

Morgan Stanley

January 7, 2020

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

Dear Secretary Galvin,

Morgan Stanley Smith Barney LLC appreciates the opportunity to comment on the Massachusetts Securities Division's (the "Division's") Fiduciary Conduct Standard for Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives (the "Proposal"). We support strong conduct standards for Broker Dealers ("BDs") and Investment Advisers ("IAs") that will protect investors, while at the same time preserving investor access to a variety of advice and service models. In addition, we support the U.S. Securities and Exchange Commission's ("SEC's") comprehensive federal regulations that meaningfully increase the conduct standards for BDs when providing personalized investment advice about securities to retail clients.

As described below, while Morgan Stanley supports the Division's goal of increased investor protection, the Proposal requires clarification or modification in discrete areas in order to avoid unintended consequences that could limit the availability of important and cost effective products and services to Massachusetts investors. To assist the Division, we respectfully submit a number of suggestions below of changes we believe would improve the Proposal without impairing the Division's overall goal.

I. MORGAN STANLEY BACKGROUND INFORMATION

Morgan Stanley is a leading full-service global financial services firm.¹ Since our founding in 1935, Morgan Stanley has been a client-focused organization providing a range of financial services and advice to individuals, corporations and institutions. Our employee code of conduct stresses the primacy of client interests over those of the company or individual employees, and four "Core Values" guide our business approach, the first of which is "Putting Clients First."²

¹ Morgan Stanley (NYSE: MS) is a global financial services firm that, through its subsidiaries and affiliates, provides products and services to a large and diversified group of clients, including corporations, governments, financial institutions and individuals. Morgan Stanley Smith Barney LLC (doing business as "Morgan Stanley Wealth Management") is registered as a broker-dealer and investment adviser with the SEC and a member of FINRA, the NYSE, NYSE MKT LLC, and NASDAQ Stock Market.

² The remaining Core Values are "Doing the Right Thing," "Leading with Exceptional Ideas," and "Giving Back."

Morgan Stanley's wealth management division, Morgan Stanley Wealth Management ("Morgan Stanley"), has approximately 15,700 financial advisors throughout the United States, servicing approximately 3.2 million wealth management relationships with approximately \$2.5 trillion in client assets. As of January 2020, Morgan Stanley had approximately 184,000 clients in the Commonwealth of Massachusetts representing over \$68 billion in client household assets. Morgan Stanley provides services through both brokerage accounts with transaction-based pricing (e.g., commissions, selling concessions), and investment advisory accounts where clients pay an annual fee based on the value of the assets in the account. In Massachusetts, clients hold approximately \$31 billion in investment advisory accounts and more than \$37 billion in brokerage accounts.

II. ABSENT MODIFICATION, THE PROPOSAL'S ONGOING FIDUCIARY DUTY COULD ELIMINATE BROKERAGE ARRANGEMENTS

Under the Proposal, the fiduciary duty for BDs, agents or advisors generally extends only through the execution of a recommendation. However, if a BD, agent or advisor a) has or exercises investment discretion in a customer's account; b) has a contractual fiduciary duty; c) has a contractual obligation to monitor a customer's account on a regular or periodic basis; d) receives ongoing compensation or charges ongoing fees for advising a customer or client as to the value of securities or the advisability of investing in them; e) engages in any act, practice, or course of business that results in a client having a reasonable expectation that he/she will monitor the client's accounts or portfolio on a regular or periodic basis; or f) uses specific titles in conjunction with associated terms, the fiduciary duty is deemed an ongoing obligation to that client.

While services provided in brokerage accounts can vary, in many cases where a brokerage account is covered by a financial advisor, that advisor will provide periodic recommendations to the client and may also earn ongoing compensation from the recommendation of certain products such as mutual funds. Even where ongoing compensation is not earned, use of the title "Financial Advisor" is common. If the Proposal is adopted as is, this may mean that many brokerage accounts will be subject to an ongoing fiduciary duty under Massachusetts Regulation. In its Request for Comment, the Division clarified that the ongoing obligations imposed under the proposal if any of the above conditions are met specifically include "the obligation to monitor the customer's or client's portfolio on an ongoing basis." Clarification of the phrase "on an ongoing basis" is critical to determining whether brokerage services can continue to be provided to Massachusetts investors in a manner consistent with federal law.

Simultaneous with its release of the SEC's Regulation Best Interest ("Reg BI"), the SEC also published the Commission Interpretation of the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser. Within this interpretation, the SEC explained that agreeing to monitor a customer's account at periodic timeframes (e.g., quarterly) for the purposes of providing a buy, sell or hold recommendation would not be inconsistent with the solely-incidental prong of the broker-dealer exclusion to the definition of Investment Adviser. However, the SEC went on to state, "such policies and procedures should not permit a broker-dealer to agree to monitor a customer account in a manner that in effect results in the provision of advisory services that are not in connection with or reasonably related to

the broker-dealer's primary business of effecting securities transactions, such as providing continuous monitoring."¹ An interpretation drawn from this guidance could be that a Commonwealth legal or regulatory requirement to provide continuous monitoring of a customer's brokerage account will subject that arrangement to the Investment Adviser's Act, eliminating the ability to provide the cost effective brokerage services Massachusetts investors have come to rely on.

In order to avoid this result, Morgan Stanley respectfully requests that the Division clarify that in circumstances where the Proposal would impose an obligation to monitor a customer's portfolio on an ongoing basis, that such monitoring need not be continuous and that periodic monitoring (e.g., quarterly) would be consistent with the Proposal's ongoing monitoring obligation. Absent this important clarification, the provision of brokerage services could be severely limited, which we believe was not the Division's intention.

III. THE PROPOSAL'S CONFLICT AVOIDANCE REQUIREMENT IS UNCLEAR AND UNNECESSARY IN LIGHT OF OTHER PROVISIONS WITHIN THE DUTY OF LOYALTY

In order to meet the Proposal's fiduciary duty, recommendations or investment advice must satisfy both a duty of care and a duty of loyalty. While Morgan Stanley supports a heightened standard of care, we believe the Proposal's duty of loyalty creates confusion with respect to the management of conflicts of interest. The Proposal's duty of loyalty requires that BDs, IAs, and their agents make all reasonably practicable efforts to avoid conflicts, eliminate those conflicts that cannot be avoided, and mitigate conflicts that cannot be avoided or eliminated. On its face, this would appear to require firms to first determine whether a conflict of interest can be avoided or eliminated, and only permit firms to mitigate a conflict in the rare instances where it is not possible to avoid or eliminate it. Such a construct would have the unintended effect of severely restricting the products and services a broker-dealer is able to offer to its retail investors.

As the Division acknowledged in its Request for Comment, there are conflicts of interest inherent in the brokerage model as a result of transaction-based compensation. Additional conflicts can result from principal transactions, the sale of proprietary products or a limited product offering. All of these conflicts can arguably be avoided by not engaging in the activity, yet the Division acknowledged that such transactions are not prohibited under the Proposal, as long as the conflicts presented by these transactions are addressed and appropriately managed, implicitly recognizing that there are circumstances where such products or arrangements can be recommended to clients in a manner consistent with a fiduciary duty. One could argue that virtually all conflicts can be avoided in one way or another, so how will firms recognize whether or not they have used "reasonably practicable efforts" to avoid them? If a conflict

¹ SEC Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Release No. IA-5249 (June 5, 2019), at

could have been avoided, but is mitigated in a manner that does not result in recommendations inconsistent with the fiduciary duty, what is the purpose of requiring that the conflict be avoided in the first place?

The Proposal's requirement that BDs, IAs and their agents make all reasonably practicable efforts to avoid conflicts of interest creates a vague standard with little perceived value to Massachusetts investors in light of the overarching requirement that recommendations be made without regard to the financial or any other interest of any party other than the customer or client. The goal of managing conflicts of interest should be to help firms ensure that recommendations can be made without regard to their own interests and solely with the goal of assisting clients in meeting their financial goals. If a recommendation is made consistent with that obligation, it stands to reason that any conflicts associated with the recommendation must have been managed appropriately. Firms with conflicts that directly cause them to make recommendations in their own interests and not in the interests of their clients will violate the third prong of the duty of loyalty because the recommendation was not made without regard to their own interests. As a result, the requirement to avoid conflicts becomes unnecessary as conflicts must be managed appropriately to meet the duty of loyalty as a whole. In order to avoid confusion, we respectfully request that the Division amend its proposal to eliminate the requirements for avoidance and elimination of conflicts of interest and require instead that conflicts of interest be appropriately mitigated.

IV. THE DUTY OF LOYALTY IS OVERLY BROAD AS IT RELATES TO INCENTIVE PROGRAMS

The Proposal creates a presumption that a recommendation made in connection with *any* (emphasis added) sales contest, implied or express quota requirement or other "special incentive program" constitutes a breach of the duty of loyalty. While an express quota requirement appears understandable on its face, what constitutes a prohibited special incentive program is far less clear. For example, if a registered representative is paid more to recommend product A as compared to product B, would the payment made in connection with product A be considered part of a special incentive program even where product A is significantly more complex than product B, requires advanced training or licensing and requiring higher levels of ongoing service and client communication? In light of this example and others we respectfully request that the Division define these terms so that firms that are attempting to comply in good faith with the Proposal do not inadvertently violate the duty of loyalty.

For ease of administration we suggest that the Division align its definition of both sales contests and special incentive programs to the definition of sales contests adopted by the SEC in Reg BI, which generally defines a sales contest as a cash or non-cash incentive with respect to specific securities or types of securities within a limited period of time.¹ Adopting a definition consistent with Reg BI will protect

¹SEC Regulation Best Interest at pp. 351-53 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>

Massachusetts investors while at the same time reducing the uncertainty and administrative complexity associated with an undefined term.

V. THE DIVISION SHOULD EXPAND ITS GUIDANCE WITH RESPECT TO PRINCIPAL TRANSACTIONS TO RECOGNIZE ESTABLISHED FINRA AND MSRB RULES CONCERNING BEST EXECUTION AND FAIR PRICING

We thank the Division for recognizing in its Request for Comment that the recommendation of a principal transaction, in and of itself is not prohibited under the Proposal. However, we respectfully request that the Division revisit its comment that breach of the duty of loyalty would occur where an agency transaction would have been cheaper for the customer.

When considering whether a principal transaction breaches or meets a firm's duty of loyalty, we respectfully submit the Division should take into account the fact that the fairness of broker-dealer pricing of securities and the quality of execution are highly regulated by FINRA and the MSRB. Firms like Morgan Stanley are required to have robust controls and policies and procedures to ensure compliance with these best execution and fair pricing rules. FINRA actively surveils reported executions for compliance with, and brings actions to enforce, these requirements, and the SEC conducts periodic exams to assess broker-dealer compliance. Moreover, investors have access to reported trade prices on TRACE and MSRB's Electronic Municipal Market Access System as an additional layer of protection and transparency against which their executions and the fairness of prices charged may be validated.

The fixed income market is a highly fragmented over the counter market, consisting in the municipal securities market alone of approximately 1 million individual CUSIPs. There is no central exchange for displaying all available prices on the bid or offer side of the market for these securities, prices that are provided through ATSS or ECNs may not be actionable or available, and there are not official market makers providing continuous two-sided quotes as there are for equity securities. In fact, there may be limited or no third party liquidity in certain securities, and speed and certainty of execution, in particular in illiquid, distressed or volatile markets can be equally or more important than receiving the absolute best price on a particular trade, assuming there were even a definitive way to establish such a price. In some instances, securities trade so infrequently and without established market makers, it is not possible to ascertain whether a better price may be (or may become) available to a firm.

Accordingly, under FINRA's and MSRB's best execution rules, while price is an important component in determining best execution, it is not the only component firms look to when determining where to route an order for execution. FINRA Rule 5310 requires that its members "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." Among the factors that firm's must consider as part of their due diligence in determining best execution are:

- A. the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications);
- B. the size and type of transaction;
- C. the number of markets checked;
- D. accessibility of the quotation; and
- E. the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

While we recognize that price is an important factor, firms have spent many years developing systems and processes to evaluate fair pricing and best execution taking the FINRA and MSRB rules into account. If price is the only consideration, customers will potentially be harmed and firms will simply avoid principal transactions. This will result in more limited product availability and in many cases higher prices paid by customers because agency will be the only available type of execution, even where principal may have resulted in better overall execution.

As a result, we strongly urge the Division to align any pricing requirements with the applicable FINRA and MSRB rules. Specifically, the Division should provide guidance that firms who enter principal trades with Massachusetts customers will not be in breach of the duty of loyalty if they comply with their obligations under FINRA's and MSRB's best execution and fair pricing rules and should specifically recognize that price is only one factor in considering whether a recommended principal transaction is consistent with the duty of loyalty.

VI. ANY RULE SHOULD APPLY TO RESIDENTS WITH A LEGAL ADDRESS IN MASSACHUSETTS

As currently drafted, the Proposal is vague regarding its general applicability. This has the potential to create confusion for investors within Massachusetts and for financial services firms that operate in multiple jurisdictions. To help clarify this issue for clients and firms alike, Morgan Stanley respectfully urges that the Proposal be limited to only those residents with a legal address in Massachusetts.

VII. EFFECTIVE DATE

As noted above, the Proposal raises many unique issues for BDs and IAs, including establishing supervisory systems to address ongoing monitoring for clients with both brokerage and investment advisory accounts. In order to comply, firms will have to develop infrastructure capabilities, implement new trainings, update marketing materials and expand and enhance supervisory controls, internal policies and procedures. Taken in the aggregate, these requirements represent a complex and time consuming undertaking which would be extremely difficult to finalize within a short time frame.

In light of this, we request that the Division provide an implementation period of at least 12 months, followed by an initial effective date thereafter.

VIII. CONCLUSION

We encourage the Division to revise the Proposal so that investors throughout Massachusetts can continue to receive a full array of financial services. Absent limited, but important changes, the Proposal's current construct would restrict investor choice, negate the many benefits available to investors who choose to receive financial services through brokerage accounts, and increase costs to Massachusetts investors. We respectfully urge the Division to consider a pragmatic approach which we believe best protects investors and preserves investor choice.

We thank you for consideration of our comments.

Sincerely,

MORGAN STANLEY SMITH BARNEY LLC

By: 
Anne Tennant
Managing Director and General Counsel