

## **ADOPTING RELEASE**

DATE: August 8, 2011

RE: Use of Expert Network Services – 950 CMR 12.205(9)(c)(16);  
Performance Based Fees – 950 CMR 12.205(9)(c)(17); and  
Other Technical Changes and Corrections.

The Massachusetts Securities Division (the “Division”) is adopting, as amended from the original proposals, the following regulations found at 950 CMR 12.200 *et. seq.* (the “Regulations”). With the exception of 950 CMR 12.205(9)(c)(16), the adopted regulations shall become effective upon publication in the Massachusetts Register. The next publication of the Massachusetts Register is scheduled for August 19, 2011. 950 CMR 12.205(9)(c)(16) shall become effective December 1, 2011.

The following is a brief description of the regulations and, if applicable, any amendments to the proposal that have been made prior to adoption. The Division also proposed regulations relating to the registration of certain private funds as investment advisers, and to the discretion and custody requirements relating to investment advisers located in the Commonwealth. Those items remain under review at this time.

### **950 CMR 12.205(9)(c)(16): Certifications Required With Respect to Certain Expert Consultants**

The Securities Division proposed to add a new section under 950 CMR 12.205(9)(c)(16) to the existing list of dishonest and unethical practices in order to address the rising use of expert network firms by investment advisers to facilitate paid consultations between investment advisers and industry experts.

As alleged in *In the Matter of Risk Reward Capital Management Corp., RRC Management LLC, RRC BioFund LP, and James Silverman*, Massachusetts Securities Division Docket No. E-2010-057, some investment advisers have paid expert networks and consultants to gain access to confidential information about publicly traded companies. The rise of expert network firms, and the number of abuses that have been addressed by regulators, make it clear that additional measures are required to ensure that confidential information is not being accessed and traded upon. The Division's proposed regulations, while not altering investment advisers' existing duty not to trade on insider information, seek to provide investment advisers with greater clarity as to what is impermissible conduct when paying consultants for information.

The Division received three (3) written comments with respect to its proposal to adopt 950 CMR 12.205(9)(c)(16), as well as oral comments at its June 23, 2011 public hearing. The Division has considered each of these comments, and in turn has made substantive revisions to the proposed regulation to address some of the concerns raised. The following is a summary of the comments received and the modifications that have been made.

## Scope

One commenter argued that the definition of “Matching or Expert Network Service” could be interpreted in an overly broad manner that could potentially require a certification when retaining compliance consultants or other consulting arrangements unrelated to the purchase or sale of securities. The Division’s intent is that the regulations will apply to investment advisers that retain firms that place or match the adviser with industry experts that are likely to be in possession of confidential information.

To address this issue, the adopted rule only requires the written certification for “Investment Consulting Services.” “Investment Consulting Services” is defined as a consultation for the purposes of assisting the investment adviser’s decision as to whether to buy, sell, or abstain from buying or selling, positions in client accounts. The definition limits the scope of services covered by the rule and addresses the concerns articulated by commenters.

Another commenter stated that requiring an expert to agree not to disclose confidentiality agreements was “good sense,” but was concerned that the proposed regulation was too broad and would therefore require the expert to disclose confidentiality agreements not relevant to consultations with investment advisers. To address this issue, the regulation was modified at 12.205(9)(c)(16)(a)(i) to limit the disclosure requirements to confidentiality restrictions relevant to the potential consultation that the consultant has, or reasonably expects to have.

## Administrative Burden on Matching or Expert Network Services

One commenter requested guidance as to the manner in which certification could be provided to the investment adviser. Specifically, the commenter was concerned that a “pen and paper” signature would be difficult and costly given the limited scope of some consulting engagements. The commenter – as well as others – indicated that the requirements of this regulation for the matching or expert network service could be considerable burden upon the service.

The adopted requirements apply only to investment advisers; no requirements are directly imposed upon matching or expert network services. Should firms providing such services to investment advisers choose, as an accommodation to the investment adviser, they may act as an intermediary and incur the administrative cost of procuring the required certifications. As is the case with other records made or procured by an investment adviser, the Division will not object to an investment adviser’s procurement of an electronic dated signature for the certification, provided the investment adviser

retains the electronic documents in compliance with general books and records requirements.<sup>1</sup>

### NSMIA Preemption

Several commenters asserted that the Division should explicitly carve-out federally registered advisers given limitations placed on the states pursuant to the National Securities Market Improvement Act of 1996 (“NSMIA”).<sup>2</sup> The Division acknowledges the preemption limitations imposed by Congress. However, as all securities regulations are subject to this preemption, where applicable, the Division does not believe 950 CMR 12.205(9)(c)(16) should be treated differently than other regulations or that the regulation warrants a special carve-out for federally registered advisers.

### Other Changes

The Division also modified the language of 950 CMR 12.205(9)(c)(16)(a)(iii) to require the consultant to sign and date the certification and certify that the information contained in the certification is accurate as of the date of the initial consultation, and any subsequent consultation.

### Effective Date

950 CMR 12.205(9)(c)(16) shall become effective December 1, 2011.

### **950 CMR 12.205(9)(c)(17): Prohibition of Certain Performance-Based Fees**

The Division proposed to add a new section under 950 CMR 12.205(9)(c)(17) to the existing list of dishonest and unethical practices that would prohibit the collection of performance based fees, except those fees collected in compliance with the restrictions and conditions outlined in Rule 205-3 under the Investment Advisers Act of 1940. Rule 205-3 provides an exception to the general prohibition on performance based fees if the client is a “qualified client.”<sup>3</sup>

The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.

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<sup>1</sup> See 950 CMR 12.205(7).

<sup>2</sup> States are preempted from applying laws requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser with respect to an investment adviser that is federally registered or excepted from the federal definition of an investment adviser. However, securities commissions of any state are not prohibited from investigating and bringing enforcement actions with respect to fraud or deceit against an investment adviser or person associated with an investment adviser. See Advisers Act Section 203A; 15 USC § 80b-3a.

<sup>3</sup> The SEC, by order, recently increased the dollar thresholds to be considered a “qualified client.” See Investment Advisers Act Release No. 3236 (July 12, 2011).

## **Updates Throughout the Regulations**

The Division proposed to make various changes in the rules to reflect industry changes and to make technical corrections.

### Updated References from the NASD to FINRA

The Division's regulations include references to the NASD and NASD rules. In 2007, the NASD merged with the NYSE and NYSE Regulation, Inc. and became the Financial Industry Regulatory Authority, or FINRA. The Division proposed amendments to update the regulations to reflect this change by referencing FINRA and FINRA member conduct rules.

The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.

### Updated References to Forms U-4 and U-5 and to Sections of Form U-4

The Form U-4 has been substantively changed, and several references to items in the Massachusetts regulations are out of date. The Division proposed amendments to update the regulations to reflect these changes. References to Forms U-4i and U-5i in the regulations were corrected to reference current forms.

The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.

### Updated Fees to Match Sec. 178 of c.184 of Acts of 2002

Section 178 of c.184 of the Acts of 2002 raised the registration fees for broker-dealer firms and their registered representatives. The Division proposed amendments to update the Massachusetts regulations to reflect these changes.

The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.

### Stock Exchanges

The Division proposed to amend 950 CMR 12.201(3) to delete language providing that Boston Stock Exchange members may elect inactive broker-dealer status. The Division believes this language is no longer applicable due to changes at the exchange. The proposed amendments to 950 CMR 14.402(A)(8) updated references to the Boston Stock Exchange, the Philadelphia Stock Exchange, and the Pacific Exchange. The Boston Stock Exchange was purchased by NASDAQ in 2007 and no longer operates under the old name. The Philadelphia Stock Exchange was also purchased by NASDAQ and has

been renamed the NASDAQ OMX PHLX. The Pacific Exchange merged with the NYSE in 2006.

The proposed new language in 950 CMR 14.402(A)(8) explicitly undesignated the proposed NASDAQ OMX BX Venture Market as an exchange that is eligible to claim the §402(a)(8) exemption. The NASDAQ OMX BX Venture Market will be a new market for the trading of penny stocks, and it will have significantly lower substantive listing standards than the old Boston Stock Exchange. The NASDAQ OMX BX Venture Market has indicated that it will not seek exemptions under state regulations that were related to its predecessor, the Boston Stock Exchange.

Amended language of 950 CMR 14.402(B)(13)(b)(2) and 14.402(B)(13)(h) replaces references to the NASD Automated Quotation System and to the NASDAQ National Market System with references to the NASDAQ Global Market.

The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.

#### Technical Correction to Fee Charts for Securities Exemptions and Notice Filings

The Division proposed amendments to correct the graduated fee charts for securities exemption filings and notice filings for offerings under Rule 506 of SEC Regulation D. **The Division did not receive any comments with respect to the proposed regulation. The regulation is therefore being adopted as proposed.**