

## Insights: Alerts

# New Jersey Releases Proposed Fiduciary Rule for Broker-Dealers and Investment Advisers

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On Monday, April 15, the New Jersey Bureau of Securities (“NJBS”) released its long-awaited proposed fiduciary rule (the “Proposed Rule”) for broker-dealers (“BDs”) and investment advisers (“IAs”).<sup>1</sup> Key points from the Rule Proposal are summarized below. Essentially, the Proposed Rule would establish a uniform fiduciary standard for IAs, investment adviser representatives (“IARs”), and most BDs and BD agents (“RRs”) doing business (*i.e.*, providing investment advice or soliciting trades) in New Jersey with clients that have less than \$50 million in assets.

### 1. Who has to comply with the proposed rule?

According to the Rule Proposal, as of January 1, 2019, there were approximately **2,050 BDs**, more than **200,000 RRs**, more than **3,200 IAs** and **nearly 30,000 IARs** registered in New Jersey (collectively, “Registrants”).<sup>2</sup> Generally, of these Registrants, only those who provide investment advice or recommend securities to persons and entities with less than \$50 million in total assets will be required to comply with the proposed fiduciary duty rules. Additionally, the Proposed Rule specifically excludes any “person acting in the capacity of a fiduciary to an employee benefit plan, its participants or beneficiaries, as those terms are defined in [ERISA].”<sup>3</sup>

### 2. What is the anticipated timeline for a final rule?

The 60-day comment period for the Rule Proposal will end on June 14, 2019, at which point NJBS will review the comments and eventually (likely in the Fall) publish a summary of the comments and, presumably, a final version of the Proposed Rule. This final version of the rule will then become final and take effect 90 days after it is published.<sup>4</sup>

### 3. What will be different under the proposed rule?

Currently, IAs and IARs are held to a fiduciary standard that is implied by law (and often through contract), but is not specifically defined in a State statute or regulation. In contrast, BDs and RRs are held to a suitability standard under both the State's and FINRA's rules.<sup>5</sup> NJBS believes (as do other securities regulators and investor groups) that differing standards for IAs and BDs confuse retail investors, especially in light of the adviser-like role many BDs hold today. NJBS has indicated that the Proposed Rule is intended, among other things, to ameliorate this confusion.<sup>6</sup>

According to the Rule Proposal, the Proposed Rule codifies the existing fiduciary duty standard for IAs, defining the fiduciary duty by reference to its two parts: the duty of care<sup>7</sup> and the duty of loyalty.<sup>8</sup> The Proposed Rule also extends the fiduciary standard to BDs and RRs, such that the fiduciary duty applies whenever a Registrant provides investment advice and/or recommends any of the following to a customer:<sup>9</sup>

- the purchase, sale or exchange of a security;
- an investment strategy;
- the opening of any type of account; or
- the transfer of assets to any type of account.<sup>10</sup>

Further, the Rule Proposal challenges certain common industry practices. Specifically, under the Proposed Rule:

- Sales contests and other incentives that “encourage and reward conflicted advice” are **presumed** to breach the duty of loyalty and thereby would violate the Proposed Rule;<sup>11</sup>
- BDs and RRs may continue to receive reasonable transaction-based fees (i.e., commissions),<sup>12</sup> but only if the fee is “the best of the reasonably available fee options for the customer” **and** the duty of care is otherwise met;<sup>13</sup> and
- Fully disclosing a conflict of interest **may not be enough** to satisfy the duty of loyalty.<sup>14</sup>

#### 4. When do Registrants owe customers the fiduciary duty?

The Proposed Rule applies when the customer has less than \$50 million in total assets and is not:

- a bank, savings and loan association, insurance company or registered investment company;
- a broker-dealer registered with a state securities commission (or agency or office performing like function); or
- 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).<sup>15</sup>

Further, BDs and RRs who, with respect to a given customer, act exclusively as a BD are held to the fiduciary obligation only at the point of sale (*i.e.*, there is no ongoing obligation to monitor the position after the trade is executed), and only when making a recommendation (*i.e.*, soliciting a trade). But, if the customer also receives investment advice—for example, through an affiliated IA or a dual-registered BD/IA or RR/IAR—then the fiduciary duty applies on an ongoing basis across all accounts held by that customer, regardless of whether the account is a brokerage account or an advisory account.<sup>16</sup> In other words, **the Proposed Rule creates both a limited episodic exception for BDs and a prohibition on hat switching** (between BD and IA, or RR- and IAR-hats).

#### 5. What would be the consequences of a violation of the Proposed Rule (if implemented as drafted)?

**Possible statutory disqualification.** The Rule Proposal imbeds the above-described fiduciary duty obligations within its rules section entitled “Dishonest and Unethical Practices.” Accordingly, unlike some other violations of the State’s securities laws, a person found in violation of these rules *may be disqualified (i.e., barred or otherwise restricted) by the SEC, SROs (e.g., FINRA) or other states from continued participation in the securities industry.*<sup>17</sup>

## **6. Why didn’t New Jersey wait on the SEC’s Reg BI? Does New Jersey understand the possible adverse consequences of its Proposed Rule?**

**Reg BI:** The Rule Proposal states that NJBS “determined to proceed with this rulemaking” because in the State’s judgement, as currently proposed, the SEC’s Regulation Best Interest “does not provide sufficient protection for New Jersey investors.”

**Economic Impact:** The Rule Proposal includes a lengthy dissertation on the anticipated impact of the Proposed Rule. We found the following sections of the “Economic Impact” section of the Rule Proposal particularly noteworthy:

- BDs “may avoid certain products or account types, despite the fact that those products or account types may be beneficial to certain customers in certain circumstances.”<sup>18</sup>
- “[T]he proposed rule may decrease incentives of agents to expend effort in researching products or account types and, therefore, may impose a cost on customers if there is a decline in the quality or variety of recommendations.”
- “The proposed new rule may . . . impact investors to the extent [BDs] determine they no longer wish to make certain recommendations and choose to forgo some of the revenue stream associated with such recommendations.”
- “The proposed new rule may require registrants to engage the professional services of attorneys to ensure they comply with the proposed new rule. The costs associated with engaging professional services of attorneys are difficult to estimate and will vary depending upon the amount of work that each registrant will require and the rate that the professional will collect . . . .”

## **7. What does it all mean?**

The Proposed Rule is a substantial development for BDs and IAs in New Jersey and elsewhere, because its protections extend not only to BDs and IAs with New Jersey offices, but also to any BD or IA with clients in the state of New Jersey.

The Proposed Rule’s threshold for customers that it is designed to protect (those with \$50 million or less) is well beyond the traditional concept of a “retail” client. The threshold for protection as a retail client encompasses super-accredited investors whose wealth greatly exceeds “accredited”, “qualified client” or “qualified purchaser” statuses under Federal securities laws.<sup>19</sup>

In light of the foregoing, the Proposed Rule will touch BDs and IAs across the country, not just in New Jersey, and will cover BD and IA services to virtually all investors (except unsolicited, pure brokerage operations and services provided to investors that fall outside of the customer definition).

The Proposed Rule's impact will also be broad because, if adopted as proposed, it represents a fundamental shift—and perhaps even a new paradigm—in regulatory securities law. In general, traditional securities laws reflect a philosophy of *caveat emptor* or “buyer beware.” As a result, securities laws and regulations are often called a “disclosure regime”, because the fundamental principal underlying securities statutes, rules and regulations is that full and fair disclosure allows investors to make up their own minds about the services they need and the products they want to buy. That said, securities laws have never allowed a total “free for all.”

Under the Investment Advisers Act of 1940 and comparable state investment adviser laws, the application of a fiduciary duty (the “IA Fiduciary Standard”) has served as a “check” on regulated activity. Under the IA Fiduciary Standard, clear and complete disclosure of organizational conflicts of interests, compensation arrangements, affiliated business relationships and other fundamental, but potentially compromising, information to the customer or client has generally been deemed to cure securities law-based fiduciary concerns, absent egregious circumstances. The Rule Proposal, however, identifies presumptions and considerations under the Proposed Rule that may render current IA practices problematic, even if fully and fairly disclosed.

While the IA Fiduciary Standard has never applied to BDs, to the extent BDs solicit transactions, those activities have long been subject to the suitability standard, which requires that the BD (and its RR) know its customer and their investment objectives and only recommend products and transactions that are suitable for that customer. The Proposed Rule would apply a fiduciary standard to BD and RR activities.

Based on our knowledge of the work done by the NJBS over the last year, we believe that the NJBS has carefully considered arguments from the securities industry, investors, other regulators and its own experiences, and ultimately, in coordination with the New Jersey Division of Consumer Affairs, has determined that the increased costs of compliance for Registrants and likelihood of decreased options for investors are outweighed by what the NJBS views as a compelling need to “protect the welfare of investors” and instill “greater confidence in the [securities] industry.”<sup>20</sup>

As a result of the foregoing, IAs and BDs in New Jersey and those with New Jersey clients including, without limitation, hedge fund managers, investment bankers, venture capitalists, traditional money managers, financial planners, private equity managers and traditional brokers (i.e., anyone registered or subject to registration as a BD or IA in the State) would be well-served to contact their Broker Dealer and Investment Management attorneys to ensure that their business practices are reviewed and considered in light of the Proposed Rule. We believe that many will find that, while the new NJBS fiduciary standard can be navigated, current business and compliance policies and practices will need to be enhanced or changed in order to ensure consistency with the new standard, and/or to document the same.

If you have a place of business or customers in the State of New Jersey, or otherwise have any questions about the Rule Proposal or the regulation of BDs and/or IAs generally, please feel free to contact us.

By the **Investment Management and Broker-Dealer Team** at Kilpatrick Townsend and Stockton

## Footnotes

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<sup>1</sup> New Jersey Division of Consumer Affairs, Bureau of Securities, Proposed Rule: Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J.R. 493 (April 15, 2019), <https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx> (hereinafter, the “Rule Proposal”).

<sup>2</sup> Under New Jersey Uniform Securities Law (“NJUSL”) § 49:3-56, persons engaged in the business of offering and selling securities, or in providing investment advice, either to investors in New Jersey or from a place of business in New Jersey, must register with the NJBS.

<sup>3</sup> We believe this was included in the proposal to circumvent preemption arguments that have been raised relative to the Nevada fiduciary rule proposal. For a discussion of these preemption issues, please see our recent Legal Alert, *Industry Groups and State and Federal Securities Regulators Grapple with Fiduciary Standards for BDs and Private Fund Advisers*, available [here](#) (hereinafter, the “Fiduciary Standard Legal Alert”).

<sup>4</sup> Rule Proposal, *supra* note 1.

<sup>5</sup> Under the suitability standard, BDs must have reasonable grounds for believing that the investment strategy, transaction, or recommendation is suitable for their client based on various factors. This suitability obligation typically ends after the BD makes the applicable recommendation. For more information about the standards currently governing IA, BD, IAR and RR conduct, please see the Fiduciary Standard Legal Alert, available [here](#).

<sup>6</sup> Rule Proposal, *supra* note 1.

<sup>7</sup> As defined in the Rule Proposal, the *duty of care* requires registrants to make a reasonable inquiry, including of the 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.

<sup>8</sup> As defined in the Rule Proposal, the *duty of loyalty* requires that recommendations or investment advice be made without regard to the financial or any other interest of the Registrant, any affiliated or related entity, and its officers, directors, agents, employees or contractors, or any other third party.

<sup>9</sup> “Customers,” as defined by the Proposed Rule, are exclusive of natural persons, corporations, partnerships, and trusts with more than \$50 million in total assets, as well as banks, savings and loan associations, insurance companies, BDs and IAs.

<sup>10</sup> Rule Proposal, *supra* note 1.

<sup>11</sup> Proposed Rule § 13:47A-6.4(a)(2)(i) (“There shall be 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 adviser 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.”).

<sup>12</sup> An existing New Jersey regulation provided that it is a dishonest or unethical practice to charge unreasonable, inequitable fees. Rule Proposal, *supra* note 1.

<sup>13</sup> The Rule Proposal does not set forth criteria regarding determinations of what is “best.”

<sup>14</sup> Rule Proposal, *supra* note 1.

<sup>15</sup> The Proposed Rule expressly excludes these entities from its definition of “customer.” *Id.*

<sup>16</sup> The Rule Proposal emphasized the necessity of applying this heightened standard across all accounts to avoid investor confusion about the requisite standard of care that applies to IA versus BD accounts.

<sup>17</sup> A final order based upon violations of a statute, rule, or regulation that prohibits fraudulent, manipulative, or

deceptive conduct may form the basis to disqualify a BD, RR, IA, IAR, or issuer from registration with a securities or commodities regulator or self-regulatory organizations (SROs) (e.g., FINRA), and/or disqualify a BD, IA, or issuer from relying upon securities registration exemptions or safe harbor provisions. See Regulation A and Rules 504 and 506 of Regulation D under the Securities Act of 1933; Securities Exchange Act of 1934 § 3(a)(39).

<sup>18</sup> This is likely alluding to products such as variable annuities and alternative investments such as unlisted REITs and business development companies.

<sup>19</sup> NJBS may have set the threshold at this level not because they felt customers with \$49 million in assets need these heightened protections, but rather to deter industry participants from exiting the portion of the New Jersey market covered by the Proposed Rule. The value of the higher-end customer market may warrant the costs of compliance in a way that a lower-balance customer base may not.

<sup>20</sup> Rule Proposal, *supra* note 1.

## Related People

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