

Massachusetts Securities Division

REGISTRATION, INSPECTIONS, COMPLIANCE AND EXAMINATIONS SECTION

▲ DECEMBER 2016 NEWSLETTER ▲

A Division of William Francis Galvin, Secretary of the Commonwealth

MSD SURVEY RESULTS ON THE DEPARTMENT OF LABOR RULE

The RICE Section conducted a survey regarding the Department of Labor's Fiduciary Rule ("Fiduciary Rule") and Best Interest Contract ("BIC") Exemption on Massachusetts-Registered Investment Advisers (the "Survey"). According to the Survey, 86% of Massachusetts-registered investment advisers that responded provide retirement advice to Retirement Investors (hereinafter "Participants").

About 98% of Participants responded that they provide advice regarding IRAs. About 80% responded that they provide advice regarding rollovers. The rollover advice was typically the result of clients either switching jobs or moving their employer-sponsored plan into their personal retirement portfolio. The Survey also asked Participants to describe the nature of advice provided to Retirement Investors. The majority of Participants indicated that they provide advice concerning the management/allocation of client investments, while some explained that they also provide financial planning advice.

When asked to estimate the potential impact on their business if they entered into a BIC Exemption:

- 36% of Participants indicated that they would not be impacted;
- 24% of Participants indicated that they would be minimally impacted;
- 10% of Participants indicated that they would be moderately impacted;
- 6% of Participants indicated that they would be significantly impacted;

- 20% of Participants were unsure of the potential impact; and
- 2% of Participants did not answer this question.

Participants were also asked to indicate whether they wanted training. 75% of Participants indicated that they wanted to receive training, and 56% of Partici-



pants provided comments regarding the training they would like to receive. A large number of Participants indicated that they would like training on how to comply with the Fiduciary Rule and BIC Exemption. Other Participants wanted to know specifically how they will need to amend their contracts in order to comply with the Fiduciary Rule or to take advantage of the BIC Exemption.

The Division plans to provide training on March 7, 2017 on the Fiduciary Rule and BIC Exemption prior to the Fiduciary Rule's applicability date of April 10, 2017 (see page 4). This training will discuss the Fiduciary Rule's impact and will provide an overview of

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the Fiduciary Rule and BIC Exemption. Please note that the Division has not yet promulgated guidance regarding the Fiduciary Rule and BIC Exemption.

For further information on the survey and the Fiduciary Rule, please see the below resources.

The Massachusetts Securities Division Survey Results can be found at: <http://www.sec.state.ma.us/sct/sctpdf/BICE-Draft-Report-Fiduciary-Rule-and-Survey-Results-10-27-16.pdf>

The complete text of the Fiduciary Rule can be found at: <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806>

FAQs meant to clarify the Fiduciary Rule can be found at: <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf> ▲

MSD POLICY STATEMENT: STATE-REGISTERED INVESTMENT ADVISERS' USE OF THIRD-PARTY ROBO-ADVISERS

As automated investment advisory services (often otherwise referred to as “robo-advisors”) have become more prevalent in the financial services industry, the Division has considered their use in the context of continuing to ensure that Massachusetts-registered investment advisers comply with the Massachusetts Uniform Securities Act and meet the fiduciary duties owed to their clients.

On July 14, 2016, the Division issued its “Policy Statement: State-Registered Investment Advisers’ Use of Third-Party Robo-Advisers” to provide guidance to Massachusetts-registered investment advisers as to how to do so when partnering with third-party robo-advisers to provide concurrent investment advisory services to their clients. (The full text of this Policy Statement is accessible on the Division’s website at <http://sec.state.ma.us/sct/sctpdf/Policy-Statement-State-Registered-Investment-Advisers-Use-of-Third-Party-Robo-Advisers.pdf>.)

The Division premises its Policy Statement on the basis that clients see the most benefit when they receive full disclosure as to the types of services with which they are provided, who is providing those services, and the fees paid to each investment adviser by each client. In that vein, the Policy Statement explains that an investment adviser utilizing such an arrangement achieves sufficient disclosure under the Act by:

- Clearly identifying any third-party robo-advisers with which it contracts; using phraseology that clearly indicates that the third party is a



robo-adviser or otherwise utilizes algorithms or equivalent methods in the course of providing automated portfolio management services; and detailing the services provided by each third-party robo-adviser;

- Informing clients that investment advisory services could be obtained directly from the third-party robo-adviser, if applicable;
- Detailing the ways in which it provides value to the client for its fees, in light of the fiduciary duty it owes to the client;
- Detailing the services that it cannot provide to the client, in light of the fiduciary duty it owes to the client;
- Clarifying that the third-party robo-adviser may limit the investment products available to the client (such as exchange-traded funds, for example), if applicable; and
- Using unique, distinguishable, and plain-English language to describe its and the third-party robo-adviser’s

services, whether the language is drafted by the state-registered investment adviser or by a compliance consultant.

Massachusetts-registered investment advisers must also comply with their fiduciary duties not only by minimizing fees for their clients, but by also considering their fees in light of the services provided to clients by third parties, particularly in a situation where both a state-registered investment adviser and a third-party

robo-adviser are each charging the client a separate fee. Accordingly, the Massachusetts-registered investment adviser must clearly disclose to the client all of its own fees as well as all fees charged by the third-party robo-adviser.

The Division considers the state-registered investment adviser’s fees with regard to (1) the level of services it provides to the client; (2) other fees charged to the client by a third-party robo-adviser; and (3) fees charged by other state-registered investment advisers utilizing similar affiliations with a third-party robo-adviser. In this analysis, the Massachusetts-registered investment adviser should focus on the specific value it provides to the client, whether due to its specialized knowledge with regard to investment products, the client’s individual personal circumstances, and/or for some other reason that it must clearly identify.

Please note the Division will soon be publishing an investor alert regarding the use of robo-advisers. The brochure will be available at <http://www.sec.state.ma.us/sct/sctinv/invidx.htm>. ▲

CHANGES TO THE DEFINITION OF “QUALIFIED CLIENT”

Effective as of August 15, 2016, the United States Securities and Exchange Commission (“SEC”) issued an Order which amends SEC Rule 205-3 under the Investment Advisers Act of 1940. The amendment increases the net worth threshold by which an advisory client or private fund investment may be considered to be a “qualified client” eligible for performance fees.

As revised, Rule 205-3 defines a “qualified client” as a natural person or a company who the investment adviser

reasonably believes, immediately prior to entering into the contract, has a net worth of more than \$2,100,000, subject to certain adjustments. Previously, the threshold for a client’s net worth was \$2,000,000.

State registered investment advisers that charge performance fees will want to amend their contracts and intake documents to reflect this change. For more information, the full text of the Order is available online at <https://www.sec.gov/rules/other/2016/ia-4421.pdf>. ▲

BUSINESS CONTINUITY PLANS

On June 28, 2016, the United States Securities and Exchange Commission (“SEC”) proposed a new rule that would require SEC-registered investment advisers to adopt and implement business continuity and transition plans. The proposed rule addresses operational and other risks related to significant disruptions in the investment adviser’s business.

Under the proposed rule, investment advisers would be required to establish policies and procedures addressing the following areas:

- maintenance of systems and protection of data;
- pre-arranged alternative physical locations;

- communications plans;
- review of third-party service providers; and
- a plan of transition in the event the adviser is winding down or is unable to continue providing advisory services.

Investment advisers would have to keep records of all plans in effect within the



past five years, and advisers would be able to tailor plans to their business models, so long as the plans addressed the areas identified by the rule. The rule proposal is accessible via the SEC’s website and the Federal Register. See <https://www.sec.gov/rules/proposed/2016/ia-4439.pdf>. The comment period for this rule has closed, but this rule has not yet gone into effect.

What does this mean for state-registered Investment Advisers? The Division’s regulation, 950 Mass. Code Regs. 12.205(9)(b), incorporates, by reference, certain SEC provisions concerning an adviser’s obligation to adopt and implement written compliance policies and procedures. Should this SEC rule be adopted, state-registered investment advisers will need to come into compliance with continuity rules. ▲

CHANGES TO FORM ADV

Every registered investment adviser must file its annual Form ADV amendments within ninety days of the end of its fiscal year as required by 950 Mass. Code Regs. 12.205(6)(a)1. Such an amendment is made by updating Form ADV Parts 1 and 2 via the Investment Adviser Registration Depository (IARD).

The Securities and Exchange Commission (“SEC”) has updated some questions in the Form ADV and investment advisers must comply with the new Form ADV starting on October 1, 2017. For many state-registered investment advisers that have a December 31, 2017 fiscal year end, these firms would need to be in compliance with the changes no later than March 2018. The following Form ADV questions may be particularly relevant to state-registered investment advisers.

Adviser’s Physical Office Locations

Form ADV Part 1A, Item 1.F. has been revised to request the total number of offices in which the adviser conducts business and information about each location. In the updated Form ADV, the adviser will disclose the number of employees performing advisory functions in each office location and report the types of securities-related activities that are conducted in each office.

Social Media

Form ADV Part 1A, Item 1.I. has been amended to ask whether the adviser has one or more accounts on social media platforms, such as Twitter, Facebook or LinkedIn. The information requested is limited to websites where the adviser controls the content and manages the social media account. The address of each of the adviser’s social media pages shall be provided in Schedule D of Section 1.I.

Chief Compliance Officer

Form ADV Part 1A, Item 1.J. has been amended to require disclosure of whether the chief compliance officer is employed anywhere other than with the investment adviser.

Wrap Fee Programs

Form ADV Part 1A, Item 5.I and Section 5.I of Schedule D has been amended to require an investment adviser to disclose its assets under management as the sponsor or portfolio manager of a wrap fee program. It also requires disclosure of the SEC File Number and CRD number for the sponsors of the wrap fee program.

Separately Managed Accounts

Form ADV Part 1A has added Item 5.K. and a corresponding section of Schedule D. The amendments will require advisers to provide certain aggregate information about separately managed accounts that they advise, including disclosure of the amounts invested into each type of asset category.

Advisory Business

Form ADV Part 1A, Item 5 has been amended to require investment advisers to report (1) the number of clients for whom the adviser provides advisory services; (2) the amount of assets under management attributable for each type of client; (3) the number of clients for whom the adviser provides advisory services, but does not have those assets under management; and (4) the amount of assets under management attributable to clients that are non-United States persons.

FORM ADV CHANGES

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Audited Financial Statements

Form ADV Part 1A, Item 7 has been amended to require advisers who receive an annual audit or annual surprise examination to provide the auditing firm's Public Company Accounting Oversight Board (PCAOB) assigned number.

This article is not a comprehensive list of each Form ADV change and the full text is available in the Federal Register at <https://www.gpo.gov/fdsys/pkg/FR-2016-09-01/pdf/2016-20832.pdf>. ▲

INVESTMENT ADVISER REGISTRATION RENEWAL

As a reminder, Massachusetts regulations require all Massachusetts investment advisers to renew their registrations annually. While the Division sends out annual notifications of this requirement near the end of each calendar year, via email and U.S. mail, we encourage every investment adviser to verify its firm's account on FINRA's IARD

website. Please ensure your email address is current on Form ADV Part 1, Item 1.J. as the Division will be

discontinuing the use of paper reminders in the future. Please ensure that accounts are sufficiently funded to pay for 2017 registration fees for both the firm and its affiliated investment adviser representatives. ▲



Investment Adviser Training

The Department of Labor's Fiduciary Rule and Best Interest Contract Exemption

SAVE THE DATE • March 7, 2017

When: Tuesday, March 7, 2017

Time: 9:00 a.m. – 12:00 p.m.
Complimentary continental breakfast

Where: Best Western Royal Plaza Hotel and Trade Center
Marlborough, Massachusetts

What: The Registration, Inspections, Compliance and Examinations (RICE) Section of the Massachusetts Securities Division will host a complimentary training to educate registrants on the implications of the Department of Labor's Fiduciary Rule and the Best Interest Contract Exemption on their practice.

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Space is limited. Complete information to follow.

