July 2019—Legislative Intelligence Update | Case Closed or Prequel? Edward Jones Beats Account-Switching Claims in Court as Reg BI Looms

Welcome to this edition of the Investments & Wealth Institute *Legislative Intelligence*. This month's column reviews a recent court case in which a U.S. district court dismissed a putative securities class-action lawsuit against St. Louis-based brokerage firm Edward D. Jones & Co. (Edward Jones) alleging unsuitable account changes. The *Edward Jones* litigation is helpful by shedding light on some of the key issues involving account recommendations when Regulation Best Interest (Reg BI) goes into effect.

Edward Jones Decision Viewed under Reg BI Lens: Brokerage Industry Faces Tougher Compliance Regimen

On July 9, 2019, a California district judge dismissed all claims against Edward Jones, a dually registered broker–dealer and investment adviser, for allegedly pushing its brokerage customers into unsuitable advisory accounts. (*Anderson v. Edward Jones & Co., L.P.* (E.D. Cal., No. 2:18-CV-00714, filed March 8, 2018, decided July 9, 2019). In what is often viewed as the investor-friendly U.S. Eastern District Court of California, Judge John A. Mendez dismissed all claims including allegations that Edward Jones's real goal for recommending account switches from commission-to fee-based accounts was to increase revenue and avoid new regulatory requirements for commission transactions under the Department of Labor (DOL) fiduciary rule.

The facts surrounding the case and the basis of the decision were watched closely by dually registered broker-dealer and investment advisory firms. In recent years dual registrants have found asset under management (AUM) fees to be a more reliable and lucrative source of revenue than traditional brokerage accounts. With regulators closely monitoring rollovers and other account transfers, the *Edward Jones* decision offers important clues to how future courts and arbitration panels may view similar disputes when Reg BI goes into effect on June 30, 2020.

Overview

Five of Edward Jones' buy-and-hold brokerage customers filed a proposed class-action against the firm based on a number of counts including the central allegation that Edward Jones and its brokers failed to fully disclose their motivation in pitching its two advisory programs to buy-and-hold brokerage customers. The brokerage accounts were subject to a suitability standard administered by the Financial Industry Regulatory Authority (FINRA) and charged commissions for each transaction. The advisory programs are regulated by the U.S. Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940. According to the court, account holders are charged asset management fees including additional services that were unavailable in the brokerage accounts. Edward Jones also awarded bonuses to brokers for switching customers over to the fee-based accounts.

Disclosure. In order to pursue disclosure violations, plaintiffs based their claims in part on a Rule 10b-5 violation for fraud. Plaintiffs alleged that the firm and its brokers made willful misstatements or omissions in connection with the account recommendations. Judge Mendez dismissed these claims, noting that the advisory brochures provided to plaintiffs compared important differences between each type of account, and clearly stated that fees in an advisory program "can be more expensive than other investment choices over the long term."

DOL Fiduciary Rule. Although Edward Jones' representatives explained the effects of the DOL fiduciary rule to its customers, plaintiffs alleged that the firm used the controversial regulation "as a pretext to make these client account changes," according to the court. However, Judge Mendez rejected this argument as well, writing that plaintiffs did not explain why this omission "was material to the investment decision," given that plaintiffs had a choice before signing the authorization.

Contests/Bonuses. Plaintiffs also claimed that the alleged omissions included sales training for the brokers, new incentive structures, and a computer system defaulting to fee-based account applications. In addition to noting the account disclosures, Judge Mendez wrote that these activities did not amount to "an actionable deceptive scheme." Moreover, he wrote that the disclosure documents also noted that the account changes can "impact your financial advisor's eligibility for a bonus," including helping agents qualify for a travel awards program. Citing case law, Judge Mendez referred to a 2012 court decision holding that "we will not conclude that there is fraudulent intent merely because a defendant's compensation was based in part on [achieving key corporate goals]."

Scienter. Nor were plaintiffs successful in persuading the court that Edward Jones and its brokers intentionally made false or misleading statements that would result in *scienter*, a legal term for intentional misconduct that is required under a 10b-5 fraud claim. Citing legal precedent in which an inference of *scienter* "must be cogent and … compelling," Judge Mendez said plaintiffs failed to adequately make a convincing argument.

Investment Costs. The court also held that the plaintiffs failed to sufficiently allege economic losses, writing that plaintiffs' amended complaint contained no allegations of losses or changes to investment performance tied to the higher fees associated with the advisory accounts.

Suitability. Plaintiffs also were unsuccessful in alleging the account switches were unsuitable. The court disagreed, writing that plaintiffs had acknowledged in writing that they were not "relying on the advice or recommendation of Edward Jones" for any decision over account type, and they were aware that the additional advisory services in the new accounts "more than justifies the additional expenses."

Fiduciary Breach Claims under State Law. Finally, plaintiffs were unable to gain traction with their fiduciary breach claims under California and Missouri state law. Although the two states' high courts affirmed a fiduciary duty for broker–dealers decades ago, Judge Mendez declined to apply state law. In his decision Judge Mendez explained that the federal Securities Litigation Standards Act of 1998 (SLUSA) was intended to deter the shift of securities class-action lawsuits to state courts by barring state causes of action based on federal 10b-5 claims, "regardless of whether that conduct is an essential predicate of the asserted state law claim."

Assuming no more judicial surprises, *Anderson v. Edward Jones* appears to be a closed case and a clean win for Edward Jones, keeping in mind that Judge Mendez left plaintiffs the option to bring an amended complaint back to court. However, he cautioned them that "a further attempt to amend the Complaint might prove futile."

Implications of the *Edward Jones* Decision under Reg BI. Now let's look at a hypothetical case, based on the *Edward Jones* fact pattern, but subject to Reg BI's enhanced disclosure and "best-interest" standard in which violations of Reg BI are asserted in Faux City.

First, we review each of the claims in *Edward Jones* and assess whether Reg BI's standard of care works to the advantage of one or the other in an investment dispute. Keep in mind that the vast majority of investment disputes likely will go to arbitration as individual claims (except in the unlikely event that a federal court certifies a class action). Then, for purposes of simplicity, we measure the heightened standard for advice under Reg BI by assigning a thumbs' up to Faux City plaintiff (a brokerage customer) or the defendant (a Faux City broker) based on whether the rule helps one or the other in an arbitration forum.

Industry proponents of the rule contend that Reg BI will enhance investor protection, implying that the industry will incur more liability. Consumer advocates argue Reg BI will at best mislead investors over the legal status of their broker; and at worst, dilute consumer protection. Let's see how it plays out in the hypothetical dispute over account switches in Faux City, using the *Edward Jones* case as proxy.

Disclosure. The debate over whether disclosure actually works as an effective remedy for managing conflicts of interest is at the heart of the debate over Reg BI's central mechanism for mitigating conflicts of interest. The Disclosure Obligation under Reg BI requires the firm and its brokers to provide to the customer "full and fair disclosure" of all material facts regarding the recommendation in writing. The rule also specifically covers account change recommendations. Material facts that must be disclosed under this requirement include capacity (i.e., acting as a broker instead of an investment adviser representative), disclosure of important fees, limitations on investment strategies or products, and material facts related to conflicts of interest associated with the recommendation. However, as described in the adopting release (p. 205), brokers are not required, for example, to detail specific amounts of compensation, including compensation for each transaction, or for year-end bonuses.

Analysis. It is important to note that the SEC's guidance on Reg BI states (p. 217 of the release) that compliance will be measured against a negligence standard, not against a standard of strict liability. The SEC clarifies the difference in a footnote on p. 218 by comparing a broker's obligation to provide "full and fair disclosure" to the disclosure obligations for investment advisers. According to the final release, consistent with an adviser's fiduciary duty, establishing *scienter* is not required under the Investment Advisers Act of 1940; rather a "showing of negligence is adequate." Stated another way, the SEC is saying that fraudulent intent is not required to establish a disclosure violation under Reg BI, only failure to provide a necessary disclosure.

In its motion to dismiss, Edward Jones asserted that plaintiffs ignored "the extensive disclosures they received about the different account options and the services and charges associated with each." It added that plaintiffs now claim to be dissatisfied with their choices, and that they use an "unfounded 'reverse churning' label to attack EDJ's business model."

Even with the extensive disclosure in *Edward Jones*, SEC Chairman Jay Clayton insisted in a congressional hearing in 2018 that a separate obligation under Reg BI—the Conflict of Interest Obligation—also requires the firm to identify and disclose or eliminate all conflicts of interest related to the broker's recommendation. Clayton called this the "most significant" requirement of Reg BI. "To be clear, disclosure alone would not be sufficient," he said.

But is disclosure really enough? Whether standard boilerplate disclosures will satisfy Reg BI won't be known until Reg BI goes into effect and the SEC or FINRA bring enforcement actions. While Clayton insisted that firms must do more than just disclose conflicts, courts and arbitration panels are more likely to look at the text of the rule, which merely requires brokerage firms to, "at a *minimum* disclose" all conflicts of interest [emphasis added]. The rule text, in short, carries far more weight as official guidance than public remarks of an SEC official. In fact, SEC staff, no matter their views, as a standard practice always disclaim that their public statements do not necessarily represent the Commission's official position. Moreover, because the SEC did not define what it means by "full and fair disclosure," in most situations firms are likely to be able to satisfy the Disclosure Obligation—as Edward Jones was—by merely providing customers with written disclosures of material information. Similarly, RIAs are obligated to provide "full and fair disclosure" but staff guidance makes clear that advisors may have to provide additional information on the specific conflict in addition to delivering a copy of the ADV brochure to the client once a year.

Verdict in favor of: **Defendant**. 👍

Contests/Bonuses. One of the hallmarks of Reg BI, as outlined in the Care Obligation, is a new ban on bonuses and other incentives for brokers who push certain securities products over the interests of customers. As such, brokerage firms are required to eliminate sales contests and related awards "based on the sales of specific securities or specific types of securities within a limited period of time." The final release goes on to say that such contests "create high-pressure situations … to increase the sales of specific securities by compromising the best interest of their customers."

Analysis. Reg BI doesn't ban other financial incentives. Moreover, the SEC makes clear in the adopting release that the bonus restriction "does not apply to compensation practices based on, for example, total products sold, or asset growth or accumulation." In other words, longer-term incentives attributable to boosting firm revenues and recognizing other aspects of individual performance, such as switching brokerage customers to AUM accounts, are not *per se* violations of the Care Obligation (as long as the Disclosure Obligation is also met).

Verdict in favor of: **Defendant.** 👍

Scienter. Assuming plaintiffs assert a Rule 10b-5 fraud claim, under the Exchange Act they must prove *scienter*. However, the SEC states in the Reg BI adopting release (p. 43) that *scienter* "will not be required to establish a violation of Regulation Best Interest." At the same time the agency said it does not believe, nor is Reg BI intended, to create a *new* [emphasis added] private right of action. As such, will plaintiffs be able to skirt *scienter* and make a negligence claim under Reg BI? We'll see. If the broker violates the firm's policies and procedures, or if the firm is not diligent in identifying and mitigating potential conflicts, then the chances increase that the plaintiff will prevail under the negligence claim.

Verdict in favor of: **Plaintiff.** 👍

Investment Costs. Under the Care Obligation in Reg BI, the SEC added "costs" to the requirement that brokers analyze the potential risks and rewards when formulating a reasonable basis for their recommendations. In the final release, the SEC explained that "we are expressly adding cost to the rule text as a factor that a broker-dealer must consider in fulfilling the Care Obligation." The release noted that consumers in focus groups and at investor roundtables hosted by the SEC believed that the fees and costs section of the new Form CRS disclosure "was the most important for determining which type of investment accounts and services are right for that person."

Analysis. Given the increased emphasis by the SEC on examining fees and costs, anything other than "full and fair" disclosure of fees comparing costs between brokerage and advisory accounts are likely to be closely scrutinized by arbitration panels. It is true that the *Edward Jones* court appeared to equate investment losses solely with stock-drop-type losses, but then the judge also implied that the plaintiffs failed to make a strong argument tying AUM fees to lower investment returns. Given the addition of "costs" to the Care Obligation, and greater emphasis by regulators on overall investment costs, going forward it seems likely that arbitrators and judges also will scrutinize these costs more closely.

Verdict in favor of: **Plaintiff.** 👍

Suitability. The factors comprising a "Retail Customer Investment Profile" that brokers must consider in meeting their suitability obligations are identical to those in FINRA Rule 2111. (The 10 factors listed under both regulations are: age, other investments, financial situations and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other information provided to the firm.) The Reg BI release also notes on p. 292 some additional factors that a broker must consider in determining whether a particular account is in the customer's best interest. These include services and products available in each type of account, the projected cost to the customer, alternative accounts available, and the services requested by the customer. However, these and other factors are noted in greater detail in FINRA Notice 13-45, although the focus of 13-45 is primarily on rollovers from qualified accounts. Still, the factors outlined in the Reg BI release are not new conditions; all of the factors summarized in the Reg BI release have been part and parcel of SEC and FINRA checklists for years and remain a priority in regular firm examinations.

In addition, the SEC eliminated the word "prudence" from the Care Obligation after protests from industry groups that the term "introduces legal confusion and uncertainty" due to regulatory and judicial interpretations of the prudent expert standard under the Employee Retirement Security Act of 1974 (ERISA). Weighing the new addition of "cost" to the Care Obligation, balanced against a robust defense in which the appropriate disclosures have been carefully documented, disclosure may indeed prove to be a sufficient suitability defense as evidenced in the *Edward Jones* decision. As a result, brokers complying with Rule 2111 (or whatever FINRA adopts to conform with Reg BI), and providing adequate documentation as to why the account change is in the customer's best interest, may be able to mount a strong defense against this charge.

Verdict in favor of: **Defendant.** 👍

Fiduciary Breach Claims under State Law.
As noted in the *Edward Jones* decision, SLUSA severely restricts efforts by the plaintiffs' bar to bring fiduciary breach claims under state law. Nor does the Exchange Act provide for a unique private right of action to enforce violations of FINRA rules. Stated simply, Reg BI appears to have little or no impact on current litigation practices or provide an opportunity for the plaintiffs' bar to pursue novel theories for violations under the new standard of conduct.

It does not mean that the plaintiffs' bar won't try; on the ERISA side, it took years for a handful of plaintiffs' firms to prevail in excessive fee claims against financial services firms and prominent universities. Most of these cases have yet to be resolved, but the bulk of them have been certified as class actions and a substantial number of settlements have been reached. However, ERISA was enacted with a clear private right of action available for fiduciary breach claims while the cause of action under the Exchange Act, according to most experts, is implied, not grounded in clear statutory language.

Analysis. Fiduciary breach claims are the most common claim brought in arbitration disputes. However, FINRA arbitration panels are not bound by the same rules as courts. As such, plaintiffs could seek to enforce Reg BI violations in FINRA arbitration forums—notwithstanding the SEC's express statement that Reg BI does not create a new cause of action. Plaintiffs also could pursue fiduciary breach claims based on state common law as part of the same action.

Result: Hung jury? 

Of course, it's unknown whether Reg BI will increase liability for brokerage firms and at the same time enhance investor protection. In theory, compliance with Reg BI can minimize liability while accomplishing the SEC's stated goals of enhancing investor protection and preserving the availability of investment advisory services under the broker-dealer business model. The thumbs' up split between plaintiffs and defendants suggests a lesson can be learned—that both sides can benefit if brokerage firms (and the SEC and FINRA) take Reg BI seriously.

Meanwhile, we have been advised that the Faux City arbitration panel has arrived at a decision.

After reviewing all of the available evidence in Reg BI, and whether it tilts more in favor of protecting investors or firms, our hypothetical arbitrators reach a mixed decision. The panel dismisses one count against **Defendant** Faux City broker alleging a violation of Reg BI's ban on sales contests.👍 However, the arbitration panel cannot reach a decision on fiduciary breach claims under state law; but it does affirm and award damages on three additional counts: 👍👍👍 (1) negligence under the Care Obligation, (2) making an unsuitable account recommendation (also a violation of the Care Obligation and FINRA Rule 2111), and (3) failure to provide "full and fair" disclosure of all material costs involved in the account switch under the Disclosure Obligation. In particular, the attorney for the Faux City plaintiff was successful in convincing the arbitration panel (unlike Judge Mendez) that the long-term drag on returns in the advisory account portfolio were more costly over plaintiff's investment time horizon than a 'buy-and-hold' strategy for the same positions in a brokerage account.

About Legislative Intelligence Update

The purpose of this update, prepared by Potomac Strategies for Investments & Wealth Institute, is to give members legislative, regulatory, and other public policy intelligence and analysis. It is strictly informational and should not be relied upon as legal or compliance advice. Investments & Wealth Institute, as an education and credentialing organization, does not lobby Congress and generally does not advocate for any particular legislative or regulatory position either on its own or through its relationship with Potomac Strategies.

If you have questions after reading this update, please contact the Institute by replying to this email. We will either respond personally to your inquiry or include a response in an upcoming issue.