Insights: Alerts

State Regulators Move Forward with Imposing State-Specific Fiduciary Standards on BDs and IAs

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Broker-dealers (“BDs”) and investment advisers (“IAs”) have witnessed a flurry of regulatory activity in recent years aimed at defining the duties each owes to its customers and clients and establishing civil and/or regulatory liability for a failure to fulfill those obligations.

At the federal level, the DOL's fiduciary rule is now defunct and the SEC's Regulation Best Interest appears far from implementation. The states' securities regulators, however, are plowing ahead. Recently, Nevada released its long-anticipated proposed rules (the “Proposed Rules”). [1] A similar release from New Jersey is expected soon with more states, such as Maryland and Illinois, poised to weigh in as well.

We believe the Proposed Rules may influence forthcoming regulation by other state and federal regulators. A summary of the Proposed Rules and their implications for BDs and IAs required to be registered in Nevada, and their representatives, is provided below.

Nevada Securities Division's Proposed Fiduciary Duty Rules

Since July 2017, Nevada's financial planner statute (the “Statute”) has included BDs and IAs, along with their registered persons, within the definition of a financial planner, a definition from which they had previously been expressly excluded.[2]

Under the Statute, financial planners (1) owe their clients a fiduciary duty; (2) are required to disclose fees and commissions at the time advice is given; and (3) must remain current on the investor's goals (for themselves and their family), financial circumstances, and obligations.[3] The Statute empowers investors to sue their financial planner for any economic losses if the financial planner violates any element of its duties.[4]

In its 2017 amendment to the Statute, Nevada authorized the State's Securities Division (the “Securities Division”) to adopt rules to further define the scope of activities that, if undertaken by BDs, IAs, or their agents, within the state, would violate the fiduciary duty imposed by the Statute.[5] The Administrator of the Securities Division has the authority to fine and/or revoke or suspend the state registration of any one found in violation of the rules.

On January 18, 2019, the Nevada Securities Division released its draft of the Proposed Rules and provided for a comment period that will end on March 1, 2019.

The Proposed Rules seem intended to reduce investor confusion about the standard of care an investor is owed when receiving investment advice. It does this by generally holding a person providing investment advice to an ongoing fiduciary duty standard (“FDS”), regardless of whether the advice comes through a BD or IA, and regardless of the

type of account in which the trade is executed.

An Ongoing Fiduciary Duty Standard Almost Always Applies

While the Proposed Rules include an "Episodic Fiduciary Duty Exemption" (the "Exemption") for broker-dealers —which ends the fiduciary duty "once the advice is received by the client, the transaction is complete, and … the required fee or gain disclosure has been made"—in practice the situations where the exemption would apply seem almost nonexistent.[6] For example:

- The Exemption does not apply to any solicited trades, and depending on the circumstances may not apply to unsolicited trades either.
- A BD is precluded from relying on the Exemption if it has "developed a fiduciary relationship with the client from previous or concurrent services."
- The Exemption does not apply if "the facts and circumstances surrounding the transaction … indicate that additional or ongoing investment advice is reasonably expected by the client relative to that transaction, type of product or advice." This might preclude reliance on the Exemption for the unsolicited sale of certain ETFs, for example.
- A registered representative ("RR") who includes any of the following terms in their title or biographical description, or otherwise holds themselves out as such, cannot ever rely on the Exemption: an adviser, advisor, financial planner, financial consultant, retirement consultant, retirement planner, wealth manager, or counselor.[7]

Maintaining Cash Position May Breach Fiduciary Duty

Under the Proposed Rules, IAs and BDs could be held to have breached their fiduciary duty by maintaining cash in a client's account if they have not advised the client of "all risks" associated with the cash position. [8]

Fiduciary Duty Standard Extends to Registered Persons Beyond RRs

Under the Proposed Rules, the definition of "Investment Advice" could result in the application of a FDS to a number of registered persons other than traditional investment adviser representatives ("IARs") and RRs, such as registered sales assistants, research analysts, and non-producing branch managers.[9]

The definition of Investment Advice under the Proposed Rules includes:

- Providing advice or a recommendation regarding an insurance product;
- Providing advice or a recommendation regarding an investment by comparing that investment to a security;
- Providing advice regarding the value of a security;
- Providing reports or analysis regarding a security;
- Providing account monitoring for the purposes of potentially recommending a buy, hold, or sale of a security;
- Providing information that is not in the offering document for a security; and
- Recommending a BD, RR, IA, IAR, or financial planner.[10]

Proposal Enumerates Per Se Violations

The Proposed Rules provide an enumerated list of specific conduct that by its very nature breaches the FDS, including when an RR or IAR:

- Fails to perform adequate due diligence on a product or investment strategy prior to transacting a sale or providing investment advice;
- Provides investment advice on a product or investment strategy without understanding or conveying all risks or features of the product or investment strategy; or
- Violates a FINRA rule that relates to client communications or disclosures.[11]

Additional Recordkeeping Obligations

The various safe harbors and disclosure requirements included in the Proposed Rules do not expressly create new recordkeeping obligations, but records will need to be created and maintained in order to evidence compliance with the Proposed Rules and to comply with existing federal recordkeeping obligations.

Increased Transparency Requirements for Solicitors, Finders

Finder's fees and referral fees must be disclosed at the time of the referral, along with a copy of any contracts relating to the referral.[12]

In sum, the Proposed Rules have a broad scope and are likely to be the first of many state-produced fiduciary rules. IAs and BDs should pay close attention to the release of any similar rules in their own jurisdictions and revise their policies and procedures accordingly.

If you have any questions about the effect of the Proposed Rules or about the regulation of IAs and BDs generally, please feel free to contact us.

Footnotes

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[1] *Notice of Draft Regulations and Request for Comment, State of Nevada*, Office of the Secretary of State (Jan. 18, 2019), https://www.nvsos.gov/sos/home/showdocument?id=6156.
[2] Nev. Rev. Stat. § 628A.010(3) (https://www.leg.state.nv.us/NRS/NRS-628A.html). Lawyers and accountants remain excluded from the definition.
[3] Nev. Rev. Stat. § 628A.020.
[4] Nev. Rev. Stat. § 628A.030.
[5] Nev. Rev. Stat. § 90.575(2).
[6] *Notice of Draft Regulations and Request for Comment, State of Nevada*, Office of the Secretary of State (Jan. 18, 2019), https://www.nvsos.gov/sos/home/showdocument?id=6156.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*

[11] *Id.*
[12] *Id.*

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