THE FIDUCIARY STUDY: A TRIUMPH OF SUBSTANCE OVER FORM?

MERCER BULLARD[*]

I. Introduction

The Dodd-Frank Act of 2010[1] brought closure to some regulatory issues, but it failed to bring closure to the issue of whether broker-dealers should be subject to a fiduciary duty when providing retail investment advice.[2] Investor advocates and financial planners lobbied Congress in support of the fiduciary duty;[3] the insurance industry fought against it.[4] Unable to achieve a consensus, Congress deflected the issue to the U.S. Securities and Exchange Commission ("SEC" or "Commission"). Section 913 of the Dodd-Frank Act requires the SEC to conduct a study of the fiduciary issue, which is already serving as a kind of pre-rulemaking combat zone in which the battle over the fiduciary duty will continue for years to come.[5] In

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[*] Associate Professor of Law, University of Mississippi School of Law.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[2] For an excellent discussion of this issue, *see* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 413-24 (2010) (arguing that brokers who provide investment advice should be treated as fiduciaries and should be subject to the Advisers Act).

[3] *See*, *e.g.*, Letter from Financial Planning Coalition to Conferees (June 23, 2010) (on file with author) (urging the Senate to reject the Harkin Amendment because it "is contrary to the goals of strengthening investor confidence in American financial markets and enhancing investor protection."); Press Release, Consumer Federation of America, Statement of CFA Director of Investor Protection Barbara Roper In Support of House Fiduciary Duty Provision (June 15, 2010), http://admin.consumerfed.org/elements/www.consumerfed.org/file/Roper_Statement_fiduciary_duty_press_conference.pdf ("[We are] urg[ing] the Conference Committee to adopt the House language on fiduciary duty.").

[4] *See*, *e.g.*, Action Alerts, Ass'n for Advanced Life Underwriting & Nat'l Ass'n of Ins. and Fin. Advisors (Dec. 2009) (providing form letters for AALU and NAIFA members to send to members of Congress opposing fiduciary duty) (on file with author).

[5] *See* Dodd-Frank Act § 913(b)-(b)(1) (requiring the Commission to conduct a study on "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing

the first three weeks of the comment period on the study, the SEC received more than 1,300 letters.[6]

Section 913 generally frames the study as an investigation of standards of conduct, as reflected in its fourteen references to legal "standard(s)" or "standards of care."[7] This orientation echoes the common critique that investment advisers and broker-dealers provide similar advisory services but are subject to different regulatory standards. Specifically, advisers are subject to a fiduciary duty under the Investment Advisers Act of 1940 ("Advisers Act").[8] Broker-dealers are not.[9] The issue therefore seems to be whether to impose

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personalized investment advice and recommendations about securities to retail customers.").

[6] *See* Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 34-62577 (July 27, 2010), *available at* http://www.sec.gov/rules/other/2010/34-62577.pdf (requesting comment on study); *Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, SEC.GOV, http://www.sec.gov/comments/4-606/4-606.shtml (last visited Aug. 22, 2010) (providing access to all comments received by the SEC in response to its "Study Regarding Obligations of Brokers, Dealers, and Investment Advisers").

[7] *See, e.g.,* Dodd-Frank Act § 913(b)-(b)(1) ("The Commission shall conduct a study to evaluate . . . the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers . . . ."); *Id.* at § 913(d)-(d)(2) (requiring that the Commission file a report describing the "findings, conclusions, and recommendations of the Commission from the study required under subsection (b), including . . . an analysis of whether any identified legal or regulatory gaps, shortcomings, or overlap in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers . . . .").

[8] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (finding a fiduciary duty under Section 206 of the Advisers Act); Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (finding that Section 206 "establishes 'federal fiduciary standards' to govern the conduct of investment advisers."); Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 472 n.11 (1977) (citing *Capital Gains Research Bureau, Inc.*, 375 U.S. at 194) ("Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.").

[9] This essay uses the term "broker-dealers" to refer to broker-dealers that are not subject to the Advisers Act, although many are. Broker-dealers that provide investment advice can avoid regulation under the Advisers Act by qualifying for the exclusion under Section 202(a)(11)(C) of the Act. *See*,

the specific, fiduciary standards of conduct on broker-dealers that apply to investment advisers under the Advisers Act.[10]

For the reasons discussed in this essay, it would be a mistake for the SEC's fiduciary study to focus on specific standards of conduct, in part because the fiduciary duty is inherently principles-based. To regulate conduct through rulemaking is to remove that conduct from the truly fiduciary sphere. The conduct standards established by a quintessentially fiduciary duty are only found in and revealed through case-by-case adjudication. To evaluate the fiduciary duty in terms of specific conduct requirements misunderstands its impetus, which is about *how*—not *what*—conduct requirements are imposed. The central question for the fiduciary study should be the efficacy of principles-based common law duties in the regulation of broker-dealers' retail investment advice.

This common law/rules-based dichotomy is not the only model that would provide a more fruitful vehicle for studying the fiduciary duty than viewing the study as an analysis of specific standards of conduct. Examples of other useful models include traditional lines of legal inquiry such as public versus private rights of action, allocation of regulatory oversight authority, comparative dispute resolution mechanisms, federalism, procedural rules and separation of powers. These models provide the positive regulatory epistemology in which securities regulation operates and retail investment advice is regulated. It is the operation of these models, not the content of specific conduct standards, that are in dire need of analysis and reform.

Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11)(C) (2010) (stating that the term "investment adviser" does not include "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 . . . ."). The exclusion requires that the advice be solely incidental to the brokerage services provided and that no special compensation be received. *See* Laby, *supra* note 2, at 407, 417 (asset-based fees and triggering of regulation under the Advisers Act).

[10] *See*, *e.g.*, Donald Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 448 (2010) ("The question, then, is whether to resort to the other authority, to regulate more substantively.").

II. The Fiduciary Duty as Principles-Based Regulation

The fiduciary duty represents a form of principles-based regulation that establishes standards of conduct only to the extent that one can identify consistent fact patterns in cases in which the fiduciary duty has been applied. It is a standard of conduct in only the loosest terms, as elegantly reflected in Judge Cardozo's characterization of the fiduciary duty in *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[11]

Judge Cardozo's punctilio, like Section 913's "best interest of the customer" and ERISA's "solely in the interest of the participants and beneficiaries,"[12] is an umbrella principle that is realized through concrete applications in particular cases.

There is no catalogue of conduct requirements that comprises the fiduciary duty under the Advisers Act. The fiduciary duty reflects requirements that have evolved as common law, that is, as a set of principles that are reflected in the decisions of courts, not as a collection of rule-based dictates.[13] The fiduciary duty is precisely that misconduct which cannot be captured by rules but that can only be regulated effectively through a common law process. The frequent complaint that the fiduciary duty should be imposed only if it can be defined as a set of conduct rules misunderstands the principles-based nature of the fiduciary duty.

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[11] Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

[12] Dodd-Frank Act § 913(g)(1) (authorizing the Commission to promulgate rules establishing a duty "to act in the best interest of the customer"); ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) ("[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . . .").

[13] *See* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1231 (1995) ("[R]ules are varied, fact-specific, and developed at the adjudication stage.").

The codification of conduct standards does not implement fiduciary duties as much as displace them.[14] A mutual fund sales charge generally will not violate a fiduciary duty in a particular case if it is no greater than the maximum allowed by rule. Similarly, the failure to disclose compensation generally will not violate a broker-dealer's fiduciary duty if it has disclosed all of the information that is required in the transaction confirmation rule.[15] The mutual fund sales charges and transaction confirmation rules have occupied the relevant conduct space, in some cases permitting anti-fiduciary conduct, in other cases prohibiting fiduciary conduct and in no cases tailoring the rule to the particular facts of the case. Conduct rules are an alternative to, not an expression of, the fiduciary duty.

Thus, the essence of the fiduciary duty is conduct that is not prohibited by rule. Actions that violate a conduct rule may also violate a fiduciary duty, but the latter violation is, in a structural sense, superfluous. To argue that broker-dealers should be subject to a fiduciary duty requires evidence that the duty would prohibit conduct that would not otherwise be prohibited under broker-dealer regulation. The fiduciary duty is not needed to regulate misconduct that otherwise violates anti-fraud rules.[16] It must find its ultimate justification in conduct that only the fiduciary duty will reach.[17] And

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[14] *See id*. at 1234 (stating that bargaining around fiduciary means the following: to "bargain around the right of the entrustor to rely on and trust his fiduciary. To bargain with his fiduciary, the entrustor must fend for himself rather than rely on his fiduciary. Thus, the first bargain will change the relational mode in which the parties operate.").

[15] *See* FINRA Manual, NASD Rule 2830, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4368&element_id=3691&highlight=2830#r4368 (addressing mutual fund sales charges); 17 C.F.R § 240.10b-10 (2010) (addressing transaction confirmation); *see also infra* Part IV and notes 35-37.

[16] Conversely, it is not the job of the fiduciary duty to prevent common fraud. *See*, *e.g.*, Arthur D. Postal, *What Did the Fiduciary Standard Do to Stop Madoff?* NATIONAL UNDERWRITER (Feb. 23, 2010), http:// www.lifeandhealthinsurancenews.com/News/2010/2/Pages/NAIFA-What-Did-The-Fiduciary-Standard-Do-To-Stop-Madoff.aspx?k=madoff (discussing whether to impose a fiduciary standard on life insurance agents who only currently need to "verify that a product sold to a consumer appears to suit the needs of that consumer").

[17] *See*, *e.g.*, Moore v. Regents of Univ. of Cal., 793 P.2d 479, 480 (Cal. 1990) (finding that a physician's taking of cells from a patient's spleen did

this truly fiduciary sphere of conduct can only be identified *ex post* in the facts of judicial decisions, not ex ante in the prospective iteration of rules.

III. Framing the Fiduciary Inquiry

The common law/rules-based law dichotomy discussed *supra* is not the only model in the epistemology of securities regulation that offers a useful tool for studying the fiduciary duty. There are many traditional models of legal processes and structures that would provide a more helpful basis for study than would a comparison of different conduct standards. The remainder of this essay briefly discusses some of these models, including public versus private rights of action, allocation of regulatory oversight authority, comparative dispute resolution mechanisms, federalism, procedural rules and separation of powers.

In order to provide a more concrete illustration of these models in action, this essay uses the practice of revenue sharing to illustrate how the fiduciary inquiry should be framed. "Revenue sharing" refers to payments by mutual fund investment advisers to brokers as compensation for selling fund shares.[18] Revenue sharing disclosure provides a useful vehicle for framing the fiduciary inquiry because investment advisers and broker-dealers generally are viewed as being treated differently in this area. Investment advisers are subject to a fiduciary duty under Section 206 of the Advisers Act to disclose revenue sharing payments to their clients. Brokers are not.[19] One might argue that this is precisely the kind of inconsistent conduct standard on which the fiduciary study should focus.

On closer inspection, however, the issue of revenue sharing disclosure does not demonstrate a problem with disparate standards

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not constitute conversion but failure to obtain the patient's consent thereto violated fiduciary duty).

[18] *See* Mercer E. Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?* 76 U. CIN. L. REV. 559, 570 (2008) ("Revenue sharing generally refers to cash payments made by a fund affiliate to brokers.").

[19] *See* Michael Koffler, *The Brave New World of Fiduciary Duty for Broker-Dealers and Investment Advisers*, SUTHERLAND ASBILL & BRENNAN LLP, at 13, 24 (Apr. 2010), http://www.investmentadvisor.com/Issues/2010/ April-2010/PublishingImages/Envestnet_Fiduciary%20Duty.pdf (subjecting broker-dealers to a fiduciary duty would require that they disclose the revenue sharing payments).

of conduct. Rather, it illustrates how the fiduciary inquiry turns primarily on issues other than conduct standards. For example, the idea that the higher fiduciary standard under the Advisers Act applies to investment advisers breaks down in the context of private claims. There is no private right of action under Section 206 of the Advisers Act.[20] With respect to private enforcement of the Act's duty to disclose revenue sharing payments and other fiduciary claims, investment advisers and broker-dealers are similarly situated.

The conventional wisdom that broker-dealers are not subject to fiduciary duties also cannot withstand scrutiny. *Both* investment advisers and broker-dealers are subject to private fiduciary claims under state law alleging a failure to disclose material information such as revenue sharing payments.[21] It is possible that state courts apply materially different standards of conduct to broker-dealers and investment advisers that, acting as fiduciaries, fail to disclose revenue sharing to their clients. There is no research supporting this view, however, or any obvious reason why this would be the case beyond the differences in outcomes that are inherent in the common law process.[22] The similar standards applied to advisers and broker-

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[20] Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) (finding no private right of action under Section 206 of the Advisers Act).

[21] *See*, *e.g.*, Kelly Wiese, *Verdicts & Settlements June 20, 2010: Settlement approved in A.G. Edwards Case*, MO. L. MEDIA, June 20, 2010, available at 2010 WLNR 12936709 (describing settlement of state law claims based on failure to disclose revenue sharing); *see also* McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989) (inferring a breach of a fiduciary duty by failure to inform inexperienced client of investment risks); *see generally* Tamar Frankel, *Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers*, 9-10 (Boston Univ. Sch. of Law, Working Paper No. 09-36, 2010), *available at* http://www.bu.edu/law/faculty/scholarship/workingpapers/Frankel-Fiduciary-Duties.html ("The California Court of Appeals held that 'the stockbroker has a *fiduciary duty* . . . to ascertain that the investor understands the investment risks in the light of his or her *actual* financial situation.'").

[22] It is not intended to be conceded here that: (1) talking about the consistent application of standards of conduct in a fiduciary context even makes sense to the extent that the fiduciary duty as common law is not susceptible to a taxonomy more precise than basic, black letter principles, or (2) the "unpredictability" of the common law is inefficient. *See generally* Paul Mahoney, *The Common Law and Economic Growth: Hayek Might be Right* (Univ. of Virginia Law Sch. Legal Studies, Working Paper No. 00-8, 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=206809 (finding higher rates of real per capita growth in common law economies); Ross

dealers in the context of private fiduciary claims under federal and state law belies the framing of the fiduciary duty issue as being about harmonizing disparate standards of conduct rather than being about rationalizing the symbiotic relationship between private and public claims or finding the optimal balance of state and federal power.

Many fiduciary claims are not brought in state court, but before an arbitration panel. Broker-dealers' clients have the right to arbitration of their claims,[23] and those that sign customer agreements with mandatory arbitration clauses are required to submit to arbitration.[24] Fiduciary claims are among the most common claims brought in arbitration,[25] including claims of undisclosed revenue sharing payments,[26] but the standards of conduct applied by arbitrators unfortunately cannot be evaluated. FINRA,[27] which administers broker-dealer arbitration, does not require that arbitrators follow any particular substantive law and arbitrators are not required

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Levine ET AL., *Financial Intermediation and Growth: Causality and Causes* (World Bank Policy Research, Working Paper No. 205 1999) *available at* http://ssrn.com/abstract=247793 (finding that common law systems enhance financial intermediary development, which causes higher economic growth).

[23] *See* FINRA Manual, FINRA Rule 12200, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5185&element_id=4106&highlight=12200#r5185 [hereinafter *FINRA Rule 12200*] (requiring members to arbitrate dispute if requested by customer).

[24] *See* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987) ("The Arbitration Act . . . mandates enforcement of agreements to arbitrate statutory claims."); FINRA Rule 12200.

[25] *See About FINRA Dispute Resolution: Dispute Resolution Statistics*, FINRA, http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm (last visited Nov. 7, 2010) (showing "breach of fiduciary duty" as most common type of controversy in FINRA arbitration, in each case by a significant margin, for 2006, 2007, 2008, and 2009, and 2010 through September 2010); Will Deener, *Suit Says Edward Jones Withheld Information: Law Firm Predicts Number of Complaints Against Broker Will Grow*, DALLAS MORNING NEWS, July 8, 2005, at 4D (describing dozens of revenue sharing disclosure cases filed in arbitration by a single firm).

[26] *See*, *e.g.*, *Aucoin v. Gauthier*, 35 So.3d 326, 330-31 (La. Ct. App. 2010) (holding that the arbitration panel's dismissal of claims based on, *inter alia*, failure to disclose revenue sharing payments was subject to the doctrine of *res judicata*).

[27] The Financial Industry Regulatory Authority, or FINRA, is the self-regulatory organization for broker-dealers.

to explain their rulings.[28] How can the SEC's fiduciary study be about standards of conduct if the conduct standards applied in a significant forum in which investors bring private fiduciary claims are unknowable? Here, it is the rules of FINRA arbitration that provide a more compelling subject for the fiduciary study than disparate standards of conduct.

The standard of conduct applied in FINRA arbitration is arguably a federal one, or quasi-federal in light of FINRA's quasi-governmental status, which reverses the disparate application of the federal fiduciary duty to broker-dealers and investment advisers as described above. While investment advisers are not subject to a private right of action based on the federal fiduciary duty under the Advisers Act, broker-dealers could be viewed as being subject to a private right of action based on a quasi-federal fiduciary duty in FINRA arbitration. In this light, it is broker-dealers, not investment advisers, who appear to be subject to a higher, federal fiduciary standard.[29]

It is not only under private rights of action that the supposed fiduciary gap between advisers and broker-dealers loses coherence. In the public enforcement arena, FINRA conduct rules cover some of the high ground claimed by the fiduciary duty under the Advisers Act,[30] thereby further blurring the perceived fiduciary gap between

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[28] *See* FINRA Manual, FINRA Rule 12904(f), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11407&element_id=4192&highlight=12904#r11407 ("The award may contain a rationale underlying the award."); *see generally* Barbara Black, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 995-98 (2002) (discussing whether and to what extent FINRA arbitrators apply substantive law).

[29] Investment advisers' clients may also be subject to mandatory arbitration clauses, assuming that enforcing such a clause would not violate an adviser's fiduciary duty, but arbitration under these clauses may occur outside of FINRA's oversight. State actions against broker-dealers for failing to disclose revenue sharing payments, which have successfully weathered federal preemption arguments, further undermine the fiduciary inquiry as being one of disparate standards of conduct.

[30] *See*, *e.g.*, FINRA Manual, FINRA Rule 2010, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."); *Langevoort, supra* note 10, at 444 ("The question, then, is whether to resort to the other authority, to regulate more substantively."); Barbara Black, *Brokers and Advisers: What's in a Name?* FORDHAM J. CORP. FIN. L. 31, 52-53 (2005)

advisers' and broker-dealers' conduct standards. As stated by the Commission, FINRA rules "embod[y] basic fiduciary responsibilities,"[31] such as a fiduciary duty to obtain best execution of transactions.[32] The rules reflect a principles-based common law model.[33]

What this brief review of a particular standard of conduct begins to reveal is that the heart of the fiduciary inquiry is not conduct standards at all, but how the dynamics of traditional models of law play out in the fiduciary context. The SEC's fiduciary study should be focused on the relationship between fiduciary standards of conduct and, *inter alia*, the: (1) efficacy of common law versus rules-based law, (2) most efficient combination of private and public enforcement mechanisms, (3) proper balance of state and federal sources of law, (4) relative merits of arbitration and litigation and (5) allocation of oversight responsibility between FINRA and the Commission. In each case, the question of whether brokers should be required to disclose revenue sharing payments, for example, is not nearly as pressing or fundamental as the question of how such fiduciary standards of conduct should be established, promulgated and enforced.

IV. The Fiduciary Inquiry and Separation of Powers

The separation of powers model deserves special consideration in the fiduciary inquiry, again as aptly illustrated by the revenue

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(discussing FINRA claim that its advertising rules are the "highest" in the industry).

[31] E.F. Hutton & Co., Inc., Exchange Act Release No. 25887, 1988 SEC LEXIS 1398, at *15 (July 6, 1988).

[32] Order Execution Obligations, Exchange Act Release No. 37619A, 61 FR 48290 (Sept. 6, 1996) ("[T]his duty of best execution must evolve as changes occur in the market.").

[33] *See*, *e.g.*, FINRA Manual, FINRA Rule 2440, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4337&element_id=3660&highlight=2440#r4337 ("[A] member buys for his own account from his customer, or sells for his own account to his customer . . . shall buy or sell at a price which is fair, taking into consideration all relevant circumstances . . . ."); FINRA Manual, FINRA IM-2440-1, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4338&element_id=3661&highlight=2440#r4338 (addressing the 5% mark-up limit policy stating that, notwithstanding 5% limit, a mark-up of 5% or less may be unfair or unreasonable).

sharing disclosure issue. Mutual funds are not required to provide detailed information about revenue sharing in their prospectuses or Statements of Additional Information ("SAI").[34] Nor are broker-dealers specifically required to include revenue sharing payments in transaction confirmations under the confirmation rule, Rule 10b-10.[35] The Commission once argued that a broker-dealer may be required to include more information than what is set forth in Rule 10b-10, such as 12b-1 mutual fund fees, which are a close cousin of revenue sharing payments.[36] The Second Circuit rejected this argument, however, in an opinion drafted by then-Judge Sotomayor. The Court reasoned that the Commission, through its own Rule 10b-10, "'has decided precisely' what disclosure was needed with regard to conflicts of interest arising from third-party payments to broker-dealers."[37]

Recognizing a regulatory gap that needed filling, the Commission proposed to require that confirmations disclose the precise amounts of revenue sharing payments earned from a fund

[34] The SAI is the part of the mutual fund registration statement that is not required to be provided to investors except upon request. *See* Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1318 (2006).

[35] *See* 17 C.F.R § 240.10b-10 (addressing transaction confirmation); *In re* Morgan Stanley & Van Kampen Mut. Fund Sec. Litig., 2006 WL 1008138, at *7 (S.D.N.Y. Apr. 18, 2006) ("Form N-1A requires the disclosure of the total fees paid by the investor in connection with a securities purchase, as well as total commissions paid by the fund, but it does not require disclosure of how differential compensation is allocated. Nor does it require disclosure of the sales contests or management bonuses.").

[36] *See* Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000) ("We need not labor long on plaintiffs' contention that the broker-dealer defendants failed to make adequate disclosures about the fees under Rule 10b-10, because we find that we are bound by the SEC's interpretation of its regulation, *i.e.,* that the general disclosures made by the fund prospectuses and SAIs are sufficient to satisfy the broker-dealers' duty under Rule 10b-10 to disclose third party remuneration.").

[37] Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438, 6445 n.55 (proposed Feb. 10, 2004) (quoting *Press,* 218 F.3d at 131-32) [hereinafter *Point-of-Sale Proposal*].

complex by the broker-dealer.[38] It also proposed a new "point-of-sale" rule to address, in part, the disclosure of revenue sharing fees by broker-dealers at or before the client makes the decision to buy shares of the fund.[39]

Notwithstanding the apparent uncertainty of broker-dealers' revenue sharing disclosure obligations and the Second Circuit's position on the preclusive effect of the confirmation rule, the Commission has sued a number of broker-dealers for failing to disclose revenue sharing payments in violation of the rule.[40] Acting in its private attorney general capacity, the Commission has extracted more than $100 million in disgorgement, payable to victims of the nondisclosure of revenue sharing payments.[41] These revenue sharing

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[38] *Id.*; *see also* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, Securities Act Release No. 85,470, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 70 Fed. Reg. 10,521 (proposed Mar. 4, 2005) [hereinafter *Point-of-Sale Proposal Request for Additional Comments*] (stating that the SEC was "reopening the comment period on proposed rules . . . that would require broker-dealers to provide their customers with information regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares, 529 college savings plan interests, and variable insurance products.").

[39] *Point-of-Sale Proposal Request for Additional Comments*, Securities Act Release No. 85,470, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 70 Fed. Reg. at 10,522 (proposing new "point of sale" rule for comment).

[40] *See*, *e.g., In re* Citigroup Global Markets, Inc., Securities Act Release No. 8557, Exchange Act Release No. 51,415, *2005 SEC LEXIS 674* (Mar. 23, 2005), http://www.sec.gov/litigation/admin/33-8557.pdf (alleging that a broker-dealer failed to disclose material facts to customers in the offer and sale of mutual fund shares); *In re* Edward Jones & Co., L.P., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 2004 SEC LEXIS 3013 (Dec. 22, 2004), http://www.sec.gov/litigation/admin/33-8520.htm (alleging that a broker failed to disclose a conflict of interest to customers arising out of certain payments it received through revenue sharing, directed brokerage, and other arrangements in connection with the offer and sale of mutual funds to its customers); *In re* Morgan Stanley DW Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 2003 SEC LEXIS 2732 (Nov. 17, 2003), http://www.sec.gov/litigation/admin/33-8339.htm#foot3 (alleging that a broker-dealer failed to disclose material facts to customers in the offer and sale of mutual fund shares.).

[41] *See*, *e.g.*, *In re* John Hancock Inv. Mgmt. Servs., LLC, Exchange Act Release No. 55,946, Investment Company Act No. 27,872, 2007 SEC LEXIS

cases broach the subject of, if not exemplify the danger of, housing executive, judicial and legislative functions in a single administrative agency.

It is this danger that was the impetus for Justice Frankfurter's famous gloss on the fiduciary duty in *SEC v. Chenery Corp.*: "to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry."[42] In that case, the Court vacated an SEC order permitting a reorganization on the condition that the officers and directors who planned the reorganization not personally profit from it.[43] The Commission had found that allowing the officers and

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1358 (June 25, 2007) http://www.sec.gov/litigation/admin/2007/34-55946.pdf (requiring a broker to repay $16.8 million in disgorgement and prejudgment interest); *In re* Hartford Investment Fin. Servs., LLC, Exchange Act Release No. 54,720, Investment Company Act Release No. 27,549, 2006 SEC LEXIS 2571 (Nov. 8, 2006), http://www.sec.gov/ litigation/admin/2006/33-8750.pdf (requiring a broker to repay $40 million)*; In re* Deutsche Inv. Mgmt. Am., Inc., Exchange Act Release No. 54,529, Investment Company Act Release No. 27,505, 2006 SEC LEXIS 2172 (Sep. 28, 2006), http://www.sec.gov/ litigation/admin/2006/34-54529.pdf (requiring a broker to repay $16.3 million); I*n re* IFMG Sec. Inc., Securities Act Release No. 8720, Exchange Act Release No. 54,139, 2006 SEC LEXIS 1589 (July 13, 2006), http:// www.sec.gov/litigation/admin/ 2006/33-8720.pdf (requiring a broker to repay $2.8 million); In the Matter of Am. Express Fin. Advisors Inc., Securities Act Release No. 8720, Exchange Act Release No. 52,861, 2005 SEC LEXIS 3076 (Dec. 1, 2005), http://www.sec.gov/litigation/admin/33-8637.pdf (requiring a broker party to repay $15 million); Capital Analysts Inc., Securities Act Release No. 8556, Exchange Act Release No. 51,414, 2005 SEC LEXIS 673 (Mar. 23, 2005), http://www.sec.gov/litigation/ admin/33-8556.pdf (requiring a broker to repay $350,000); *Edward Jones*, *supra* note 40 (requiring a broker to repay $37.5 million); *Morgan Stanley*, *supra* note 40 (requiring a broker to repay $25 million).

[42] SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) (*Chenery I*).

[43] At the time, the Commission was authorized to review and modify reorganizations of companies registered under the Public Utility Holding Company Act. *See* 15 U.S.C. § 79(g) & (i) (giving the Commission the power described above). The Act was repealed in 2005. *See* Pub. L. 109-58, 119 Stat. 974 (Aug. 8, 2005) (repealing sections 79 to 79z-6 of the U.S. Code pertaining to the Public Utility Holding Company Act). Pursuant to the reorganization, the directors and officers would have been entitled to exchange their preferred shares for common stock representing 10 percent of the common stock of the surviving entity and having a book value 3.5 times that of the preferred stock. *See Chenery I*, 318 U.S. at 96 (J. Black dissenting).

directors to profit from the reorganization would violate their fiduciary duty to the affected shareholders.[44]

Justice Frankfurter did not disagree with the fiduciary standard of conduct announced and applied by the Commission. Rather, he disagreed with the way in which the Commission had exercised its policymaking authority. Justice Frankfurter found that the "Commission dealt with this as a specific case, and not as the application of a general rule formulating rules of conduct for reorganization managers," instead basing its decision "upon the applicability of principles of equity announced by courts."[45] He concluded that, because there was no judicial precedent supporting the SEC's fiduciary standard and the Commission had not "promulgated a general rule of which its order here was a particular application," its order could not be upheld.[46]

The Court reversed itself when the case returned on appeal four years later.[47] In *Chenery II*, Justice Murphy rejected the view that the Commission needed to have promulgated a rule that had "capture[d]" the particular facts in the case.[48] The Court held that:

> [T]he agency must retain power to deal with the problems on a case-to-case basis if the administrative process is to be effective. There is thus a very definite place for the case-by-case evolution of

[44] *See Fed. Water Serv. Corp., 1941 SEC LEXIS 1787, at *51* (Mar. 24, 1941) ("We hold further that in the process of formulation of a "voluntary" reorganization plan, the management of a corporation occupies a fiduciary position toward all of the security holders to be affected, and that it is subjected to the same standards as other fiduciaries with respect to dealing with the property which is the subject matter of the trust.").

[45] *Chenery I*, 318 U.S. at 86-87, 93 ([T]he Commission "purported merely to be applying an existing judge-made rule of equity.").

[46] *Id.* at 92-93 ("[B]efore transactions otherwise legal can be outlawed or denied their usual business consequences, they must fall under the ban of some standards of conduct prescribed by an agency of government authorized to prescribe such standards—either the courts or Congress or an agency to which Congress has delegated its authority.").

[47] *See SEC v. Chenery Corp.*, 332 U.S. 194 (1947) (*Chenery II*).

[48] *Id.* at 202-203 ("[T]he agency may not have had sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule. Or the problem may be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule.").

> statutory standards. And the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency.[49]

Justice Murphy's position that the potentially "retroactive effect [of case by case administrative rulemaking] was not necessarily fatal to its validity" generally still holds today.[50]

The revenue sharing cases squarely present the issue that Justices Frankfurter and Murphy were debating. That issue, in Justice Frankfurter's words, is "the rule of law in its application to the administrative process and the function of this Court in reviewing administrative action."[51] In these cases, the Commission exercised prosecutorial discretion, made common law, adjudicated guilt, imposed punitive sanctions and recovered ill-gotten gains on behalf of private citizens—all in an effectively unreviewable capacity[52]—in apparent contradiction to the rules contemporaneously proposed by its own legislative offices.[53] The SEC's executive, judicial and legislative roles create at least the appearance of a "forbidden conjoining of powers"[54] in a fourth branch of government that has a broader range of functions (albeit covering a narrow range of

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[49] *Id.* at 203; *see also* Am. Power & Light Co. v. SEC, 329 U.S. 90, 106 (1946) (regarding Congressional delegation of authority to the Commission: "Nor is there any constitutional requirement that the legislative standards be translated by the Commission into formal and detailed rules of thumb prior to their application to a particular case. If that agency wishes to proceed by the more flexible case-by-case method, the Constitution offers no obstacle.").

[50] *Chenery II*, 332 U.S. at 203.

[51] *Id.* at 209.

[52] This assumes not that *all* settlements are "effectively unreviewable" and have the force of law, but rather settlements with entities under these circumstances. This distinction warrants further explanation, but this is, unfortunately, beyond the scope of this essay.

[53] *See generally* Langevoort, *supra* note 10, at 446 (noting differences in state and federal regulators' and courts' views of revenue sharing). *Cf.* Geman v. SEC, 334 F.3d 1183 (10th Cir. 2003) (imposing a fiduciary duty based on the Advisers Act on conduct not subject to the Act on the basis of common law agency principles apparently derived from the federal law).

[54] Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 579 (1984).

conduct) than any other branch.[55] Indeed, the most urgent issue for the SEC's fiduciary study may be one of the proper exercise of government power. What mix of administrative roles should the Commission assume with respect to the fiduciary duty as opposed to other types of legal duties that it is tasked with administering?

V. Conclusion

It is unfortunate that the fiduciary debate is often framed as being about substantive standards of conduct, and even more unfortunate that Section 913 of the Dodd-Frank Act's description of the study seems to reflect this perspective. Justice Frankfurter's "only begins the analysis" gloss on the fiduciary duty may reveal far more about the best direction for the fiduciary inquiry than Judge Cardozo's conduct-oriented "punctilio of an honor most sensitive." The fiduciary duty is indeed "most sensitive"—too sensitive, in fact—to be captured by specific conduct rules. The law punishes those who ignore such elemental imperatives.

The Commission should use the fiduciary study as a vehicle for considering the interaction of the fiduciary duty with different models of regulation. The revenue sharing disclosure issue discussed *supra* suggests that where the law lacks coherence is its current resolution—in the context of regulating broker-dealers' advisory activities—of issues relating to, *inter alia*, principles-based regulation, federalism, dispute resolution mechanisms, allocation of oversight authority and, particularly, separation of powers. There are many other analytical models that should be brought to bear on the fiduciary issue. This brief discussion touches on only a few.[56]

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[55] *See* FTC v. Rubberoid Co., 343 U.S. 470, 487 (1952) (J. Jackson dissenting) ("[Administrative agencies] have become a veritable fourth branch of the Government, which has deranged our three-branch legal theories much as the concept of a fourth dimension unsettles our three-dimensional thinking."); *see generally* Strauss, *supra* note 54 (discussing the contested role of agencies as outside the three branches of government explicitly stated in the Constitution).

[56] Examples include the contractual and inalienable models of fiduciary duties. S*ee generally* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99 (2008). Examples also include consideration of legal duties as a reflection of investors' behavior as rational or irrational actors. *See generally* Lauren Willis, *Against Financial Literacy*, 94 IOWA L. REV. 197 (2008).

Just as the fiduciary duty may be innately inhospitable to codification, it may be too factually calibrated to be left to administrative authority as presently exercised. The context for Justice Frankfurter's *Chenery I* critique was not, after all, a questioning of the standard of conduct applied by the Commission, but rather of the ad hoc foundation for the fiduciary duty on which the Commission relied. His opinion was a prescient recognition of the particular threats posed by the evolving administrative state, informed undoubtedly by his personal connection with the creation of the federal securities laws and the Commission itself.[57]

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[57] *See* Joel Seligman, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 57-72 (Houghton Mifflin Co. 1982) (discussing Justice Frankfurter's dominant role and impact on the Supreme Court.).