LEGAL UPDATE

Massachusetts Advances Regulations Imposing Fiduciary Duty on Broker–Dealers

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In November 2019, the Commonwealth of Massachusetts issued revised regulations imposing a fiduciary standard upon broker–dealers. The regulations would not apply to a broker–dealer who is a fiduciary under ERISA, a status currently in limbo since the invalidation by the Court of Appeals for the Fifth Circuit of the Department of Labor's conflict of interest/fiduciary rule. In issuing this revised proposal, Massachusetts indicated that in its view the SEC's Regulation Best Interest (Reg BI) provided inadequate relief to investors, in part by failing explicitly to recognize that broker–dealers act in a fiduciary capacity to their clients or customers.

Under the regulations, it is an unethical or dishonest practice for a broker–dealer to fail to act in accordance with a fiduciary duty to a customer or client when providing investment advice, recommending an investment strategy, opening or transferring of assets to any type of account, or the purchase, sale, or exchange of any security, commodity, or insurance product. It is also an unethical or dishonest practice to fail to act in accordance with a fiduciary duty to a customer or client during any period which a broker–dealer: (i) has or exercises discretion with respect to a customer's or client's account, unless the discretion relates solely to the time and/or price of the execution of the order; (ii) has a contractual fiduciary duty; (iii) has a contractual obligation to monitor a customer or client's account on a regular or periodic basis; (iv) receives ongoing compensation or charges ongoing fees for advising a customer or client as to the value of securities, or the advisability of investing in, purchasing or selling securities;

and (v) engages in any act, practice, or course of business that results in a customer or client having a reasonable expectation that the broker–dealer will monitor the customer's or client's account or portfolio on a regular or periodic basis. With respect to this fifth requirement, the proposal elaborates that the use of a title, credential, or professional designation containing any variant of the terms adviser, manager, consultant, or planner, in connection with any of the terms financial, investment, wealth, portfolio, or retirement or any words of similar meaning or import, constitute engaging in such conduct. In situations in which no fiduciary duty is required, the current suitability standard remains in effect.

The fiduciary duty has two (2) components – a duty of care and a duty of loyalty. With respect to the duty of care, the broker–dealer must make reasonable inquiry as to: (i) the risks, costs, and conflicts of interest related to all recommendations made and investment advice given; (ii) the customer's or client's investment objectives, risk tolerance, financial situation, and needs, and (ii) and any other relevant information. The duty of loyalty requires a broker–dealer to: (i) disclose all material conflicts of interest; (ii) make all reasonably practical efforts to avoid conflicts of interest, eliminate conflicts that cannot be avoided, and mitigate conflicts that cannot be avoided or eliminated. In contrast to Reg BI, the proposal states that disclosure or mitigating conflicts alone does not meet or demonstrate the duty of loyalty. It is also a presumptive breach of the duty of loyalty for a broker–dealer to recommend any investment strategy, open or transfer assets to a specific type of account or purchase, sell, or exchange any security, commodity, or insurance product if the recommendation is made in connection with any sales contest, implied or express quota requirements, or other special incentive program.

If the proposal is adopted in substantially its current form, it will almost certainly be subject to legal challenge, on the same grounds that similar regulation of broker–dealers by Nevada and New Jersey will be challenged. The Massachusetts regulation acknowledges that certain requirements with respect to the regulation of broker–dealers are entirely matters of federal law, such as requirements for capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operational reporting. However, states believe that imposition of fiduciary duties upon brokers is not preempted by Federal Securities Law, and that will be an issue for the courts to resolve.

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