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SECURITIES GROUP

Massachusetts Adopts First-in-the-Nation Fiduciary Duty Regulations Applicable to Broker-Dealers and Agents – Three Key Considerations

By Anthony R. Leone | February 25, 2020

On February 21, 2020, the Massachusetts Securities Division adopted final amendments to its regulations, formalizing a fiduciary duty rule applicable to broker-dealers and broker-dealer agents (the "Amendments"). The Amendments appear to remove many problematic provisions contained in the proposed rule issued on December 13, 2019 (the "Proposed Rule"), add a handful of additional wrinkles, and leave certain substantive provisions intact. Here are key considerations for financial professionals to consider prior to the effective date of the Amendments.[1]

1. The Amendments Remove Significant Provisions as Contained in the Proposed Rule

Investment advisors and investment advisor representatives (including state-registered investment advisors[2]) can breathe a sigh of relief: The Amendments completely remove all reference to investment advisors and investment advisor representatives. In so doing, the MSD acknowledged that these persons are already subject to a fiduciary duty, and thus the change avoids unnecessary ambiguity and confusion.

Next, the Amendments expressly remove all language referencing commodities and insurance products. Overall, this is also a positive change for the broker-dealer community. While this still does not foreclose any activity by the MSD in this space (see https://www.sec.state.ma.us/sct/current/sctsummitfinancial/Complaint.pdf as a recent example of the MSD's creativity in structuring arguments to include such products within the purview of their statutory authority), it is overwhelmingly a positive change.

Consistent with the aforementioned provisions, the Amendments likewise refine substantive provisions concerning "ongoing" fiduciary duties. First, unlike the Proposed Rule, the Amendments remove the "titling" provision, which previously provided that titles such as "'advisor,' '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" could trigger fiduciary duty requirements. Second, the MSD has removed the ongoing compensation provision contained in the proposed rule—which would have otherwise subjected, for example, financial firms who received ongoing compensation as a result of issuing publications concerning the value of, or advisability of investing in securities. Finally, with respect to ongoing monitoring services, the MSD has acknowledged that such monitoring may be determined on a case-by-case basis as contractually agreed upon with a customer as compared to a continuous monitoring requirement mandated by regulation.

1 Enforcement of the Amendments will commence on September 1, 2020.

2 As with federal investment advisors and representatives, state investment advisors and representatives are already "subject to a fiduciary duty."

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2. The Amendments Modify Conflict of Interest Provisions Regarding a Broker-Dealer or Agent's Duty of Care

The duty of loyalty has also been somewhat modified with respect to necessary disclosure, elimination, mitigation, and avoidance of conflicts of interest. Notably, the MSD has included a "reasonable" modifier that qualifies (and weakens) the avoidance and elimination clauses. Parsing the language of 12.207(2)(b) suggests the following: (1) disclosure is mandatory; (2) a broker-dealer or agent must make reasonable efforts to avoid a conflict; (3) if a broker-dealer or agent cannot avoid a conflict, they must eliminate the conflict; and (4) if a broker-dealer or agent isn't reasonably able to avoid or eliminate a conflict, the conflict must be mitigated. Thus, only "reasonable" efforts must be undertaken to avoid and/or eliminate a conflict, but the requirement to mitigate a conflict that is either unavoidable or not possible to eliminate requires absolute mitigation. What it means to "mitigate" a conflict will raise substantial concerns as well as questions among the broker-dealer community, both from a practical and theoretical perspective.

The Amendments soften certain other conflict language as well. In particular, unlike previous versions of the rule which included language that merely "disclosing or mitigating" conflicts would violate the duty of loyalty, in the Amendments, "mitigation" has been struck, thus presenting a potential (albeit potentially confusing) path forward to satisfying the duty of loyalty. Similarly, references to implied or express quota requirements and other special incentive programs have been stripped from the Amendments (they were previously identified as presumptive breaches of the duty of loyalty). Finally, and interestingly, municipal securities are also carved out of the scope of the Amendments—the MSD noted, in accompanying commentary, that "several protective mechanisms are in place with respect to municipal and other government securities," and "issuance and trading of municipal securities is subject to regulation by the Municipal Securities Rulemaking Board."

3. Prospective Customer Language Remains, No Modification To "Customer" Definition

From this author's perspective, perhaps the most interesting language in the Amendments concerns the definition of a customer and prospective customer. Notably, all of the fiduciary duties imposed by the Amendments will apply equally to both current and prospective customers. What defines a "prospective" customer is unclear, thus creating uncertainty regarding the reach of the Amendments. The MSD has commented in its adopting release that "the Massachusetts Uniform Securities Act is clear as to the scope and applicability . . . ." This is troubling as the scope of the Act is broad—and in fact reaches beyond Massachusetts, assuming that a core Massachusetts nexus exists.

From a technical perspective, Mass. Gen. Laws c. 110A § 414 provides the scope of the Massachusetts Uniform Securities Act (the "Act") including the jurisdictional reach of the Division with respect to the offer and sale of securities. According to Mass. Gen. Laws c. 110A § 414(a), "Sections 101, 201(a), 301, 405 . . . apply to persons who sell or offer to sell when (1) an offer to sell is made in the commonwealth, or (2) an offer to buy is made and accepted in the commonwealth. Mass. Gen. Laws c. 110A §414(c) adds, in pertinent part, "an offer to sell or to buy is made in the commonwealth, whether or not either party is then present in the commonwealth, when the offer (1) originates from the commonwealth or (2) is directed by the offeror to the commonwealth and received at the place to which it is directed, or at any post office in the commonwealth in the case of a mailed offer." For completeness' sake, Mass. Gen. Laws c. 110A § 414(d) states, in pertinent part, "an offer to buy or to sell is accepted in the commonwealth when acceptance (1) is communicated to the offeror in the commonwealth and (2) has not previously been communicated to the offeror, orally or in writing, outside the commonwealth; whether or not either party is then present in the commonwealth, when the offeree directs it to the offeror in the commonwealth reasonably believing the offeror to be in the commonwealth and it is received at the place to which it is directed, or at any post office in the commonwealth in the case of a mailed acceptance."

It is unquestionable that the Amendments only apply to those broker-dealers and agents registered in Massachusetts. In fact, the Amendments, as regulations, are only triggered when a firm or individual is statutorily required to register in Massachusetts under Section 201 of the Act. However, the Amendments do leave open the possibility that a Massachusetts-registered broker-dealer or agent (who is subject to the Amendments) would be subject to the fiduciary duty standard even when servicing non-Massachusetts customers or prospective customers. Thus, the impact of the Amendments may reach beyond the "vanilla" Massachusetts-to-Massachusetts transactions that one would traditionally expect to be within of the scope of a state securities regulator's authority.

We expect that the law in this area will develop rapidly, and for regulatory enforcement efforts to follow shortly after the effective date. If you have any questions, please feel free to contact us. If you are a Massachusetts investment advisor, please follow the Massachusetts Association of Investment Advisors at https://www.linkedin.com/company/massinvestmentadvisor for further discussion.