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SEC's First Reg BI Lawsuit Takes Strong Position on Individual Liability



The U.S. Securities and Exchange Commission (SEC) is putting some muscle behind Regulation Best Interest (Reg BI).

On June 16, 2022, nearly two years after Reg BI went into effect, the SEC filed its [first federal lawsuit](#) to enforce the rule against a broker-dealer and its registered representatives.

The SEC sued Western International Securities, Inc. (Western), a dually registered broker-dealer and investment advisor, along with five of its registered representatives, in the U.S. District Court for the Central District of California for allegedly violating Reg BI's care obligation; the defendants allegedly recommended certain high-risk, speculative bonds to retail customers without themselves fully understanding the associated asset risks and without establishing how the investments served the customers' best interests. The SEC also charged Western with violating its compliance obligation under Reg BI for allegedly failing to maintain adequate policies and procedures and other controls.

The fact that the SEC sued registered representatives -- notwithstanding allegations that their firm had inadequate internal controls and policies -- is a strong statement that individuals must use their best judgment to make their own independent inquiries and determinations about the products they recommend to their clients. Registered representatives cannot hide behind their firm's guidance and control failures to escape primary liability under Reg BI.

Regulation Best Interest

[Reg BI](#), which went into effect on June 30, 2020, requires broker-dealers and their associated persons 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."

Pursuant to Reg BI, broker-dealers and their associated persons must satisfy their duty by complying with four specific obligations: a disclosure obligation, a care obligation, a conflict of interest obligation, and a compliance obligation. The care obligation requires broker-dealers and their associated persons to exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs associated with recommending a securities transaction to a retail customer. The rule has no scienter or intent-based requirement; violations may be found in cases where the broker-dealer or associated person's recommendation was negligent.

SEC v. Western International Securities, Inc.

The case against Western and its registered representatives is the first action the SEC has filed in federal court since Reg BI came into effect. The SEC's [complaint](#) alleges that in 2020, Western and its registered representatives recommended and sold unrated corporate L bonds offered by GWG Holdings, Inc. (GWG) to certain retail investors and received commissions on those sales. As described by GWG in its prospectus for the bonds at issue, the bonds were illiquid, high-risk, speculative investments suitable only for investors with significant financial resources who were not seeking liquidity in this investment.

Nevertheless, the SEC alleges that Western and its representatives sold the bonds to customers with minimal financial resources, including to retirees who sought moderate to low-risk investments. In more than one instance, the registered representative allegedly brokered purchases that conflicted with the customer's documented desires and, at other times, sold L bonds without verifying the customer's financial ability to purchase the bond. In all cases, the representatives allegedly failed to detail how the investment served the customers' best interests.

Importantly, GWG had offered L bonds in three separate bond offerings prior to the 2020 offering at issue. During those earlier bond offerings, GWG's business model focused on acquiring life insurance policies in the secondary market. But in 2018–2019, shortly before the fourth bond offering, GWG switched to what seemed to be a riskier business model and began extending loans backed by cash flows from illiquid alternative investments. This switch went unnoticed by the registered representatives but, as described below, not by Western.

The SEC charged Western and each of the five registered representatives with violating Reg BI's care obligation by failing to use reasonable diligence, care, and skill in recommending the L bonds and by recommending the bonds without a reasonable basis to believe they were in the customers' best interests. For example, several of the individual defendants allegedly were unaware of publicly disclosed information about GWG's new business model, assets, and profitability or the risk profile and collateral securing the 2020 L bonds.

The SEC also charged Western with violating Reg BI's compliance obligation because its policies and procedures were deficient and not reasonably designed to ensure compliance with Reg BI's care obligation. As the policies relate to the sales of L bonds, the SEC alleged that Western did not require registered representatives to take additional training on L bonds to learn about the recent changes to GWG's business model, did not require the registered representatives recommending L bonds to receive or review a due diligence report prepared by Western's chief compliance officer on GWG's 2020 L bond issuance, and did not provide registered representatives any clear guidelines on who could invest in the 2020 L bonds through Western.

Aggressive Pursuit of Individuals

The SEC's decision to charge the registered representatives in this first federal court action based on Reg BI seems aggressive in light of the alleged significant and overarching compliance and control failures attributable to Western. Indeed, the allegations indicate that Western was aware that GWG had moved to a higher-risk business model but inexplicably failed to inform and train many of its registered representatives of that fact.

Furthermore, firm supervisors preapproved and signed off on the relevant bond purchases. Here are some other allegations of note:

- Western's CCO performed due diligence on GWG just prior to its June 2020 issuance of L bonds but didn't share the results of the due diligence with the firm's registered representatives or supervisors.
- Western did not "set any criteria or thresholds for its customers to invest in L Bonds" or restrict the sale of those L bonds "to customers with certain risk profiles or investment objectives."
- "Prior to recommending them to customers, Western required each of its registered representatives to take an online training course on L Bonds" but did not require them "to take L bond training on the current L Bond offering if they had already taken training [on earlier] issuances . . ." during which time GWG had employed a more conservative business model. According to the SEC's complaint, four of the five individual defendants opted out of training on the fourth bond issuance because they had taken the prior training.
- The customers' client agreement with Western, client disclosure forms, and GWG bond purchase form—which contained all of the relevant client information, including investment objectives, risk profile, investing knowledge, net worth, and the investment amount and percentage of net worth—were reviewed and signed by a Western supervisor.
- The dollar amount of commissions earned by the individual defendants was modest. As alleged by the SEC, the registered representatives each received between \$5,400 to \$32,000 in total commissions for the sale of the L bonds.
- In one instance, the SEC alleged that a registered representative defendant had relied on his client's net worth representation, suggesting that the registered rep had an obligation to independently verify that representation.

Although the individuals appeared to have complied with Western's specific procedures with respect to informing themselves about L bonds, the SEC still faults them for failing to take additional steps to ensure that they were adequately informed. Registered representatives should take notice. According to the SEC, neither minimum adherence to firm policies and procedures regarding a particular investment option nor approvals from supervisory review are enough—under Reg BI, registered representatives have their own individual and non-delegable duty to conduct an independent analysis to ensure that the products they recommend serve their clients' best interests.

Authors

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