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Massachusetts Brings Enforcement Action Against Brokerage Firm Based on Violations of Fiduciary Rule Compliance Policies

On February 15, 2018, the Enforcement Section of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth ("Massachusetts") filed an administrative complaint (the "Complaint") against Scottrade, Inc. ("Scottrade") based on alleged violations of Scottrade's policies and procedures adopted in light of the Department of Labor's ("DOL") Fiduciary Rule. The Complaint seeks an order requiring Scottrade to (i) permanently cease and desist from further conduct in violation of state law, (ii) review its supervisory procedures to ensure compliance with applicable state and federal laws, (iii) provide a verified accounting of all proceeds received as a result of the alleged wrongdoing, (iv) disgorge all profits and other direct and indirect remuneration received from the alleged wrongdoing, and (v) pay an administrative fine. Although the Complaint alleges violations of state law only, it has the effect of challenging a financial institution's compliance with the Fiduciary Rule and "Best Interest Contract Exemption," which became applicable on June 9, 2017, and raises alarm bells that the states are stepping in to regulate the retirement advice market in the absence of enforcement by the DOL or private litigants to date.

Challenged Behavior

According to the Complaint, Scottrade's violations of state law stem from sales contests held in the third and fourth quarters of 2017. Massachusetts alleged that the sales contests violated Scottrade's own policies and procedures that were adopted in light of the Fiduciary Rule and constituted unethical or dishonest conduct under state securities laws.

In response to the Fiduciary Rule, Scottrade updated its policies and procedures to prohibit the firm from engaging in activities that would cause its representatives to give recommendations that are not in the "best interest" of retirement investors. Scottrade then continued to hold sales contests designed to encourage sales. Employees who sold investment advisory services were rewarded with cash prizes or raffle tickets which lead to cash prizes. The Complaint states that sales relating to retirement assets were included as part of the sales contests, and that the sales contests were not disclosed to any clients. Additionally, Scottrade formally encouraged its representatives to use emotional appeals to sell to customers. The Complaint alleges that Scottrade intentionally violated its policies and procedures by encouraging its representatives to sell in these ways.

Basis for Massachusetts Case

Massachusetts alleges that Scottrade violated state law only. However, these claims relate to Scottrade's compliance with the Fiduciary Rule and Best Interest Contract Exemption.

Massachusetts first claims that Scottrade's conduct violated a provision of the Massachusetts Uniform Securities Act (the "Act") that prohibits "unethical conduct or dishonest conduct or practices in the securities, commodities or insurance business." Massachusetts did not clearly delineate whether it interpreted the "unethical" or "dishonest" conduct to consist of (i) the violation of Scottrade's own policies and procedures, (ii) holding sales contests that could incent its representatives to make recommendations not in the best interests of its customers, (iii) the failure to disclose Scottrade's sales contests, or (iv) a combination of all of the foregoing. As such, it is not clear whether Massachusetts interprets the Act to prohibit all conduct that would violate the Fiduciary Rule and Best Interest Contract Exemption, or only conduct that would violate policies and procedures adopted by a financial institution to ensure compliance with the Fiduciary Rule and Best Interest Contract Exemption. Either interpretation is concerning, but the former would represent an especially expansive view of state enforcement authority. Additionally, the potential claim based on Scottrade's failure to disclose its sales contests is particularly alarming as it can be interpreted as Massachusetts banning sales contests that are not disclosed.

Massachusetts also claims that Scottrade failed to follow its own policies and procedures concerning employee compensation, and that this failure violated a provision of the Act that requires brokerage and advisory firms to reasonably "supervise agents, investment adviser representatives or other employees . . . ." In this respect, Massachusetts is clearly taking aim at a financial institution that took some steps to comply with the Fiduciary Rule but that failed to rid itself of all conflicts. Again, this is a cause for concern as it could be read to mean that any time a company violates its policies and procedures, it is failing to comply with law.

Big Picture

The Complaint has garnered attention because it is the first enforcement action related to the Fiduciary Rule and also because it is part of a wave of state action (regulatory, legislative, and now enforcement) that sends a signal that if the DOL relaxes its requirements, states may step in. The Complaint also represents the first enforcement effort that relates to a financial institution's compliance with the Fiduciary Rule. Should Massachusetts be successful in its effort, it is possible that other states will bring similar lawsuits seeking to challenge the compliance activities of financial institutions in light of the Fiduciary Rule and Best Interest Contract Exemption.

This case will likely affect the DOL's ongoing review of the Fiduciary Rule. The President directed DOL to consider, among other things, whether the Fiduciary Rule is "likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services," and decide, based on its review, whether to revise or rescind the Fiduciary Rule. The prospect of state-level enforcement through litigation will need to be considered.

A final reason why the Complaint is significant is that it provides a new reason for the Fifth Circuit to finally decide *Chamber of Commerce v Acosta* – a lawsuit alleging that the DOL's issuance of the Fiduciary Rule and related exemptions violated its regulatory authority. Some had been speculating that the Fifth Circuit has been holding off on deciding whether the Fiduciary Rule was validly promulgated in the hope that its decision would become moot. With states bringing enforcement action, there is a renewed sense of urgency for courts to act.