



# *The Commonwealth of Massachusetts*

*Secretary of the Commonwealth*  
*State House, Boston, Massachusetts 02133*

*William Francis Galvin*  
*Secretary of the Commonwealth*

August 7, 2018

The Hon. Jay Clayton, Chairman  
The Hon. Kara M. Stein  
The Hon. Michael S. Piwowar  
The Hon. Robert Jackson  
The Hon. Hester M. Pierce  
U.S. Securities and Exchange Commission  
c/o Brent Fields, Secretary  
100 F Street, NE  
Washington, DC 20549-1090.

Re: Comments on: (i) "Regulation Best Interest" Proposal, Release No. 34-83062; File No. S7-07-18; RIN 3235-AM35; (ii) "Form CRS, Customer Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names and Titles" Proposal, Release: 34-83063; IA -4888; File S7-07-18; RIN 3235-AL27; and (iii) "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation," Release No. IA-4889; File No. S7-09-18 RIN: 3235-AM36

Dear Chairman Clayton and Commissioners:

I write in my capacity as the chief securities regulator for Massachusetts. The Office of the Secretary of the Commonwealth administers and enforces the Massachusetts Uniform Securities Act, M.G.L. c.110A, through the Massachusetts Securities Division. We welcome this opportunity to comment on the Securities and Exchange Commission's (the "SEC" or the "Commission") Regulation Best Interest ("Regulation BI") proposal, the related Form CRS proposal, and the proposed Commission interpretation regarding investment adviser conduct (together, the "Proposals").

The Proposals address the most fundamental of investor protection issues: the duties that providers of investment advice owe their customers and clients. As a regulator, I have seen the grievous harm suffered by Main Street investors who mistakenly trusted and relied on conflicted investment advice. The Commission now has the opportunity of a generation to protect them. Unfortunately, the Proposals are inadequate to provide this protection. I urge the Commission to replace the current Proposals with a strong uniform fiduciary standard, comparable to the standard applicable under the Investment Advisers Act of 1940, that will apply to advice provided to retail investors by both investment advisers and broker-dealers. If the Commission does not adopt a strong and uniform fiduciary standard, Massachusetts will be forced to adopt its own fiduciary standard to protect our citizens from conflicted advice by broker-dealers.

## **I. To Protect Investors, Broker-Dealers Must Provide Advice under a True Fiduciary Standard.**

The Commission's Regulation Best Interest proposal and related proposals fall short of providing the reforms needed to protect retail investors when they receive advice and recommendations from broker-dealers. We are concerned that while the Proposals purport to reform conduct standards and disclosure to customers, they will exacerbate current confusion about securities advice.

We strongly support the principle stated in Section 913 of the Dodd-Frank Act, which authorized the SEC to establish a standard of conduct for broker-dealers providing investment advice about securities to retail investors that is "no less stringent than" the fiduciary duty standard under the Advisers Act.<sup>1</sup> We also agree with SEC Chairman Clayton's statement that there should be "no daylight" between the conduct standards applicable to investment advisers and broker-dealers who provide advice and recommendations to retail investors.<sup>2</sup> Unfortunately, we are disappointed that the Proposals will not accomplish those goals. Instead, the heart of the Proposals is a so-called "best interest" conduct standard for broker-dealers that will foster confusion and will fail to protect vulnerable investors and that is for all intents and purposes substantially the same as the current suitability standard.

Under current law, a broker-dealer is a merchant that is subject to fair dealing and suitable recommendation requirements when it deals with customers. Too often, we have seen broker-dealer firms assert in enforcement actions and in customer suits that their obligations to customers are limited, and are not fiduciary in nature. When customers are harmed, it is typical for the same broker-dealers, who formerly had portrayed themselves as trusted advisers, to make every possible legal argument to limit their liability exposure under the brokerage industry's weak suitability rule. This includes using subscription documents signed by investors to defend against suitability charges.

### **a) Adopt a Clear and Uniform Fiduciary Standard**

To ensure clarity and accountability, broker-dealers should provide advice pursuant to a contract with the customer that includes a clear statement that the broker stands in a fiduciary relationship with the customer and that all advice and recommendations will be in the best interest of the customer. Best interest must be defined as no less stringent than the standard under

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<sup>1</sup> Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011) at page (v): "The Commission should exercise its rulemaking authority to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that: 'the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.'" (emphasis added)

<sup>2</sup> David Armstrong, *SEC's Clayton: "No Daylight" Between Advisor, Broker/Dealer Duties in Proposed Rules*, WEALTH MANAGEMENT, May 23, 2018, <https://www.wealthmanagement.com/regulation-compliance/sec-s-clayton-no-daylight-between-advisor-brokerdealer-duties-proposed-rules>.

the '40 Act. Investors should be able to sue to enforce the contract, an enforcement mechanism that is key to making the new standard effective.

The underlying best interest obligation of broker-dealers should include:

- That the broker-dealer must take every reasonable measure to avoid conflicts of interest,
- That advice is solely in the interest of the customer/client,
- That advice be provided with the care, skill, prudence and diligence that a prudent person would use,
- That direct and indirect compensation to the broker-dealer, the financial institution, or any of their affiliates or related entities must be reasonable,
- That the broker-dealer not make any materially misleading statements regarding the applicable fees, material conflicts of interest or any other matters relevant to the investment decision, and
- The investor has a private right of action to bring claims for violation of the duty.

In contrast to the above, the proposed standard lacks clarity and certainly falls below a true fiduciary standard.

#### **b) A Fiduciary Standard Should Apply to Episodic Advice**

We understand the Commission's desire to design standards that will apply to advice that is provided to customers on an episodic, or pay-as-you-go, basis. We agree that any new rule should accommodate episodic advice, but we urge that such advice must be provided under a fiduciary standard, taking into account the time-limited nature of the engagement of the adviser. The rules on episodic advice should be drafted precisely to avoid inadvertently creating a loophole in the broker-dealer's fiduciary obligation to monitor accounts when needed. For example, the payment of ongoing compensation, such as a trail commission, indicates an ongoing relationship and so must carry ongoing duties to monitor the investment.

## **II. Fundamental Problems with the Proposed "Best Interest" Standard**

A fundamental problem is that the Proposals do not define what "best interest" means under the new conduct standard. This places the standard, and the Proposals overall, on a path for failure. SEC Commissioner Kara Stein correctly focused on this problem in April 2018, when the Proposals were released by the Commission.<sup>3</sup> The Best Interest nomenclature used in the Proposals will certainly promote confusion. The fiduciary standard under the '40 Act is often defined as a "best interest" standard and in the Proposals, the same wording is used to describe a weaker conduct standard.

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<sup>3</sup> Public Statement, *Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers*. Commissioner Kara M. Stein, April 18, 2018, . <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818>, "[T]he lack of a definition of best interest, the use of similar terms to mean different things, the use of different terms to mean the same things, and the possibility that the SEC and FINRA interpret the same language in their suitability standards differently. All of these concerns would make it difficult for the industry to discern a clear compliance path. Any resulting confusion may well result in higher compliance costs for broker-dealers, which will likely be passed onto the investor. What's more, the lack of a clear standard is not likely to give investors more confidence in the broker-dealer business model." (citations omitted)

Although the proposed standard is not clear, it is evident that the Commission has abandoned a fiduciary standard in the name of choice and the preservation of the broker-dealer advice model. The Commission should not move away from a true fiduciary standard based on a spurious claim of investor choice. We urge the Commission to reject the *status quo* and to upgrade the Proposals to a true fiduciary investor protection standard.

The Commission has shaped its “best interest” regulation to preserve the traditional broker-dealer advice model, with investor protection taking a back seat. The Proposals present the veneer of a fiduciary standard without providing the substance needed to protect retail investors.

**a) The Proposals Place Improper Emphasis on “Reasonable” Procedures to Satisfy the Best Interest Standard**

We note that the Proposals state in numerous places that a broker-dealer will meet the proposed best interest standard if it has acted “reasonably.” This includes requirements that broker-dealers should “reasonably” disclose conflicts, establish policies “reasonably designed” to identify and at a minimum disclose all material conflicts, exercise reasonable diligence, care, and prudence . . . , and have a “reasonable basis to believe” a recommendation is in the customer’s best interest. Taken together, this softening language fundamentally weakens the best interest standard.

Currently, when disputes arise between brokers-dealers and customers, a key defense will be that the broker acted “reasonably” under the rules, even if the customer was harmed by bad advice or recommendations. The Division has seen brokerages raise this kind of defense under the current suitability conduct standard. In a case that was the subject of a Securities Division enforcement action, a brokerage sold millions of dollars’ worth of speculative, privately-placed notes to a large segment of its retail customers.<sup>4</sup> When the value of the notes collapsed, the brokerage attempted to justify those sales based on the firm’s adherence to its investment screening procedures and based on language in the subscription agreements that imposed responsibility for selecting the investment on the customers.

We foresee that firms will raise the same kinds of defenses under the Regulation Best Interest conduct standard when inappropriate recommendations are alleged. If anything, the Proposals will give broker-dealers more opportunities to argue that they fully complied with the requirements of Regulation Best Interest because they provided disclosures and their procedures were reasonable and defensible under the rules. Capable corporate counsel can do much to decimate investors’ claims under an amorphous “reasonableness” standard.

**b) The Proposals Should Designate Practices that are Inconsistent with the Best Interest of Customers**

The Proposals do not designate any brokerage practices which tend to be so harmful to investors that they will not meet the best interest standard even when steps are taken to mitigate and disclose conflicts.<sup>5</sup> We ask the Commission to specifically name practices like the following

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<sup>4</sup> Massachusetts Securities Division, Docket No. E-2009-0085 (Jan. 26, 2010) (Consent Order filed on May 23, 2011).

<sup>5</sup> Regulation Best Interest Proposing Rel. at 183-184, “Broker-dealers that make recommendations to retail customers that may involve such compensation practices [sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management] should

as *per se* violations of the best interest standard because they are fundamentally contrary to the requirement for broker-dealers to provide advice that is in the true best interest of customers:

- Sales contests
- Sales quotas (especially for in-house products), and
- Incentives to sell high-cost and high-risk products.

The Securities Division has seen time and time again sales contests that have harmed investors. An investor's life savings should not be caught up in a contest to win a trip or other award. These practices must be prohibited.

It is dangerous not to address these issues now; failing to do so will imply that even the worst brokerage conflicts can be adequately addressed under the new conduct standard if the brokerage makes disclosures and can demonstrate that it has observed "reasonable" procedures.

**c) The Proposals Improperly Rely on Disclosure in an Attempt to Remedy Conduct Standard Problems**

The provisions of the Proposals are directly contrary to years of data reflected in past studies and reports on disclosure and the conduct standards for applicable to broker-dealers. The Proposals disregard the findings of the 2008 RAND Report<sup>6</sup> as well as the specific recommendation by the SEC Staff in the Section 913 Report that a uniform fiduciary standard should apply to both investment advisers and broker-dealers when they make recommendations to retail customers.

The empirical studies supporting the RAND Report showed that investors were fundamentally confused about the differences between broker-dealers and investment advisers.<sup>7</sup> Such confusion has been fostered by an array of industry practices (such as misleading professional titles and firm advertising campaigns) and the current disclosure system.<sup>8</sup> A key finding of the RAND Report is that most investors mistakenly believed the intermediary (whether it is a broker-dealer or an investment adviser) is acting in the investor's best interest.<sup>9</sup> The RAND Report concluded that investors do not have the education and background to understand and effectively use disclosures such as Form ADV, Part 2. Investors do not read long formulaic documents, so they are not useful in practice.

Relationship disclosure is important for all investors, but it cannot replace the benefits a clear fiduciary standard of conduct will provide retail investors. The genie cannot be put back in the bottle; disclosure is not the answer to the conflicts that the brokerage industry has created by trying to benefit from calling themselves advisers.

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carefully assess the broker-dealer's ability to mitigate these financial incentives and whether they can satisfy their best interest obligation." (emphasis added)

<sup>6</sup> Investor and industry perspectives on investment advisers and broker-dealers / Angela K. Hung ... [et al.]. "RAND Report" (2008).

<sup>7</sup> RAND Report at 19.

<sup>8</sup> RAND Report at p. 19, "Questionable Value of Disclosures."

<sup>9</sup> RAND Report at 19.

### **III. Massachusetts Securities Division Enforcement Actions Demonstrate the Need for a Uniform Fiduciary Standard**

As the Commission knows, retail investors are suffering severe financial harm under the current “suitability” conduct standard for broker-dealers. The following enforcement cases may have been avoided if a true uniform fiduciary standard had been in place:

- a. Conflicts of Interest Cases
  - i. Sales Contests
    - 1. 2016-0055: Sales contests at a large broker-dealer firm involving cross-selling.
    - 2. 2017-0045: Sales contests at a large broker-dealer firm involving sales in violation of internal policies and procedures.
  - ii. Churning
    - 1. 2012-0118: Churning in senior citizen’s brokerage account involving covered securities.
    - 2. 2016-0085: Churning in brokerage accounts and unsuitable sales of alternative investments.
- b. Suitability Cases
  - i. Broker-dealers on Bank Premises
    - 1. 2015-0103: Unsuitable sales of securities products to a senior citizen by a representative working out of the offices of a large state chartered bank.
    - 2. 2016-0060: Representatives of a mid-sized independent broker-dealer working out of state chartered bank premises made unsuitable sales of alternative investments including structured CDs, non-traded REITs and BDCs.
    - 3. 2016-0095: Failure to supervise by large independent broker-dealer of their agents working out of Massachusetts based credit unions.
  - ii. Failure to Supervise and Alternative Investments
    - 1. 2012-0036: Failure to supervise by a large independent broker dealer of their agents in the sale of non-traded REITs.
    - 2. 2015-0178: Failure to supervise by a large broker-dealer firm of their agent, who made unsuitable recommendations of warrants, REITs and covered securities to investors, including many seniors - specifically, this involved warrants of exchange-listed securities
  - iii. Failure to Supervise and Unsuitable Investments
    - 1. 2016-0039: Failure to supervise by large independent broker-dealer of their agent who made unsuitable recommendations involving sales of the exact same financial product carrying a very high commission, to more than 80 customers.

While I do not know that similar violations will not occur under a true fiduciary standard, these kinds of activities will be constrained by strong regulation and industry’s concerns about investors’ private rights of action.

### **IV. The Flaws in the Best Interest Standard Will Prevent Form CRS from Achieving its Purpose of Reducing Investor Confusion**

Done right, a form to educate retail investors on the duties owed to them by broker-dealers and investment advisers should help them make educated decisions on what is right for their needs. However, we cannot support the proposed Form CRS because it will promote investors' current confusion about conduct standards.

The Proposals are built around a confusing and vague best interest conduct standard for broker-dealers. Then, the form attempts to summarize the proposed standards of conduct owed by broker-dealers and investment advisers in brief descriptions for the sake of comparison. The result is a complex and vague form that reflects the flaws in the proposed conduct standard.

The resulting standard comparison will look somewhat like this, based on the required language as pulled from the Hypothetical Relationship Summary for a Dually Registered Investment Adviser and Broker-Dealer found in Appendix C:

Broker-Dealers	Investment Advisers
<p>“We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities.” “When we provide any service to you, we must treat you fairly and comply with a number of specific obligations.”</p>	<p>“We are held to a fiduciary standard that covers our entire investment advisory relationship with you.”</p>

While lawyers and securities industry professionals may understand these differences, retail investors are even more likely to be confused or misled. It would not be clear to the average retail investor what the difference between these standards is or what this means for them when making important decisions regarding their finances. This flaw cannot be fixed by simply redrafting the form because it goes to the core of the Best Interest standard proposal.

To make matters more confusing, the fiduciary standard is often defined as a “best interests” standard. This is clearly not enough to help investors understand which standard is stronger or in what way.

Further, the length of Form CRS reduces its potential. Form CRS should be a shorter form of 1-2 pages that will be easier to use and understand given that investors are unlikely to read a long and complicated form.

The evident problems with Form CRS shine a glaring light on the flaws in Regulation Best Interest. The Best Interest standard remains unclear and how this standard of conduct differs from the fiduciary duty standard for investment advisers remains muddled as well. A uniform fiduciary standard that applies to both investment advisers and broker-dealers would resolve these issues since it would be easier for financial firms to disclose and for investors to understand.

**a) Restrictions on the Use of Titles, including “Adviser” and “Advisor,” Provide Greater Clarity, but More is Needed**

The title reform proposed by the SEC should provide investors with clarity on the precise role, and associated standards, of their financial professionals.

As a threshold issue, investors should be able to identify, when speaking with a registered person, what standard of conduct covers the relationship. Preventing standalone broker-dealers

from using the title “advisor” and “adviser” is a small but important step towards distinguishing broker-dealers from investment advisers. This reform is overdue but welcome. This labelling issue will diminish in importance if a uniform fiduciary standard is adopted. We also ask the Commission to prohibit the use of other titles that improperly suggest an advisory-type relationship, including, financial consultant, investment consultant, and wealth manager by those who are not subject to a fiduciary standard.

When a uniform conduct standard applies, what brokers or investment advisers call themselves will no longer be crucial.

## **V. The Commission’s Proposed Interpretation of the Fiduciary Standard is Ineffective Due to the Problems of Regulation Best Interest**

We support the Commission’s effort to improve investor protection by offering guidance on the fiduciary duty under the Advisers Act. However, the Commission’s proposed interpretation will only cause more confusion when read alongside Regulation Best Interest.

The Commission says it is proposing different standards of conduct for broker-dealers and investment advisers but it is really fusing the two standards in substance while distinguishing them by name. The proposal incorporates components of the investment adviser fiduciary duty into the broker-dealer standard of conduct, and vice versa. The Commission insists that the standards are different and serve different relationship dynamics. In reality, many broker-dealers and their agents hold themselves out as providing the kinds of advice and guidance that have traditionally been offered by investment advisers. Accordingly, broker-dealers and investment advisers should be held to the same standards of care, loyalty, and conduct, and we urge the Commission to adopt a uniform fiduciary standard for both broker-dealers and investment advisers.

### **a) More and Clearer Guidance is Needed on the Fiduciary Duty**

The Commission’s interpretation fails to clarify the fiduciary duty under the Advisers Act because it fails to offer real guidance in terms of how investment advisers can satisfy their fiduciary duty. More and clearer guidance is necessary in three key areas:

First, more guidance is necessary on the best interest obligation under the fiduciary duty. Investment advisers will wonder whether the best interest obligation under the fiduciary duty is the same as that set out in Regulation Best Interest. In using the term “best interest” to describe both the investment adviser and broker-dealer standards of conduct, the Commission’s interpretation dilutes the fiduciary standard by attempting to bring investment advisers in line with broker-dealers. Instead, we urge the Commission to bring broker-dealers in line with investment advisers and hold both to the higher fiduciary duty standard of conduct.

Second, more guidance is needed on the factors that determine whether an investment adviser has an ongoing relationship with a client because this determination impacts the investment adviser’s duty to provide advice and monitoring to the client. The Commission implies but does not clearly state that investment advisers that earn asset-based fees have ongoing client relationships. The Commission should clarify the degree to which an investment adviser’s fee structure impacts the scope of its relationship with a client. We urge that the payment of trailing commissions indicates that the relationship is something other than episodic, so a duty to monitor the investment should apply.



Finally, more guidance is needed on full and fair disclosure of conflict of interests. The Commission suggests that in certain circumstances an investment adviser cannot rely on disclosure of conflicts to satisfy its fiduciary duty. However, the Commission fails to shed light on any such circumstances. The Commission illustrates how an investment adviser may handle conflicts but uses only innocuous examples, which leads to an oversimplification of the fiduciary duty. Investment advisers would benefit from examples of how to satisfy the fiduciary duty in less mundane situations.

**b) Additional Investment Adviser Regulation Proposals Should Mirror Existing State Regulation**

If the Commission puts forth proposals regarding licensing and qualification requirements for investment adviser representatives, we would advocate for requirements that mirror those already in place at the state level. Uniform qualification requirements would ease the transition for investment advisers on the cusp of federal-state registration without hampering business or client service. Similarly, we would advocate that any future proposals for additional investment adviser regulations are in harmony with those already in place at the state level.

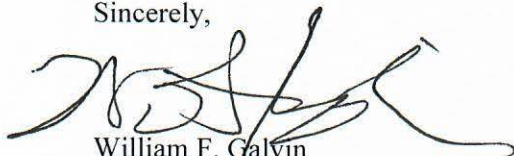
**c) In the Absence of Meaningful Action by the Commission, Massachusetts is Prepared to Adopt a Fiduciary Standard for Broker-Dealers**

My Office has repeatedly seen the harm caused by broker-dealers that provide conflicted investment advice to their customers, and we see the need to act protect our citizens. Due to the Commission's long delay in addressing these issues and the serious problems with the current Proposals, we are prepared to adopt a requirement that broker-dealers must provide advice and make investment recommendations under a fiduciary conduct standard comparable to investment advisers' under the '40 Act.

We urge the Commission to withdraw the current Proposals and replace them with a set of proposals built around a uniform fiduciary standard, as recommended in the Dodd-Frank Section 913 Report. Retail investors demonstrably need the protection of a uniform fiduciary standard. The Commission should propose revised rules to address that need.

If you have questions about this letter or we can assist in any way, please contact me or Bryan J. Lantagne, Director of the Massachusetts Securities Division at [REDACTED] or [REDACTED].

Sincerely,



William F. Galvin  
Secretary of the Commonwealth  
Commonwealth of Massachusetts