Institute for Portfolio Alternatives

December 14, 2018

Via electronic submission to: http://www.njconsumeraffairs.gov/Proposals/Pages/default.aspx

Christopher W. Gerold
Bureau Chief, Bureau of Securities
PO Box 47029
Newark, NJ 07101

Dear Mr. Gerold:

The Institute for Portfolio Alternatives ("IPA")[1] submits the following comments in response to the New Jersey Bureau of Securities ("Bureau") Notice of Pre-Proposal regarding potential amendments to require that broker-dealers, agents, investment advisers, and investment adviser representatives be subject to a fiduciary duty ("Notice").[2]

The IPA has an immediate interest in applicable standards of conduct for financial professionals in New Jersey as our members include both regulated broker-dealer firms and their investment professionals in your state and nationwide. IPA member firms support individual investor access to a wide variety of asset classes with low correlation to the traded markets and historically available only to institutional investors. These investment products have been held in the accounts of more than 3 million individual investors. With over $135 billion in capital investments, they remain a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for national, state and local economies.[3]

The IPA is concerned about the Bureau's Notice for the reasons detailed below. We appreciate the Bureau's consideration of public comments and are willing to assist the Bureau as it considers this important issue.

1. **A Uniform Federal Standard Will Soon Exist.** On April 18, 2018, the U.S. Securities and Exchange Commission ("SEC") proposed and sought public comment on heightened standards of conduct for broker-dealers, which is referred to as Regulation Best Interest. The U.S. Department of Labor ("DOL") also announced plans for a revised fiduciary rule package to replace the rule

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1 On Monday, April 9, 2018, the Investment Program Association became the Institute for Portfolio Alternatives. The change reflects our organization's continued commitment to champion the portfolio diversifying investment industry.

2 Pre-Proposed Amendment: N.J.A.C. 13:47A-6.3 pursuant to N.J.S.A. 49:3-67(a); Pre-Proposal Number PPR 2018-004.

3 For over 30 years the IPA has raised awareness of portfolio diversifying investment (PDI) products among stakeholders and market participants, including investment professionals, policymakers and the investing public. We support increased access to investment strategies with low correlation to the equity markets: lifecycle real estate investment trusts (Lifecycle REITs), net asset value REITs (NAV REITs), business development companies (BDCs), interval funds and direct participation programs (DPPs). Through advocacy and industry-leading education, the IPA is committed to ensuring that all investors have access to real assets and the opportunity to effectively diversify their investment portfolios.

vacated by the U.S. Court of Appeals for the Fifth Circuit earlier this year. Signaling their intent to coordinate their efforts, the SEC and the DOL have both issued regulatory notices that their rules will be finalized by September 2019.[4] The IPA cautions the Bureau from creating an additional state standard in light of the soon to be released federal standard. Duplicative and/or conflicting federal and state standards will undermine the goals of investor protection and lead to increased investor confusion. Moreover, given that many financial professionals operate in multiple states, the legal and compliance costs associated with varying state and federal standards will have a direct impact on the availability and cost of financial advice for investors in New Jersey. As the Notice correctly states, Congress provided the SEC with rulemaking authority to adopt a standard under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We strongly encourage the Bureau to allow the SEC to complete its rulemaking before promulgating a fiduciary standard in New Jersey.

2. **FINRA Imposes a Strong Regulatory Regime.** We encourage the Bureau to consider the totality of the existing broker-dealer regulatory regime. FINRA Rule 2111 requires that "[a] broker's recommendations […] be consistent with his customer's best interests, and he or she […] abstain from making recommendations that are inconsistent with the customer's financial situation."[5] Broker-dealers must deal fairly with their customers and "observe high standards of commercial honor and just and equitable principles of trade"; broker-dealers must have a reasonable basis for recommendations regarding securities in light of a customer's financial situation and needs; and a broker-dealer's recommendations must be consistent with its customer's "best interest," thus prohibiting a broker-dealer from placing its interests ahead of its customer's interest.[6] FINRA provides examples of violations of this standard.[7] FINRA also imposes additional product-specific suitability obligations, including those for variable annuities (Rule 2330), day trading (Rule 2130), direct participation programs (Rule 2310), index and currency warrants (Rule 2350 Series), options (Rule 2360) and security futures (Rule 2370). Finally, FINRA has rules related to fair prices (Rule 2121), prohibitions against trading ahead of customer orders (Rule 5320), front running (Rule 5270), and gifts (Rule 3220). FINRA has sought comment on proposed rules relating to non-cash compensation (proposed Rule 3221) and entertainment (proposed Rule 3222). We believe that FINRA already provides a strong

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4 *See* DOL Regulatory Agenda at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=1210-AB82 and SEC Regulatory Agenda at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=3235-AM35.

5 In the Matter of the Application of Dane S. Faber, Exchange Act Release No. 49216 (Feb. 10, 2004) (emphasis added).

6 *See* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 2111 (Suitability); FINRA Rule 2111 (Suitability), FAQ Question 7.1, "Acting in a Customer's Best Interests;" and FINRA Regulatory Notice 12-25. Broker-dealers have a "special duty" to the public, i.e., an obligation to deal fairly with their customers, and actions that are not fair to the customer must be disclosed. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

7 For example, a violation includes recommending one product over another in order to receive larger commissions; making mutual fund recommendations designed to maximize commissions rather than establish an appropriate portfolio; recommending speculative securities that pay high commissions or new issues from a broker's employer for the broker's benefit; or recommending trading on margin to increase commission. *See* FINRA Regulatory Notice 12-25.

regulatory regime for broker-dealers, and an additional state fiduciary standard is not necessary.

3. **Preemption is a Significant Concern.** Section 15(i)(1)[8] of the Securities Exchange Act of 1934 ("Exchange Act") precludes a state from enacting regulations establishing "capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act]."[9] Under the Exchange Act, Rule 17(a)-4 requires broker-dealers to keep a record of all communications by a [FINRA] member relating to its business as such."[10] It is likely that the Bureau's potential rulemaking may run counter to federal standards for broker-dealers. For example, the rulemaking may require the making and keeping of records that are different or in addition to those required to be made and kept under the federal securities laws, which would be preempted. The Bureau should also consider preemption concerns with respect to ERISA, which preempts state laws relating to employee benefit plans.

4. **Impact of the DOL Fiduciary Rule.** Numerous studies and anecdotal evidence have shown that the complexity, cost and litigation component of the DOL fiduciary rule resulted in a shift away from commission-based brokerage services to fee-based and self-directed accounts.[11] The DOL rule resulted in changes even within available brokerage services, such as the elimination of certain products, and asset and share classes.[12] These changes primarily impacted retirement accounts but also impacted other types of accounts. Ultimately, the DOL rule resulted in substantial costs to financial professionals, both in time and money, as well as to investors without sufficient account minimums to maintain fee-based accounts or who no longer received personalized advice on self-directed accounts, among other direct and indirect impacts.[13]

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8 The National Securities Markets Improvement Act of 1996 (NSMIA) added Section 15(i)(1) to the Exchange Act.

9 15 U.S.C. § 78o(i)(1).

10 17 CFR §§ 240.17a-4(b)(4).

11 "As of June 9th, 53% of study participants reported limiting or eliminating access to advised brokerage for retirement investors, impacting 10.2 million accounts and $900b AUM." *See, e.g.*, Deloitte, The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors (Aug. 9, 2017), at 11, *available at* https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf.

12 "Products affected included, but were not limited to, mutual funds, annuities, structured products, fixed income, and private offerings. It was also noted that study participants had to limit asset classes for which a prohibited transaction exemption was not available (e.g., risk-based principal sales of non-investment grade debt, certain underwriting and new-issue activities)." Deloitte, *supra* note 10, at 13.

13 For example, Jerry Lombard, President of the Private Client Group at Janney Montgomery Scott stated, "[u]pwards of 10,000 of our customer retirement accounts will be relegated to a 'no advice service' desk as they are too small for the risks imposed by the DOL or too costly to place in an advisory account." *See* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jlombard-20170713.pdf.

We respectfully request that the Bureau consider all of the points discussed above before promulgating an additional state-based fiduciary standard. If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at (202) 548-7190.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

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