

## Securities Litigation & Enforcement Alert | June 23, 2022

### SEC Issues First Enforcement Action for Reg. BI Violation



#### Overview

Regulation Best Interest (Reg. BI), a rule codified pursuant to the Securities and Exchange Act of 1934, heightens the standard of conduct for broker-dealers and individual registered representatives at the time they make securities recommendations to retail customers. The rule went into effect on June 30, 2020, and imposes specific obligations relating to disclosure, care, conflicts of interest and compliance.

The Securities and Exchange Commission (SEC or Commission) has brought its first enforcement action charging a dual registrant investment adviser and broker-dealer with violations of Reg. BI. On June 15, 2022, almost two years after the rule's implementation, the SEC filed a complaint in the United States District Court for the Central District of California, charging Western International Securities, Inc. (Western) and five of its registered representatives with violating Reg. BI in the sale of certain debt securities known as L bonds.

#### L Bonds

Western and certain registered representatives sold \$13.3 million in L bonds, a high-yield security issued by GWG Holdings (GWG), a financial services company located in Dallas, Texas, to some of Western's retail investors. GWG initially issued the bonds to finance its business of purchasing life insurance policies from insured individuals at a discount and collecting on the policy's death benefit. The bonds paid a fixed rate of interest and had maturity dates between two and seven years. The bonds were not rated. During the time GWG was issuing the bonds, it changed its business model from purchasing insurance policies to providing loans and other liquidity to acquirers of alternative and certain illiquid assets but continued to issue new L bonds. The L bonds issued by GWG after the change in its business are the focus of the enforcement action.

GWG disclosed in the prospectus that the bonds were speculative investments that involved a "high degree of risk, including the risk of losing [one's] entire investment." The prospectus stated that the bonds were illiquid, not listed on any securities exchange, and warned that a secondary market for the bonds was not expected to develop. The prospectus specifically stated that investors "should not expect to be able to resell [the bonds] regardless of how [the company] perform[s]" and that "L Bonds [are] not suitable for investors that require liquidity in advance of their L Bond's maturity date." Investors could not redeem the bonds without a "fee of 6% against the outstanding principal balance of the redeemed L Bond."

By early 2022, GWG was unable to make interest or principal payments on the L bonds. GWG ultimately suspended all sales of L Bonds and, by April 2022, had declared bankruptcy.

#### The Alleged Violation of Reg BI

The SEC alleges that the defendants violated Reg BI in the sale of L bonds to retail investors by failing to comply with the duties of care and compliance required by the rule. The duty of care requires broker-dealers to understand the potential risks, rewards

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and costs associated with the recommended security. The duty also requires the broker-dealer to determine if the security is in the best interest of the particular retail customer given the investment profile and to avoid putting the financial or other interests of the broker-dealer ahead of the investor. Scierter is not required to establish a violation of Reg. BI.

With respect to this duty, the complaint alleges that the individual registered representatives sold more than \$2 million worth of L bonds to retail customers (notably fixed-income retirees or low-net-worth individuals), received more than \$70,000 in sales commissions but did not adequately understand important aspects of the L bonds. Specifically, the registered representatives were unaware that: 1) GWG had changed its business from purchasing life insurance policies to providing loans and liquidity to alternative illiquid asset holders; 2) the L bonds were high-risk investments as described in the prospectus; 3) the L bonds were not directly collateralized by the life insurance policies and investor claims were subordinate to creditors of GWG's subsidiaries and 4) GWG and its associated entities had a history of incurring substantial net losses.

Relatedly, the duty of compliance requires the broker-dealer to “establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI.” The complaint alleges that despite preparing a due diligence report on the L bonds, Western’s compliance department failed to provide the report to the registered representatives who were selling the bonds. Further, Western failed to set any sales criteria, thresholds or restrictions with respect to sales of the bonds to certain customers based solely on their risk profiles and investment objectives. Finally, Western did not update its training for the registered representatives after GWG’s business model changed.

Notably, Western appears to have had a compliance plan in place to address the sale of the L bonds. The plan included client disclosure forms, client agreements, bond purchase forms and concentration level limits. Despite this plan and specific prohibitions, the SEC’s complaint alleges that Western’s compliance department failed to “examine whether an investment was in the customers’ best interest.”

### Key Takeaways

The most notable takeaway is that Western and its five registered representatives have not settled the SEC’s charges. Assuming the parties continue to litigate, an important precedent interpreting Reg. BI may be on the horizon. Current interpretations of Reg. BI is limited to the SEC’s interpretive release, guidance and this enforcement action. While an agency’s interpretation of its own rules may be informative, it is not law and, therefore, of limited utility in a litigated context.

The complaint is filed in the Central District of California as Western, and most of the individual defendants are located in that district. The California district courts appear to be the SEC’s forum of choice for first-time enforcement cases such as this Reg. BI matter and the SEC’s novel “shadow insider trading” case filed in the Northern District of California. While the California district courts and the Ninth Circuit may be friendly to the SEC, the Supreme Court has shown a recent willingness to review lower court rulings on securities-related matters and has not frequently ruled in the Commission’s favor.

The complaint lacks important details relevant to the application of Reg. BI. First, although the rule imposes enhanced duties upon broker-dealers at the time of recommendation, there are no facts detailing any conversations or disclosures provided to investors at the time of the recommendations. Second, the complaint relies heavily upon the risks identified in the prospectus but fails to note whether the defendants provided investors with the prospectus or similar disclosures at the time of the recommendations. Finally, the complaint does not provide any details regarding customer-specific interest in L bonds or discontent with their purchases; significant issues should the case proceed to a jury trial.

### For more information, contact:



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