

Morgan Lewis

MEMORANDUM

TO: **Morgan Lewis Fiduciary Standards Working Group – PUBLICATION VERSION (OBSERVATIONS AVAILABLE UPON REQUEST)**

FROM: Lindsay B. Jackson
Helen Rizos
Daniel R. Kleinman
Natalie R. Wengroff

DATE: September 19, 2023 *DRAFT*

SUBJECT: **Comparison of SEC’s Reg. BI. / Massachusetts Fiduciary Rule / NASAA’s Dishonest or Unethical Business Practices (Proposed)**

The table below lays out the principal elements of SEC Regulation Best Interest (“Reg. BI”), the Massachusetts fiduciary rule and NASAA’s proposed model rule changes to incorporate Reg. BI. We note that the full table with our observations and insights is available upon request. Please contact any Morgan Lewis attorney listed above to request a copy.

NASAA’s proposal goes significantly beyond the Reg. BI and the Massachusetts fiduciary rule (at least based on the rule texts), including most importantly that the proposal would:

- *Effectively prohibit receipt of compensation other than commissions* by including *a rebuttable presumption* that a firm’s or representative’s *receipt of such compensation violates the duty of loyalty*. Such rebuttable presumptions are problematic because they create significant hurdles to resolving litigation without proceeding to discovery, favoring plaintiffs.
- *Expand the definition of “recommendation”* to include *featuring or promoting an account type*, specific security, or investment strategy directly or through a third-party. This is similar to the approach the SEC took in its recent proposed rule regarding conflicts of interest associated with predictive data analytics (“PDA”) and other technologies, the DOL took in its Crypto Letter, and FINRA took in its Complex Products request.
- *Require conflicts of interest to be “neutralized”* if they cannot be avoided or eliminated. Departing from Reg. BI, NASAA takes the position that disclosure alone does not mitigate conflicts or otherwise satisfy the model rule’s obligations. The concept of “neutralizing” conflicts was introduced in the SEC’s PDA proposal and may echo the concept of “neutral factors” from the DOL’s 2016 fiduciary rule, which the industry (and DOL, at least informally) found to be unworkable in implementation.

While the NASAA proposal will need to be finalized and adopted in one or more states to be effective, the proposal is particularly concerning because:

- *Certain states have provisions that allow for the automatic adoption* of final NASAA model rules (we are currently researching the states that include such provisions);
- Even if not adopted, concepts in the proposal and its novel constructs of fiduciary standards *may find their way into SEC, FINRA, DOL and banking exams and enforcement actions, and private litigation*.
- Though the rule is a “model,” NASAA has positioned it as a menu of options individual states can select from, raising the *potential for a multiplicity of different standards across the 50 states*.

Comments on the NASAA proposal are requested by *December 4, 2023*.

Proposed NASAA Model Rule	Reg. BI	Massachusetts Fiduciary Rule	Observations
Scope/Covered Transactions			
<ul style="list-style-type: none"> • “When making a recommendation to a retail customer...” • Recommending an investment strategy or the sale or purchase of any security <p>Does not apply to “unsolicited transactions” executed in a “self-directed or non-discretionary account.”</p> <p>A transaction is <i>deemed to be a recommendation</i> if the broker-dealer or agent “utilized any means, method or mechanism <i>to feature or promote an account type, specific security, or investment strategy</i> to a retail customer, whether directly or through a third-party.”</p>	<p>Recommending:</p> <ul style="list-style-type: none"> • securities transactions, or • investment strategies involving securities (including account recommendations) 	<ul style="list-style-type: none"> • Providing investment advice, or • Recommending: <ul style="list-style-type: none"> ○ an investment strategy; ○ the opening of any type of account; ○ the transfer of assets to any type of account; or ○ the purchase, sale, or exchange of any security. 	<p>***** ***** ***** *****</p>
Covered Customers/ Clients			
<p>“<i>Retail customer</i>” is not specifically defined, but includes both <i>current and prospective</i> customers.</p> <p>Rule expressly <i>excludes</i> recommendations and advice to:</p> <ul style="list-style-type: none"> • a bank, savings and loan association, insurance company, trust company or registered investment company • a broker-dealer registered with a state securities regulator; • an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities regulator; • any other institutional buyer as defined in [state rule citation]. <p>The proposal also would not apply to “a person” acting in the capacity of a fiduciary to an ERISA-covered employee benefit plan, its participants, or beneficiaries.</p>	<p>“<i>Retail customer</i>”—a natural person, or legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer (or natural person who is an associated person) and uses the recommendation primarily for personal, family, or household purposes.</p>	<p>“<i>Customer</i>” is not defined, but includes both <i>current and prospective</i> customers.</p> <p>Rule expressly <i>excludes</i> recommendations and advice to:</p> <ul style="list-style-type: none"> • a bank, savings and loan association, insurance company, trust company or registered investment company • a broker-dealer registered with a state securities commission (or agency or office performing like function); • an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like function); • any other institutional buyer as defined in 950 CMR 12.205(1)(a)6 and 14.401 (which includes qualified institutional buyers and various other entities). <p>The rule also does not apply to “a person” acting in the capacity of a fiduciary to an ERISA-covered employee benefit plan, its participants, or beneficiaries.</p>	<p>***** ***** ***** *****</p>

Proposed NASAA Model Rule	Reg. BI	Massachusetts Fiduciary Rule	Observations
Loyalty/ Conflicts			
<p>Act <i>without placing the financial or other interest</i> of the broker, dealer, or natural person who is an associated person <i>ahead of</i> the interest of the retail customer.</p> <p>Must <i>make all reasonable efforts to avoid or eliminate conflicts</i> of interest. Conflicts of interest that cannot reasonably be avoided or eliminated <i>must be disclosed and mitigated</i>.</p> <p><i>Mitigating</i> a conflict of interest means <i>neutralizing or reducing the potential for harm or adverse impact</i> of the conflict to the retail customer.</p> <p><i>Presumes</i> the broker-dealer to have placed its financial interest ahead of the interest of the retail customer where the broker-dealer or agent participates in (i) sales contests; (ii) sales quotas; (iii) bonuses; or (iv) any other non-cash compensation that are based on the <i>sales of specific securities or specific types of securities within a limited period of time</i>, or rewards the broker-dealer or agent with additional <i>cash or non-cash compensation beyond the sales commission as the result of that recommendation</i>.</p>	<p>Act <i>without placing the financial or other interest</i> of the broker, dealer, or natural person who is an associated person from making the recommendation <i>ahead of</i> the interest of the retail customer.</p> <p>Must establish, maintain, and enforce written policies and procedures reasonably designed to:</p> <ul style="list-style-type: none"> • Identify and at a minimum <i>disclose, or eliminate, all conflicts of interest</i> that are associated with such recommendations. • Identify and <i>mitigate any</i> conflicts that create an incentive for a natural person who is an associated person of a broker-dealer to place the broker-dealer’s or associated person’s interests ahead of the retail customer’s interests. • Identify and <i>disclose any material limitations</i> placed on recommendations of securities or investment strategies and <i>any conflicts of interest associated</i> with such limitations. <i>Prevent such limitations and associated conflicts of interest</i> from causing the broker, dealer, or natural person who is an associated person to make recommendations that places their interest ahead of the retail customer. • Identify and <i>eliminate any</i> sales contests, sales quotas, bonuses, and non-cash compensation that are based on the <i>sales of specific securities or specific types of securities within a limited period of time</i>. 	<p>Must <i>disclose all material conflicts</i>.</p> <p>Must make <i>reasonably practicable efforts</i> to <i>avoid</i> conflicts of interest, <i>eliminate</i> conflicts that <i>reasonably</i> cannot be avoided, <i>and mitigate</i> conflicts that cannot <i>reasonably</i> be avoided or eliminated.</p> <p>Must make recommendations and provide advice <i>without regard to</i> the financial or any other interest of <i>any party other than the customer</i>.</p> <p>Disclosing a conflict of interest alone does not meet or demonstrate the duty of loyalty.</p> <p><i>Presumes</i> a breach of the duty of loyalty for any recommendation of an investment strategy, opening or transferring assets to a specific type of account, or purchase sale, or exchange of a security that is made <i>in connection with any sales contest</i>.</p>	<p>***** ***** ***** *****</p>

Proposed NASAA Model Rule	Reg. BI	Massachusetts Fiduciary Rule	Observations
Care			
<p>When recommending an investment strategy or the sale or purchase of any security, the broker-dealer or agent must have a <i>reasonable basis</i> to believe that the recommendation is in the <i>best interest</i> of the retail customer based on the customer’s investment profile and the potential risks, rewards, and costs associated with the recommendation.</p> <p>Must use the “care, skill, and diligence that a person acting in a like capacity and familiar with such matters would use, taking into consideration all of the relevant facts and circumstances,” including:</p> <ul style="list-style-type: none"> • The <i>risks, costs, and conflicts</i> of interest related to the recommendation made and any related investment advice given to the retail customer; • Securities and investment strategies that can achieve the retail customer’s investment objectives <i>with less risk or less costs</i>; • The customer’s investment profile and • <i>Any other relevant information.</i> <p><i>Investment profile</i> includes, the customer’s age, <i>education</i>, other investments, <i>debt</i>, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.</p> <p>Must make reasonable inquiry regarding lower-cost and lower-risk securities and investment strategies that are reasonably available to the broker-dealer or agent, as well as products or services available if the agent is also [licensed/registered] in other capacities such as an investment adviser representative or insurance agent.</p> <p>“<i>Costs</i>” include “potential fees and costs based on the anticipated holding period, including: account fees, commissions, other transactional costs such as markups</p>	<p>Must act in the retail customer’s best interest and exercise reasonable diligence, care, and skill to:</p> <ul style="list-style-type: none"> • <i>Understand</i> the potential <i>risks, rewards, and costs</i> associated with the recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers; • Have a <i>reasonable basis</i> to believe that the recommendation is in the <i>best interest of a particular retail customer based on</i> that retail customer’s <i>investment profile</i> and the potential <i>risks, rewards and costs</i> associated with the recommendation and does not place financial or other interests ahead of retail customer’s interests; and • Have a <i>reasonable basis</i> to believe that a <i>series of recommended transactions</i>, even if in the retail customer’s best interest when viewed in isolation, <i>is not excessive</i> and is in the retail customer’s <i>best interest when taken together</i> in light of the retail customer’s investment profile and does not place financial or other interests ahead of retail customer’s interests. <p><i>Investment profile includes</i>, but is not limited to, the retail customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose.</p>	<p>Must:</p> <ul style="list-style-type: none"> • Use the care, skill, <i>prudence</i>, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration of all the facts and circumstances, and • Make <i>reasonable inquiry</i>, including: <ul style="list-style-type: none"> ○ risks, costs, and conflicts of interest related to <i>all</i> recommendations made and investment advice given ○ customer’s investment objectives, financial situation, and needs, and ○ any other relevant information. 	<p>***** ***** ***** *****</p>

Proposed NASAA Model Rule	Reg. BI	Massachusetts Fiduciary Rule	Observations
<p>and markdowns, <i>costs arising from tax considerations</i>, costs associated with payment for order flow and cash sweep programs, other indirect costs that could be borne by the retail customer, fees associated with the investment products that are available through the account, such as the internal expenses of funds, management fees, distribution and servicing fees, including any front-end and back-end fees.”</p> <p>Costs must be considered with regard to the “anticipated investment horizon.”</p>			
On-going/ episodic			
<p>“When making a recommendation”</p>	<p>Obligation applies <i>at the time recommendation is made</i>.</p>	<p>The obligation applies at the time a recommendation is made, but is ongoing during <i>any period</i> the firm or financial professional:</p> <ul style="list-style-type: none"> • has or exercises <i>discretion</i> over a customer account (other than time or price of execution); • has a <i>contractual</i> fiduciary duty; or • has a <i>contractual obligation to regularly or periodically</i> monitor a customer’s account. 	<p>***** ***** ***** *****</p>
Disclosures			
<p><i>Cannot satisfy obligations through disclosure alone.</i></p> <p>Conflicts that cannot be avoided or eliminated must be disclosed (and mitigated/neutralized).</p>	<p>Must disclose <i>prior to or at the time</i> of the recommendation <i>all material facts</i> relating to the scope and terms of the relationship with the retail customer, including broker-dealer capacity, material fees and costs, type and scope of services (including any material limitations) and all material facts regarding conflicts of interest associated with the recommendation.</p> <p>Must provide disclosure in writing either prior to or at time of the recommendation.</p>	<p>Must <i>disclose all material conflicts</i> to satisfy the duty of loyalty (see above).</p>	<p>***** ***** ***** *****</p>

Proposed NASAA Model Rule	Reg. BI	Massachusetts Fiduciary Rule	Observations
Titles			
Using a title, purported credential, or professional designation containing any variant of the terms “adviser” or “advisor” without licensure as either an investment adviser or an investment adviser representative, unless otherwise permitted by law, is deemed to be a dishonest or unethical business practice.	Disclosure obligation presumed to be breached if a broker-dealer or representative uses the terms “adviser” or “advisor” unless dually registered as an investment adviser.	No express restrictions.	***** ***** ***** *****
Savings clause			
Provides that the rule will not be construed to establish requirements, including for making and keeping records that differ from or are in addition to those that apply to broker-dealers under the federal securities laws.	N/A	Provides that the rule will not be construed to establish requirements, including for making and keeping records that differ from or are in addition to those that apply to broker-dealers under the federal securities laws.	***** ***** ***** *****
Effective Date			
N/A	June 30, 2020	Effective date March 6, 2020; Enforcement date September 1, 2020	***** ***** ***** *****