

Publications

Proposed New Jersey Fiduciary Regulation Far Exceeds Proposed Regulation Best Interest and the DOL's 2016 Rulemaking

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New Jersey believes that a uniform standard of care is necessary for the provision of securities recommendations- and that such standard must be a fiduciary one.

New Jersey's Division of Consumer Affairs issued on April 15, 2019, a far-reaching [proposed regulation, under N.J.A.C. 13:47A-6.3 and N.J.A.C. 13:47A-6.4](#), imposing a fiduciary duty on financial professionals. The "Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives" proposal:

- includes an expansive definition of what constitutes a "recommendation,"
- imposes a uniform fiduciary duty on brokers and advisors,
- and creates presumptive breaches if brokers and advisors do not recommend the best reasonably available option and fee arrangement.

This proposal follows the 2018 pre-proposal that resulted in 61 comments and two conferences. Comments on the current proposal are due June 14, 2019. Below, we outline the proposal and then compare the proposal to the SEC's Regulation Best Interest proposal and to the DOL fiduciary rule.

The Proposal

The proposal will apply a uniform fiduciary standard to broker-dealer representatives and investment advisers. The standard has two elements: a duty of loyalty and a prudence-based duty of care based upon knowledge of the customer's characteristics. The duty of loyalty requires that the recommendation be made without regard to the financial or other interests of the person making the recommendation, his or her affiliates, or any third party. Disclosure as a conflict mitigation technique is disfavored and is not presumed to satisfy the duty of loyalty.

The proposal's fiduciary duty would apply to recommendations to purchase, sell, or hold securities, and to recommendations about an investment strategy, the opening of an account, or the transfer of assets to any type of account. It will apply to contractual and discretionary fiduciaries in addition to investment advice fiduciaries. If investment advice is provided, the regulation would impose an ongoing fiduciary duty for the entire relationship.

Importantly, under the standards imposed in the proposal, a financial professional would be presumed in breach of the duty of loyalty for certain recommendations that are not the best of the reasonably available options. Additionally, the proposal permits transaction-based compensation only if it is the best of the reasonably available fee options.

Non-retail consumers are excluded from coverage by the regulation, including banks, broker-dealers, investment advisers, insurance companies, and persons with at least \$50 million in assets. Importantly for those in the retirement services space, New Jersey's proposal also does not apply to persons acting in the capacity of ERISA fiduciaries.

New Jersey's proposal explicitly recites that it does not require capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements on broker-dealer beyond 15 U.S.C. section 78o(i). Presumably, this provision was intended to thwart arguments that the regulation is preempted by the National Securities Markets Improvement Act.

Failure to adhere to the proposed regulation's requirements would constitute a dishonest and unethical business practice.

Similarities to the SEC's Regulation Best Interest

Like New Jersey's proposal, the SEC's proposed [Regulation Best Interest](#) would impose a care obligation upon broker-dealers and the representatives when providing recommendations. This duty would include a best interest standard that requires knowledge of the customer's risk profile characteristics.

Beyond Regulation Best Interest

Unlike the New Jersey proposal, proposed Regulation Best Interest does not apply a fiduciary standard to broker-dealer representatives. The SEC obligation is a best interest obligation that does not allow the representative to place his or her interests ahead of the customer's interest.

Under this standard, some, but not all, duty of loyalty type conflicts can be mitigated through proper disclosure to the customer under the SEC's proposal.

The proposed New Jersey regulation explicitly states that there is no presumption the duty of loyalty is met through disclosure.

Like the DOL's Rulemaking

In 2016, the DOL issued a [final regulation defining investment advice](#) that was expansive. It explicitly covered rollover recommendations and recommendations as to the type of account (brokerage v. advisory). New Jersey has likewise proposed that the fiduciary duty apply to recommendations regarding the transfer of assets to or opening of an account.

The DOL's definition excluded communications to independent fiduciaries with investment expertise where it was understood that no investment advice was intended. A similar exclusion is contained in the New Jersey proposal. SEC's proposed Regulation Best Interest also applies only to "retail investors" rather than parties deemed to have sufficient sophistication and bargaining power.

Beyond the DOL's Rulemaking

While the DOL's rulemaking is widely viewed as having been more onerous than the SEC's proposed Regulation Best Interest, New Jersey's proposal goes even further. DOL's rulemaking acknowledged that it is possible to provide one-time recommendations without establishing an ongoing fiduciary duty. New Jersey's proposed obligation will extend for the life of the relationship whether that be a brokerage relationship or an advisory relationship if investment advice is provided. This is intended to reduce confusion when dual registered persons provide both brokerage recommendations and investment advice to the customer. Therefore, only broker agents who act in a broker-only capacity have the ability to have the fiduciary obligation extinguish upon execution of the recommended transaction.

Further, for both investment advisers and for brokerage representatives, there is a presumptive breach when the recommendation is not the best of the reasonably available options. The DOL's rulemaking and the SEC's proposal both recognized the impossibility of demonstrating that there is one absolute best investment option. An important question regarding the New Jersey proposal is how much the "reasonably available" phrase qualifies "best". Is reasonably available every publically offered option? Is it only the options the recommender can offer? Does best of the reasonably available fee options mean that a provider must match and best the discounts offered by every competitor?

Under New Jersey's proposal, a broker or broker representative cannot receive a transaction-based fee if it is not the best of the reasonably available fee options.

Heading Off ERISA and Exchange Act Preemption?

Federal regulatory schemes can give rise to preemption challenges against state standard of care initiatives. Proposals in other states have faced allegations that, as applied to ERISA covered accounts, ERISA would preempt the state law. Under the Exchange Act, state initiatives cannot impose additional capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements on broker-dealers. Other state initiatives, such as the [Nevada initiative](#), are alleged to violate this provision by requiring additional record-keeping to prove compliance. It seems likely that the two provisions included in the New Jersey proposal carving out ERISA fiduciaries and stating that no additional recordkeeping requirements are imposed upon brokers were included as an attempt to stave off the two preemption challenges that predominate state fiduciary duty initiatives.

Recently Maryland's Senate Finance Committee voted down efforts to impose a fiduciary duty on financial professionals. Meanwhile, Nevada edges closer to finalizing regulations that impose a fiduciary duty. As more and more individual states continue to promulgate conduct standards in the financial services space, it will be interesting to see the response from both the courts and federal regulators in this crowded arena.

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