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# Massachusetts Broker-Dealers Now Owe Fiduciary Duties to Retail Customers

The Massachusetts Securities Division (MSD) on Friday[1] issued Final Regulations (http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/Amended-Regulations.pdf) that impose a fiduciary standard of care on broker-dealers and their agents when they make recommendations and provide investment advice to customers with respect to an investment strategy, the opening of, or transferring of assets to, any type of account, or the purchase, sale or exchange of any security.[2] The MSD made a number of important changes from its proposal, which we highlight below, but one notable change worthy of mention at the outset is that investment advisers and investment adviser representatives are not subject to the Final Regulations. Here are the key points:

- The Final Regulations' effective date will be March 6, 2020; however, the Final Regulations will not be enforced until September 1, 2020.[3] This gives firms some time to review their policies and procedures for compliance with the Final Regulations.

- The standard of care consists of the duty of care and the duty of loyalty.

  - **Duty of Care:** The duty of care requires a broker-dealer or agent to use the care, skill, prudence, and diligence that a person acting in a like capacity and familiar with such matters

would use, taking into consideration all of the relevant facts and circumstances. For purposes of this paragraph, a broker-dealer or agent shall make reasonable inquiry, including the risks, costs, and conflicts of interest related to all recommendations made and investment advice given, the customer's investment objectives, risk tolerance, financial situation, and needs, and any other relevant information.

- **Duty of Loyalty:** The duty of loyalty requires a broker-dealer or agent to disclose all material conflicts of interest, make all reasonably practicable efforts to avoid conflicts of interest, eliminate conflicts that cannot reasonably be avoided, and mitigate conflicts that cannot reasonably be avoided or eliminated, and make recommendations and provide investment advice without regard to the financial or any other interest of any party other than the customer.
    - The duty of loyalty cannot be satisfied without disclosure of all material conflicts of interest.
    - MSD emphasized in the adopting release of the Final Regulations, "not all conflicts must be avoided. Likewise, not all conflicts must be eliminated. Accordingly, conflicts that arguably could be avoided or eliminated do not need to be if it would not be reasonable for a broker-dealer or agent to do so."
    - The MSD conceded that transaction-based compensation "cannot reasonably be avoided or eliminated." Moreover, the recommendation and sale of proprietary products, and sales in principal transactions also cannot reasonably be avoided or eliminated. MSD indicated that, in this instance, "the broker-dealer and agent may mitigate this conflict by, for example, ensuring that the fee earned for the recommendation is reasonable and complying with the remainder of the fiduciary duty."
    - The adopting release (http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/Adopting-Release.pdf) emphasized that disclosure of conflicts alone does not satisfy the duty of loyalty.
    - The Final Regulations creates a presumption that a recommendation made in connection with any sales contest violates the duty of loyalty.[4]

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- As a general matter, the broker-dealer's fiduciary duty runs during the period in which incidental advice is made in connection with the recommendation of a security to the customer.[5] Only when the broker-dealer or its agent act "outside the traditional broker-dealer customer relationship" will the fiduciary duties apply for a longer period:
    - Where the broker-dealer or agent has discretionary authority over the customer's account (ongoing duration).
    - Where there is a contractual obligation that imposes a fiduciary duty (duration based on contract).
    - Where the contract provides that the broker-dealer or agent shall monitor of the account (duration based on contract).
- Though the proposal covered advice on *commodities* and insurance products, MSD opted not to include them within the scope of the Final Regulations.
- The Final Regulations no longer include a presumption that the use of certain titles by a broker-dealer or agent imposed an ongoing duty.
- The term "customer" includes *current and prospective* customers, but does not include: (a) a bank, savings and loan association, insurance company, trust company, or registered investment company; (b) a broker-dealer registered with a state securities commission (or agency or office performing like functions); (c) an investment adviser registered 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 functions); or (d) any other institutional buyer, as defined in 950 CMR 12.205(1)(a)6. and 950 CMR 14.401. The MSD declined to clarify whether a customer needed to have a legal address in Massachusetts or otherwise be a resident of the Commonwealth.
- Broker-dealers not subject to these fiduciary duties remain subject to the existing suitability standard.
- The Final Regulations retain the exclusion for person acting in the capacity of a fiduciary to an employee benefit plan, its participants, or its beneficiaries, as those terms are defined in the Employee Retirement Income Security Act (ERISA). Moreover, the Final Regulations retain the provision that they do not establish any capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operational reporting requirements for any broker-dealer or agent that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78o(i).

It is possible the Final Regulations will be challenged in Federal court on preemption grounds. If the Final Regulations withstand court scrutiny, then it is also possible other states will move forward with their own versions modeled off the Final Regulations.[6]

[1] We were somewhat surprised by how quickly MSD moved toward finalization after the comment period closed on January 7, 2020 re. the proposed regulations, especially because Governor Charlie Baker released a comment letter (https://fiduciarygovernanceblog.com/2020/01/14/update-on-massachusetts-uniform-fiduciary-rule/) asking the MSD to delay a final promulgation of these rules.

[2] The failure to adhere to the fiduciary standard of utmost care and loyalty will be deemed a dishonest or unethical practice under M.G.L. c. 110A, § 204(a)(2)(G).

[3] Unlike the Department of Labor Fiduciary Rule transition period, the Final Regulations do not appear to leave open the possibility of enforcement via private rights of action.

[4] The proposal also created a presumption that recommendations made in connection with implied or express quota requirements or other special incentive programs constituted breaches of the duty of loyalty. This additional presumption did *not* make it into the Final Regulations.

[5] The proposal imposed a fiduciary duty during any time in which the broker-dealer or agent received ongoing compensation or provided investment advice to the customer in connection with other non-brokerage financial advice. Commenters expressed concern to the MSD that this proposed provision may violate the "incidental" exemption from the Investment Advisers Act of 1940. The MSD removed this provision from the Final Regulations.

[6] New Jersey (https://fiduciarygovernanceblog.com/2019/04/16/new-jersey-proposes-uniform-fiduciary-standard/), Nevada (https://fiduciarygovernanceblog.com/2019/01/22/nevada-proposes-sweeping-fiduciary-regulation/), New York (https://fiduciarygovernanceblog.com/2019/01/31/ny-senate-considering-companion-bill-to-dinowitzs-proposed-investment-transparency-act/), Maryland (https://fiduciarygovernanceblog.com/2019/04/04/as-reported-maryland-fiduciary-bill-fades-away/) and Illinois (https://fiduciarygovernanceblog.com/2019/03/18/illinois-disclosure-bill-put-on-back-burner/) have all floated legislative or regulatory fiduciary proposals. None have been finalized yet.