Statement of Kevin Carroll

On Behalf of the Securities Industry and Financial Markets Association

To the New Jersey Bureau of Securities

July 17, 2019

Thank you for the opportunity to present the views of the Securities Industry and Financial Markets Association ("SIFMA").[1] SIFMA represents the interests of hundreds of broker-dealers ("BDs"), investment banks and asset managers operating in the U.S. and global capital markets. Many of our members do business and serve retail investors in New Jersey. We appreciate the opportunity to further comment on the New Jersey Bureau of Securities' (the "Bureau's") proposed, state-specific, fiduciary duty for BDs (the "Proposal").[2]

The stated purpose of today's hearing is to address the impacts of the rulemaking on New Jersey investors and BDs – particularly impacts that have *not* been adequately anticipated or understood by the Bureau.

To that end, I will focus on three issues: (i) first, the passage of Reg BI, and next, two elements of the New Jersey Proposal: (ii) the ongoing fiduciary duty, and (iii) the "best of" standard.

Reg BI substantially enhances the standard of conduct for BDs and will fully protect New Jersey investors.

By far the most significant change between April 15, 2019 – the date the Bureau published its Proposal – and the present is the SEC's adoption of Regulation Best Interest on June 5, 2019.[3]

The Reg BI rulemaking package is substantial – comprised of four distinct components and running for over 1300 pages. Few have read all of those pages. I have. And I can confidently report that Reg BI substantially raises the bar from the existing FINRA suitability standard and adds the following new, meaningful, investor protections:

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

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

[3] SEC Regulation Best Interest, Release No. 34-86031; File No. S7-07-18 (June 5, 2019), available at https://www.sec.gov/rules/final/2019/34-86031.pdf; and SEC Form CRS Relationship Summary, Release No. 34-86032; File No. S7-08-18 (June 5, 2019), available at https://www.sec.gov/rules/final/2019/34-86032.pdf ("Form CRS") (collectively, "Reg BI").

- *Duty of loyalty – conduct standard:* Reg BI establishes an explicit requirement that recommendations must be *in* the customer's "best interest," and not just suitable.[4] And, the BD cannot place its interest ahead of the customer's interest.

- *Duty of loyalty – account types and transfers:* Reg BI extends to recommendations about account types and account transfers (e.g., IRA rollovers, etc.).

- *Duty of loyalty – implicit hold recommendations:* If a BD agrees to account monitoring, then Reg BI applies to *implicit* recommendations to *hold*.

- *Duty of care – skill:* BDs must exercise reasonable "diligence, care and skill" in making recommendations. This raises the bar by holding a BD accountable for failures of knowledge or skill.

- *Duty of care – cost:* BDs must explicitly consider the cost of the security or strategy as a factor in determining whether to recommend a security or strategy.

- *Duty of care – reasonably available alternatives:* BDs must consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that a recommendation is in the customer's best interest.

- *Duty of care – quantitative suitability:* Under Reg BI, the quantitative suitability requirement applies regardless of whether the BD has actual or de facto control over the customer's account.

- *Disclosures:* BDs must make "full and fair disclosure" under the Disclosure Obligation. The suitability standard has no specific disclosure requirements.

- *Disclosure alone not enough:* Reg BI cannot be satisfied by disclosure *alone*. BDs must also have policies and procedures to disclose and mitigate (e.g., limited product menu, proprietary products only, etc.), or eliminate certain conflicts.

- *Scienter:* Scienter (intent or knowledge of wrongdoing) is not required to establish a violation of Reg BI. In contrast, scienter is required to establish a violation of the current suitability obligation under the antifraud provisions of the federal securities laws.

In the Bureau's Proposal (which *predates* the passage of Reg BI), the Bureau states that "[Reg BI] does not provide sufficient protections for New Jersey investors." Despite this conclusory statement, however, the Bureau has *not* made the case against Reg BI.

[4] Under the FINRA suitability standard, BDs are not explicitly required to make recommendations that are *in* a customer's best interest. *See* FINRA Regulatory Notice 12-25 (recommendations should be *consistent with* the customer's best interest).

The Bureau has not identified any specific aspect of Reg BI that does not provide sufficient protection for New Jersey investors. And, the Bureau has not articulated how its Proposal provides any actual, tangible protections for New Jersey investors that Reg BI lacks.

Regardless, over the next year, firms will spend substantial time and money, making substantial changes to implement Reg BI. In fairness, the Bureau should get behind this concerted effort to help Reg BI succeed.

Respectfully, the best way to help is to wait. Wait for Reg BI to become fully implemented and operational. Wait to see what additional guidance and interpretation the SEC provides. Wait to see how the SEC and FINRA and other regulators examine for and enforce compliance with Reg BI. Give Reg BI a fair chance.

Now is not the time to layer-on state-specific fiduciary requirements that would add *no* additional investor protection value, but that would be costly to implement, and that would limit New Jersey investors' choice of and access to products, services, and advice.

I want to highlight two such requirements in the Proposal. The first is the imposition of an ongoing fiduciary duty in a brokerage account.

Imposing an ongoing fiduciary duty on brokerage accounts would effectively eliminate brokerage accounts in New Jersey and deny access to investment advice for many New Jersey retail investors.

Imposing an ongoing fiduciary duty would have a seismic, unanticipated, negative impact. In fact, it would effectively eliminate BD business in New Jersey, and would completely block access to investment advice for many New Jersey investors.

The text of the rule Proposal 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 investment adviser ("IA") and a BD to the same customer.[6]

This requirement would essentially impose on BDs a new, continuous and ongoing duty to monitor the performance of a customer's brokerage account. As a matter of law, however, BDs are simply *not* free to engage in continuous monitoring of brokerage accounts.

The SEC drove this point home in their June 5, 2019 interpretive guidance. The SEC explained that continuous monitoring in a brokerage account is *not* consistent with the "solely incidental"

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

[6] 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. At a minimum, the rule text should be revised to conform and agree with the language in the preamble.

prong of the broker-dealer exclusion from the definition of investment adviser.[7] Thus, if a BD engages in continuous monitoring in a brokerage account, then the BD would be subject to *all* of the requirements of the Investment Advisers Act of 1940 (the "Advisers Act"). SEC Chairman Clayton warned about this same legal pitfall in his most recent speech, emphasizing that such a move "would mean less access and choice, and higher costs, for retail customers."[8]

Likewise, under the second prong of the broker-dealer exclusion from the definition of investment adviser – the "special compensation" prong, a BD *cannot* receive separate or additional compensation in a brokerage account for providing continuous investment advice.[9]

New Jersey's continuous monitoring requirement would effectively require firms to shutter their brokerage accounts in the state because federal law is clear: BDs *cannot* engage in continuous monitoring, or receive special compensation for ongoing advice, in brokerage accounts. Those activities can *only* be performed in an investment advisory account subject to the Advisers Act.

Impact on New Jersey investors

How would the hundreds of thousands of New Jersey investors who currently hold brokerage accounts be impacted by the ongoing fiduciary duty requirement?

First, these investors would lose access to the type of account that they wanted and chose – their brokerage account. They would be forced out by the state's regulation. Next, BDs may recommend that these customers transfer their brokerage assets to a fee-based advisory account (but only if such recommendations are in their best interest under Reg BI). If the customer's assets were transferred to a fee-based advisory account, then the customer would essentially be paying for the additional cost of ongoing advice that they didn't necessarily want or need.

If, however, a recommended transfer to a fee-based advisory account would *not* be in the customer's best interest; *or* if the customer did not qualify for a fee-based account because, for example, the investor did not meet the account opening and/or balance minimums (which would be the case for many middle-class Americans); *or* if the customer did not want to pay for, *or* could not afford, the additional cost of ongoing advice, then the customer would be left in the lurch – with virtually *no* access to investment advice in the state.

Impact on New Jersey commerce

What else does New Jersey stand to lose if it effectively kills the BD model in the state?

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[7] SEC Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Release No. IA-5249 (June 5, 2019), at. p. 21, available at https://www.sec.gov/rules/interp/2019/ia-5249.pdf.

[8] Speech by Chairman Jay Clayton, *Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors* (July 8, 2019), available at https://www.sec.gov/news/speech/clayton-regulation-best-interest-investment-adviser-fiduciary-duty.

[9] *See* Release Nos. 34-51523; IA-2376; File No. S7-25-99, *Certain Broker-Dealers Deemed Not to be Investment Advisers* at pp. 25 – 29, available at https://www.sec.gov/rules/final/34-51523.pdf.

The demise of brokerage accounts would also cause a sharp decline in principal transactions[10] in New Jersey because the vast majority of principal transactions are done in brokerage accounts.[11]

Principal transactions benefits investors by providing them access to securities that may not be available on the open market or that are only available on an agency basis at higher prices. Principal transactions allows BDs to offer investors a greater variety of securities from firm inventories, execute trades in such securities more quickly, and offer customers better prices on such securities.

Principal transactions include, for example, instances where a BD acts as an underwriter, alone or as part of a syndicate of underwriters, for the issuance of new securities – such as equities (e.g., equity initial public offerings ("IPOs")) or fixed income (e.g., municipal bonds or corporate bonds) – and sells those new issue securities to the clients of the BD.

For underwriting activities, particularly in the municipal market, where principal transactions are by far the most common form of trading, BDs would need to withdraw from participating in the bidding for new issue municipal bonds, and thus would be unable to offer those same new issue bonds for purchase by its New Jersey or other retail clients. Such an outcome would likely prove very disruptive to the New Jersey municipal underwriting market.

Moreover, even if those same New Jersey municipal bonds were later offered by another BD that was not part of the original syndicate, and the New Jersey investor purchased the bonds on an agency basis (i.e., not in a principal transaction), then the client would likely pay a higher price (given that mark-ups on municipal agency trades are usually higher than mark-ups on principal transactions).

Thus, the demise or sharp curtailment of brokerage activity in New Jersey would be *not only* materially disruptive to the New Jersey municipal and other bond issuance process, *but also* result in higher cost New Jersey municipal bonds for investors.

Based on the foregoing, the Bureau should carefully reconsider whether the requirement of an ongoing fiduciary duty in brokerage accounts is really in the best interest of New Jersey investors or New Jersey commerce.

The second – and final – requirement in the Proposal that I want to highlight is the "best of" standard.

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[10] In a principal transaction, the BD, acting for its own account, either buys a security from, or sells a security to, the account of a client. In contrast, in an agency transaction, the BD arranges a transaction between different clients.

[11] The Advisers Act restricts the ability of an IA to engage in principal transactions with clients, primarily by requiring advisers to make trade-by-trade disclosures and receive client consent. Advisers Act Section 206(3). As the SEC has observed, practical difficulties by firms in complying with the trade-by-trade written disclosure and consent requirements under Section 206(3) has led most firms to refrain from engaging in principal trading with their advisory clients altogether. *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, 72 Fed. Reg. 55022-01, 55023 (Sept. 28, 2007).

Imposing a "best of" standard for account types, securities, and transaction-based compensation would be impossible to satisfy, and would create negative incentives that disadvantage New Jersey investors.

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 "the best of the reasonably available fee options…."[12]

Reg BI, however, imposes a Care Obligation that requires a BD to exercise reasonable diligence, care, and skill to: (A) understand the risks, rewards, and *costs* associated with the recommendation, (B) have a reasonable basis to believe the recommendation is in the customer's best interest, and (C) have a reasonable basis to believe that a series of recommended transactions are in the customers' best interest. The Care Obligation likewise applies to recommendations about securities, account types, and account transfers, and requires the BD to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that a recommendation is in best interests of the customer.[13]

While it is clear that the Proposal's "best of" standard is different than the new Reg BI standard, it is far from clear – in fact it is dubious – that the "best of" standard is stronger, or more protective of investors, than Reg BI. Moreover, it is equally dubious that the "best of" standard is susceptible to fair administration by regulators, or to adequate compliance by BDs.

In fact, historically, the SEC and FINRA – and even the Department of Labor ("DOL") – have explicitly rejected a "best of" approach to securities recommendations because: (i) modern portfolio theory holds that there is no single "best" securities recommendation, and (ii) the "best" option can only be definitively determined in hindsight – which renders the standard illusory and impossible to satisfy in the present tense.[14]

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

[13] SEC Regulation Best Interest, Release No. 34-86031; File No. S7-07-18 (June 5, 2019) at pp. 253 – 254, available at https://www.sec.gov/rules/final/2019/34-86031.pdf.

[14] *See SEC Beginner's Guide to Asset Allocation, Diversification and Rebalancing*, available at https://www.sec.gov/reportspubs/investor-publications/investorpubsassetallocationhtm.html; *FINRA's Diversifying Your Portfolio*, available at http://www.finra.org/investors/diversifying-your-portfolio; *DOL 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. "[A]n Adviser and Financial Institution do not have to recommend the transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors." *Id.* at 21,030.

SEC Chairman Clayton reiterated this point in his most recent speech, stating that there is no single "best" product and that "[m]any different options may in fact be in the retail investor's best interest…."[15]

Here is another impact that hasn't been considered by the Bureau: In adopting Reg BI, the SEC again rejected a "best of" approach because it recognized that different securities products are rarely perfectly comparable on an apples-to-apples basis, and that differences will be both quantitative and qualitative in nature. The SEC was also quite concerned that a "best of" approach might encourage BDs to limit their product menus or otherwise restrict access to products and services currently available to retail customers. That outcome, the SEC reasoned, would be contrary to the purpose and goals of Reg BI to preserve investor choice.[16]

In sum, the Proposal's "best of" standard is *not* demonstrably stronger, or more protective of investors, than Reg BI. Even worse, the standard is impossible to satisfy in the present, and only knowable with the benefit of hindsight – thereby inviting unfair and unnecessary legal and regulatory challenges. Finally, as the SEC pointed out, it will likely encourage limited product menus and restricted access to products and services that retail customers currently enjoy.

For all of the foregoing reasons, the Proposal should eliminate the "best of" standard for account types, securities, and transaction-based compensation because the standard is unworkable and would likely encourage limited product and service offerings. Instead, the Bureau should give Reg BI's Care Obligation a fair opportunity to better serve New Jersey's retail customers.

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In sum, we urge the Bureau to give Reg BI a chance. Help it succeed. The best way to do so is to let it play out. See how it performs. See how it protects New Jersey investors.

In the meantime, we further urge the Bureau to set-aside the Proposal – particularly the ongoing fiduciary duty and "best of" standard provisions – which would *not* contribute to investor protection, but would only impose new costs, burdens and disadvantages on both New Jersey investors and New Jersey commerce.

Thank you for your time and consideration. We are happy to answer any questions or provide any additional information.

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[15] Speech by Chairman Jay Clayton, *Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors* (July 8, 2019), available at https://www.sec.gov/news/speech/clayton-regulation-best-interest-investment-adviser-fiduciary-duty.

[16] SEC Regulation Best Interest, Release No. 34-86031; File No. S7-07-18 (June 5, 2019) at pp. 284 – 286, available at https://www.sec.gov/rules/final/2019/34-86031.pdf.