BROKERS, FIDUCIARIES AND A BEGINNING

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I. Introduction

Under our securities regime, investment advisers[1] are considered to be fiduciaries, whereas broker-dealers[2] are not. This historical divergence emerges from a combination of statute and federal common law: brokers were exempted from the definition of "investment adviser" in 1940,[3] while the United States Supreme Court in 1963 declared investment advisers to have fiduciary obligations.[4]

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), signed into law on July 21, 2010,[5]

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[1] Per § 202(a)(11) of the Investment Adviser Act of 1940,

> 'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. . . .

15 U.S.C.S. § 80b-2(a)(11) (2010).

[2] Per §3(a) of the Securities and Exchange Act of 1934, a broker is "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C.S. § 78c(a)(4) (2010). A dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C.S. § 78c(a)(5) (2010).

[3] The definition of "investment adviser" excludes "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor . . . ." 15 U.S.C.S. § 80b-2(a)(11)(C) (2010).

[4] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963) ("Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be . . . ."). The term "fiduciary," however, does not appear in the Investment Advisers Act.

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

effectively questions whether this bifurcation makes sense. The new legislation acts along three principal dimensions. First, it asks the Securities and Exchange Commission ("SEC") to study "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers . . . for providing personalized investment advice and recommendations about securities to retail customers"[6] and ascertain "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards."[7] Second, it suggests the SEC commence a rulemaking "to address the legal or regulatory standards of care for brokers, dealers, investment advisers . . . for providing personalized investment advice about securities to such retail customers."[8] Third, Congress gives the SEC the statutory authority to make the standard of conduct of brokers-dealers congruent with that of investment advisers when advising retail customers[9] and to make this standard the following: "[T]o act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer."[10]

This essay, structured in three parts, argues that though the new legislation represents a positive beginning, the difficult work lies ahead. Part I suggests that there is much to applaud in the new legislation: it gives the SEC the authority to simplify and unify functionally similar financial services and thereby reduce investors' confusion; moreover, it gets beyond the conventional contractarian rhetoric to interpose fiduciary protections for investors. Part II addresses two objections to making broker-dealers subject to a fiduciary standard: (1) that sales activities are not fiduciary in nature, and (2) that brokers also acting as dealers and underwriters will be in

[6] *Id.* at § 913(b)(1). Topics to study include "the potential impact of eliminating the broker and dealer exclusion from the definition of 'investment adviser' under section 202(a)(11)(C) of the Investment Advisers Act of 1940 . . . ." *Id.* at § 913(c)(10).
[7] *Id.* at § 913(b)(2).
[8] *Id.* at § 913(f).
[9] § 913(g)(1) of the Dodd-Frank Act adds a new § 15(k)(1) to the Exchange Act notes that "the Commission may promulgate rules to provide that . . . the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser. . . ." *Id.* at § 913(g)(1).
[10] *Id.* (adding a new § 211(g)(1) to the Investment Advisers Act).

conflict with their customers. Neither of these concerns is sufficient to eschew the fiduciary standard. Finally, Part III outlines the two practical issues that must be confronted if the fiduciary standard is to protect investors: (1) its definition and (2) its enforcement.

II. A Laudable Step

The Dodd-Frank Act represents a positive and important starting point for reform for two principal reasons. First, it offers the SEC the possibility of unifying the regulation of functionally similar services: a step that would simplify the law and reduce investor confusion. Second, the paradigm it suggests—fiduciary duty—is particularly germane to the provision of investment advice to retail customers, the locus of Dodd-Frank's efforts in this regard.[11]

To begin with, retail investors are confused about the difference between a broker-dealer and an investment adviser.[12] This becomes altogether unsurprising once one recognizes that broker-dealers and investment advisers "often provide practically indistinguishable services to retail investors and direct them to the same products,"[13] as well as enjoy similar compensation structures. As such, the broker-dealer exclusion to the definition of "investment

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[11] *See supra* notes 6-8 and accompanying text (explaining the tasks charged to the SEC laid out by the Dodd-Frank Act). The term "retail customer" is further defined in the statute: "For purposes of this section, the term 'retail customer' means a natural person, or the legal representative of such natural person, who—(1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes." Dodd-Frank Act § 913(a).

[12] *See* ANGELA A. HUNG ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, 112 (2008) (explaining that such investors fail to grasp "key distinctions between investment advisers and broker-dealers").

[13] Elisse B. Walter, *Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?*, 35 J. CORP. L. 1, 2 (2009). *See also* Tamar Frankel, *Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers* (Boston Univ. Sch. of Law, Working Paper No. 09-36 12, 2009), *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/FrankelT101009Revsep2010.pdf ("B[roker]-d[ealer]s' functions cannot be distinguished from those of advisers and financial planners.").

adviser"[14]—while perhaps meaningful in 1940—seems precarious today.[15] Put simply, "[a]lthough the nature of their services can appear identical to retail investors, broker-dealers and investment advisers are subject to different regulatory schemes and standards of conduct, which has led to investor confusion and concern about the adequacy of retail investor protection."[16]

One might be tempted to try to unify the regulation of broker-dealers and investment advisers by making both groups subject to the regulatory regime for brokers rather than the fiduciary standard for investment advisers. Unfortunately, though, the standards governing broker-dealer regulation have the dubious distinction of being both inadequate and confusing at the same time—an unsatisfying smorgasbord of doctrines that leaves investors wanting.

Given that "nowhere in the Exchange Act's registration provision is the duty of a broker-dealer to his customers spelled out,"[17] courts and the SEC have evolved a series of doctrines. In a very limited set of circumstances—namely, when brokers are

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[14] *See* 15 U.S.C.S. § 80b-2(a)(11)(C) (2010).

[15] *See, e.g.*, Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAWYER 395, 424 (2010) ("Thus, the idea that most advice provided today by broker-dealers is or could be considered solely incidental to brokerage sounds fanciful. It comes as no surprise that brokerage firms market themselves as providing trusted advice, calling themselves financial advisers, as opposed to stockbrokers."). Perhaps unsurprisingly, the SEC's recent attempt to expand the exception was invalidated by the United States Court of Appeals for the District of Columbia Circuit. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (finding that the text of § 80b-2(a)(11)(C) provided an exemption only for broker-dealers who did not receive special compensation for investment advice and that the SEC had exceeded its authority in trying to broaden this exception); Certain Broker-Dealers Deemed Not to be Investment Advisers, Exchange Act Release No. 51,523, 70 Fed. Reg. 20,424 (Apr. 19, 2005) (explaining the SEC's expansion of the broker-dealer exception).

[16] Barbara Black, How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act 2 (2010) (unpublished manuscript), *available at* http://works.bepress.com/barbara_black/2/.

[17] Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 88 (1997).

managing discretionary accounts,[18] or have created a special relationship of "trust and confidence"[19]—courts have invoked fiduciary obligations.[20] Nevertheless, broker-dealers are generally not considered fiduciaries.[21] As such, the three predominant doctrines regulating them are not fiduciary ones: the "shingle" theory,[22] the "suitability" rule,[23] and "commercial honor."[24] All three ideas have

[18] *See* SEC v. Charles Zandford, 535 U.S. 813, 823-24 (2002) (finding that defendant stockbroker violated his fiduciary duty to his client by committing fraud in connection with a transaction for that client).

[19] *See, e.g.*, Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 555 (2005) ("The special circumstances theory, then, provides that broker-dealers owe fiduciary duties to a customer whenever they create a relationship of trust and confidence in their dealings with that customer.").

[20] *See, e.g.*, Thomas Lee Hazen, Stock Broker Standards of Conduct—Principles, Rules and Fiduciary Duties 3 (2010) (unpublished manuscript), *available at* http://works.bepress.com/thomas_hazen/2/ ("[I]t has long been the case that stock brokers owe fiduciary duties when acting in certain capacities.").

[21] *See, e.g.*, Weiss, *supra* note 17, at 108 ("Under some circumstances, a broker may have a fiduciary duty to a particular customer. That duty, however, is not posited due merely to the broker's status as a broker-dealer."); Frankel, *supra* note 13, at 13 ("B[roker]-d[ealer]s are not generally considered fiduciaries. That is even though broker-dealers pose very high risk to entrustors.").

[22] *See, e.g.*, Gedicks, *supra* note 19, at 557 ("[T]he 'shingle' theory of broker-dealer liability holds that merely by identifying themselves as brokers and dealers in securities—by 'hanging out a shingle'—broker-dealers impliedly represent that they will deal fairly with the public.").

[23] *See, e.g.*, Weiss, *supra* note 17, at 96 ("'Suitability' is a cause of action that refers to the requirement, imposed on brokers by the self-regulatory organizations, or by the SEC for non-members, to exercise varying degrees of diligence in inquiring about the customer's resources, sophistication, and investment objectives when making recommendations."). The suitability rule, often phrased informally as "know your customer" and "know your security," is promulgated by the self-regulatory organization for broker-dealers:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any,

their roots in contract law: under the "shingle" theory, the broker is impliedly representing that she will deal fairly with customers;[25] the suitability rule is akin to the due diligence one performs in contract; and "commercial honor" reads like an implied contractual obligation of good faith. To be sure, there have been instances where these concepts have been used to help investors,[26] but overall they

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> disclosed by such customer as to his other security holdings and as to his financial situation and needs.
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
> (1) the customer's financial status;
> (2) the customer's tax status;
> (3) the customer's investment objectives; and
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

FINRA Manual, NASD Rule 2310, available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315&element_id=3638&highlight=2310#r4315.

[24] FINRA Manual, FINRA Rule 2010, available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905&element_id=5504&highlight=2010#r6905 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.").

[25] *See, e.g.*, Weiss, *supra* note 17, at 67 ("The 'shingle theory' derived from a theoretical implied representation of fairness based in contract law . . . ."); Frankel, *supra* note 13, at 9 ("B[roker]-d[ealer]s were viewed and regulated as securities salespersons, and the SEC imposed on them a duty of fairness in their contracts with their customers—the 'shingle theory.' The SEC has held that once broker-dealers hang their shingles and invite clients, broker-dealers should follow a *high ethical contract standard*, and deal fairly with their clients.").

[26] For example:

> [U]nder the shingle theory, it has been held fraudulent to engage in unauthorized trading in a customer's account, to charge excess markups or markdowns, to "churn" a customer's account to obtain commissions, to accept customers' securities while insolvent, or to fail to consum-

represent anemic investor protections because contract law is an inapposite construct to regulate the provision of investment advice to retail customers.

The fiduciary concept, on the other hand, is much more appropriate in this context. After all, clients are trusting their broker or adviser, and "[a]t the heart of fiduciary relationships is *entrustment of property or power* that clients hand over to their fiduciaries in order to enable fiduciaries to perform a service to them."[27] Given the temptations to abuse property or power, "[f]iduciary law aims at reducing the fiduciaries' temptations to misappropriate entrustment."[28] It is essential to note that fiduciary law is not contract law: "[t]he main difference between the two systems revolves around the right of one party to rely on the other. Entrustors are entitled to rely on their fiduciaries to a greater extent than contracting parties are entitled to rely on each other."[29]

> mate a transaction or make prompt delivery without disclosure of appropriate facts.

Weiss, *supra* note 17, at 88-89.

[27] Frankel, *supra* note 13, at 3.

[28] *Id.* at 5. *See also* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 832 (1983) (observing that the central problem in a fiduciary relationship is the potential "abuse of delegated power").

[29] Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1275-76 (1995). Frankel provides a useful exposition of the differences:

> *First*, because fiduciary law is aimed at reducing the entrustors' risks, the law regulates mostly the fiduciaries. Contract law regulates both parties equally. *Second*, although most types of fiduciary relationships are grounded in the consent of both parties, fiduciary law is triggered primarily by the consent of the fiduciary to serve. . . . Contracts require, in all cases, the consent of all parties. *Third*, fiduciary law is easily applicable because entry into fiduciary relationships involves low costs, requiring no formalities or special conditions. These requisites are far less formal than the requisites for contract. *Fourth*, because fiduciary law addresses the entrustors' risks from relationships, the rules dictate how fiduciaries should behave. Contract rules are far less intrusive. *Fifth*, because entrustors' risks from the relationship vary, fiduciary rules that address these risks vary more than contract rules. *Sixth*, the focus on the entrustor's potential harm from the relationship explains the ascendancy of fiduciary rules over other legal arrangements. Because the private arrangements and other rules that govern the

Fiduciary law is attractive in the regulation of investment advice for a number of reasons. Unlike classical contract law, it is well attuned to unequal bargaining power and informational asymmetries which so often characterize the relationship between retail investors and their financial service providers. It recognizes that it is very difficult to predict terms ex ante in long-term relational contracts,[30] and as such imposes extra-contractual obligations to protect the party who has entrusted property or power—a traditional idea supported by modern research in game theory[31] and transaction cost economics.[32]

By far the most important feature of fiduciary duty, however, is that its *sine qua non* is loyalty. As one commentator sums it up, "the duty of loyalty that is the essence of fiduciary duty protects beneficiaries against opportunistic behavior by fiduciaries."[33] This is

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> relationships are not deemed sufficient to protect entrustors, fiduciary law is superimposed on the other rules.

Id. at 1225-26 (emphasis added).

[30] *See, e.g.*, William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, *in* PROGRESSIVE CORPORATE LAW 139, 160 (Lawrence E. Mitchell ed., 1995) ("[C]omplete contractual protection *ex ante* is not cost effective because of informational asymmetries and a long list of possible future relational problems."); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1465-66 (1989) ("It is almost impossible to deal adequately with this potential for ex post opportunism by ex ante contracting.").

[31] *See, e.g.*, Bratton, *supra* note 30, at 153 ("[T]he game theoretic firm implies a new endorsement of the traditional dual justification of fiduciary law.").

[32] *See, e.g.*, D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1428 (2002) ("Courts supply fiduciary duties as default rules to reduce the costs associated with providing the fiduciary with incomplete instructions."); Kenneth B. Davis, Jr., *Judiciary Review of Fiduciary Decision Making—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 20-21 (1985) (characterizing fiduciary law "as a low transaction cost alternative to ad hoc bargaining between fiduciary and principal"). Transaction costs include "search and information costs, bargaining and decision costs, policing and enforcement costs." Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979).

[33] Smith, *supra* note 32, at 1402. *See also* Weiss, *supra* note 17, at 66-67 ("The relation of parties to a contract might be adverse, whereas a fiduciary is required to act in the interests of the other party. Where a fiduciary duty exists, loyalty is coextensive with the entire duty.").

in marked distinction to the professional standards—"shingle" theory, "suitability," or commercial honor"—under which broker-dealers are regulated. In the context of investment advice, "[t]he centerpiece of the fiduciary duty is the requirement that investment advisers act in the best interest of their clients."[34] Thus, it is no coincidence that "[i]t is the treatment of conflicts of interest that largely separates investment advisers and broker-dealers under the fiduciary and fair dealing standards."[35] Otherwise thoughtful proposals—advocating, for instance, that "broker-dealers and investment advisers should be held to professional standards of care and competence"[36]—seemingly ignore the fact that beyond "care and competence," investors are seeking loyalty. Thankfully, fiduciary law understands this well.

III. Some Misplaced Objections

Before proceeding further, it is important to address two objections to making brokers subject to a fiduciary standard: (1) that sales activities are not fiduciary in nature, and (2) that brokers also acting as dealers and underwriters will be in conflict with their customers.

The first objection is hardly convincing. It can perhaps be best summarized by the notion that "selling is not a fiduciary occupation."[37] While it may have been true historically that brokers-dealers were primarily concerned with buying and selling securities, they are now increasingly focused on providing investment advice.[38]

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[34] Steven D. Irwin et al., *Wasn't My Broker Always Looking Out for My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41, 50 (2009).

[35] Kristina A. Fausti, *A Fiduciary Duty for All?*, 12 DUQ. BUS. L.J. 183, 189 (2010).

[36] Black, *supra* note 16, at 4.

[37] Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 440 (2010). *See also id.* at 445 ("[T]o fiduciarize the sale of investment products prompts the question of why we do not even think about doing the same in so many other areas where consumers are also at risk of overpaying.").

[38] *See supra* Part II (discussing modern developments in the activities of broker-dealers); Matthew P. Allen, *A Lesson from History, Roosevelt to Obama—The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability, to Federal Regulation, Litigation, and Fiduciary Duty*, 5 ENTREPRENEURSHIP BUS. L.J. 1, 23 (2010) ("The

Moreover, they are providing such advice on an intangible good and typically on an ongoing basis—hardly the stuff of one-off transactions for tangible goods where the informational asymmetries are less pronounced. This is not even to mention that "there are few reported decisions holding a securities broker to the standard of care to which virtually every other trade or profession is held."[39]

The second objection is more nuanced, but also ultimately unpersuasive. The argument focuses on the notion that it is difficult for a broker acting as trader or underwriter to act in the best interest of her client.[40] After all, the objection goes, "[w]hen acting as a dealer, the firm seeks to buy low and sell high—precisely what the customer seeks. It is hard to see how any dealer can act in the 'best interest' of his customer when trading with her."[41] Several nuanced responses have been proposed to this dilemma, including requiring disclosure[42] and permitting principal trades "only for readily marketable liquid instruments."[43] The most effective solution, however, is also the simplest: requiring both disclosure *and* consent before a principal transaction, as is already required under § 206(3) of the Investment Advisers Act.[44] To the extent that such a requirement will in practice restrict principal trading by brokers—as

rationale for not imposing fiduciary duties on brokers-dealers under the suitability rule is based on the rationale underlying the job descriptions of broker-dealers at the time the '33 and '34 Acts were enacted—broker-dealers merely bought and sold securities, they did not offer or provide investment advice to customers as part of their primary duties.").

[39] Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 567 (2002).

[40] *See, e.g.*, Laby, *supra* note 15, at 439 ("An obligation to act in the sole interest—or even the best interest—of a customer cannot easily be squared with the self-interest inherent in trading for one's own account or the interest of a broker-dealer in completing a distribution for an issuer.").

[41] *Id.* at 425.

[42] *See id.* at 429-30 (suggesting that the SEC make permanent its temporary rule requiring broker-dealers to make oral or written disclosures before a principal transaction takes place).

[43] *Id.* at 431.

[44] *See* 15 U.S.C.S. § 80b-6(3) (2010) (stating that investment advisors are required to disclose to their clients in writing certain conflicts of interest and to obtain client consent before moving ahead with the transaction).

it already has for investment advisers[45]—then this would represent a positive protection for investors.[46]

The problem of an underwriter having divided loyalties—between the issuer for whom it is working and the investor to whom it is selling the offering[47]—can similarly be addressed in a variety of ways. The fiduciary standard could be prioritized toward investors,[48] the offering could be supervised by an independent underwriter[49]—or most straightforwardly, broker-dealers could be prohibited from acting as underwriters.

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[45] *See* Laby, *supra* note 15, at 408 ("[S]ection 206(3) is effectively a ban on principal trading for advisers.").

[46] In a similar vein, consider Donald Langevoort's observation:

> To be most potent, then, reform would have to be structural to make brokers into fiduciaries: turn broker-customer dealings to a solely fee-based relationship, with a prohibition on any incentives apart from those based on the customer's (now client's) financial success. In essence, this would require a segregation of the broker function from the dealer function, via a "Chinese Wall" that would have to be watched constantly and very carefully for cracks and leaks. The broker, in other words, becomes solely an investment adviser, with the ability to execute trades.

Langevoort, *supra* note 37, at 449. Broker-dealers, of course, may not be pleased with such a development. *See* Laby, *supra* note 15, at 407 ("Notwithstanding the prospect of owing fiduciary obligations, the primary reason many brokers oppose application of the Advisers Act is due to restrictions on conducting principal transactions imposed on advisers but not brokers.").

[47] *See* Laby, *supra* note 15, at 428 ("Acting on behalf of both the issuer and investor client raises a conflict of duty. This conflict is similar to a conflict of interest, but instead of a conflict between the broker-dealer's self-interest and its duty to a customer or client, the firm is faced with conflicting demands of two opposing clients.").

[48] *See id.* at 432 ("In propounding a fiduciary standard for brokers, Congress could clarify that the broker-dealer's primary duty runs to the investor, not the underwriting client.").

[49] *See id.* at 433 ("An additional possible reform to help ensure that an underwriter acts in a fiduciary capacity with respect to customers is to require an issuer conducting a public offering to engage an independent outsider to superintend the offering, with a skeptical eye to ensuring the interests of investors.").

IV. Practical Realities

Beyond these objections, two practical issues must be confronted to make the fiduciary standard useful in practice: (1) meaningfully specifying the duties it entails and (2) enforcing them. As the Supreme Court once famously observed, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."[50] The natural place to look, of course, is the fiduciary duty imposed on investment advisers, but there is precious little jurisprudence on the issue.[51] This is particularly troubling in an era where the fiduciary construct is under attack both in the law of corporations[52] and the law of unincorporated associations.[53] In a nutshell, the law of business associations "has relaxed—*without either explanation or justification*—the fiduciary strictures imported from trusts and agency so as to permit direct and indirect self-dealing

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[50] SEC v. Chenery, 318 U.S. 80, 85-86 (1943). *See also* Hazen, *supra* note 20, at 23 ("However, the fact that the relationship is a fiduciary one only takes one so far. The key question is to determine what actual duties arise out of the relationship.").

[51] *See, e.g.*, Black, *supra* note 16, at 9 ("Neither *Capital Gains* nor *Transamerica Mortgage Advisors*, however, presented the Court with the opportunity to explore concretely the nature of fiduciary duties owed by an investment adviser providing individualized investment advice, and there is limited case law or regulatory guidance on the issue.").

[52] *See* Reza Dibadj, *Delayering Corporate Law*, 34 HOFSTRA L. REV. 469, 470 (2005) ("Existing fiduciary duties are little more than rhetorical flourish."); J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318 (2004) ("Over time, state courts interpreted the [fiduciary] duties in a manner that left little substance."); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 691 (2006) ("[T]he genius of Delaware lawmakers lies in their ability to generate a thick fiduciary law without at the same time imposing a significant compliance burden.").

[53] *See generally* Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451 (2006) ("Unfortunately, the law of unincorporated associations is engaged in a misguided march: it is transforming the duty of loyalty into a contractarian construct. This article argues that these developments reflect doctrinal confusion, outworn economics, and weak policy. If anything, the duty of loyalty needs to be strengthened, not watered down.").

and other diversionary transactions"[54] to rely instead on "the *imagery* of contract and consent."[55]

There is a risk that a similar evisceration might occur even if the regulation of broker-dealers and investment advisers were unified under a fiduciary rubric. Consider that very recently, when faced with interpreting an investment adviser's fiduciary duty with respect to the receipt of compensation, a unanimous Supreme Court noted that "to face liability . . . an investment adviser must charge a fee that is so disproportionately large that it bears *no reasonable relationship* to the services rendered and could not have been the product of *arm's length bargaining*."[56] The Court also placed great importance on whether proper process was followed in determining the fee.[57] Much like in the law of business associations, the focus seems to be on contract and process—not a deeper judicial inquiry into the fairness of the transaction that one might expect in fiduciary analysis.[58] As such, the burden will likely be on the expert agency, the SEC, to articulate and specify the notion that fiduciary obligations rise above contractual ones, and that process cannot simply redeem unfair transactions. One possibility would be to return to first principles in the laws of trusts[59] and agency.[60] Put succinctly in the words of one

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[54] Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1434 (1985) (emphasis added).
[55] *Id.* (emphasis added).
[56] Jones v. Harris Associates, No. 08-586, slip op. at 9 (2010) (emphasis added). The case was brought under § 36(b) of the Investment Company Act of 1940 which stipulates that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser." 15 U.S.C. § 80a-35(b) (2006).
[57] *See* Harris Associates, No. 08-586, slip op. at 15 ("When a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process.").
[58] As Justice Thomas noted in his concurrence, "[w]hatever else might be said about today's decision, it does not countenance the free-ranging judicial 'fairness' review of fees. . . ." *Id.*, No. 08-586, slip op. at 2 (Thomas, J., concurring).
[59] *See, e.g.*, Allen, *supra* note 38, at 70-73 (stating that review of trustee's fiduciary standards may be helpful in understanding where broker-dealer duties may be heading).
[60] *See, e.g.*, Gedicks, *supra* note 19, at 546 ("This article argues that the common law of agency supplies a powerful justification for holding broker-

Commissioner, "I believe it is important that the Commission explain what the fiduciary standard requires."[61]

A second practical difficulty involves enforcing the fiduciary duty in a way that gives aggrieved investors redress. The Dodd-Frank Act gives the SEC enforcement authority to enforce the applicable standard of conduct that might emerge, thereby harmonizing enforcement of broker-dealers to that of investment advisers when offering investment advice to retail customers.[62] The central

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dealer firms liable for customer losses from unrecommended securities investments.").

[61] Walter, *supra* note 13, at 9; *see also* Fausti, *supra* note 35, at 197 ("Ultimately, with or without legislation, the responsibility for extending the fiduciary standard will lie with the SEC."). *Cf.* Langevoort, *supra* note 37, at 456 ("Simply placing the fiduciary label on the securities industry and leaving the rest to ad hoc decisions will produce a platform that is neither stable nor functional.").

[62] Dodd-Frank Act § 913(h)(1) amends § 15 of the Securities and Exchange Act as follows:

> The enforcement authority of the Commission with respect to violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer shall include—
>
> (1) the enforcement authority of the Commission with respect to such violations provided under this Act; and
>
> (2) the enforcement authority of the Commission with respect to violations of the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940, including the authority to impose sanctions for such violations, and
>
> the Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under this Act to the same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to an investment advisor under the Investment Advisers Act of 1940.

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(h)(i), 124 Stat. 1376, 1829 (2010).

question, though, is whether the SEC has sufficient resources?[63] Consider that while a self-regulatory organization ("SRO"), the Financial Industry Regulatory Authority ("FINRA"), provides front-line enforcement against broker-dealers, there is no SRO for investment advisers.[64] The problem becomes particularly acute when one considers that the SEC currently "registers and regulates 11,300 investment advisers,"[65] and enforcement harmonization would add "the registration and regulation of 4,900 brokerage firms, 174,000 brokerage branch offices and over 650,000 registered representatives."[66]

To be sure, some of the strain on public enforcement might be alleviated. Commentators have already begun proposing solutions in this regard. For example, even though § 410 of the Dodd-Frank Act increases the threshold of assets under management to trigger investment adviser registration from $25 million to $100 million,[67] the threshold might be increased even further;[68] or one might consider expanding exemptions from registration while subjecting broker-dealers and advisers to antifraud liability.[69] Another possibility might involve changing the SEC's funding mechanism to enhance resources for enforcement.[70]

Another avenue toward relieving the burden on the SEC would be to contemplate the creation of an SRO for investment advisers. Interestingly, § 914 of the Dodd-Frank Act directs the SEC

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[63] *See, e.g.*, Laby, *supra* note 15, at 439 ("In addition, regulating brokers that give advice as advisers would swell the number of advisers subject to registration and have sweeping implications for the SEC's resources.").
[64] *See* Irwin et al., *supra* note 34, at 48 ("Where broker dealers have a self-regulatory organization (FINRA), there is no self-regulation for investment advisers.").
[65] Allen, *supra* note 38, at 48.
[66] *Id.*
[67] *See* Dodd-Frank Act § 410.
[68] *Cf.* Laby, *supra* note 15, at 435 ("The first is to raise the monetary threshold for the amount of assets under management that triggers SEC registration for investment advisers.").
[69] *See, e.g., id.* ("The second and preferred solution is to exempt from Advisers Act registration certain broker-dealers providing advice, while preserving antifraud regulation under the Advisers Act for the exempt firms.").
[70] *See, e.g.,* Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233 (2004).

to study this issue.[71] While worthy of discussion, such an approach is at least in tension with the concern that arbitration proceedings conducted under the auspices of SROs are unfair to investors; presumably based on these concerns, § 921 of the Act gives the authority to the SEC to restrict mandatory pre-dispute arbitration.[72]

The more meaningful solution, however, may lie neither with the SEC nor an SRO but with private enforcement. As a starting point, it is important to remember that under the Securities and Exchange Act of 1934, which regulates trading transactions, investors are generally unable to bring a private right of action unless they can show fraud—hence the overwhelming importance of § 10(b) and Rule 10b-5 to securities litigation. More specifically, showing that a broker-dealer violated an SRO regulation is not sufficient to sustain a private cause of action,[73] unless the violations are so egregious that these transgressions can be used to make a case under §10(b) and Rule 10b-5. In reality, "suitability and negligent recommendation cases have all but been eliminated from federal court."[74]

A private plaintiff might get more creative and plausibly sue for negligent investment advice by looking to § 12(a)(2) of the Securities Act of 1933, which provides a rescissionary remedy if a security is sold "by means of a prospectus or oral communication"[75] which contains a material misstatement or omission, unless the seller

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[71] *See* Dodd-Frank Act § 914(a)(2)(B) (directing the SEC to examine "the extent to which having Congress authorize the Commission to designate one or more self-regulatory organizations to augment the Commission's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers.").

[72] *See id.* at § 921 ("The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.").

[73] *See, e.g.*, Ramirez, *supra* note 39, at 548 ("Noticeably absent from the entire scheme of mandatory self-regulation is any authorization of a private right of action for a violation of an SRO rule or regulation."); Weiss, *supra* note 17, at 101 ("The weight of opinion rejects the proposition that a breach of SRO suitability rules provides a private right of action.").

[74] Irwin et al., *supra* note 34, at 48.

[75] 15 U.S.C. § 77l(a)(2) (2006).

can show that "he did not know, and in the exercise of reasonable care could not have known of such untruth or omission."[76] This would appear to be an attractive cause of action for a plaintiff. After all, in contrast to §10(b) and Rule 10b-5, which require the plaintiff to establish scienter, in a §12(a)(2) action, the burden is on the defendant to show that he took reasonable care. Unfortunately for investors, however, in 1995 the Supreme Court in the *Gustafson* case held § 12(a)(2) inapplicable to aftermarket transactions.[77] As such the 1933 Act route appears unpromising as well, unless the investor has purchased her shares in a public offering.

Beyond the 1933 and 1934 Act, one is naturally tempted to look to the Investment Advisers Act. Perhaps surprisingly, the statute only does slightly better.[78] Ironically, while in 1963 the Supreme Court embraced the fiduciary standard in interpreting the Act in the *Capital Gains*[79] decision, in 1979 it sharply restricted the ability of investors to bring private actions under the standard in the *Transamerica* case.[80] In a 5-4 opinion, the Court held that "there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable."[81] As with the 1934 Act, then, damages are unavailable to aggrieved investors for

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[76] *Id.*

[77] *See* Gustafson v. Alloyd Co., 513 U.S. 561, 578 (1995) ("Under Alloyd's view any casual communication between buyer and seller in the aftermarket could give rise to an action for rescission, with no evidence of fraud on the part of the seller or reliance on the part of the buyer. In many instances buyers in practical effect would have an option to rescind, impairing the stability of past transactions where neither fraud nor detrimental reliance on misstatements or omissions occurred. We find no basis for interpreting the statute to reach so far.").

[78] *See, e.g.*, Allen, *supra* note 38, at 84 ("If broker-dealers are fiduciaries, and broker-dealers are treated like investment advisers as SEC commentators and Congress have suggested they should be, then it is possible plaintiffs will be relegated to bringing breach of fiduciary duty claims under the Advisers Act, which provides very limited private remedies?").

[79] *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

[80] *See* Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1979).

[81] *Id*. at 24. *See also* Irwin et al., *supra* note 34, at 51 ("Private rights of action under the 1940 Act are limited to voiding an investment advisory contract and for rescission or restitution of any consideration paid (such as advisory fees) under the contract.").

the negligence of their advisers.[82] In sum, unless they can show fraud or be willing to countenance private arbitration, investors are essentially left without private remedy.[83]

Perhaps most interestingly, the Dodd-Frank Act does not change this state of affairs. As one scholar aptly points out, the legislation "provides no explicit remedy for an investor harmed by an investment advice provider's negligence or breach of fiduciary duty. Thus, after the enactment of Dodd-Frank, investors who purchased securities in trading transactions are still without a federal damages remedy unless they can establish fraud."[84] Furthermore, it is very unlikely that contemporary federal courts will imply a private cause of action as a matter of federal common law[85] or even lessen the scienter requirement in securities fraud cases.[86] Thus, relief would have to come from Congress, which could permit a private cause of action for damages for breach of a broker-dealer or investment adviser's fiduciary duty.[87] A starting point may be legislative action

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[82] *See, e.g.*, Black, *supra* note 16, at 11 ("[T]he only investors' remedy in the Advisers Act is a limited rescissionary remedy; there is no provision for compensating losses caused by negligent investment advisers.").

[83] *Cf.* Allen, *supra* note 38, at 28 ("There exists no express or implied private right of action under the '34 Exchange Act for violation of FINRA's suitability or other rules. So before the advent and Supreme Court-approval of industry arbitration agreements in the 1970's, most suitability claims were brought as section 10(b) and Rule 10b-5 implied private rights of action.").

[84] Black, *supra* note 16, at 19.

[85] In other words, it is unlikely that a twenty-first century federal court would agree with the notion that "in the absence of a private right of action for damages, victimized clients have little hope of obtaining redress for their injuries." Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 35 (1979) (White, J., dissenting).

[86] Interestingly, the Supreme Court declared investment advisers to have fiduciary obligations by reading out the intent requirement in§ 206 of the Investment Advisers Act. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 192 (1963) ("It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients.").

[87] *Cf.* Black, *supra* note 16, at 5 ("Despite the frequent expression of the need to improve retail investor protection, at no time did Congress give serious consideration to amending federal securities legislation to provide an explicit damages remedy for careless and incompetent investment

that would make §12(a)(2) applicable to trading transactions, effectively "overruling" *Gustafson*.

V. Conclusion

The Dodd-Frank Act's mandate to the SEC to conduct a study to improve the regulation of broker-dealers and investment advisers, as well as its granting of statutory authority to the SEC to interpose a fiduciary duty on broker-dealers, is to be commended. Should the SEC choose to follow Congress' lead, it has the opportunity to simplify and unify regulation in an area crucial to investor protection.[88]

Espousing a fiduciary standard also gives the message that fiduciary law, and its concomitant moral component,[89] is important—a particularly relevant message in an era where the fiduciary principle is under attack in the law of business associations generally. This point cannot be overemphasized. As Justice Harlan Stone reflected in the wake of excesses of the 1920s:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ,

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advice."). Of course, if one espouses the fiduciary concept, then the cause of action would not only be for breaches of the duty of care, but also of loyalty.

[88] As one SEC Commissioner notes:

> I believe that there are numerous advantages to harmonizing legislations. First and foremost, it would provide a clear congressional statement that all financial professsionals should be held to the same high standard of conduct. It would also address investor confusion by providing a unified system of regulation for all financial professionals offering comparable securities products and services.

Walter, *supra* note 13, at 10.

[89] *See, e.g.*, Frankel, *supra* note 28, at 830 ("This moral theme is an important part of fiduciary law. Loyalty, fidelity, faith, and honor form its basic vocabulary.").

> that "a man cannot serve two masters . . . . Yet those who serve nominally as trustee, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, . . . financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle.[90]

Stone's words are at least as relevant today as they were in 1934.[91]

Objections to the fiduciary standard—namely, that selling securities is not a fiduciary activity or that brokers cannot serve two masters when acting as dealers or underwriters—remain unconvincing. Rather, for reform to make a difference, the real challenges will lie in defining the duty carefully and in enforcing it effectively. Notwithstanding the difficult work ahead, Dodd-Frank presents a beginning and an opportunity.[92]

[90] Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8-9 (1934).

[91] As Tamar Frankel reminds us, "[u]nlike status and contract societies, a fiduciary society emphasizes not personal conflict and domination among individuals, but cooperation and identity of interest pursuant to acceptable but imposed standards. . . . A contract society values freedom and independence highly, but it provides little security for its members." Frankel, *supra* note 28, at 802.

[92] *Cf.* Irwin et al., *supra* note 34, at 61 ("Despite the plethora of unanswered questions, simple enactment of a fiduciary standard is an important step in restoring confidence in our financial markets.").