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New Jersey Proposes Uniform Fiduciary Standard

On April 15, the New Jersey Bureau of Securities (Bureau) followed through on its plan (https://www.stradley.com/insights/publications/2018/10/risk-and-reward-october-16-2018) to create a uniform fiduciary standard for broker-dealers and investment advisers by proposing a regulation (https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx) that imposes fiduciary duties on broker-dealers and agents for certain types of recommendations and advice made to retail customers (the Proposal). The Proposal would also codify and extend the existing fiduciary duties for investment advisers and investment adviser representatives. The Proposal comes nearly three months to the day after Nevada proposed a similar fiduciary regulation (https://fiduciarygovernanceblog.com/2019/01/22/nevada-proposes-sweeping-fiduciary-regulation/).

The Bureau opted not to wait for the release of the Securities and Exchange Commission's final Regulation Best Interest (Reg BI) because it did not think proposed Reg BI provides "sufficient protections for New Jersey investors." The Bureau made clear that the Proposal is a higher standard than proposed Reg BI.

Interested persons may submit comments to the Bureau regarding the Proposal by June 14, 2019.

Scope

The Proposal covers advice or recommendations by a broker-dealer or investment adviser, or their respective agents or representatives, with respect to (1) an investment strategy; (2) the opening of, or

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transfer of assets to, any type of account; or (3) the purchase, sale, or exchange of any security.

The Proposal applies to advice and recommendations that are provided to a "customer." The Proposal specifically excludes from coverage any recommendation or advice given by a fiduciary to an employee benefit plan, or its participants or beneficiaries, under the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Proposal also specifically excludes the following entities from the scope of the definition of "customer":

1. A bank, savings and loan association, insurance company, or registered investment company;

2. A broker-dealer registered with a state securities commission (or agency or office performing like function);

3. An investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like function); and

4. Any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

Presumably, firms will seek representations in customer contracts to attest to falling within one of the foregoing categories. The likely need for representations, and the $50 million threshold, have strong echoes of the "independent fiduciary exception" of the Department of Labor Fiduciary Rule.

Fiduciary Duties
The advice or recommendation by a broker-dealer, agent, investment adviser, or investment adviser representative must satisfy the duties of care and loyalty.

- **Duty of Care:** The duty of care means that a broker-dealer, agent, investment adviser, or investment adviser representative must use "the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration all of the facts and circumstances." The Proposal indicates that, specifically, this duty requires a broker-dealer, agent, investment adviser, or investment adviser representative to "make reasonable inquiry, including risks, costs, and conflicts of interest related to the recommendation or investment advice, and the customer's investment objectives, financial situation, and needs, and any other relevant information."

- **Duty of Loyalty:** The duty of loyalty requires that any recommendation or advice is made without regard to the financial or any other interest of the broker-dealer, agent, investment adviser, investment adviser representative, any affiliated or related entity and its officers, directors, agents, employees, or contractors, or any other third party.

  - Notably, the Proposal provides that there is no presumption "that disclosing a conflict of interest in and of itself shall satisfy the duty of loyalty." The Bureau was dismissive of the value of disclosures, citing evidence that simply disclosing conflicts does not provide adequate protection and does not shield investors from potential financial harm of conflicted advice. This approach is notably different from that of the federal Investment Advisers Act of 1940, which casts its fiduciary duty in disclosure terms.

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- There is a presumption of a breach of the duty of loyalty "for offering, or receiving, direct or indirect compensation to or from the broker-dealer, its agent, or [the investment adviser or investment adviser representative] for recommending the opening of, or transfer of assets to a specific type of account, or the purchase, sale, or exchange of a specific security that is not the best of the reasonably available options." The Bureau noted that it was "concerned about harmful incentives, such as sales contests, that encourage and reward conflicted advice." Recommendations of proprietary products would clearly be affected by the duty of loyalty requirements. The Proposal states, however, that a broker-dealer or agent may receive a transaction-based fee if it "is reasonable and is the best of the reasonably available fee options and the duty of care is satisfied." The Bureau does not explain how a broker-dealer could demonstrate that a fee is the best of the reasonably available fee options.

For broker-dealers that are not providing investment advice to the customer, the fiduciary duties apply when making the recommendation through the execution of the recommendation. Importantly, though, these broker-dealers would not "be deemed" to have an ongoing obligation to the customer, unless they exercised discretion over the customer's account or contractually agreed to serve as a fiduciary.

An ongoing fiduciary duty applies to the broker-dealer or agent that "provides, in any capacity, investment advice to" the customer.

Preemption

The Proposal seeks to address preemption concerns for broker-dealers and agents by providing that the Proposal shall not be construed "to establish any capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements for any broker-dealer or agent of any broker-dealer that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78o(i)." If the Proposal did establish requirements of this type that differ from or add to the requirements of federal law, they would be preempted by the Securities Exchange Act of 1934.

The Proposal does not directly address any possible preemption under the Investment Advisers Act of 1940. However, under the existing New Jersey regulation[1], the Proposal would apply to federally registered investment advisers "to the extent permitted" by federal law.

Effective Date

The Proposal, if adopted, would be effective upon publication. Broker-dealers and investment advisers affected by the Proposal would have 90 days from the effective date of a final rule to comply.

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[1] N.J.A.C. § 13:47A-6.1(e). (https://www.njconsumeraffairs.gov/regulations/Chapter-47A-Bureau-of-Securities.pdf)

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