VIA Email to: securitiesregs-comments@sec.state.ma.us

July 25, 2019

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

Re: Fiduciary Duty of Broker-Dealers and Investment Advisers - Preliminary Proposal 950 CMR 12.204, 12.205, and 12.207

Ladies and Gentlemen:

Please allow this to serve as comments of Cetera Financial Group, Inc. ("Cetera") with regard to proposed amendments to 950 CMR 12.204 and 12.205 and proposed new 950 CMR 12.207 (collectively, the "Proposal"). The proposed regulations would establish and expand fiduciary obligations applicable to broker-dealers and Registered Investment Advisers in Massachusetts.

Cetera is the corporate parent of a group of six broker-dealers and five Registered Investment Advisers ("RIAs"), with more than 8,000 affiliated representatives. Our firms collectively serve more than 1 million retail investors, the large majority of whom are individuals, families, and small businesses. Through our representatives, we provide both transaction-based brokerage and fee-based investment advisory services. We have extensive experience with both business models, the differing standards that are applicable to each, and the circumstances under which the interests of a client may be better served by one rather than the other.

The broker-dealer and RIA subsidiaries of Cetera currently have approximately 300 registered representatives and Investment Adviser Representatives ("IARs") who reside in Massachusetts. They collectively serve more than 35,000 client accounts and produce annual gross revenue in excess of $23 million. Considering a multiplier effect, Cetera representatives are responsible for approximately $75 million of annual economic activity in Massachusetts.

All of our representatives are independent contractors, not employees of Cetera. They operate small business that are focused on the communities in which they live and work. Their clients are often their friends, neighbors, and relatives, and they feel an obligation to act in the best interest of those clients in a way that transcends ordinary business relationships.

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Cetera strongly supports implementation of a standard of care applicable to broker-dealers providing financial advice to retail investors with respect to investments in securities. We have advocated publicly for this on several occasions, and we commend Secretary Galvin and the Massachusetts Securities Division (the "Division") for undertaking this effort to enhance investor protection. Massachusetts and other states play an important role in enforcing the laws applicable to securities and the provision of investment advice, and we welcome their participation in the discussion of how to strengthen investor protection while maintaining consumer choice and continued access to investment advice and products.

Approximately six weeks ago, the Securities and Exchange Commission ("SEC") adopted Regulation Best Interest ("Reg. BI") and a series of related regulations and interpretations regarding standards of conduct for broker-dealers and RIAs. Reg. BI establishes a comprehensive regime designed to enhance investor protection by requiring that broker-dealers not place their financial or other interests above those of their clients. A series of related new regulations require extensive disclosure about the services broker-dealers and RIAs provide, the capacit(ies) in which they are acting, fees and expenses, and conflicts of interest that may exist between the adviser and the client. While the SEC does not refer to Reg. BI as a fiduciary standard, it draws extensively on common law fiduciary principles and will produce the same practical results for most investors. Importantly, Reg. BI provides a clear and straightforward compliance roadmap for broker-dealers and other financial professionals.

Along with the SEC, a few states in addition to Massachusetts have taken steps to establish their own best interest or fiduciary regulations. We have specific misgivings about each of those proposals, but our larger concern is that individual state regulations will create a patchwork of inconsistent, conflicting or duplicative rules that will significantly impair consumers' access to valuable financial products and professional assistance. Perhaps more than any other industry, the securities markets are national or global in nature. There are hundreds of millions of investors, hundreds of thousands of financial advisers, and tens of thousands of investment products, all operating in the same markets with the goal of generating investment returns. As the Division deliberates on whether and how to move forward, we respectfully urge that it consider how the Proposal fits within the broader scheme of regulations governing the conduct of financial professionals. In particular, we suggest that the Division delay further action with respect to adoption of new standards of conduct until it has taken the time to review and understand the full impact of Reg. BI. The substantive differences between Reg. BI and the Proposal and the practical effects that they will produce are not as dramatic as the Division appears to believe. Even if Reg. BI does not cover every issue in precisely the same way as the Proposal, it deals with the same substantive matters in a comprehensive way that strikes the appropriate balance between enhancing investor protection and maintaining consumer choice. We hope the Division will recognize the value of deferring action on the Proposal and avoiding the creation of duplicative, conflicting, or incompatible rules which could deprive the citizens of Massachusetts of access to advice which is critical to their ability to save and invest.

In the statement accompanying release of the Proposal, the Division notes several issues that it believes are not sufficiently addressed in Reg. BI, including failure to define the term "best interest" and how conflicts of interest will be disclosed and managed. It is literally true that the term best interest is not defined, but we believe that this is more form than substance. Reg. BI

explicitly requires that broker-dealers not place their interest above those of their customers. It mandates extensive disclosure regarding the services to be provided by advisers, how they will be compensated, and what conflicts of interest may exist. It requires that broker-dealers adopt specific policies and procedures to identify and manage conflicts of interest through disclosure, mitigation, or elimination of incentives that create them. It recognizes that there are conflicts of interest that are most appropriately dealt with through disclosure, while others present conflicts that are so severe that they must be eliminated. Reg. BI specifically recognizes that disclosure of conflicts of interest is not always sufficient to address them.

The Division has stated that it believes investors are confused regarding the standards that apply to broker-dealers and RIAs. A new regulation adopted with Reg. BI requires that any financial adviser who wishes to publicly identify themselves with the titles "adviser" or "advisor" must be registered as an RIA or an Investment Adviser Representative ("IAR"). We will offer additional comments below with respect to disclosure and management of conflicts, but we suggest that the framework established in Reg. BI accomplishes virtually all of the substantive goals embodied in the Proposal. At a minimum, the Division should take the time to identify the many areas in which Reg. BI accomplishes the desired results and for which there is no need for additional rulemaking. This serves the important goal of harmony with the regime adopted by the SEC while also enhancing investor protection.

We would also note that, prior to adopting Reg. BI, the SEC considered several alternative approaches, including those taken by the U.S. Department of Labor ("DOL") in its "Fiduciary Rule"[1], and the fiduciary standard recommended by the SEC staff in its Dodd-Frank Section 913 study.[2] The Commissioners carefully weighed the costs and benefits of each regime and concluded that neither the DOL nor the SEC staff's approach in the Section 913 study struck the correct balance. They conceded that a single fiduciary standard applicable to broker-dealers and RIAs would produce greater uniformity between broker-dealers and investment advisers, but also noted that such a uniform standard would be detrimental to investor choice, cost, and consumer access in the market for financial advice. (See for example, the comments of SEC Chairman Jay Clayton during the SEC meeting at which Reg. BI was adopted.[3]) Instead, the Commission's approach in Reg. BI recognizes the benefits of maintaining both the brokerage and advisory business models, with enhancements designed to update and strengthen investor protection.

The SEC had every opportunity to take the same approach as that embodied in the Proposal and explicitly declined to do so. Given its role as the only regulatory agency that has jurisdiction over all of the broker-dealers and RIAs in the United States, we believe that their conclusions are entitled to a high degree of deference. Any state-by-state approach will impose structural burdens and increase administrative and compliance costs to the point that some types of financial advice will no longer be available to a large segment of the investing public. In particular, the Division should consider the negative effects that adoption of the DOL Fiduciary Rule had on investor choice. In direct response to it, many broker-dealers announced that they

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[1] 29 CFR Part 2510, RIN 1210-AB79 and related provisions
[2] www.sec.gov/news/studies/2011/913studyfinal.pdf
[3] https://www.sec.gov/video/webcast-archive-player.shtml?document_id=060519openmeeting

would no longer offer brokerage accounts that featured transaction-based compensation for Individual Retirement Accounts ("IRAs").[4] This effectively meant that IRA owners who wished to have access to investment advice would be forced to establish fee-based investment advisory accounts. This was problematic for at least two reasons: First, many investors would have been forced to pay for services that they did not need or want. In addition, most RIAs have a minimum account size for advisory accounts, often $100,000 or more. This would have the effect of depriving customers with limited means access to services that they need and desire.

The DOL Fiduciary Rule was ultimately vacated by a decision of the U.S Court of Appeals for the 5th Circuit. We believe that this was an appropriate outcome for a regulation that was flawed for all of the reasons cited by the court in its opinion vacating the rule and others that were not specifically addressed. That being said, the debate surrounding the Fiduciary Rule has provided a valuable learning experience. Broker-dealers and RIAs have used it as an opportunity to look closely at many of their business practices, particularly with respect to compensation of individual advisers and the incentives that those practices may create. In many cases, broker-dealers have made substantive changes to address these issues, increasing transparency and mitigating conflicts of interest. This has addressed many of the issues that the Proposal covers and led to better alignment between the interests of advisers and investors.

In addition to harmonizing state and federal regulation, there is a substantive reason why the Division should consider the full impact of Reg. BI before proceeding with its' own rulemaking. If the Proposal is adopted in its current form, it will almost certainly come into direct conflict with federal law. We will offer additional comments relating to federal pre-emption below, but the Proposal creates an almost certain path to litigation regarding its scope and validity. We believe that the time and energy that would be expended on that would be better used by both the regulated community and the Division in addressing workable alternatives that will serve the interests of investors in a more balanced way.

The goal of adopting a fiduciary standard applicable to financial advisers is to enhance investor protection, an objective which we wholeheartedly support. However, all regulation must balance the benefits to the class of individuals it is designed to protect against the cost. In this instance, the costs would be both direct and indirect. The cost of compliance for financial advisers will increase, but they will also naturally tend to restrict business practices or limit availability of services that investors find valuable. There is no such thing as a free lunch. In virtually all cases, the cost of compliance with regulation is borne by the ultimate consumer of the goods or services. Increasing the cost of investment advice will ultimately reduce returns for investors. We urge the Division to consider both the direct costs involved in implementing any new regulations and the indirect cost to investors in the form of reduced availability of services or innovation by financial services providers.

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[4] https://www.investmentnews.com/article/20161024/FREE/161029956/commonwealth-financial-eliminates-commission-based-retirement;
https://www.investmentnews.com/article/20161006/FREE/161009942/merrill-lynch-eliminates-commission-ira-business-in-response-to-dol

As we have noted, one of the primary goals of any regulation of financial advice should be to preserve customer choice with respect to the types of services investors wish to receive and how they choose to pay for them. The Proposal nominally permits brokerage arrangements with transaction-based compensation without creating an ongoing duty to the customer, but it establishes conditions that are so onerous and restrictive that such services may well cease to be economically viable to provide. When faced with similar regulations proposed by the State of Nevada, many broker-dealers have stated that they would discontinue offering transaction-based brokerage services in that state.[5]

Transaction-based compensation models present conflicts of interest. However, the Proposal appears to start with the assumption that other compensation models such as fee-based advisory arrangements are free from conflicts. That is simply not the case. Any provider of professional advice who is compensated for their services has a conflict of interest in that they need to convince clients to retain them in order to generate revenue. This is true of financial advisers, physicians, attorneys, and all other professionals. Fee-based advisory relationships present different types of conflicts that must be managed, but they are not conflict-free. If the Division believes that transaction-based compensation models present conflicts of interest so severe that that they cannot be managed or mitigated, it should say so and declare them to be impermissible. The conditions established by the Proposal are so burdensome as to render advice in connection with brokerage services nearly impossible to provide.

In Reg. BI, the SEC identified certain types of activity (for example, sales contests that were focused on sales of a single product or service in a limited period of time) as being likely to create conflicts of interest so severe that they cannot be effectively mitigated, and required broker-dealers to adopt policies and procedures to eliminate them. Transaction-based compensation models predate the enactment of the federal securities laws and have been widely used for more than 100 years. The conflicts they present can be effectively disclosed and managed. The Division should reconsider the extent to which provision of brokerage services with transaction-based compensation models can realistically be maintained under the terms of the Proposal.

We would also note that compensation models with asset-based advisory fees are best for some investors but not for all of them. Many investors have adopted "buy and hold" investment strategies. They invest in assets that will be held for long periods of time, regardless of their short-term performance. Examples include diversified mutual fund portfolios and "bond ladders", strategies in which the investor assembles a group of fixed income investments with staggered maturities. The intention is that once these portfolios are created, they will not require substantial attention or transaction activity for long periods of time. Advisory models generally include ongoing monitoring by the adviser, which is a service that must be paid for. Elimination of transaction-based compensation models will inevitably force many investors to either pay for services that they do not want or need or lose access to professional investment advice. While the Proposal may be well-intentioned in this regard, we do not believe it serves the interests of most investors.

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[5] https://www.investmentnews.com/article/20190313/FREE/190319968/morgan-stanley-threatens-to-pull-out-of-nevada-over-states-fiduciary

In addition to the above, we offer the following comments with respect to specific aspects of the Proposal:

I. Scope of covered activities

a. Definitions of "advice" and "recommendations".

The Proposal creates standards of conduct relating to the provision of advice and recommendations made to clients, but does not specifically define the terms "advice" or "recommendation". The Proposal should make clear that it applies only to personalized recommendations that are intended to be acted upon by the individual to whom they are conveyed, and should be modeled on the "call to action" concept embodied in FINRA Rule 2111. It should exclude generalized investment commentary, educational material, or information that is not directed to any individual with whom the adviser has an existing relationship.

The Proposal should also make clear that the rendering of advice with respect to securities or other investments that is solely incidental to the execution of securities transactions does not, in an of itself, create any duty to monitor investment recommendations absent the existence of an advisory relationship that is explicitly agreed to between the parties. We will offer additional comments regarding the scope of the ongoing fiduciary duty in the Proposal below, but we believe that the Division should be guided by the interpretation of the SEC regarding investment advice that is solely incidental to the execution of securities transactions and recognize that not all advice should create such an ongoing duty.[6]

b. Investment strategies.

The Proposal covers recommendations with respect to purchases and sales of securities, investment strategies, and the opening of any type of account, including transaction-based brokerage or fee-based investment advisory arrangements. Subject to our comments regarding the definition of the terms advice and recommendations, above, we believe that the Proposal takes the correct approach on this issue.

c. Discretionary trading authority in brokerage accounts.

950 CMR12-207(b)(2) provides that a broker-dealer or agent has an ongoing fiduciary duty if they exercise discretionary authority over a customer's account. Exercise of discretionary authority is a hallmark of an advisory relationship. (See our comments above regarding SEC Release No. IA-5249.) We agree that brokerage arrangements that include unlimited investment discretion (not those

[6] SEC Release No. IA-5249.

limited in scope, such as arrangements covering only "time and price") should be subject to an ongoing obligation similar to that applicable to RIAs.

d. Non-exclusive list of violative conduct or activities.

950 CMR 12-207(b) lists several activities that would be deemed to violate the fiduciary obligation, but specifically states that this list is "non-exclusive". This does not provide reasonable notice to broker-dealers regarding conduct from which they should refrain or standards for how to determine it, and creates a potentially endless number of activities that may be alleged to constitute breaches of the fiduciary obligation. It will lead to an explosion of claims from customers and an unmanageable burden for courts and arbitral forums that are charged with adjudicating such disputes. Broker-dealers and customers need to know what conduct is acceptable prior to entering into a relationship. This provision will create exactly the opposite effect.

II. The Duty of Care

The framework that the Division has established for the duty of care generally represents an appropriate set of factors that are important to investors, and one with which broker-dealers are familiar. It is similar to FINRA Rule 2111, which creates "Know Your Customer" and "Due Diligence" obligations. These require broker-dealers to review the characteristics, risks, and potential benefits of securities that they recommend to customers to determine if they are suitable for any investor, and to understand and take into account the attributes of the investor to whom the recommendation is made to ascertain that it is appropriate for them individually.

950 CMR12-207 (c)(1)(iii) also requires broker-dealers to take into account "any other relevant information" when making recommendations. We believe that this is well-intentioned, but the phrase "any other relevant information' is overly broad, imprecise, and not reasonably calculated to give broker-dealers or RIAs sufficient notice regarding the factors that they are required to consider in meeting the duty of care. It is also likely to spawn a large number of disputes without any realistic standards by which to decide them.

In the interest of regulatory consistency and minimizing administrative and compliance costs, the Proposal should include a safe harbor provision confirming that broker-dealers that comply with the provisions of FINRA Rule 2111 satisfy the duty of care established by the Proposal. Alternatively, it should provide that compliance with FINRA Rule 2111 creates a presumption that the duty of care is satisfied.

III. <u>The Duty of Loyalty</u>

In its present form, the duty of loyalty set forth in the Proposal is unworkable. It creates a number of issues, including the following:

a. "Without regard to the financial interest of the broker-dealer."

950 CMR12-207(c)(2) states that any recommendation by a broker-dealer or agent must be made "…***without regard to*** the financial or any other interest of the broker-dealer, agent …" (Emphasis added.) Not only is the concept of "without regard to" difficult to define, it is virtually impossible for any provider of professional services to meet because all professionals who are compensated by their clients need to generate revenue to pay the costs of operating their business and earning a profit. Largely for this reason, the SEC provided in Reg. BI that a broker-dealer may not place their interest ***above*** that of the client when providing advice or recommendations. Reg. BI establishes a specific framework of conditions that must be satisfied in order to meet this standard. It is much more realistic and comprehensible than the standard embodied in the Proposal. The formulation that the Division has adopted is capable of a wide range of interpretations and will lead to endless litigation about how it should be applied. This provision should be amended to be consistent with the Reg. BI standard.

We would also note that the concept of "without regard to" the interest of the adviser is in direct conflict with the framework of Reg. BI. We will offer further comments on the issue of conflicts between the Proposal and federal law below, but we believe that the "without regard to" provision is in direct conflict with Reg. BI and increases the likelihood that the Proposal would be preempted by federal law.

b. Disclosure and Conflict Mitigation

i. Avoidance of conflicts of interest.

CMR 950 12-207(c)(2) provides that broker-dealers must "avoid" conflicts of interest. This creates a standard that is not only ambiguous but literally impossible to meet. As discussed above, all professionals have conflicts of interest in their relationships with clients. Every compensation model creates one or more conflicts between the interests of the adviser and the client. The mandate that any adviser avoid conflicts is noble but not realistic. The key to dealing with conflicts is to require that they be disclosed and managed. Reg. BI establishes a specific regime under which disclosure and management of conflicts must occur. The Proposal should take a similar approach.

ii. Disclosure and management of conflicts of interest.

The Proposal specifies that there is no presumption that disclosure of a conflict of interest or other risk will satisfy the duty of loyalty. This creates both legal and practical concerns for broker-dealers. The fundamental principle on which the laws applicable to offerings of securities and provision of financial advice by broker-dealers and RIAs rests is the concept of disclosure. This has been the case for more than 75 years and is based on the conclusion of Congress that it represents the most reasonable way to balance investor protection and the ability of business enterprises to raise capital through offerings of securities. In the Proposal, the Division appears to have cast much of this aside. We believe this is misguided.

In Reg. BI, the SEC has set forth a regime under which firms are required to evaluate material conflicts of interest and the financial or other incentives that create them. All such conflicts must be addressed through some combination of disclosure, mitigation, or elimination, based on a good faith evaluation by the firm. Reg. BI requires broker-dealers to identify and disclose all material conflicts of interest that apply to investment recommendations and to manage or mitigate them based on the nature of the issues that they raise.

The Proposal states that disclosure of a conflict will not be deemed enough to meet the duty of loyalty, but does not offer any further guidance regarding under what circumstances disclosure would be sufficient, what other approaches may be permissible, and how broker-dealers can make these judgments. In the absence of certainty, broker-dealers will mitigate the risk of violating this provision by reducing their product and service offerings for investors in Massachusetts. This is not in anyone's interest. At a minimum, the Division should set forth standards which will make clear how conflicts of interest, especially those arising out of adviser compensation practices, can be managed. Reg. BI provides a specific template for the Division to consider.

iii. Materiality of matters requiring disclosure.

The Proposal should make clear that the duty of loyalty would be satisfied if a broker-dealer discloses and/or manages those conflicts of interest or risks that would be ***material*** to the investor to whom the recommendation is being made. The concept of materiality is set forth by the U.S. Supreme Court in *TSC Industries* *v. Northway*[7] and subsequently affirmed in *Basic,*

[7] 426 U.S 438 (1976).

Inc. v. Levinson [8], which has become the accepted standard for materiality in connection with recommendations to execute securities transactions. The Proposal should incorporate the well-established definition of materiality set forth in ***Basic****:* The significance that a reasonable investor would place on the withheld or misrepresented information. The current version of the Proposal would adopt an overbroad standard that would require many disclosures that may not be relevant or useful to an average investor.

Defining material conflicts of interest as the Supreme Court did in *Basic* would have numerous benefits for investors. It would provide them with information pertinent to their investment decisions while avoiding the problem of over-disclosure. For the securities industry, using the *Basic* definition would achieve a greater degree of legal certainty by employing a standard with which it is already familiar, and for which an existing legal framework exists.

iv. Disclosure and management of conflicts of interest should be limited to persons or entities for whom they actually exist.

Standards of conduct and obligations to identify and mitigate conflicts of interest should generally apply in the same way to both broker-dealers and their associated persons. However, it should be recognized that there are conflicts of interest that exist for the firm (for example, with respect to certain revenue-sharing arrangements and principal transactions), but do not also apply to the individual adviser. Representatives of most broker-dealers do not receive any portion of this revenue, and these practices do not create adverse incentives for the representative who actually makes investment recommendations to the client. Identification and mitigation of conflicts of interest, especially regarding compensation, should recognize this and limit application to those individuals or entities that have actual conflicts rather than adopting a blanket standard for all members of an affiliated group.

c. Duration of the Fiduciary Obligation

The Proposal establishes the concept of a "standalone" recommendation and provides that the fiduciary duty of a broker-dealer shall extend through the execution of the transaction and not be deemed an ongoing obligation. However, the term "standalone" is not defined. In addition, 950 CMR 12-207(b)(1)(i) is qualified by12-207(b)(1)(ii), which provides that "*If a broker-dealer agent also provides, **in any capacity**, investment advice to the customer, the fiduciary duty shall be deemed an ongoing obligation to that customer***.**" (Emphasis added.) The effect of these provisions is to create ongoing obligations for broker-dealers

[8] 485 U.S. 224 (1988).

in transaction-based brokerage relationships, which represents an enormous and unwarranted departure from the current standard.

Substantive differences between the broker-dealer and RIA models have appropriately led to different conduct standards. Brokerage relationships are almost always transactional and episodic in nature. The representative makes a recommendation that the customer acts upon, and is compensated through a sales charge or commission. The client pays for the type and quantity of service that they desire. If they do not need advice or wish to execute a transaction, they don't pay for it.

Fee-based advisory services are specifically designed to be ongoing in nature. They contemplate ongoing monitoring and regular communications between the adviser and the client and compensation for those services. In addition, advisory relationships usually involve discretionary authority to execute transactions. In most brokerage relationships, the customer approves or rejects each recommendation made by the adviser.

A duty to provide ongoing monitoring of clients' investments and financial circumstances creates an obligation for the adviser to expend time, effort, and other resources. Advisers must be compensated for this. In addition, the fact that the adviser has discretionary investment authority creates a heightened level of incentive to execute transactions if the adviser is compensated for each transaction. These are among the reasons why investment advisors have traditionally been compensated based on flat or periodic fees or on the value of the assets under management rather than on a transaction basis.

Both the brokerage and advisory models make sense for some clients, based on factors such as the investor's level of expertise and reliance on the adviser, the degree to which they wish to be consulted regarding investment decisions, the expected level of transaction activity, and the size and complexity of their investment portfolio. The point is that there are important differences between how transaction-based brokerage services and fee-based advisory arrangements function. These differences are among the primary reasons why RIAs have traditionally been subject to a fiduciary standard and broker-dealers have not. The approach adopted by the Division appears to ignore these historical facts in favor of a one-size fits all model.

The framework of the Proposal creates several separate but related issues:

i. **The definition of "standalone".**

   As noted above, the Proposal does not define the term "standalone" and we are not aware of any other instance in which it has been used in a regulation. At a minimum, the Proposal should set forth more detail regarding the parameters of this concept.

ii. Advice provided "in any capacity".

RCM 950 12-207(b)(1)(ii) provides that broker-dealers shall have an ongoing duty to the client if they provide advice "in any capacity". The scope of the phrase "in any capacity" is unclear and potentially unlimited. For example, a broker-dealer or agent may communicate with a customer regarding a current holding in their brokerage account, but the communication does not rise to the level of a recommendation and does not result in a transaction. The Proposal should clarify this provision by stating that the duty of the broker-dealer or agent with respect to any transaction terminates upon execution of the transaction **unless the agent is receiving separate compensation for providing investment advice to the customer as part of an advisory relationship or otherwise**. Advice which is incidental to the brokerage relationship, especially if it does not result in a transaction, should not subject the broker-dealer to an ongoing obligation to monitor the investments in the client's portfolio or their financial circumstances.

iii. Dually-registered advisers.

It is common for agents of broker-dealers to be simultaneously registered as agents of an RIA, and to provide services as both broker-dealers and investment advisers. (This is referred to as dual registration, or "switching hats".) A substantial percentage of Cetera advisers are registered as both IARs and agents of a broker-dealer. This allows them to offer both types of services to clients, and allows clients to select the advice and compensation model that makes the most sense for them. In many cases, a client maintains both a transaction-based brokerage arrangement and a fee-based advisory relationship with the same adviser.

Investors often have different objectives for different accounts or investments. Some accounts may seek to achieve shorter-term goals such as saving for the purchase of a home. Some may be longer-term, such as saving for retirement. Some accounts may have objectives such as seeking tax-efficiency through minimum portfolio turnover. Each of these account types require differing levels of service from the adviser, and lend themselves to different compensation models.

The Proposal would effectively eliminate the ability for an adviser to provide both transaction-based brokerage services and fee-based advisory services to the same client without assuming an ongoing obligation to monitor all of the customer's accounts. This will lead to one of two results: Either broker-dealers will cease offering brokerage services in

Massachusetts and force all clients to utilize a fee-based advisory model, or they will raise the price of transaction-based arrangements to compensate for the increased effort and risk that they assume. This reduces the availability of products and services to customers without a concomitant benefit.

We understand that the premise for the limitation on "hat-switching" in the Proposal originates in the Division's concern about confusion on the part of investors regarding the capacity in which the agent is acting. This concern is understandable, but the approach taken in the Proposal produces a solution far more draconian than is warranted. The SEC explicitly considered the issue of dually-registered advisers when it adopted Reg. BI and concluded that the more appropriate solution was to require explicit disclosure of the capacity in which the adviser is acting and requiring that any adviser who offers both brokerage and advisory services provide a written disclosure (Form CRS) that compares the two options.[9] This approach appropriately balances the need to ensure that investors understand the nature of their relationship with the adviser and the continued availability of investment-related services.

The elimination of the ability to maintain both advisory and brokerage accounts at the same time also creates a practical problem: What happens to all of the investors who currently have multiple arrangements with the same adviser? On the effective date of any new regulations in Massachusetts, they will be faced with a set of unpalatable options: Either convert one or more of their accounts to a different model, move one or more accounts to another adviser, or reconsider the model that they have previously utilized with the adviser. None of these options are appealing.

d. "**Reasonable fees" and the "best of the reasonably available fee options"**

950 CMR12-207(c)(2)(i) provides that "It shall not be deemed a breach of the fiduciary duty owed to a customer when the broker-dealer or agent receives a transaction-based fee, ***provided that the fee is reasonable and the best of the reasonably available fee options***…". (Emphasis added.) This provision raises more questions than it answers. What constitutes a "reasonable fee"? What factors go into establishing that any recommendation is the best of the reasonably available fee options? It will be extremely difficult for broker-dealers to understand the scope of this obligation and operate within it. These provisions create several issues, including the following:

i. Definition of the term "best". In crafting the standard embodied in the Proposal, the Division has relied on common law fiduciary principles such as the duties of care and loyalty. However, the concept of advice or

[9] SEC Release No. 34-86032

recommendations constituting the “best” of all available options does not exist in any version of the fiduciary standard of which we are aware. The idea that any single course of action or recommendation is quantitatively or qualitatively better than all of the others does not comport with reality. Making a recommendation about anything requires a reasonable process to evaluate the risks and rewards of any particular course of action which may consist of multiple independent variables, the outcome of which cannot be predicted. In its recommendations regarding Reg. BI, the SEC Investor Advisory Committee’s Investor as Purchaser Subcommittee (chaired by Barbara Roper of the Consumer Federation of America) acknowledged this, observing that “…there will often not be a single best option and that more than one of the available options may satisfy this standard…,” and stating that “…compliance should be measured based on whether the broker or adviser had a reasonable basis for the recommendation at the time it was made, and not on how the recommendation ultimately performed for the investor…”

The approach taken by the Proposal will lead to an inevitable result: Endless second-guessing of recommendations with the benefit of hindsight. This is not a standard that any financial adviser can operate under. Investments come with risks, and to suggest that all of them can be known and predicted with the level of certainty required to meet the “best of the available options” standard is unrealistic at best. Instead of mandating that advisers determine or recommend the “best” of the available options, it should require that they have a process under which they review the circumstances and objectives of the customer, evaluate the available actions, and recommend that which best fits the circumstances. All of these concepts are included in the duty of care established by the Proposal, which eliminates the need to layer on the unprecedented and ambiguous concept of the best of the available options. This concept should be eliminated from the Proposal.

Consider the following examples illustrating the difficulty in applying the “best of the reasonably available options” formulation to recommendations by advisers. Given the scope of the Proposal, the considerations applicable to any recommendation consist of at least four separate variables, including the type of account (brokerage or advisory), the securities recommended, the universe of investment products from which the agent makes recommendations and the costs and expenses applicable to each of them. Each of these components is important in determining what constitutes an appropriate recommendation, but none should be considered determinative in and of themselves.

- **Recommendations as to account type**

  Compensation payable to the agent, in both the short-and the long-term, depends to some extent upon the type of account that the client chooses. Transaction-based brokerage accounts are often less expensive than advisory accounts over time, depending on the level of transaction activity, type of investments under management, and account size. The two options are structurally different and cannot be compared on an apples-to-apples basis. This makes it exceedingly difficult to determine which type is "best".

- **Recommendations as to security type**

  Different types of securities have different risk and return profiles, characteristics, and expense structures. Purchases of individual listed equities and fixed income investments generally involve payment of commissions or other sales charges. Investment company shares such as mutual funds have sales and distribution charges, advisory fees, and other expenses that are borne by shareholders. Exchange-Traded Funds are similar to mutual fund shares, but have different underlying characteristics and expense structures. Illiquid alternative investment products such as hedge funds and non-traded REITs have similar investment objectives but often have multiple types of fees that differ among products. Variable annuities consist of many different parts, including life insurance, underlying investment accounts similar to mutual funds, and contract features known as "riders" that provide different types of benefits to purchasers. What factors should a broker-dealer consider in determining which is the "best", considering all of these variables? Is "best" synonymous with lowest cost? What other qualitative factors must be considered?

- **Total cost of ownership**

  The sales charges and other fees applicable to purchasing a security are clearly important elements in determining whether a recommendation is in the best interest of the customer, but so is the ongoing cost of owning it. However, as noted above, every investment is different, and each has its own unique cost structure. The expected and actual holding periods for the investment also have a large effect on the total cost to the investor, especially if it is held in an advisory account that has ongoing fees. All of this combines to make any determination of a single "best" alternative nearly impossible.

- **Available Products**

  Broker-dealers have obligations under FINRA Rule 2111 to perform a "due diligence" review of investment products and to reach a determination as to whether or not a particular security is suitable for any investor ("reasonable basis" suitability). This concept is embodied in the duty of care provisions of the Proposal, and requires broker-dealers to review investments to determine their risks, benefits, costs, and other relevant factors prior to recommending them to clients. Most broker-dealers have a process under which they perform this due diligence review and create what is referred to as an "approved products" list. Agents of broker-dealers can only recommend the products that are on that firm's list. This allows broker-dealers to ensure that they are familiar with the products and services that their agents are providing and have made an examination sufficient to satisfy both FINRA Rule 2111 and any applicable common law duty of care. There are literally tens of thousands of investment products that are currently available to the public. Broker-dealers make judgments about which of these products to approve based on the nature of their clientele, the focus and experience of their agents, the resources that the firm has to review and supervise products, and several other factors. Some broker-dealers also offer "proprietary" products, which are sponsored by affiliates. These products present their own unique due diligence and conflict of interest issues.

The "best of the reasonably available options" formulation set forth in the Proposal is not workable and should be eliminated in its entirety. Failing that, it should be clarified as follows:

➢ Determinations as to the type of account which is best for the client are inherently subjective and not capable of being reduced to a binary conclusion. The Proposal should state that financial advisers that offer both transaction-based brokerage accounts and advisory accounts must disclose to the customer the material features, benefits and costs associated with both types of relationships, but that if such disclosure is provided, it would presumptively satisfy the "best of the reasonably available options" criteria as to the type of account recommended. Looking back at such recommendations with the benefit of hindsight creates uncertainty that does not serve the interest of either investors or financial advisers.

➢ The cost of acquiring and holding any investment product, including sales charges and other compensation to the agent, should be a factor

in determining which is the best of the reasonably available fee options, but it should not be the sole or determining factor.

- When comparing the cost of an investment and compensation payable to the adviser, products should only be compared to others that are substantially equivalent. For example, equity-oriented mutual funds should be compared to other similar funds, and not to ETFs or other products that have similar attributes but which are not functionally identical. Annuities and other insurance products should be compared to similar products, and not to other types of investments.

- The Proposal should explicitly permit firms to create approved product lists that are limited and consistent with their business models and resources. The fact that a broker-dealer chooses not to offer any specific category of investment or any product within that category should be deemed acceptable. Firms should also be allowed to limit their product offerings to proprietary products so long as that fact is clearly disclosed to clients prior to a recommendation.

IV. Pre-emption of state conduct standards for broker-dealers

950 CMR 12-207(f) provides that "…nothing in this section shall be construed to establish any capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements for any broker-dealer of any agent of any broker-dealer that differ from, or are in addition to, the requirement established under 15 U.S.C. Section 78o(i)."

We believe that this is a well-intentioned effort by the Division to avoid the provisions of The National Securities Markets Improvement Act of 1996 ("NSMIA"). NSMIA precludes states from enacting regulations relating to the making and keeping of records "***that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act]***" (Emphasis added). Exchange Act Rule 17(a)-4 requires broker-dealers to keep a record of "all communications … by the member … relating to its business as such….". [10] We submit that it would be extremely difficult if not impossible for broker-dealers to establish compliance with the standards embodied in the Proposal without creating and maintaining a significant amount of documentation in addition to that which is currently required by Rule 17a-4.

A few examples include:

- If a broker-dealer has an ongoing obligation to a customer by virtue of providing them "advice in any capacity", it would presumably be required to monitor investment recommendations and the financial circumstances of the client after a

[10] 17 CFR §§ 240.17a-4(b)(4).

transaction is executed. In order to demonstrate that such monitoring was done, it would be necessary to create written records memorializing as much. There is no requirement in Rule 17a-4 to create such records in connection with recommendations or transactions in brokerage accounts.

- If a broker-dealer must demonstrate that any fees charged to customers in connection with transactions are "reasonable", they would be required to create written records establishing that transactions meet this standard. There is no requirement in Rule 17a-4 to create such records in connection with recommendations or transactions in brokerage accounts.

- If a broker-dealer must demonstrate that any recommendation represents the best of the reasonably available options it would be required to demonstrate that the agent considered the account type recommended to the client and all securities that are substantially similar. This would mandate creation of records that are not currently required under Rule 17a-4.

The recitation in the Proposal that it will not create any new recordkeeping requirements directly contradicts any realistic interpretation of its other provisions. The only way to cure this contradiction while retaining the other provisions of the Proposal would be to provide that, notwithstanding any new obligations it creates, broker-dealers and other financial advisers would not be required to create records documenting any actions they took to comply. This would be unorthodox at best, and not likely to accomplish the Division's desired result.

By crafting the Proposal to effectively prohibit "hat-switching," the Proposal is also in direct conflict with the federal securities laws, which expressly authorize and permit dual registrants to simultaneously provide transaction-based brokerage and investment advisory services to the same clients. The ability to maintain multiple relationships is a core principle of Reg. BI. It implicitly recognizes that broker-dealers are not required to provide ongoing monitoring by requiring disclosure of limitations on the scope of services they offer.

V. Creation of Private Rights of Action

The Proposal should explicitly state that it is not intended to confer or create any private rights of action for alleged violations of the fiduciary duty. We understand that the intent of the Proposal is to enhance protection for investors and affirm the right of the state to take action against individuals or entities that violate applicable rules. While we disagree with the substance of many of the provisions in the Proposal, we acknowledge and accept the role of the state in creating standards that the Division itself may enforce. That being said, allowing customers of broker-dealers and RIAs to predicate civil actions on alleged violation of these regulations creates numerous adverse consequences. If the Proposal creates private rights of action, enforcement of these regulations will effectively be outsourced to the claimant's bar. This will create financial and other incentives to bring

frivolous claims, ultimately increasing the cost for financial advisers of providing services to their clients. As we have noted, there is no free lunch. The cost of providing any service will ultimately be passed on to the consumer of those services. In this case, that is the investing public.

VI. Dishonest or unethical business practices

950 CMR 12-204 deems failure to conform to the fiduciary obligation a dishonest or unethical business practice. We share the Division's desire to ensure that investors are adequately protected and that bad actors are appropriately punished, but any regulation as new, comprehensive, and difficult to interpret as this will almost certainly produce inadvertent or de minimis breaches that do not result in harm to investors. Unfair trade practices laws and rules in place throughout the country generally recognize this concern, and therefore require evidence of a pattern or practice of bad behavior before imposing penalties. We respectfully urge the Division to adopt a similar requirement by revising Section 12-204 to provide as follows:

a. ***"Dishonest or unethical business practices"…shall include providing investment advice or recommending to a customer, an investment strategy, the opening of, or transfer of assets to, any type of account, or the purchase, sale, or exchange of any security when:***

   i. ***A broker-dealer, or its agent, <u>engages in a pattern or practice of failing</u> to act in accordance with a fiduciary duty to a customer when making a recommendation or providing investment advice.***

VII. Economic Impact

We note that the Proposal does not contain a discussion of potential economic impacts that it will have on investors or financial advisers who reside or do business in Massachusetts. Whether or not Massachusetts law requires such a review, we believe it is incumbent upon the Division to undertake an analysis of all the economic impacts before proceeding. The following is a non-exclusive list of questions that should be considered:

- The extent to which the cost of providing investment advice to residents of Massachusetts will rise or fall.
- The effects on investment returns experienced by Massachusetts residents.
- The economic value, in the form of better investment returns or lessening of risks that will accrue to residents of Massachusetts.

- The cost of compliance for advisers in Massachusetts and the extent to which that cost will be borne by investors.

- The extent to which broker-dealers and other financial advisers will alter their product offerings or cease providing services in Massachusetts and the effect on employment of Massachusetts residents who are employed by financial advisers.

All of these factors will have impacts on investors and advisers who live in Massachusetts. The Division should take a close look at how all of them interact and their likely effects before proceeding.

VIII. Effective dates and timing for implementation

As noted above, the Proposal represents a substantial departure from the current regulatory regime. The experience of broker-dealers with the DOL Fiduciary rule has demonstrated that compliance with any such new framework involves a long process of review to understand what activities may be impacted and how compliance may be achieved. In addition, there are numerous dependencies and parties that need to be included in implementation of any new processes that must be developed. They include broker-dealers, product sponsors, clearing firms, and other service providers. Until the final version of any new regulations is published, most firms cannot begin preparing for implementation, and necessary adjustments are not within the control of any one party. We suggest that the Division provide for a period of at least 24 months from the time that any new regulations are adopted until they become effective.

IX. Presumptions regarding investor comprehension of disclosures

In the release announcing the Proposal, the Division makes reference to a study undertaken by the RAND Corporation with regard to the ability of investors to understand the differences between brokerage and investment advisory services and their ability to make appropriate judgments about what best serves their interests.[11] The Rand Report reached a number of conclusions, some of which we believe are supported by evidence and others that are not. It is beyond the scope of this letter to discuss all of the findings of the RAND Report and whether or not they are accurate. That being said, we are concerned that the Division has concluded that most investors are not able to understand disclosures regarding the types of financial advice that they are receiving and the steps they should go through to determine if it is in their best interest. The foundational concept in the federal and most state securities laws is disclosure to investors and other securities market participants. Not only do we believe that the conclusions of the Division on this issue are unwarranted, they completely discount the ability of investors to make their own decisions about matters that will have significant effects on their lives. It directly reduces their incentives to know and understand the factors they should consider and take responsibility for their actions. We do not believe

[11] Investor and industry perspectives on investment advisers and broker-dealers / Angela K. Hung ... [et al.]. "RAND Report" (2008).

this is in the best interest of investors, and creates a significant risk of taking Massachusetts so far outside of the investment mainstream that it will have negative effects on its residents. These are actions that should only be taken with much more deliberation.

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We appreciate the opportunity to provide these comments, and look forward to working with the Division as it considers further action. If we any offer any additional information or assistance, please let me know.

Sincerely,

Mark Quinn
Director of Regulatory Affairs
Cetera Financial Group