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STAYING TRUE TO NSMIA: A ROADMAP FOR SUCCESSFUL STATE FIDUCIARY RULES AFTER REG BI

MARIA E. VAZ FERREIRA†

INTRODUCTION

As Americans, there is hardly anything we value more than freedom. Being "free to choose" is the core guarantee through which we pursue our livelihood and succeed at happiness. The more choices, the better. But what if we we are supposed to choose blindly? In our postindustrial society, we often feel overwhelmed by the myriad choices we must make simply to get through our daily lives. To inform our choices, we rely on assumptions. More importantly, we rely on each other.

Reliance is central in the world of financial investments. Financial products are increasingly complex, and investors need specialized information to choose suitable investments. In our current economy, more than half of all families own stocks either directly or indirectly as part of a fund, and many resort to the services of a financial services professional.[1] Americans place their hopes for economic progress and stability on financial advisers, who can be broker dealers ("BDs"), investment advisers ("IAs"), money managers, investment consultants, financial planners, general partners of hedge funds, and many others who get paid for giving

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[1] Jesse Bricker et al., *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finan*ces, FED. RSRV. BULL., Sept. 2017, at 1, 20, https://www.federalreserve.gov/publications/files/scf17.pdf [https://perma.cc/2FVF-AUHM].

personalized securities advice.[2] However, investors largely ignore that most of these professionals are not required to disclose all conflicts of interest, or to put their own interests aside when making recommendations.[3] Only registered *investment advisers* must adhere to this fiduciary standard, and the consequences to investors can be devastating.[4]

Traditionally, the role of BDs was limited to executing securities transactions for a transaction fee, and IAs provided ongoing account management and investment advice for a fixed percentage of managed assets.[5] Today, however, the differences between traditional BDs and IAs are not so clear-cut.[6] BDs now offer a wide spectrum of services and products, including investment advice and recommendations, both to institutional and retail investors.[7] Some BDs are also registered as IAs, which allows their representatives to act as IAs for some of a client's accounts and as BDs for that client's other accounts.[8] Investors often do not distinguish between BDs and IAs, but they do expect to receive honest, unconflicted advice from financial professionals they trust.[9]

However, BD compensation and incentive structures may prompt their representatives to recommend the investments that will pay the broker the most.[10] Thus, BDs often recommend high-fee, high-yield investments, but fail to inform their clients of how

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[2] *Investment Adviser*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/investment-adviser [https://perma.cc/S4MH-9UYJ] (last visited Jan. 2, 2021).

[3] Pub. Invs. Arb. Bar Ass'n ("PIABA"), Comment Letter on Draft Fiduciary Duty Regulations 2–3 (Mar. 1, 2019), https://piaba.org/system/files/2019-03/Comment%20Letter%20%28March%201%202019%29.pdf [https://perma.cc/9SDM-FCJN]; *see also* U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 101 (2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf [https://perma.cc/CKV8-XXP5].

[4] Christine Lazaro, *The Future of Financial Advice: Eliminating the False Distinction Between Brokers and Investment Advisers*, 87 ST. JOHN'S L. REV. 381, 382 (2013); Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248, 84 Fed. Reg. 33,669, 36,671 (July 12, 2019).

[5] Lazaro, *supra* note 4, at 398.

[6] *Id.* at 382.

[7] Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 711 (2012); U.S. SEC. & EXCH. COMM'N, *supra* note 3, at 8.

[8] Lazaro, *supra* note 4, at 412.

[9] Andrew Osterland, *Is Your Advisor a Fiduciary? Chances Are, You Have No Idea*, CNBC: ADVICE & THE ADVISOR (Jun. 17, 2015, 9:08 AM), https://www.cnbc.com/2015/06/16/is-your-advisor-a-fiduciary-chances-are-you-have-no-idea.html [https://perma.cc/K69F-SSPZ].

[10] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,426 (July 12, 2019).

risky and illiquid these products are.[11] Focusing on their own interests, BDs can cause investors to suffer losses from which they may not recover, by investing in high-risk products, accelerating their retirement, or withdrawing their defined benefit pension as a lump sum.[12]

Recently, the Securities and Exchange Commission ("SEC") approved Regulation Best Interest ("Reg BI"), a package of rulemakings and interpretations designed to protect retail investors while preserving their ability to choose the services and compensation structure that better serve their needs.[13] Regulation BI sought to set a clearer standard of BD conduct. However, the new standard falls short of what many investor advocates, and even the SEC, had previously deemed necessary.[14] Some state legislators have responded by proposing rules that bring the fiduciary duties of those BDs who provide investment advice in line with the duties of care and loyalty imposed on IAs by the common law.[15] Industry actors oppose these state efforts and argue that the National Securities Markets Improvement Act of 1996 ("NSMIA")[16] preempts state efforts in this field.[17] This Note argues that NSMIA does not necessarily preempt state regulations imposing fiduciary duties on BDs. While it is true that NSMIA sets bounda-

[11] Christine Lazaro, President, PIABA, Statement Before the New Jersey Bureau of Securities (Nov. 19, 2018), https://piaba.org/system/files/2018-11/Statement%20of%20Christine%20Lazaro%20NJ%20Bureau%20of%20Securities%20Nov%2019%202018_0.pdf [https://perma.cc/X3HQ-4794].

[12] PIABA, *supra* note 3, at 7.

[13] *See generally* Regulation Best Interest, 17 C.F.R. § 240.15l–1 (2020).

[14] *See, e.g.*, James Lundy & Robert Mancuso, *Seven States and D.C. Aggressively Challenge Reg BI*, JD SUPRA (Sept. 11 2019), https://www.jdsupra.com/legalnews/seven-states-and-d-c-aggressively-76074/ [https://perma.cc/N3BS-BT3M]; U.S. SEC. & EXCH. COMM'N, *supra* note 3, at 101.

[15] *See, e.g.*, Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (proposed April 15, 2019) (to be codified at N.J. ADMIN. CODE § 13:47A-6.3, 4); Amendments to the Standard of Conduct Applicable to Broker-Dealers and Agents (notice of adoption Feb. 21, 2020) (to be codified at 950 MASS. CODE REGS. 12.200) [hereinafter Mass. Adopting Release], https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/Adopting-Release.pdf [https://perma.cc/NM7V-37W9]; Notice of Draft Regulations and Request for Comment (Jan. 18, 2019), https://nvsos.gov/sos/home/showdocument?id=6156 [https://perma.cc/37ZL-QKY9].

[16] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[17] Sec. Indus. & Fin. Mkts. Ass'n ("SIFMA"), Comment Letter on Regulation Best Interest (Mar. 29, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5263945-183727.pdf [https://perma.cc/KQJ6-3YZG].

ries to state regulatory authority over BD conduct, it also provides a roadmap for the states to successfully avoid preemption.[18]

This Note is divided into five parts. Part I describes the historical landscape of securities laws and regulations. Part II addresses NSMIA's purpose, and the allocation of duties between the states and the federal government. Part III analyzes whether NSMIA preempts state fiduciary rules governing BDs who give investment advice. Part IV argues that state fiduciary rules can avoid preemption by successfully balancing the competing purposes of NSMIA, avoiding vague language, and imposing a scope of duties that is consistent with common law precedent. Part V offers policy arguments supporting state regulation of BD conduct affecting retail consumers.

I. BACKGROUND

A. *History of Securities Regulation*

Today, the professionals who carry out securities transactions and provide financial advice to investors must comply with several layers of regulation: federal laws, state laws, federal rules such as those adopted by the SEC, state rules, and rules of self-regulatory organizations such as the Financial Industry Regulatory Authority ("FINRA").[19]

This multilayered system of regulation first emerged when the federal government entered the field of securities regulation, which, up until that point, the states had been regulating for almost two decades.[20] In 1917, the Supreme Court of the United States decided the *Blue Sky Cases* and held that state "blue-sky laws . . . did not violate the Fourteenth Amendment" and did not "unduly burden interstate commerce."[21] With the onset of the Great Depression, Congress saw the need to intervene and enacted the first federal securities laws.[22] Congress first centered its regulatory efforts on issuers and enacted the Securities Act of 1933 ("1933 Act").[23] Next, it focused on brokers. With the Securities

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[18] *Can State Laws One-Up SEC's Regulation Best Interest?*, LAW360 (Nov. 13, 2019, 4:34 PM), https://www.law360.com/articles/1219205 (subscription required).

[19] Lazaro, *supra* note 4, at 381.

[20] Evan J. Leitch, *The Antifraud Savings Clause of the National Securities Markets Improvement Act of 1996*, 94 IOWA L. REV. 1769, 1771–72 (2009).

[21] *Id.* at 1772–73.

[22] Lazaro, *supra* note 4, at 381.

[23] Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended in scattered sections of 15 U.S.C.).

Exchange Act of 1934 ("1934 Act"),[24] Congress created the Securities and Exchange Commission ("SEC").[25] By then, forty-seven of the then existing forty-eight states had adopted their own blue-sky statutes.[26] According to the SEC, the broad purposes of national securities laws "can be reduced to two common-sense notions": (1) "[c]ompanies offering securities for sale to the public must tell the truth about their business, the securities they are selling, and the risks involved in investing in those securities"; and (2) "[t]hose who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly."[27] Soon after, Congress passed the Maloney Act of 1938,[28] which amended the Exchange Act to entrust a self-regulatory organization ("SRO") with making the rules necessary to discipline member misconduct and ensure market integrity and investor protection.[29] That SRO is now known as FINRA.[30] When Congress enacted the Investment Advisers Act of 1940 ("1940 Act"),[31] BDs were already regulated by both the SEC and the National Association of Securities Dealers ("NASD"), FINRA's predecessor.[32] The 1940 Act provides a comprehensive framework for regulating federally registered IAs and expressly excludes BDs.[33] These are some of the historical reasons why the conduct of BDs and IAs is governed by separate regulatory schemes.[34]

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[24] Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended in scattered sections of 15 U.S.C.).

[25] 15 U.S.C. § 78d (2018).

[26] Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 229 (2003).

[27] *The Role of the SEC*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec [https://perma.cc/23DU-PKUR] (last visited Jan. 2, 2021).

[28] Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended in scattered sections of 15 U.S.C.).

[29] *The Laws That Govern the Securities Industry: Investment Advisers Act of 1940*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry#invadvact1940 [https://perma.cc/8BW3-T4U4] (last visited Jan. 2, 2021).

[30] Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 402 (2010).

[31] Pub. L. No. 76-768, 54 Stat. 847 (1940) (codified as amended in scattered sections of 15 U.S.C.).

[32] Laby, *supra* note 30, at 402.

[33] 15 U.S.C. §§ 80b-2, 80b-6 (2018).

[34] See *infra* Section I.B.

Congress did not intend that federal laws occupy the entire field of securities regulation.[35] However, the financial services industry grew rapidly, and its participants brought the issue of ineffícent, overlapping regulations to Congress' attention.[36] NSMIA was enacted to address the inefficiencies of duplicative federal and state regulations, and to promote "efficiency, competition and capital formation" in addition to investor protection.[37]

After NSMIA, the federal government enacted several additional statutes governing the securities industry. In 1998, Congress passed the Securities Litigation Uniform Standards Act ("SLUSA"),[38] which preempted private securities class actions against nationally traded securities.[39] In 2002, Congress enacted the Sarbanes-Oxley Act ("SOA"),[40] which sought to foster corporate responsibility in financial disclosures and to combat corporate fraud, especially in accounting. Another major securities upheaval took place on July 21, 2010, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[41] Dodd-Frank's explicit goal was to "promote the financial stability of the United States by improving accountability and transparency in the financial system, . . . to protect the American taxpayer . . . , [and] to protect consumers from abusive financial services practices."[42] Particularly, Dodd-Frank authorized the SEC to (1) conduct a study on the effectiveness of the existing standards of care for BDs and IAs and (2) promulgate rules to harmonize these standards.[43] The SEC exercised this authority when it adopted Reg BI.[44]

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[35] Christopher H. Pierce-Wright, *State Equity Crowdfunding and Investor Protection*, 91 WASH. L. REV. 847, 866 (2016); Leitch, *supra* note 20, at 1773–74.

[36] *Securities Investment Promotion Act of 1996: Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 104th Cong. 30–31 (1996) (testimony of Arthur Levitt, Chairman, U.S. Securities Exchange Commission).

[37] 15 U.S.C § 77b(b).

[38] Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.).

[39] *Id.* at 3228.

[40] Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 28 U.S.C. § 1658(b) (2018) and in scattered sections of 15 U.S.C.).

[41] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C.).

[42] *Id.*

[43] *Id.* at 1824–30.

[44] Regulation Best Interest, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,329–30 (July 12, 2019).

B. Dual System of Laws Governing Conduct of BDs and IAs

1. Federal Regulation of BD and IA Conduct

On a federal level, two separate regulatory regimes govern BDs and IAs: (1) the 1940 Act governs IA conduct; and (2) the 1934 Act governs BD conduct.[45] Congress charged the SEC with implementing the regulatory framework governing both BDs and IAs, and the SEC delegated regulatory authority over BDs to FINRA, which it supervises.[46]

The separate frameworks governing BDs and IAs led to the evolution of distinct fiduciary standards.[47] IAs are subject to broad fiduciary standards per the antifraud provisions of the 1940 Act,[48] as interpreted by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[49] In *Capital Gains*, the Court held that Congress recognized IAs as fiduciaries, subject to an "affirmative duty of 'utmost good faith, and full and fair disclosure of material facts,' " and a duty " 'to employ reasonable care to avoid misleading' [their] clients."[50] The Court also found that Congress intended to codify fraud broadly—as developed by the courts in the common law[51]—and that an IA's failure to disclose material facts, even without intent to deceive, was enforceable as fraud under the 1940 Act.[52] The SEC subsequently defined the scope of IA fiduciary duties, which currently includes: (1) acting in "the best interest of the client"; (2) "seek[ing] best execution"; (3) providing ongoing "advice and monitoring"; (4) fully disclosing material facts about prospective investments; (5) learning about the client's goals and needs; (6) never "subordinat[ing] its clients' interests to its own"; (7) fully "disclos[ing] all conflicts of interest" when giving advice; and (8) describing all fees related to an investment.[53]

BDs, on the other hand, are not fiduciaries under federal law. In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that the 1934 Act does not confer a fiduciary duty on BDs because unlike the 1940 Act, the antifraud section of the 1934 Act requires scien-

[45] Lazaro, *supra* note 4, at 390, 392.
[46] *Id.* at 381–82.
[47] *Id.* at 394.
[48] 15 U.S.C. § 80b-6 (2018).
[49] 375 U.S. 180 (1963).
[50] *Id.* at 194.
[51] *Id.* at 195.
[52] *Id.* at 194–95.
[53] *See* Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248, 84 Fed. Reg. 33,669, 36,672–78 (July 12, 2019).

ter.[54] Instead, BDs were traditionally subject to the "suitability" standard as defined and enforced by FINRA, now replaced by the Reg BI standard adopted by the SEC.[55]

Reg BI requires brokers to act in the "best interest" of the customer when recommending securities transactions or investment strategies to retail customers.[56] Reg BI limits BDs' duties of care and loyalty to the duration of the particular transactions they are executing, and although the "best interest" standard adopted in Reg BI is higher than the "suitability" standard, it does not match the "best interest" duty applicable to fiduciaries under the common law.[57] Instead, the SEC lists a series of requirements that BDs can meet to satisfy the Reg BI "best interest" standard, which closely resembles the preexisting suitability standard required by FINRA.[58] To protect investors, Reg BI mandates that BDs always place their clients' interests ahead of their own.[59] Reg BI relies heavily on disclosures, which require that BDs and IAs furnish their clients with a disclosure form called "Form CRS Relationship Summary."[60] However, Reg BI does not require complete disclosure or elimination of all conflicts.[61] Simply put, it leaves the onus

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[54] 425 U.S. 185, 214 (1976).

[55] FINRA, RULE 2111(a) (2020). The rule outlines the three main suitability obligations: reasonable-basis, customer-specific, and quantitative suitability. It requires that a BD or BD representative "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [BD or BD representative] or associated person to ascertain the customer's investment profile." *Id.* A customer's investment profile would include factors such as "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance." *FINRA Rule 2111 (Suitability) FAQ*, FINRA, https://www.finra.org/rules-guidance/key-topics/suitability/faq [https://perma.cc/3TS9-V97L] (last visited Jan. 2, 2021). The rule includes an exemption for institutional customers. *Id.*

[56] Regulation Best Interest, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,321 (July 12, 2019).

[57] Jessica Kinslow, *Regulation Best Interest: The Good, the Bad, and the Ugly*, ADVOCATE, Oct. 2019, at 22, 22.

[58] Jacob Crawley, *State-Specific Fiduciary Duties and Regulating Financial Advice in the Future*, 25 PIABA B.J. 411, 431–32 (2018); *see also* PIABA, Comment Letter on Proposed Fiduciary Conduct Standard for Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives (July 26, 2019), https://piaba.org/piaba-newsroom/comment-letter-proposed-amendments-massachusetts-950-cmr-sections-requiring-broker [https://perma.cc/3J8A-KMWE].

[59] 17 C.F.R. § 240.15l–1(a)(1) (2020).

[60] Form CRS Relationship Summary; Amendments to Form ADV, Exchange Act Release No. 34-86032, Investment Advisers Act Release No. IA-5247, 84 Fed. Reg. 33,492, 33,493 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 248, 275, 279).

[61] Regulation Best Interest, 84 Fed. Reg. at 33,388–89.

on the investor to read the fine print, and directs companies to make the fine print bigger. Reg BI also gives wide latitude to BDs providing securities advice. The 1940 Act establishes that BDs who give advice that is "solely incidental" to a securities transaction are not subject to the duties imposed on IAs, and Reg BI defines "solely incidental" as any advice given "in connection with and . . . reasonably related to the broker-dealer's primary business of effecting securities transactions."[62]

BDs must also satisfy the extensive recordkeeping and monitoring requirements under Section 17(a) of the 1934 Act,[63] and its corresponding SEC regulations under Rule 17a.[64] Additionally, FINRA can enforce Rule 17a and impose its own recordkeeping requirements. FINRA's recordkeeping rules include: (1) Rule 2210,[65] requiring BDs to retain records of all communications with retail customers; (2) Rule 4511,[66] mandating compliance with federal and FINRA books and records requirements; (3) Rule 4530,[67] imposing a duty to report certain disciplinary and legal matters; and (4) Rule 3110,[68] establishing supervision requirements. Rule 3110 requires BDs to implement a written supervisory system to ensure that everyone associated with the firm complies with all regulations applicable to BDs, and the rule requires that BDs retain books and records documenting compliance with the firm's inspection and supervision duties.[69] Therefore, any additional rule imposed on a BD, regardless of whether the rule requires recordkeeping per se, would indirectly create a duty to keep records of compliance through FINRA Rule 3110.

In sum, the key differences between the scope of the fiduciary duties applicable to BDs and those applicable to IAs are: (1) that while IAs have an ongoing duty of care and monitoring, the duty of care imposed on BDs ends when the transaction ends; and (2) that the standard of required disclosures under the duty of

[62] Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Investment Advisers Act Release No. IA-5249, 84 Fed. Reg. 33,681, 33,685 (July 12, 2019) (to be codified at 17 C.F.R. pt. 276).

[63] 15 U.S.C. § 78o(b)(4)(E) (2018).

[64] 17 C.F.R § 240.17a–1 (2020).

[65] FINRA, RULE 2210 (2019).

[66] FINRA, RULE 4511 (2011).

[67] FINRA, RULE 4530 (2020).

[68] FINRA, RULE 3110(b)(1), (7) (2020).

[69] *Id.*

loyalty is higher for IAs. The actual effect of disclosures and investor protections afforded by Reg BI will be further defined by FINRA, the states, and the courts through future implementation.

2. Regulation of BD and IA Conduct at the State Level

States typically have strong antifraud rules mirroring federal standards, and their role in policing fraud has not diminished since the passage of NSMIA.[70] States interpret their antifraud statutes broadly,[71] and some state statutes do not require scienter in civil securities-fraud enforcement actions.[72] Although federal antifraud provisions do not recognize a private right of action for IA misconduct, their state counterparts often do.[73] Prior to NSMIA, most states already had rules targeting dishonest and unethical conduct of BDs and IAs[74]—some modeled after the Dishonest or Unethical Business Practices Model Rules promulgated in 1983 by the North American Securities Administrators Association ("NASAA").[75] Some states have defined BD unethical conduct very broadly, giving state enforcement agencies great latitude to find violations, even if the conduct found to transgress the state statute is permitted under federal statutes.[76]

Overall, states have construed federal standards as a baseline, and have enhanced regulation of BD and IA conduct to address new fraudulent and unethical schemes affecting their

[70] Rutheford B. Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the Jobs Act*, 66 DUKE L.J. 605, 618–19 (2016).

[71] *See, e.g.*, People v. Federated Radio Corp., 244 N.Y. 33, 38–39 (N.Y. 1926) (holding that the word "fraud" under New York's antifraud statute, the Martin Act, should "be given a wide meaning" and include all deceitful or misleading acts that come within the purpose of the law, regardless of intent to harm or defraud); People v. Simon, 886 P.2d 1271, 1286 (Cal. 1995) (authorizing enforcement actions under California's antifraud statute even where an "offeror was unaware that his or her sales pitch was misleading"); People *ex rel.* Cuomo v. Greenberg, 95 A.D.3d 474, 482–83 (1st Dep't 2012), *aff'd*, 21 N.Y.3d 439 (N.Y. 2013).

[72] *See* Foster v. Alex, 572 N.E.2d 1242, 1245 (Ill. App. Ct. 1991).

[73] *See* AARP PUB. POL'Y INST., SURVEY OF STATE INVESTMENT ADVISER LAWS 31 (1999), https://assets.aarp.org/rgcenter/consume/d15130_invest.pdf [https://perma.cc/9PJA-WEMY].

[74] *Id.* at 26–27. *See also* CONN. AGENCIES REGS. § 36b-31-15b (2020); IOWA ADMIN. CODE r. 191-50.16(502) (2020); MO. CODE REGS. ANN. tit. 15, § 30-51.170 (2020).

[75] *Compare* 950 MASS. CODE REGS. 12.204 (2020), *with* MODEL RULE, DISHONEST OR UNETHICAL BUSINESS PRACTICES OF BROKER-DEALERS AND AGENTS (N. AM. SEC. ADM'RS ASS'N 1983), http://www.nasaa.org/wp-content/uploads/2011/07/29-Dishonest_Practices_of_BD_or_Agent.83.pdf [https://perma.cc/42B9-54QB].

[76] *See*, *e.g.*, CAL. CORP. CODE § 25216 (West 2020) ("The commissioner shall, for the purposes of this subdivision, by rule define such schemes, devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.").

citizens. State statutes of this kind have not been preempted, and investors have continued to rely on states' statutory causes of action for relief.[77]

3. BD Fiduciary Duties Under the Common Law

State efforts to impose statutory fiduciary duties on BDs are new, but these duties have been long recognized under the common law. The *scope* of BD fiduciary duties under the common law depends on the nature of the agency relationship.[78] In *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the court recognized three different scenarios: (1) where the BD has discretion over a client's account; (2) where the account is nondiscretionary, and the client makes the trading decisions; and (3) where the BD has *de facto* control over a nondiscretionary account.[79] When a BD is handling a discretionary account, he becomes a full-fledged fiduciary, owing a duty of loyalty, due care, and utmost good faith.[80] If the customer has a nondiscretionary account with the broker, the BD has a limited duty "to serve his customer's financial interest within the framework of a single transaction only."[81] The third scenario is the special circumstances scenario. In this scenario, the court will look at the client's sophistication, the degree of trust and confidence in the relationship, and other special circumstances to determine whether the client was sufficiently informed and involved in his account so as to have "retained control."[82] The courts will analyze the facts and circumstances of each case, and a BD's broad advice regarding investment decisions and strategies, upon which the customer has frequently relied, can be a strong indication that the account is discretionary.[83]

However, some state courts have gone even further, holding BDs of nondiscretionary trading accounts to broad fiduciary duties. In *Holmes v. Grubman*,[84] the Georgia Supreme Court

[77] Yokell v. Draper, No. 18-CV-02124, 2018 WL 3417514, at *2, *8–9 (N.D. Cal. July 13, 2018).

[78] Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 723 (2010).

[79] 461 F. Supp. 951, 952–54 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

[80] *Id.* at 953.

[81] *Id.* at 952.

[82] *Id.* at 954–55.

[83] Ron A. Rhoades, Comment Letter on Proposed Rule Defining the Term "Fiduciary" 41 & n. 97 (Apr. 12, 2011), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB32/posthearing00030.pdf [https://perma.cc/82Q4-NHUX].

[84] 691 S.E.2d 196 (Ga. 2010).

stated that "[a] stock broker's duty to account to its customer is fiduciary in nature, so that the broker is obligated to exercise the utmost good faith."[85] California courts have also found that BDs are fiduciaries of their clients and that BDs have "the duty to act in the highest good faith toward the customer."[86] The California Court of Appeals noted that a fiduciary duty *always* exists in a broker-customer relationship, and that the real issue is determining the scope of the fiduciary obligation, which depends on the facts of the case.[87]

II. NSMIA'S ROLE IN THE SECURITIES REGULATORY LANDSCAPE

A. *NSMIA's General Purpose*

NSMIA amended federal securities laws to "promote efficiency and capital formation in the financial markets, and . . . to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation."[88] Congress did not intend to sacrifice investor protection for efficiency; its concern was that the existing dual system burdened the national industry "without providing commensurate protection to investors or to our markets."[89]

To achieve its dual goal, NSMIA chose to "reallocat[e] responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal government and the states."[90] First, Congress preempted state regulation in (1) "offerings of securities by mutual funds"; (2) "offerings by companies traded on a national securities exchange"; and (3) "exempt offerings under Rule 506,"[91] and it also gave the SEC discretion to expand preemption by defining "qualified purchasers."[92] Second, Congress deliberately preserved the states' ability to bring anti-fraud enforcement actions against covered BDs and IAs operating

[85] *Id.* at 201 (quoting Minor v. E.F. Hutton & Co., 409 S.E.2d 262, 264 (Ga. Ct. App. 1991)).

[86] Apollo Cap. Fund, LLC v. Roth Cap. Partners, LLC, 70 Cal. Rptr. 3d 199, 215 (Cal. Ct. App. 2007) (quoting Duffy v. Cavalier, 215 Cal. Rptr. 740, 752 (Cal. Ct. App. 1989)).

[87] *Id.* at 215–16.

[88] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C).

[89] H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.).

[90] *Id.* at 39–40.

[91] Campbell, *supra* note 70, at 614.

[92] 15 U.S.C. § 77r(b)(3) (2018).

within their borders.[93] Congress wanted states to continue "protect[ing] investors through application of state antifraud laws."[94]

B. *The Arguments for and Against State Preemption in the Current Debate*

Investor advocates and some state regulators believe that NSMIA does not preempt state-specific fiduciary regulations, as shown by NSMIA's savings clause[95] and Congress's acquiescence in the historical development of state laws in the field.[96] They argue that state fiduciary regulations are necessary because the existing standards do not match investors' expectations and do not effectively protect them against losses caused by BD conflicts of interests,[97] churning in senior citizen's brokerage accounts, sales of unsuitable products, and inadequate supervision of BD's agents' activities, among others.[98] They argue that Reg BI and other federal standards should be interpreted as a "floor, not a ceiling."[99]

On the other hand, industry advocates argue that NSMIA preempts these regulations[100] because: (1) NSMIA preempts state books and records requirements; and (2) BDs would inevitably need to maintain books and records to show compliance with the new fiduciary standard.[101] For example, through the operation of

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[93] *See infra* Section III.A.

[94] H.R. REP. NO. 104-864, at 40.

[95] 15 U.S.C. § 77r(c)(1); *see also infra* text accompanying note 123.

[96] Crawley, *supra* note 58, at 422–25; Comment Letter for NASAA as Amicus Curiae Supporting the Massachusetts Securities Division, Fidelity Brokerage Servs., LLC, at 7, Docket No. E-2015-0078 (Mar. 30, 2017) [hereinafter NASAA Amicus Letter], https://www.nasaa.org/wp-content/uploads/2017/04/NASAA-Amicus-Letter-Massachusetts-3-30-17.pdf [https://perma.cc/R6LL-BHM5].

[97] *See, e.g.*, Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (proposed Apr. 15, 2019) (to be codified at N.J. ADMIN. CODE § 13:47A-6.3, 4).

[98] *Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/seniors/elderfraud.pdf [https://perma.cc/MF6J-Z5RT] (last visited Jan. 2, 2021).

[99] Robert J. Jackson Jr., *Statement on Final Rules Governing Investment Advice*, U.S. SEC. & EXCH. COMM'N (June 5, 2019), https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd [https://perma.cc/NP2N-LM68].

[100] SIFMA, Comment Letter on Massachuesetts Securities Division's Proposed Fiduciary Conduct Standard 15–17 (July 26, 2019), https://www.sifma.org/wp-content/uploads/2019/07/SIFMA-Comments-on-MA-Fiduciary-Proposal-July-26-2019.pdf [https://perma.cc/X4V7-A2RW].

[101] *Id.*; *see also* SIFMA et al., Comment Letter on Massachusetts Securities Division's Proposed Fiduciary Conduct Standard 6 (July 26, 2019), https://www.sifma.org/wp-content/uploads/2019/07/Joint-Trade-Association-Letter-on-MA-Fiduciary-Proposal-July-26-2019.pdf [https://perma.cc/E9U5-WSDD].

rules such as FINRA 3110, firms would have to keep documents to prove whether they made "reasonable inquiries into the risks, costs and conflicts of interest" related to a recommendation.[102] To weather additional legal exposure and compliance costs, some BDs would need to reduce the number of BD representatives operating in the state or pass the costs to investors, limiting access to the cheaper, transaction-based advice that benefits investors who cannot afford the services of an IA.[103] Both the SEC and the financial services industry believe that the Reg BI package is more than a new suitability standard, and that it adds meaningful protections for investors while preserving their ability to choose the financial services and products that better suit their needs.[104] They also contend that the balkanized fiduciary standard would further confuse investors, so it would unnecessarily disrupt capital markets without bringing added benefits to investors, contrary to NSMIA's explicit purpose.[105]

The industry presented these arguments when the SEC was considering Reg BI,[106] and urged the SEC to preempt state regulatory initiatives, but the SEC declined.[107] It stated that "[w]hether Regulation Best Interest would have a preemptive effect on any state law would be determined in future judicial proceedings, and *would depend on the language and operation of the particular state law at issue*" and on whether that language is "the type of law, rule, or regulation that is expressly preempted by the securities law or impliedly preempted under principles applied by courts."[108]

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[102] David Libowsky & Daniel Strashun, *N.J. Fiduciary Rule Would Add to Investment Firms' Burdens*, LAW360 (May 1, 2019, 3:48 PM), https://www.law360.com/articles/1153679/nj-fiduciary-rule-would-add-to-investment-firms-burdens (subscription required).

[103] SIFMA, *supra* note 100, at 1, 13.

[104] Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules and Interpretations To Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals (June 5, 2019), https://www.sec.gov/news/press-release/2019-89 [https://perma.cc/UW2T-2ASF]; SIFMA, *supra* note 100, at 4–5.

[105] SIFMA, *supra* note 100, at 2.

[106] SIFMA, *supra* note 17, at 2–4.

[107] Regulation Best Interest, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,327, 33,435 n.1163 (July 12, 2019).

[108] *Id.* at 33,435 n.1163 (emphasis added).

III. PREEMPTION OF STATE REGULATIONS IMPOSING COMMON LAW FIDUCIARY DUTIES ON BDS WHO PROVIDE INVESTMENT ADVICE

The Supremacy Clause of the United States Constitution states that federal law "shall be the supreme Law of the Land,"[109] and it is well established that "state law that conflicts with federal law is 'without effect.' "[110] However, the analysis of issues arising under the Supremacy Clause "start[s] with the assumption that the historic police powers of the States [are] not to be superseded by . . . Federal Act unless that [is] the clear and manifest purpose of Congress."[111]

"Congress has the constitutional power to preempt state law . . . expressly—through clear statutory language—or implicitly."[112] Implicit preemption can take the form of either field or conflict preemption.[113] Courts find field preemption when they establish that it was Congress's intention to occupy an entire field of regulations.[114] Conflict preemption occurs in cases where federal law is in conflict with state law, because the contradictions that would result imply Congress's intent to preempt state law.[115] Federal law is in conflict with state law if a party's compliance with both federal and state requirements is impossible or if, considering "the federal statute's purpose and intended effects, state law poses an obstacle to the accomplishment of Congress's objectives."[116]

In sum, congressional purpose is the "ultimate touchstone" in every preemption case.[117] Consequently, the analysis must look at the structure and purpose of the statute as a whole, both through its text and through a "reasoned understanding of the way in which Congress intended the statute and its surrounding regulatory scheme to affect business, consumers, and the law."[118]

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[109] U.S. CONST. art VI, cl. 2.

[110] Cipollone v. Liggett Grp., 505 U.S. 504, 516 (1992) (quoting Maryland v. Louisiana, 451 U.S. 725, 746 (1981)).

[111] *Id.* (alterations in original) (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

[112] Whistler Invs., Inc. v. Depository Tr. & Clearing Corp., 539 F.3d 1159, 1164 (9th Cir. 2008) (citations omitted).

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] Cipollone v. Liggett Grp., 505 U.S. 504, 516 (1992) (quoting Malone v. White Motor Corp., 435 U.S. 497, 504 (1978)).

[118] Medtronic, Inc. v. Lohr, 518 U.S. 470, 486 (1996).

A. Express Preemption

The plain language of NSMIA's express preemption clause is the starting point of any inquiry.[119] Where the statute contains an express preemption clause, the Court does not focus on the presumption against preemption but on "the plain wording of the clause, which necessarily contains the best evidence of Congress' pre-emptive intent."[120]

With regards to BDs, NSMIA preempts state regulations that impose books and records requirements in addition to those established by federal law.[121] The BD state law exemption reads:

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish 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 this chapter.[122]

However, there is a zone of activity reserved for the states. NSMIA's "savings clause" states that:

> *Consistent with this section*, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions, in connection with securities or securities transactions
> (A) with respect to—
> (i) fraud or deceit; *or*
> (ii) *unlawful conduct* by a broker, dealer, or funding portal . . . .[123]

It is important to note that the savings clause authorizes enforcement actions for BD "unlawful conduct" in addition to fraud and deceit.[124] If every word and every provision of the statute is to be given effect, "unlawful conduct" must mean that the state's enforcement authority includes some other type of conduct beyond mere fraud or deceit.[125]

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[119] *See, e.g.*, Puerto Rico v. Franklin Cal. Tax-Free Tr., 136 S. Ct. 1938, 1946 (2016).
[120] *Id.*
[121] 15 U.S.C. § 78o(i)(1) (2018).
[122] *Id.* (emphasis added).
[123] *Id.* § 77r(c)(1) (emphasis added).
[124] *Id.*
[125] *See, e.g.*, Kungys v. United States, 485 U.S. 759, 778 (1988).

No other provisions within NSMIA define these terms and their scope.[126] However, the text, history, and purpose of the savings clause, as well as state interpretations through enforcement, establish that the intent of Congress was to leave the state's power to define and proscribe unlawful conduct broadly, just as they had before NSMIA.[127]

The clause's title is "*Preservation* of authority," and it emphasizes that states "shall retain jurisdiction *under the laws of such State* to investigate and bring enforcement actions."[128] The plain language of the statute shows that Congress intended to preserve the states' preexisting laws with respect to BD fraudulent or otherwise unlawful conduct.

Legislative history supports this broad reading of the statute. The House Report emphasizes that the statute did not intend to "alter, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud or deceit, including broker-dealer sales practices, in connection with securities or securities transactions."[129] This language unambiguously extends to covered securities.[130] Additionally, in the House Conference Report, Congress noted that the "preservation of authority is intended to permit state securities regulators to *continue* to exercise their police power to prevent fraud *and broker-dealer sales practice abuses*, such as churning accounts or misleading customers."[131]

Congress left the states free to apply their own antifraud statutes, knowing that states could modify and expand those statutes.[132] NSMIA's plain language left the states free to "define their antifraud standards as they saw fit and to enforce their own sets of regulatory rules."[133] This is significant because some states' antifraud statutes offer broader protections than the federal standard.[134] The savings clause preserves the state investigative and enforcement authority "[c]onsistent with this section,"[135] which means that state powers are preserved as long as they are

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[126] Linda M. Stevens, Comment, *The National Securities Markets Improvement Act (NSMIA) Savings Clause: A New Challenge to Regulatory Uniformity*, 38 U. BALT. L. REV. 445, 454 (2009).

[127] NASAA Amicus Letter, *supra* note 96, at 7.

[128] 15 U.S.C. § 77r(c)(1) (emphasis added).

[129] H.R. REP. NO. 104-622, at 34 (1996).

[130] *Id.* at 33–34.

[131] H.R. REP. NO. 104-864, at 40 (1996) (Conf. Rep.) (emphasis added).

[132] H.R. REP. NO. 104-622, at 33–34.

[133] Leitch, *supra* note 20, at 1783.

[134] *See supra* Section I.B.2.

[135] 15 U.S.C. § 77r(c)(1) (2018).

not expressly preempted by the statute. Congress was aware that giving states the discretion to apply their own antifraud statutes could defeat the purposes of NSMIA, because states could try to circumvent federal preemption by indirectly imposing requirements on issuers of covered securities.[136] Congress intended to avoid that result and required state enforcement actions to be "*grounded in conduct* other than that which states are expressly preempted from regulating more generally."[137] However, Congress also considered that in some cases a legitimate enforcement action under a state's antifraud laws could be an adequate basis for incidentally stepping into preempted territory.[138]

Thus, NSMIA distinguishes regulation of disclosure language at the point of issuance—a federal issue—from BD conduct at the point of sale, where client interaction occurs—a federal and state issue.[139] Under this regime, states would be expressly preempted from enacting regulations intended to impose additional books and records requirements on BDs,[140] but the states' antifraud jurisdiction would still allow states to reach conduct of BD representatives who are violating the antifraud statutes of the states where they operate.[141]

Recent court decisions also support the premise that states' antifraud enforcement jurisdiction can be legitimate even if it incidentally encroaches on federal territory. In *Capital Research & Management Co. v. Brown*,[142] the California Attorney General brought an enforcement action for BD fraud based on additional compensation payments made to the BDs, which were not adequately disclosed in a fund's offering documents.[143] The undisclosed compensation was the result of shelf-space agreements, which are permitted under federal law.[144] The Court reasoned that the enforcement action fell within NSMIA's express preemption provisions because the state was "indirectly" requiring additional disclosures on offering documents of covered securities—namely,

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[136] Stevens, *supra* note 126, at 455–56; Leitch, *supra* note 20, at 1783.
[137] Stevens, *supra* note 126, at 467–68 (emphasis added).
[138] H.R. REP. NO. 104-622, at 34 (1996).
[139] *Id.*
[140] 15 U.S.C. § 78*o*(i)(1).
[141] Stevens, *supra* note 126, at 467–68.
[142] 53 Cal. Rptr. 3d 770 (Cal. Ct. App. 2007).
[143] *Id.* at 773.
[144] *Id.* at 773–774. Shelf space agreements are contracts where BDs give preferential treatment to certain fund companies in exchange for payment by the fund. Client Commission Practices, Exchange Act Release No. 34-52635, 70 Fed. Reg. 61,700, 61,709 n.111 (Oct. 25, 2005).

mutual fund shares.[145] However, the court found that the action "just as plainly" came within NSMIA's savings clause.[146] After considering NSMIA's language, purpose and legislative history, the *Brown* court was persuaded that "Congress intended to preserve the states' anti-fraud authority to control the conduct of brokers and dealers, notwithstanding that the exercise of such controls might prospectively influence the disclosures made by a covered security."[147] The court held that enforcement actions that (1) are "brought by a state officer" on behalf of "a securities commission" (2) under state law (3) "with regard to fraud and deceit" (4) "in connection with covered [securities and] securities transactions" are "squarely within the ambit of the savings clause."[148]

The court's holding is relevant in several ways. First, it allows state enforcement actions that indirectly affect preempted regulation areas. Second, it expressly commits enforcement actions triggered by BD statements to the laws of the state. Third, it allows for a broad interpretation of a state's antifraud statute, encompassing conduct that was not expressly identified as unlawful by any "state or federal law, rule or regulation."[149] Fourth, it illustrates the broad scope of conduct subject to enforcement under a state's antifraud provisions. The court reasoned that the legality of these shelf-space agreements was not in question, but that the adviser's and distributor's intentional failure to disclose them had the effect of hampering the client's understanding of the statements contained in the fund's disclosure documents.[150] Therefore, the misconduct was enforceable under the state's statutes as an inducement to buy the fund's shares "by means of manipulative, deceptive, and otherwise fraudulent contrivances."[151] Last, the court held that the Attorney General's action challenging the conduct of a covered broker dealer "cannot be reasonably construed as an effort to regulate a non-party issuer," suggesting that the *intention* of the state regulator may be relevant to the express preemption analysis.[152] The court in *Brown* concluded by holding that "[t]he savings clause is sufficiently broad to permit this

[145] *Brown*, 53 Cal. Rptr. 3d at 775.
[146] *Id.* at 775–76.
[147] *Id.* at 776.
[148] *Id.*
[149] *Id.* at 772–73.
[150] *Id.* at 776.
[151] *Id.*
[152] *Id.* at 777.

action, and as applied to this case is entirely consistent with the purpose of NSMIA."[153]

Brown was one of many actions brought by the California Attorney General immediately following the passage of a California law giving him "unusually broad latitude to prosecute corporate conduct," including "inadequate disclosure of shelf-space agreements."[154] In *People v. Edward D. Jones & Co.*,[155] where the plaintiff sued a national brokerage firm for failing to adequately disclose shelf-space agreements incentivizing the firm to recommend certain mutual funds, the court held that neither NSMIA nor the applicable federal rule preempted the state from enforcing their broadly defined antifraud statutes.[156] In *Papic v. Burke*,[157] the court cited *Brown* and stated that "[t]he State's authority to enforce its laws under [the Connecticut Uniform Securities Act], in connection with fraud and/or with material omissions which would mislead investors in connection with the offer, sale, or purchase of securities, remains intact."[158]

To conclude, even though the language of NSMIA does not expressly address whether the states have jurisdiction to impose fiduciary duties on covered BDs, courts have consistently embraced the argument that NSMIA did not "interfere with states' ability to protect their citizens from fraud, or to implement greater protections from fraudulent activities than the federal law provides."[159]

B. *Implied Preemption*

Courts give special value to Congress's express statements of preemption, but the inquiry does not end there: If "the question is whether a Federal act overrides a state law, the entire scheme of the statute must be considered, and that which . . . must be implied is of no less force than that which is expressed."[160] Hence, the in-

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[153] *Id.* at 776 (citations omitted).

[154] Stevens, *supra* note 126, at 457.

[155] 65 Cal. Rptr. 3d 130 (Cal. Ct. App. 2007).

[156] *Id.* at 140–41.

[157] No. HHBCV054008511S, 2007 WL 1019000 (Conn. Super. Ct. Mar. 22, 2007), *aff'd*, 965 A.2d 633 (Conn. App. Ct. 2009).

[158] *Id.* at *5.

[159] Chamberlin v. Advanced Equities, Inc., No. C01-502R, 2002 WL 34419450, at *3 (W.D. Wash. Jan. 17, 2002); *see also* IDS Bond Fund, Inc. v. Gleacher NatWest Inc., No. CIV. 99-116, 2002 WL 373455, at *7 (D. Minn. Mar. 6, 2002); Houston v. Seward & Kissel, LLP, No. 07CV6305, 2008 WL 818745, at *3 (S.D.N.Y. Mar. 27, 2008).

[160] Crosby v. Nat'l Foreign Trade Council, 530 U.S. 363, 373 (2000) (quoting Savage v. Jones, 225 U.S. 501, 533 (1912)).

quiry must move to implied preemption, which can occur through either field preemption or conflict preemption.

1. Field Preemption

Courts have found field preemption "when Congress 'so thoroughly occupies a legislative field,' that it effectively leaves 'no room' for states to regulate conduct in that field."[161] Conversely, there is no field preemption where Congress has shown "awareness of the operation of state law in a field of federal interest, and has nonetheless decided to stand by both concepts and to tolerate whatever tension there [is] between them."[162]

NSMIA was Congress's first of many opportunities to preempt state regulation of covered BD conduct, and it expressly declined to do so. NSMIA's allocation of jurisdiction between federal and state government was the product of intense cross-lobbying by the states and the industry, and Congress made a conscious effort through the years to preserve this balance.[163] After NSMIA, states continued to enforce their misconduct statutes against covered BDs, and Congress acquiesced.[164] Congress had the opportunity to speak in SLUSA and Sarbanes-Oxley as well as in Dodd-Frank, where it squarely addressed the issue of BD-provided investment advice.[165] However, it repeatedly chose to affirm the states' authority to enforce their own antifraud statutes and common law precedent.[166]

In *Zuri-Invest AG v. NatWest Finance Inc.*,[167] the court held that NSMIA did not preempt state common law claims.[168] The court reasoned that although NSMIA's savings clause does not expressly address the question, Congress unequivocally expressed that

[161] Whistler Invs., Inc. v. Depository Tr. & Clearing Corp., 539 F.3d 1159, 1164 (9th Cir. 2008) (quoting Cipollone v. Liggett Grp., 505 U.S. 504, 516 (1992)).

[162] CTS Corp. v. Waldburger, 573 U.S. 1, 18 (2014) (alteration in original) (quoting Wyeth v. Levine, 555 U.S. 555, 575 (2009)).

[163] Campbell, *supra* note 70, at 614.

[164] Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc., 552 U.S. 148, 163 (2008) ("[W]hile the views of subsequent Congresses cannot override the unmistakable intent of the enacting one, such views are entitled to significant weight, and particularly so when the precise intent of the enacting Congress is obscure." (alteration in original) (quoting Seatrain Shipbuilding Corp. v. Shell Oil Co., 444 U.S. 572, 596 (1980))).

[165] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828–30 (2010).

[166] People v. Greenberg, No. 401720/05, 2010 WL 4732745, at *14–15 (N.Y. Sup. Ct. N.Y. Cnty. Oct. 21, 2010).

[167] 177 F. Supp. 2d 189 (S.D.N.Y. 2001).

[168] *Id.* at 191.

NSMIA does not in any way affect the state's common law with respect to fraud and deceit in securities.[169] It also observed that NSMIA did not amend the saving provisions of either the 1933 Act or the 1934 Act, which affirm that the rights and remedies afforded by the federal law shall be "in addition to any and all other rights and remedies that may exist at law or in equity."[170] Courts have relied on *Zuri* to hold that NSMIA allows both state commissioners and private parties to bring state common law claims against BDs for conduct beyond fraud, including breach of fiduciary duties.[171] Recognizing the states' authority to bring common law claims against covered BDs while preempting states' efforts to codify those claims in their statutes would be absurd.

2. Conflict Preemption

Conflict preemption occurs where a court, considering the federal statute as a whole, determines that (1) it is not possible for parties to comply with both federal and state requirements, or that (2) in view of the federal statute's purpose and intended effects, the state law "poses an obstacle to the accomplishment of Congress's objectives."[172] Although BD compliance with state-heightened standards ensures that the federal standards are accomplished, onerous compliance costs could conflict with NSMIA's purpose of promoting efficient capital markets.[173]

States cannot enforce their antifraud and unethical conduct statutes in a manner that is designed to circumvent the limitations imposed by NSMIA, or in a manner that excessively burdens BD operations.[174] Even when the states decide to regulate solely on antifraud policing grounds, their regulations may create unintended "books and records" requirements, as BDs need to document compliance and create systems to supervise the conduct of their representatives.[175]

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[169] *Id.* at 193–94 (citing H.R. REP. NO. 104-622, at 33–34 (1996)).

[170] *Id.* at 194 (quoting 15 U.S.C. §§ 77p(a), 78bb(a)(2) (2018)).

[171] *See, e.g.*, *In re* Regions Morgan Keegan Sec., Derivative, & ERISA Litig., No. 09-2009, 2014 WL 12808159, at *5–6 (W.D. Tenn. July 29, 2014); Scognamillo v. Credit Suisse First Bos. LLC, No. C03-2061, 2005 WL 8162733, at *5 (N.D. Cal. Feb. 1, 2005).

[172] Whistler Invs., Inc. v. Depository Tr. & Clearing Corp., 539 F.3d 1159, 1164 (9th Cir. 2008) (citing Crosby v. Nat'l Foreign Trade Council, 530 U.S. 363, 372–73 (2000)).

[173] SIFMA, *supra* note 17, at 2.

[174] 15 U.S.C. § 78o(i)(1).

[175] Libowsky & Strashun, *supra* note 102.

The holdings in *Edward D. Jones* and *Brown* support the proposition that incidental recordkeeping burdens arising from state regulations and enforcement actions targeting BD *conduct* may be tolerated. However, in *Dahl v. Charles Schwab & Co.*,[176] the Minnesota Supreme Court found that claims against a BD brought under Minnesota's common law of agency and Minnesota's consumer protection statutes were impliedly preempted by federal law because they conflicted with Congress's and the SEC's understanding of efficient capital formation.[177] Consequently, if these "incidental effects" of policing misconduct are too burdensome for the industry, they can hinder the purpose of the statute and lead to conflict preemption.

IV. NSMIA DOES NOT PREEMPT STATE FIDUCIARY RULES THAT ARE REASONABLY CONSISTENT WITH THE FIDUCIARY DUTIES IMPOSED BY JUDICIAL PRECEDENT

In light of NSMIA's dual purpose, disposition of the current legal controversy hinges on whether the burdens to market efficiency outweigh the benefits of added protections to investors.[178] As the SEC has noted when it promulgated Reg BI, preemption of state fiduciary regulations must be assessed on a case-by-case basis.[179] The imposition of statutory fiduciary duties on BDs does not necessarily create excessive compliance requirements, because courts already find BDs are fiduciaries under certain circumstances. The impact on the industry depends on the scope of the duties imposed by the fiduciary rule in question.

State-specific rules that impose IA fiduciary duties on BDs can create substantial compliance costs for BDs, especially for those operating on a national level. Unlike smaller, state-based firms, nationwide firms bear the costs of implementing the fiduciary standards on a national scale, and when some states adopt higher fiduciary standards, the highest state standard becomes the rule across the board.[180] The more state statutory standards depart from the federal requirements, the more implementation costs burden BDs' nationwide operations, potentially leading to less affordable options for consumers seeking advice. However, state statutes that shadow common law fiduciary standards, as

[176] 545 N.W.2d 918 (Minn. 1996).
[177] *Id.* at 925.
[178] *See supra* Section II.A.
[179] *See supra* text accompanying note 107.
[180] Crawley, *supra* note 58, at 427–28.

applied to BDs, would not result in excessive compliance costs. First, case law precedent has been sensitive to the nature of the BD business model. Second, both state and nationwide firms were *already* subject to those standards. Third, reference to established common law principles would lead to consistency among state-specific statutes, which would reduce the burdens of regulatory balkanization. Last, even in states that adopt the strictest BD fiduciary standards imposed by the common law,[181] empirical studies show that the relatively stricter fiduciary standard of care does not impact BDs' ability to provide a broad range of products and services to consumers.[182]

States can further moderate the adverse impact on the industry by effectively tailoring the scope of the fiduciary duty and by clearly defining its triggers. For instance, one of the main problems facing BDs under some of the proposed rules is that standalone investment recommendations could trigger IA duties that include continuous account monitoring. Ongoing account monitoring conflicts with the BD "transactional" model and could carry significant compliance costs. State fiduciary rules can eliminate these burdens by limiting the application of the fiduciary duties to the duration of the transaction.

For example, the rule adopted by Massachusetts acknowledges that BDs often satisfy demands for one-time recommendations that do not rise to the level of continued strategic advice.[183] Consequently, the fiduciary duty imposed by the rule is limited to the period where the incidental advice is made, and the advice is only deemed "ongoing" when: (1) the account is discretionary; (2) there is "a contractual fiduciary duty"; or (3) there is "a contractual obligation to monitor."[184] New Jersey's proposed rule contains similar terms, and also imposes an ongoing duty if the BD is acting as an adviser or is dually registered as an IA.[185]

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[181] *See supra* Section I.B.2.

[182] Michael Finke & Thomas P. Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice*, J. FIN. PLANNING, July 2012, at 28, 36, https://www.financialplanningassociation.org/sites/default/files/2020-09/JUL12%20JFP%20Finke.pdf [https://perma.cc/JJ7Z-5K35].

[183] Mass. Adopting Release, *supra* note 15, at 3–4.

[184] 950 MASS. CODE REGS. 12.207(1)(b) (2020).

[185] Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (proposed April 15, 2019) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(a)); *see also* Kevin Smedley, Note, *New Jersey's Rule Proposal for Applying a Uniform Fiduciary Standard to Broker-Dealers: Why State Fiduciary Action Is Required To Protect Investors*, 15 RUTGERS BUS. L. REV. 304, 323–27 (2020) (addressing New Jersey's proposed rule).

Both rules impose an ongoing duty to monitor in special circumstances, which is consistent with the precedent established by the courts in *Capital Gains*[186] and in *Leib*.[187]

Massachusetts incorporated breach of fiduciary duties to the list of BD "conduct [and] practices" deemed "unethical or dishonest" by the state's securities laws.[188] Its rule imposes clearly defined duties of "utmost care and loyalty" on BDs and their agents who provide investment advice or recommend investment strategies, account transfers, or security exchanges.[189] The duty of care as outlined by both Massachusetts and New Jersey requires that BDs make a "reasonable inquiry" into the "risks, costs, and conflicts" related to the investment advice they give and consider the client's particular circumstances, taking into account "any other relevant information."[190] The duty of loyalty requires that BDs make recommendations "without regard to the financial or any other interest of any party other than the customer."[191] This standard goes further than Reg BI, because it requires more than putting a client's interest first: it requires BD agents to put aside their personal interests completely when making a recommendation. However, the enhanced fiduciary standard in both rules is in line with traditional agency law, and it is plainly consistent with the standard Dodd-Frank contemplated for BDs who give investment advice to retail investors: a standard "no less stringent than the standard applicable to" IAs under the Advisers Act, requiring action "without regard to the financial . . . interest of the broker."[192]

The Massachusetts rule engages in a balancing act. Unlike the New Jersey proposal, the Massachusetts duty of loyalty requires BDs to disclose "all material conflicts of interest," but it

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[186] *See supra* text accompanying notes 49–52.

[187] *See supra* text accompanying notes 79–82.

[188] 950 MASS. CODE REGS. 12.207(1).

[189] *Id.* 12.207(1)(a), (2).

[190] *Id.* 12.207(2)(a); Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(1)).

[191] *See* 950 MASS. CODE REGS. 12.207(2)(b); Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(2)).

[192] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1828–29 (2010) (codified in relevant part at 15 U.S.C § 80b-11(g)).

does not impose specific disclosure requirements.[193] It also requires BDs to "[m]ake all reasonably practicable efforts" to avoid, eliminate, or mitigate conflicts of interest, but it allows them to mitigate those conflicts that are intrinsic to the BD model and cannot be reasonably avoided.[194] The rule only establishes a presumption of breach when BD agents make recommendations in connection to sales contests.[195] Massachusetts' rule further protects investors by stating that mere disclosure of conflicts does not satisfy the duty of loyalty.[196] However, in line with established common law principles of agency, the rule excludes sophisticated parties such as banks, IAs, and institutional investors from its scope of operation.[197] In sum, Massachusetts (1) imposes IA duties on BDs when "special circumstances" are present, and (2) shapes the scope of the duties to preserve the existing BD model.[198] For these reasons, NSMIA should not preempt Massachusetts's rule.

Nevada's proposed rule, on the other hand, is problematic. First, its BD duties are ongoing by default, and BDs must comply with detailed requirements to avail themselves of an "Episodic Fiduciary Duty Exemption."[199] Second, the rule establishes a presumption that BDs owe a broad fiduciary duty to their clients, and then proceeds to enumerate some exceptions—the opposite of the common law majority rule.[200] Third, some portions of the rule are too broad and result in vagueness, unnecessarily increasing BD

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[193] 950 MASS. CODE REGS. 12.207(2)(b)(1); *cf.* Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(2)).

[194] 950 MASS. CODE REGS. 12.207(2)(b)(2). For example, receiving compensation for a recommendation would technically be a conflict. Mass. Adopting Release, *supra* note 15, at 5–6. However, BDs cannot reasonably avoid it within their current business model, so the rule only requires BDs to mitigate it. *Id.* Similarly, New Jersey would allow BDs who meet the duty of care to receive transaction-based remuneration and commissions that are "reasonable and [are] the best of the reasonably available fee options." Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(3)).

[195] 950 MASS. CODE REGS. 12.207(2)(d); *cf.* Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(2)(i)).

[196] 950 MASS. CODE REGS. 12.207(2)(c); *cf.* Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(b)(2)(ii)).

[197] 950 MASS. CODE REGS. 12.207(3); *cf.* Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(c)).

[198] PIABA*, Where We Stand*, 26 PIABA B.J. 361, 391 (2019).

[199] Notice of Draft Regulations and Request for Comment, *supra* note 15, § 2.

[200] *Id.* § 9.

liability exposure and related compliance costs.[201] Last, unlike the Massachusetts rule, the Nevada rule requires compliance with extensive specific disclosures in addition to those required by Reg BI.[202] Because these disclosure requirements add actuarial and recordkeeping burdens without adding protections to investors, they are likely preempted.

State regulators can also minimize implied compliance costs by expressly stating that any books and records requirements arising from the new fiduciary statutes are deemed satisfied through compliance with the federal requirements in 15 U.S.C. § 78o(i).[203] State regulators could similarly avoid conflict preemption risks arising from the written requirements of FINRA supervisory rule 3110[204] by expressly stating that the rule does not establish any written supervision procedures that differ from, or are in addition to, those required under federal securities laws and regulations, and applicable FINRA rules.

To conclude, by effectively tailoring their statutes' language and operation, states can boost investor protection beyond the federal law baseline without risking conflict preemption.

V. STATE FIDUCIARY RULES FURTHER PUBLIC TRUST IN THE MARKETS, WHICH IS KEY TO A HEALTHY ECONOMY AND GOOD PUBLIC POLICY

When state rules carefully balance the competing interests embraced by NSMIA, the added protections to investors outweigh the incidental burdens of duplicative regulation. Moreover, such state rules can add efficiency to the capital markets in several ways.

To an individual investor, the cost of conflicted advice on returns is one percentage point each year.[205] To the United States, these

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[201] *See, e.g.*, *id.* §§ 2, 5.

[202] *Id.* § 7. For example, the rule requires disclosure of actual gains. *Id.* These are hard to determine at the time of the transaction and would often require disclosures after conclusion of the transaction.

[203] *See, e.g.*, 950 MASS. CODE REGS. 12.207(5) (2002) ("Nothing in [this section] shall be construed to establish any requirements for capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operational reporting for any broker-dealer or agent that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78*o*(i)."); Fiduciary Duty of Broker-Dealers, Investment Advisers, and Agents, 51 N.J. Reg. 493(a) (proposed April 15, 2019) (to be codified at N.J. ADMIN. CODE § 13:47A-6.4(e)) (same).

[204] *See supra* note 69 and accompanying text.

[205] COUNCIL OF ECON. ADVISERS ("CEA"), THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS 25 (2015), https://obamawhitehouse.archives.gov/

aggregate costs can add up to $17 billion per year.[206] A recent study of the annuities markets suggests that contracts sold by BDs with fiduciary duties are about five percent more valuable than contracts sold by BDs without fiduciary duties.[207] A modest annual increase of $1,000 in savings per investor could save the country "$33 billion on public assistance programs between 2018 and 2032."[208] That is efficient.

If states enforce higher fiduciary standards on BDs providing investment advice, industry participants will likely find cost-effective ways to comply. BDs have strong incentives to continue providing services in the states where they operate. In Massachusetts, for example, "hundreds of thousands" of consumers who hold BD accounts seek "episodic brokerage advice."[209] The need for financial advice will continue to rise with the wave of retiring Baby Boomers.[210] BDs are unlikely to walk away from these profitable markets, especially where state fiduciary rules allow them to preserve their transaction-based model.

Reliable investment advice is key to healthy capital markets.[211] Retail investor interactions with financial advisors are seldom at arm's length. The law has traditionally imposed a fiduciary duty on the dominant party to reduce agency cost risks to the client and encourage participation: individual investors who do not trust their financial advisors are less likely to participate in the capital markets.[212] Studies show that in complex societies the level of economic prosperity is directly related to the level of trusting rela-

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sites/default/files/docs/cea_coi_report_final.pdf [https://perma.cc/X723-L9QL].

[206] *Id.*

[207] Vivek Bhattacharya et al., *Fiduciary Duty and the Market for Financial Advice* 26 (Nat'l Bureau of Econ. Rsch., Working Paper No. 25861, 2019), https://retirementincomejournal.com/wp-content/uploads/2019/05/NBER-Regs-and-Annuities-5-19.pdf [https://perma.cc/9J6A-MAE5].

[208] William Shiflett & Catherine Harvey, *The U.S. Could Save $33 Billion by Helping People Save for Their Own Retirement*, AARP PUB. POL'Y INST. (Feb. 2018), https://www.aarp.org/content/dam/aarp/ppi/2017/National.pdf [https://perma.cc/RG9J-CK8M].

[209] SIFMA, *supra* note 100, at 7.

[210] James Sanford, *Aging Baby Boomers, Rising Millennials Will Shake up the Investment Landscape*, THESTREET (Sep. 1, 2016, 9:31 AM), https://www.thestreet.com/opinion/aging-baby-boomers-rising-millennials-will-shake-up-the-investment-landscape-13684738 [https://perma.cc/8TS8-4VMH].

[211] Rhoades, supra note 83, at 28.

[212] Luigi Guiso et al., *Trusting the Stock Market* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 11648, 2005), https://www.nber.org/papers/w11648.pdf [https://perma.cc/8UJB-QC5J].

tionships between its members.[213] As much as investors value cheaper, transaction-based advice, conflicted advice comes with hidden costs. From a business perspective, trust is also key to attracting millennial investors, who have a deep sense of distrust in the financial services industry and largely chose do-it-yourself ("DIY") investment platforms.[214] State fiduciary rules that harness the wisdom of common law agency principles encourage and reward trust in the financial system, which in turn contributes to market efficiency and capital formation.[215]

Even when they largely mirror protections afforded to investors by the common law, state fiduciary rules bring added value. First, they inject predictability into the system. Judicial precedent applying fiduciary duties to BDs does not define BD duties with precision and is "widely inconsistent."[216] Many cases are solved through arbitration, which leads to a paucity of well-reasoned decisions and contributes to arbitrary fact finding and unpredictable outcomes.[217] State fiduciary rules signal to investors that their financial interests will be protected in consistent ways, and give BDs concrete guidance on how to effectively avoid liability. Second, state fiduciary rules incentivize a shift in BD culture. They reflect investors' expectation that a BD representative recommending an investment is not just a salesperson, but someone who holds a position of high responsibility and integrity. Moreover, they incentivize the industry to develop low-cost, quality advice alternatives to the traditional models, which BDs will need to thrive in a skeptical consumer market that is quickly shifting to cheap e-platforms and robo advisers.[218]

The economic efficiency achieved by NSMIA's strategic allocation of duties between the federal government and the states is enhanced when states invest more in antifraud enforcement, and all state efforts to deter unethical conduct should be encouraged.[219] The broad purposes of securities laws are served when the federal

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[213] Tamar Frankel, *Trusting and Non-Trusting: Comparing Benefits, Cost and Risk* 13 (Bos. U. Sch. of Law, Working Paper No. 99-12, 1999), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=214588.

[214] Sanford, *supra* note 210.

[215] *See supra* Section I.B.2; *see also* Smedley, *supra* note 185, at 336.

[216] Crawley, *supra* note 58, at 429.

[217] *Id.* at 429–30.

[218] Lisa Beilfuss, *The Price of Financial Advice Is, Finally, Falling*, WALL ST. J. (Oct. 7, 2018, 10:17 PM), https://www.wsj.com/articles/the-price-of-financial-advice-is-finally-falling-1538965020 [https://perma.cc/69Q8-XARY]; *see also* CEA, *supra* note 205, at 21.

[219] Campbell, *supra* note 70, at 627.

and state governments coordinate their efforts to foster corporate responsibility, transparency, and integrity.

State rules that incorporate the protections traditionally recognized by the common law are better suited than a uniform federal rule to achieve these goals. Policing misconduct and protecting the public interest are within states' historical powers. State autonomy fosters experimentation and more efficient regulations. A state is in a better position than the federal government to assess the behavior of its citizens as securities consumers, to detect new deceptive and unethical schemes, and to devise regulations tailored to the specific issues faced by investors in the state.[220]

Federal regulators are hesitant to take actions with unpredictable systemic effects on the market, and state innovation reduces systemic risks while providing concrete data that Congress can consider in future legislative initiatives.

CONCLUSION

State fiduciary rules are not necessarily preempted by NSMIA because they fall within the area reserved to the states by NSMIA's antifraud savings clause. State common law precedents imposing fiduciary duties on BDs are not preempted, and allowing states to enforce their common law fiduciary standards while preempting their codification of those standards would be absurd. Congress has acquiesced to state enactment of broad unethical conduct rules, and state fiduciary rules are a logical outgrowth of this practice. State fiduciary rules aimed at BD conduct are not expressly preempted, even if they imply incidental book- and recordkeeping burdens. However, states should avoid imposing fiduciary schemes that excessively burden BD operations. Fiduciary rules that (1) impose ongoing monitoring requirements only when justified by the nature of the broker-client relationship, and (2) preserve the traditional BD commission-based fee structure are likely not preempted. Last, allowing states to apply heightened fiduciary standards to the BDs who shape their citizens' financial future is sound public policy: it preserves efficient markets and the right of investors to rely on the kind of advice that will make their choices informed, and free.

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[220] Chase Ponder, *Fiduciary Standards and Best Interests: Should States Take the Lead?*, 24 N.C. BANKING INST. 241, 268–69 (2020).