

GIBSON DUNN



Securities Enforcement and Investment Funds Update

June 7, 2024

Recent SEC Enforcement Action Potential Harbinger of More Regulation Best Interest Enforcement Against Broker-Dealers

There has been a dearth of Commission enforcement actions relating to Reg BI since the rule became effective in June 2020. This action for ordinary conflict of interest concerns, and another from February, may signal a more active Reg BI enforcement regime moving forward.

On May 21, 2024, the Securities and Exchange Commission (the “SEC” or the “Commission”) entered an administrative cease and desist order (the “Order”)^[1] against a dually-registered broker-dealer and investment adviser (the “BD/RIA” or “Firm”) concerning “failures . . . to address conflicts of interest in compliance with Regulation Best Interest (“Reg BI”) and the [Investment Advisers Act of 1940 (“Advisers Act”).” In particular, the Firm’s representatives recommended that clients “transfer securities . . . to new investment accounts” at the Firm’s affiliated private bank without disclosing that the representatives would be compensated for the recommendations and resulting transfers.

There has been a dearth of Commission enforcement actions relating to Reg BI since the rule became effective in June 2020. The Commission thus far has seemed content to leave enforcement to FINRA, which has settled approximately 30 Reg BI enforcement matters since 2020. **This action for ordinary conflict of interest concerns, and another from February^[2], are indicative of a more active SEC Reg BI enforcement regime moving forward.**

The Order states that the Firm, through its representatives, “recommended that certain of its brokerage customers and advisory clients transfer securities . . . to new investment accounts”

with an affiliated “wealth management firm that is part of the same parent organization.” The BD/RIA paid a “finders’ fee” to representatives that made “three or more customer referrals” in a quarter, and an “additional annual fee based on the value of any securities and other assets that were transferred.” The SEC found that the BD/RIA “did not disclose in writing that the representatives were acting as associated persons of [BD/RIA] when they made the transfer recommendations, or that the representatives would receive compensation . . . for making the recommendations, or the conflict of interest associated with the transfer recommendation.”

The Firm’s written broker-dealer Reg BI policies required the Firm to periodically review and evaluate conflicts, disclose all conflicts, and review and update disclosures. But, according to the Order, the policies failed to specify **how** registered representatives (“RR”) and supervisors could “identify, review, or address conflicts of interest related to the receipt of finders’ fees and annual fees,” or (2) “provide a mechanism for the [F]irm to identify and disclose . . . to retail customers that [RRs] . . . would receive finders’ fees and annual fees.”

Similarly, the SEC found that the Firm’s investment adviser “had written policies and procedures that required disclosure of all conflicts of interest to its advisory clients, however, this policy did not require any disclosure of compensation related to the account referrals and securities transfers.”

The Enforcement action apparently followed from a referral from the Division of Examinations (“Examinations”). The Order states that Examinations issued a deficiency letter “concerning the [F]irm’s lack of compliance with Regulation BI” and that the Firm quickly “addressed the deficiencies . . . by adopting new written policies and procedures related to the disclosure of conflicts of interest concerning . . . recommendations of securities transfers to its affiliates.” Nonetheless, it also resulted in a settled order, in which the Firm agreed to (1) pay a civil penalty of \$223,228 and (2) neither admit nor deny findings that it (a) “failed to satisfy the General Obligation of Regulation BI by failing to comply with the Disclosure Obligation, Conflict of Interest Obligation, and Compliance Obligation,” in violation of Rule 15c-1(a) under the Exchange Act, and (b) “violated” Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, the latter of which requires that investment advisers “adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.”

Analysis & Takeaways

- This action is likely only the beginning of enforcement actions following from the SEC’s increased Reg BI enforcement focus, particularly on the conflicts and duty of care elements of the Rule.
- The Order reflects an SEC expectation that Reg BI policies:
 - Explain “how” to identify and address conflicts of interest related to compensation for product recommendations, and
 - Provide a “mechanism” to identify and disclose conflicts of interest related to compensation for product recommendations.
- Dual registrants may be particularly compelling targets for Reg BI enforcement so that the SEC can make side-by-side findings, one under the Advisers Act and the other under the

Exchange Act (Reg BI), with respect to the same conduct by dual-hatted representatives implicating both regulatory regimes. This will enable the Commission to add settled enforcement actions as “precedent” to support the Staff’s FAQs on Reg BI, which arguably seek to substantially expand the scope of the Rule, in part by conflating the distinct roles of financial advisors when acting on behalf of the investment adviser versus the broker-dealer.

[1] Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 100186 (May 21, 2024), available at <https://www.sec.gov/files/litigation/admin/2024/34-100186.pdf>.

[2] On February 16, 2024, the SEC entered an administrative cease and desist order against a dually-registered broker-dealer and investment adviser for Reg BI disclosure, care, and compliance violations for recommending to retail clients its “core menu funds” that “earned higher fees” without disclosing “substantially equivalent, lower-cost share classes of affiliated funds.” See <https://www.sec.gov/news/press-release/2024-22>.

The following Gibson Dunn lawyers assisted in preparing this update: Lauren Jackson, Tina Samanta, Jon Seibald, Mark Schonfeld, David Woodcock, Tim Zimmerman, and Bryan Clegg.

Gibson Dunn’s lawyers are available to assist with any questions you may have regarding the issues and considerations discussed above. Please contact the Gibson Dunn lawyer with whom you usually work, any leader or member of the firm’s Securities Enforcement practice group, or the authors:

Lauren Jackson – Washington, D.C. (+1 202.955.8293, ljackson@gibsondunn.com)

Tina Samanta – New York (+1 212.351.2469, tsamanta@gibsondunn.com)

Jon Seibald – New York (+1 212.351.3916, mseibald@gibsondunn.com)

Mark K. Schonfeld – Co-Chair, New York (+1 212.351.2433, mschonfeld@gibsondunn.com)

David Woodcock – Co-Chair, Dallas (+1 214.698.3211, dwoodcock@gibsondunn.com)

Timothy M. Zimmerman – Denver (+1 303.298.5721, tzimmerman@gibsondunn.com)

Bryan Clegg – Dallas (+1 214.698.3365, bclegg@gibsondunn.com)

liability in connection with any use of these materials. The sharing of these materials does not establish an attorney-client relationship with the recipient and should not be relied upon as an alternative for advice from qualified counsel. Please note that facts and circumstances may vary, and prior results do not guarantee a similar outcome.

If you would prefer NOT to receive future emailings such as this from the firm,
please reply to this email with "Unsubscribe" in the subject line.

If you would prefer to be removed from ALL of our email lists,
please reply to this email with "Unsubscribe All" in the subject line. Thank you.

© 2024 Gibson, Dunn & Crutcher LLP. All rights reserved. For contact and other information, please visit us at gibsondunn.com