

Using Litigation Releases as Case Studies: The SEC's First Reg BI Case

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*“It is good to learn from your mistakes. It is better to learn from the mistakes of others.”
– Warren Buffet*

“The SEC’s First Reg BI Enforcement Action” by Brian Rubin, Issa Hanna and Andrew Mount provides an insightful analysis of the SEC’s first Reg BI case. The article below is intended to serve as a tool for firms to use litigation releases to evaluate their firm’s compliance program.

Litigation Releases

Just as good detectives study the methods of criminals, good compliance professionals should read litigation releases to learn from the misfortunes of others. Both the SEC and FINRA publish litigation releases and they highlight important ones in press releases. The first issue that must be addressed is how will one become aware of key litigation releases? There is not a “best” method, instead each person will need to find what works best for them. Here is a non-inclusive list of methods:

- Subscribe to SEC email feeds;
- Subscribe to email feeds from law firms or compliance consultants;
- Read online news from various sources including “NSCP Currents” and social media posts by law firms or compliance consultants;
- Listen to industry podcasts, such as [The Securities Compliance Podcast](#); and
- Periodically review the releases on the SEC website.¹

Turning Litigation Releases into Case Studies

When you see an enforcement case that is relevant to your firm, you can turn it into a learning exercise that can help improve your compliance program. Our suggestion is to begin by reading the release twice. This first pass is to understand the issues and what happened to the litigant. The second read should be from the perspective of YOUR firm and you should be constantly asking yourself, “what are the lessons learned?” Finally, the release can be transformed into a case study with relevant questions and items for follow up. An example is provided below.

“Death By Meeting”²

“Death By Meeting” by Patrick Lencioni is a great book on how to run productive meetings. Borrowing from the idea in the book of conducting quarterly strategic meetings, a case study is a terrific topic for team building, professional development and compliance testing. In advance of the quarterly meeting, attendees should read the litigation release and be provided a copy of the case study questions.

Sample Case Study - In the Matter of Western International Securities, Inc. et al.

Note: although this is the SEC’s first Reg BI case against a broker-dealer (“BD”), there were investment advisers that invested in corporate bonds offered by GWG Holdings, Inc (“GWG”) known as L Bonds. While this case study may also be pertinent to RIAs, the questions are from the perspective of a BD.

1. See U.S. Securities and Exchange Commission website, Litigation Releases page available at: [Litigation Releases \(sec.gov\)](#).

2. See “Death By Meeting” by Patrick Lencioni. Available at [Death by Meeting: A Leadership Fable...About Solving the Most Painful Problem in Business: Lencioni, Patrick: 8601404616433: Amazon.com: Books](#). <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-110.pdf>. <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-110.pdf>.

Required reading:

- The litigation release - [Western International Securities, Inc., Nancy Cole, Patrick Egan, Andy Gitipityapon, Steven Graham, and Thomas Swan](#)
- The firm's Reg BI policies, procedures, disclosures and forms

Be prepared to discuss the following questions.

Item #	Question
Initial and Ongoing Due Diligence	
1	With regard to due diligence, the facts in this case are sparse. The CCO reviewed GWG's most recent Form 10-K and a third-party due diligence report. However, firms are expected to conduct robust due diligence beyond regulatory filings and third-party due diligence reports. It is an industry best practice to utilize a comprehensive due diligence questionnaire. Review our firm's policies, procedures and due diligence workflows. Are the policies and procedures adequate? How would you expect our due diligence to differ from GWG's due diligence?
2	Western International Securities ("WIS") will not approve a product that has not been subject to third-party due diligence, which is a good safeguard, but is inadequate in and of itself. Does our firm insist upon third-party due diligence as a condition for product approval? What other sources of information must be used?
3	Do the people responsible for due diligence at our firm have the requisite knowledge and experience to perform robust reviews? What training, education, and background requirements must be met?
4	Have other well-known firms approved the products on our approved product list?
5	Due diligence is both an initial and an ongoing obligation. In the case of GWG, they started offering "Renewable Secured Debentures" in 2012. However, the fourth offering in 2020 had a significant change in that the bonds, referred to as L Bonds, were no longer backed by life insurance contracts, but instead became a general obligation of GWG's subsidiary, Beneficient Company Group, LP ("Beneficient"). This was a significant change in the investment. Does our firm have a robust process for monitoring and ongoing due diligence? Is due diligence monitoring required at certain frequencies and if so are the frequencies adequate? Should monitoring frequency be increased for certain types of products?
6	GWG (and Beneficient) had a history of net losses and was not generating cash flow sufficient to fund its operations. ³ Would an issue such as this have been detected in the due diligence of products on our approved product list?
7	As of December 31, 2019, GWG's largest asset was Beneficient's goodwill (\$2.4 billion) which constituted 65% of GWG's consolidated assets. Ignoring the goodwill, GWG's liabilities were well in excess of its assets. Would an issue such as this have been detected in the due diligence of products on our approved product list?
8	The internet is a powerful tool for due diligence. An internet search of GWG would have revealed numerous FINRA enforcement actions against BDs and registered representatives ("RRs") beginning in 2014 for suitability violations. Although none of the

3. <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-110.pdf>.

	<p>enforcement actions were directly against GWG, it is logical to assume there were issues with the Renewable Secured Debentures early on, which should have been a red flag. Does our firm perform robust internet searches on products on the approved product list? Does the firm set alerts on approved products?</p>
9	<p>GWG was unable to timely file its Annual Report on Form 10-K for the year ended December 31, 2020, and they temporarily ceased offering L Bonds in April 2021. GWG subsequently filed its 10-K for 2020 and resumed selling L Bonds on November 5, 2021. On January 15, 2022, GWG filed a Form 8-K disclosing they were unable to make the January 15, 2022 interest payment of \$10.35 million and principal payments of \$3.25 million. GWG again ceased offering the L Bonds. Would an issue such as this have been detected in the due diligence of products on our approved product list? Does our firm have policies and procedures to periodically review filings (and determine if any filings are missed) for approved products?</p>
10	<p>Grant Thornton was GWG's fourth auditor since August 2019 and Grant Thornton resigned on December 31, 2021. Would an issue such as this have been detected in the due diligence of products on our approved product list?</p>
11	<p>Does our firm have a systematic process to detect issues, remove a product from the approved list and proactively communicate with staff and investors?</p>
12	<p>The WIS due diligence policies and procedures required the CCO to review the third-party due diligence report but did not require any other personnel, including supervisors or RRs to receive or review the report. The third-party due diligence report contained a detailed analysis of the L Bonds and GWG that could have helped WIS Supervisors and RRs to understand the risks, rewards and costs associated with the L Bonds. Does our firm have a policy of sharing due diligence with Supervisors and RRs?</p>
Training	
13	<p>Prior to recommending L Bonds to customers, WIS required product specific training via an online course on L Bonds. However, the online training was dated and did not reflect the substantive changes with Beneficent. Does our firm require product specific training prior to recommending certain approved products to customers? Does our firm have sufficient oversight of personnel?</p>
14	<p>Does the firm require ongoing training and provide product updates?</p>
Policies and Procedures	
15	<p>The Compliance Obligation of Reg BI requires firms to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. The firm must consider the nature of the firm's operations and how to design such policies and procedures. The litigation release stated, "Western's written policies and procedures merely recited the objectives of Reg BI, without offering registered representatives specific guidance tailored to Western's operations. Western also had inadequate procedures for enforcing what limited policies it had regarding compliance with the Care Obligation of Reg BI." The WIS Reg BI policies and procedures were substantially copied from the SEC Small Entity Compliance Guide⁴. Thus, the policies were general and not tailored to the business. Moreover, the policies did not include mechanisms for enforcing the policies and procedures. Are our firm's Reg BI policies and procedures sufficiently tailored to our business and sales practices?</p>

4. See SEC Small Entity Compliance Guide available at <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>.

16	<p>With regard to Reg BI's Care Obligation, the WIS policies and procedures stated RRs "[s]hould consider reasonably available alternatives offered in determining whether there is a reasonable basis for making the recommendation." However, the policies and procedures did not provide an explanation of what may or may not constitute a reasonably available alternative and there were no procedures or guidelines for RRs or supervisors to follow in determining how to comply with this requirement. The litigation release provided details for eight clients and none of them had documented an analysis of reasonable alternatives to the recommendation. Does our firm require documentation of reasonable alternatives, and if so, are the policies and procedures sufficiently specific to be actionable with guidelines for what is, and is not, acceptable? Is there a process to periodically review the required documentation?</p>
17	<p>The WIS policies and procedures instruct RRs to take "particular care" in dispensing their Care Obligation with respect to complex or risky products, such as L Bonds. However, the policies and procedures did not elaborate or provide any specific guidance as to which investments are risky or how RRs should exercise this particular care. Does our firm provide sufficient guidance with regard to complex or risky products and tailored guidance for RRs meet their duty of care?</p>
18	<p>WIS required RRs to provide an investment "rationale" on the disclosure form; however, the policies and procedures did not provide any guidance or instruction as to the purpose of the rationale section of the form or what information should be included. In each of the eight examples cited by the SEC in the litigation release the descriptions were described as unreasonable, vague and unsupported. Some of the rationale descriptions were:</p> <ul style="list-style-type: none"> • "Customer is seeking a higher rate of interest from funds sitting in a bank savings at 0.05%. They will utilize the interest for supplemental income each month." • "L Bonds offer good returns and are not too risky." • "Seeking an additional income stream to supplement his retirement income" • "Client had a CD come due and does not need the funds for a few years. She likes the interest rate of the bond and understands the risk of the GWG bond. This bond meets all of her needs and objectives." • "Client had extra cash in the bank and wanted to earn more interest than can be done in his bank. Client will also have a large cash balance in his bank account in addition to the \$20,000 at GWG."⁵ <p>Has our firm provided adequate guidance and training to adequately describe the rationale for each investment recommendation consistent with the Care Obligation of Reg BI?</p>
19	<p>The 2020 prospectus stated, "L Bonds are only suitable for persons with substantial financial resources and with no need for liquidity in this investment." All eight of the investors profiled in the litigation release had a moderate risk tolerance and none of them listed speculation as an investment objective. What is our firm's policy with regard to a risky investment for an investor with a moderate risk tolerance?</p>
20	<p>None of the eight investors met the criteria of an accredited investor and there were no minimum net worth or income requirements in the WIS policies. Does our firm have such policies for investments on the approved product list?</p>
21	<p>To their credit, WIS did have and enforced a 10% of net worth concentration limit on the purchase of L Bonds; however, this was insufficient to protect the investors or the firm. Generally, concentration limits are a best practice when dealing with complex, illiquid and risky investments. Has our firm implemented concentration limits for such investments?</p>

5. <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-110.pdf>.

Best Interest	
22	The L Bonds were offering fixed yields of between 5.5% on two-year bonds and 8.5% on seven-year bonds. At this time, the ten-year U.S. Treasury yield was approximately 2%. The L Bonds were unrated and yields commensurate with low credit quality or unrated bonds. At the very least the L Bonds should be treated as junk bonds. Does our firm have a policy with regard to junk bonds or any other high-yielding fixed income instruments?
23	To purchase L Bonds, WIS required their completed New Account Form, the WIS Client Agreement, the product disclosure form and the GWG bond purchase form. Although the product disclosure form contained an admonition that the investment is illiquid and risky and was signed by the Clients, this was deemed insufficient to meet the Care Obligation. Has our firm created adequate product specific disclosures for investments on the approved product list?
24	Examine the fact patterns of the eight investors detailed in the litigation release. Did the fact patterns expose any gaps in our policies and procedures? If so, how can and should they be addressed?
25	What are the lessons learned from this case study?

Conclusion

In a sense, turning litigation releases into case studies is a form of transactional testing of your firm's compliance program. The litigation release will serve as a guide to developing the testing questions as was done in this article. The case studies offer the advantages of team building and professional development, as well as testing the firm's policies and procedures. Case studies are an excellent topic for quarterly strategic meetings as described in "Death By Meeting." ■