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NEW JERSEY BUREAU OF SECURITIES PROPOSES UNIFORM FIDUCIARY STANDARD FOR INVESTMENT ADVISERS AND BROKER-DEALERS

The New Jersey Bureau of Securities has proposed its uniform fiduciary standard on broker-dealers and investment advisers.

As proposed, the rule would make it a “dishonest or unethical business practice” as defined in the New Jersey Uniform Securities Act and the rules thereunder to breach a “fiduciary duty” to a customer “when providing investment advice”. The rule makes clear that an investment adviser, broker-dealer, or agent would need to satisfy the duty of care and duty of loyalty to carry out its fiduciary duty. The proposal describes the duty of care obligation as follows:

> When making a recommendation or providing investment advice, the duty of care requires a broker-dealer, agent, or adviser to use the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration all of the facts and circumstances.
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> A broker-dealer, agent, or adviser shall make reasonable inquiry, including risks, costs, and conflicts of interest related to the recommendation or investment advice, and the customer's investment objectives, financial situation, and needs, and any other relevant information.

The proposal sets very clear prohibitions relating to the duty of loyalty:

> When making a recommendation or providing investment advice, the duty of loyalty requires that a recommendation or the advice *is made 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.*
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> There shall be a presumption of a breach of the duty of loyalty for offering, or receiving, direct or indirect compensation to or from the broker-dealer, its agent, or adviser for recommending the opening of, or transfer of assets to a specific type of account, or the purchase, sale, or exchange of a specific security that is not the best of the reasonably available options.
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> There shall not be a presumption that disclosing a conflict of interest in and of itself shall satisfy the duty of loyalty.

The proposed rule would apply to “customers”, which noticeably does not include other investment advisers, registered investment companies and clients with more than $50mm (natural and corporate).

I have serious concerns about several issues raised by this rule that are largely intended to address the behavior of broker-dealers engaged in business with New Jersey residents.

1. The rule seems to lack jurisdiction over investment advisers registered with the U.S. Securities and Exchange Commission. Federal law limits state authority over these investment advisers to matters involving fraud, which this rule is not specifically designed to address. The state would have some level of authority over “investment adviser representatives”, broker-dealers, and their agents that are registered with the state, but there are also difficult issues involving preemption that must be addressed.

2. There are difficult jurisdictional issues at play. The proposal does not address specifically whether the rule is intended to apply only to those individuals and entities with customers located in New Jersey. It seems that it is not designed to apply to the activities that are conducted in New Jersey but delivered to customers in states other than New Jersey. However, the rule is ambiguous on this issue.

3. Is the rule designed to eliminate all business development activities of wholesalers in New Jersey? Can an investment adviser and its representatives be entertained by wholesalers and product sponsors? Do these relationships result in the receipt of "direct or indirect compensation"? How will the Bureau interpret the phrase "best of the reasonably available option" when determining whether a breach of the duty of loyalty has occurred?

I am continuing to monitor the rule proposal and intend on submitting a comment letter in an effort to address some of these issues. If you have any concerns about the application of this proposed rule to your activities, I am available to discuss these matters. I can be reached at mschatzow@stark-stark.com or (609) 219-7450.

ON THE HORIZON – CALIFORNIA CONSUMER PRIVACY ACT MAY TRIGGER GDPR-LIKE OBLIGATIONS FOR REGISTERED INVESTMENT ADVISERS

The California Consumer Privacy Act of 2018 (the "CCPA"), was enacted on June 28, 2018 and is slated to go into effect on January 1, 2020.

As currently drafted, the CCPA would apply to companies including registered investment advisers if they do business in California, have a role in determining the means and purposes of the processing "personal information", and: (a) have annual gross revenues exceeding $25,000,000; (b) annually process the "personal information" of 50,000 or more California residents, households, or "devices"; or (c) derive at least half of their gross revenue from the sale of "personal information."

The CCPA defines "personal information" broadly to include: "information that identifies, relates to, describes, is capable of being associated with, or could be reasonably linked, directly or indirectly, with a particular consumer or household." That would include: IP addresses; email addresses; purchasing or consumer histories or tendencies; web browsing and web search history; geolocation data; audio, visual, or thermal information; professional or employment information; and education information.

The CCPA also defines "device" broadly to mean "any physical object that is capable of connecting to the Internet, directly or indirectly, or to another device." Notably, the definition is not currently limited to devices located in California or owned by California residents.

The anticipated requirements under the CCPA are similar to the obligations imposed for residents of the European Union and European Economic Area under the General Data Protection Regulation ("GDPR"). The CCPA will essentially allow consumers to access and control how their personal information is collected and used, including: the right to obtain a record of the personal information collected; the right to delete the personal information once it is no longer needed; and the right to opt-out of any personal information.

The California Attorney General is required to "solicit broad public participation to adopt regulations to further the purposes of" the CCPA. Based on that, we were anticipating that compliance obligations under the CCPA could significantly change before the 2020 effective date. However, the proposed changes came in a different form, when on April 4, 2019, a California Assembly Member proposed massive changes that serve to repeal the CCPA in favor of the Privacy for All Act of 2019 ("PAA").

If the PAA passes as drafted, it will not go into effect until January 1, 2021. The PAA expands the compliance obligations, regulatory oversight, and potential liability to affected entities beyond the scope of the CCPA, bringing it closer to the requirements of the GDPR. By way of example, under the CCPA, affected entities would only be required to disclose the categories of personal information and the types of third parties with whom that personal information is shared. However, under the PAA, affected entities would also be required to describe the "specific pieces of information" collected and the identity of the third parties to whom the personal information is disclosed. Under the PAA, affected entities would also be required to contractually prohibit downstream recipients from re-identification of consumer information, and would be required to make reasonable efforts to ensure service providers comply with the PAA. Moreover, while the CCPA only required opt-out consent for the selling of applicable personal information, the PAA would require affected entities to provide an affirmative opt-in consent to share that consumer's personal data.

In light of this proposal, we will continue to track the CCPA and the PAA, but do not suggest taking any major action such as preparing new policies, notices, or contract amendments based on these regulations until we get closer to the applicable effective date. In the meantime, it could be helpful for firms that are concerned with their anticipated obligations under the CCPA and PAA to identify the scope of "personal information" they collect, especially from California residents and households, and how they share that "personal information" with third-parties.

INDIVIDUAL REGISTRATIONS – A HELPFUL GUIDE TO EVALUATING REGISTRATION REQUIREMENTS FOR REPRESENTATIVES OF SEC-REGISTERED FIRMS

With Form ADV annual amendments now out of the way for another year for many investment advisers, these advisers can switch their compliance focus to other areas of need. Reviewing advisory agreements, drafting compliance manual updates, and countless other activities are sure to keep compliance personnel busy over the remaining months of the year.

One area that often presents a source of confusion, for investment advisers registered with the U.S. Securities and Exchange Commission ("SEC"), is registration and licensing for investment adviser representatives. Unlike firms, where registration and oversight responsibilities are divided between state and federal jurisdiction, individuals are subject to registration and licensing exclusively at the state level.

But how does an investment adviser determine whether its personnel are registered in the appropriate states? This article examines the licensing requirements for representatives of an investment adviser registered with the SEC.

Section 203A(b) of the Investment Advisers Act of 1940 (the "Advisers Act") provides:

> (1) No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person—(A) that is registered under section 80b–3 of this title as an investment adviser, or that is a supervised person of such person, except that a State may license, register, or otherwise qualify any investment adviser representative who has a place of business located within that State."

In short, this section of the Advisers Act provides that a state may not require licensing for any supervised person of an investment adviser unless that person meets the definition of "investment adviser representative" and has a "place of business" located within that state.

Under the Advisers Act, a "supervised person" is defined as:

> Any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

This is a fairly broad standard and will likely capture the vast majority of individuals traditionally understood to be investment adviser representatives. Importantly, this would not cover third party solicitors (solicitors who operate as independent contractors and are not otherwise providing services beyond solicitation), since such solicitors would not be officers, directors, or employees of the firm and would not provide investment advice on behalf of the adviser.[1]

If an individual does not meet the definition of supervised person, then the Advisers Act will not preempt state law and whether licensing of the individual is necessary requires a further analysis of state law.

If the individual is a supervised person, then we must continue the analysis to determine whether the individual meets the definition of "investment adviser representative" or has a "place of business" in the state. First, we continue to analyze whether the person is an "investment adviser representative.

An "investment adviser representative" of an investment adviser generally means a supervised person of the investment adviser:

1. Who has more than five clients who are natural persons (other than excepted persons); and
2. More than ten percent of whose clients are natural persons (other than excepted persons).

An "excepted person", for the purposes of this definition, is a "natural person who is a qualified client". This generally includes individuals with $1 million under the management of the investment adviser or those that have a net worth of more than $2.1 million (excluding their primary residence).

If the individual is determined to not be an investment adviser representative, then no state can compel that individual to be licensed or registered! [2]

If the individual meets the definition of investment adviser representative, then we move on to the final stage of the analysis and that is

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[1] Rules Implementing Amendments to the Advisers Act, Rel. No. 1633 (May 15, 1997)("The 1633 Release") at n.125 and accompanying text.

[2] Certain states, such as Texas, acknowledge the limitations of this statute. However, Texas still subjects supervised persons with no place of business in Texas to a "notice filing". However, Texas law appears to avoid preemption because it is not a requirement to "license, register, or otherwise qualify".

to determine whether the individual has a “place of business” in that state. A “place of business” of an investment adviser representative means:

1. An office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and

2. Any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

In the 1633 Release, the SEC provided useful guidance for determining whether a particular location would be considered a “place of business”:

> For the purposes of rule 203A-3(b), an representative would be considered to hold himself out to the general public as having a location at which he conducts advisory business by, for example, publishing information in a professional directory or a telephone listing, or distributing advertisements, business cards, stationery, or similar communications that identify the location as one at which the representative is or will be available to meet or communicate with clients.
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> The definition encompasses permanent and temporary offices as well as other locations at which a representative may provide advisory services, such as a hotel or auditorium. Whether a representative will be subject to the qualification requirements of a state in which the hotel or auditorium is located will turn on whether the adviser representative has let it generally be known that he or she will conduct advisory business at the location, rather than on the frequency with which the representative conducts advisory business there.

A supervised person of an investment adviser can only be compelled to register or be licensed in states in which they maintain a place of business. So if an SEC-registered investment adviser only has a single place of business in New Jersey, then New Jersey would be the only state that could require registration of that firm’s investment adviser representatives, regardless of the number of clients served or amount of assets they managed in any other state.[3]

It is important to note that New Jersey would be the only state that **could require** registration in this example—this is not to be conflated with registration would automatically be required. Once the firm has determined the individual in question meets the definition of “investment adviser representative, then the state would be permitted to require registration or licensing. It still remains a question of whether the state law would require registration or licensing.

Although the analysis of various state licensing requirements is a job best left to attorneys, the above analysis can serve as a helpful guide in narrowing down the number of possible states for review.

If you have any questions about individual registrations, or the various state requirements associated with investment adviser representative registration, feel free to contact Ryan Walter at rwalter@stark-stark.com or (609) 895-7392 or your regular attorney contact within Stark & Stark’s Investment Management Practice Group.

SPRING CLEANING TIPS FOR COMPLIANCE OFFICERS

By this time of year, compliance officers at most registered investment advisers have submitted their Form ADV annual updating amendment. This process typically culminates with the offering or delivery of the newly revised Form ADV Disclosure Brochure. With the completion of this annual process, and with the approach of summer, many compliance officers may find themselves better positioned to undertake some compliance “spring cleaning”. Spring cleaning can include a review of compliance program fundamental requirements, such as an assessment of the firm’s current compliance policies and procedures. Firms that are more comfortable with their general compliance program may direct their attention to specific concerns, such as topics identified by the Securities and Exchange Commission (“SEC”) as “Examination Priorities”. Of course, the goal of any investment adviser compliance program should be to ensure that the firm has implemented policies and procedures to address each of its relevant regulatory requirements and related business /compliance risks.

Firms seeking to conduct a review of their fundamental compliance requirements may want to consider some of the following topics:

Compliance Manual/Policies and Procedures: Advisers should review their compliance manuals to affirm that the guidelines are current and tailored to the firm’s business. Regulatory examiners will typically study a firm’s manual and use it as a roadmap to review procedures and processes. Thus, investment advisers should proactively “test” their manual to ensure that it accurately reflects

[3] Certain states, such as Texas, acknowledge the limitations of this statute. However, Texas still subjects supervised persons with no place of business in Texas to a “notice filing”. However, Texas law appears to avoid preemption because it is not a requirement to “license, register, or otherwise qualify”.

firm processes and procedures. This testing process dovetails naturally into the next topic.

Annual Review of Policies and Procedures/Risk Assessment: Advisers must conduct an annual review to assess the effectiveness of their policies and procedures and whether such policies and procedures have been appropriately implemented. Best practice entails conducting various tests to ensure that compliance procedures are being undertaken as required and performed in the correct manner. This testing and review process should then be summarized in an annual review document. The summary should note any issues identified by the firm and how such issues were addressed or remedied.

General Compliance Program: If a firm conducts a robust review of the first two items, it may likely identify opportunities for improvement with respect to its general compliance program. As discussed above, the first order of business is typically to examine existing program procedures and processes to determine weaknesses or blind spots. For example, compliance staff may identify new conflicts of interest, which must be addressed through additional disclosure or procedural changes. This is the time to address any "red flags" stemming from earlier reviews. Consider as well whether your business staff has been appropriately trained with respect to compliance requirements and whether a "culture of compliance" exists within the firm. Having undertaken this comprehensive analysis, the firm is also in a better position to determine if it possesses the appropriate resources to address compliance responsibilities. Often, firms will realize that they need more resources to address compliance tasks, which may include additional employees, enhancements to compliance technology or outsourcing to qualified compliance firms to reduce the compliance burden.

Firms may also want to focus on specific areas that have been the focus of examination scrutiny.

Best Execution: Even if a firm recommends only one broker-dealer/custodian to its clients, the SEC staff expects that the firm perform some level of due diligence. These reviews should be appropriately documented. Best execution reviews should consider both quantitative and qualitative factors. Quantitative testing may include trade reviews to verify that your custodian is achieving optimal price execution. Qualitative factors to consider include an evaluation of service levels provided by the custodian and the custodian's financial responsibility.

Advisory Fees and Expenses: The SEC's examination staff are closely reviewing the manner in which firms assess advisory fees. Compliance staff should take the time to ensure that the fee billing description set forth in the firm's Disclosure Brochure is aligned with language contained in its client agreement. This may include quarterly testing of certain client accounts to ensure that the firm is adhering to its stated methodology for fee deduction. Consider as well any necessary proration of advisory fees for client relationships that begin or terminate during a given quarter, excluded assets, or tiered billing.

Email Review: Firms should review the adequacy of their current email program. Is the firm conducting a periodic email review based upon key words searches or a specific percentage of email? Are all emails (including internal communications) being maintained by the firm? Firms should be sure to have a process for documenting such testing, including how any escalated emails were handled. Firms should also be sure to capture and review their social media communications.

If you need assistance or wish to discuss how our firm can assist with your compliance program, please call or email your regular attorney contact within Stark & Stark's Investment Management Practice Group.

PROPOSED LEGISLATION SEEKING TO END MANDATORY ARBITRATION

While the Supreme Court continues to trend favorably on arbitration, seen most recently last month in the Court's *Lamps Plus, Inc. v. Varela* decision, Senate and House Democrats seem resolved to place greater restrictions on the availability and use of arbitration in consumer and employee agreements. Two recently proposed bills seek to effectively end the inclusion of mandatory arbitration clauses in contracts, particularly in the financial industry.

In March, U.S. Sen. Sherrod Brown (D-OH), ranking member of the U.S. Senate Banking Committee, introduced the Arbitration Fairness for Consumers Act (S. 630). Sen. Brown's bill proposes amendments to the Consumer Financial Protection Act of 2010 (the "CFPA") which would prohibit mandatory arbitration provisions and class action waivers in agreements that relate to a "consumer financial product or service." Going forward, Sen. Brown's bill would apply "to any dispute or claim that arises or accrues on or after the date of the enactment of this Act." While the Arbitration Fairness for Consumers Act is primarily focused on student loans, credit card agreements, and employment contracts, the bill would also apply to the arbitration systems for broker-dealer customer disputes run by FINRA, as well as the American Arbitration Association system used by most investment adviser clients. This legislation would end pre-dispute arbitration agreements that are part of nearly every brokerage and investment-adviser contract.

Additionally, a separate bill, the Forced Arbitration Injustice Repeal Act, was introduced last month by Rep. Hank Johnson (D-GA), in the House (H.R. 1423), and Sen. Richard Blumenthal (D-CT), in the Senate (S. 620) (collectively the "FAIR Act"). The FAIR Act contains even stricter provisions prohibiting mandatory arbitration provisions in consumer agreements. The FAIR Act would also prevent various businesses, including investment advisers and broker-dealers from including mandatory arbitration clauses in

contracts with employees and consumers. The Fair Act, being the broader and more sweeping of the proposed bills would also place restrictions on the use of mandatory arbitration agreements in civil rights and antitrust matters.

Unlike Sen. Brown's bill, which proposes amendments to the CFPA, the FAIR Act would directly amend the Federal Arbitration Act of 1925, invalidating arbitration agreements and class action waivers in consumer and employment contracts executed from the date of enactment going-forward, and furthermore would retroactively invalidate previously executed arbitration agreements and class waivers for all disputes which arise after the law goes into effect.

The FAIR Act House and Senate bills are each pending with their respective judiciary committees, while Sen. Brown's bill is pending in the Senate's Banking, Housing, and Urban Affairs committee. If enacted, this legislation would drastically alter employer-employee relations nationwide.

Currently there is no need to amend pre-dispute arbitration clauses within existing employment and advisory contracts. At this time we still strongly favor the use of pre-dispute arbitration. We will continue to monitor any developments regarding this proposed legislation and follow up with future alerts.

TIME TO UPDATE POLICIES AND PROCEDURES

If you have not updated your Policies and Procedures in the last 6-12 months (**or longer, which should not happen**), now is the time to do so. Please contact cpike@stark-stark.com, jcanela@stark-stark.com, or jsedes@stark-stark.com to get the ball rolling and begin the process of bringing your Policies and Procedures up-to-date, including new SEC focus areas such as Senior Clients, Rankings, Mutual Fund Share Class Selection, Custody post the SEC 2017 no-action letter, ERISA post DOL Rule demise, GDPR/Foreign clients, and Gifts and Entertainment.

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Stark & Stark has offices in Princeton, New Jersey, Marlton, New Jersey, and Philadelphia, Pennsylvania. The Stark & Stark Investment Management & Securities practice understands the legal and practical issues confronting investment professionals in providing advice and counsel on relevant areas of law, including investment adviser registration and ongoing compliance, security arbitration, litigation and enforcement, broker-dealer compliance, investment company and hedge fund formation and ongoing compliance, investment banking, venture capital and corporate governance.