ADISA™
ALTERNATIVE & DIRECT INVESTMENT SECURITIES ASSOCIATION
Education ▲ Networking ▲ Advocacy

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December 31, 2019

Via electronic submission to:
securitiesregs-comments@sec.state.ma.us

William Francis Galvin, Secretary of the Commonwealth of Massachusetts
Attn: Proposed Regulations – Fiduciary Conduct Standard
Massachusetts Securities Division
One Ashburton Place, Room 1701
Boston, MA 02108

Re: Standard of Conduct to Broker-Dealers, Agents, Investment Advisors, and IA Representatives; Proposed Amendments to 950 Mass. Code Regs. 12.200

Dear Mr. Galvin:

We appreciate your continued engagement with the industry and the opportunity to comment on the proposed fiduciary duty regulations referenced above. The Alternative and Direct Investment Securities Association ("ADISA"),[1] has particular interest in Massachusetts since we have many members, mostly from small and medium-sized businesses, either located or doing business in the state and working with hundreds of retail investors.

ADISA's distinctive role, among the many organizations operating in the financial services industry, is to support a judicious and yet robust array of investments for retail investors that derive their returns from assets other than publicly traded stocks and bonds – so-called "Alternative Investments." These investments are typically neither listed on any exchange nor traded in any organized market; their performance generally does not correlate to that of the public market for investment securities, and they can have a powerfully diversifying effect on client portfolios as a result. ADISA agrees with the need to set appropriate standards around advice provided by all financial professionals, whether episodic or on-going in nature, but we will focus in detail here only on those issues which we believe are likely to have a direct impact on the Alternative Investment arena.

Specifically, as you develop the Division's final regulation, we encourage you to consider the following:

[1] ADISA is the nation's largest trade association for the non-traded alternative investment space. ADISA represents over 5,000 financial industry members nationwide, reaching over 220,000 finance professionals, with sponsor members having raised in excess of $200 billion in equity in serving more than 1 million investors.

1. **"Non-Traded" Investment Products are Distinct from their Publicly-Traded Counterparts and are Typically Marketed and Sold in a Different Way**

The duty of care owed by financial professionals to their customers must be capable of being observed in a manner that is consistent with the unique nature of Alternative Investments. Characteristics of Alternative Investments and the process whereby such Investments are recommended to or otherwise included in client portfolios include:

- A diversity of non-traded products and programs, as well as a plethora of underlying assets and investment strategies;
- The non-regular basis of most Alternative Investment recommendations;
- The relationship between buyers and their financial professionals with respect to these types of investment securities, which is generally more infrequent in nature when compared to advisory relationships involving publicly-traded securities.

Markedly, Alternative Investments play a crucial role in retail portfolios: 78% of so-called "Millennials" and 70% of "Gen X" savers endorse having access to alternatives for their investment accounts.[2] Evidence shows that these products can have (and historically have had), a significant, positive impact on investor rates of return when incorporated into more traditional and more liquid portfolios.[3] The Division should account for these crucial distinctions unambiguously in any final regulation.

2. **ADISA Applauds the Division for Recognizing An Episodic Duty, Similar to the State of Nevada.**

Like Nevada, Massachusetts recognizes the unique and important nature of episodic transactions, meaning those that do not involve an on-going course of advice and activity, but rather entail a single or several discrete recommendations and sale transactions.[4] Certain products are designed to have durations over several years, and therefore are less liquid investments when acquired and held as anticipated; in other words, some investment ideas are by their nature entered into only episodically and with a long term investment horizon.

- Allowing a broker-dealer's duty to effectively reflect these facts and creating a regulation that allows firms to receive one-time or periodic commissions, aligns the interest and, importantly, the

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[2] Natixis Global Asset Management Survey, http://durableportfolios.com 2014.

[3] From 1999-2009 the generic "balanced" (i.e., 60% equity/40% bond) portfolio after fees returned zero percent (0%), while the Yale, Harvard, and Stanford portfolios with alternatives generated returns ranging from 135% to 198% in total (Wildermuth, D. *Wise money: How the Smart Money Invests*. McGraw Hill, 2012, pp. 64-65).

[4] See Nevada Revised Statutes 90.575, 628.010 and 628.020. The Securities Division of the Nevada Secretary of State's Office has, as required, promulgated draft regulations that would if adopted amend Chapter 90 of the Nevada Administrative Code to impose a fiduciary duty on broker-dealers and their representatives. These proposed regulations include the concept of an "Episodic Fiduciary Duty" exemption to the general fiduciary duty imposed on broker-dealers thereby. Nevada's draft fiduciary regulations can be found at: http://www.nvsos.gov/sos/licensing/securities/new-fiduciary-duty.

expectations and understanding, of the broker-dealer and its representative with that of the client. Such alignment is the essence of a financial professional's duty toward its clients.

We appreciate that the Division has stated that "the Proposal accommodates both ongoing advice relationships and truly episodic advice relationships," and that the Proposal "does not impose any ongoing duty where one does not already exist, whether to monitor the account or otherwise." We nonetheless believe that the final regulation should make clear that the episodic element at issue involves more than a duty to monitor, but rather pertains to the whole of the episodic nature of the recommendation itself and the time period in which the investment is held by the client.

3. **The Division should add greater clarity to the Scope and Application of the Duty of Due Care**.

ADISA recognizes that the Division has stated that, "[u]nder the Proposal, the duty of care requires each broker-dealer, agent, investment adviser, and investment adviser representative to use the care, skill, prudence, 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."

We encourage the Division to incorporate language in the final regulation which reinforces the distinct client relationship elements – the differing duties - that are inherent in the recommendation and sale of Alternative Investments. We believe that creating a safe harbor is not sufficient to establish this principle and call for the Division to instead articulate this difference on the face of the regulation as adopted.

4. **Recognizing the Unique Nature of the Alternative Marketplace, the Division should add Greater Clarity to the "Best of" Language.**

The Division has stated that, regarding its "Best of the Reasonably Available Options" standard, it "intends to pursue enforcement action for breach of the duty of loyalty if transaction-based compensation is paid or received for a recommendation or advice, and other options were available which would have been less remunerative or [if] transaction-based compensation is unreasonable or if another available compensation structure would result in a greater benefit to the customer or client."

While we recognize the Division's interest in not specifying an enumerated list, we suggest the "best of" language should, at a minimum, be clarified to make unambiguous the idea that the standard cannot be applied in a vacuum and needs to include the concept of equivalence. Holding a broker-dealer or other financial professional to account for a violation of the Commonwealth's fiduciary regulation simply because he or she did not recommend a lesser remunerative option would have the effect of reducing the analysis to simply one of relative cost/remuneration. Such an approach would essentially eviscerate the financial professional's ability to use his or her judgment to choose the investment security or program that best suits his or her clients' needs and circumstances. It would tend to lessen the ability of the advisor to use his or her judgment and experience to recommend investment securities, including Alternative Investments, that are tailored to serve the best interest of the clients, and allow if not command advisory firms to focus solely on cost rather than the host of other qualities that can and should go into a recommendation. This is particularly true of Alternative Investments, which as noted above have important elements missing from traded securities, including liquidity, structure and other harder-to-measure qualities.

We are mindful of the need to create clear and comprehensive standards for application to the financial advisory industry, so that retail customers can plainly understand the obligations that their financial professionals owe them. At the same time, we wish to help ensure that said financial professionals can align their conduct involving Alternative Investments with the requirements of the regulation, and to that end support clear line-drawing in the regulation. Given the challenges involved in comparing investment products made available by broker-dealers, it is important that such firms can see a clear and unambiguous path to satisfying their duties of care and loyalty to their clients with respect to securities (and especially Alternative Investments), that they recommend to their clients.

A standard that emphasizes cost and/or remuneration to the exclusion of other factors, however, risks substituting simplicity for what needs to be an informed and client-focused comparison among available products and programs. Alternative Investments choices vary a great deal from one another, and from one broker-dealer to another, on bases other than cost. Broker-dealers need to be incented to make those subtle evaluations and not just default to cost comparison exercises to avoid liability under a regulation that makes cost and remuneration paramount considerations.

The Division should make clear that transaction-based fees alone cannot be the sole determining factor for 'Best of' options; rather, the emphasis needs to be on the totality of cost and benefits when determining options. Benefits in the case of Alternative Investments include for instance, a sponsor, or manager's profile, volatility, price and correlation to other investments or market conditions. A 1% load certainly is less expensive than a 3% load, but a security issued by a sponsor with limited experience, for instance, may be far riskier in spite of a lower commission. Similarly, an investor who gains a 10% return on a 3% load is in a superior economic position than the investor who 'only' pays a 1% load but only enjoys just a 5% return.

We urge the Division to keep in mind that no such "best of" standard exists under the federal securities laws, and to recognize that both the SEC and FINRA have long recognized that there is no single "best" security recommendation. (In fact, this is a core tenet of modern portfolio theory.) Further, federal agencies and securities regulators have generally accepted the fact that it is not possible to definitively identify a single "best" option.[5] Indeed, even the DOL conceded as much in connection with its now vacated fiduciary rule.[6]

5. <u>The Proposal should Explicitly Limit its Application to Retail Investors who are Legal Residents of Massachusetts or Who Reside in Massachusetts</u>.

Given the difficult and potentially harmful consequences associated with the Rule detailed above, it is important that firms can limit the application of the Rule to retail customers who are residents of

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[5] See*, e.g., SEC Beginner's Guide to Asset Allocation, Diversification and Rebalancing*, available at https://www.sec.gov/reportspubs/investor-publications/investorpubsassetallocationhtm.html. *See also FINRA's Diversifying Your Portfolio,* available at http://www.finra.org/investors/diversifying-your-portfolio.

[6] *See* Preamble to the BIC Exemption, 81 Fed. Reg. at 21,029 ("… the [DOL] also *confirms that the Best Interest standard does not impose an unattainable obligation on Advisers and Financial Institutions to somehow identify the single 'best' investment for the Retirement Investor out of all the investments in the national or international marketplace, assuming such advice were even possible."), available at* https://www.federalregister.gov/documents/2016/04/08/2016-07925/best-interest-contract-exemption.

Massachusetts. A financial services firm with a place of business in New York should not owe the fiduciary duty imposed by the Rule to all their clients, regardless of whether they have any nexus to Massachusetts. Moreover, the fiduciary duties imposed by the Rule may be inconsistent with duties owed to clients in their state of domicile. Accordingly, we recommend that the Proposal be revised to explicitly limit its application to retail investors who are legal or actual residents of Massachusetts.

Sincerely,

Greg Mausz
President

cc: Drafting Committee: John Grady, Thomas Rosenfield