Recent Regulation BI Enforcement Proceedings

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Overview of Topics

- Overview of Reg BI
- *SEC vs. Western*
- Analysis of Western Allegations
- Regulatory Insights

Four Reg BI components

Regulation Best Interest

Effective Compliance Date: June 30, 2020. § 240.15l-1 Regulation Best Interest.

(a) Best interest obligation. (1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

Regulation Best Interest

(2) The best interest obligation in paragraph (a)(1) of this section shall be satisfied if:

(i) Disclosure obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, provides the retail customer, in writing, full and fair disclosure of: (A) All material facts relating to the scope and terms of the relationship with the retail customer, including: (1) That the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation; (2) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (3) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and (B) All material facts relating to conflicts of interest that are associated with the recommendation.

(ii) Care obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill to: (A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; (C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.

Regulation Best Interest

(iii) Conflict of interest obligation. The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to: (A) Identify and at a minimum disclose, in accordance with paragraph (a)(2)(i) of this section, or eliminate, all conflicts of interest associated with such recommendations; (B) Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; (C)(1) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with subparagraph (a)(2)(i), and (2) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

(iv) Compliance obligation. In addition to the policies and procedures required by paragraph (a)(2)(iii) of this section, the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. (b) Definitions. Unless otherwise provided, all terms used in this rule shall have the same meaning as in the Securities Exchange Act of 1934. In addition, the following definitions shall apply for purposes of this section: (1) Retail customer means a natural person, or the legal representative of such natural person, who: (i) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) Uses the recommendation primarily for personal, family, or household purposes. (2) Retail customer investment profile includes, but is not limited to, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation. (3) Conflict of interest means an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer —consciously or unconsciously—to make a recommendation that is not disinterested.

First SEC Enforcement Action

SEC vs. Western International Securities, Inc.

- First Reg BI enforcement action. Filed in federal court not as an administrative action.
- Current status of case.
- Trial scheduled for January 30, 2024
- Case involves sale of GWG L Bonds to retail investors between July 2020 and April 2021.
- GWG subject of hundreds of suits. Bonds based on life insurance receivables/viaticals.
- $1.3 billion sold through dozens of firms.

SEC vs. Western: General Allegations

Care Obligation

- Defendants allegedly failed to comply with Reg BI's "Care Obligation" because they did not exercise reasonable diligence, care, and skill to understand the risks, rewards, and costs associated with L Bonds
- Defendants allegedly failed to comply with Reg BI's "Care Obligation" because they recommended L Bonds to at least seven particular customers without a reasonable basis to believe the bonds were in their customers' best interests.

Compliance Obligation

- The complaint also alleges Western failed to comply with Reg BI's "Compliance Obligation" because it did not adequately establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.

Reg BI Does Not Prohibit Certain Cited Conduct

Specific Allegations not Prohibited by RegBI:

- "the Chief Compliance Officer did not provide the Due Diligence Report to Western registered representatives, supervisors, or other compliance personnel."
- "Western did not set any criteria or thresholds for its customers to invest in L Bonds. Western also did not restrict the sale of L Bonds to customers with certain risk profiles or investment objectives."
- "Western did not require registered representatives to take L Bond training on the current L Bond offering if they had already taken a training for one of the prior issuances of L Bonds, notwithstanding the significant changes in GWG's business and finances following its [merger] transactions with Beneficient."

“Reasonable Diligence, Care, and Skill”

Reg BI does not specify the requirements of “reasonable diligence, care, and skill.” For example, the SEC alleges that each of the registered representatives “misunderstood important issues regarding GWG and L Bonds” as set forth below:

- “several [registered representatives] Defendants failed to use reasonable diligence, care, and skill to understand the business combination with Beneficient, Beneficient’s business, or the impact of that business combination on the L Bonds’ risk”;
- “did not understand the risk of L Bonds”;
- “did not understand the nature of the collateral for L Bonds”; and
- “knew little, if anything, about Beneficient’s finances, including its history of operating losses, and did nothing to educate themselves.

SEC v. Western

- Five brokers recommended GWG L Bonds which were unsuitable for conservative investors
- Seven customers had conservative or moderate risk tolerance and were unsuited for L Bonds.

Background/Refresher

- Prior to 2018: GWG bought Viatical Life Insurance policies.
- January 2018: GWG acquired Beneficent Company.
- Beneficent loaned money to customers secured by illiquid alternative investments.

GWG 2020 Prospectus

- L Bonds are risky and speculative.
- "L Bonds are only suitable for persons with substantial financial resources and with no need for liquidity in this investment."

SEC Complaint, ¶33.

- Western did not restrict sales to customers with "substantial financial resources."
- (Prospectus recommended only for high net worth investors)

- L Bonds were underwater.
- GWG filed for Chapter 11 Bankruptcy on April 20, 2022.

Care Obligation:

1. Recommendation must be suitable
2. Need match between customer profile and recommendation

- SEC: Western International CCO did not share DD report with firm's RR's or supervisors

- Western limited L Bonds to 10% of customers net worth

SEC Complaint ¶ 63

SEC v. Western International

- Poor training by firm: firm trained RR's on initial L Bond offering.
- Firm did not train RR's on Beneficent loans
- Brokers didn't understand that L Bonds were undersecured
- RRs didn't realize that Beneficent had historic losses

Suitability allegations as to customers:

- Customer A:
  - $100,000 to 79 year old retired truck driver
  - Income $35,000/Liquid net worth $300,000
  - L Bonds were one-third of Customer A's liquid net worth

- Customers B and C:
  - $250,000 to married couple
  - Annual income $106,000/Liquid net worth $760,000
  - $250,000 investment was 12% of overall net worth and 33% of liquid net worth of Customers B and C

Compliance Function:

- SEC complains that WSPs are cut and pasted from SEC compliance guide.
- SEC seeks further details.

- (Query: unfair for SEC to critique use of its own language?)

- SEC claims that firm's policies and procedures provided insufficient guidance.
- No explanation of reasonably available alternatives or investment rationale.

- SEC: CCO should have shared DD reports with RRs

- Firm failed to investigate or drill down sudden increase in customer net worth.

Relief:

SEC seeks:

1. Permanent Injunction
2. Disgorgement
3. Civil Penalties

FINRA ENFORCEMENT ACTIONS

First FINRA Reg BI case: Charles v. Malico

- Six month suspension and $5,000 fine
- RR made excessive trades in customer account
- Commissions were $54,000
- Customer: 63 year old tax preparer
- Income: $100,000/Net worth $50,000
- Average account balance: $30,000

Malico Churning

- RR made 350 trades in account
- Heavy churning: buy and sell same positions
- Cost/Equity Ratio: 158%
- Trading lasted 17 months
- Customer repeatedly bought and sold same
- position

Malico FINRA Enforcement Action

- Referral was through customer arbitration
- (remember to settle these cases quickly)

FINRA Enforcement: Cirella and Short

January 31, 2023: Two Laidlaw brokers AWC

- Todd Cirella (3 month suspension)
- Edward Short (7month suspension)

Cirello

- Seven months of trading
- 46 trades/$27,000 commissions/$12,000 losses
- Cost equity ratio 37%
- Turnover rate 20
- Sanction: three month suspension
- $5,000 fine
- $27,000 restitution

Edward Short

- Laidlaw RR
- 30 years' experience
- 2.5 years of trading for rich 77 year old customer
- In 2.5 years 200 trades
- $116,000 commissions/$185,000 losses
- Costs/equity ratio 76%
- Turnover rate ratio 47%

Short:

- 7 month suspension
- $5,000 fine
- $116,000 restitution

- The FINRA cases would have been brought under prior regulations
- Churning not unique to Reg BI

Key Insights from *Western* and Depositions in Separate Action involving Reg BI

- Reg BI does not distinguish between the obligations of the Broker-Dealer and its Associated Persons.
- Enforcement of Reg BI does not appear to reflect the actual practices in the industry.

Best Practices from Real Cases

- ❑ Concentration, concentration, concentration!
  - Set hard limits on alternatives, and look at ratios.
- ❑ Red flags
  - Changes in suitability profiles and net worth.
- ❑ Bad broker audits
  - Same brokers in multiple cases.
  - Significant portion of our caseload relate to "one bad apple".
- ❑ Alternatives

Question & Answer

CLE Credit

Code: ENFORCEMENT