Center for Capital Markets Competitiveness

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Re: Comments on Pre-Proposal 2018-04 Concerning Amendment N.J.A.C. 13:47A-6.3 Establishing a New Fiduciary Duty with Respect to Securities Transactions and Investment Advisory Services

Chief Gerold:

The U.S. Chamber of Commerce ("the Chamber") appreciates the opportunity to comment on Pre-Proposal 2018-04 amending N.J.A.C. 13:47A-6.3 to create a fiduciary duty for recommendations regarding investment strategies, securities transactions, and investment advisory services ("the Pre-Proposal"). Our members, their employees and their families are the consumers that the Bureau seeks to protect, and we share the Bureau's goal of ensuring that everyone in New Jersey have access to quality, affordable financial services and advice.

We thank the New Jersey Bureau of Securities ("the Bureau") for providing an opportunity for public comment on the Pre-Proposal, as it is vital the Bureau fully understands the potential effects of such a regulatory action on New Jersey consumers. Accordingly, we supplement our testimony at the November 19, 2018 hearing with these additional comments.

The Chamber supports strong, Federal regulation of financial services that protect our members, their employees and their families while ensuring access to quality, affordable financial assistance and investment advice. That is why we offered comments supporting the Securities and Exchange Commission's ("SEC") regulatory proposals enhancing the standards applicable to broker-dealers and registered investment advisors, and providing disclosure regarding the nature of the relationship between the consumer and the financial professional.[1]

While we share the Bureau's goal of ensuring strong consumer protection, we believe that the course of action suggested by the Pre-Proposal is not likely to achieve this goal. If the Pre-Proposal results in unilateral action to establish a state fiduciary standard that conflicts with Federal Standards (and potentially other state standards), and that restricts consumer choice of business models for receiving advice and assistance, then New Jersey will have repeated many of the mistakes the U.S. Department of Labor ("DOL") made in its fiduciary rule. However well-intentioned, the Pre-Proposal could, like the DOL's actions, increase consumer costs and restrict consumer access to services. Below, we outline five points regarding the potential effects of the Pre-Proposal.

1. **Lessons Learned from the DOL Rule:** Our experience with the DOL regulation expanding the definition of fiduciary advice ("the DOL Rule") for Employee Retirement Security Act-covered ("ERISA") retirement plans and Individual Retirement Accounts ("IRA") shows that ill-considered regulatory action can harm the very consumers regulators sought to protect. The DOL Rule reduced access to financial services and investment advice because, unlike the SEC proposals, the DOL Rule did not take into account the different needs of all consumers and disfavored transaction-based payment models. Further, the DOL adopted its rules through unilateral action without sufficient coordination with other applicable financial regulators, resulting in conflict between regulatory standards applicable to the same financial professionals. To protect our members from the harmful effects of the rule, we and a number of other groups successfully challenged the DOL Rule, which was vacated by the Fifth Circuit U.S. Court of Appeals earlier this year.[2]

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[1] *See,* U.S. Chamber comment letters on SEC proposals dated August 7, 2018 and September 5, 2018, available at https://www.sec.gov/comments/s7-08-18/s70818-4184380-172570.pdf and https://www.sec.gov/comments/s7-08-18/s70818-4305975-173214.pdf (accessed on December 5, 2018).

[2] *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et al.*, No. 17-10238, slip op. 46 (5th Cir. Mar. 15, 2018).

2. **Preserving Consumer Choice and Access to Transaction-Based Services:** Different consumers have different investment needs, and need access to different investment models to achieve their goals. While not yet complete, the SEC's proposals represent an effort to provide comprehensive regulation of financial assistance and investment advice that will better protect consumers while preserving retail consumer choice and access to different financial professional service models, including the brokerage "pay as you go" model widely used by consumers with small account balances. Though we do not yet know the details of the final rules the SEC will adopt, we are encouraged that the proposals recognized the need to preserve transaction-based payment models for financial services that better serve the needs of some consumers, especially those with small account balances. The Bureau should not adopt a fiduciary standard that has the effect of preventing or significantly limiting transaction-based payment models.

3. **Unilateral State Action Harms Consumers and Risks Unnecessary Conflicts with New Federal Standards:** The SEC soon will promulgate enhanced Federal standards governing investment recommendations and advice. New Jersey consumers will be harmed by state standards that conflict with these new Federal standards, as this will increase costs and reduce the availability of financial services. The Bureau should not proceed unilaterally, but should coordinate its process with the SEC before deciding how to proceed.

4. **Consumers Will Be Harmed by a Patchwork of Conflicting State Regulations:** Fiduciary or best interest standards adopted on a state-by-state basis likely will materially conflict with each other, as well as with Federal standards, making it very difficult for financial professionals to serve their clients. The increased compliance burdens and risks will increase costs and reduce access, especially for small account consumers. The Bureau should not adopt a rule that will create unnecessary regulatory barriers for New Jersey consumers.

5. **State Fiduciary Standards Will Face Significant Federal Preemption Litigation Risks**: Federal securities and employee benefits law preempts certain aspects of state regulation with respect to financial professionals and ERISA-covered retirement plans. The National Securities Markets Improvement Act (NSMIA) and ERISA will be the basis for challenges against regulations promulgated by the Bureau that have the effect of increasing documentation requirements on financial professionals or creating new legal remedies. The Bureau should not proceed with a fiduciary standard that will become a test-case for Federal preemption litigation, as this will increase costs and cause marketplace confusion for New Jersey consumers.

We address these issues in more detail below.

Lessons Learned from the DOL Rule

The DOL Rule offers many useful lessons and warnings to regulators seeking to adopt a broad fiduciary standard. One of these is that fiduciary status brings with it legal and practical ramifications that are not always clearly understood in the debate.

For example, the DOL Rule made most recommendations to ERISA plans and IRAs fiduciary advice. As a consequence of being a fiduciary as defined in ERISA, the prohibited transaction rules in ERISA and the Tax Code applied. These rules broadly define and prohibit conflicts, such that commissions in general, and nearly any variation in compensation related to recommended investments, would be prohibited. Thus, one of several negative effects of the DOL Rule was to make it very difficult for traditional brokerage and other transaction-based payment models to comply with the complex prohibited transaction rules and special exemptions to those rules that DOL created. Even before the rule was fully implemented, consumers began losing access to financial services and products as financial professionals made difficult compliance decisions.

This illustrates a reality that is not always clear from the debate over adopting "a fiduciary standard"—there are two aspects to fiduciary status, the duty of care (the quality of the process by which a recommendation is developed and documented) and the duty of loyalty (what is viewed as a conflict and the degree to which it can be mitigated).

The Bureau must clearly understand the difference between these two aspects and what they mean in practice. For example, under the vacated DOL rule, it did not matter whether the underlying recommendation was the "best" advice or not—the quality of the advice was irrelevant if the form of the compensation did not comply with the prohibited transaction rules. It was necessary for DOL to develop complex new exemptions (such as the Best Interest Contract Exemption) to permit commissions under certain circumstances, greatly increasing the cost and complexity of compliance, as well as introducing new litigation risks. If the Bureau were to make all financial professionals common law fiduciaries in New Jersey, how would this affect many useful and appropriate business models? Would the Bureau be able to ensure transaction-based business models could continue, and if so, how would it do so?

Preserving Consumer Choice and Access to Transaction-Based Services

Different service models exist for valid reasons—consumers have different needs and different service models meet these needs. For example, transaction-based service models are very common and very efficient for small account balance consumers, or for those who do not change investments frequently.

The Bureau should not adopt a fiduciary standard that has the effect of preventing or significantly limiting transaction-based payment models, as this will disadvantage many consumers who will pay more for financial services, or who may not be served at all.

We have attached to this comment letter the Chamber's 2017 report detailing the harmful effects of the DOL Rule on consumers, and especially on savers with small account balances.[3] These effects were largely due to the new restrictions on business models and compensation structures. The report examined what steps financial service providers had already taken in response to partial implementation of the DOL Rule, and what steps they were planning to take had the DOL Rule been fully implemented. These findings clearly show that the bias of the DOL fiduciary rule against transaction-based compensation was harming small consumers. Specifically:

- 92% of firms surveyed reported that the DOL Rule would have limited or restrict investment products for their customers, which could ultimately have effected some 11 million households;
- Up to 7 million individual retirement account (IRA) owners could lose access to investment advice altogether; and
- 71% of advisors would have stopped providing advice to at least some of their current small accounts due to the risk and increased costs of the rule, and 35% would have stopped serving accounts under $25,000.

[3] "The Data is In: The Fiduciary Rule will Harm Small Retirement Savers," U.S. Chamber of Commerce, Spring 2017.

Unilateral State Action Harms Consumers and Risks Unnecessary Conflicts with New Federal Standards

The Chamber is very concerned that our members in New Jersey, as well as their employees and family members, will be harmed if the Bureau moves forward before the SEC has completed its work. New and materially different Federal standards are coming, and coming soon—the regulatory process is well-advanced and the Federal agencies are committed to their efforts. The SEC's most recent regulatory agenda indicates that the Commission anticipates issuing final rules and guidance by September.[4] DOL's most recent regulatory agenda indicated that it will issue new regulations or exemptions related to the vacated DOL Rule by September as well.[5] Proceeding to establish a new state fiduciary standard without knowing what the Federal standards will be is a recipe for regulatory conflict, marketplace disruption and consumer confusion that will not serve New Jersey consumers.

The Bureau, the SEC and DOL share the same goals—all three agencies intend to protect consumers from improper financial advice that will harm them. It is important that all three coordinate to ensure consistent outcomes. Conflicting regulatory regimes are in no one's best interest. We urge Bureau to coordinate with the SEC and wait for its final regulations before making any further determinations about the future of the Pre-Proposal.

Consumers Will Be Harmed by a Patchwork of Conflicting State Regulations

The Chamber supports efficient regulation of financial services that will ensure the protection of our members' interests. We have actively engaged in Federal and state regulatory efforts intended to protect consumers, and we will continue to do so. However, strong and efficient regulation cannot be achieved on a state-by-state basis through a patchwork of conflicting state regulations that differ materially with respect to one another as well as to Federal regulations.

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[4] *See*, "Fall 2018 Unified Agenda **of** Regulatory and Deregulatory Actions," The Office of Management and Budget, The White House, available at https://www.reginfo.gov/public/do/eAgendaMain (accessed on December 5, 2018).

[5] Id.

The reality is that no state can take such action in a vacuum—financial professionals simply cannot efficiently serve their clients if they are subject to material differences in regulation in every state regarding their legal obligations, documentation requirements and legal risks. This should be particularly evident for New Jersey given the major metropolitan areas of New York and Philadelphia and the long history of cooperative efforts between neighboring states to facilitate transportation and commerce. States must adopt common standards or harm their own citizens.

A financial professional in New Jersey likely also has clients in Delaware, New York and Pennsylvania and financial professionals in those states likely also have clients in New Jersey. If each of those states have different standards, how do those professionals serve their clients? How do the entities charged with supervising their activities do so if each state has different standards? While there have always been some differences between states in financial regulation, the imposition of a fiduciary obligation is a fundamental change with significant ramifications that go well beyond minor difference in licensing or similar issues.

Strong Federal regulations, such as those in the process of being promulgated by the Securities and Exchange Commission, are the best protection for all Americans. To move toward a patchwork of conflicting State and Federal regulations will harm consumers in New Jersey and other states by reducing the availability of investment advice and increasing the cost of access for those able to receive it.

State Fiduciary Standards Will Face Significant Federal Preemption Litigation Risks

The Pre-Proposal implicates some significant Federal preemption questions. While we cannot offer a detailed analysis of this issue as the Pre-Proposal does not provide specific provisions, it is quite likely that both securities and ERISA preemption statutes will be relevant to the Bureau's deliberations.

- NSMIA

The National Securities Markets Improvement Act of 1996 (NSMIA) preempts regulatory requirements imposed by state law on SEC-registered advisers relating to their advisory activities or services, except those provisions relating to the enforcement of anti-fraud prohibitions, notice filings, and fees permitted under the Investment Advisors Act of 1940. NSMIA was specifically passed by Congress to restrict the ability of states to add financial regulatory requirements that burdened financial professionals and increased costs to consumers. While the Bureau might

argue that a fiduciary standard is an anti-fraud prohibition, a standard of care is not automatically an anti-fraud provision—fraud is already prohibited for all financial professionals regardless of their different standards of care, and it seems debatable that courts would so broadly construe the term "fraud" given Congressional intent.

NSMIA also prohibits state entities from 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 Federal requirements.

If the Bureau proceeded with a final rule, a fiduciary advisor presumably would be required to document the basis for his or her recommendations to consumers. If he or she did not do so, how could there be any review of his or her compliance? It is quite likely that a challenge to any final rule promulgated by the Bureau would assert that this is a new requirement to make and keep records that differ from, or are in addition to, the Federal requirements.

While NSMIA may not be complete preemption of all state regulatory activities, is does broadly preempt many aspects of state regulation, some of which appear to be central to a fiduciary standard.

- ERISA

ERISA broadly preempts state laws that "relate to" employee benefit plans. While the statute does not preempt state laws regulating certain aspects of state insurance, banking and securities regulation,[6] there are significant areas of likely preemption nonetheless. To the extent the Bureau is considering applying a fiduciary standard to advisors serving ERISA plans, this would be an area of significant controversy and likely litigation.

For example, the fiduciary obligation owed by an advisor to an ERISA plan is defined by Federal law. If a state fiduciary standard were to conflict with this Federal standard, it is not clear that the state standard would prevail despite an assertion that it is a "securities regulation." There has been considerable case law defining the scope

[6] *See*, ERISA Sec. 514.

of state insurance law preemption, but relatively little case law regarding the scope of state securities law preemption.

On the other hand, the remedies for violations of ERISA requirements generally have been exclusively Federal remedies, resulting in the removal of state law claims to Federal court. If the Bureau is considering imposing a different fiduciary obligation and a different legal remedy for advisors to ERISA plans than that provided under Federal law, it is very likely that litigation against the regulation will result.

We believe that these difficult preemption issues highlight the need for Federal standards to ensure consistent protection of consumers, rather than differing and incomplete state standards to the extent their provisions survive preemption.

Conclusion

The U.S. Chamber strongly supports Federal regulation protecting our members and their families. We respect the motivations of the Bureau in issuing the Pre-Proposal, and we appreciate the opportunity to comment. Based on our experiences with the vacated DOL fiduciary rule, we strongly believe that the Bureau will likely harm the consumers it intends to protect if it moves forward on a stand-alone basis. We urge the Bureau to coordinate with the SEC and DOL to best protect the citizens of New Jersey.

Sincerely,

Tom Quaadman