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VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

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Via electronic submission to:
http://www.njconsumeraffairs.gov/proposals/pages/default.aspx

Christopher W. Gerold, Bureau Chief
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PO Box 47029
Newark, New Jersey 07101

Re: Fiduciary Duty of Broker-Dealers and Investment Advisers (Proposal Number: PRN 2019-044); Proposed New Rule N.J.A.C. 13:47A-6.4[1]

Dear Mr. Gerold:

We the undersigned trade associations appreciate your continued engagement with the industry and the opportunity to comment on the proposed fiduciary duty regulations referenced above. We, as a group, represent a cross-section of the financial services industry and all of us have members serving retail investors in New Jersey. Many of us of have sent separate letters and would like to take this opportunity to highlight some key universal concerns applicable across all our membership.

Specifically, as you consider the comments and develop the Bureau of Securities' final regulation, we encourage you to consider the following:

[1] Available at: https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx.

1. **The Bureau should pause its process and reevaluate its Proposal in light of Reg BI.**

On June 5, 2019, the SEC passed Reg BI, thereby creating a new, nationwide, heightened standard of conduct for BDs that are member firms of the Financial Industry Regulatory Authority ("FINRA") or another SRO. Under Reg BI, a BD making a personalized recommendation to a retail customer in a brokerage account involving a securities transaction or an investment strategy must act in the client's best interest, without placing its financial or other interest ahead of the client's interest. That best interest obligation requires a BD to, among other things: (1) disclose all material facts about the scope and terms of the relationship and all material facts relating to conflicts of interest; (2) exercise diligence, care, and skill, including understanding the risks, reward and costs associated with a recommendation; and (3) mitigate under various circumstances, and eliminate in specific instances, conflicts of interest associated with the recommendation.

SIFMA generally supports Reg BI because it: (i) raises the bar from the existing FINRA suitability standard and incorporates fiduciary principles; (ii) adds meaningful new investor protections; (iii) preserves investor choice and allows investors to continue to receive advice through the brokerage model, and allows BDs to continue to receive commissions for executing transactions; (iv) applies broadly to all retail customer accounts, including retirement accounts; and (v) allows the primary federal securities regulatory agency – the SEC – to enforce a uniform standard, not only across the industry, but also across the country.

While the best interest obligation under Reg BI applies at the time of the recommendation, the obligation is fundamentally consistent with the fiduciary obligation imposed on an investment adviser when providing personalized investment advice about securities to a client.[2]

Based on the foregoing, we urge the Bureau to pause its rulemaking process, review Reg BI, and reevaluate its Proposal before deciding whether it is necessary to proceed with an additional state regulation. Doing so would give the Bureau an opportunity to determine if there are material gaps between Reg BI and the Bureau's proposed regulation. This is especially critical, as the creation of overlapping, duplicative or potentially conflicting requirements could create serious issues for the industry – particularly if such rules go into effect across multiple states, which would likely lead to increased investor confusion and undermine the intent of federal law.

2. **The duration of the duty should be limited to when a recommendation is made.**

Under federal laws, including the new Reg BI, the duration of a BD's suitability or best interest obligation is limited to the point in time when a recommendation is made.[3] FINRA's rules require that BDs establish a reasonably designed, risk-based, supervisory system and procedures to supervise recommended transactions and investment strategies.[4]

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[2] Adopting Release at p. 13 ("The [SEC] has crafted Regulation Best Interest to draw on key principles underlying fiduciary obligations, including those that apply to investment advisers under the Advisers Act, while providing specific requirements to address certain aspects of the relationships between broker-dealers and their retail customers.").

[3] The term "recommendation" has the meaning long-interpreted and applied under FINRA rules and broker-dealer regulation generally. *See* FINRA Rule 2111 (Suitability) FAQ, available at http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq. Factors that are considered when determining whether a broker-dealer has made a recommendation include whether the communication "reasonably could be viewed as a 'call to action'" and whether it "reasonably would influence an investor to trade a particular security or group of securities." *See* FINRA Notice to Members 01-23, *Suitability Rule and Online Communications* (April 2001), available at http://www.finra.org/industry/notices/01-23.

[4] FINRA Rule 3110 (Supervision), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11345.

Under the Proposal, however, the text of the rule states, "[i]f a broker-dealer or agent also provides, in any capacity, investment advice to the customer, the fiduciary duty shall be deemed an ongoing obligation to that customer."[5] The preamble to the Proposal states that this rule text is intended to impose an ongoing fiduciary duty in a brokerage account in situations where a dual registrant acts as both an IA and a BD to the same customer.

Notwithstanding the preamble's explanation, however, the rule text can actually be read much more broadly to mean that even if a BD is not dually registered, or the customer does not have an IA account, if the BD provides any investment advice, then the fiduciary duty is ongoing. Accordingly, at a minimum, as a matter of clarity, the rule text should be revised to conform and agree with the language in the preamble.

Yet, even if the rule text was so conformed – such that with respect to dually-registered individuals and firms with customers who maintain both a brokerage and an advisory account, "the fiduciary duty [in the BD account] shall be deemed an ongoing obligation to that customer" – it would remain problematic. As a practical matter, this requirement would impose on dually registered BDs a new duty to monitor the ongoing performance of a customer's brokerage accounts, as well as the factors establishing suitability for the client,[6] in cases where the customer also maintains an investment advisory account. This would be required even if the customer did not ask the broker to do so and did not want to pay the additional cost required to monitor their brokerage account.

Many customers understand that, for some of their assets, it makes sense to pay an ongoing fee for the additional services an advisory account can provide. They also make a rational decision not to enroll certain accounts or assets in what is often a more expensive investment advisory program. For example, some clients might favor a buy-and-hold, longer-term strategy in an IRA and thus make the choice to maintain the IRA in a brokerage account without paying ongoing advisory fees.

Moreover, there is no basis in the securities laws for effectively imposing a presumption that dually registered BDs or dually licensed representatives shall be deemed to be acting in an advisory capacity in servicing their brokerage accounts – or that a firm that carries a customer's advisory accounts should be deemed to be acting as an IA for that customer's brokerage accounts.[7]

As drafted, New Jersey's overbroad fiduciary duty, however, would cause some BDs to consider limiting brokerage services to New Jersey clients, thereby requiring many of these investors of modest means to purchase additional services. In this regard, the Proposal undermines investor choice of and access to the level of services that they want and currently enjoy.

For the above reasons, we recommend that the Proposal conform the duration of the duty to be consistent and in harmony with current FINRA rules and the SEC's Reg BI and include an explicit exemption from the fiduciary duty for unsolicited transactions and self-directed accounts.

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[5] Proposal at Section 13:47A-6.4(a)1.ii.

[6] FINRA Rule 2111 (Suitability), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

[7] The SEC's long-standing view is that a dual registrant is an IA solely with respect to those accounts for which it provides advice or receives compensation that subjects it to the Investment Advisers Act of 1940 (the "Advisers Act"). *See* 83 FR 21574, 21596; Adopting Release at p. 35. Reg BI addresses this issue directly by requiring the firm to disclose the capacity in which a dual registrant is acting. *See* 83 FR at 21596; Adopting Release at pp. 188 – 190.

3. <u>The "best of" standard for account types, securities, and transaction-based compensation is impermissibly vague and fails to provide a sufficiently defined standard to put advisors on fair notice of what it requires</u>.

The Proposal requires that a recommended security or account type must be "the best of the reasonably available options" and that any transaction-based fee received by the BD must be both "reasonable"[8] and "the best of the reasonably available fee options…."[9] No such "best of" standard exists under current federal securities laws, nor are we aware of any other fiduciary law that imposes a similar standard. In fact, federal agencies and securities regulators have generally accepted the fact that it is not possible to definitively identify a single "best" option without the benefit of hindsight, essentially rendering the standard unattainable and impossible to satisfy.[10]
As a group, we believe that the "best of" standard should be eliminated.

4. <u>The scope of the proposed fiduciary duty should be limited to recommendations of securities transactions or investments strategies</u>.

Under the Proposal, the scope of the fiduciary duty extends to recommendations about "the opening of, or transfer of assets to, any type of account…."[11] Firms, however, are already required to exercise reasonable care in recommending account types. Today, both the SEC and FINRA regularly examine for account type recommendations, including recommendations to roll over or transfer assets from an ERISA account to an IRA.[12]

Moreover, the new, federal, best interest obligation explicitly applies to BDs' recommendations about *account types* (even if there is not a recommendation of a securities transaction) and *IRA rollovers* (regardless of whether it is tied to a specific securities transaction).[13] Consistently, the SEC also extended IAs' fiduciary duty to include advice about account types and whether to roll over assets from one account (e.g., a retirement account) into another.[14]

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[8] FINRA rules already require that BD commissions and fees be fair and reasonable. *See* FINRA Rules 2100 et seq. Accordingly, we recommend that the Proposal adopt the definition and interpretation of "reasonableness" as set forth under FINRA rules and associated guidance.

[9] Proposal at Section 13:47A-6.4(b)2.i and (b)3.

[10] Both the SEC and FINRA have long recognized that there is no single "best" security recommendation, which is a core tenet of modern portfolio theory. *See, e.g., SEC Beginner's Guide to Asset Allocation, Diversification and Rebalancing*, available at https://www.sec.gov/reportspubs/investor-publications/investorpubsassetallocationhtm.html. *See also FINRA's Diversifying Your Portfolio*, available at http://www.finra.org/investors/diversifying-your-portfolio. Even the DOL conceded as much in connection with its now vacated fiduciary rule. *See* Preamble to the BIC Exemption, 81 Fed. Reg. at 21,029 ("… the [DOL] also *confirms that the Best Interest standard does not impose an unattainable obligation on Advisers and Financial Institutions to somehow identify the single 'best' investment for the Retirement Investor out of all the investments in the national or international marketplace, assuming such advice were even possible."), available at* https://www.federalregister.gov/documents/2016/04/08/2016-07925/best-interest-contract-exemption.

[11] Proposal at Section 13:47A-6.4(a) and (b)2.i.

[12] *See, e.g.,* FINRA Regulatory Notice 13-45 (reminding firms of their responsibilities when recommending a rollover or transfer of assets in an employer-sponsored retirement plan to an individual retirement account ("IRA"), or marketing IRAs and associated services), available at http://www.finra.org/industry/notices/13-45.

[13] Adopting Release at pp. 85, 96, 98.

[14] SEC Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, File No. S7-07-18 (June 5, 2019), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

Thus, it would be duplicative and unnecessary, and would not provide any additional investor protection benefit to either prospective or existing customers, to extend the Proposal's fiduciary duty to recommendations about account types and transfers. In fact, doing so could have the opposite effect on investor protection; the Proposal would thereby impose a competing standard – subject to differential interpretation and application from the federal standards – such that BDs and IAs would likely be discouraged from advising their New Jersey customers (and prospective customers) to switch account types, or transfer accounts, when in fact such switches and transfers may be appropriate.

For these reasons, we recommend that the scope of the Proposal's fiduciary duty for BDs should not apply to recommendations about account types or transfers.

5. The duty of loyalty should: (i) strike the "without regard to …" formulation and use the SEC's formulation instead; (ii) provide additional guidance on the types of products and compensation that are permissible; and (iii) clarify the disclosure obligation.

a. "Without regard to …" The Proposal's duty of loyalty requires that recommendations be made "without regard to the financial or any other interest of the [BD] …"[15] Notably, in Reg BI, the SEC replaced the foregoing phrase with the phrase "without placing the financial or other interest … ahead of the interest of the retail customer."[16] The SEC did so out of concern that the "without regard to" language could be inappropriately construed to require a BD to eliminate *all* of its conflicts (not possible) and because the SEC believed that its own formulation appropriately reflects the underlying intent of the "without regard to" formulation." We agree.

The "without regard to" formulation lacks clarity. The SEC formulation does not. The SEC formulation accomplishes the same purpose as the "without regard to" formulation, but with greater clarity and less confusion about the expectations associated with the obligation. For these reasons, we recommend that the Proposal replace its formulation with the SEC's formulation.

b. Principal transactions, affiliated and proprietary products, and limited range of products. Neither the preamble nor the text of the Proposal make any reference to recommendations of principal transactions, affiliated or proprietary products, or making a recommendation based on a limited range of products. Both Congress in the Dodd-Frank Act[17] and the SEC in Reg BI,[18] however, explicitly call-out these categories of recommendations as ones that may well be consistent with a fiduciary and/or best interest standard, respectively.

We recommend that the Proposal be amended, consistent with Reg BI, to explicitly acknowledge that: it does not prohibit recommendations of principal transactions, affiliated or proprietary products, or from among a limited range of products; that such recommendations do not presumptively breach the proposed fiduciary duty; and that the "best of" and "reasonably available" standards discussed above do not apply to such recommendations.

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[15] Proposal at Section 13:47A-6.4(b)2.

[16] 83 FR 21586; Adopting Release at pp. 62 – 67.

[17] Dodd-Frank Act, § 913, available at http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_913.html.

[18] 83 FR 21586, 21609, and 21620; Adopting Release at pp. 175, 188 – 190.

c. Direct and indirect compensation. Because the Proposal is specifically targeted at "harmful incentives" such as "sales contests," the Proposal should be revised to specify the particular incentives that trigger a breach, and should include a cross-reference to Reg BI which requires firms to eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.[19]

The Proposal should also be revised to specify the many other forms of unobjectionable "direct or indirect compensation" that would not trigger a breach, including rewards for gathering and growing assets, for example, whether in the form of recruiting bonuses or as part of annual compensation – which are fundamental to our industry's compensation structure.

d. Disclosure obligation. For the reasons we outline in our individual letters, and to be consistent with current federal securities laws and Reg BI, the Proposal should: (i) strike the provision in 13:47A-6.4(b)(2)(ii) that "[t] here shall not be a presumption that disclosing a conflict in and of itself shall satisfy the duty of loyalty"; (ii) clarify that disclosure obligations are limited to *material* conflicts of interest (as such term was defined by the U.S. Supreme Court in *Basic v. Levinson*) thereby making the Proposal consistent with Reg BI; and (iii) explicitly state that the disclosure obligation of an associated person of a BD is satisfied by satisfying the Disclosure Obligation under Reg BI.

6. The Proposal Raises Pre-Emption and Other Legal Concerns.

As outlined in more detail in our individual letters, we believe the draft regulations have both pre-emption issues and legal deficiencies. We find there to be conflicts with the National Securities Markets Improvements Act ("NSMIA"), the Advisers Act, the Employee Retirement Income Security Act of 1974 ("ERISA") and the Federal Arbitration Act, among others.

Specifically, the State is pre-empted from imposing regulatory requirements on Registered Investment Advisers as its jurisdiction is limited to enforcement of antifraud provisions.[20] The law and draft regulations go well beyond the State's legal authority.

The State is also pre-empted from imposing different or additional recordkeeping requirements.[21] The draft regulations would impose new recordkeeping requirements on BDs. The draft regulations state that they should be "interpreted and applied in harmony with [NSMIA]." This simply is not possible as the regulations are currently drafted.

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[19] Adopting Release at pp. 337, 352.

[20] 15 U.S.C. §80b-3a(b)(1). Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA–1633, File No. S7–31–96, (May 22, 1997), available at https://www.govinfo.gov/content/pkg/FR-1997-05-22/pdf/97-13284.pdf ("On its face, section 203A(b)(2) preserves only a state's authority to investigate and bring enforcement actions under its antifraud laws with respect to Commission-registered advisers. The Coordination Act does not limit state enforcement of laws prohibiting fraud. Rather, states are denied the ability to reinstitute the system of overlapping and duplicative regulation of investment advisers that Congress sought to end." (text at nn.155-56)).

[21] Section 15(i)(1) of the Securities Exchange Act of 1934 precludes a State from enacting regulations relating to the making and keeping of records "that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act]" (emphasis added). 15 U.S.C. §78o(i)(1). In addition, under the Exchange Act, Rule 17(a)-4 requires BDs to keep a record of *"*all communications … by the member … relating to its business as such…. *"* 17 CFR §§ 240.17a-4(b)(4).

7. The Proposal must properly account for its economic impact.

In support of its economic impact analysis, the Proposal cites a study published in the Journal of Financial Planning entitled, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice*, by Michael Finke, Ph.D., CFP, and Thomas P. Langdon, J.D., LL.M., CFP, CFA (the "Finke Langdon study"). The Finke Langdon study explored the proposed application of a universal fiduciary standard and the impact on the financial adviser industry and we do not believe this study to be relevant to the Proposal. Our individual letters highlight relevant data for your consideration.

8. The Proposal should explicitly limit its application to retail investors who are legal residents of New Jersey or who reside in New Jersey.

Given the harmful consequences detailed above, it is important that firms can limit the application of the Proposal to retail customers who are legal residents of New Jersey or who reside in New Jersey. A BD or IA who has a place of business in New Jersey should not owe the fiduciary duty imposed by the Proposal to all their clients, regardless of whether those clients have any nexus to New Jersey. Moreover, the New Jersey fiduciary duties may be inconsistent with the duties owed to the client in their state of domicile. Accordingly, we recommend that the Proposal be revised to explicitly limit its application to retail investors who are legal or actual residents of New Jersey.

9. The Proposal should specify an appropriate future effective date and provide for a sufficient implementation period prior to such date.

The final section of the Proposal's rule text states that "[t]he provisions of this section shall take effect on (90 days from the effective date of this new rule)." This appears to state that the new rule would become applicable 90 days after publication as a final rule. Ninety days is an insufficient transition period. Firms will require a significantly longer implementation period and thus a much later, more reasonable future effective date.

As discussed, the Proposal requires significant revision as it is currently unworkable, unreasonable, and raises many new issues for BDs and IAs, including establishing supervisory systems to address the ongoing monitoring for clients with both brokerage and investment advisory accounts. In order to comply with the Proposal's new requirements, firms would need to develop significant new infrastructure and policies and procedures, which would be a complex and resource intensive undertaking, particularly considering the range of business models that would be subject to the proposed regulations. Firms would also need enough time to implement training programs and to build systems to comply with the prospective new regulations, including those necessary to create new books and records.[22]

Alternatively, firms would also need sufficient time to identify whether and how to scale back all or a portion of their business activity in New Jersey in order to comply with the new regulations. Since there is currently no grandfathering provision in the Proposal, BDs and their representatives cannot limit their fiduciary duty by ceasing to make recommendations to existing New Jersey brokerage account clients. Firms will therefore need time to determine whether to scale-back or terminate these relationships.

Based on the foregoing, we recommend that the Bureau provide an implementation period of at least 18 months, followed by an initial effective date thereafter (the "Effective Date"). We further recommend that the Proposal provide for grandfathering such that the provisions of the Proposal do not apply to a firm's customers and their accounts existing prior to the Effective Date.

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[22] *See* discussion of federal preemption issues, *infra* **Appendix A**.

Sincerely,

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