

Massachusetts Securities Division

REGISTRATION, INSPECTIONS, COMPLIANCE AND EXAMINATIONS SECTION

▲ 2017 MID-YEAR NEWSLETTER ▲

A Division of William Francis Galvin, Secretary of the Commonwealth

THE DEPARTMENT OF LABOR'S FIDUCIARY RULE TRAINING

On March 7, 2017, the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth's ("Division") Registration, Inspections, Compliance and Examinations ("RICE") Section hosted a conference on the Department of Labor's Fiduciary Rule ("DOL Rule"). Invited speakers **Tamar Frankel** and **Michael Kitces** discussed the DOL Rule's history and projected impact on state-registered investment advisers. The conference drew over 200 attendees, primarily consisting of individuals affiliated with Massachusetts-registered investment advisers and with compliance-related organizations.

Tamar Frankel is a long-time member of the Boston University School of Law faculty specializing in the areas of fiduciary law, corporate governance, mutual funds and the regulation of the financial system. She has published ten books

and more than eighty articles and book chapters. In 2013, the Institute for Fiduciary Standard established the annual Frankel Fiduciary Prize in her honor to award individuals who advance fiduciary principles.



In her remarks at the conference, Frankel discussed the DOL Rule's origins and necessity, noting:

- The fiduciary standard of acting in a client's best interest is the adviser's execution of both the duty of care and the duty of loyalty.
- An advisory relationship requires that clients depend and trust in their investment advisers because the investment

advisers have more knowledge and expertise in a specialized field.

- The duty of care requires that the quality of the service provided must be reasonably related to the service itself.
- A fiduciary cannot delegate the duties owed to a client to another party.

Michael Kitces is a Partner and the Director of Research for Pinnacle Advisory Group, a private wealth management firm located in Columbia, Maryland that oversees approximately \$1.8 billion of client assets. In addition, he is a co-founder of the XY Planning Network and New Planner Recruiting,



the former Practitioner Editor of the *Journal of Financial Planning*, and the publisher of the popular financial planning industry blog *Nerd's Eye View* through his website Kitces.com, dedicated to advancing knowledge in financial planning.

In his remarks at the conference, Kitces discussed the DOL Rule's status and impact on state-registered investment advisers, including:



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FIDUCIARY RULE TRAINING

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- The DOL Rule may face potential alterations in the future, but it will likely not be rescinded completely.
- Under the DOL Rule, best interest advice is advice that would be prudent for a client regardless of the presence of a commission. Fiduciary advice is advice another expert would have provided in the same circumstances if she were not receiving compensation.
- Investment advisers should be clear about the scope of the services they are providing and should charge commensurate fees for their services.
- Advice for Advisers: 1) update advisory agreements; 2) document recommendations in light of the standard of what other prudent advisers would do; 3) conduct due diligence for each recommendation while documenting the diligence process.



Editor's Note

On June 9, 2017, portions of the DOL Rule became effective, and the remaining parts of the rule will be fully effective as of January 1, 2018. On June 29, 2017, the Department of Labor announced it is seeking further feedback on the DOL Rule, which includes a request for comment on the proposed January 1, 2018 effective date. Further information on the request for comment is located at <https://www.dol.gov/sites/default/files/ebsa/temporary-postings/definition-of-the-term-fiduciary-request-for-information.pdf>. The Securities and Exchange Commission ("SEC") is also seeking comments on the standards of conduct for investment advisers and broker-dealers. More information on the request for comment can be found at <https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31>. ▲

INVESTMENT ADVISER EXAMINATION PRIORITIES

In furthering the Massachusetts Securities Division's mission of investor protection, the Division's Registration, Inspections, Compliance and Examinations Section (hereinafter the "RICE Section") conducts regular examinations of its state-registered investment advisers. In addition to continuing to conduct for-cause investment adviser examinations in conjunction with Division inquiries and investigations, client complaints, industry developments, and other factors, the RICE Section's examination program will focus on a number of key areas during the course of its regular examinations. While such areas of focus may change during the upcoming year due to any number of factors, the areas of focus currently include, but are not limited to, the following:



IRA Rollover Recommendations

RICE Section examiners will continue to concentrate on investment advisers that specifically recommend that their clients roll assets into individual retirement accounts. Examiners will look at the suitability review conducted by investment advisers prior to making these recommendations. Specifically, the RICE Section will review the client-specific circumstances surrounding each recommendation; request insight into the types of conversations the investment adviser has with its clients in making those recommendations; and consider whether the investment adviser appropriately discloses the conflicts of interest that exist when making such recommendations. Examiners will also compare the

FIDUCIARY RULE TRAINING PHOTOS



fees paid by each client prior to and after an IRA rollover, as fees are a significant factor when determining whether the recommendation is truly in the client's best interest.

This focus is particularly important in light of the currently uncertain future surrounding the Department of Labor's heightened fiduciary standard, as discussed in the RICE Section's training offered earlier this year to Massachusetts-registered investment advisers. (See page 1.)

Exchange-Traded Funds

The RICE Section examiners will scrutinize Massachusetts-registered investment advisers who recommend exchange-traded funds (ETFs) to their clients. The increasing popularity of this investment vehicle only emphasizes the need of investment advisers to undertake significant due diligence before purchasing them for client portfolios. Accordingly, RICE Section examiners will ask how investment advisers analyze and disclose the risks of investing in ETFs to their clients; whether clients have been placed in alternative, leveraged, or other types of exotic ETFs that may not be suitable for all (or any) clients; and whether ETF holding periods exercised by investment advisers adequately correspond with each ETF's stated purpose. In conducting these examinations, the RICE Section will continue to emphasize that investment advisers' fiduciary duties to their clients require knowing the products recommended to those clients, and possessing the insight to consider whether such recommendations make sense in light of each client's individual circumstances.

Third-Party Asset Managers & Robo-Advisers

The RICE Section will examine arrangements in which investment advisers refer their clients to third-party asset managers. Examiners will probe into the due diligence conducted by investment advisers into the third parties; the methods by which investment advisers choose the third parties to recommend to their clients; and how those efforts are reflected in the investment adviser's disclosure documents, as well as in any other client

communications. The RICE Section will also focus on fee-sharing arrangements between the investment adviser and third parties to ensure that clients are getting a complete picture of to whom, and for which services, they are paying fees. RICE Section examiners will focus on these areas to consider whether the investment adviser adds value to the client when a third party manages the client's assets.

For state-registered investment advisers who partner with third-party robo-advisers in providing concurrent investment advisory services, the RICE Section will examine whether the state-registered firm's practices comply with the Division's July 14, 2016 "Policy Statement: State-Registered Investment Advisers' Use of Third-Party Robo-Advisers." The Division's policy statement, which is located at <http://sec.state.ma.us/sct/sctpdf/Policy-Statement-State-Registered-Investment-Advisers-Use-of-Third-Party-Robo-Advisers.pdf>, requires that state-registered investment advisers provide additional detailed disclosures and provide specified fee considerations when utilizing such a partnership in servicing their clients.

Pooled Investment Vehicles

Examinations will also inspect investment advisers who manage pooled investment vehicles and recommend that clients invest in those pooled investment vehicles. The RICE Section will pay particular attention to whether the state-registered investment adviser has appropriately assessed the client's suitability to invest in an illiquid, highly risky product that is often favored by high-net-worth investors. Furthermore, the RICE Section will also consider whether state-registered investment advisers have adequately accounted for potential conflicts of interest resulting from pooled investment vehicles, especially in scenarios where an investment adviser could not alleviate a significant conflict of interest by simply providing additional

disclosure. RICE Section examiners will also look at the fund's registration status and performance reporting, will test the investment adviser's methodology for confirming that qualified clients are in fact eligible to be charged performance fees, and will examine the due diligence conducted by the investment adviser before deciding to place clients in the fund.

Custody

RICE Section examiners will also continue to focus on investment advisers maintaining custody of client assets. Common ways in which investment advisers maintain custody of client assets may include, but are not limited to, the following:

- Serving as a trustee or having a power of attorney over client accounts;
 - Acting as a general partner of a limited partnership or in a similar position with a pooled investment vehicle that is an investment advisory client;
 - Providing bill-paying services or having check-writing authority on a client's behalf;
 - Having physical possession of client assets such as securities certificates or checks made out to clients; and
 - Accessing clients' online accounts using client usernames and passwords.
- In their examinations, the RICE Section will ensure that those investment advisers maintaining custody are fulfilling the regulatory obligations incurred because of their authority.

Cybersecurity

The RICE Section will also focus on cybersecurity issues to make sure that investment advisers are implementing

the appropriate safeguards to protect client assets and sensitive information. In doing so, RICE Section examiners will inquire as to firms' practices regarding protections such as passwords and encryption techniques,

as well as firms' data backup, storage and destruction processes. Tangentially, the



PROTECTION OF SENIOR INVESTORS FROM FINANCIAL EXPLOITATION

The heightened risk of financial exploitation to senior investors has resulted in state and federal regulatory responses.

On January 22, 2016, the North American Securities Administrators Association (“NASAA”) adopted “An Act to Protect Vulnerable Adults from Financial Exploitation” (the “Model Act”).

In addition, on February 3, 2017, the Securities and Exchange Commission approved additional Financial Industry Regulatory Authority (“FINRA”) rules designed to protect senior clients of FINRA broker dealers from financial exploitation. The changes which will take effect on February 5, 2018, will amend FINRA Rule 4512 and adopt new FINRA Rule 2165. Rule 4512 has been amended to require members to make reasonable efforts to obtain the name and contact information of a trusted contact person for a customer’s account. Rule 2165 is a new rule that permits members to place temporary holds on

disbursements of funds or securities from specified customers’ accounts where there is a reasonable belief that these customers have been, are being, or will be subject to financial exploitation.

State-registered investment advisers can take steps to protect senior clients from financial exploitation by considering best practices, including:

- Implementing policies and procedures that subject accounts of senior clients to heightened supervision.
- Confirming the authenticity of client wire transfer requests received by electronic communication or a third party by telephone.
- Increasing awareness of risks to senior clients, such as diminished decision making capacity or memory loss.



- Obtaining the name and contact information of a trusted contact person, such as a financial proxy, for each senior client. ▲

INVESTMENT ADVISER EXAMINATION PRIORITIES *cont'd*

RICE Section will review and discuss the investment adviser’s business continuity plan not only to ensure that the investment adviser has planned for the loss of key personnel, but also to ensure that the investment adviser has continuity procedures in place in the event of a data breach or cyber-attack.

Senior Clients

Examinations will also continue to focus on the services provided by state-registered investment advisers to senior clients. RICE Section examiners will analyze the composition of each Massachusetts-registered investment adviser’s client base to consider whether the investment adviser may benefit from policies and procedures regarding heightened supervisory oversight for senior clients. The RICE Section will also examine the investment adviser’s processing and resolution of written or verbal complaints made by senior clients. In implementing this focus, the RICE Section intends to encourage Massachusetts-registered investment advisers to be mindful that their fiduciary obligation to act in a senior client’s best interest may involve additional steps that consider their senior clients’ specific factual circumstances.



As always, the RICE Section encourages Massachusetts-registered investment advisers to contact the Division with suggestions as to how best accomplish the Division’s goal of protecting Massachusetts investors through its examination program. Please notify the RICE Section at MSD@sec.state.ma.us. ▲

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LPL FINED \$1 MILLION FOR FAILED SUPERVISION OF ITS AGENTS AT DIGITAL FEDERAL CREDIT UNION

On May 4, 2017, the Division fined LPL Financial LLC \$1 million for failing to supervise its financial advisors who operated out of Digital Federal Credit Union (“DCU”) premises. The LPL agents, who were also employees of DCU, operated under the trade name DCU Financial. For further information on this matter, the Consent Order is located at <http://www.sec.state.ma.us/sct/current/sctlplfinancial2/LPL-Consent-Order-Docket-No-R-2016-0095.pdf>.

