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Massachusetts Follows in New Jersey's Footsteps by Proposing Similar Fiduciary Duty Rule Applicable to Broker-Dealers and Investment Advisers

Massachusetts' fiduciary duty proposal is the first such action of any state in the wake of the Securities and Exchange Commission's adoption of Regulation Best Interest, and its close similarity to New Jersey's proposal may suggest a model is emerging.

A mere nine days after the Securities and Exchange Commission (SEC) voted to approve its standards of conduct rulemaking, including Regulation Best Interest (https://fiduciarygovernanceblog.com/2019/06/06/sec-adopts-regulation-best-interest-form-crs-and-advisers-act-interpretations/), the Massachusetts Securities Division (Division) circulated for preliminary comment a regulation (https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/Regulations-as-amended-clean.pdf) that would impose a fiduciary standard of care on broker-dealers and investment advisers. The June 14 announcement (https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryconductstandardidx.htm) by the Division marked the first state to respond to the SEC's adoption of its own standard of conduct rulemaking. The Massachusetts proposal (Proposal) is also *very similar* to the New Jersey uniform fiduciary duty proposal (https://fiduciarygovernanceblog.com/2019/04/16/new-jersey-proposes-uniform-fiduciary-standard/). As further described below, the comment period for the Proposal closes on **July 26**.

William F. Galvin, Secretary of the Commonwealth of Massachusetts

Before delving into the Proposal, we note some big picture considerations:

1. The fact that the Proposal is so similar to New Jersey's may suggest an emerging model of regulation with respect to uniform standards of conduct is afoot. This would be a double-edged sword in that it would result in less variance among the state approaches to standards of conduct, while also magnifying the scope and interpretive issues of, and preemption issues related to (https://fiduciarygovernanceblog.com/2019/04/16/new-jersey-proposes-uniform-fiduciary-standard/), the New Jersey proposal.

2. As the Proposal goes beyond Regulation Best Interest, federal preemption – including by reason of the National Securities Markets Improvements Act – will come into sharper focus. The Proposal,

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as with New Jersey's, seeks to address preemption concerns for broker-dealers by providing that it does not establish "any requirements for capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting for any broker-dealer or agent that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78o(i)."

3. The Proposal is the first formal response from a specific state in the wake of the SEC standards of conduct package. The Division made numerous criticisms of the SEC rulemaking, including:

    a. Regulation Best Interest did not define "best interest";

    b. Regulation Best Interest "sets ambiguous requirements for how longstanding conflicts in the securities industry must be addressed under the new rule";

    c. The SEC failed "to indicate whether some of the most problematic practices in the securities industry would be prohibited under the new rule." For example, while the Division acknowledged that Regulation Best Interest would disallow product-specific sales contests, "it did not indicate that broader-based sales contests or quotas would be contrary to its requirements"; and

    d. At least "in many instances," the mitigation of conflicts of interest required under Regulation Best Interest can be achieved through *disclosure* on Form CRS (see below on how the Proposal addresses disclosure as a method to address conflicts of interest).

4. Absent the SEC adopting a uniform fiduciary duty standard, the Division appears to have been unlikely to be swayed by an SEC rulemaking, as the Division all but admitted in its press release. Previous enforcement actions (https://fiduciarygovernanceblog.com/2018/06/12/galvin-asserts-that-state-law-was-basis-for-complaint-against-scottrade/) brought by the Division, and statements by William Galvin (https://fiduciarygovernanceblog.com/2018/08/10/states-not-backing-away-from-fiduciary-standard/), its head, were also prior warnings that the Division would proceed with the Proposal despite the SEC rulemaking.

Below is a summary of the core components of the Proposal.

- **Recommendations:** The Proposal covers advice or recommendations by a broker-dealer or investment adviser, or their respective agents or representatives, with respect to (1) an investment strategy; (2) the opening of, or transfer of assets to, any type of account (including recommendations to open IRA roll-over accounts); or (3) the purchase, sale or exchange of any security.

    - For purposes of the Proposal, an "adviser" means "any person, including persons registered or excluded from registration under M.G.L. c. 110A, who receives any consideration from another person primarily for advising the other person as to the value of securities or their purchase and sale, whether through the issuance of analyses or reports or otherwise." The Proposal adds that, "[i]t is a rebuttable presumption that such term includes all investment advisers and investment adviser representatives, as well as other persons who charge fees based on assets under management or portfolio performance for rendering investment advice."

- ***Retail Investors:*** The Proposal applies to advice and recommendations that are provided to a "customer" or "client." The Proposal defines these terms by what they are not, namely, by excluding (1) a bank, savings and loan association, insurance company, or registered investment company; (2) a broker-dealer registered with a state securities commission (or agency or office performing like function); (3) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like function); and (4) certain "institutional buyers," within the meaning of 950 CMR 12.205(1)(a)6 (e.g., an organization described in Section 501(c)(3) of the Internal Revenue Code with a securities portfolio of more than $25 million, an investing entity whose investors are only accredited investors, as defined in Rule 501(a) of the Securities Act of 1933, and each of whom has invested a minimum of $50,000, etc.). Regulation Best Interest, in contrast, applies to recommendations made to natural persons acting for their own account, regardless of sophistication.

- ***Fiduciary Duties:*** The advice or recommendation by a broker-dealer, agent, or investment adviser must satisfy the duties of care and loyalty.

  - **Duty of Care:** A broker-dealer, agent or adviser must 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." The Proposal indicates that, specifically, this duty requires a broker-dealer, agent or adviser to "make reasonable inquiry, including risks, costs, and conflicts of interest related to the recommendation or investment advice, the customer's or client's investment objectives, financial situation, and needs, and any other relevant information."

  - **Duty of Loyalty:** The duty of loyalty requires a broker-dealer, agent or adviser "to avoid conflicts of interest," and that each recommendation or advice is made *without regard to* the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity or its officers, directors, agents, employees or contractors, or any other third party.

  - **Disclosure of Conflicts of Interest:** There is no presumption "that disclosing a conflict of interest alone" satisfies the duty of loyalty. This will attract a lot of attention because, *generally speaking*, disclosure under the Investment Advisers Act of 1940, as amended (including the new Interpretive Release (https://fiduciarygovernanceblog.com/2019/06/14/sec-issues-interpretive-release-on-investment-adviser-standard-of-conduct/), and under Regulation Best Interest (https://fiduciarygovernanceblog.com/2019/06/06/sec-adopts-regulation-best-interest-form-crs-and-advisers-act-interpretations/)), may be sufficient to cure many conflicts of interest.

  - **Problematic Practices:** There is a presumption of a breach of the duty of loyalty "for offering, or receiving, direct or indirect compensation to or from a broker-dealer, agent, or adviser for recommending an investment strategy, the opening of, or transferring of assets to a specific type of account, or the purchase, sale, or exchange of any security that is not the *best of* the reasonably available options for the customer or client." The sale of proprietary products, principal transactions, and broad-based sales contests/quotas, are likely implicated here.

  - **Transaction-Based Remuneration:** The Proposal states that there would *not* be presumed

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a breach of the duty of loyalty for the broker-dealer, agent or adviser to receive transaction-based remuneration if the amount is reasonable and it is the *best of* the reasonably available remuneration options for the customer or client. The Proposal does not explain how a broker-dealer could demonstrate that a commission, for instance, is the best of the reasonably available fee options, a shortcoming we also identified with the New Jersey proposal.

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- ***Duration of Fiduciary Duties:*** If a broker-dealer, agent or adviser makes a *standalone* recommendation, the fiduciary duties "extend through the execution of the recommendation and shall not be deemed an ongoing obligation." Importantly, if a broker-dealer, agent or adviser (1) makes ongoing recommendations, (2) provides investment advice in any capacity to the customer/client, or (3) receives ongoing compensation in connection with the recommendation or advice, then the fiduciary duty is deemed to be ongoing. This raises the possibility that broker-dealers will have ongoing fiduciary duty for recommendations made to a retail investor's brokerage account when either that broker-dealer (1) is dually registered and also provides investment advisory services to the same investor or (2) separately provides investment advice to the investor.

- ***Exclusion of ERISA Plans:*** The Proposal specifically excludes from coverage any recommendation or advice given by a fiduciary to an employee benefit plan, or its participants or beneficiaries, under the Employee Retirement Income Security Act of 1974, as amended (ERISA). This exclusion does not appear to extend to communications to ERISA plan participants that are not fiduciary in nature under ERISA, such as investment education.

Written comments on the Proposal must be received no later than **Friday, July 26, 2019 at 5:00 p.m**.

Submission via Mail
Please mail any comments on the proposed amendments to:

Office of the Secretary of the Commonwealth
Attn: Proposed Regulations – Fiduciary Conduct Standard
Massachusetts Securities Division
One Ashburton Place, Room 1701
Boston, MA 02108

Submission via Facsimile
Faxed comments may be sent to 617-248-0177. Comments sent via facsimile should include a cover sheet to the attention of "Proposed Regulations."

Submission via Email
Email comments or submissions of scanned comment letters attached to an email may be submitted to securitiesregs-comments@sec.state.ma.us.

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