The Asset Management Industry
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**MEMO# 32242**

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# Massachusetts Finalizes Amendments to Fiduciary Conduct Standard Regulations

[32242]

February 26, 2020 TO: ICI Members
Bank, Trust and Retirement Advisory Committee
Broker/Dealer Advisory Committee
Chief Compliance Officer Committee
Investment Advisers Committee
Operations Committee
Pension Committee
Pension Operations Advisory Committee
SEC Rules Committee
Small Funds Committee
Transfer Agent Advisory Committee
Variable Insurance Products Advisory Committee SUBJECTS: Compensation/Remuneration
Distribution
Fees and Expenses
Investment Advisers
Pension
State Issues RE: Massachusetts Finalizes Amendments to Fiduciary Conduct Standard Regulations

On February 21, 2020, the Massachusetts Securities Division (the "Division") released final amendments to its fiduciary conduct standard regulations, which will impose a fiduciary duty on broker-dealers and agents.[1] These amendments will become effective on March 6, 2020, the date of their publication in the Massachusetts Register. The Division will begin enforcing the amended regulation on September 1, 2020.

## Background

The flurry of state activity regarding standards of conduct in the last few years was prompted by the demise of the Department of Labor's 2016 fiduciary rule. Many state regulators strenuously opposed the SEC's Regulation Best Interest (Reg BI), asserting that it would not adequately protect their residents. While Massachusetts was not the first state to respond with heightened standards, it has moved the most quickly. On June 14, 2019, the Division issued a Preliminary Solicitation.[2] In December 2019, the Division released an official Proposal, using the feedback it received on the Preliminary Solicitation.[3] The Division released its final regulation on February 21, 2020, only 46 days after the end of the

comment period for the Proposal.

## Substance of Amendments

While the Division retains the structure of earlier versions for the final regulation, it has removed some of the most problematic provisions that would have made it more likely that the Division would face lawsuits over the regulation.

### Structure and Scope

The Division structured its regulation to impose a fiduciary duty on certain financial professionals and provide that the failure to act in accordance with a fiduciary duty when providing investment advice or a recommendation will constitute a dishonest or unethical conduct or practice. Both the Preliminary Solicitation and the Proposal would have applied this fiduciary conduct standard to broker-dealers, agents, investment advisers, and investment adviser representatives. In its final regulation, the Division narrowed the application of the amendment, imposing the fiduciary standard only on broker-dealers and agents.

This change is significant because it better reflects the Division's authority under the National Securities Markets Improvement Act of 1996 (NSMIA). Notably, NSMIA expressly limited states' authority over Federally-registered investment advisers to investigating and bringing

enforcement actions with respect to fraud and deceit.[4] The SEC, in turn, has interpreted the states' ability to regulate fraud and deceit narrowly.[5]

The final regulation does not apply to recommendations regarding municipal securities or insurance products.

### Duration of Fiduciary Duty

In the Proposal, the Division had extended the duration of the fiduciary duty in a number of ways that raised significant concerns from the industry. According to the Division, many commenters argued that this section "imposed an ongoing duty on a broker-dealer or agent where one otherwise would not exist."[6] The Division removed these problematic provisions so that under the final regulation, a fiduciary duty will be deemed an ongoing duty only if the broker-dealer or agent (1) has or exercises discretion in a customer's account, unless the discretion relates solely to the time and/or price for the execution of the order, (2) has a contractual fiduciary duty, or (3) has a contractual obligation to monitor a customer's account on a regular or periodic basis, as such regular or periodic basis is determined by agreement with the customer.

In addition, the Proposal had provided that the fiduciary duty would be ongoing if the broker-dealer or agent (1) receives ongoing compensation or charges ongoing fees for advising a client, either directly or through publications or writings, as to value of securities or as to the advisability of investing in, purchasing, or selling securities, or providing the foregoing services as an integral component of other financially related services,[7] or (2) engages in any act or practice that results in the a client having a reasonable expectation that the financial professional will monitor the account on a regular or periodic basis. For purposes of item (2), the Proposal specified that the use of a title including certain terms would constitute such an act or practice and would result in an ongoing fiduciary duty.[8] Notably, the omission of items (1) and (2) from the final regulation results in the regulation

being more closely aligned with the SEC's Reg BI.

**Duties of Care of Loyalty**

The final regulation provides that a broker-dealer or agent must adhere to the duties of "utmost" care and loyalty.

The duty of care provision is unchanged from the Proposal. It provides that when making a recommendation or providing investment advice, the broker-dealer or agent 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 duty of loyalty requires a broker-dealer or agent to (1) disclose all material conflicts of interest, (2) 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,[9] [emphasis added] and (3) make recommendations and provide investment advice without regard to the financial or any other interest of any party other than the customer. While the "without regard to" language raised industry concerns, the Division declined to modify this language in the final regulation.

Under the final regulation, a breach of duty will be presumed in any case when a recommendation is made in connection with any sales contest.[10] Note the contrast between this provision and Reg BI, which requires firms to have policies and procedures reasonably designed to eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or types of securities within a limited period of time.

**Carveouts**

The final regulation includes the following carveouts from the rule, unchanged from the Proposal.

1. The final regulation appears intended to address NSMIA preemption by stating that nothing in the regulation should be "construed to 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 those required under federal security law.[11]
2. The regulation appears intended to address ERISA preemption by carving out broker-dealers and agents acting as ERISA fiduciaries to an employee benefit plan or to its plan participants and beneficiaries.
3. The final regulation limits its application to retail investors by excluding advice provided to a bank, savings and loan association, insurance company, trust company, or registered investment company, state-registered broker-dealers, an SEC- or state-registered investment adviser or any other institutional buyer, as defined in the regulation.

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**endnotes**

[1] The final regulations are *available at* https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.

[2] The preliminary solicitation (essentially a draft proposal) is *available at* http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryconductstandardidx.htm. This draft was nearly identical to the proposed regulation issued in New Jersey in April 2019. Comments on the draft proposal were due by July 26, 2019. ICI submitted a comment letter (*available at* https://www.ici.org/pdf/19_ltr_mafidicuiary.pdf), which focused on the application of NSMIA.

[3] The Proposal is *available at* https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryruleidx.htm. Comments were due on January 7, 2020, and the Division held a hearing on January 7, 2020. Along with the Proposal, the Division posted a 12-page Request for Comments document, which provided the rationale for moving forward with the Proposal. Secretary Galvin explained that the SEC's Reg BI was not sufficient because it was not a true fiduciary standard. ICI submitted a comment letter (*available at* https://www.ici.org/pdf/20_ltr_massfiduciary.pdf) on January 6, 2020, along with a statement for the record for the hearing. ICI's letter, in addition to focusing on the application of NSMIA, noted the valid reasons SEC had for not making Reg BI a fiduciary standard.

[4] Section 203A of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits any state from requiring the registration, licensing, or qualification of any Federally-registered investment adviser. As explained by the SEC in implementing this provision, Section 203A "preempts not only a state's specific registration, licensing, or qualification requirements, but all regulatory requirements imposed by state law on Commission-registered advisers relating to their advisory activities or services, except those provisions that are specifically preserved by [NSMIA]." *See* Rules Implementing Amendments to the Advisers Act, SEC Release No. IA-1633 (May 15, 1997).

[5] Id. at 73-74. For an additional description of NSMIA's application, *see* ICI Memorandum No. 30834, dated August 14, 2017, *available at* https://www.ici.org/my_ici/memorandum/memo30834.

[6] Page 2 of the Division's Adopting Release, dated February 21, 2020, *available at* https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/Adopting-Release.pdf.

[7] According to commenters, this provision (1) may have run contrary to the "incidental" exemption from the Advisers Act, (2) would require broker-dealers and agents to conduct ongoing monitoring, which in turn would be outside the scope of the "incidental" exemption, and therefore would require broker-dealers to register with the SEC as investment advisers, and (3) would result in additional costs for the broker-dealers and their agents, which may then be passed on to the customers. *Id.* at page 3.

[8] The Division's list included "the use of a title, purported credential, or professional designation containing any variant of the terms 'adviser,' 'manager,' 'consultant,' or 'planner,' in conjunction with any of the terms 'financial,' 'investment,' 'wealth,' 'portfolio,'

or ‘retirement,’ or any terms of similar meaning or import.” While the Division removed this provision in the final regulation, it states in the Adopting Release that it disagrees with the position that that the use of certain titles alone does not create an expectation that a broker-dealer or agent will monitor a customer’s account, and therefore does not warrant an ongoing duty. *See* page 4 of the Adopting Release.

[9] According to the Division, the two additions of the word “reasonably” were added in the final regulation to provide additional clarity. In the Adopting Release, the Division discusses receipt of compensation and recommendation of a proprietary product or principal transaction as examples to explain that not all conflicts must be avoided. “The Division recognizes that professionals who are in the business of making recommendations on the purchase and sale of securities do so for compensation. Arguably, this conflict cannot reasonably be avoided or eliminated. Instead, 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.” Page 5-6 of Adopting Release. “The Division recognizes that broker-dealers and agents engage in [proprietary product or principal] transactions. Arguably, these conflicts cannot reasonably be avoided or eliminated. Instead, the broker-dealer or agent may mitigate these conflicts by, for example, ensuring that the fee earned for the recommendation is reasonable and complying with the remainder of the fiduciary duty.” Page 6.

[10] In the Proposal, this presumption also applied in the case of any implied or express quota requirement, or other special incentive program.

[11] Section 15(i) of the Securities Exchange Act of 1934, added by NSMIA, prohibits any state from establishing “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 federal law].”

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