Testimony of M. Patricia Smith
National Employment Law Project

In Support of Proposed N.J.A.C. 13:47A-6.4:
Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers and Investment Adviser Representatives

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Hearing before the New Jersey Division of Consumer Affairs
Bureau of Securities
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Thank you, Attorney General Grewal, Bureau Chief Gerold and members of the New Jersey Division of Consumer Affairs Bureau of Securities. My name is Patricia Smith and I am Senior counsel at the National Employment Law Project ("NELP"). NELP appreciates the opportunity to present these remarks on the New Jersey Bureau of Securities' (Bureau) proposal to require that broker-dealers and investment advisers be subject to a fiduciary duty when providing a broad range of investment advice concerning securities. NELP is a non-profit research and policy organization that for over 50 years has advocated for the employment and labor rights of low wage workers. These workers count on every dollar of their retirement and non-retirement savings to make ends meet. NELP's constituents include the millions of workers and their families in the U.S. who invest their savings for retirement. These investors (also called "retail investors" in the trade) are hardworking individuals who rely on advice for their economic security. Retail investors, especially small investors, are generally not aware of the different regulatory frameworks that apply among financial services professionals. They are being harmed every day by endemic confusion regarding the duties they are owed when they interact with different financial services professionals; and the weak standards of conduct that govern the provision of personalized investment advice.

NELP urges the Bureau to quickly finalize the proposal that would make it a dishonest and unethical business practice if broker-dealers or investment advisers that provide a broad range of personalized investment advice to retail customers do so without adhering to a common law fiduciary duty. This proposal, when finalized, will fill the regulatory gap created by the demise of the Department of Labor's (DOL) Fiduciary Rule and the inadequateness of the Securities and Exchange Commission's final, Regulation Best Interest rule (SEC rule) which, as more fully described later, is not strong enough to protect retail investors. [1]

I. NELP strongly supports the Bureau's proposal that would impose a fiduciary standard that applies uniformly to financial professionals that engage in a broad range of advisory activities.

As previously mentioned, retail investors are confused about the roles and duties of different financial services professionals. There are several reasons for this. Many financial services companies advertise themselves to the public in such a way that conveys they are advisors who occupy a position of trust and confidence, i.e. fiduciaries, when in fact they do not conduct themselves as such. Non-fiduciary broker dealers often hold themselves out as a "financial advisor" or "wealth manager". They often describe their services as "investment advice" or "investment planning". Misleading advertising only heightens the public's confusion. Numerous examples exist of broker-dealers' advertisements that claim that the client's interests come first[2] or that the relationship is one of trust[3] when in fact their legal position, is that they are mere salespersons selling products.[4] This confusion costs retail investors billions of dollars a year. Investors who mistakenly believe their advisor is putting their best interests first can pay higher costs, face unnecessary risks, or receive substandard returns.

[1] For a much more detailed explanation of the deficiencies of the SEC rule see SEC Commissioner Robert J. Jackson Jr., Statement on Final Rules Governing Investment Advice, June 5, 2019, https://bit.ly/2XJsaSP.
[2] Instead of repeating example after example of misleading titles and advertising, I refer you to the November 2nd, 2018 testimony in support of the pre-proposal of the Micah Hauptman of the Consumer Federation of America and Kathleen McBride, Accredited Investment Fiduciary Analyst who both numerous provide real world examples of major financial services companies holding themselves out to be what reasonable persons would consider fiduciaries.
[3] *Id*.
[4] *See* Brief for *Chamber of Commerce, SIFMA, FSI, et al., Chamber v. DOL*, Case Number 17- 10238, at 1, http://bit.ly/2f4wVBW ("A broker, insurance agent, or other financial-sales professional may make 'individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.'") (internal cites omitted).

Conflicted advice is pervasive in an industry where compensation incentives can lead to biased sales recommendations. The White' House's Council of Economic Advisors found in 2016 that conflicted advice costs investors nationwide $17 billion a year.[5] Another study estimated that conflicted advice costs New Jersey IRA investors $610 million a year.[6] That number would be much higher if additional investment products were included.

To stem these losses and clear up the confusion that leads to those losses, the Bureau has proposed that any financial professional, if they hold themselves out to be an "advisor" or if their sales recommendations are "advice", be held to a common law fiduciary duty. If financial professionals, including broker dealers, wish to avoid fiduciary standards of conduct, they must make it clear to investors that they are simply engaging in sales transactions, not providing advice recommendations that puts the clients' interests first. If they hold themselves out in any way that implies that they occupy a position of trust and confidence, either by title or by advertising, but do not comply with fiduciary standards, they will be held liable for dishonest and unethical business practices. Uniform application of the fiduciary standard is important as studies have demonstrated that retail investors do not distinguish between broker dealers and investment advisors and expect both to act in their best interests when providing financial advice.[7]

NELP also strongly supports the proposal's application to a broad range of advisory activities. The fiduciary standard would and should apply when a broker dealer or agent, an investment advisor or its representative, recommends to a retail investor the opening of or transfer of assets to any type of account, the purchase, sale or exchange of a security or the recommendation of any other investment strategy.[8]

The SEC rule is grossly inadequate. Instead of imposing a uniform best interest standard on all investment advisors, it maintains different standards for investment advisors and broker-dealers advice. While the SEC rule purports to impose a fiduciary standard in some instances, that standard is vague and undefined. Moreover, the SEC's rule provides a narrow application of its non-fiduciary standard which more closely resembles FINRA's suitability standard than a true best interest standard.

II. The Bureau's proposed fiduciary standard correctly incorporates all aspects of the common law duty and appropriately interpreters them broadly.

At common law, fiduciaries had both a duty of care and a duty of loyalty. Both duties were incorporated into the DOL's definition of "best interest" when it required ERISA fiduciaries to give advice in the "best interest" of their clients. Importantly, the proposed fiduciary standard incorporates both these duties and defines them in a way that improves protections for retail investors beyond FINRA rules and the new SEC rule.

We especially support the language in the proposal that the duty of loyalty requires advice be given ""without regard to the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity and its officers, directors, agents, employees, or contractors, or any other third party." Furthermore, the Bureau has made clear that its intent with this language is to require firms to rein in the use of harmful incentives that

[5] Kelley Holland, New Investment Rule Could Save Investors Billions, CNBC, April 6, 2016, https://www.cnbc.com/2016/04/05/new-investment-rule-could-save-investors-billions.html

[6] Heidi Shierholz and Ben Zipperer, Here is what's at stake with the conflict of interest ('fiduciary') rule, ECONOMIC POLICY INSTITUTE, May 30, 2017, https://bit.ly/2EQJ9gE.

[7] *See*, e.g., Brian Scholl, Office of the Investor Advocate, and Angela A. Hung, RAND Corporation, The Retail Market for Investment Advice, October 2018, https://bit.ly/2PwCPz8

[8] NELP does urge the Bureau to clarify that a recommendation to hold a security is also a covered investment advice.

encourage and reward conflicted advice. This includes the use of sales contests, trips, bonuses, and quotas for advisors and financial professionals meeting certain production requirements. It also includes regulation of firm policies that favor the sale of products and services that are most profitable for the firm, rather than those that are best for the customer.

We also support the provision in the proposal that establishes a presumption of a breach of a fiduciary duty if advice is given that is not the best of the reasonably available alternatives. As discussed previously, retail investors already believe, sometimes erroneously, that they are being recommended the best of the available options that will maximize the value of their investments. This provision, which is conspicuously absent in the SEC rule means that an advisor or broker must take costs into account when they recommend an option. But it does not mean that the lowest cost option is always required.

III. Concerns about federal preemption are overblown.

NELP understands that many in the industry are arguing that the proposal is preempted by federal law. Although the National securities Markets Act (NSMIA) preempts state laws that impose additional recordkeeping requirements, this proposal does not do that. They appear to claim that any state law that might cause a firm to voluntarily keep a record not required by federal law is preempted. This is just not the law. Whatever a firm may decide to do as a business practice, additional records are neither required nor necessary under this proposal.

Concerns have also been raised about ERISA preemption. While ERISA may preempt additional state standards or causes of action imposed upon broker dealers who are already ERISA fiduciaries, this proposal makes clear that it does not apply to ERISA fiduciaries, participants or beneficiaries. Imposing additional requirements upon those who are not ERISA fiduciaries is a very different matter. Many circuits have held that ERISA does not preempt ordinary state-law claims against non-fiduciaries.[9]

In any event, ERISA expressly excepts from its preemption "any law of any State which regulates ... securities." 29 U.S.C. § 1144(b) (2) (A). New Jersey’s proposal would regulate the sales and management of securities, including the relationship between securities dealers and retail investors. That type of regulation would be saved from ERISA preemption by this savings clause of ERISA even if the above were not true.

IV. Conclusion

The Bureau has the opportunity to close the gap in the regulatory framework that governs securities professionals who provide personalized investment advice to retail investors, including working families across New Jersey. Implementing an enforceable fiduciary standard for investment advisors and broker-dealers would reflect economic and marketplace realities, protect investors from harmful conflicts of interest, and prove eminently manageable for the financial services industry.

On behalf of working families who depend on receiving fair investment advice to protect their hard-earned savings, we urge the Commission to implement this proposal, with certain modifications, as promptly as possible.

[9] Please see NELPs comments on the pre-proposal dated December 11th, 2018 for a complete list of these cases.