ADOPTING RELEASE

DATE: February 21, 2020

RE: Amendments to Standard of Conduct Applicable to Broker-Dealers and Agents – 950 MASS. CODE REGS. 12.200

The Massachusetts Securities Division (the "Division") is adopting the following amendments to 950 MASS. CODE REGS. 12.200 (the "Regulations") as they relate to the standard of conduct applicable to broker-dealers and agents. The adopted amendments to the Regulations (the "Final Regulations") will apply a fiduciary conduct standard to broker-dealers and agents when dealing with their customers, at Section 12.207. The failure to adhere to the fiduciary standard of utmost care and loyalty will be deemed a dishonest or unethical practice under M.G.L. c. 110A, § 204(a)(2)(G). In addition, the Final Regulations will revise certain paragraphs in Section 12.204 to make clear that the existing suitability standard still applies to any relationships or transactions expressly excluded from the fiduciary standard.

The Division conducted a preliminary comment period in which it requested comment on potential amendments to the Regulations that would impose a fiduciary standard of conduct on broker-dealers, agents, investment advisers, and investment adviser representatives. The Division received 53[1] comments from the public in response to this preliminary request for comment.

After reviewing these comments, the Division moved forward and proposed amendments to the Regulations (the "Proposal"). The Division gave notice of the Proposal, the public hearing on the Proposal, and the public comment period on December 13, 2019 via the Division's website and a published notice in The Boston Globe. On its website, the Division provided a summary of its reasons for proposing amendments to the Regulations, as well as copies of the Proposal, and a copy of its initial small business impact statement. Notice of the public hearing and comment period was published in the Massachusetts Register as of December 27, 2019. The Division held a public hearing on the Proposal on January 7, 2020, and the public comment period ended on January 7, 2020. The Division received and reviewed approximately 682[2] written comments, as well as oral testimony from 23 speakers.

The Final Regulations shall become effective upon publication in the Massachusetts Register. The next publication of the Massachusetts Register is scheduled for March 6, 2020. Notwithstanding the Final Regulations becoming effective upon publication in the Massachusetts Register, the Final Regulations shall be enforced as of September 1, 2020.

The following is a summary of the Final Regulations, where applicable, modifications made to the Proposal prior to adoption.

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[1] The preliminary public comment period began on June 14, 2019 and closed on July 26, 2019. The Division received 52 comments during the preliminary public comment period and one comment after the close of the preliminary public comment period.

[2] The public comment period began on December 13, 2019 and closed on January 7, 2020. The Division received 425 comments during the public comment period and 257 comments after the close of the public comment period.

1. 950 MASS. CODE REGS. 12.207: Imposing a Fiduciary Conduct Standard on Broker-Dealers and Agents

Section 12.207 of the Final Regulations will hold broker-dealers and agents to a fiduciary standard of conduct when making recommendations and providing investment advice to customers. The Division has issued this Adopting Release to provide guidance on how broker-dealers and agents can comply with the Final Regulations.

A. Scope of the Amended Regulations

In response to the Proposal, the Division received many comments asking for clarification on certain parts of the Proposal or requesting that the Division reconsider the scope of the Proposal. The Division has addressed those comments below.

i. Regulated Persons

Section 12.207 of the Proposal covered broker-dealers, agents, investment advisers, and investment adviser representatives. Multiple commenters wrote that the Proposal should not apply to federally-registered investment advisers and their representatives. These commenters wrote that federally-registered investment advisers and their representatives are already held to a fiduciary standard and including them within the scope of the Proposal may create unintended consequences.[3]

Based on comments received, Section 12.207 of the Final Regulations has been revised to remove references to investment advisers and investment adviser representatives, who are already subject to a fiduciary duty. The Final Regulations will continue to make broker-dealers and agents subject to a fiduciary duty when they make recommendations or provide advice with respect to securities.

ii. Commodities and Insurance Products

Sections 12.207(1)(a) and 12.207(2)(d) of the Proposal included references to commodities and insurance products. Multiple commenters wrote that variable annuities and insurance products are excluded from the definition of "security," as defined in M.G.L. c. 110A, § 401(k) and that the Proposal should be limited only to securities. In response, the Division has removed the express language regarding advice on commodities and insurance products from the Final Regulations.

iii. Application of the Fiduciary Duty

Section 12.207(1)(a) of the Final Regulations sets out when a fiduciary duty applies to broker-dealers and agents. Many commenters raised concerns about this section of the Proposal, arguing that it imposed an ongoing duty on a broker-dealer or agent where one otherwise would not exist.

[3] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Investment advisers also have antifraud liability with respect to prospective clients under § 206 of the Advisers Act and M.G.L. c. 110A, § 102.

In response to these comments, the Division is clarifying the scope of Section 12.207(1)(a)-(b) of the Final Regulations. In Section 12.207(1)(a) of the Final Regulations, the duty runs during the period in which incidental advice is made in connection with the recommendation of a security to the customer. The duty has not been deemed to be ongoing except as set out in Section 12.207(1)(b) of the Final Regulations.

Section 12.207(1)(b) of the Final Regulations extends the duty beyond the recommendation period under certain circumstances. This extended duty is based upon ancillary factors that occur outside the traditional broker-dealer customer relationship.

Section 12.207(1)(b)1. of the Final Regulations states that an ongoing fiduciary duty exists if the broker-dealer or agent has discretionary authority over the customer's account. Under these facts and circumstances, the broker-dealer or agent, by taking control of the account, has assumed a position of trust and confidence. For this reason, the duty has been extended beyond the initial recommendation. Section 12.207(1)(b)2. of the Final Regulations similarly has extended the broker-dealer's or agent's duty when there is a contractual obligation that imposes a fiduciary duty. In such a case, the duty has been extended beyond the initial recommendation, based upon the terms of the contract with the customer.

Section 12.207(1)(b)3. of the Final Regulations likewise extends the broker-dealer's or agent's duty beyond the recommendation period when there is an agreement to monitor the customer's account on a regular or periodic basis. Some commenters requested guidance as to the breadth of the duty set out in Section 12.207(1)(b)3. of the Proposal. Specifically, the concern was whether the duty to monitor must be continuous, even if the agreement set out defined periods of monitoring. In response to these comments, the Final Regulation has been amended to clarify that the duration of the fiduciary duty is determined by the agreement with the customer. For example, if the agreement with the customer is to monitor the account four times a year, the fiduciary duty will commence and end each quarter period when the review is performed.

Section 12.207(1)(b)4. of the Proposal also extended the fiduciary duty beyond the time a recommendation is made. This section of the Proposal imposed a fiduciary duty during any time in which the broker-dealer or agent received ongoing compensation or provided investment advice to the customer in connection with other non-brokerage financial advice. Many commenters wrote that this extended duty may run contrary to the "incidental" exemption from the Investment Advisers Act of 1940 (the "Advisers Act").

These commenters claimed that this section would require broker-dealers and agents to conduct ongoing monitoring, which in turn would be outside the scope of the "incidental" exemption. As such, according to these commenters, broker-dealers would be required to register with the Securities and Exchange Commission ("SEC") as investment advisers.

Commenters also asserted that the ongoing monitoring resulting from Section 12.207(1)(b)4. of the Proposal would impose additional costs for the broker-dealers and their agents, which may then be passed on to the customers. These commenters then predicted that any increased operational costs would be substantial and would result in material restrictions on the broker-dealer model in Massachusetts. They further asserted that this ongoing duty would result in higher costs,

less choice, and limited services for the customer. In response to these comments, the Division has removed Section 12.207(1)(b)4. from the Final Regulations.

Commenters likewise argued that Section 12.207(1)(b)5. extends the fiduciary duty beyond what is agreed upon with the customer, and would impose an ongoing duty where one otherwise would not exist. A number of commenters wrote that any customer contact could lead a customer to have a reasonable expectation that the broker-dealer or agent would monitor their accounts on an ongoing basis. For example, one commenter expressed the concern that the section would prevent them from sending out "helpful reminders" and other informational notices. Similar to the arguments made above, commenters wrote that this would impose an ongoing duty on the broker-dealer or agent that would take them outside the scope of the "incidental" exemption in the Advisers Act. In response to these comments, the Division has removed Section 12.207(1)(b)5. from the Final Regulations.

iv. Use of Certain Titles

Section 12.207(1)(c) of the Proposal addressed the use of certain titles by a broker-dealer or agent and created a presumption that the use of such titles imposed an ongoing duty. Many commenters expressed the concern that the use of certain titles alone does not create an expectation that a broker-dealer or agent will monitor a customer's account, and therefore does not warrant an ongoing duty. The Division disagrees. Broker-dealers advertise themselves today as financial advisers and consultants rather than stockbrokers. These advisory titles imply that they provide much more than "incidental advice." A 2007 study by the Rand Corporation found that customers did not understand the key distinctions between the titles of investment advisers and broker-dealers. The study attributed part of customer confusion to the dozens of titles used in the field, including generic titles, such as *financial advisor* and *financial consultant*.

Holding broker-dealers and agents to a fiduciary standard of conduct as set out in the Final Regulations provides customers with additional protections when receiving a recommendation or investment advice from financial professionals, whether they are investment advisers or broker-dealers. Given the protections provided under the Final Regulations, the Division has removed Section 12.207(1)(c) from the Final Regulations.

v. Definition of "Customer"

Section 12.207(3) of the Final Regulations provides a definition of "customer" for the purpose of this section. Several commenters wrote that the Proposal should explicitly limit its application to retail investors with a legal address in Massachusetts or who reside in Massachusetts. Commenters further wrote that the Proposal would create confusion for investors in Massachusetts and for financial services firms that operate in multiple jurisdictions.

The Division has not made any changes to the Final Regulations in response to these comments. The 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

A majority of commenters did not provide comments with respect to the Division's proposed duty of care, as set out in Section 12.207(2)(a) of the Proposal. However, a few commenters wrote that the language requiring parties to make reasonable inquiry into "[a]ny other relevant information" is overly broad.

The requirement to make reasonable inquiry into what the broker-dealer or agent determines may be relevant to the recommendation is consistent with state and federal regulations. Accordingly, the Division has retained this language in the Final Regulations.

C. Duty of Loyalty

Several commenters presented questions to the Division regarding the duty of loyalty as set out in the Proposal. The Division has addressed these questions below.

i. Disclosure of Conflicts of Interest

Section 12.207(2)(b)1. of the Final Regulations states that a broker-dealer or agent must disclose all material conflicts of interest. Commenters did not raise questions or concerns with this portion of the Proposal. Accordingly, the Division has not made any changes to this section in the Final Regulations. The duty of loyalty cannot be satisfied without disclosure of all material conflicts of interest.

ii. Avoidance, Elimination, and Mitigation of Conflicts of Interest

Section 12.207(2)(b)2. of the Final Regulation states what a broker-dealer or agent must do, in addition to disclosure, when facing conflicts of interest or potential conflicts of interest. Several commenters expressed concerns with this portion of the Proposal, arguing that, as proposed, it was vague and difficult to satisfy. In response to these comments, the Division has provided clarification on how broker-dealers and agents should handle avoidance, elimination, and mitigation of conflicts of interest under the Final Regulations.

Section 12.207(2)(b)2. of the Final Regulations now requires that broker-dealers and agents "[m]ake 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 [emphases added]…." The Division revised this portion of the Regulations from that which was in the Proposal to clarify that not all conflicts must be avoided. Likewise, not all conflicts must be eliminated. Accordingly, conflicts that arguably could be avoided or eliminated do not need to be if it would not be reasonable for a broker-dealer or agent to do so.

Many commenters wrote that the receipt of compensation in connection with making a recommendation presents a conflict of interest. They raised the concern that they would be unable to receive compensation in this manner under the Proposal. The Division recognizes that professionals who are in the business of making recommendations on the purchase and sale of securities do so for compensation. Arguably, this conflict cannot *reasonably* be avoided or

eliminated. Instead, the broker-dealer and agent may mitigate this conflict by, for example, ensuring that the fee earned for the recommendation is reasonable and complying with the remainder of the fiduciary duty.

Other commenters wrote that the recommendation or sale of proprietary products creates a conflict of interest, as does making a recommendation or sale in a principal transaction. These commenters also raised concerns that they would be unable to engage in these activities under the Proposal. The Division recognizes that broker-dealers and agents engage in these transactions. Arguably, these conflicts cannot *reasonably* be avoided or eliminated. Instead, the broker-dealer or agent 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.

iii. "Without Regard To"

Section 12.207(2)(b)3. of the Final Regulations requires broker-dealers and agents to "[m]ake recommendations and provide investment advice to customers without regard to the financial or any other interest of any party other than the customer." Under this provision, broker-dealers and agents must make a recommendation or provide investment advice to a customer with only the customer's interests in mind. Several commenters raised concerns that the "without regard to" language in the Proposal required broker-dealers and agents to give conflict-free advice. Specifically, these commenters were concerned that transaction-based compensation would be prohibited under this provision.

Section 12.207(2)(b)3. of the Final Regulations, like Section 12.207(2)(b)1.-2., does not prohibit the existence of conflicts, including the receipt of compensation in connection with making a recommendation or providing investment advice. Section 12.207(2)(b)2.-3. of the Final Regulations states that after disclosing and avoiding, eliminating, or mitigating conflicts, a broker-dealer or agent may not factor its own compensation, any of its other interests, or any interest of any other party, into the decision-making process behind the recommendation or investment advice.

iv. Demonstration of the Duty of Loyalty

Section 12.207(2)(c) of the Proposal stated that disclosure or mitigation alone could not meet or demonstrate the duty of loyalty. Several commenters wrote that the statement in Section 12.207(2)(c) of the Proposal was difficult to understand when read together with Section 12.207(2)(b)1.-2.

The Division has revised Section 12.207(2)(c) of the Final Regulations to clarify that disclosure of conflicts alone does not meet or demonstrate the duty of loyalty. In certain situations, conflicts of interest must be avoided or eliminated. In other situations, conflicts may exist, but must be mitigated and disclosed. In no case will disclosing a conflict of interest, without more, satisfy a broker-dealer's or agent's duty of loyalty.

v. Sales Contests, Implied or Express Quota Requirements, or Other Special Incentive Programs

Section 12.207(2)(d) of the Final Regulations creates a presumption that a recommendation made in connection with any sales contest is a breach of the duty of loyalty. In the Proposal, Section 12.207(2)(d) also created the presumption that recommendations made in connection with implied or express quota requirements or other special incentive programs were also breaches of the duty of loyalty. Commenters raised concerns that the presumption in the Proposal was broad enough to cover and effectively prohibit certain compensation systems or a firm's ability to determine health and welfare benefits for certain of its employees.

The Division has seen sales practice abuses in sales contests, both product- and non-product-specific. Accordingly, the presumption of a breach of duty remains for recommendations made in connection with sales contests, whether product-specific or not. However, in response to commenters and given the protections provided under the Final Regulations, implied or express quota requirements and other special incentive programs have been removed from the scope of Section 12.207(2)(d) of the Final Regulations.

vi. Municipal Securities

The Proposal did not specifically address municipal securities. However, commenters expressed concern that the Proposal could have detrimental effects on the markets for municipal securities. Because principal transactions are the most common form of trading in these markets, some commenters expressed concerns that such transactions could not meet the requirements under the Proposal to avoid conflicts and to make recommendations without regard to the interests of any other party. Similar concerns were raised with respect to municipal bond underwriting, which is a form of principal transaction. These commenters argued that the regulation could increase costs in, or potentially disrupt, the markets for municipal securities. These commenters also argued that an increase in costs or disruption could be detrimental to local governments.

As discussed earlier in this Adopting Release, the Division disagrees with these comments and believes the Final Regulations will not have these effects. Moreover, the Division notes that the markets for municipal bonds and other government securities are specialized markets, and that many trades are done on a principal basis. The Division also notes Executive Order 145: *Consultation with cities & towns on administrative mandates* (October 21, 1978), relating consideration of state-local concerns in the formulation of administrative policies and regulations.

Accordingly, Section 12.207(2)(e) of the Final Regulations has been added, which excludes securities issued by U.S. federal, state, and municipal governments from the duty of loyalty provision in Section 12.207(2)(b) of the Final Regulations. The language of this exclusion substantially mirrors the "government securities" exemption provided under M.G.L. c. 110A, § 402(a)(1).

The Division notes that several protective mechanisms are in place with respect to municipal and other government securities. The issuance and trading of municipal securities is subject to

regulation by the Municipal Securities Rulemaking Board. Additionally, recommendations and advice provided in connection with these securities continue to be subject the duty of care under Section 12.207(2)(a) of the Final Regulations, as well as provisions of Section 12.204 of the Final Regulations.

D. Implementation Period

The Proposal did not address an enforcement date or implementation period. However, multiple commenters wrote that the Division should postpone taking any action for one year or more following implementation of SEC Regulation Best Interest ("Reg BI"). Others wrote that an 18-24 month transition period from the effective date would provide sufficient time to comply.

The Division has been careful and deliberate in its approach to the Final Regulations. The Division did not propose its own fiduciary standard until after the SEC adopted Reg BI. The Division then sought comment on its Proposal. After reviewing and considering all of the comments, the Division moved forward with the Final Regulations.

The Final Regulations shall become effective upon publication in the Massachusetts Register. The next publication of the Massachusetts Register is scheduled for March 6, 2020. In response to the comments articulated above, enforcement of the Final Regulations will begin on September 1, 2020.

2. 950 MASS. CODE REGS. 12.204: Clarifying That Existing Suitability Standard Still Applies Where Fiduciary Conduct Standard Does Not Apply

The Division received no substantive comments on the Proposal with respect to Section 12.204 and the Division has adopted the Final Regulations without amendment.

Given that the Division has limited the scope of the Final Regulations from that which was in the Proposal, the Division has not adopted the amendments to the Regulations in Section 12.205.