under the arbitrary and capricious standard, specifically addressing the Network Petitioners' two arguments.²¹ First, the Network Petitioners argued that the SEC relied on an incorrect interpretation of an IAA provision, which exempts broker-dealers from the definition of an investment adviser. Rejecting this argument, the Court reasoned that the two key aspects of the IAA definition that the Network Petitioners argued the SEC had incorrectly interpreted — “solely incidental” and “special compensation” — appeared in the Regulation Best Interest adopting release only in passing or not at all. As a result, the SEC's interpretation of the broker-dealer exemption was not “so ‘fundamental’” to Regulation Best Interest as to render the rule arbitrary.²²

Second, the Network Petitioners argued that the SEC failed to adequately address the “significant evidence that consumers are not meaningfully able to differentiate between the standards of conduct owed by broker-dealers and investment advisers.” The Court rejected this argument based on the SEC's consideration of several thousand comments during the comment period and because the SEC “carefully considered and rejected a fiduciary rule based on its findings” regarding the structure and characteristics of broker-dealers and investment advisers.²³ The SEC specifically considered evidence of consumer confusion and used that information to determine that the benefits of decreased costs and consumer choice fell in favor of a “best interest” obligation. The Court observed that “[p]etitioners' preference for a uniform fiduciary standard instead of a best-interest obligation is a policy quarrel dressed up as an APA claim” and reasoned that, “[a]lthough Regulation Best Interest may not be the policy that petitioners would have preferred, it is what the Commission chose after a reasoned and lawful rulemaking process.”²⁴ That the SEC prioritized what it viewed as consumer choice and affordability over potential confusion was not a sufficient basis upon which to reject the regulation.

IV. Implications

Absent any further appeals,²⁵ under the holding in *XY Planning Network*, broker-dealers are required to comply with Regulation Best Interest, which went into effect on June 30, 2020. Broker-dealers should confirm that

²⁰ The Court observed that the legislative history, while not an essential consideration here because the statute was clear, provides insight into the intended relationship between Section 913(f) and (g). Opinion at *6 n.8. The version of the bill passed by the House contained language requiring that the SEC “shall promulgate rules” making the standard of care for broker-dealers and investment advisers “the same.” The Senate version required that the SEC “shall commence a rulemaking, as necessary or appropriate” to the extent that it identified “regulatory gaps and overlap.” Ultimately, both concepts — a consistent standard of care for broker-dealers and investment advisers and rule-making to fill regulatory gaps — remained in the final version of the statute. Importantly, however, where both versions of the statute initially mandated that the SEC “shall” act, the final version directed that the SEC “may” act.

²¹ *Natural Resource Defenders Council, Inc. v. FAA*, 564 F.3d 549, 555 (2d Cir. 2009) (“[W]e will set aside the agency's decision only if it is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”).

²² Opinion at *8.

²³ *Id.* at *7.

²⁴ *Id.* at *1, 7.

²⁵ As of the date of this memorandum, petitioners have not filed a petition for a writ of *certiorari* with the United States Supreme Court, although they have until September 24, 2020 to do so. See Sup. Ct. R. 13.

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their policies and procedures outlining their relationships with retail customers are consistent with the regulation, a checklist for which FINRA has authored and provided on its website.²⁶ The checklist advises that broker-dealers apply the best interest standard in their consideration of both explicit and implicit hold or investment recommendations, and that broker-dealers take into account the elements of care, skill, and costs when making recommendations to retail customers. Additionally, FINRA further recommends that broker-dealers apply heightened scrutiny in determining whether high-risk or complex investments — including inverse and leveraged exchange-traded funds — are in the customer’s best interest.

XY Planning Network not only provides a relatively rare insight into the Second Circuit’s view of the SEC’s rule-making authority, but it also reveals something of its position on standing, both with respect to states and private plaintiffs. The Second Circuit, though reaffirming the concept of competitors’ standing, was divided on the issue of Ford’s — and by extension, XY Planning’s — ability to challenge Regulation Best Interest. The true extent to which Ford’s business would be impaired as a result of Regulation Best Interest, while accepted by a majority of the panel, raised serious concerns for the dissent. This view of Article III standing, including the critical review of the States’ tax revenue claims, is an important consideration to bear in mind, given the constant developments in administrative law and regulation.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email authors Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Peter Linken at 212.701.3725 or plinken@cahill.com; or Julia C. Koch at 212.701.3741 or jkoch@cahill.com; or email publications@cahill.com.

²⁶ *Reg BI and Form CRS Firm Checklist*, FINRA, <https://www.finra.org/sites/default/files/2019-10/reg-bi-checklist.pdf> (last visited July 16, 2020).