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## Restoring Confidence in the Financial Services Industry: Advocating for a Uniform, Rules-Based Fiduciary Standard

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# Restoring Confidence in the Financial Services Industry: Advocating for a Uniform, Rules-Based Fiduciary Standard

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## I. THE RELATIONSHIP BETWEEN CONTEMPORARY AMERICANS AND THE FINANCIAL SERVICES INDUSTRY

With over 11,000 investment advisers and 5,100 broker-dealers managing \$38 trillion in retail and institutional accounts,<sup>1</sup> millions of Americans rely on financial services providers to navigate their investments.<sup>2</sup> While their reliance is based on each provider’s knowledge and expertise, many Americans look to their individual service provider as

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1. U.S. SEC. & EXCH. COMM’N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (Jan. 2011) [hereinafter STUDY ON INVESTMENT ADVISERS AND BROKER DEALERS], *available at* <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

2. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 701 (2010). Financial services providers “offer advice regarding retirement accounts, college savings plans, and other means through which individuals and families save for their future.” *Id.* Nearly seventy-five percent of Americans engaged with these providers receive advisory, management, or planning services. ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 90 (2008) [hereinafter INVESTOR AND INDUSTRY PERSPECTIVES], *available at* [http://www.sec.gov/news/press/2008/2008-1\\_randiabreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabreport.pdf). This same portion of Americans use providers “for conducting stock market or mutual fund transactions.” *Id.*

more than a tactical expert—their provider is a source of trust and confidence.<sup>3</sup> In the wake of recent corporate scandal and investor fraud,<sup>4</sup> the delicate relationship between financial services providers and their clients “ha[s] led the public to view the financial service industry with more skepticism. It is an industry based on trust, and many [individuals] . . . d[o] not trust the industry.”<sup>5</sup>

While both financial investment advisers and broker-dealers are considered financial services providers, there are tangible differences between the two.<sup>6</sup> The 1934 Securities Exchange Act (“1934 Act”) defines broker-dealers as individuals who execute securities transactions.<sup>7</sup> Their

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3. According to a focus group conducted by the Securities and Exchange Commission (“SEC”), “[t]rust of the individual financial service professional was the most cited feature of what investors would be looking for in a financial service provider. Trust of the individual professional was cited as more important than trust of the firm for which that individual works.” INVESTOR AND INDUSTRY PERSPECTIVES, *supra* note 2, at 107. In fact, “[p]articipants felt that the personal relationship is very important.” *Id.*

4. Two recent scandals include the collapse of corporate giants WorldCom and Enron, both of whose underhanded accounting and trading practices led to financial ruin. See Zubin Jelveh & Karl Russell, *The Rise and Fall of Enron*, N.Y. TIMES, 2006, [www.nytimes.com/ref/business/20060201\\_ENRON\\_GRAPHIC.html](http://www.nytimes.com/ref/business/20060201_ENRON_GRAPHIC.html) (last visited Mar. 5, 2014); Simon Romero & Riva D. Atlas, *WorldCom’s Collapse: The Overview; WorldCom for Bankruptcy; Largest U.S. Case*, N.Y. TIMES (Jul. 22, 2002), <http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html>. The SEC filed a civil complaint against telecommunications giant WorldCom for manipulating earnings to “keep profits in line with Wall Street expectations,” inaccurately reporting \$3.8 billion in illusory earnings. *SEC Files Civil Fraud Complaint Against WorldCom: SEC v. WorldCom Inc.*, 8 No. 14 ANDREWS SEC. LITIG. & REG. REP. 9, 9 (2002).

Similarly, Enron Corporation, a United States energy-trading and utilities company, engaged in complex trading with buyers and sellers in “a hybrid of traditional [securities] exchanges.” Lucky Shackelford et al., *Special Report: Enron Probe, Rising Power*, WASH. POST, 2002, <http://www.washingtonpost.com/wp-srv/business/enron/>. The company was ultimately exposed for overstating \$586 million in earnings, leaving Enron liable for up to \$3 billion in outstanding obligations. *Id.* Thousands of Enron employees and retirees lost their life savings while investors watched the corporation’s stock lose billions of dollars in value. *Id.*

5. INVESTOR AND INDUSTRY PERSPECTIVE, *supra* note 2, at 107; see also Andrew R. Simank, *Deliberately Defrauding Investors: The Scope of Liability*, 42 ST. MARY’S L. J. 253, 254 (2010) (“The Enron scandal, along with similar corporate collapses that have followed in its wake, exposed the distrust and corruption prevalent in the United States’ securities market. Since the Enron debacle, shareholders and investors have increasingly filed suit in state and federal courts to recoup financial losses resulting from fraudulent representations made by failing corporations.”).

6. Despite their differences, approximately eighteen percent of registered broker-dealers are also registered as investment advisers. STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 1, at iii.

7. Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2012); see also

duties include performing research, providing advice, and maintaining customer funds.<sup>8</sup> Broker-dealers' firms are regulated under the 1934 Act and are subject to the rules and penalties mandated by the Financial Industry Regulation Authority ("FINRA"),<sup>9</sup> a self-regulatory organization that enforces rules, disciplines malfeasance, detects and prevents wrongdoing, and educates and informs investors.<sup>10</sup> In contrast, investment advisers are governed by the Investment Advisers Act of 1940 ("1940 Act").<sup>11</sup> The 1940 Act defines an investment adviser as "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."<sup>12</sup> It is the difference between offering continuous financial advice and providing commission-based transactional services that distinguishes broker-dealers from investment advisers.<sup>13</sup>

A more striking difference between broker-dealers and investment advisers is the extent of their fiduciary duties to their clients. Broker-dealers are not held to a formal fiduciary duty.<sup>14</sup> Rather, they are subject to a suitability standard,<sup>15</sup> which prohibits engaging in manipulative, deceptive,

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Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005) (quoting 70 Fed. Reg. 20,424 at 20,431 (Apr. 19, 2005)).

8. Black, *supra* note 7, at 36.

9. Laby, *supra* note 2, at 702.

10. *About FINRA: What We Do*, FINANCIAL INDUSTRY REGULATORY AUTHORITY, <http://www.finra.org/AboutFINRA/WhatWeDo/> (last visited Mar. 4, 2014).

11. *See* Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11) (2012).

12. *Id.*; *see also* Peter Isakoff, *Agents of Change: The Fiduciary Duties of Forwarding Market Professionals*, 61 DUKE L.J. 1563, 1568–69 (2012) (highlighting the differences between broker-dealers and investment advisers).

13. Isakoff, *supra* note 12, at 1569.

14. Black, *supra* note 7, at 36 ("A broker-dealer's relationship with his customers is not, however, generally considered a fiduciary one, unless the broker exercises investment discretion over the customer's account . . . they are [also] not bound by the fiduciary prohibition on self-dealing transactions without the principal's informed consent.").

15. Financial Industry Regulatory Authority ("FINRA") Rule 2111 establishes the suitability standard and requires broker-dealers to make reasonable efforts to discover the client's "age, other investments, financial situation and needs, tax status, investment objectives investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose . . . in connection with such [suitability] recommendation." FINRA Manual, FINRA Rule 2111 (eff. Feb. 4, 2013), *available at* [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=9859](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9859); *see also* STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 1, at iv (identifying that the suitability standard "generally requires a broker-dealer to make recommendations that are consistent

or fraudulent transactional behavior.<sup>16</sup>

In contrast, investment advisers *do* have fiduciary obligations to their clients under section 201 of the 1940 Act.<sup>17</sup> While broker-dealers are, in fact, governed by this Act, section 201 explicitly exempts them from fiduciary obligations so long as they exercise appropriate discretion and do not receive “special compensation.”<sup>18</sup> Congress’s rationale for this exclusion lies in a desire to prevent broker-dealers from being doubly regulated under both the 1934 Act and the 1940 Act.<sup>19</sup> However, subsequent technological advances eroded the relevance of this policy by decreasing broker-dealers’ transactional roles and increasing their advice and strategy functions—functions that were traditionally reserved for investment advisers.<sup>20</sup>

As the distinctions between investment advisers and broker-dealers continue to blur, “retail customers today see little difference between a broker and an adviser.”<sup>21</sup> Their confusion is warranted in that approximately forty percent of all broker-dealers are in control of, or associated with, an

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with the interests of its customer”).

16. Securities Exchange Act of 1934, § 15(c)(1)-(2); *see also* Isakoff, *supra* note 12, at 1571. A broker-dealer’s obligations, detailed in Rule 10b-10, are limited to disclosure of the date and time of the transaction, his roles as agent or principal, information pertaining to odd-lot differentials, and statements of debt security, among others. SEC, 17 C.F.R. § 240.10b-10 (2005).

17. Black, *supra* note 7, at 38 (“It is well established that the relationship between an investment adviser and his customer is a fiduciary one . . . [B]ecause he is a fiduciary, an investment adviser cannot, either as a principal or broker, knowingly engage in a securities transaction with a client unless he discloses in writing to the client the capacity in which he is acting and obtains the client’s consent to the transaction, prior to completion of the transaction.”); *see also* Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (finding that there is a “delicate fiduciary nature [in] an investment advisory relationship”).

18. A broker-dealer providing investment advice to a consumer is not subject to the 1940 Act if the advice is “solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore.” Investment Advisers Act of 1940 § 201, 15 U.S.C. § 80b-2(a)(11) (2012). Furthermore, an investment advisor “does not include . . . any broker 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,” Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C).

19. Isakoff, *supra* note 12, at 1569–70.

20. *Id.* at 1570; *see also supra* notes 6–13 and accompanying text.

21. Laby, *supra* note 2, at 702; *see also* Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 *FORDHAM J. CORP. & FIN. L.* 203, 215 (2011) (“[T]he contemporary distinction between broker-dealers and investment advisers is complex and increasingly blurred . . . [given that] they ‘provide practically indistinguishable services to retail investors and direct them to the same [financial] products.’”) (internal citation omitted).

investment firm that performs advisory services.<sup>22</sup> The blurred roles of broker-dealers and investment advisers have also bred a high degree of mistrust among American investors given recent scandals surrounding Bernard Madoff's billion-dollar Ponzi scheme and the Securities and Exchange Commission's Goldman Sachs investigation.<sup>23</sup> It is therefore necessary to re-visit broker-dealers' fiduciary obligations and establish a uniform standard throughout the financial services industry.<sup>24</sup>

## II. AN IMPETUS FOR CHANGE

As mastermind of the world's largest Ponzi scheme, Bernard Madoff lost \$50 billion of individual, corporate, and nonprofit investments through fraudulent and manipulative tactics.<sup>25</sup> The investment giant applied a mysterious black box model of buying and selling and used his hedge fund to orchestrate "a facade of profitability" that convinced thousands of Americans to entrust their life savings to his hedge fund, Ascot Partners.<sup>26</sup> Broker-dealers perpetuated the façade by directing client funds to Ascot Partners despite having knowledge of its fraudulent characteristics.<sup>27</sup>

Among the implicated broker-dealers was Fairfield Greenwich Group, which "allegedly received coaching from Madoff to avoid Securities and Exchange Commission (SEC) inquiries and had possessed at least constructive knowledge—if not actual knowledge—of Madoff's illegal

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22. Varnavides, *supra* note 21, at 216 ("[I]t is unsurprising that 'the typical retail investor finds it difficult to understand the nature of the business' that is providing them with investment advisory or brokerage services.") (internal citation omitted).

23. *See infra* notes 25–38 and accompanying text; *see generally* Simank, *supra* note 5, at 253 (discussing the impact of fraud, Ponzi schemes, federal investigations, and corporate scandal on Americans' opinions of the financial services industry);

24. Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 712 (2010) [hereinafter Hazen, *Existing Stock Broker Standards*] (emphasizing that "the extent to which broker-dealers are or should be subject to fiduciary duties is another issue that has been at the forefront due to recent financial events").

25. Robert Lenzner, *Bernie Madoff's \$50 Billion Ponzi Scheme*, FORBES (Dec. 12, 2008, 6:45 PM), [http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in\\_rl\\_1212croesus\\_inl.html](http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in_rl_1212croesus_inl.html); *see also* Diana Henriques, *Madoff Fraud Rippled Around the World*, N.Y. TIMES (Nov. 21, 2008), [http://www.nytimes.com/2008/12/21/business/worldbusiness/21iht-madoff.4.18852346.html?page\\_wanted=all&r=0](http://www.nytimes.com/2008/12/21/business/worldbusiness/21iht-madoff.4.18852346.html?page_wanted=all&r=0) (describing the magnitude of the Madoff fraud, which scammed international investors throughout Europe and East Asia as well as domestic institutions like the North Shore-Long Island Jewish Health System, Yeshiva University, and New York Law School).

26. Isakoff, *supra* note 12, at 1564; Lenzner, *supra* note 25.

27. Isakoff, *supra* note 12, at 1565.

Ponzi scheme.”<sup>28</sup> Moreover, even though Fairfield became Madoff’s primary feeder,<sup>29</sup> its brokers failed to notify their clients of Fairfield’s decision to invest in Madoff’s hedge fund.<sup>30</sup> Such conduct illustrates the need to reevaluate broker-dealers’ fiduciary obligations, since none of Fairfield’s actions were outwardly prohibited by the 1934 Act’s due diligence standard.<sup>31</sup> Thus, Fairfield escaped without penalty and settled all claims without having to admit to wrongdoing or to breaching a duty of care to its clients.<sup>32</sup>

Similarly, the SEC investigated the multinational investment banking firm Goldman Sachs for fabricating derivative instruments<sup>33</sup> and trading ahead of, and adversely to, its own clients.<sup>34</sup> In its claim, the SEC alleged that:

Goldman and Tourre, in the offer or sale of securities or securities-based swap agreements, by the use of means or instruments of interstate commerce or by the mails, directly or indirectly (a) employed devices, schemes or artifices to defraud; (b) obtained money or property by means of untrue statements . . . made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon purchasers of securities.<sup>35</sup>

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28. *Id.*

29. Henriques, *supra* note 25.

30. Isakoff, *supra* note 12, at 1565.

31. *See* Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2006)); *see also* Isakoff, *supra* note 12, at 1565.

32. Isakoff, *supra* note 12, at 1565; *see also* In re Fairfield Greenwich Advisors LLC, No. 2009-0028, 2009 WL 3157459, at \*1 (Mass. Sec. Div. Sept. 8, 2009).

33. Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 712–13. A derivative instrument is “a financial instrument whose value depends on some underlying financial asset, commodity index or predefined variable.” *Glossary of Statistical Terms: Derivative Instrument*, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (Mar. 3, 2003), <http://stats.oecd.org/glossary/detail.asp?ID=601>.

34. Andrew Ross Sorkin, *Goldman Acknowledges Conflicts with Clients*, N.Y. TIMES (Jan. 12, 2010, 11:30 AM), <http://dealbook.nytimes.com/2010/01/12/goldman-executive-discloses-conflicts-policy/> (“In one such situation . . . Goldman created and sold bundles of mortgages known as collateralized debt obligations while at the same time selling them short.”).

35. Complaint ¶ 69, SEC v. Goldman Sachs & Co., 790 F.Supp.2d 147 (S.D.N.Y. 2010) (No. 1:10-CV-03229), 2010 WL 1508202.

Despite evidence of fraud and deceit, the court failed to clarify Goldman's obligations to its clients.<sup>36</sup> Thus, the litigation and final settlement of the case left scholars questioning how to prevent such a massive ethical violation—should the industry impose legal formalities by means of formal rules similar to other federal securities laws, or should the industry turn to the gap-filling standard of fiduciary duties?<sup>37</sup> At the core of the Goldman Sachs dispute was a changing standard for trust-based relationships in the financial industry—a standard that must be addressed before another scandal deprives Americans of their financial security.<sup>38</sup>

Imposing fiduciary obligations on broker-dealers in the same way these obligations apply to investment advisers would begin to restore investors' trust in the financial services industry. At common law, relationships were fiduciary when one party's knowledge far outweighed that of a beneficiary whose reliance on said expertise necessitated an ethical safeguard.<sup>39</sup> Thus, a fiduciary was obligated to uphold and respect the beneficiary's trust in his extensive knowledge and skill.<sup>40</sup> However, "[t]he fiduciary's duties go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests. The fiduciary must avoid acts that put his interests in conflict with the beneficiary's. . . . [T]he fiduciary must be candid and must evince utmost good faith."<sup>41</sup>

These traits—honesty, trust, and good faith—speak to the nature of a

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36. Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 713 (citing Litigation Release No. 21592: *Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre*, Civil Action No. 10 Civ. 3229 (July 15, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21592.htm>); see Patricia Hurtado & Christine Harper, *SEC Settlement with Goldman Sachs for \$550 Million Approved by U.S. Judge*, BLOOMBERG, (July 21, 2010), <http://www.bloomberg.com/news/2010-07-20/goldman-sachs-settlement-with-sec-for-550-million-approved-by-u-s-judge.html>.

37. Steven M. Davidoff et al., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 541 (2012). The SEC's complaint "appeared to be applying the rule to enforce a trust-like relationship among Goldman Sachs and its counterparties analogous to a fiduciary duty-type relationship." *Id.* at 532. For a more extensive discussion of rules and principles, see *infra* notes 61–66 and accompanying text.

38. Davidoff, *supra* note 37, at 541.

39. Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 723–24.

40. *Id.*

41. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882 (1988); see also RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) ("A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.").

broker-dealer's relationship with his clients.<sup>42</sup> Not only does a broker-dealer recommend well-researched and suitable stock, he has a duty to expedite orders, disclose trading risks, avoid conflicts of interest, refrain from material misrepresentations, and receive customer authorization.<sup>43</sup> The parallels between these obligations and the obligations traditionally assigned to fiduciaries suggest that heightened duties should extend not only to investment advisers, but to broker-dealers as well. After all, the Goldman Sachs investigation was grounded in the very fraud, deceit, and distrust that the common law fiduciary duty sought to avoid.<sup>44</sup> When evaluated alongside Madoff's Ponzi scheme and the scandals at WorldCom and Enron,<sup>45</sup> the industry's recent history illustrates the need for a standard that restores trust, loyalty, and confidence in the financial market.<sup>46</sup> As former SEC Chairman Mary Schapiro emphasized, "Too many financial institutions, securities firms, mortgage originators and credit rating agencies . . . simply ignored the risks they were tasked with identifying. . . . So now we're all trying to find our way back—back to a place where investors have faith . . . ."<sup>47</sup>

### III. THE DODD-FRANK ACT

In response to the aforementioned investment scandals and the financial crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").<sup>48</sup> The Dodd-Frank Act is "the most comprehensive financial regulatory reform measure[] taken since the Great Depression,"<sup>49</sup> mandating changes in the supervision,

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42. Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 748.

43. *Id.*

44. *See supra* notes 33–38 and accompanying text.

45. For more detail on the WorldCom and Enron scandals, *see supra* note 4.

46. *See supra* notes 33–38 and accompanying text.

47. Mary Schapiro, Chairman, United States Securities and Exchange Commission, Speech: The Road to Investor Confidence (Oct. 27, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch102709mls.htm>.

48. Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 714–15; *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code); Thomas Lee Hazen, *Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*, 15 N.C. BANKING INST. 47, 47 (2011) [hereinafter Hazen, *Stock Broker Fiduciary Duties*] (noting that the Dodd-Frank Act was "cobbled together" as a compromise bill).

49. MORRISON & FOERSTER, THE DODD-FRANK ACT: A CHEAT SHEET 2–25 (2010), *available at* <http://www.mofo.com/files/uploads/images/summarydoddfrankact.pdf>.

responsibility, regulation, and governance of financial institutions, credit ratings agencies, and compensation practices.<sup>50</sup> Specific to investor protection, section 913 of the Dodd-Frank Act gives the SEC rulemaking authority to impose a fiduciary duty on broker-dealers.<sup>51</sup> Thus, while the Act itself does not impose a fiduciary duty on broker-dealers, it *does* permit the SEC to do so.<sup>52</sup> The Dodd-Frank Act has thereby ignited a national discussion about the merits of pursuing such a mandate.<sup>53</sup> It is a discussion made more complex given the Act's additional provision that:

[I]nvestment advisers providing personalized investment advice to retail customers may be required to act in the best interest of the customer without regard to the financial or other interest of the adviser providing the advice. The SEC rulemaking authority also . . . require[s] material conflicts of interest to be disclosed and consented to by the customer. . . . [T]he SEC's rulemaking authority over broker-dealers [also] now includes the ability to adopt rules to require that broker-dealers who sell proprietary or a limited range of products provide notice to the customer and obtain the customer's consent or acknowledgment.<sup>54</sup>

Notably, the majority of these provisions are already mandated by the 1940 Act;<sup>55</sup> accordingly, they serve as mere reminders to SEC rule-makers

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50. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code). For a more comprehensive summary of the Act, see THE DODD-FRANK ACT: A CHEAT SHEET, *supra* note 49, at 2–25, which independently overviews the details of the Act's financial stability reform, agencies and agency oversight reform, securitization reform, derivatives regulation, investor protection reform, credit rating agency reform, the Volker Rule provision, compensation and corporate governance, and capital requirements.

51. Dodd-Frank Act, § 913, 124 Stat. 1824–1830, 15 U.S.C. §§ 78o, 80b-11 (2012); *see also* Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 715 (“For instance, the Commission may choose to issue a rule which places on broker-dealers who give investment advice to retail clients the same fiduciary duty as that currently placed on investment advisers under the Investment Advisers Act of 1940.”).

52. *See* Hazen, *Existing Stock Broker Standards*, *supra* note 24, at 717 (“The Act also provides that the SEC may choose to create a rule requiring broker-dealers offering personalized investment advice to retail customers to act in the best interest of the customer, as well as requiring broker-dealers to disclose certain conflicts of interest.”).

53. *Id.*

54. Hazen, *Stock Broker Fiduciary Duties*, *supra* note 48, at 48–49.

55. *See* Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11) (2012); *see*

that the trust and confidence inherent to an investment adviser or broker-dealer's relationship with his client demands a heightened duty of reliability and loyalty.

Section 913 of the Dodd-Frank Act further mandates that the SEC conduct a study of broker-client relationships prior to engaging in rulemaking.<sup>56</sup> Consequently, the Investor Advisory Committee completed a study assessing "the effectiveness of existing legal or regulatory standards of care" among broker-dealers.<sup>57</sup> As prescribed, the study addressed fourteen considerations encompassing the following topics: confusion between investment advisers and broker-dealers, enforcement resources, the potential impact of changing regulatory requirements and/or eliminating the broker-dealer exclusion from the 1940 Act, and the cost of altering regulatory requirements.<sup>58</sup> Six months of analysis led the SEC to make the following recommendation:

The Commission should exercise its rulemaking authority to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

[T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to 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.<sup>59</sup>

This recommendation is consistent with the opinions advanced by The

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*also* 15 U.S.C. § 80b-11(g)(2012).

56. Dodd-Frank Act, § 913, 124 Stat. 1824-30.

57. *Id.* §§ 913(b)(1); *see also*, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 1, at i; ("Retail investors generally are not aware of these differences [between broker-dealers and investment advisers] or their legal implications. . . . [I]nvestor confusion has been a source of concern for regulators . . .").

58. *See generally* STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, *supra* note 1.

59. *Id.* at vi.

Committee for the Fiduciary Standard,<sup>60</sup> former SEC Chairman Mary Schapiro,<sup>61</sup> and FINRA Chairman Richard Ketchum,<sup>62</sup> all of whom recognize that the ambiguity of broker-dealer obligations obstructs the trust, loyalty, and confidence necessary to a thriving securities industry.<sup>63</sup>

#### IV. ADVOCATING FOR A UNIFORM, RULES-BASED FIDUCIARY STANDARD

Despite the SEC's recommendation that broker-dealers be held to a uniform fiduciary standard, such a standard has yet to be imposed.<sup>64</sup> This delay is, for the most part, due to an ongoing debate about the need to supplement general principles-based regulations with specific rules-based standards.<sup>65</sup> The debate implicates the troublesome reality that fiduciary duties in the financial services industry uniquely possess both principle- and rule-like attributes.<sup>66</sup> While most broker-dealer regulations "ultimately derive from principles that predate U.S. federal securities acts," disclosure laws—as well as other fiduciary regulations—are often more rules-centric.<sup>67</sup> It is thus logical that stricter fiduciary standards should derive from specific rules-based standards that outline industry expectations for broker-dealers.<sup>68</sup>

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60. See *Why did The Committee for the Fiduciary Standard form and what is its objective?*, THE COMMITTEE FOR THE FIDUCIARY STANDARD (2013), <http://www.thefiduciarystandard.org/about-us/>.

61. See Schapiro, *supra* note 47.

62. See Kathleen M. McBride, *FINRA's Ketchum Speaks of Fiduciary Duty*, THINK ADVISOR (Oct. 29, 2009), <http://www.thinkadvisor.com/2009/10/29/finras-ketchum-speaks-of-fiduciary-duty>.

63. Scholars suggest that the ambiguity inherent to broker-dealer obligations is not only a product of the different standards imposed on broker-dealers and investment advisers, but is also attributable to a paucity of litigated cases, high settlement rates, contractual variation, and differences in state law. Laby, *supra* note 2, at 705–15.

64. See Hazen, *Stock Broker Fiduciary Duties*, *supra* note 48, at 56–57.

65. See *id.* In general, "[p]rovisions characterized by generality, abstractness, or universality are principles, while those that are specific, concrete, and particular are rules." Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1420 (2007).

66. Cunningham, *supra* note 65, at 1414. In securities regulation, the difference between rules and principles is largely temporal: Rules define boundaries for future behavior and principles evaluate behavior that has already occurred. *Id.* at 1420. It is impossible to categorize the entirety of securities regulation as either principles-based or rules-based given the complexity of the financial services industry. *Id.* at 1449–51.

67. This is due to the specificity of timing, filing, and content requirements of current disclosure laws. *Id.* at 1448–49.

68. See *supra* notes 64–66 and accompanying text. Critics suggest that fiduciary regulations should remain grounded in principle-based standards because strict rule-based regulation risks "evasion by being too inflexible to catch newly conceived schemes." Cunningham, *supra* note 65, at

Doing so will ameliorate the adverse effects of recent financial crises, namely a diminished standard of investor care, disregard of investment advice as a professional service, and negative perceptions of financial intermediaries.<sup>69</sup>

The Committee for a Fiduciary Standard recommends that the following five principles govern the uniform fiduciary standard:

- [1] Put the client's best interests first
- [2] Act with prudence; that is, with the skill, care, diligence and good judgment of a professional
- [3] Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts
- [4] Avoid conflicts of interest; and
- [5] Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.<sup>70</sup>

Together, these principles reflect the exact policy that informed the 1940 Act's mandate for investment advisers' fiduciary duties: that the potential for detrimental self-dealing warranted a heightened standard of duty and obligation.<sup>71</sup>

The risk of detrimental self-dealing has increased given that the distinctions between advice-based investment advisers and transaction-based broker-dealers continue to blur.<sup>72</sup> Because investors now rely on both investment advisers and broker-dealers for advice and recommendations, the SEC needs to adopt a uniform standard to protect them. Moreover, investors' reliance is reinforced by the fact that broker-dealers hold themselves out as having a degree of expertise implicative of loyalty,

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1424. However, the current scheme of principles-based regulation has been vulnerable to schemes like those perpetrated by Enron, WorldCom, and Bernard Madoff, none of whom were deterred or reprimanded under existing regulatory principles. *See supra* notes 4, 25–47 and accompanying text.

69. *See* Blaine F. Aikin, *How a 'universal' fiduciary standard would change how financial advisers do business*, INVESTMENT NEWS (May 10, 2009, 12:01 AM), <http://www.investmentnews.com/article /20090510 /REG/305109993#>.

70. THE COMMITTEE FOR THE FIDUCIARY STANDARD, *supra* note 60.

71. The 1940 Act imposed a fiduciary obligation on investment advisers because their "basic function . . . is grounded in 'furnishing to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments.'" Black, *supra* note 7, at 38 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187 (1963)).

72. *See supra* notes 21–24 and accompanying text.

competence, and equitable conduct.<sup>73</sup> Therefore, investor interests should govern securities regulation because it is they who fully rely on broker-dealers' knowledge and expertise.<sup>74</sup> The present suitability standard to which broker-dealers are held is thereby insufficient because it improperly prioritizes broker-dealer interests over investor interests.<sup>75</sup>

As of November 22, 2013, the Investor Advisory Committee unanimously voted to send a uniform fiduciary standard proposal to the SEC.<sup>76</sup> The decision to impose a uniform standard has been endorsed by SEC Commissioner Elisse Walter, who called the standard a "gold standard" because it "would require the same level of service from both brokers and investment advisors."<sup>77</sup> Despite Walter's endorsement, industry groups and other stakeholders are wary of a new standard for fear of weakening investment advisers' existing fiduciary obligations.<sup>78</sup> Yet given that the new proposal is designed to protect investors by mandating a "stricter ethical

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73. This concept of holding oneself out as an expert in the field is derived from the Shingle Theory, which the SEC first applied in addressing excessive broker-dealer markups. See *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437–38 (2d Cir. 1943) (determining that the broker-dealer had offered to act on the consumer's behalf and should therefore be held to a higher standard of obligation); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cole*, 457 A.2d 656, 664 (Conn. 1983) ("The 'shingle' theory . . . has become a well established doctrine in the securities field."). Because the Shingle Theory mandates a reasonableness standard, and not the standard of a fiduciary, this theory provides a conceptual foundation from which to derive a uniform fiduciary duty. Laby, *supra* note 2, at 722.

74. See THE COMMITTEE FOR THE FIDUCIARY STANDARD, *supra* note 60.

75. Furthermore, "[i]f an investor is wronged by a broker, the burden is on the investor to prove the broker's wrongdoing; if the investor is wronged by a fiduciary advisor, the burden is on the advisor to prove they acted in the client's best interest." *Id.* (emphasis in original).

76. Matthias Rieker, *Uniform Fiduciary Standard Proposal Sent to SEC*, WALL ST. J. (Nov. 22, 2013, 12:44 AM), <http://online.wsj.com/news/articles/SB10001424052702304337404579214043533487308>.

77. Lorie Konish, *SEC's Walter Calls for Uniform Fiduciary Standard for Investment Industry*, ON WALL STREET (May 20, 2013), <http://www.onwallstreet.com/news/SEC-Commissioner-Elisse-Walter-Uniform-Fiduciary-Standard-2684956-1.html>. This proposed standard expands disclosure requirements, requiring broker-dealers to disclose their method of compensation, limitations to their services, professional background, and disciplinary record. Rieker, *supra* note 76. Broker-dealers may also be required to provide clients with access to BrokerCheck and other credential, disciplinary, and employment information made public on FINRA's website. *Id.*

78. Maris Lokshin, *Groups, Stakeholders Offer Mixed Views on Potential Uniform Standard for B-Ds, IAs*, BLOOMBERG LAW (2014), <http://about.bloomberglaw.com/law-reports/groups-stakeholders-offer-mixed-views-on-potential-uniform-standard-for-b-ds-ias/> (last visited Mar. 5, 2014). More specifically, a June 27, 2013 letter written to the SEC by the Massachusetts Secretary of the Commonwealth articulated concerns about watering down the current fiduciary standard under the 1940 Act. *Id.*

standard” for broker-dealers,<sup>79</sup> the likelihood of *decreasing* advisers’ current fiduciary duties is minimal at best. As SEC Chair Mary Jo White remarked, “Any time you have the same conduct regulated differently . . . you need to take a very close look at that and see what to do about it.”<sup>80</sup> The proposal seeks to do just this—remedy the inconsistencies in contemporary securities regulation.<sup>81</sup>

At its core, the Investor Advisory Committee’s proposal focuses on “convey[ing] information to the investors so it doesn’t drown them in information.”<sup>82</sup> It focuses on the best interests of the client.<sup>83</sup> Since Americans’ general impression of the financial services industry is characterized by the fear of losing money, a lack of knowledge, and general mistrust of industry professionals,<sup>84</sup> the Committee’s emphasis on clarity aims to ease the public’s qualms about the industry as a whole.

Given that the 1940 Act defines investment advisers as individuals who, “for compensation, engage[] in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities,”<sup>85</sup> and that, today, “advice is an essential ingredient of a broker’s financial services,”<sup>86</sup> broker-dealers should be held to a fiduciary standard that is identical to that of their investment adviser counterparts. After all, the purpose in adopting a fiduciary standard for any type of professional lies in his duty to act in the beneficiary’s best interest.<sup>87</sup> Thus, broker-dealers should not be exempt from these heightened ethical obligations by virtue of their more frequent involvement in transactional

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79. Rieker, *supra* note 76.

80. Kelley Howes, *Uniform Fiduciary Standard Still a Priority, But No Timeline Yet*, THE BD/IA REGULATOR (Nov. 15, 2013), <http://www.bdiaregulator.com/2013/11/uniform-fiduciary-standard-still-a-priority-but-no-timeline-yet/>.

81. See Rieker, *supra* note 76..

82. *Id.*

83. In response to criticism about the financial and regulatory impact of a uniform standard on industry professions, FINRA Chairman and CEO Richard Ketchum emphasized that “broker-dealers should worry less about the legal standard and focus more on acting in the best interest of clients.” Howes, *supra* note 80.

84. INVESTOR AND INDUSTRY PERSPECTIVES, *supra* note 2, at 103.

85. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (2012). As previously established, investment advisers may be liable to their clients for negligent preparation or negligent interpretation of investment advice. DeMott, *supra* note 41, at 906.

86. Laby, *supra* note 2, at 742.

87. DeMott, *supra* note 41, at 882.

work.<sup>88</sup>

Furthermore, the fact that brokers now also perform advisory functions<sup>89</sup> should be dispositive in requiring of them the identical duties of trust, loyalty, and reliability that are expected elsewhere in the profession. For in the aftermath of events like the Goldman Sachs investigation and Bernard Madoff's Ponzi scheme, what Americans need most is assurance that such mismanagement will never occur with their personal investments.<sup>90</sup> Imposing a uniform fiduciary standard for investment advisers and broker-dealers will support a growing confidence in the financial marketplace, a confidence that is necessary not only for their personal growth, but also for the viability of the American financial industry as a whole.<sup>91</sup>

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88. *See supra* notes 85–87 and accompanying text.

89. *See supra* notes 21–24 and accompanying text.

90. *See supra* notes 25–38 and accompanying text.

91. *See supra* notes 39–47 and accompanying text.

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