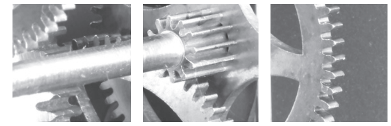

Increased scrutiny from state and local regulators

CASE IN POINT: New Jersey —No day at the beach

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As the Trump administration continues to take a more hands-off approach to regulation of financial markets and financial services firms than its predecessors, many state and local government entities have felt the need to step in and 'fill the void.' For example, last fall New Jersey Governor Phil Murphy marked the 10th anniversary of the 2008 financial crisis by announcing rule making being initiated by the New Jersey Bureau of Securities which would impose a fiduciary duty on all investment professionals in New Jersey. "New Jersey is pursuing state-level regulatory reforms that would enhance the integrity of its financial services industry by holding every investment professional to the highest standard under the law" said Governor Murphy. "The fiduciary rule announced today would provide New Jersey with the strongest investor protections in the nation and send a clear message to Washington that New Jersey is committed to ensuring its residents are never again left vulnerable to the predatory financial practices that led to the economic collapse ten years ago." Paul R. Rodriguez, the Acting Director of New Jersey's Division of Consumer Affairs, followed Governor Murphy's statement by saying "Today we are taking an important step in fulfilling Governor Murphy's promise to protect New Jersey's consumers, who find themselves increasingly exposed by the federal government's regulatory retreat. We are exercising our authority to initiate the first of many actions that will serve as the building blocks of a robust state-level consumer financial protection framework to safeguard the interests of all New Jersey residents."

As state and local government regulators become more pro-active, financial services firms face new challenges in terms of coming up with best practices for dealing with increased regulatory scrutiny and answering to n number of state specific legislation. For example, the New Jersey Bureau of Securities recently conducted an investigation into an alternative investment program and sent a number of broker-dealers a request for information about all firm customers who had invested in this alternative investment program. When we responded that our client did not have any investors in that program who reside in the State of New Jersey, the Bureau of Securities advised us (and others that inquired) that its request was broader than just New Jersey investors. We initially advised the New Jersey Bureau of Securities that their request was too broad and that the Bureau lacked jurisdiction in this instance. We cited the website for the New Jersey Bureau of Securities, which states that the "Bureau is charged with ... regulating the securities industry in New Jersey, ... bringing investigative and enforcement actions against firms or individuals who violate the New Jersey Uniform Securities Law and Regulations and ... oversee[ing] firms and individuals selling securities or providing investment advice to New Jersey residents." With no New Jersey residents to protect, we advised the Bureau that it was operating outside of its charge as stated in its website. However, the New Jersey Bureau of Securities took the position that it had the right to inspect the books and records of the private placement company at issue and that there was a nexus to New Jersey insofar as the private offering had several New Jersey LLCs associated with it and had an office located in New Jersey.

At this point, we had a difficult decision to make. On the one hand, we had a solid legal argument that the New Jersey Bureau of Securities lacked jurisdiction to request information related to firm customers outside of the state who had invested in the alternative investment program at issue. After all, our broker-dealer client did not have an office in New Jersey and did not have any New Jersey customers who had invested in the private placement program at issue. We also felt that the privacy rights of the non-New Jersey residents were at risk of being violated if information was provided to a state regulatory authority that was not overseeing the consumer protection of these non-New Jersey residents. In fact, the Massachusetts Department of Securities (which is notorious for subjecting financial services firms to heightened regulatory scrutiny) had issued the same type of information request to our client asking for information about the same investment program, but ultimately agreed that our response could be limited to firm clients who were residents of Massachusetts. On the other hand, the New Jersey Bureau of Securities had made it clear that it would not accept our argument about the jurisdictional limitations of its inquiry, which could mean protracted litigation within the administrative process for New Jersey and their Administrative Law Judges. In addition to protracted litigation, there was also certainly a risk that non-compliance with the request for information could subject our broker-dealer client to disqualification in New Jersey. Our clients, and others similarly situated, ultimately agreed to comply with the request for information from the New Jersey Bureau of Securities.

Interestingly, our clients received an almost identical request for information from FINRA's New Jersey office in the form of an 8210 request several weeks later – and had to comply with this request since FINRA's jurisdiction is not limited on a state-by-state basis. The take-away from all of this is that financial services firms and their counsel must remain vigilant as state and local regulators seek to exert additional authority in the face of what they perceive to be a more relaxed approach to financial services regulations from the Trump administration. Dealing effectively with these state and local regulators requires not only an understanding of the relevant state and local rules and regulations, but also a common sense approach which takes into account the significant authority these regulators can bring to bear and business considerations of broker-dealer clients.

Another example of where our broker-dealer clients are encountering more aggressive regulation at the state level involves pending state responses to perceived deficiencies in the SEC's rulemaking proposal entitled 'Regulation Best Interest.' By way of background, the SEC's proposed Regulation Best Interest is the Commission's response to the Fifth Circuit

continued.

Court of Appeal's overturning of the Department of Labor's Fiduciary Rule and its attempt to harmonize the duties owed by broker-dealer representatives and investment adviser representatives. Under this proposed regulation, a broker-dealer would be required to act in the "best interest" of retail customers when making a recommendation of any securities transaction or investment strategy involving securities. The proposed Regulation Best Interest is designed to make it clear that a broker-dealer and its registered representatives may not put their financial interests ahead of the interests of a retail customer in making recommendations. Other salient features of the proposed Regulation Best Interest include: (1) proposals to help address investor confusion about the nature of their relationship with investment professionals through a new short-form disclosure document with a simple summary of the nature of the customer relationship; and (2) proposals to restrict broker-dealers and their registered representatives from using the term 'advisor' with retail investors.

Many state and local regulators have criticized the SEC's proposed Regulation Best Interest as not going far enough and are now exploring whether to enact their own more stringent versions of the Department of Labor's now-defunct Fiduciary Rule. As noted above, the New Jersey Bureau of Securities is developing a uniform fiduciary standard at the direction of Gov. Phil Murphy. Nevada recently proposed a regulation that would apply a fiduciary duty to advisors and brokers in most contexts. Among other things, Nevada's rule would subject brokers who do not qualify for an exemption to an explicit and ongoing fiduciary duty. Dually registered brokers and advisors would also be presumed to be acting as an advisor and therefore have a fiduciary duty at all times. New York's legislature is working on a bill that would require non-fiduciaries to make blunt disclosures about their conflicts of interest. This bill, referred to by critics as the "buzzkill disclosures bill", would require brokers in New York to tell their clients that they are not fiduciaries, that they are not required to act in their best interests and can therefore recommend investments that may earn higher fees for the broker even if those investments do not have the best combination of fees, risks and expected returns for the customers. The prospect of inconsistencies and outright conflicts between the SEC's Regulation Best Interest and more stringent state versions of a fiduciary rule pose obvious concerns as broker-dealers strive to create a uniform system of best practices for their brokers and advisors. Broker-dealers would be well-served to take note of and comply with these more stringent rules when dealing with customers from various states as the requirements may differ from state to state and at the federal level.

Comments suggestions or inquiries are welcome and should be directed to: mary.pat.fischer@aon.com

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