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SECURITIES GROUP

Massachusetts Files First-Of-Its-Kind Action Concerning The Massachusetts Fiduciary Rule: Initial Considerations For Broker-Dealers and FinTech Firms

By Anthony R. Leone | December 22, 2020

In February 2020, the Massachusetts Securities Division (the "MSD") adopted a first-in-the-nation state fiduciary duty rule applicable to broker-dealers and broker-dealer agents.[1] Now, roughly three months after enforcement of the Fiduciary Rule began, the MSD has filed its first enforcement action, *In the Matter of: Robinhood Financial, LLC* (Docket No. E-2020-0047) (the "Administrative Complaint"). The Administrative Complaint represents an ambitious first step by the MSD which may have significant impact on the financial services industry including FinTech operators. While the Administrative Complaint consists only of allegations, a deeper assessment of the allegations, as well as the nuances of the Fiduciary Rule, presents important takeaways for broker-dealers and agents registered in Massachusetts.

The Administrative Complaint itself is far reaching—taking issue with power outages, lists of securities, gamification/encouragement of frequent trading, order flow, and options trading approval as alleged support for the MSD's breach of fiduciary duty claim against the FinTech leader. The most noteworthy portion of the Administrative Complaint is Count II of the Administrative Complaint, which alleges that Robinhood violated 950 Mass. Code Regs. 12.207(1)(a). This regulation, in particular, provides that "[f]ailing to act in accordance with a fiduciary duty to a customer when providing investment advice or recommending an investment strategy, the opening of or transferring of assets to any type of account, or the purchase, sale, or exchange of any security[]" is an "'unethical or dishonest conduct or practice[]'...." The regulations go on to provide: "to meet the fiduciary duty, each broker-dealer or agent shall adhere to duties of utmost care and loyalty to the customer." 950 Mass. Code. Regs. 12.207(2).

> Since 950 Mass. Code Regs. 12.207(1)(a) requires acting in accordance with a fiduciary duty when providing investment advice[2] or ***recommending*** (1) an investment strategy; (2) the opening of an account; or (3) the purchase, sale, or exchange of a security, what constitutes "recommending"—and whether the allegations constitute a recommendation on the part of Robinhood—lies at the heart of the case.

The Fiduciary Rule does not define "recommending" or what constitutes a recommendation under the rule. The MSD's Adopting Release for the Fiduciary Rule, for its part, is largely silent concerning what constitutes a "recommendation" under 950 Mass. Code Regs. 12.207(1)(a). With respect to the duty of care, the MSD commented that broker-dealers or agents must "make *reasonable inquiry* into what the broker-dealer or agent determines may be *relevant to the recommendation*." (emphasis added). In addressing a slightly different issue, the MSD also commented: "the duty runs during the period in which incidental advice is made in connection with the recommendation of a security to the customer." Nowhere in the MSD's Adopting Release, however, does the Division provide guidance concerning what constitutes a recommendation. In a scenario similar to the Administrative Complaint. Instead, the Adopting Release speaks generally with respect to traditional recommendations concerning the purchase or sale of securities.

The Securities and Exchange Commission's (the "SEC") Regulation Best Interest ("Reg. BI") does provide analogous guidance which may prove to be a critical guidepost. Reg. BI provides: "when making a recommendation of any securities transaction or investment strategy involving securities . . . [a broker-dealer] shall act in the best interest of

[1] For additional commentary on the enactment of 950 Mass. Code Regs. 12.207 (the "Fiduciary Rule"), see our previous guidance on the Fiduciary Rule [Massachusetts Adopts First-in-the-Nation Fiduciary Duty Regulations Applicable to Broker-Dealers and Agents] and [Massachusetts Proposes Final Fiduciary Rule - Takeaways for Financial Professionals].

[2] Unlikely to apply given the "self-directed" nature of the accounts.

the retail customer . . . ." 17 CFR § 240.15l-1. As set forth in the SEC's Adopting Release, to identify whether a "recommendation" has been made under Reg. BI, the SEC signaled it would rely on precedent from the anti-fraud provisions of the federal securities laws and SRO rules, including FINRA Rule 2111 (concerning suitability). See SEC Adopting Release, Regulation Best Interest: The Broker-Dealer Standard of Conduct (June 5, 2019). The SEC has indicated that certain communications are not recommendations, including, providing "general financial and investment information," information regarding retirement plans, and "asset allocation models." Id. at 89-90. Nevertheless, the SEC guidance suggests that in most cases a "facts and circumstances" analysis is necessary to parse out what constitutes a recommendation.[3] To this end the SEC has stated that "[f]actors considered in determining whether a recommendation has taken place include whether the communication 'reasonably could be viewed as a call to action' and 'reasonably would influence an investor' . . . [t]he more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'" Id. at 79-80.

The Administrative Complaint is not clear regarding which action or group of actions allegedly violate(s) the Massachusetts Fiduciary Rule. Nevertheless, it would seem unlikely that certain categories of allegations, e.g. power outages, constitute a "recommendation" at all. Thus, it is difficult to see how these allegations alone lead to a violation of the Massachusetts Fiduciary Rule. Other categories, for example, the opening/approval of accounts and provision of lists of securities, would seem to draw closer, if not within the ambit of the Massachusetts Fiduciary Rule. Nonetheless, it is interesting that the MSD did not directly assert that Robinhood *recommended* either (1) an investment strategy; (2) the opening of an account; or (3) the purchase, sale, or exchange of a security.

Finally, while the headliner is certainly the alleged breach of fiduciary duty, the Administrative Complaint, does include other, more ordinary counts. In particular in Count I, the MSD asserts a general "unethical or dishonest conduct" claim pursuant to Mass. Gen. Laws c. 110A, § 204(a)(2)(G)—a "workhorse" of the MSD and other states through analogous provisions. The Administrative Complaint also includes a "failure to supervise" count pursuant to Mass. Gen. Laws c. 110A, § 204(a)(2)(J)—the most straightforward of the alleged violations--concerning oversight of options trading approvals which will rise or fall based on the "reasonableness" of the firm's supervision.

Given the allegations and the additional counts under Section 204(a)(2)(G) and (a)(2)(J), it seems certain that the Administrative Complaint would have been filed even in the absence of the Massachusetts Fiduciary Rule. Nevertheless, the MSD's decision to include an alleged violation of the Massachusetts Fiduciary Rule has rightfully drawn the attention of financial professionals from across the country and raises the specter of truly industry changing state regulation.

We encourage broker-dealers and agents to follow this action carefully. If you have any questions or would like more information on this analysis contact Murtha Cullina's lawyers Anthony R. Leone at aleone@murthalaw.com or 617.457.4117 or Mark J. Tarallo at 617.457.4059 or mtarallo@murthalaw.com.

[3] See Id., n.176.

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