

MASSACHUSETTS FINALIZES STATE FIDUCIARY STANDARD AMID REGULATION BEST INTEREST

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Investment Management Alert

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I. SUMMARY

On February 21, 2020, the Massachusetts Securities Division (the "Division") officially adopted regulations (the "MA Fiduciary Rule") that would raise the standard of conduct applicable to broker-dealers and their agents (the "Covered Persons").^[1] The MA Fiduciary Rule will impose a fiduciary duty on all Covered Persons when providing investment advice or making recommendations to certain current or prospective customers with respect to: (1) opening or transferring assets to any account type, or (2) the purchase, sale or exchange of any security.^[2] It also imposes a fiduciary duty when the Covered Person has: (1) discretion in a customer's account (unless the discretion relates solely to the time and/or price for the execution of the order); (2) a contractual fiduciary duty; or (3) 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.

This alert summarizes the MA Fiduciary Rule's applicability to the Covered Persons and its requirements, and describes the modifications made to the originally proposed version of the MA Fiduciary Rule based on the public comments on the final proposal. The MA Fiduciary Rule becomes effective upon publication in the Massachusetts Register on March 6, 2020, although the Division has stated that it does not intend to begin enforcement of the MA Fiduciary Rule until September 1, 2020.

II. BACKGROUND

On June 14, 2019, a mere nine days after the Securities Exchange Commission (the "SEC") voted to approve its standards of conduct rulemaking, including the adoption of Regulation Best Interest ("Regulation Best Interest"), the Division circulated a preliminary proposal with respect to the MA Fiduciary Rule for public comment. Following the receipt of initial feedback from the public, the Division published an updated proposal on December 13, 2019, and hosted a public hearing on January 7, 2020, at which many industry participants and industry groups voiced concerns about the adoption of the regulations.

Although the adoption of the MA Fiduciary Rule remains controversial, the Division finalized and adopted the MA Fiduciary Rule after making certain adjustments to the proposal. In adopting the MA Fiduciary Rule, the Secretary of State of the Commonwealth of Massachusetts stated that the Division was determined to move forward with the MA Fiduciary Rule because, in its view, Regulation Best Interest is not "a meaningful conduct rule to protect working families from abusive practices in the brokerage industry," and that "[e]nacting [the MA Fiduciary Rule] will provide stronger protections for Massachusetts investors by imposing a heightened duty of care and loyalty on broker-dealers and agents."^[3]

The adoption of the MA Fiduciary Rule will add further confusion for broker-dealers trying to determine the applicable standard of conduct for transactions with retail customers. Although Massachusetts is the first state to adopt regulations imposing a fiduciary duty for broker-dealers, various other states, including New Jersey and Nevada, have proposed similar regulations of their own. The proposals vary state-by-state but generally would result in the application of a state law fiduciary status to broker dealers, and in at least one state will codify the common-law fiduciary status of investment advisers. There are various arguments to be made that the National Securities Markets Improvement Act of 1996 ("NSMIA")^[4] preempts all or aspects of these proposals as applied to federally-registered broker-dealers.^[5] In adopting Regulation Best Interest, however, the SEC specifically chose not to expressly preempt the states from adopting their own standards of conduct.^[6] Regulation Best Interest sets the standard of conduct at the federal level, but is not necessarily the last word at the local level. States, such as Massachusetts, are free to establish their own standards of conduct that are higher and with more substantive obligations than Regulation Best Interest, at least until the matter of preemption is considered and resolved by the U.S. courts. This issue of fragmentation has been, and will continue to be, a concern for the industry and will only become more exacerbated if the U.S. Department of Labor ("DOL") follows through on its stated intention to adopt a new fiduciary rule applicable to retirement plan assets.^[7]

III. SCOPE OF THE MA FIDUCIARY RULE

The MA Fiduciary Rule amends existing Massachusetts suitability regulations to expressly impose a fiduciary standard on Covered Persons, requiring them to adhere to both a duty of care and a duty of loyalty in dealing with customers. Any failure of a Covered Person to act in accordance with its fiduciary duties as prescribed in the MA Fiduciary Rule will be deemed to be an unethical or dishonest conduct or practice under Massachusetts law and be subject to regulatory action on the part of the Division.^[8] The MA Fiduciary Rule neither adds nor amends the scope of existing private rights of action available with respect to certain material misstatements or omissions in connection with the offers and sales of securities.^[9]

A. Definition of "Customer"

As discussed above, the fiduciary duty applies to Covered Persons in connection with certain interactions with customers. Under the MA Fiduciary Rule, the term "customer" is defined to include current and prospective customers but excludes: (1) a bank, savings and loan association, insurance company, trust company, or registered investment company; (2) a broker-dealer registered with a state securities commission (or agency or office performing like functions); (3) an investment adviser registered with the SEC under the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); and (4) any other "institutional buyer" as defined under Massachusetts regulations.

By this definition, the Division has attempted to make the provisions of the MA Fiduciary Rule applicable to interactions between broker dealers and their agents and retail customers; however, it is important to note that by defining "customer" to include all current and prospective customers other than the specified list of institutional customers described in the prior paragraph, there is a risk that interactions with an institutional customer not described may be subject to the MA Fiduciary Rule.^[10] Importantly, the Division refused to modify the MA Fiduciary Rule to explicitly limit the application of the MA Fiduciary Rule to retail customers with a legal address in Massachusetts or who reside in Massachusetts as had been requested by several commenters. In the commenters view, the failure to include that express limitation creates confusion for customers in Massachusetts

and for financial services firms that operate in multiple jurisdictions. However, the Division did not make the requested changes in adopting the MA Fiduciary Rule, noting in its adopting release that "[t]he Massachusetts Uniform Securities Act is clear as to the scope and applicability of the Final Regulations and does not need further clarification."

B. Duty of Care

The duty of care established in the MA Fiduciary Rule requires the Covered Persons 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 when making recommendations to customers.

The MA Fiduciary Rule further states that a Covered Person's consideration of "all of the relevant facts and circumstances" can be manifested by the Covered Person's making reasonable inquiry into, among other things: (1) the risks, costs and conflicts of interest related to all recommendations and investment advice, (2) the customers' investment objectives, risk tolerance and financial situations, and needs, and (3) any other relevant information.[11]

C. Duty of Loyalty

The duty of loyalty established in the MA Fiduciary Rule requires the Covered Persons to (1) disclose all material conflicts of interest; (2) make all reasonably practicable efforts to avoid conflicts of interest, eliminate conflicts that cannot be avoided, and mitigate conflicts that cannot be avoided or eliminated; and (3) make recommendations and provide investment advice without regard to the financial or any other interest of any party other than their customers.[12]

The requirements of the MA Fiduciary Rule leave open to interpretation what would be considered to be conflicts that cannot "reasonably" be avoided or eliminated. For example, commenters noted that the receipt of compensation in connection with making a recommendation or the recommendation of proprietary products create conflicts of interest, and that under the MA Fiduciary Rule they may no longer be able to engage in those activities. In the adopting release, the Division noted that each of those conflicts is "arguably" a conflict that cannot reasonably be avoided or eliminated and that Covered Persons "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."

In addition, Covered Persons should be aware that the MA Fiduciary Rule treats investment recommendations made in connection with sales contests differently than Regulation Best Interest. Although the MA Fiduciary Rule, as adopted, does not include a proposed provision that would exclude implied or express quota requirements and other special incentive programs from the scope of the regulation, it nevertheless creates a presumption that sales contests, *whether product-specific or not*, constitute a breach of the duty of loyalty for Covered Persons in connection with any recommendation of 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. In contrast, the prohibition on sales contests in Regulation Best Interest applies where the sales contests, sales quotas, bonuses, and non-cash compensation are based on the sale of *specific* securities or *specific types* of securities within a limited period of time.

D. Adjustments Based on Public Comments

The MA Fiduciary Rule, as adopted, makes certain important changes advocated for by members of the asset management and insurance industries. Particularly, in contrast to the proposal, the MA Fiduciary Rule, as adopted:

- Does not apply to insurance sales professionals;
- Does not apply to investment advisers and their investment adviser representatives;
- Does not create a presumption that the use of certain titles (e.g. investment adviser, wealth planner, portfolio manager) by a broker-dealer or agent impose an ongoing fiduciary duty;
- Does not impose an ongoing fiduciary duty on the Covered Person beyond the time that a recommendation is made, unless the Covered Person has: (1) discretion in a customer's account (unless the discretion relates solely to the time and/or price for the execution of the order); (2) a contractual fiduciary duty; or (3) 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; and
- Does not govern municipal bond sales.

IV. TAKEAWAYS

The adoption of the MA Fiduciary Rule, like other similar state initiatives, is not without controversy. It is possible, and in fact extremely likely, that the MA Fiduciary Rule will face a significant challenge in the U.S. federal courts on grounds that its adoption is preempted by U.S. Federal Securities law, including NSMIA and Regulation Best Interest. However, as firms prepare for compliance with Regulation Best Interest that, absent the success of its own ongoing court challenge, will be effective on June 30, 2020, firms should also evaluate the potential impact of the MA Fiduciary Rule by considering the scope and geographic reach of their businesses.

K&L Gates will continue to monitor these important developments and may issue further client alerts, as needed.

Notes:

[1] *Adoption of Amendments to Fiduciary Conduct Standard Regulations*, William Francis Galvin, Secretary of the Commonwealth of Massachusetts (Feb. 21, 2020),

<http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm>.

[2] 950 MASS. CODE REGS. 12.204(1).

[3] *Mass. Securities Chief Sets up State Rules, Blasting SEC Regs*, Chris Villani, LAW360 (Feb. 21, 2020), <https://www.law360.com/articles/1246146/mass-securities-chief-sets-up-state-rules-blasting-sec-regs>.

[4] National Securities Market Improvement Act of 1996, PUB. L. NO. 104-290, 110 STAT. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[5] Many interest groups have commented on NSMIA's federal preemption of state fiduciary regulations. See *Re: Federal Preemption of State Regulation under NSMIA*, SIFMA (March 29, 2019), available at <https://www.sifma.org/wp-content/uploads/2019/04/s70718-5263945-183727.pdf>; *Re: Regulation Best Interest*, Tom Quaadman, CENTER FOR CAPITAL MARKETS COMPETITIVENESS (May 16, 2019), available at

<https://www.sec.gov/comments/s7-07-18/s70718-5528937-185232.pdf>. However, the SEC has declined to address this issue as of the date of this alert.

[6] See Federal Preemption of State Regulation under NSMIA: Regulation Best Interest (SEC Release No. 34-83062; File No. S7-07-18); and Form CRS Customer Relationship Summary (SEC Release No. 34-83063; IA-4888; File No. S7-08-18).

[7] On May 1, 2019, during an oversight hearing held by the U.S. House of Representatives Education and Labor Committee, then-Department of Labor Secretary Alexander Acosta stated that the DOL is collaborating with the SEC to issue new rules regarding the standard of conduct applicable to broker-dealers in connection with the provision of investment recommendations. Any new DOL rules would be designed to fit within the SEC's own rulemaking efforts in this area, including the SEC's Regulation Best Interest. However, on July 12, 2019, Secretary Acosta announced his resignation, which may affect the rule proposal.

[8] A Covered Person's breach of fiduciary duty as prescribed in the MA Fiduciary Rule will be deemed an unethical or dishonest conduct or practice for the purposes of the Massachusetts Uniform Securities Act ("MUSA"). See M.G.L. c. 110A, § 204(a)(2)(G).

[9] Pursuant to §410(a)(2) of MUSA, "[a]ny person who . . . offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six per cent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security." *Id.* at §410(a)(2).

[10] For example, a family office that does not fall within the definition of an "institutional buyer" under 950 MASS. CODE REGS. 12.205(1)(a)6.

[11] *Id.* at 12.207(2)(a).

[12] *Id.* at 12.207(2)(b).

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