THE TEXAS LAWBOOK

SERVING BUSINESS LAWYERS IN TEXAS

Massachusetts Heats up Fiduciary Rule Discussion with Cold-blooded Enforcement

By Ronak V. Patel of Winstead – (Feb. 21, 2018) – Financial services firms occasionally implement programs for their representatives to receive incentives in connection with specific product or service offerings. For as long as firms have used such programs, securities regulators have scrutinized them. The latest iteration of regulatory attention to sale incentives, however, signals a shift in strategy that carries broader implications for financial firms in Texas and throughout the country.

Ronak V. Patel

The Wall Street Journal recently reported that individuals working at certain brokerage firms stand to make more money if they direct clients to costlier investment products. On the same day, the Massachusetts Securities Division publicly confirmed that it had requested records from companies regarding their use of sales initiatives.

Securities regulators have always scrutinized such efforts in order to understand how products tied to a sales initiative serve clients and to assess how the products affect a financial services firm's bottom line.

But last week, the issue took on a new light when the MSD filed an administrative complaint against a financial services firm in connection with its alleged use of an incentive program. While this is hardly the first case regarding a broker-dealer's use of incentives, it is the first enforcement action – of any kind – to incorporate the U.S. Department of Labor's fiduciary rule.

In light of the approach now demonstrated by a prominent securities regulator, financial firms should reassess existing controls and their compliance with internal procedures.

Regulatory background

Many regulatory investigations in the securities industry focus on whether a potential conflict of interest exists and, if so, whether that conflict was disclosed appropriately. Securities regulators also often examine the adequacy of a broker-dealer's procedures and supervisory controls.

These regulatory assessments must be tied to the relevant standard of care, which is generally based in common law, securities statutes and regulations, and industry rules. In reality, however, financial firms can expect a number of regulators to take aggressive positions as to the existence of a potential conflict of interest and a broker-dealer's duty to disclose such a conflict.

Financial services firms, such as securities broker-dealers and asset managers, regularly develop new investment products and services. Although the development process is complex, the goal is simple – maximize the tools available to meet clients' unique needs. Some firms occasionally use incentive programs to encourage discussion of the products and services and possibly expand their use.

The U.S. Securities and Exchange Commission, the Financial Regulatory Authority and state securities regulators enhance their review and expectations if certain investments or services offered to clients appear to present extra incentives or favorable payments to the financial advisors.

In other words, such incentive programs constitute ideal fodder for a regulator seeking to press the standard of care.

Observers of the financial services industry are keenly aware of the dialogue about the scope >

of a broker-dealer's fiduciary duty. Under the securities laws, broker-dealers typically owe limited fiduciary duties to their customers. On the other hand, registered investment advisers are regarded as full-blown fiduciaries that are to act in their clients' best interests.

The DOL, through rule-making, implemented its fiduciary rule to unify the standard of care with respect accounts under its jurisdiction (i.e., retirement accounts). The lack of a corresponding uniform fiduciary standard in the securities laws for all account types has drawn significant political ire.

The procedural arrow

Against this backdrop, the recent Massachusetts filing is especially notable. First, it appears unlikely the DOL will be enforcing its fiduciary rule in the near future. Second, MSD's allegations are a relatively transparent attempt to enforce, albeit indirectly, the DOL's fiduciary standard. Finally, the MSD's emphasis on the development and enforcement of procedures related to conflicts of interest – and the DOL fiduciary rule specifically – is a creative attempt to enforce a federal standard within the confines of Massachusetts' jurisdiction.

In its current case, the MSD alleges that the broker-dealer established procedures to account for the DOL fiduciary rule. But the key issue is the MSD's claim that the broker-dealer failed to enforce those procedures because it did not segregate retirement assets from others. As a result, the MSD alleges the broker-dealer failed to meet its supervisory obligation because it violated existing policies and because it did not develop procedures to segregate retirement assets from others with respect to one very specific type of activity.

It is critical to note that all state securities regulators carry in their quivers the ability to require broker-dealers to maintain and enforce supervisory procedures designed to reasonably ensure compliance with applicable laws. In fact, cases involving failure to supervise and inadequate supervisory procedures are common in the industry. Thus, it will be enlightening to see how many other state regulators seek opportunities to use this existing procedures requirement to indirectly enforce the DOL fiduciary rule.

Two wrongs won't make it right

There are sound legal arguments against claims by Massachusetts, and other states, that supervision requirements under state securities laws can address the DOL's fiduciary rule standard. However, the current interest in homogenizing the duties owed by various financial professionals will likely encourage other securities regulators to follow Massachusetts' lead.

Ignoring the possibility of heightened scrutiny, even if it is founded on an imperfect theory, will not best serve the financial firms' interests. Instead, broker-dealers and investment advisers should consider taking certain steps, such as:

- Reviewing business practices with a broad interpretation of what might constitute a potential conflict of interest;
- Assessing whether activity related to retirement assets should be segregated to support compliance with the firm's policies; and
- Developing manageable and effective documentation tools and strategies to record activity with all clients, and especially when retirement assets are involved.

Based on measures like these, a financial firm and its counsel will be in position to tighten up disclosures and procedures as needed. Just as important, they will be armed with the ability to demonstrate additional good faith with respect to the firm's practices and controls. >

The truth is that many financial service firms have invested significant resources towards complying with the DOL fiduciary rule. The sense that the DOL was not going to enforce its standard may have reduced firms' concerns.

However, the recent action by the MSD should serve as a stark reminder of the outstanding risk. Broker-dealers and investment advisers should utilize the view into regulatory strategy offered by the MSD's filing to reassess their practices and controls and thereby maximize the value of their earlier investments into fiduciary rule compliance.

Please visit www.texaslawbook.net for more articles on business law in Texas.