PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
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June 14, 2019

Christopher W. Gerold
Bureau Chief
Bureau of Securities
153 Halsey Street, 6th Floor
Newark, New Jersey 07101

Re: Comment on PRN 2019-044, Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives; Proposed New Rule N.J.A.C. 13:47A-6.4 and Proposed Amendment to N.J.A.C. 13:47A-6.3

Dear Mr. Gerold:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules which govern the conduct of those who provide advice to investors.

On April 15, 2019, the Bureau of Securities issued a Rule Proposal soliciting comments on a proposed amendment to N.J.A.C. 13:47A-6.3 and proposed new rule N.J.A.C. 13:47A-6.4 (collectively, "the Draft Regulations") to require that broker-dealers, agents, investment advisers, and investment adviser representatives be subject to a fiduciary duty when recommending to a customer an investment strategy, or the purchase, sale or exchange of any security, or providing investment advisory services to a customer.[1] In its proposing release, the Bureau recognized the necessity of ensuring that "persons involved in the securities markets are uniformly held to a high standard" to protect New Jersey investors and "rectify investor confusion that results from lack of uniformity."[2]

[1] Rule Proposal, 51 N.J.R. 493(a) (April 15, 2019). On October 15, 2018, the Bureau of Securities issued a Notice of Pre-Proposal soliciting comments regarding amendments to its rules to require that broker-dealers, agents, investment advisers, and investment adviser representatives be subject to a fiduciary duty when making investment recommendations. Notice of Pre-Proposal, 50 N.J.R. 2142 (Oct. 15, 2018). PIABA submitted a comment letter on December 14, 2018, providing extensive comments and information in support of regulations imposing a uniform fiduciary duty on financial professionals who provide investment advice to all investors. PIABA refers the Bureau to that letter in further support of the proposed Draft Regulations.
[2] *Id.* at 2.

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PIABA has long advocated for a true fiduciary standard for all those who provide investment advice to retail customers, including brokers, and our organization fully supports the Bureau's proposed fiduciary rule. Consistent with numerous studies, including the Securities and Exchange Commission's findings in 2011, we believe that a uniform fiduciary duty applicable to all financial intermediaries who provide investment advice would eliminate confusion and best protect customers.[3] A fiduciary duty would also mitigate the substantial costs to investors as a result of conflicted advice, which costs New Jersey retirement savers and investors *$610 million every year*.[4]

We therefore believe that the fiduciary duty should: 1) apply to all forms of financial advice; 2) arise whenever a financial or investment recommendation is made; and 3) last throughout the duration of the advisor-customer relationship. The Bureau's Draft Regulations provide those protections to a large degree. Further, as anticipated by the Bureau in promulgating the fiduciary rule, the SEC's recent adoption of a rulemaking package concerning brokers and investment advisers, including Regulation Best Interest ("Reg BI"), does not provide sufficient protections for New Jersey investors. For these reasons, we urge the Bureau to adopt the Draft Regulations, with a minor modification suggested below regarding sales incentives from third parties.

I. PIABA Supports the Draft Regulations' Provision of a Uniform Fiduciary Duty on Broker-Dealers, Agents and Advisers who Provide Investment Advice

A. Application of a Fiduciary Duty to Financial Professionals Who Provide Investment Advice

The Draft Regulations protect New Jersey investors because they impose a fiduciary duty on all financial professionals who render investment advice, and broadly define the types of investment recommendations and advice which trigger that obligation. PIABA supports the Bureau's approach to require all financial professionals, regardless of title or license, to adhere to a uniform fiduciary duty when providing investment advice.

To a large degree, the proposed rule is consistent with what most retail customers believe about their financial advisor – whether that person is a broker or other financial professional – that he or she is a fiduciary.[5] Indeed, brokerage firms give their "registered representatives" titles that sound trustworthy, like "Financial Advisor," "Wealth Consultant," and "Wealth Manager."[6] Brokers also pay millions of dollars

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[3] SEC, *Study on Investment Advisers and Broker-Dealers* ("SEC Study") (Jan. 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. The SEC reviewed two studies which it sponsored (the "Seigel & Gale Study" and the "RAND Report"), and a study conducted by Consumer Federation of America. The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors did not understand the differences between investment advisers and broker-dealers. The SEC determined that this misunderstanding is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals." *Id.* at 101.

[4] *See*, Economic Policy Institute, "Here is what's at stake with the conflict of interest ('fiduciary') rule (May 20, 2017), available at https://www.epi.org/publication/here-is-whats-at-stake-with-the-conflict-of-interest-fiduciary-rule/

[5] *See* Spectrum Group, *Fiduciary – Do Investors Know What it Means* (2015), available at http://spectrum.com/Content_Whitepaper/fiduciary.aspx.

[6] Peiffer, Joseph C. and Christine Lazaro, Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty, Misleading Ads Fuel Confusion, Underscore Need for

every year in advertising to tell investors that they put the interests of customers ahead of their own. Brokers encourage investors to *trust* them, saying they will provide *advice* and *guidance.* As a result, when a customer meets with a broker, she reasonably expects that she is being given advice that is for her benefit.

The Bureau recognizes that there are circumstances when the broker's duty to his or her customers should be deemed to be on-going. This is particularly true as to broker-dealers and financial professionals who are dually registered as investment advisers. Specifically, if the broker provides investment advice to the customer in any other capacity, the duty will be deemed to be on-going. As the Draft Regulations recognize, professionals who provide investment advice to a customer should not be allowed to "switch hats" to a lower standard of care depending on the particular type of investment they have recommended to a customer and/or how they are being compensated for that recommendation. The Draft Regulations will finally align the duty that financial professionals owe to customers in rendering investment advice with the representations made by such professionals and with the customers' reasonable expectations. The Draft Regulations may be improved by making it clear that if a broker holds himself out as offering advice, the duty will be deemed to be on-going as well. This will better align brokers' duties with investor expectations, especially when the firms' advertising creates those expectations.

PIABA also strongly supports the definition under proposed new rule 13:47A-6.4(a) to include a broad definition of the types of investment advice that would trigger a fiduciary duty. Specifically, the standards of conduct will apply to both investment advice, as well as recommendations of an investment strategy, the opening of, or transfer of assets to, any type of account, or the purchase, sale, or exchange of any security. The Bureau correctly recognizes that investment strategy includes the opening of or transfer of assets to any type of account, and explicitly includes such conduct within the scope of the rule. It is not clear from the language of the rule if it is intended to cover recommendations of other financial courses of action preceding the recommendation of a particular security or investment strategy, in order to earn the client's trust and cause the client to entrust their assets to the financial professional for management. Prime examples of such scenarios include a recommendation to roll over an employer-based retirement account into a new IRA account, or a recommendation that a prospective client retire early and/or elect a lump sum payment in lieu of a defined benefit pension and turn the lump sum over to the financial professional for investment. Obviously, the financial professional has a pecuniary incentive to recommend these courses of action. The Draft Regulations may be improved by explicitly including such recommendations within the scope of the rule.

B. Incorporating the Duty of Care and Duty of Loyalty

PIABA supports incorporation and definition of the two primary duties of a fiduciary: the duty of care and the duty of loyalty, which are set forth in the Draft Regulations.[7]

We believe that the Bureau's approach to fiduciary duties and the definitions it has utilized in the Draft Regulations strike an appropriate balance between accommodating the traditional, compensation-based model of many broker-dealers and other sales agents, with the interests of protecting investors from the financial harm caused by conflicted advice.

Fiduciary Standard (March 25, 2015), available at https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf.

[7] Proposed Rule 13:47A-6.4(b).

We believe, however, that further clarification is warranted as to one area within the proposed duty of loyalty. Specifically, it is not clear that the offer or receipt of direct or indirect compensation from a *third party* (such as an issuer of a variable annuity or other investment product) would be considered a potential conflict of interest that would give rise to a presumption of a breach of duty of loyalty. In its Release, the Bureau explained its concern with harmful incentives such as sales contests that encourage or reward conflicted advice. Many sales incentives are often offered by third party issuers of annuity products, mutual funds and other investments, including vacations to exotic locales, golf packages, marketing support, and other incentives. The conflicts that arise from these types of incentives are significant. PIABA therefore recommends that the Bureau add language in subsection 13:47A-6.4(b)(2)(i) to include direct or indirect compensation from third parties, including issuers of investment products.

II. The Draft Regulations Are Necessary and Appropriate Because They Provide Greater Protection for New Jersey's Investors than the Securities and Exchange Commission's "Regulation Best Interest"

On June 5th, the Securities and Exchange Commission ("SEC") adopted a final version of the standard of care brokers owe to their customers, Regulation Best Interest ("Reg BI").[8] Unfortunately, the final version of Reg BI did not substantially depart from the proposed regulation released a year ago,[9] which the Bureau already determined "does not provide sufficient protections for New Jersey investors."[10] We agree, and urge the Bureau to adopt a uniform fiduciary duty.

A. Reg BI Does Not Sufficiently Protect Investors

Despite its title, Reg BI does not really require brokers put their clients' interests first and certainly falls short of imposing a true fiduciary standard upon broker-dealers and affiliated persons who provide investment advice. Reg BI essentially builds upon and codifies FINRA's interpretation of its suitability rule.[11] Reg BI does not define best interest, but rather, creates a checklist of four obligations a firm must discharge to meet the standard – disclosure, care, conflict of interest, and compliance obligations – none of which actually obligates the firm to place the customer's interests ahead of the firm's.

Reg BI substantially relies on disclosure rather than meaningful investor protection. While theoretically an enhancement of FINRA rules, the Customer Relationship Summary form ("the CRS") that Reg BI requires and relies upon will not provide investors with timely, useable information. This is not merely PIABA's opinion. In fact, the SEC's own commissioned study by the RAND Corporation confirmed that the CRS was largely ineffective in helping investors understand the different duties of financial professionals, and that many individuals still remained confused about when firms and their agents owed them fiduciary duties and when they did not, even after reading the CRS.[12] Further, in an attempt to provide

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[8] Securities and Exchange Commission, Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031, 17 C.F.R. pt 240 (June 5, 2019) ("Final Reg BI Rule").
[9] Proposed Rule – Regulation Best Interest, 17 CFR 1240, Rel. No. 34-83082 (May 9, 2018).
[10] Rule Proposal, 51 N.J.R. 493(a), at 4.
[11] Final Rule, *supra* note 8, at 5, 252-53.
[12] Investor Testing of Form CRS Relationship Summary, SEC 46 (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationshipsummary.pdf. In fact, the written responses to specific questions about the disclosures reveal that a significant number of participants did not understand important sections of the form, and still had a general misunderstanding of the different standards

greater "flexibility for firms to tailor the wording" of the CRS disclosures,[13] the final rule does not require firms to disclose every material conflict, but instead, gives firms wide discretion on what to disclose.[14] Reg BI still allows brokers to satisfy their purported disclosure obligations regarding costs by providing percentages or ranges, rather than the dollar amounts likely to be understood by investors. In short, under Reg BI, firms will be able to satisfy their disclosure obligation through boilerplate disclosures, and withhold actual cost and conflict of interest information until after the sale of the product at issue has been made.

In contrast to the Bureau's proposed fiduciary rule, Reg BI limits the purported "best interest" obligation to the beginning and end of a transaction, rather than for the duration of the customer-broker relationship. As discussed above, the Draft Regulations recognize that there may be circumstances under which the broker's duties should be on-going rather than transactional. In starkest contrast, Reg BI continues to allow dually registered investment advisers and brokers to adhere to different standards based on the account type, even if the same client has both a brokerage and an advisory account with the same individual. It is simply not possible to reasonably believe unsophisticated investors are going to be able to know when a dually registered representative is acting as a fiduciary or not.

Lastly, Reg BI's conflict obligation does not prohibit firms from creating conflicts that would reasonably be expected to encourage and reward advice that is not in the customer's best interests. Reg BI does eliminate a limited range of conflicts, including "sales contests, sales quotas, bonuses and non-cash compensation," but it only does so if such compensation is "based on the sales of specific securities and specific types of securities within a limited period of time."[15] However, there are many conflicts that incentivize brokers to put their clients' interests second to their own. Other conflicts which create an incentive for the broker to place his own interests ahead of the client's interests need only be mitigated under Reg BI.

The weak and ineffective provisions of Reg BI stand in sharp contrast to the Bureau's Draft Regulations. As discussed in Section I above, the Draft Regulations hold all financial professionals who render investment advice to a fiduciary standard. The Draft Regulations provide that conflicts of interest are presumed to be a breach of the duty of loyalty. The Draft Regulations require that financial professionals adhere to a duty of care and a duty of loyalty, that cannot be discharged solely through purported disclosures. The Draft Regulations define what the fiduciary duty requires, and what is meant by the duty of care and the duty of loyalty. The Draft Regulations recognize that the fiduciary duty should endure for the duration of the relationship under certain circumstances. Lastly, the Draft Regulations eliminate the false distinction between investment advisers and brokers by treating both as the financial professionals which they hold themselves out to be, and by requiring both to adhere to the same standard of conduct.

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governing investment accounts and financial professionals. The RAND report also reflects that many of the participants were unable to synthesize and apply the information. *Id.* at 47-48.

[13] Final Rule, *supra* note 8, at 81.

[14] "Firms are not expected to disclose every material conflict of interest, and should instead consider what would be most relevant for retail investors to know in deciding whether to select or retain the particular firm. *Id.* at 161.

[15] *Id.* at 352.

Simply put, the differences between Reg BI and the fiduciary standard proposed in the Draft Regulations are significant. Consequently, the Draft Regulations are necessary and appropriate in order to sufficiently protect New Jersey investors, as the Bureau had already determined in its original proposal.[16]

B. Reg BI Does Not Preempt the Bureau from Enacting a Fiduciary Standard

We believe that some in the financial services industry may argue that the SEC's adoption of Reg BI preempts States from enacting a fiduciary standard. Such an argument is not supported by Reg BI, nor by the Dodd-Frank Act under which Reg BI has been promulgated.

Specifically, there is no express language in Reg BI which alters or supersedes any existing obligations applicable to brokers and broker-dealers with respect to the circumstances under which brokers may owe customers a fiduciary duty under state law. To the contrary, the SEC explained in its Release that "the preemptive effect of [Reg BI] on any state law governing the relationship between regulated entities and their customers [will] be determined in future judicial proceedings."[17]

Further, Reg BI was promulgated pursuant to Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). This provision required the SEC to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care (imposed by the Commission, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers; and whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.[18] It is clear from the foregoing that the SEC's task was to determine whether a rule establishing a baseline standard for investment advice was warranted based on gaps in the existing regulatory scheme. As a result, the Dodd-Frank Act does not provide that rulemaking by the SEC in this area would preempt state law. Likewise, Reg BI itself does not indicate that it is intended to preempt state law and the SEC has not taken the position that Reg BI preempts state law. Rather, it is only brokerage firms who want to advertise fiduciary services, but not be held to a fiduciary standard, that are arguing Reg BI preempts a state from enacting further protections to its citizens.

Finally, to the extent any potential challenge is made to the Draft Regulations under the National Securities Markets Improvement Act of 1996 ("NSMIA"), the Bureau has considered such challenges and has addressed them. Section 103 of NSMIA limits states from enacting any rule or regulation that imposes upon broker-dealers any "[c]apital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements" that are greater than those imposed under federal law, rules or regulations.[19] Proposed Rule 13:47A-6.49(e) expressly addresses this concern.

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[16] Rule Proposal, 51 N.J.R. 493(a), at 4.
[17] Final Reg BI Rule, *supra* note 8 at 43.
[18] *See* "Study on Investment Advisers and Broker-Dealers," Executive Summary, p. i, January 2011, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[19] 15 U.S.C. §780(i).

III. Conclusion

PIABA supports the Bureau's efforts to heighten the duty of those who provide investment advice to their customers, including brokerage firms and their registered representatives. PIABA urges the Bureau to adopt its Draft Regulations, with the improvements and clarifications discussed in Section I above. PIABA thanks the Bureau for the opportunity to comment on this important issue.

Very truly yours,

Christine Lazaro
PIABA President