NORRIS McLAUGHLIN

ATTORNEYS AT LAW

New Jersey Proposes Fiduciary Duty Rule for Broker/Dealers and Investment Advisors

Norris McLaughlin Securities Law Alert
May 15, 2019

General Introductory Observations

On Monday, April 15, 2019, the New Jersey Bureau of Securities proposed fiduciary duty rule (the "Proposal") was published in the New Jersey Register. The comment period for the Proposal ends Friday, June 14, 2019. That 60-day period provides an opportunity to those affected to comment upon, criticize, and/or oppose the Proposal. The Bureau's Regulatory Flexibility Analysis in the Proposal notes that there were approximately 2,050 broker/dealers, 200,800 registered representatives (the sales agents employed by broker/dealers), 3,230 investment advisors, and 29,730 investment advisor representatives (the individuals employed by investment advisors) registered with the Bureau as of January 1, 2019. After the comment period expires, the Bureau may, under the New Jersey Administrative Code, abandon the proposal, modify it, or adopt it. If the decision is to adopt the Proposal, either as originally published or as modified, the Bureau must republish the rule including the Bureau's responses to comments received.

The Proposal may, in large measure, be beyond, or contrary to, the regulatory authority of the Bureau under the relevant New Jersey statute, N.J.S.A. 49:3-49, *et seq*. Moreover, even if the Bureau has the legal authority to adopt a fiduciary duty rule, the Proposal may not be a wise or practical regulation of the conduct of licensed securities professionals. These rather fundamental concerns help explain the Bureau's preproposal efforts to preempt or at least constrain critical discussion of the Proposal.

The Background

The Bureau issued a notice of preproposal on October 15, 2018. That notice also announced the scheduling of informal conferences offering interested parties the opportunity to discuss the concepts involved. The Summary in the Bureau's April 15 Proposal notes that the Bureau received 62 comments and heard from 21 speakers at the conferences following the October 15 notice. The Bureau's Summary contains extensive analysis and arguments supporting the Proposal. The Bureau describes the 2016 promulgation of the U.S. Department of Labor fiduciary duty rule for financial and insurance professionals dealing with retirement plans, while conceding that the March 2018 Fifth Circuit U.S. Court of Appeals decision found that the Department of Labor had exceeded its statutory authority. The Bureau also discusses at length a Securities and Exchange Commission ("SEC") study mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2008, noting that as a result of that study, the SEC staff recommended that the SEC establish a uniform fiduciary duty standard for securities industry professionals (whether broker/dealers or investment advisors) when providing advice to retail customers.

The Bureau also notes that broker/dealers register with the Financial Industry Regulatory Authority ("FINRA").

A key FINRA rule requires registrants to adhere to "just and equitable principles of trade and high standards of commercial honor." Further, the Bureau observes that following the Fifth Circuit decision, and in response to the Section 913 Study, the SEC on April 18, 2018, proposed "Regulation Best Interest," but also notes that the SEC proposal still awaits action a year later. The Bureau states that the SEC proposed regulation, even if adopted, would not afford retail customers the same protections as would be afforded by imposing a fiduciary duty on all securities professionals.

It is noteworthy that the Bureau's Summary cites sources of a type not always included in administrative agency regulatory proposals, including testimony by the AARP before the SEC's Investor Advisory Committee; a *New York Times* story on investing; an article in *Psychological Science*; and an aritcle in the *Journal of Financial Planning*. These sources help the Bureau explain the reasons for policy choices made in framing the Proposal. In contrast, the discussion of the statutory authority for the Proposal is very limited.

The Metaphysics of Securities Law

American capital markets, indeed the entire American economic system, have been built upon Adam Smith's insights in *The Wealth of Nations*. The "invisible hand" works best when individuals are able to follow their own enlightened self-interest (at least as they perceive it). Necessarily the market system relies in part on a desire for gain. The seller of a security seeks to obtain cash from the buyer; the buyer seeks to own an interest in a business that will become more valuable as (and if) the business succeeds. The transactions are not risk free; values can decline. Part of the capitalist system is the "right to be wrong" — the "right" to invest in a losing business. Of course, for buyers and sellers to close transactions, there must be some level of trust in the integrity of the buying and selling processes. One can see the need for a proverbial "honest broker" throughout a market economy. When selling horses or cars and the like, the traditional view of the law was captured in the Latin phrase "caveat emptor" – buyer beware. Many state and federal laws and regulations, as well as court decisions, developed significant protections over time for a buyer against unscrupulous sellers or buyers. But when dealing with securities, perhaps particularly because of the perceived greed factor on the part of investors, government has become far more intrusive in the marketplace. By the late 19th century, state securities regulators sought to insist that brokers be honest to bring more integrity to the system. Indeed, the patriarchal instincts of that Progressive Era saw the development of merit regulation of securities sales in many (but not all) states. Under merit regulation, a state government employee could determine whether an individual in that state would be allowed to risk money by buying a security. The alternative regulatory approach, favored in large commercial states like New York, focused on requiring greater disclosure beforehand to a buyer, with substantial civil and criminal penalties for the dishonest seller. Then came the Stock Market Crash of 1929 and, with it, federal legislation. That federal legislation adopted the disclosure approach. Indeed, in his message to Congress with the Securities Act of 1933, President Roosevelt invoked the wisdom of Justice Brandeis in a December 1913 article in *Harper's Weekly*: "Sunlight is said to be the best disinfectant." A disclosure regime reserves investment decisions to the individual; it preserves the "right to be wrong." Very generally, it can be said that disclosure has prevailed over merit regulation, especially with later federal enactments like the National Securities Markets Improvement Act of 1996 ("NSMIA").

Regulating Securities Professionals

While disclosure is generally accepted today as the key to maintaining strong capital markets, the regulation of securities professionals, i.e., broker/dealers (and their employees known as registered representatives) and investment advisors (and their employees known as investment advisor representatives) is more complex, and as shown by the Bureau's April 15, 2019 Proposal, potentially far more intrusive into the workings of that marketplace. Originally broker/dealers were seen simply as sellers, so that *caveat emptor* ("buyer beware") applied. Securities regulators, both state and federal, developed rules to impose obligations on securities professionals. Broker/dealers themselves (especially under the rules of self-regulatory organizations like the New York Stock Exchange and the Financial Industry Regulatory Association) adopted standards of what might

be called "honest brokerdom." The key to this was and is the "suitability" rule, which requires a broker/dealer to learn enough about a customer (e.g., age, financial status, plans) and a particular security to determine that the security is a "suitable" purchase for that customer. The broker/dealer remains, however, an independent business; there is no agency relationship between them.

In contrast, an investment advisor is engaged by a client (note the difference in nomenclature) to give the client good investment advice — advice that is in the client's best interest. The investment advisor is an agent of the client (for the limited purpose of investment advice) and will be held to the standard of being faithful to the client (i.e., not putting the advisor's interest ahead of the client's). Investment advisors have over time also been seen to have an obligation to be competent, although there is no agreed-upon test for competency. In view of this agency relationship, courts, commentators, and regulators frequently say that an investment advisor owes a common law (i.e., developed by court decisions rather than by legislation or regulation) fiduciary duty to its (his or her) client. While this is probably not a technically accurate characterization of the obligation owed to an investment advisor's client, it is widely used.

Compounding the potentially confusing differences in identifying the respective legal obligations here is the fact that many registered representatives also function as investment advisor representatives. These are so-called "dual hat" people. One may seriously doubt that a typical retail investor could tell whether he or she is a "customer" or a "client" when dealing with one of these "dual hats."

As also noted in the Bureau's Summary, the Department of Labor initiative was motivated in part by a 2015 U.S. Economic Council of Advisers study, which reported that Americans lose approximately $17 billion each year in retirement earnings due to conflicted advice, i.e., where the registered representative or investment advisor representative puts his or her best interests ahead of the best interests of the customer or client. Hence the Proposal contains provisions focused on conflict issues.

The SEC, as noted above, has proposed Regulation Best Interest, which would impose significantly higher responsibilities on registered representatives from those imposed by the suitability standard. But the Bureau states in the Summary of the Proposal:

> The Bureau believes that the proposed new rule is necessary to ensure that persons involved in the securities markets are held to a uniformly high standard in their dealings with the general public and are necessary to ensure the welfare of New Jersey investors (emphasis added).

The Proposal and Its Problems

The Proposal addresses two separate subjects to be covered within the Bureau's regulations forbidding a securities professional from engaging in dishonest or unethical business practices.

First, the Proposal would amend the existing "suitability" provision of the N.J.A.C. 13:47A-6 to provide that:

- recommending an investment strategy to a customer
- opening an account or transferring assets to any account
- purchase, sale or exchange of any security

is forbidden, unless the representative "has reasonable grounds to believe that such strategy, transaction or recommendation is suitable" (thus adding strategy recommendations and account openings or transfers to the scope of the existing suitability requirement in the regulation).

Second, the Proposal would add a new section of these "Dishonest or Unethical Business Practices" regulations at N.J.A.C. 13:47A-6.4, subjecting all securities professionals to a fiduciary duty standard. That duty arises when

making a recommendation and/or executing the recommendation, but does not continue as an ongoing duty unless the professional has discretionary authority over the customer's account or is subject to such a duty under the professional's contract with the customer. The proposed new regulation goes on to set forth the details of that fiduciary duty, namely (i) a duty of care (requiring the use of the care, skill, prudence and diligence that "a prudent person acting in a like capacity and familiar with such matters would use"); AND (ii) a duty of loyalty (requiring recommendations or advice "without regard to the financial or any other interest" of the professional). The proposed regulation also states that, if the securities professional receives incentive compensation with respect to a recommendation or transaction, the securities professional shall be presumed to have breached his duty of loyalty. Further, the proposed regulation states that there is no presumption that disclosure of a conflict by a professional to the customer will absolve the professional of having breached the duty of loyalty. The proposed rule includes a definition of "customer" that expressly excludes banks, insurance companies, registered investment companies, registered broker/dealers, and investment advisors and "any other person [natural person or entity] with total assets of at least $50 million." None of these are retail customers.

To allow some time for the regulated professionals to implement procedures and protocols with respect to these duties, the rule as proposed would be effective 90 days after the rule is adopted.

The New Jersey version of the Uniform Securities Law (the "Uniform Securities Law" [1997]), has two provisions cited by the Bureau as authority for the Proposal: N.J.S.A. 49:3-53(a)(3), which states:

> It shall be unlawful for any person who receives, directly or indirectly, any compensation from another person for advising the other person as to the value of securities or their purchase or sale, whether through issuance of analyses or reports or otherwise,
> . . . .
> (3) to engage in dishonest or unethical practices as the bureau chief may by rule define in a manner consistent with and compatible with the laws and regulations of the Securities and Exchange Commission, the self-regulatory organizations, and uniformity with other states, the remedies for which shall be civil or administrative only;

AND; N.J.S.A. 49:3-58(a)(2)(vii), which states

> (a) the bureau chief may by order deny, suspend, or revoke any registration if he finds:
> . . . .
> (2) that the applicant or registrant or, in the case of a broker-dealer, investment advisor, or Internet site operator, any partner, officer, or director, or any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer, investment advisor, or Internet site operator:
> . . . .
> (vii) has engaged in dishonest or unethical practices in the securities, commodities, banking, insurance or investment advisory business, as may be defined by rule of the bureau chief;
> . . . .

The cited sections of the New Jersey statute are essentially "Thou shalt not" statements. In Section 53(a)(3), the law says: "It shall be unlawful [for a securities professional] … to engage in dishonest or unethical practices." Section 58(a)(2)(vii) empowers the Bureau Chief to deny, suspend, or revoke the registration of any registered securities professional, if the bureau finds that a securities professional "has engaged in dishonest or unethical practices." Each Section expressly authorizes the bureau chief to define what constitutes "dishonest or unethical practices." Yet, in the new N.J.A.C. 13:47A-6.4 as set forth in the Proposal, the Bureau would create affirmative obligations for securities professionals. They are to conduct their business in a particular way, a way that reflects carrying out "duties," which are only "created" by the Proposal. The Bureau does not address how

the cited statutory authority to define practices that are forbidden authorizes the Bureau to create new affirmative obligations.

In an administrative enforcement proceeding or in a judicial proceeding the Bureau would be required either to prove that a security professional had engaged a dishonest or unethical conduct, or at least to bear the burden of making a *prima facia* showing that a security professional had engaged in dishonest or unethical conduct. Under the Proposal, it appears that the burden to show that a security professional has met his or her fiduciary duty would rest upon the professional. This shift shows that the Proposal imposes a burden on the security professional that is beyond authority that the statute gives to the Bureau. Moreover, that shifted burden may well be in violation of the professional's due process rights.

The express limitations on Bureau authority in Section 53(a)(3) must also be considered:

> [Any Bureau rule shall be] … consistent with and compatible with the laws and regulations of the Securities and Exchange Commission, the self-regulatory organizations, and uniformity with other states. . . .

In addition, New Jersey Uniform Securities Law (1997) also states in part in N.J.S.A. 49:3-75:

> This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact similar laws and to coordinate the interpretation and administration of this act with federal regulations.

In his June 4, 1997, Memorandum to the New Jersey Securities Committee covering proposed revisions to New Jersey's Uniform Securities Law, the then Bureau Chief stated concerning Section 75:

> Section 75 <u>requires</u> the Bureau Chief to construe the law so as to foster uniformity with other states and with federal law (emphasis added).

Nowhere in the Summary does the Bureau address either the limitation in Section 53(a)(3) or the Bureau's obligation under Section 75 to be consistent and compatible with uniformity and with federal regulations. The Summary in the Proposal also fails to acknowledge that due to NSMIA, the Bureau does not have jurisdiction over SEC-registered investment advisors (generally firms with over $100 million under management), even if the investment advisor has a presence in New Jersey. Investment advisor representatives of those SEC-registered firms who are registered as investment advisor representative in New Jersey MAY be subject to the Bureau's regulation, although NSMIA may preempt the Bureau's authority to impose on them the duties set forth in the Proposal. This again underscores how the Proposal undercuts uniformity and how it is not "consistent and compatible" with federal law and regulations.

Further as to uniformity, the financial press has already reported that one major investment banking firm has threatened to cease operating in Nevada unless Nevada changes its recently adopted fiduciary duty rule. At least three other national firms have said that they would reduce the types of investment products that they would offer in any state adopting a fiduciary duty requirement. One wealth manager was quoted as saying:

> It's hard to argue with the fact that multiple inconsistent, duplicative and conflicting standards will increase costs and make the [capital market] system less efficient.

The Proposal is not consistent and compatible with the laws of other states; it does not foster uniformity.

In addition, the Proposal is NOT "consistent with and compatible with the laws and regulations of the Securities and Exchange Commission." The Bureau in the Summary states:

> ... the SEC's proposed Regulation Best Interest ... is purportedly greater than that of the suitability rule but is less than that of a fiduciary duty. Accordingly, should the SEC adopt Regulation Best Interest, the Bureau's proposed new rule will exceed this standard. (emphasis added).

Hence, the Proposal, if the SEC moves forward with its Regulation Best Interest, would not meet the requirements of Section 53(a) or 75.

The Proposal would, however, establish in New Jersey much of the philosophy of state regulators who in earlier years utilized "merit regulation" to "protect the welfare of their citizens" from not just the risks of the marketplace, but also from themselves. The fiduciary duty in the Bureau's proposed rule mirrors the fiduciary duty standards in statutes applicable to the governance of business entities. In those settings, the standards prescribe standards of conduct expected for persons in control of the respective entity. Here the Bureau appears to have decided simply that New Jersey residents must be protected from themselves. The quoted statement of the Bureau in the Summary is telling:

> [This new fiduciary duty rule is necessary] ... to ensure the welfare of New Jersey investors. (emphasis added)

After the Department of Labor proposed a fiduciary standard for security professionals dealing with retirement plans, many large broker/dealers adopted a pricing model for retail customers based on the account size, whether or not any purchase or sale transactions occurred. This provoked widespread criticism (according to the financial press) from customers who enjoyed making their own buy-sell decisions and who did not want to be charged a fee when the broker/dealer was not doing anything. This development suggests governmental "protection" is not always welcome.

In a sense, the Bureau's Proposal may create a tantalizing "game of chance" for securities professionals. Under the Proposal, honesty and disclosure may not be enough to fulfill a newly imposed duty of loyalty. The Proposal provides that full disclosure does not ensure that the duty was not breached. The Bureau in the Summary, as noted above, cites the testimony of the AARP before the SEC's Investor Advisory Committee:

> Recent behavioral science studies have shown that disclosures are largely ineffective because they tend to increase conflict in advisors and make the investor more likely to trust the advisor and thus follow biased advice.

If the Proposal is adopted, it is not inconceivable that investors may claim a breach of a security professional's duty, especially the duty of loyalty, thereby creating a "money-back guarantee" from the professional. It might be more forthright of the Bureau simply to bar a security professional from engaging in any recommendation or transaction that involves a conflict, or even an appearance of a conflict, of interest.

A security professional who breaches his, her, or its duty of loyalty faces suspension or revocation of professional's license in New Jersey. Furthermore, the Bureau can seek civil penalties of $10,000 for the first breach and $20,000 for subsequent breaches. Although N.J.S.A. Section 49:3-10 generally makes it a criminal offense to knowingly or recklessly violate a New Jersey securities regulation, Section 53(a)(3) expressly precludes criminal prosecution for engaging in dishonest or unethical practices.

Conclusion

The Proposal appears seriously at odds with both the Bureau's statutory authority and the statutory requirements of consistency and compatibility with the laws of other states and federal law. It would also

impose operational costs unique to doing business in New Jersey. Abusive acts and omissions by securities professionals deserve prompt and substantial enforcement of existing laws and regulations, but do not justify the imposition of standalone obligations, particularly as it is not at all clear that the impositions envisioned by the Proposal would have any significant effect in either preventing abusive acts and omissions or disciplining the responsible actors.

This article was written by Peter D. Hutcheon, a Member of law firm Norris McLaughlin, P.A., American Bar Association State Regulation of Securities Committee Liaison to the New Jersey Bureau of Securities for over 38 years, Chair of the New Jersey Attorney General's appointed Security Advisory Committee to the New Jersey Bureau of Securities 1994-2001, and co-author of New Jersey's Uniform Securities Law (1997); and Oren M. Chaplin, a Member of the firm.

If you have questions or would like to discuss any business law, banking, or financial services issue, please contact the authors at (908) 722-0700. You may also send an email to pdhutcheon@norris-law.com or omchaplin@norris-law.com.

This alert provides information about current legal developments of general interest in the area of securities law. The information contained in this alert should not be construed as legal advice and readers should not act upon such without professional counsel. Copyright © 2019 Norris McLaughlin, P.A.