

# Massachusetts Securities Division

REGISTRATION, INSPECTIONS, COMPLIANCE AND EXAMINATIONS SECTION

▲ 2024 MID-YEAR NEWSLETTER ▲

*A Division of the Office of Secretary of the Commonwealth, William Francis Galvin*

## THE SJC UPHOLDS MASSACHUSETTS FIDUCIARY DUTY RULE

In March 2020, the Securities Division (the “Division”) promulgated a first-in-the-nation fiduciary duty regulation applicable to Massachusetts registered broker-dealers and agents (the “Fiduciary Duty Rule”). The Fiduciary Duty Rule became enforceable on September 1, 2020. Under the Fiduciary Duty Rule, broker-dealers and agents must act in a customer’s best interest when providing investment advice or recommending an investment strategy, the opening of or transferring of assets to any type of account, or the purchase, sale, or exchange of any security or when other circumstances are present.

On December 16, 2020, the Massachusetts Securities Division filed a complaint against broker-dealer Robinhood Financial, LLC (“Robinhood”) alleging unethical or dishonest conduct, failure

to supervise, and failure to comply with the Fiduciary Duty Rule.

In April 2021, Robinhood sued the Division and the Secretary of the Commonwealth challenging the validity of the Fiduciary Duty Rule. Following a Superior Court ruling, which declared the rule invalid, the Massachusetts Supreme Judicial Court agreed to hear

the case. On August 25, 2023, the SJC unanimously reversed the Superior Court’s decision. The SJC found (1) that the Secretary did have the authority to implement a fiduciary conduct standard on broker-dealers; (2) that the legislature granted broad and expansive authority to the Secretary of the Commonwealth



to define unethical and dishonest conduct; and (3) that the federal “regulation best interest” exists as a floor. Following the SJC decision, the parties agreed to settle the matter resulting in an overhaul of how Robinhood operates in Massachusetts as well as a \$7.5 million dollar fine. ▲

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## MASSACHUSETTS FIDUCIARY DUTY RULE 101

Recent examinations of investment advisers (“IA”) conducted by the RICE Section, have brought to light that many dually registered investment adviser representatives (“IAR”) and broker-dealer agents are not aware of the Massachusetts fiduciary duty rule<sup>1</sup> that applies to broker-dealers and its agents. The Regulations make a broker-dealer or agent subject to a fiduciary duty to a brokerage customer when providing investment advice or recommending an investment strategy, the opening of or transferring of assets to any type of account, or the purchase, sale, or

exchange of any security. Unlike the ongoing fiduciary duty IAs and IARs have to their clients, the fiduciary rule applies to broker-dealers and agents at the time the recommendation is made and the investment advice is given or when other circumstances are present. The fiduciary conduct standard has two components: (1) the duty of utmost care and (2) duty of loyalty. The duty of care requires a broker-dealer or agent 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. This means a broker-dealer or agent must make reasonable inquiry including the risk, costs,

<sup>1</sup> Mass. Code Regs. 12.205(7). Additional information is available on the Division’s Website at <https://www.sec.state.ma.us/divisions/securities/enforcement/fiduciary-rule.htm>

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## A WARNING ON THE RISE OF AI SCAMS

With the rise of artificial intelligence (“AI”), many businesses have incorporated such technologies into their daily practices. Investment advisers are already seeing AI used for predictive modeling to help provide investment advice to clients. However, the use of AI does not come without issues. Advisers should be cautious when approaching AI practices with clients.

Investment advisers should be wary of investment companies claiming to be in the forefront of developing or employing AI. Fraudsters take advantage of rapid technological advances to lure investors into schemes through high-pressure sales tactics, promises of profits, or guaranteed returns with little or no risk. To protect clients from such schemes, advisers should review the company’s disclosures and compare it to other companies working on comparable AI products and services to assess the risk.<sup>1</sup>

Furthermore, individuals can also use AI to scam investors by spreading false information through cloned voices, altered images, and fake videos, also known as “deepfake.” Individuals can also use deepfakes to impersonate clients in an attempt to have money transferred from their accounts to the scammers.

Investment advisers can protect them-

<sup>1</sup> <https://www.sec.gov/edgar/search-and-access>



selves from deepfake audio and video by reminding clients to verify communication. No matter how urgent the claim appears, advisers should stress the importance of independently verifying the situation before transferring money. This can be done by creating a password or phrase between clients and their adviser to verify their identities. Bad actors may also create fake websites to impersonate an investment professional. To verify they are communicating with the actual investment professional, investment advisers should remind clients to compare the firm’s phone number or website to the firm’s brochure, business card, and advisory agreement.

Advisers should be aware that AI-generated information might depend on

inaccurate, incomplete, or misleading data. Before recommending making an investment, advisers should fact check the information by reviewing multiple sources, and asking questions of the prospective investment. A good rule of thumb to follow is that AI technology can only do so much; outlandish promises of gains or successful investments tend to be inaccurate. Anything that seems too good to be true should be reviewed to help clients avoid any investment mishaps. Additionally, some AI systems have been known to create false results that may appear to be realistic but are the result of incorrect data input. Advisers should attempt to check the results of the AI systems by conducting their own calculations and due diligence. ▲

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## SEC APPROVES SPOT BITCOIN EXCHANGE-TRADED PRODUCTS

In January 2024, the U.S. Securities and Exchange Commission (“SEC”) allowed the listing and trading of shares of eleven Spot Bitcoin Exchange-Traded Products (“ETPs”).<sup>1</sup> Importantly, the SEC and Chairman Gensler did not endorse or approve bitcoin and reminded investors to remain cautious about risks associated with bitcoin and crypto-related products. ETPs are pooled investment vehicles that trade throughout the day on national securities exchanges. Spot Bitcoin ETPs are investment vehicles that track the price of Bitcoin and

hold Bitcoin as the ETP’s underlying asset, akin to a derivative instrument. In contrast, Spot Bitcoin Exchange-Traded Funds do not hold Bitcoin directly, but instead attempt to replicate the price of Bitcoin through the use of futures contracts. Spot Bitcoin ETPs are not governed by the Investment Company Act of 1940 (the “1940 Act”). Sponsors of the approved Spot Bitcoin ETPs are required to provide disclosures in periodic filings, including information regarding how the products work, their management, and their risk factors.<sup>2</sup>

The SEC’s decision to allow the listing and trading of certain Spot Bitcoin ETPs allows investors to gain exposure to Bitcoin through these investment vehicles. Notably, existing standards of conduct for financial professionals under state and federal securities law apply to investment advice and recommendations involving the purchase, sale, and exchange of approved Spot Bitcoin ETPs. For further detail, The Division has recently issued an Investor Alert on its website.<sup>3</sup> ▲

<sup>1</sup> <https://www.sec.gov/files/rules/sro/nysearc/cal/2024/34-99306.pdf>

<sup>2</sup> Disclosures can be found in the initial Form S-1 registration statements for approved Spot Bitcoin

ETPs as well as subsequent filings.

<sup>3</sup> <https://www.sec.state.ma.us/divisions/securities/corporate-finance/bitcoin-investor-alert.htm>

## INVESTOR EDUCATION SECTION UPDATE

The Division has hosted and participated in several community events throughout Massachusetts to help further educate the investing public with a particular focus on the protection of older adults.<sup>1</sup>

### Multi-Partner Scam Awareness Conference

In September 2023, the Division spoke at the Medford Senior Center for the Multi-Partner Scam Awareness Conference. Also in attendance was the Mayor of Medford, a Middlesex District Attorney, representatives from the Medford Police Department, and representatives from local banking institutions. Together, these participants educated attendees on recent scams and other related issues facing the community.

<sup>1</sup> Refer to the Division's website for investor education materials: <https://www.sec.state.ma.us/divisions/securities/links-and-resources/investor-education.htm>.

### Senior Investor Education Forum

In September 2023, the Division hosted a forum entitled *Senior Investor Education Forum: Retiree Issues in Focus* educating the public regarding financial exploitation of older adults. The forum consisted of panel discussions regarding common investment scams, alternative investments, and other financial related issues. The Division was joined by the Pension Action Center to discuss pension related issues and Paul Greenwood, an elder abuse specialist, who discussed issues regarding elder abuse and financial exploitation of older adults.

### Summit to Fight Fraud at UMass Boston

In March 2024, the Division co-sponsored the Summit to Fight Fraud alongside the Pension Action Center at UMass Boston. Secretary Galvin delivered opening remarks in which he spoke about protecting members of the public from

## SAVE THE DATE:

### VIRTUAL INVESTMENT ADVISER CONFERENCE OCTOBER 2024\*



\*Exact date and time will be provided via email. Please ensure the email address on your ADV Part 1A is up-to-date to receive further communications.

fraudulent financial schemes. Division staff delivered presentations on the rise of new technologies such as crypto assets and artificial intelligence. ▲

## ALTERNATIVE INVESTMENTS: ISSUES TO CONSIDER, QUESTIONS TO ASK, AND RED FLAGS

Increasingly, alternative investments are being promoted to retail investors. Alternatives are often recommended as a way to generate an increased investment return, improve overall portfolio return, or to reduce overall risk through the benefits of diversification. Broadly, alternative investments include any kind of investment that is not a stock or a bond. Examples of alternatives include: real estate investment partnerships; commodity pool programs, business development companies; hedge funds, private equity investments, and various kinds of virtual assets, like cryptocurrencies.

Before you purchase an alternative investment for your client, consider the following:

- **Review Offering Documents:** Be sure to review all offering documents or prospectuses before recommending the investment.
- **Selling Fees and Commissions:** What is the firm or person selling the investment being paid? The commissions paid will reduce the amount of your client's mon-



ey that will go into the investment.

- **Ongoing Fees and Expenses:** What ongoing fees and costs will your client pay for the investment? What will these add up to over the lifetime of the investment?
- **Complex Investments:** Complexity can be a source of risk. Avoid investing your client's money into an investment that you do not understand.
- **Risks of Illiquid Investments:** Will your client be able to sell or redeem the investment when your client wants or needs the funds?
- **Publicly Available Information:** Will you be able to look up the investment in a newspaper or on the Web to track its value and performance?
- **Transparency:** What reports will you

or your client receive about the performance of your client's investment? How often will the reports be provided?

- **Tax Consequences:** Consider how tax rules apply to the investment. Consider talking to your client's tax preparer regarding tax implications.

### How to Identify Red Flags:

- Ask if the investment is properly registered or has made required government filings.
- Ask if the selling-person is properly registered or licensed to sell the investment? Who regulates them? The seller should be willing to indicate how they are registered and what kind of oversight applies to them.
- Beware of promises of unrealistic or astronomical returns. Promises of high returns are typically too good to be true. The investment may not be genuine or it may be speculative and highly risky.
- Any pressure to buy or pressure to make a decision quickly is a red flag. Pressure alone is a reason not to invest. ▲



## RECENT ENFORCEMENT ACTIONS

### Two Florida-Based Firms Ordered To Return Unreasonable Commissions

In July 2023, the Enforcement Section entered into a settlement with two Florida-based firms to return excessive commissions charged over a five-year period. Leading a group of other state securities regulators, the Enforcement Section uncovered commission practices resulting in nationwide restitution of approximately \$8.25 million.

The investigation revealed that order systems automatically applied a \$75 minimum commission regardless of the principal amount of the transaction. Without adequate systems to adjust commissions for small principal transactions, the Firms regularly overcharged their customers with some paying more than 90% of the principal value in commissions. Over a five-year period, the Firms charged excessive commissions on upwards of 270,000 equity transactions.

The Consent Order stated that the Firms failed to reasonably supervise their agents. In addition to returning \$8.25 million to customers in restitution, the Firms were ordered to pay a total of \$4.2 million in fines and penalties. Impacted customers in Massachusetts received restitution of more than \$185,000, plus 6% interest.

### New York-Based Online Broker-Dealer Fined \$500,000 over Compliance Inadequacies

In November 2023, the Enforcement Section ordered a New York-based broker-dealer to pay an administrative fine of \$500,000, retain the services of an independent third-party compliance consultant, and make substantial improvements to its compliance program after uncovering numerous failures related to the firms supervision and compliance department.

During the COVID-19 pandemic, like many other online broker-dealers, the Firm experienced increases in account openings. The Firm failed to anticipate the increase in accounts and scale its

compliance department to accommodate the unprecedented growth in its business.

As the Firm's customer base began to grow, the outside compliance consultant saw an increase in regulatory inquiries from regulators. As the Firm failed to develop a compliance system to accommodate the increase in regulatory inquiries and customer issues, it struggled to produce accurate and complete information.

The Firm also failed to properly train its representatives in identifying and handling potential customer complaints. The Division alleged that the Firm lacked any meaningful, structured training program to prepare its customer service staff to identify communications that could be construed as customer complaints.

### Enforcement Settles With Cryptocurrency Company

In March 2024, the Enforcement Section entered into a settlement with a cryptocurrency company regarding the firm's crypto interest-earning program and paying an administrative fine to Massachusetts. The settlement was part of a larger \$1.5 million multistate investigation into the company's activities for failure to comply with registration requirements.

The Florida-based company provided crypto asset-related financial services to retail and institutional customers, including investing and trading services. The company provided digital asset trading accounts for the purpose of buying, selling, trading, and holding digital assets such as Bitcoin, Ether, and USD Coin.

The company also offered a crypto interest-earning program to Massachusetts investors. Under this program, investors passively earned interest on crypto assets by loaning them to the company. To pay for the interest, the company would lend these assets to institutional borrowers, earn commissions by customer trading activity in the digital asset trading

accounts, and from capital contributed to the company in connection with the start-up of its business operations. The company offered and promoted their crypto interest-earning program in Massachusetts via its website and various platforms. Customers who were interested in this feature were allowed to apply for a digital asset trading account by using an online account opening process. After opening an account, customers were required to agree to the company's ability to hold customer assets in the company's name. ▲

## FIDUCIARY DUTY RULE 101

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and conflict of interest related to all recommendations made and investment advice given as well as the customer's investment objective, risk tolerance, financial situation, and needs. The duty of loyalty requires a broker-dealer or agent to disclose all material conflicts of interest; 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; and make recommendations and provide investment advice without regard to financial or any other interest of any party other than the customer. Therefore, dually registered IARs and broker-dealer agents are subject to a fiduciary standard when advising Massachusetts clients and customers. ▲

**MASSACHUSETTS  
SECURITIES  
DIVISION**

**William Francis Galvin**  
*Secretary of the Commonwealth*

*Office of the Secretary of the Commonwealth*

*Securities Division*

*One Ashburton Place – Room 1701*

*Boston, MA 02108*

*(617) 727-3548*

*[www.sec.state.ma.us/sct](http://www.sec.state.ma.us/sct)*