



Entrepreneurial Business Law Journal

Volume 5 • Number 1 • 2010

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

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I. INTRODUCTION

*It is no accident that the [1934 Securities Exchange] Act was promulgated in the aftermath of the greatest economic catastrophe in U.S. history. The law and macroeconomics of the Act was patent: Roosevelt sought to place the American capitalistic system upon a firmer legal and regulatory foundation. Most urgently, Roosevelt sought to take positive action to restore investor confidence and spur more investment transactions leading to greater economic growth.*¹

Here we are again. History repeated. This time, President Obama is the man history will find at the center of an economic crisis rivaled only by Roosevelt's Great Depression. President Obama has acted swiftly in the face of this "Great Recession,"² proposing his own financial New Deal in June 2009, styled: Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (Obama Whitepaper).³ President Obama has continued with regulation of the securities industry where President Roosevelt left off with the industry's self-regulation.⁴ Congress then took the baton, with the House and Senate introducing their financial reform bills.⁵

This Article examines and compares the key proposals from the Obama Administration and Congress that affect broker-dealers. It then argues that Congress should specifically study and then legislate these new standards, and not give the SEC broad new authorities to regulate them. The Article concludes that permitting the SEC to regulate these new standards will create years of judicial confusion and policymaking by the courts, which will in turn make business practices and transactions in the securities industry riskier and more uncertain, the costs of which will ultimately be borne by the consumer in the form of higher costs and lack of robust product options as issuers, underwriters, and sponsors market their

¹ Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 559-60 (2002).

² See Justin Lahart, *U.S. Economy Pulls Out of Tailspin*, WALL ST. J., Aug. 1-2, 2009, at A1 (confirming with data that "[t]he current recession is now the worst since World War II").

³ See generally, U.S. TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) [hereinafter Obama Whitepaper].

⁴ *Id.*

⁵ See Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2d Sess. 2010); The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2010); Investor Protection Act of 2009, H.R. 3817, 111th Cong. (1st Sess. 2009).

products in non-U.S. regulated markets.⁶ And because overzealous enforcement of the U.S. securities markets could drive companies to foreign exchanges,⁷ this Article calls for moderation in enacting practical yet effective new standards for securities broker dealers.

This Article follows this historic financial legislation and legislative process in “real time,” with pen first put to paper when the Obama Administration released its Whitepaper, and subsequent drafts following the proposed congressional bills, as well as the concomitant heated political and legal debates and challenges facing this unique and comprehensive financial overhaul. After early drafts of this Article were sent to Congress, various proposals in the Article found their way into draft congressional bills.⁸

A. Executive Summary

President Obama’s Whitepaper outlines the challenges facing modern financial supervision and regulation, and proposes to meet those challenges with reforms geared toward meeting five objectives, one of which is to “protect consumers and investors from financial abuse.”⁹ This objective includes empowering the SEC, through legislation, with new tools

⁶ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 163-64 (2008) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1974)).

⁷ See, e.g., Jonathan Weisman & Damian Paletta, *Climax Looms for Finance Bill*, WALL ST. J., Apr. 23, 2010 at A1, A4 (“New Hampshire Sen. Judd Gregg responded that if Republicans do not unify against the bill, Congress could pass legislation that would chase the derivatives industry overseas and into even darker corners.”); see also John D. McKinnon, *Lawmakers Target Investment Banks*, WALL. ST. J., May 5, 2010, at C1 (noting that Congress raising investment bank duties to customers from suitability to fiduciary in the wake of the Goldman investigation could “foster unintended consequences that harm business and investors alike.”).

⁸ On August 24, 2009, the Author sent an early copy of this Article’s manuscript to Representative Barney Frank, Chairman of the House Committee on Financial Services and Sponsor of HR 4173. It appears that some of the proposals and concerns raised in the manuscript of this Article were adopted or addressed in the most recent bills pending before Congress. The Author is unable to confirm whether this Article contributed to any of the subsequent amendments to the House or Senate bills. Particularly interesting is the Senate bill’s adoption of one of this Article’s primary proposals — that Congress first study and then legislate new conduct standards for broker-dealers and advisers. See S. 3217, §913(b).

⁹ Obama Whitepaper, *supra* note 3, at 3.

and authority to regulate broker-dealers, investment advisers, and the products and services they provide.¹⁰

Attempting to add legislative form to its proposals in the Obama Whitepaper, Treasury released its first piece of proposed legislation entitled the Consumer Financial Protection Agency Act of 2009 (Consumer Protection Act).¹¹ The Consumer Protection Act proposes reforms in regulating the banking, financial, mortgage, and credit card industries by, among other things, greatly expanding the power of the Federal Reserve, and creating a powerful new Consumer Financial Protection Agency to regulate and oversee all financial matters and products affecting retail financial consumers.¹² But the Consumer Protection Act expressly exempts from its authority and jurisdiction brokers and dealers that must register under the Securities Act of 1934, and investment advisers and companies “required to be registered under the Investment Advisers Act of 1940” and “Investment Company Act of 1940.”¹³

On July 10, 2009, one month after issuing the Whitepaper, President Obama’s Treasury Department released a second proposed statute entitled the Investor Protection Act of 2009 (Investor Protection Act), designed to carry out the consumer-protection objective as to broker-dealers and investment advisers.¹⁴

On October 15, 2009, the U.S. House of Representatives introduced House Bill 3817, a bill entitled the Investor Protection Act of 2009, embodying Treasury’s proposed statute, but adding some additional and different provisions.¹⁵ On December 2, 2009, Congressman Barney Frank sponsored House Bill 4173, entitled the Wall Street Reform and Consumer Protection Act of 2009.¹⁶ The Investor Protection Act of 2009 is contained in Title V, Subtitle C of House Bill 4173,¹⁷ and supplements House Bill 3817 with additional important and controversial provisions affecting broker-dealers.

¹⁰ *See id.* at 15.

¹¹ *See generally* U.S. TREASURY, TITLE X—CONSUMER FINANCIAL PROTECTION AGENCY ACT (2009), *available at* <http://www.financialstability.gov/docs/CFPA-Act.pdf> [hereinafter Consumer Protection Act].

¹² *See id.*

¹³ Consumer Protection Act, *supra* note 11, §§ 1002(28), 1022(f)(2)(A).

¹⁴ *See* U.S. TREASURY, TITLE IX – ADDITIONAL IMPROVEMENTS TO FINANCIAL MARKETS REGULATION (2009), *available at* <http://www.treas.gov/press/releases/docs/tg205071009.pdf> [hereinafter Investor Protection Act].

¹⁵ *See* Investor Protection Act of 2009, H.R. 3817, 111th Cong. (1st Sess. 2009).

¹⁶ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2d Sess. 2009) [hereinafter Investor Protection Act of 2009]

¹⁷ *Id.* §§ 7001-7803.

On November 10, 2009, Senator Chris Dodd introduced 1,100 pages of draft legislation styled the Restoring American Financial Stability Act of 2009.¹⁸ On March 15, 2010, after months of partisan debate and rancor, Senator Dodd introduced the formal Senate bill, styled the Restoring American Financial Stability Act of 2010.¹⁹ The Senate bill mandates a study of fiduciary conduct standards for broker-dealers, followed by appropriate legislation or regulation.²⁰ The Senate bill's "study proposal is likely to survive the floor debate and the reconciliation with the House bill."²¹ Indeed, the final bill passed by the Senate on May 20, 2010 includes the study. On June 26, 2010, the House and Senate merged their versions of the bill into the "Dodd-Frank Wall Street Reform and Consumer Protection Act." The combined bill retains the fiduciary duty study. Because future study and legislation of conduct standards for broker-dealers will be based on the draft Obama legislation and most recent House and Senate bills,²² this Article includes a thorough analysis of each.

¹⁸ See Radio broadcast: Dodd Proposes Financial Reform Legislation (National Public Radio Nov. 10, 2009). Senator Dodd's draft legislation was the starting point for the final version of the bill formally introduced in the Senate on March 15, 2010. For an overview of Senator Dodd's draft bill, see James Hamilton & Richard Roth, *Senate Banking Committee Releases Draft Legislation: Restoring American Financial Stability Act of 2009* (CCH) (2009). On November 2, 2009, the House introduced H.R. 3996, similarly styled the Financial Stability Improvement Act of 2009, but much shorter and limited in scope to regulating the systemic risks to the U.S. financial system and the global economy. Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (1st Sess. 2009). H.R. 3996 confirms that the SEC is the "primary financial regulatory authority" for all brokers, dealers, investment companies, and investment advisers, but, interestingly, as those terms are defined under the pre-Obama securities laws. See H.R. 3996, §§1000(b)(6)(E), 1403(2)(F).

¹⁹ Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2d Sess. 2010).

²⁰ See *id.* at §913(b).

²¹ *Hill Watch*, Sec. Reg. & Law Rep. (BNA) No. 14, at 645 (Apr. 5, 2010); see also Report Accompanying S. 3217, Senate Committee on Banking, Housing, and Urban Affairs, at 87 ("The study in Section 913 will provide the opportunity to reexamine this issue and may provide a basis for future regulatory actions."). Indeed, the final bill passed by the Senate on May 20, 2010 excluded various proposed amendments that would have immediately imposed the same fiduciary duties on broker dealers and investment advisers, and rejected attempts by some Senators to impose criminal liability for willful violations of the fiduciary duty. See *Specter, Kaufman Seek Fiduciary Duty for Brokers, Coupled With Threat of Jail Time*, Sec. Reg. & Law Rep. (BNA) No. 19, at 889 (May 10, 2010).

²² See, e.g., Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE's Power*, Sec. Reg. & Law Rep. (BNA) No. 13, at 571-72

There are many aspects to the Obama Whitepaper and proposed bills in Congress. This Article discusses the five arguably most important proposals that are relevant to securities broker-dealers:

1. legislating a mandate to the SEC to enact rules replacing the suitability standard with a uniform, federally defined fiduciary duty governing both broker-dealers and investment advisers;²³
2. legislating authority for the SEC to limit or prohibit mandatory pre-dispute arbitration clauses in broker-dealer customer agreements;²⁴
3. providing monetary awards and attorney fees for whistleblowers reporting securities fraud to the SEC, as well as steep civil penalties and separate attorney fee awards against employers that retaliate against whistleblowers;²⁵
4. providing authority for the SEC to propose an amendment to the federal securities laws to provide a “single explicit standard for primary liability [for securities fraud] to replace various circuits’ formulations of different ‘tests’ for primary liability;”²⁶ and
5. legislating Senior Investment Protection provisions that require the SEC to establish a federal grant program to encourage States to, among other things, adopt suitability rules for sales of securities to seniors, with mandates that states receiving federal grant funds each establish rules regulating the suitability and sale of all annuity products.²⁷

(Mar. 29, 2010) (noting that SEC Commissioner Aguilar still wants uniform fiduciary standard for broker-dealers and advisers, expressing his opinion on the House and Senate bills).

²³ S. 3217, §913; H.R. 4173, § 7103; Obama Whitepaper, *supra* note 3, at 71-72.

²⁴ S. 3217, §921; H.R. 4173, § 7201; Obama Whitepaper, *supra* note 3, at 62-63.

²⁵ S. 3217, §922; H.R. 4173, §§ 7203-04; Obama Whitepaper, *supra* note 3, at 72-73.

²⁶ Obama Whitepaper, *supra* note 3, at 72-73. This will prove interesting because the U.S. Supreme Court rejected one version of the SEC’s primary liability test that had been adopted by the Ninth Circuit. *See Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008). This is a paradigm of why Congress should not provide the SEC with increased broad powers to regulate and penalize broker-dealers as proposed by the Obama Administration. Instead, Congress itself should study and legislate specific new standards.

²⁷ H.R. 4173, §§ 7703-06. Other notable proposals in the House bill (H.R. 4173) of which broker-dealers should be aware include:

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- Amending the Sarbanes Oxley Act of 2002 to subject “brokers” and “dealers” to its accounting and auditing provisions, legislating responsibility for broker dealers to fund the oversight of the Public Company Accounting Oversight Board (the “Board”) under Sarbanes “in proportion to the broker or dealer’s net capital compared to the total net capital of all brokers and dealer[s],” and authorizing the Board to refer investigations of broker dealers under Sarbanes to the SEC or a self regulatory organization. H.R. 4173, §§7601-7610; *see also SEC Reviewing Point-of-Sale Disclosures Beyond Mutual Fund Industry, Schapiro Says*, Sec. Reg. & Law Rep. (BNA) No. 7, at 260-61 (Feb. 15, 2010) (SEC Chairman Shapiro notes that in the Spring 2010 the SEC “will consider staff recommendations to have SROs develop and maintain a consolidated audit trail that captures data across markets.”);
 - Authorizing the SEC to designate “one or more self-regulatory organizations,” or a “national securities organization,” to “augment” the SEC’s efforts to regulate investment advisers, *see* H.R. 4173, §§7107(a)(2)(B), 7208(g); *see also* 155 CONG. REC. H14747, 14748-49 (daily ed. Dec. 11, 2009) (statement of Reps. Cohen & Bachus) (stripping a proposed provision that would permit the SEC to delegate regulation of investment advisers to FINRA, as opposed to the current language allowing FINRA to “augment” the SEC’s oversight. Representative Cohn slammed FINRA as biased towards broker dealers and thus too conflicted to oversee investment advisers. Representative Bachus objected, noting that Bernie Madoff operated both a brokerage and investment adviser office, and that his fraud occurred in the investment adviser side of the business, and was not caught by the SEC, but may have been by FINRA); *see also SEC Staff Mulling Recommendation for Custody Disclosures from Brokers*, Sec. Reg. & Law Rep. (BNA) No. 7, at 263-64 (Feb. 15, 2010) (noting the SEC wants to impose adviser custody rules on brokers because Madoff held advisory clients’ assets in a related brokerage he owned).
 - Mandating a study by the Comptroller General of the United States on the unique role of financial planners, *see* H.R. 4173, §7108;
 - Settling a circuit split on interpretation of the SEC’s statutory aiding and abetting standard by amending the statute to provide that one who “recklessly” provides substantial assistance is liable for aiding and abetting securities fraud, *see* H.R. 4173, §7215;
 - Extending jurisdiction of U.S. district courts to handle securities fraud lawsuits involving conduct or actions occurring outside the United States, *see* H.R. 4173, §7216;
 - Enhanced SEC authority to conduct surveillance, examinations, and risk assessments for broker dealers and investment advisers, *see* H.R. 4173, §7218;
 - Comprehensive study examining the SEC’s organization, operations, and relationship with self-regulatory organizations, *see* H.R. 4173, §7304;

The Article concludes with a request that Congress resist the inclination to reactively swing the regulation and enforcement pendulum too far and unnecessarily over-regulate broker-dealers. This could adversely affect the U.S. financial markets by driving publicly-traded companies to foreign exchanges. The good news is that Congress, with its experience and expertise in studying, analyzing, and making policy, is in a much better position to strike the right balance between increased regulation of broker dealers and ensuring the most suitable securities products are still available on U.S. securities exchanges.

B. Topical Summaries

1. Fiduciary Duty

Imposing a uniform fiduciary duty on broker-dealers and investment advisers is arguably the most important and wide-ranging proposal of the Obama Whitepaper. But it does not endeavor to define the specifics of what the fiduciary duty will look like. The draft Investor Protection Act does by seeking to amend the 1934 Act and the 1940 Investment Advisers Act by providing the SEC with authority, but not requiring it, to “establish a fiduciary duty for brokers, dealers, and investment advisers, and harmoniz[e] . . . the regulation of brokers, dealers, and investments advisers.”²⁸ But the Act does not really legislate a

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- Creation of a Municipal Securities Rulemaking Board that will assist the SEC in governing the registration and regulation of all “Municipal Financial Advisers,” as defined by the Act, *see* H.R. 4173, §7411; and
 - Authorizing the SEC Chairman to appoint an Ombudsman to act as a confidential intermediary between the SEC and any affected person, including broker dealers, *see* H.R. 4173, §7420.

²⁸ Investor Protection Act, *supra* note 14, §913. *See also* Mutual Fund Transparency Act of 2009, S. 1964, 111th Cong. (1st Sess. 2009). This Act, introduced in the Senate, also seeks to impose a uniform fiduciary duty on broker dealers. But the focus of the Mutual Fund Act is on disclosure of the financial relationships between broker dealers and mutual fund companies, and the commissions paid to broker dealers from mutual fund companies in exchange for selling their funds. 155 CONG. REC. S10852, 10856-57 (daily ed. Oct. 28, 2009) (statement of Sen. Akaka). It is unclear whether this Senate bill will die in its Senate committee due to its similarity to H.R. 4173. *Cf. SEC Reviewing Point-of-Sale Disclosures Beyond Mutual Fund Industry, Schapiro Says*, Sec. Reg. & Law Rep. (BNA) No. 7, at 260-61 (Feb. 15, 2010) (SEC Chairman Shapiro notes that if the mutual fund legislation does not pass, “we will work as best we can under our existing authority to try and maximize our ability to do real point-of-sale disclosures.”); *cf. Kimberley Strassel, Carbon Caps Through the Backdoor*, WALL ST. J., Mar. 5, 2010, at A19 (taking issue with securities and insurance regulators imposing regulations that cannot otherwise pass as legislation).

fiduciary standard; rather, it says the SEC “may promulgate rules” that compel broker-dealers “to act solely in the interest of the customer or client without regard to financial or other interest of the” broker-dealer.²⁹ House Bill 4173 imposes a mandate on the SEC to promulgate rules providing for this fiduciary standard,³⁰ and adds some additional requirements and exceptions discussed *infra*. The Senate bill delays enactment of a fiduciary standard for one year to allow the SEC to study the issue, also discussed *infra*.³¹

In the next subsection of Obama’s draft legislation, the SEC is provided a broad but vague mandate to ensure that broker-dealers and investment advisers provide “simple and clear disclosures to investors regarding the terms of their relationship.”³² H.R. 4173 follows suit.³³ This is consistent with the SEC’s historical disclosure-based regulation of broker dealers. But the next subsection can be seen as merits-based regulation of broker-dealer products by providing broader and even vaguer legislative authority for the SEC to “promulgate rules prohibiting...sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”³⁴ What is contrary to the public or investors’ interest the Act does not say. This lack of policy direction and more specific congressional authority is a breeding ground for mischief.

While the Investor Protection Act is short on specifics of what its mandated fiduciary duty will look like, there are plenty of existing ideas and scholarship on what a fiduciary duty may look like for broker dealers because the idea is not new at all, and has been presaged and studied in depth by many commentators and the SEC for some time. A review of these authorities, discussed *infra*, reveals that if ultimately passed by Congress, these sections of the Investor Protection Act have the potential to drastically change the business practices and bottom line of broker-dealers. Imposing a fiduciary duty on broker-dealers will require them to avoid self-dealing and all conflicts of interest with customers, which may curtail the most profitable securities products currently sold by broker-dealers; products which may be the most suitable and appropriate for many

²⁹ Investor Protection Act, *supra* note 14, § 913.

³⁰ See H.R. 4173, §§ 7103(m)(1), 7103(g)(1).

³¹ See Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 913 (2d Sess. 2010).

³² Investor Protection Act, *supra* note 14, §913(a)(l)(1).

³³ H.R. 4173, § 7103(a)(h)(1).

³⁴ Investor Protection Act, § 913(l)(1)-(2); H.R. 4173, § 7103(n)(2).

investors.³⁵ Moreover, broker-dealers that sell “only proprietary or other limited range of products” must disclose this to customers and obtain their “consent or acknowledgement” before making a sale.³⁶

A uniform fiduciary duty may also chill efforts by issuers and sponsors to create new products that conform and adapt to changes in customer needs based on consequences in the global financial market. For example, these new duties carry with them the potential of effectively precluding broker-dealers from offering transaction-based commission accounts along with the now popular fee-based brokerage accounts, or preventing broker-dealers from offering otherwise suitable securities products because they are underwritten by them or for which they are paid a fee by the product’s underwriter or issuer. H.R. 4173 notes that “[t]he receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer.”³⁷ But, significantly, it does *not* say (as it does say for investment advisers) that the receipt of “fees” shall not be considered a violation.³⁸ So are broker dealers offering fee-based brokerage accounts presumed to be violating the new fiduciary duty standard?

In addition, it remains unclear whether the proposed uniform fiduciary duty will obligate all broker-dealers to obtain training, licensing, and expertise in areas traditionally occupied by investment advisers, such as tax, accounting, estate planning, retirement planning, investment planning, pension consulting, and portfolio management and wrap fee programs.³⁹ And if broker dealers don’t obtain this expertise, are they liable for securities fraud? Will broker dealers continue to exist separately from investment advisers?⁴⁰ Will broker dealers or investment advisers be able to sell many of the securities products currently marketed that violate a strict fiduciary standard? These issues and questions may hamper the

³⁵ H.R. 4173’s amendment to the Investment Advisers Act references a waiver provision when it notes in passing that a conflict of interest “may be consented to by the customer.” H.R. 4173, §7103(g)(1).

³⁶ *See id.* § 7103(m)(2).

³⁷ *Id.* § 7103(m)(1).

³⁸ *Cf.* H.R. 4173, *supra* note 16, § 7103(m)(1), 7103(a)(3)(g)(1).

³⁹ A “wrap fee” program is an investment program that bundles together a suite of services, such as brokerage, advisory, research, and management, for a single flat fee. The wrap fee is usually paid quarterly, and typically ranges from one percent to three percent of the value of the assets in the account. Wrap fee programs are a common service offered by investment advisers. *See* RAND INST. FOR CIV. JUST., 49, t.4.9 (2008) [hereinafter RAND Study].

⁴⁰ Indeed, a section entitled “Harmonization of Enforcement” in H.R. 4173 notes that the SEC can use the enforcement authority of the 1940 Investment Advisers Act against broker dealers for violating the fiduciary duty standard, as well as use the 1934 Exchange Act against investment advisers. H.R. 4173, § 7103(b)(1).

ability of U.S.-based retail securities to compete with those in other countries and exchanges. An example of current profitable broker-dealer arrangements that will violate the proposed fiduciary standard are arrangements some broker-dealers have with insurance companies in which insurers pay broker-dealers to exclusively offer their annuity products.

2. Abrogation of Arbitration Agreements

Another major proposal of Obama's Investor Protection Act is to give the SEC power to "prohibit, or impose conditions or limitations on the use of," mandatory pre-dispute arbitration agreements that currently compel customers to arbitrate disputes with their broker-dealer under the rules of the Financial Industry Regulatory Authority (FINRA).⁴¹ FINRA is the self-regulatory organization created pursuant to the congressional intent of the 1934 Act that broker-dealers regulate themselves. The only condition on the SEC's new grant of authority is that it "find" that abrogating an arbitration agreement is "in the public interest and for the protection of investors."⁴² The Act again does not define when this new power to abrogate arbitration agreements is "in the public interest and for the protection of investors."⁴³ But one thing is clear: the Obama Administration proposes a marked shift from Roosevelt's policy of self-regulation of broker-dealer conduct and their disputes with customers.

This provision calls into question the future relevance and effectiveness of self-regulatory organizations like FINRA. And if suitability (or fiduciary) claims are forced back into court under the Exchange Act, courts will be required to ensure plaintiffs plead and prove the stringent requirements of scienter and reliance before a jury has the ability to render big-money damage judgments. But if broker-dealers are fiduciaries, then it is possible plaintiffs will be relegated to bringing breach of fiduciary duty claims under the Advisers Act, which provides more lenient liability standards but limited private remedies; it precludes private damage remedies for lost investment value. Perhaps this is why the Investor Protection Act provides handsome rewards and protections to

⁴¹ Investor Protection Act, *supra* note 14, § 921(m); H.R. 4173, § 7201(p); S. 3217, §921(a)(l).

⁴² Investor Protection Act of 2009, H.R. 4173, *supra* note 16, § 7201(p); S. 3217, §921(a)(l).

⁴³ Investor Protection Act of 2009, H.R. 4173, *supra* note 16, § 7201(p); S. 3217, §921(a)(l).

whistleblowers and their lawyers; an olive branch for gutting big damage securities fraud cases.⁴⁴

3. *Whistleblower Rewards and Protections*

The Investor Protection Act also proposes to empower the SEC to financially reward, and protect from retaliation, securities fraud whistleblowers. If the fraud exposed by the whistleblower results in a monetary sanction of \$1 million or more, the SEC may pay an award to the whistleblower in an amount not exceeding thirty percent of the total sanction.⁴⁵ The Senate bill limits the award to thirty percent “of what has been collected” of the total sanction, but also provides for a minimum award of “not less than ten percent” of the total sanction collected.⁴⁶ In a boon to the securities plaintiffs bar, one of the factors the SEC must consider when determining an award amount is “the degree of assistance provided by . . . any legal representative of the whistleblower in such action.”⁴⁷ In yet another boon for the plaintiffs bar, the Act also provides a new cause of action for whistleblowers against an employer for retaliating against a whistleblower employee reporting under the Act. It also provides statutory penalties of two times the amount of back pay due the employee “with interest,” and any “special damages” incurred by the whistleblower, which include “litigation costs, expert witness fees, and reasonable attorneys’ fees.”⁴⁸ In short, the Investor Protection Act seeks to essentially transform the securities plaintiffs bar into a private SEC. As currently enacted, the 1933 Securities Act and 1934 Exchange Act prohibit the SEC from paying attorneys’ fees and expenses of “private parties” with funds disgorged as a result of an SEC action absent a court or administrative order.⁴⁹ The 1940 Investment Advisers Act is silent on this score.⁵⁰

This provision is likely a response to the recent criticism that the SEC Division of Enforcement has not historically “aggressively pursued tips and whistle-blower complaints,” citing the Bernie Madoff debacle as

⁴⁴ H.R. 4173 requires the Comptroller of the United States to conduct a detailed study, due to Congress no later than one year after enactment, reviewing the costs, recoveries, and other issues relating to securities arbitrations. H.R. 4173, *supra* note 16, § 7202. The Senate bill does not mandate a study, but gives the SEC discretion to conduct a rulemaking on the issue. *See* S. 3217, § 921(a)(1).

⁴⁵ Investor Protection Act, *supra* note 14, § 922; H.R. 4173, § 7203.

⁴⁶ *See* S. 3217, § 922(b)(1)(B).

⁴⁷ Investor Protection Act, *supra* note 14, § 922(b)(1); H.R. 4173, § 7203(b)(1); S. 3217, § 922(c)(B)(ii).

⁴⁸ Investor Protection Act, *supra* note 14, § 922(g)(1)(A)-(B); H.R. 4173, § 7203(g)(1)(c); S. 3217, § 922(h)(1)(C).

⁴⁹ *See* Securities Act of 1933 § 20, 15 U.S.C. § 77t(f) (2002); Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u(d)(4) (2002).

⁵⁰ *See* Investment Advisers Act of 1940 § 209, 15 U.S.C. § 80b-9 (2002).

the agency's "biggest black eye."⁵¹ Indeed, H.R. 4173 requires the SEC to submit a report to Congress entitled Report on Implementation of 'Post-Madoff Reforms.'⁵² The SEC is responding even before new legislation becomes effective.⁵³ But legislating generous rewards for whistleblowers and their lawyers subjects this provision to abuse. One need only review the serial filings for quick settlements and attorney fee payments by some plaintiffs' lawyers under a similar provision of the Americans with Disabilities Act to see a clear example of why this provision of the Investor Protection Act should be eliminated or substantially curtailed.⁵⁴

But are the whistleblower reward and fee provisions enacted to offset the potential that securities plaintiffs will lose their implied private right to bring big-money damage lawsuits against broker-dealers and others under the Securities Exchange Act of 1934, in exchange for the limited private remedies afforded for an investment adviser's breach of his fiduciary duties under the Investment Advisers Act?⁵⁵

4. Avoiding Problems Created by Congress Providing Too Much Power to the SEC

A paradigm of the problematic consequences of providing the SEC with too much discretion to regulate these new securities standards is the current judicial confusion in determining under what standards Congress intends to hold someone primarily liable for securities fraud under section

⁵¹ Kara Scannell, *SEC Says it Got 45 Pequot Tips it Pursued*, WALL ST. J., Aug. 11, 2009, at C1.

⁵² H.R. 4173, § 7306.

⁵³ See Kara Scannell, *'Urgency' Drives SEC Crackdown*, WALL ST. J., Aug. 12, 2009, at A21. The SEC is also embarking on additional controversial crackdowns, not the least of which is an SEC interpretive release that imposes significant new disclosure obligations on companies relating to climate change. See Matthew P. Allen, *SEC Opens the Door for Climate Change Related Shareholder Proposals and Disclosure Requirements, With Potential New Liabilities on Public Companies*, Sec. Reg. & Law Rep. (BNA) No. 9, at 359 (Mar. 1, 2010).

⁵⁴ See also, Mark Maremont, Tom McGinty & Nathan Koppel, *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, at A1 (examining political monetary contributions by securities plaintiffs law firms to institutional investors that are those firms' most profitable clients).

⁵⁵ See *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 25 (1979) (holding that private implied remedies under the Investment Advisers Act for violation of an adviser's fiduciary duties preclude monetary awards for diminution of the value of investments, and are limited to rescission of the adviser-customer agreement and restitution of any consideration paid for the agreement (fees) less any value conferred by the other party).

10(b) of the Securities Exchange Act of 1934, and then whether those standards are a reasonable interpretation of the statute. The debate centers on whether Congress intended to provide for primary liability under a “scheme-liability” standard that does not require some direct misleading statement or omission by the defendant to the investing public. This scheme-liability standard was created by the SEC and some federal courts based on an interpretation of SEC Rule 10b-5.

After decades of judicial interpretations and significant splits in the federal circuits on this issue, the Supreme Court purported to finally make a decision on this dispositive issue.⁵⁶ But after the Supreme Court decided, circuit courts are still split. Indeed, Treasury Secretary Geithner reminded the SEC in connection with the current proposed regulatory reform that “the administration and Congress set policy, not the regulatory agencies.”⁵⁷ Ironically, the Obama Whitepaper indicates that the administration supports providing the SEC an opportunity to regulate its way around the adverse Supreme Court precedent by noting that the “SEC . . . proposes amending the federal securities laws to provide a single explicit standard for primary liability to replace various circuits’ formulation of different ‘tests’ for primary liability.”⁵⁸

5. *Mandate of Fifty State Suitability Rules for Variable Annuities*

At the same time H.R. 4173 creates a federal fiduciary standard, it only requires states receiving federal grant money under the Act to adopt FINRA’s suitability rules for sales of securities, with a focus on variable annuities.⁵⁹ The Act accomplishes this with a brand new provision, entitled Senior Investment Protection, which seeks to protect seniors⁶⁰ from “salespersons and advisers using misleading certifications and professional designations.”⁶¹ The Act identifies as part of the problem the fact that existing State laws have inadequate “suitability standards” to protect senior investors. To remedy this problem, the Act requires the SEC to create and oversee a grant program for states to “investigate and prosecute misleading and fraudulent marketing practices.”⁶²

⁵⁶ See *Stoneridge Inv. Partners v. Scientific Atlanta*, 552 U.S. 148 (2008).

⁵⁷ Damian Paletta & Deborah Solomon, *Geithner Vents at Regulators as Overhaul Stumbles*, WALL ST. J., Aug. 4, 2009, at A4.

⁵⁸ Obama Whitepaper, *supra* note 3, at 73.

⁵⁹ H.R. 4173, § 7703(c)(3), (5).

⁶⁰ Defined as “any individual who has attained the age of 62 years or more.” H.R. 4173, § 7702(4).

⁶¹ *Id.* § 7701(1).

⁶² *Id.* § 7703(a)(1)(A).

The Act imposes various requirements on states receiving the grants, two of which are: 1) that the State adopt “standard rules on the *suitability* requirements in the sale of securities,” which at a minimum must conform to FINRA suitability requirements; and 2) that the State adopt suitability and supervision rules for “insurers and insurance producers” for all annuity products sold in the State that are at least as protective as FINRA Rule 2821, entitled “Members’ Responsibilities Regarding Deferred Variable Annuities.”⁶³ The Act requires states to “coordinate” FINRA rules “governing broker dealers” for “State insurance regulators to rely on.”⁶⁴

Recognizing the tension on broker-dealers operating under a federal fiduciary standard while selling annuity products that are created by insurers operating under a state suitability standard, the Act permits States to grant “exemption from such rules only if such exemption is consistent with the protection of consumers.”⁶⁵ It will be surprising if Congress passes this portion of the Act; it seems too rife with operational and jurisdictional confusion for broker-dealers. Indeed, the Senate bill does not include this provision. However, the Senate bill leaves open all possibilities with its mandate to the SEC to study these issues. And some within the SEC are more partial to the House bill.⁶⁶ So a complete analysis of the House bill is important to the continuing debate and analysis of conduct standards for broker-dealers when selling products like annuities.

6. *Policy Effects of Increased Securities Regulation*

It is no secret that calls in Washington for increased regulation of the securities markets is largely the result of political pressures from interest groups and the public. This is what makes our representative system of government so wonderful. But political will is a pendulum. For example, after a series of big money judgments against corporations in securities fraud cases, the Clinton Administration and Congress enacted the Private Securities Litigation Reform Act (PSLRA).⁶⁷ The PSLRA took effect on December 22, 1995 and created heftier pleading and proof

⁶³ *Id.* § 7703(c)(5)(B)(ii)-(vi).

⁶⁴ *Id.* § 7703(c)(5)(B)(vii).

⁶⁵ *Id.* § 7703(c)(5)(B)(vii)-(viii).

⁶⁶ See, e.g., Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE’s Power*, Sec. Reg. & Law Rep. (BNA) No. 13, at 571-72 (Mar. 29, 2010) (noting that SEC Commissioner Aguilar still wants uniform fiduciary standard for broker-dealers and advisers, as reflected in the House bill).

⁶⁷ See 15 U.S.C. § 78u-4 (2006).

standards for private securities plaintiffs.⁶⁸ After the Enron and WorldCom scandals became public in 2001, there was an understandable push for increased regulation of corporate disclosures and additional grounds upon which private plaintiffs could bring suit. The Sarbanes-Oxley Act of 2002 was born. After a few years of stronger regulation and enforcement under Sarbanes-Oxley, Congress, the U.S. Chamber of Commerce, and some in the financial industry began to call for relaxed regulation and enforcement because publicly-traded companies were joining foreign securities exchanges instead of U.S. exchanges. The fear was that New York would lose its title as the financial capital of the world.⁶⁹

Now we have the market meltdowns and vulnerability caused by the failures of mortgage-backed securities and the Bernie Madoff fraud. This brings us the proposals by the Obama Administration and Congress to once again increase securities enforcement and regulation. However, Congress should be the entity to overhaul securities regulation, not the SEC. Congress has the ability to avoid again swinging the pendulum too far in one direction because it has the experience and expertise to carefully study, analyze, and draft policy that will strike the right medium between better regulation and enforcement of securities, and ensuring that the U.S. securities market offers the best and most competitive securities products available in the world.

* * * *

President Obama's regulatory overhaul builds upon and strengthens the foundation of Roosevelt's New Deal securities regulation, yet differs in some material respects from both Roosevelt's overhaul and President George W. Bush's 2008 regulatory reform proposal.⁷⁰ So any serious analysis of the Obama proposal's affect on broker-dealers necessarily requires context in the form of an overview of the reasoning and historical

⁶⁸ *See id.*

⁶⁹ "When the pendulum last swung in favor of stronger enforcement, after the Enron and WorldCom prosecutions, business groups including the U.S. Chamber of Commerce said aggressive enforcement was driving U.S. Companies offshore." *See Scannell, supra* note 53; *see also* Kara Scannell, *Panel Urges Steps to Boost Allure of US Markets: Restructuring of SEC [Is] Among Proposals*, WALL ST. J., Mar. 12, 2007, at A1. Even then-Governor Spitzer ceded this point. *See* Press Release, Sen. Charles Schumer, Mayor Michael Bloomberg, Schumer/Bloomberg Report: NY in Danger of Losing Status As World Financial Center Within 10 Years Without Major Shift in Regulation and Policy (Jan. 22, 2007) (on file with The Entrepreneurial Business Law Journal); *see also* Gregory M. Drahuschak, *Investor Protection Act Had Its Consequences*, PITT. TRIB. REV., Nov. 19, 2006 ("[Most] tangible evidence of the consequences of Sarbanes-Oxley, however, is the number of companies going public on foreign exchanges instead of the U.S.").

⁷⁰ THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter Bush Whitepaper].

background underlying the relevant parts of the regulatory proposals of Presidents Roosevelt and Bush that affect broker-dealers. So that is where this Article begins.

II. HOW WE GOT HERE: AN OVERVIEW OF WHAT LED TO THE CURRENT SECURITIES PATCHWORK AND OVERLAP, FROM ROOSEVELT TO G.W. BUSH

The current securities regulatory system is a product of historical development “rather than a single overarching rationale.”⁷¹ “As a result, it reflects the accumulation of decades of legislative and regulatory developments that have largely expanded, rather than streamlined, the set of laws, rules, and procedures that apply to securities markets and market participants.”⁷² Currently, there exists a patchwork of federal, state, and industry regulators “operating under a myriad of state and federal laws.”⁷³ But it all started with the first enforceable standards and duties under the Securities Act of 1933 and the Securities Exchange Act of 1934, which still govern the securities industry today.⁷⁴

A. 1934 Foundation — *In Response to the Stock Market Crash of 1929 and Resulting Great Depression, President Roosevelt Creates the Securities and Exchange Commission and Securities Laws in Order to Create Standards Higher than Caveat Emptor and Empower the Securities Industry to Self Regulate Standards of Conduct for Broker Dealers Outside of Federal Legislation*

After the fallout from the 1929 stock market crash and resulting Great Depression, President Roosevelt proposed legislation that would protect the investing public and elevate business standards in the securities brokerage industry. The result was the Securities Act of 1933 and the Securities Exchange Act of 1934, passed by the 73rd Congress.⁷⁵ The '33 Securities Act “focuses on the issuance and initial registration of

⁷¹ *Id.* at 52.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *See id.* at 54. Technically, the first set of securities laws and duties were proposed in the Uniform Sales of Securities Act in 1929, which was promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL). But only a handful of states adopted this Act before Congress enacted the '33 and '34 securities acts, which rendered the NCCUSL's efforts obsolete. *Id.*

⁷⁵ *See* *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 170-71 (1994).

securities,” while the ’34 Exchange Act “focuses on transactions in securities and the regulation of the securities industry.”⁷⁶ Broker dealers were and are regulated under the ’34 Exchange Act. Before the Great Depression, there were no standards governing the conduct of those selling securities to the public. Roosevelt and Congress used the 1934 Exchange Act to raise the standard of professional conduct in the securities industry from the standardless principle of caveat emptor⁷⁷ to a “clearer understanding of the ancient truth” that brokers managing “other people’s money” should be subject to professional trustee duties.⁷⁸ But neither Roosevelt nor Congress wanted the federal government to regulate the brokerage industry on a wide scale.⁷⁹ This was because industry participants were seen as better able to more quickly respond to regulatory problems given their expertise and intimate knowledge of the securities industry.⁸⁰

These New Deal Acts were a compromise – federal law would elevate industry standards from caveat emptor, yet preserve the self regulation of the industry that existed before the Acts, but do so “within a legal framework that assured the enforcement of higher industry standards.”⁸¹ So self-regulatory organizations (SROs) were empowered with initial regulatory authority, “subject to federal oversight of the [SEC],” a new federal agency created by Section 4 of the ’34 Act.⁸² SROs were empowered under the Act to create and enforce rules and standards governing the securities and brokerage industry.⁸³

Congress and President Roosevelt intended the self-regulation mandate to permit SROs to create standards of conduct to protect investors without Congress legislating those standards. To accomplish this hands-off approach, and consistent with the theme of self-regulation, the ’34 Act rejects merit regulation of securities, and is premised instead “on the disclosure of material facts relating to securities, rather than their intrinsic financial merit.”⁸⁴ In other words, the government did not want to prohibit

⁷⁶ Bush Whitepaper, *supra* note 70, at 56.

⁷⁷ See Caveat Emptor, BLACK’S LAW DICTIONARY (9th ed. 2009) (*Caveat emptor* is a Latin phrase meaning “let the buyer beware.” Caveat emptor is an old property law doctrine under which a buyer could not recover from the seller for defects in the property that rendered it unfit for ordinary purposes. The only exception was if the seller actively concealed latent defects).

⁷⁸ Ramirez, *supra* note 1, at 534 (quoting H.R. Rep. No. 73-85, at 1-2 (1933)).

⁷⁹ See *id.* at 540.

⁸⁰ *Id.* at 548.

⁸¹ *Id.* at 528.

⁸² *Id.*

⁸³ *Id.* at 540.

⁸⁴ Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 586-87 (2005); see also Ramirez, *supra* note 1, at 534.

or encourage the sale of any specific securities, and instead sought only to ensure that the people or entities selling them adequately disclosed the appropriate facts and terms of the product being sold.

There is no mention of the term fiduciary in the Act's statutory scheme mandating general industry standards for broker-dealers. Not only that, the legislative history and President Roosevelt's language supporting the Act evince "an intent to avoid invoking the term."⁸⁵ For a variety of reasons — lack of government expertise, lack of government resources, avoiding government bureaucracy — Roosevelt felt that the SROs and states were best positioned to create standards to govern broker-dealers.⁸⁶ "Imposing broad fiduciary obligations or detailed statutory mandates [on broker dealers] would frustrate the foundations of self-regulation."⁸⁷

1. *Broker-Dealers Generally Were Not Subject to a
Fiduciary Duty Because They Were Viewed as Arm's-
Length Salesman Rather Than Agents Providing Advice –
The Suitability Standard is Born*

At the time the '34 Act was passed, broker-dealers performed clearly defined functions, which are defined under the Act: a "broker" "effected transactions in securities for the accounts of others," while a "dealer" bought and sold securities for his own account.⁸⁸ Brokers filled a customer's buy order by going into the market and purchasing designated securities "from an exchange specialist or an over-the-counter market-maker."⁸⁹ As such, courts treated brokers as agents of their principal customers before enactment of the '34 Act, and thus applied fiduciary principles to impose duties of care and loyalty on stockbrokers.⁹⁰ But "dealers" filled a customer's order by selling the customer securities from the dealer's own inventory of securities. Thus a dealer and customer are acting at arm's-length as buyer and seller, or principal to principal, and

⁸⁵ Ramirez, *supra* note 1, at 547.

⁸⁶ *See id.* at 548.

⁸⁷ *Id.*

⁸⁸ See 15 U.S.C. § 78c(a)(4)-(5) (2006); *see also* Angela Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, & Farrukh Suvankulow, *Perspectives on Investment Advisers and Broker Dealers*, RAND Study, *supra* note 39, at 7; *see also* Gedicks, *supra* note 84, at 550 & n.47.

⁸⁹ Gedicks, *supra* note 84, at 552.

⁹⁰ See Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 77 (1997) (providing a summary of the historical development of brokers and dealers before the '33 and '34 securities acts).

“were regarded as being in an adverse contractual relationship in which agency principles did not apply.”⁹¹ So a dealer, acting as a principal rather than an agent, owed only ordinary duties of care to the customer, not fiduciary duties.⁹²

With the support of the securities brokerage industry, Congress passed the Maloney Act in 1938 to extend the SEC’s authority to over-the-counter broker-dealers, and not just those that were exchange members. The Maloney Act, and the self-regulation authority under the ’34 Act, gave rise to the primary SRO regulating the vast majority of broker-dealers today — the National Association of Securities Dealers (NASD), reconstituted as the Financial Industry Regulatory Authority (FINRA) in 2007.⁹³ Congress amended the ’34 Act with the Securities Acts Amendments of 1964, which required the NASD to promulgate specific rules and standards of conduct governing broker-dealers.⁹⁴

In the 1960s, the “suitability” obligation emerged as the industry standard governing broker-dealers.⁹⁵ The suitability standard was ultimately codified by the NASD. Consistent with the historical definitions of brokers and dealers and the policy of self-regulation underlying the ’34 Act, the NASD created NASD Rule 2310 to govern the conduct of broker-dealers: if a broker-dealer recommends that a customer purchase, sell, or exchange a security, he must have a reasonable belief that his recommendation is suitable for the customer by informing himself of the customer’s financial and tax status, investment objectives, risk tolerances, and “such other information used or considered to be reasonable . . . in making recommendations to the customer.”⁹⁶ This has been called “customer-specific” suitability.⁹⁷

A “second dimension” of suitability has been identified, dubbed “reasonable-basis” suitability.⁹⁸ Unlike customer-specific suitability, reasonable-basis suitability focuses on the suitability of the security product sold, rather than on the individual customer who purchased it. A security product passes the reasonable basis suitability test if the broker-dealer has a reasonable belief that the security purchased by the customer is suitable for

⁹¹ Gedicks, *supra* note 84, at 553 & n.56 (quoting Weiss, *supra* note 90, at 67).

⁹² Gedicks, *supra* note 84, at 553.

⁹³ Ramirez, *supra* note 1, at 537 (in 2007, FINRA was created as a consolidation of the NASD and the “member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE)”; *see also* RAND Study, *supra* note 39, at 7 & n.3).

⁹⁴ *See* Ramirez, *supra* note 1.

⁹⁵ Gedicks, *supra* note 84, at 543.

⁹⁶ Gedicks, *supra* note 84, at 541 (quoting Nat’l Assoc. of Sec. Dealers Manual, Conduct R. 2310 (2003)).

⁹⁷ *See* Gedicks, *supra* note 84, at 547-48.

⁹⁸ *Id.* at 549.

somebody.⁹⁹ In other words, a broker-dealer only violates reasonable basis suitability if he “recommends a security that no rational person would purchase – that is, which is unsuitable for *any* investor”¹⁰⁰

A broker dealer’s “suitability obligation under Rule 2310 applies only to securities that have been recommended by the” broker-dealer.¹⁰¹ So, if a customer wants to purchase a security and the broker-dealer did not recommend it, there is no express duty on the broker-dealer to ensure that that the security is suitable for the customer.

The suitability rule, on its face, does not impose fiduciary duties on broker-dealers. In other words, broker-dealers can effect securities transactions for customers that pose conflicts of interest or are not in the customer’s best interest, but only if the securities are suitable for the customer given the customer’s background and risk tolerance, and then only if the broker-dealer recommends the security. Currently, broker-dealers are compensated in various ways that pose multiple conflicts of interests with customers: they are paid by the issuers, underwriters, and sponsors of the securities products they sell (e.g. insurance companies sponsoring variable annuities); they earn higher commissions for selling certain (sometimes riskier) securities over other (sometimes less volatile) securities; and they may earn a commission for each security purchased or trade effected for the customer, among other conflicts. But as long as the broker-dealer does not recommend the sale, or recommends the sale of a security suitable for the customer, these conflicts of interest are not unlawful.

The rationale for not imposing fiduciary duties on broker-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. So they were not agents or fiduciaries of their customers like investment advisers were in the 1930s and 1940s.

⁹⁹ *See id.*

¹⁰⁰ *Id.* It is postured that violating this reasonable basis standard requires fairly egregious conduct, such as “recommending securities of a thinly traded shell corporation with no operations, earnings, or assets, or by recommending securities that purport to guarantee an unreasonably high rate of return.” *Id.* at 42 n.36 (citing F. Harris Nichols, *The Broker’s Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435, 437 (1977)).

¹⁰¹ *See* National Association of Securities Dealers, NASD Notice to Members 96-60 (Sept. 1996), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p016905.pdf>.

2. *Investment Advisers Were (and Are) Subject to Fiduciary Duties as Legislated by Congress and Interpreted by the Supreme Court*

In addition to “brokers” and “dealers,” Roosevelt and Congress had a third class of financial intermediaries to regulate — “investment advisers.” But unlike broker-dealers, investment advisers were viewed as providing investment advice and counsel to what were perceived as largely less knowledgeable retail customers. Investment advisers therefore were envisioned as having superior knowledge than, and thus greater responsibility for, their customers. In addition, various imposters posing as investment advisers were operating on the unregulated fringe of the industry, offering “tips” as opposed to bona fide investment advice. These “tipsters” would “crash in on the good will of these reputable organizations . . . by giving themselves a designation of investment counselors.”¹⁰²

President Roosevelt and Congress therefore saw the need to more directly regulate investment advisers and subject them to more onerous fiduciary duties. So Congress passed the Investment Advisers Act of 1940.¹⁰³ The Act “regulates the collection of financial professions that typically includes financial planners, money managers, and investment consultants.”¹⁰⁴ The Act defines an investment adviser as:

[A]ny person who, for compensation, engages in the business of advising others . . . 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.¹⁰⁵

Congress specifically excludes from the definition of investment adviser “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

¹⁰² Certain Broker Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 34-51523, 70 Fed. Reg. 20424 (Apr. 19, 2005). The SEC Release provides a decent history of the SEC’s Investment Counsel Report to Congress detailing its study of the investment adviser industry from 1935 and 1939. The SEC’s Study was the subject of congressional hearings that would become the outline for the Investment Advisers Act of 1940. But SEC Release No. 34-51523 proposed a rule excepting broker-dealer fee arrangements from the purview of the 1940 Act, which was struck down by a D.C. circuit court of appeals. See discussion *infra* Part II.E for a detailed analysis of this Release.

¹⁰³ See 15 U.S.C. § 80b-1- 21. Congress also passed the corresponding Investment Companies Act of 1940 to regulate investment companies that employed investment advisers. See 15 U.S.C. § 80a-1- 64.

¹⁰⁴ RAND Study, *supra* note 39, at 12.

¹⁰⁵ 15 U.S.C. § 80b-2(a)(11).

receives no special compensation therefore.”¹⁰⁶ Thus, in 1934 and 1940, Congress viewed broker-dealers as merely order clerks “effecting transactions in securities,” and investment advisers as being compensated for providing advice and analyses of securities as part of their regular business. That is how the statute reads today. So if a broker-dealer today is paid “special compensation” for providing investment advice that is not “solely incidental” to his selling or buying securities, then he is considered an investment adviser and compelled to comply with the Investment Advisers Act.¹⁰⁷ This has significant consequences.

The Investment Advisers Act of 1940 prescribes a fiduciary obligation on all investment advisers to their clients as a categorical matter.¹⁰⁸ So an investment adviser must act solely “with the client’s investment goals and interests in mind, free from any direct or indirect conflicts of interest that would tempt the adviser to make recommendations that would also benefit him or her,” including any practice in which an adviser has a pecuniary interest in recommending a transaction to a client, through, for example, “fees or profits generated in another commercial relationship, finder’s fees, outside commissions or bonuses.”¹⁰⁹ And because the duties in the Act apply to prospective as well as current clients, the Act even prescribes as deceptive any advertising that violates these duties and standards.¹¹⁰

The Investment Advisers Act also prescribes more onerous registration, reporting, and bookkeeping obligations and other requirements.¹¹¹ For example, an investment adviser managing at least \$25 million in assets must register with the SEC using the voluminous and detailed Form ADV, which must be filed at least annually and in some cases more frequently.¹¹² Part 1 of the ADV “contains information about

¹⁰⁶ 15 U.S.C. § 80b-2(a)(11)(C).

¹⁰⁷ See discussion *infra* Part II.E, addressing whether brokerage-fee accounts constitute special compensation for advisory services, the 2005 SEC rule declaring they did not, and the 2007 court decision saying they do and thus vacating the 2005 SEC rule.

¹⁰⁸ RAND Study, *supra* note 39, at 13. The words “fiduciary duty” do not appear in the Investment Advisers Act. In 1963, the Supreme Court interpreted the Act’s “manifest purpose” to impose a fiduciary duty on investment advisers. See *Sec. & Exch. Comm’n v. Capital Gains*, 375 U.S. 180, 192, 283 (1963).

¹⁰⁹ RAND Study, *supra* note 39, at 13.

¹¹⁰ *Id.* at 13.

¹¹¹ *Id.* at 12-14.

¹¹² *Id.* at 12; see also U.S. Securities and Exchange Commission (Form ADV), available at www.sec.gov/answers/formadv.htm. The SEC is currently accepting comments on a proposal to revise its Form ADV to add more “meaningful”

the adviser's education, business and disciplinary history within the last ten years," and Part 2 "includes information on an adviser's services, fees, and investment strategies," including whether the adviser or any related person executes trades as a broker-dealer, and whether any of those brokerage accounts are discretionary. All Form ADVs are accessible by the general public for review.¹¹³ According to the SEC's Director of Compliance Inspections and Examinations, inaccurate, incomplete, or misleading statements in Forms ADV comprise half of the inadequate disclosure deficiencies found in SEC examinations and investigations of advisers under the Investment Advisers Act.¹¹⁴ Compare this to the relatively short Form U-4s currently required to be submitted by registered representatives of broker-dealers, which are published only to securities industry participants and not to the investing public.¹¹⁵

B. Fifty State Securities Laws and Regulators of Broker-Dealers and Eventual Preemption by Congress, the '34 Exchange Act, and the NASD

The first modern state securities law was enacted by Kansas in 1911.¹¹⁶ Over the years, many other states enacted securities laws patterned after the Kansas statute. These early state statutes were forms of "merit" regulation in which state administrators "wielded broad, subjective discretion in determining the securities permitted to be registered."¹¹⁷ Today, all fifty states and U.S. territories have statutes regulating securities, called "Blue Sky Laws."¹¹⁸ But today's state securities laws do not subjectively evaluate the merits of individual securities; rather, they enact a

disclosures of an investment adviser's business practices and conflicts of interest. See Amendments to Form ADV, SEC Release No. IA-2711, Investment Advisor Act No. 34-57419, 2008 SEC LEXIS 466 (Mar. 3, 2008).

¹¹³ RAND Study, *supra* note 39, at 12.

¹¹⁴ Lori Richards, Director of SEC Compliance Inspections and Examinations, Speech at Eighth Annual Investment Adviser Compliance Summit (Feb 27, 2006).

¹¹⁵ "The Form U-4 (Uniform Application for Broker-Dealer Registration) . . . [is] used by broker-dealers to register . . . associated persons with self-regulatory organizations (SROs), and jurisdictions." FINRA – Current Uniform Registration Forms for Electronic Filing in Web CRD, <http://www.finra.org/industry/compliance/registration/crd/filingguidance/p005235>.

¹¹⁶ Bush Whitepaper, *supra* note 70, at 53.

¹¹⁷ *Id.* at 53.

¹¹⁸ The origin of the term "blue sky" is thought to have emanated from Justice McKenna's opinion in the Supreme Court case styled *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917), where the Court upheld the constitutionality of state securities regulations to prevent fraud: "The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of 'blue sky' . . .'"

disclosure-based approach akin to the current federal securities laws.¹¹⁹ Broker dealers and investment advisers must register with the relevant state securities regulator or agency unless an exception applies. Like the SEC, its state counterparts can regulate, investigate, and prosecute violations of the state's securities laws.

In 1956, seeing a need to coordinate and make uniform the individual states different regulatory schemes, the Uniform Securities Act was promulgated by the National Conference of Commissioners of Uniform State Laws (NCCUSL).¹²⁰ A majority of states enacted the 1956 Act. The Act was amended in 1985, but only six states adopted that amendment. The Uniform Securities Act was again revised in 2002. This version was adopted by thirteen states, and provides for registration and supervision of broker-dealers and investment advisers.¹²¹ Currently, various states are again amending their Uniform Securities Acts in coincidence with the current federal regulatory overhaul.

State regulation of broker-dealers and investment advisers was substantially curtailed in 1996, when Congress passed the National Securities Markets Improvement Act (NSMIA) in order to reduce the complex and duplicative regulation among state and federal regulators. To achieve this, NSMIA amended the federal securities laws to preempt many state securities laws. It also "substantially curtailed states' rulemaking and supervisory authority over broker-dealers. Though states [can] still require broker-dealer registration, the SEC and [FINRA] . . . carry out most broker-dealer regulation."¹²² The regulatory overhaul of the securities laws proposed by the Obama Administration has the potential to strip FINRA of its current jurisdiction to make and enforce rules, and arbitrate disputes of those rules.

¹¹⁹ Bush Whitepaper, *supra* note 70, at 53.

¹²⁰ *Id.* at 54. The NCCUSL enacted the first Uniform Securities Act in 1929. But the Act was adopted by only a handful of states, and was rendered obsolete with the enactment of the 1933 Securities Act.

¹²¹ Another organization committed to uniformity in state securities laws is the North American Securities Administration Association, Inc. (NASAA). NASAA was founded in 1919, and represents all state securities regulators in the U.S. NASAA works to coordinate the regulation and enforcement activity of its members, as well as coordinate state legislative and regulatory initiatives with Congress and the SEC. *See id.*

¹²² *Id.* at 55.

C. Starting in the 1970's, Courts Impose More Rigorous Standards for Securities Fraud Liability Under the '34 Exchange Act that Make Suitability Claims against Broker-Dealers More Onerous

There exists no express or implied private right of action under the '34 Exchange Act for violations of FINRA's suitability or other rules.¹²³ 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.¹²⁴ A broker-dealer was liable if it made a material misrepresentation or omission in connection with the purchase or sale of a security to a customer.¹²⁵ But at the same time suitability claims were finding their legs under the securities laws in the 1970s, courts were imposing substantial limits on implied private rights of action under the federal securities laws. The most significant barriers to implied private actions were the requirements that plaintiffs plead and prove scienter — that a broker had a specific intent to defraud plaintiffs — and that plaintiffs reasonably relied on the broker's material misrepresentation.¹²⁶

These new requirements made suitability claims notoriously difficult to plead and prove under the Exchange Act because rarely will a broker fail to perform basic due diligence on the customer or the security to render a recommendation intentionally fraudulent, even under the relaxed

¹²³ Gedicks, *supra* note 84, at 562 & n.91 (citing MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 9.03[2] (2000); Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1025 (2002)).

¹²⁴ Gedicks, *supra* note 84, at 562; *see also, e.g.*, Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 & n.9 (1971) (noting that it is "established that a private right of action is implied under §10(b)" and Rule 10b-5); Leib v. Merrill Lynch, 461 F. Supp. 951 (E.D. Mich. 1978) (still the seminal case analyzing a broker-dealer's suitability duties, and when those become fiduciary duties). Aggrieved investors have also recovered on federal and state law fraud, fiduciary duty, and negligence theories of broker-dealer breaches of the suitability standards. *See* Gedicks, *supra* note 84, at 543 & n.22. Rule 10b-5 was adopted by the SEC in 1942. *See also Central Bank*, 511 U.S. at 172.

¹²⁵ Gedicks, *supra* note 84, at 563. *See also Leib*, 461 F. Supp. 951 (opining that a broker has the following duties on a single transaction in a non-discretionary account: "(1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction.") (internal citations omitted).

¹²⁶ *See* Gedicks, *supra* note 84, at 563.

“reckless” intent standard that has been adopted by some federal circuits.¹²⁷ At most, typical plaintiffs could show that a broker’s judgment was wrong, but this only amounts to negligence, which is always insufficient to support a misrepresentation or omission claim under the Exchange Act.¹²⁸ If the broker establishes that he disclosed the risk that his recommendation may be unsuitable, formally or informally, the plaintiffs cannot prove reliance.¹²⁹

Consequently, stand-alone suitability claims became rare, with recovery for such claims even rarer still.¹³⁰ Instead, they were typically included as “add-on” counts for Rule 10b-5 claims involving more egregious broker-dealer conduct, such as “churning a discretionary account, ignoring customer orders in a nondiscretionary account, or converting or otherwise mishandling account funds.”¹³¹ Attempting to avoid the high pleading bar under the Exchange Act, plaintiffs began arguing that a broker’s unauthorized trading and churning created a *de facto* discretionary account,¹³² which raised the broker’s standard of care from suitability to fiduciary duty. It is much easier for plaintiffs to prove an intentional or reckless violation of a discretionary account.¹³³ And reliance is essentially presumed in a discretionary account.

¹²⁷ Some federal circuits hold that the intent element of a securities fraud claim under section 10(b) and Rule 10b-5 is satisfied if plaintiffs plead and prove that a defendant was reckless in making his misrepresentation, which has been defined as “an extreme departure from the standards of ordinary care.” *S.E.C. v. George*, 426 F.3d 786, 642 (D.C. Cir. 1992).

¹²⁸ See *Gedicks*, *supra* note 84, at 563-64; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (holding that section 10(b), and therefore Rule 10b-5, do not reach negligent conduct); see also *Central Bank*, 511 U.S. at 173-74.

¹²⁹ See *Gedicks*, *supra* note 84, at 564.

¹³⁰ See *id.* at 654.

¹³¹ *Id.*

¹³² See *Leib*, 461 F. Supp. 951 (A discretionary account is one where the broker exercises discretion and control over the customer’s investments. A broker owes a fiduciary duty to customers with discretionary accounts. Typically, a written customer agreement is needed to create an express discretionary account. But plaintiffs arguing the existence of a *de facto* discretionary account argue that a broker is alleged to have usurped actual control of a non-discretionary account, thus effectively making it a discretionary account subject to heightened fiduciary duties.).

¹³³ See *Leib*, 461 F. Supp. at 953 (opining that a broker with a discretionary account must 1) actively manage the account in accord with the customer’s interests and objectives; 2) keep himself informed of all changes in the market that affect the customer’s investment interests; 3) keep the customer informed as to every transaction the broker completes; and 4) “explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.”).

D. *The 1980s Begin the Blurring of the Line Between Broker-Dealers and Investment Advisers — The Supreme Court Permits Broker-Dealers to Execute Customer Agreements With Provisions Requiring Private Binding Arbitration of Retail Securities Disputes, Eliminating Pleading Barriers for Suitability Claims But Preventing Public Development of Suitability Standards that Kept Pace With Evolving Global Markets, Products, and Compensation Structures Facing Broker-Dealers*

In 1987 and 1989, the Supreme Court upheld the enforceability, “under the 1933 and 1934 Acts, of contractual provisions mandating arbitration of claims by customers against broker-dealers.”¹³⁴ These decisions were significant in several respects. First, broker-dealers added mandatory arbitration provisions to all their customer agreements, and the New York Stock Exchange and the NASD created arbitration rules and forums to handle customer claims under these provisions.¹³⁵ As a result, most customer disputes with broker-dealers to date have been resolved through private, binding arbitration. And, because FINRA arbitration awards are neither reasoned nor published, the suitability standards governing broker-dealers have not been developed to keep pace with the changing landscape of the global securities market and products. This is manifest by the fact that the seminal case analyzing the suitability versus fiduciary standards for broker dealers was published in 1978.¹³⁶ Because the suitability standard was not officially published until the 1960’s, there was little time for it to develop in the courts before it was relegated to the realm of mostly non-reasoned, non-published industry arbitration decisions beginning in the late 1980s.

Broker-dealers complain that arbitrators have ignored the strict pleading requirements of section 10(b) in adjudicating suitability claims, and instead issue damage awards to customers based on equitable

¹³⁴ Gedicks, *supra* note 84, at 564 & n.102 (citing *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 482-84 (1989) (upholding arbitration provision under the ’33 Act), and *Shearson/Am. Express v. McMahon*, 482 U.S. 220, 234-40 (1987) (upholding arbitration provision under the ’34 Act)). Since 1817, well before securities arbitration received the imprimatur of the Supreme Court, the New York Stock Exchange has permitted its members to arbitrate disputes between them. In 1829 the NYSE “expanded the jurisdiction of its arbitral forum to hear disputes between individual investors and members firms.” SIFMA, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 6 (Oct. 2007), available at <http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf> [hereinafter SIFMA Whitepaper].

¹³⁵ See Gedicks, *supra* note 84, at 564.

¹³⁶ See *Leib*, 461 F. Supp. 951 (still the seminal case analyzing a broker-dealer’s suitability duties, and when those become fiduciary duties).

considerations such as compliance with industry ethics, consideration of which would otherwise be barred under a strict legal analysis.¹³⁷ In its 2007 whitepaper on securities arbitration provisions, the Securities Industry and Financial Markets Association (SIFMA)¹³⁸ confirmed that recent Supreme Court opinions increasing the burden to survive a motion to dismiss “make certain that investors are far more likely to have their claims dismissed in court than in arbitration, where dismissals are rare.”¹³⁹ Whereas the “[r]elaxed pleading standards in securities arbitration encourage disputes to be filed.”¹⁴⁰

So the chances of a customer recovering on a suitability claim were substantially increased with the advent of arbitration and concomitant consideration of ethics and equity over the strict pleading requirements of the '34 Act.¹⁴¹ Moreover, arbitration awards are rarely overturned because of the onerous legal standard to do so, combined with the fact that most awards are not reasoned opinions.¹⁴²

E. *2005, The Beginning of the End For Suitability — Federal Courts Reject the SEC’s Attempt to Exempt Broker Dealers Offering Brokerage-Fee Accounts From the Fiduciary Duties Imposed by the Investment Advisers Act*

On April 12, 2005, the SEC issued a rule entitled “Certain Broker-Dealers Deemed Not to be Investment Advisers.”¹⁴³ The 2005 Rule

¹³⁷ See Gedicks, *supra* note 84, at 565-66.

¹³⁸ SIFMA represents the interests of over 600 securities firms. “SIFMA’s mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public’s trust in the industry and the markets.” *Industry Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Svcs.*, 111th Cong. (July 17, 2009) (testimony of Randolph C. Cook, Executive V.P., SIFMA) [hereinafter *Hearings*].

¹³⁹ SIFMA Whitepaper, *supra* note 134, at 3. SIFMA notes in its Whitepaper that twenty percent of all arbitration claims are heard on the merits, compared with 1.5% of civil claims that are heard and decided by a judge or jury. See *id.*

¹⁴⁰ *Id.* at 3.

¹⁴¹ See Gedicks, *supra* note 84, at 565-66. The statistics bear this out; the “percentage of securities arbitration claimants who recover — either by award or settlement — has held steady in recent years, and in 2006 was 66 percent.” SIFMA Whitepaper, *supra* note 134, at 4.

¹⁴² See Gedicks, *supra* note 84, at 565.

¹⁴³ Registration Under the Advisors Act of Certain Hedge Fund Advisors, Advisors Act Release No. IA-2333, 72056, 17 C.F.R. Part 275 and 279 (2004).

attempted to address the increasingly popular fee-based accounts offered by broker-dealers. “Fee-based accounts allow for registered representatives to be compensated based on the amount of assets in an account regardless of the transaction activity.”¹⁴⁴ The rise of fee-based brokerage accounts was the result of three things: 1) increased competition in the brokerage industry; 2) decrease in transaction-based commissions; and 3) a 1995 report commissioned by the SEC¹⁴⁵ that identified fee-based accounts as a best practice to avoid conflicts of interest because they decreased incentives to churn accounts, recommend unsuitable yet profitable securities, or use high-pressure sales tactics.¹⁴⁶

The Advisers Act exempts broker-dealers from its definition of investment adviser if the broker’s advisory services are “solely incidental” to its brokerage business, and it does not receive “special compensation” for the advisory services.¹⁴⁷ If broker-dealers offer advisory services that are not incidental or are paid special compensation for the advice, then they would have to treat their customers as adviser customers with the incumbent fiduciary and disclosure duties: this would result in precluding the sale of many traditional brokerage products.

Fee-based brokerage programs typically offered a suite of services for which a customer paid a fee based on the total assets in the account, including services like execution, investment advice, arranging for delivery and payment, and custodial and recordkeeping services.¹⁴⁸ This was different than traditional commission or transaction-based broker-dealer compensation arrangements. Therefore, these fee-based programs generated a debate about whether broker-dealers offering them were being paid “special compensation” for advisory services, and thus satisfying the definition of an investment adviser under the Act.¹⁴⁹

Significantly, and contrary to the current Obama proposal, the SEC in 2005 rejected the proposal to employ a uniform fiduciary standard for investment advisers and broker-dealers offering fee-based accounts. The SEC acknowledged that “the lines between full service broker-dealers and investment advisers continue to blur, but we do not believe that requiring most or all full-service broker-dealers to treat most or all of their customer

¹⁴⁴ RAND Study, *supra* note 88, at 2.

¹⁴⁵ The Tulley-Levitt report was commissioned by then SEC Chairman Arthur Levitt in response to concerns about conflicts of interest in the retail brokerage industry. RAND Study, *supra* note 88, at 2.

¹⁴⁶ RAND Study, *supra* note 88, at 2.

¹⁴⁷ 15 U.S.C. § 80b-2(a)(11)(C) (2006).

¹⁴⁸ RAND Study, *supra* note 88, at 15.

¹⁴⁹ It was this proposed SEC rule that caused the SEC to commission the RAND Institute for Civil Justice to study investor and industry perspectives on investment advisers and broker dealers, which was published under this name in 2008, after the D.C. Circuit’s opinion. See RAND Study, *supra* note 88.

accounts as advisory accounts is an appropriate response to this blurring.”¹⁵⁰

So the SEC crafted a regulation¹⁵¹ that exempted from the Advisers Act broker-dealers offering fee-based brokerage accounts as long as the broker-dealer: “1) does not charge a separate fee for advisory services; 2) does not provide advice as part of a financial plan or in connection with financial planning services; 3) does not exercise investment discretion over any customer accounts; and 4) includes the following statement in any advertisements” or account-related documents:

Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product over time.¹⁵²

In short, the SEC would permit broker-dealers offering incidental investment advice to sell securities that conflicted with the customer’s interest as long as the broker-dealer tells the customer in clear terms that they are not fiduciaries of the broker-dealer. The SEC’s proposed rule also expressly provided that broker-dealers offering financing planning services — the tax, accounting, insurance, estate planning, and investment advice traditionally the province of investment advisers — would not be considered rendering advice incidental to brokerage services and thus would be regulated as fiduciaries under the Investment Advisers Act.¹⁵³

¹⁵⁰ Certain Broker-Dealers Deemed Not to be Investment Advisers, 70 Fed. Reg. 74, 20424 (Apr. 19, 2005). In 2009 and 2010, the SEC under President Obama has changed its position, and advocates a uniform fiduciary standard for broker dealers and advisers. See, e.g. Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE’s Power*, Sec. Reg. & Law Rep. (BNA), No. 13, at 571-72 (Mar. 29, 2010) (noting opinion of SEC Commissioner Aguilar that the existing fiduciary standard as developed under the Advisers Act should also govern broker dealers).

¹⁵¹ 17 C.F.R. § 275.202(a)(11)-1 (2006).

¹⁵² See RAND Study, *supra* note 88, at 1; Certain Broker-Dealers Deemed Not to be Investment Advisers, 70 Fed. Reg. 74, 20424.

¹⁵³ See Certain Broker-Dealers Deemed Not to be Investment Advisers, 70 Fed. Reg. 74, 20424.

This attempt by the SEC to extend the broker-dealer exemption in the Advisers Act was met with much criticism, chief of which was that consumers would be more confused than ever about the difference between broker-dealers and investment advisers, and that broker-dealers would provide investment advice but at the same time be permitted to sell more profitable brokerage products that violated traditional fiduciary duties.¹⁵⁴

In 2007, the D.C. Circuit Court of Appeals sided with the critics and rejected the SEC's attempt to exempt from the Investment Advisers Act, and its accompanying fiduciary obligations, broker-dealers that receive special compensation for offering fee based accounts in connection with financial advisory services.¹⁵⁵ This was a clear forecast that courts were not going to honor any artificial or non-statutory-based distinctions between broker-dealers and advisers in order to absolve broker-dealers from the plain language and incumbent duties intended by Congress in enacting the Investment Advisers Act. Congress attempts to legislate the DC Circuit's holding in the Investor Protection Act, and then some.¹⁵⁶

F. *2008 Reaction to Market Meltdown Caused by Sub-Prime Mortgage-Backed Securities: G. W. Bush Issues a Detailed "Blueprint for a Modernized Financial Regulatory Structure"*

After the initial market meltdown caused by the sub-prime mortgage disaster, the Bush Administration published its own Whitepaper in March 2008 outlining an overhaul to the financial regulatory system.¹⁵⁷ The Bush Whitepaper acknowledged the need to align the current patchwork of "[f]ederal, state, and industry regulators, operating under the authorities of a myriad of state and federal laws, carry[ing] out securities regulation in the United States."¹⁵⁸ There are many similarities between the Bush and Obama Whitepaper proposals, such as the creation of a new consumer financial protection agency.¹⁵⁹ But they are materially different when it comes to regulation affecting broker dealers and investment advisers: Bush sought to significantly reduce the role and authority of the

¹⁵⁴ See, e.g., Bob Veres, *False Fiduciaries: The so-called resolution of the SEC's 'Merrill Lynch rule' does nothing to keep brokers from providing financial advice without assuming legal responsibility*, FIN. PLANNING 37, 40 (May 2006).

¹⁵⁵ See *Fin. Planning Assoc. v. Sec. & Exch. Comm'n*, 482 F.3d 481, 492 (D.C. Cir. 2007) (holding that the 2005 Rule exceeded the SEC's rulemaking authority by improperly expanding the broker-dealer exception in the Adviser's Act beyond a reasonable interpretation of the exception contained in the Act).

¹⁵⁶ See discussion *infra* Part III.A.3.

¹⁵⁷ See Bush Whitepaper, *supra* note 70.

¹⁵⁸ *Id.* at 52.

¹⁵⁹ *Id.* at 14. The Bush Treasury dubbed the consumer protection entity a business conduct regulator and called it the Conduct of Business Regulatory Financial Agency.

SEC,¹⁶⁰ while Obama proposes to enhance it;¹⁶¹ Bush sought to go even further than Roosevelt with self-regulation of the retail securities industry by seeking to govern investment advisers with similar self regulatory organizations and standards that currently govern broker-dealers,¹⁶² while Obama proposes to treat broker dealers just like investment advisers.¹⁶³

The shift by the Obama Administration from abrogating to strengthening the SEC, and from imposing self-regulation on investment advisers to imposing investment adviser duties on broker dealers, is the result of the public outcry over the revelation of the Bernie Madoff scheme, which revealed various deficiencies in the way the SEC investigated and prosecuted fraud in connection with retail securities sold to the public, costing public investors billions of dollars.¹⁶⁴ When the Bush Whitepaper was published pre-Madoff, non-mortgage securities products were the darlings of Wall Street because they were seen as “real” wealth generators, as opposed to the unchecked and largely valueless sub-prime mortgage-backed securities. The failings of retail securities regulation and supervision in connection with the Madoff mess changed this view for the public and the new Obama Administration. Madoff was seen as exploiting the SEC’s regulatory gap between Madoff’s broker-dealer registration and FINRA oversight, and his later registration as an investment adviser subject to SEC oversight.¹⁶⁵

¹⁶⁰ *Id.* at 20-21.

¹⁶¹ Obama Whitepaper, *supra* note 3, at 8, 15, 70-73.

¹⁶² Bush Whitepaper, *supra* note 70, at 20, 126, 178.

¹⁶³ Obama Whitepaper, *supra*, note 3 at 71-72. *But see*, H.R. 4173, §§ 7107(a)(2)(B), 7208(g) (authorizing the SEC to designate “one or more self-regulatory organizations,” or a “national securities organization,” to “augment” the SEC’s efforts to regulate investment advisers).

¹⁶⁴ *See* Obama Whitepaper, *supra* note 3, at 70.

¹⁶⁵ *See* Thomas P. Lemke & Steven W. Stone, *The Madoff “Opportunity:” Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice*, 13 WALL ST. LAWYER 4 (2009); *see also* Sec. & Exch. Comm’n v. Madoff, Bernhard L. Madoff Inv. Sec., LLC, Civ. O8 CV 10791 (LLS) (S.D.N.Y. 2008); Sec. & Exch. Comm’n v. DiPascali, Jr., Civ. 09 CV 7085 (LLS) (S.D.N.Y. 2009); *see also* 155 CONG. REC. H14747, 14748-49 (daily ed. Dec. 11, 2009) (statement of Reps. Cohen & Bachus).

III. 2009 REACTION TO SUPERVISORY AND REGULATORY FAILURES OVER SALES OF SUB-PRIME MORTGAGE-BACKED SECURITIES AND BERNIE MADOFF'S MULTI-BILLION DOLLAR FRAUD ON RETAIL SECURITIES CUSTOMERS

A. *Fiduciary Duty: Obama and Congress Propose a Uniform Fiduciary Standard for Broker Dealers and Investment Advisers to Unblur the Now Artificial Distinction between Modern Broker- Dealers and Investment Advisers*

The Obama Whitepaper acknowledges that there is no longer a meaningful difference between the broker-dealer that provides “incidental advice” on securities, and the investment adviser who provides “primary advice,” as existed in the 30’s and 40’s.¹⁶⁶ The Obama Whitepaper concludes that “[r]etail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities may not be the same.”¹⁶⁷ Most importantly, FINRA and SEC rules and regulations permit broker-dealers to sell profitable securities despite conflicts of interests with its customers, while the Investment Advisers Act, with its related SEC rules and regulations, do not. The Obama Administration proposes to rectify this defined inequity by imposing on broker-dealers the duties and obligations currently imposed on investment advisers; namely, both intermediaries will have a fiduciary duty.

In the Obama Whitepaper, the Treasury calls on the SEC to change broker-dealer standards and compensation structures:

The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that

¹⁶⁶ See Obama Whitepaper, *supra* note 3, at 71.

¹⁶⁷ *Id.* Though the Obama Whitepaper provides no scientific or empirical data to support its conclusion that investors no longer appreciate the difference between the services provided by broker-dealers and investment advisers, the SEC commissioned a detailed study of the issue, which culminated in the RAND Institute for Civil Justice publishing a study which substantiated this conclusion based on thorough empirical and statistical research and analysis. See RAND Study, *supra* note 88.

are profitable to the intermediary, but are not in the investors' best interest.¹⁶⁸

The Obama Whitepaper suggests that new legislation “bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:”

- Requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;
- Providing simple and clear disclosures to investors regarding the scope of the terms of their relationships with investment professionals; and
- Prohibiting certain conflicts of interests and sales practices that are contrary to the interests of investors.¹⁶⁹

1. *The Obama Administration Issues the Proposed Investor Protection Act, Legislating the Fiduciary Duty Outlined in the Whitepaper*

One month after issuing its whitepaper proposing a fiduciary duty standard for broker-dealers, the Obama Administration provided it in legislative form when it released its draft of the Investor Protection Act of 2009 (“Investor Protection Act”). Section 913 of the Investor Protection Act is entitled “Establishment of a Fiduciary Duty for Brokers, Dealers, and Investment Advisers, and Harmonization of the Regulation of Brokers, Dealers, and Investment Advisers.”

Section 913 proposes to amend the '34 Exchange Act and the Investment Advisers Act by adding a provision styled “Standards of Conduct,” which provides the SEC with authority to regulate a uniform fiduciary duty standard for broker-dealers and investment advisers:

The Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide) shall be to act solely in the interest of the

¹⁶⁸ Obama Whitepaper, *supra* note 3, at 71-72.

¹⁶⁹ *Id.* at 72.

customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.¹⁷⁰

The Investor Protection Act goes further than the Whitepaper by proposing that the SEC have authority to regulate a fiduciary duty to customers or clients “other” than retail customers or clients.

The Investor Protection Act takes yet another step further than the Whitepaper and proposes providing the SEC with authority not only to regulate *disclosures* of securities products sold by broker-dealers and investment advisers, but also the *merits* of the securities, along with sales practices and compensation structures associated with them:

The Commission shall: (1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals; and (2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.¹⁷¹

2. SIFMA's Position

The Executive Vice President of the Securities Industry and Financial Markets Association (“SIFMA”)¹⁷² testified before Congress regarding SIFMA’s views on the Obama Administration’s proposal to impose a uniform fiduciary duty on broker-dealers and investment advisers.¹⁷³ SIFMA advocates applying a uniform fiduciary duty on broker-dealers when they provide “personalized investment advice about securities to individual investors.”¹⁷⁴ But SIFMA argues that broker-dealers should not be subject to a fiduciary duty when they simply execute customer orders, “or engage in market-making, underwriting or providing cash sweep

¹⁷⁰ Investor Protection Act, *supra* note 14, § 913(a)(k).

¹⁷¹ *Id.* § 913(k)(1)(1)-(2).

¹⁷² SIFMA represents the interests of over 600 securities firms. “SIFMA’s mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public’s trust in the industry and the markets.” *Hearings, supra* note 138, at 1 (statement of Randolph C. Snook, Executive V.P., SIFMA).

¹⁷³ *See id.*

¹⁷⁴ *Id.* at 21.

services.”¹⁷⁵ SIFMA does not say how this differs from the SEC’s failed attempt to make this distinction in 2005.

SIFMA argues that the “hallmark” of the new standard should be “putting investors’ interests first.” It includes three general suggestions to implement this interest: (1) financial services providers must communicate and document in “plain English” the “duties, obligations and expectations of the customer” and financial adviser; (2) financial advisers should “seek” to avoid conflicts of interest; (3) and if they cannot, “they must effectively manage conflicts through clear, unambiguous disclosure” and investor consent.¹⁷⁶

But SIFMA also calls for Congress to permit broker-dealers to continue to innovate their products, services, and capital formation in order to provide a robust and diverse range of choices for investors.¹⁷⁷ To facilitate this objective, SIFMA argues that investors should be permitted to “define or modify” their relationships with their financial adviser; presumably SIFMA advocates that investors would be able to contract around the uniform fiduciary standard.¹⁷⁸ SIFMA further advocates for SEC rescission of its rule prohibiting principal trading,¹⁷⁹ which it argues stifles investor choice by “foreclosing opportunities for investors to obtain more favorable pricing on transactions because of the requirement of transaction-by-transaction consent.”¹⁸⁰

¹⁷⁵ *Id.* at 21-22.

¹⁷⁶ *Id.* at 22-23.

¹⁷⁷ *Id.* at 23.

¹⁷⁸ *Id.* at 23 (“A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice about securities to individual investors.”).

¹⁷⁹ Principal trading is where a broker-dealer sells a customer products from its own inventory. Currently, § 206(3) of the Advisers Act requires written notice to and approval of a customer before such a transaction is executed. *See* John Churchill, SEC Principal Trading Proposal: A Stalling Tactic?, REGISTERED REP., Aug. 28, 2007, http://registeredrep.com/securities_law/SEC_Principal_Trade_Proposal_a_Stalling.

¹⁸⁰ *Hearings, supra* note 138, at 23 (statement of Randolph C. Snook, Executive V.P., SIFMA).

3. *Congress Adds Teeth To and Tempers the Fiduciary Duty Proposed by the Obama Administration*

a. *The House Bill*

The bill proposed by the U.S. House of Representatives adopts some of SIFMA's suggestions, and simultaneously strengthens and tempers the conduct and disclosure regulations proposed for broker-dealers. Unlike the Obama proposal, which says the SEC "may" promulgate a uniform fiduciary duty for broker-dealers and investment advisers, the House version directs that the SEC "shall" do so.¹⁸¹ The Obama proposal requires broker-dealers and investment advisers to act "*solely* in the interest" of customers, while the House bill requires that broker-dealers and advisers "act in the *best* interest" of customers.¹⁸² The House also takes up SIFMA's advice to impose the fiduciary duty on broker-dealers providing "personalized" investment advice, as opposed to the Obama proposal imposing the duty on simply "investment advice."¹⁸³ This difference does not appear material though because both the Obama proposal and the House

¹⁸¹ Compare Investor Protection Act, *supra* note 14, §913(a)(k)), with H.R. 4173, 111th Cong., *supra* note 16, § 7103(a)(1)(m)(1), (g)(1) (2009).

¹⁸² See H.R. 4173, § 7103(a)(1)(m)(1), (g)(1) (emphasis added). House Bill 4173 does not amend the '34 Exchange Act to add the text of this fiduciary duty; instead, it amends the '34 Exchange Act to note 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 under the Investment Advisers Act of 1940." *Id.* § 7103(a)(1)(m)(1). The '40 Advisers Act is amended to provide for the fiduciary duty standard above. See *id.* § 7103(a)(1)(g)(1); see also *id.* § 7103(b)(1)(o)(2) (authorizing the SEC to "prosecute and sanction" broker dealers "to the same extent" it does investment advisers under the '40 Advisers Act).

¹⁸³ H.R. 4173, §7103(a)(1)(m)(1), As discussed *supra* note 18, Senator Dodd's draft bill, Restoring Financial Stability Act, is similar to HR 4173. But one area in which it markedly differs is the scope of a broker dealer's fiduciary duty. Instead of limiting that duty to broker's providing personalized investment advice, as does HR 4173, it simply erases the exemption broker-dealers currently have under the Investment Advisor's Act, "and require[s] them to register as advisors, making them fiduciaries." Tara Siegel Bernard, *Struggling Over a Rule for Brokers*, N.Y. TIMES, Feb. 16, 2010; see also SEC Reviewing Point-of-Sale Disclosures Beyond Mutual Fund Industry, Schapiro Says, Sec. Reg. & Law Rep. (BNA) Vol. 42, No. 7, at 261 (Feb. 15, 2010) (SEC Chairman Schapiro remarks that the SEC is considering imposing on broker dealers the custody controls currently imposed on investment advisors, which will likely "have a wider impact on the industry."); SEC Staff Mulling Recommendations for Custody Disclosures from Brokers, Securities Reg. & Law Rep. (BNA) No. 7, at 263-64 (Feb. 15, 2010).

bill limit the imposition of a fiduciary duty to broker-dealers offering advice “about securities to *retail* customers.”¹⁸⁴

The House bill goes further than the Obama proposal in specifying to which retail customers broker-dealers and investment advisers will owe a fiduciary duty:

[T]he term ‘retail customer’ means a natural person, or the legal representative of such natural person, who—

(A) receives personalized investment advice about securities from a broker or dealer;¹⁸⁵ and

(B) uses such advice primarily for personal, family, or household purposes.¹⁸⁶

By limiting the definition of retail customer to only “natural persons” investing “primarily” for personal purposes, the House seems to imply that corporate and institutional investors, including influential pension funds, will not be covered by the Act.¹⁸⁷ Thus, it appears that those constituents will only be permitted a suitability standard of care. This could prove a blow to the securities plaintiffs’ bar, whose most profitable clients are pension fund class members, who may now face a higher burden of proof than individual plaintiffs under the Act.¹⁸⁸

Also interesting is that while the House bill amends both the ’34 Exchange Act and the ’40 Advisers Act with the above definition of retail customer, only the ’40 Advisers Act is amended with the following language:

¹⁸⁴ H.R. 4173, § 7103(a)(1)(m)(1), (g)(1) (emphasis added). Another seemingly innocuous change is that Congress covers “retail customers,” while the Obama proposal covers “retail customers or clients.” Congress could have simplified the definition to simplify drafting of other provisions in the Bill defining “retail customer.”

¹⁸⁵ H.R. 4173, § 7103(m)(3)(A).

¹⁸⁶ H.R. 4173, § 7103(a)(1)(m)(3), (g)(2).

¹⁸⁷ See, e.g., *In re North (Gadd Fee Application)*, 12 F.3d 252, 254-55 (D.C. Cir. 1994) (interpreting act of Congress and noting that “natural person” is “distinguished from a partnership, corporation, or association.”).

¹⁸⁸ See Mark Maremont, Tom McGinty & Nathan Koppel, *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, available at <http://online.wsj.com/article/SB10001424052748703837004575013633550087098.html> (examining political monetary contributions by securities plaintiffs law firms to institutional pension fund investors that are those firms’ most profitable clients “because federal law encourages judges to pick big institutional investors for the role” of lead plaintiffs in shareholder suits).

[T]he Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.¹⁸⁹

In other words, an investment adviser who enters into an advisory contract with an investor in a private fund, and manages that fund, will not owe a fiduciary duty to that private fund investor.¹⁹⁰ So does this mean a “natural person” that is an investor in a private fund managed by an investment adviser is not entitled to a fiduciary duty? What about natural persons who are investors in public pension funds? Under this reading, only “natural persons” are owed fiduciary duties, unless they are investors in a private fund managed by an investment adviser.

House Bill 4173 says that the Commission “shall” prosecute and sanction broker dealers under the ’34 Exchange Act “to the same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940.”¹⁹¹ Does this mean that broker dealers also do not owe fiduciary duties to public and private funds, or to natural persons who are investors in a private fund? Harmonious may not be the best word to describe this section, currently dubbed “Harmonization of Enforcement.” Yet these provisions were kept in the final bill reconciling the House and Senate versions.

The House bill gives passing reference to the compensation issue that vexed the SEC in 2005 by amending the 1934 Exchange Act to read that:

The receipt of compensation based on commission or *other standard compensation* for the sale of securities shall not, in and of itself, be considered a violation of such standard *applied to a broker or dealer*.¹⁹²

¹⁸⁹ H.R. 4173, §7103(g)(1). This provision, amending the ’40 Advisers Act, is dense and contains many critical changes affecting both investment advisers and broker dealers. Hopefully in the final version of the Investor Protection Act Congress will more clearly delineate these changes in separate or more clearly defined provisions.

¹⁹⁰ Senate Banking Committee member Tim Johnson (R-S.D.) is considering an amendment to H.R. 4173 that requires the SEC “to develop a rule for treating all providers of investment advice as fiduciaries.” *SEC Would Be Required to Develop One Fiduciary Rule Under New Plan*, Sec. Reg. & Law Rep. (BNA), No. 8, at 290 (Feb. 22, 2010). SIFMA disagrees with such a uniform fiduciary standard on all financial advisors, cautioning that “brokers operate under very different business models than advisors.” *Id.* at 291.

¹⁹¹ H.R. 4173, § 7103(b)(1)(o)(2).

¹⁹² *Id.* § 7103(a)(1)(m)(1) (emphasis added).

But the 1940 Advisers Act is amended on this issue as follows:

The receipt of compensation based on commission *or fees* shall not, in and of itself, be considered a violation of such standard *applied to a broker, dealer, or investment adviser*.¹⁹³

This statutory construction appears to place certain presumptions against broker-dealers based on the type of compensation they receive. To illustrate, H.R. 4173 says that a broker-dealer's receipt of a "commission or other standard compensation" does not in itself violate the fiduciary duty standard. It does *not* say, as it does for advisers, that a broker-dealer's receipt of a "fee" will not in itself violate the fiduciary duty standard. So, is Congress saying that a broker dealer offering investment advice to a retail customer in a fee-based brokerage account is presumed to be violating the fiduciary duty standard? If so, this not only legislates the 2007 decision of the DC Circuit Court of Appeals, which rejected the SEC's attempt to exempt broker-dealer fee-based accounts from the fiduciary duty imposed under the Adviser's Act, but goes even further to impose a presumption that broker-dealers operating under a fee based account are violating the fiduciary duty standard.¹⁹⁴ Yet these provisions were kept in the final bill reconciling the House and Senate versions.

Another interesting difference between the amendments affecting broker-dealers and investment advisers is the fact that H.R. 4173 amends the 1940 Advisers Act to include a provision that allows customers to "consent[] to" and waive "any material conflicts of interest."¹⁹⁵ But the amendment to the 1934 Exchange Act, which is otherwise similar in substance and structure, does not contain an express right for broker-dealers to obtain similar waivers.¹⁹⁶ However, it is unclear whether broker-dealers may still be able to waive material conflicts of interest given that the "Harmonization of Enforcement" provisions of HR 4173 apply the same standards of conduct and disclosure on broker-dealers and investment advisers.¹⁹⁷

But the SEC cannot propose any rules under the Harmonization of Enforcement provisions of HR 4173 until it publishes a study examining, among other things, the "nature of a 'retail customer,'" the products and

¹⁹³ *Id.* § 7103(a)(1)(g)(1) (emphasis added).

¹⁹⁴ Compare discussion *supra* Part II.E.

¹⁹⁵ H.R. 4173, § 7103(a)(1)(g)(1).

¹⁹⁶ See *id.* § 7103(a)(1)(m)(1).

¹⁹⁷ See *id.* §§ 7103(b)(1)(o)(2), 7103(b)(2)(i)(2) (noting that the SEC can "prosecute and sanction" broker dealers and investment advisers "to the same extent" under both the '34 Exchange Act and the '40 Advisers Act).

services sold to retail customers; the fees charged for those products and services; and any conflicts of interest that may arise.¹⁹⁸ This delay in the enactment of the Harmonization of Enforcement rules by the SEC does not affect the SEC's ability to immediately impose the fiduciary duty standards and disclosure requirements on broker-dealers and investments advisers under §7103 of H.R. 4173.¹⁹⁹

H.R. 4173 does contain one waiver provision that will immediately apply only to broker-dealers — they will have to “obtain the consent or acknowledgement” on every sale to every customer if they sell “only proprietary or other limited range of products, as determined by the Commission.”²⁰⁰ Thus, it appears any broker-dealer with registered representatives holding a Series Six²⁰¹ or similar limited license, or that are under agreement to only sell products from a single sponsor, issuer, or underwriter, will have greater disclosure burdens than other broker-dealers. Moreover, the provision does not specifically legislate details on the application of this provision, instead giving the SEC total discretion to determine what it means for broker-dealers to offer only “proprietary or other limited range of products,” thus subjecting these broker-dealers to more onerous and less predictable disclosure obligations.

b. *The Senate Bill*

i. *The Senate Struggles to Find Bipartisan Compromise*

After the House bill passed in December 2009, SEC Commissioner Luis Aguilar chided the Senate in February 2010 for stalling reform, expressing “doubt that ongoing reform efforts in the Senate ‘will lead to actual legislation.’”²⁰² One week later, Senate Banking Committee Chairman Chris Dodd (D-Conn.) said he was “optimistic” about developing

¹⁹⁸ See *id.* § 7104(a)(1)-(5); see also *id.* § 7102 (clarifying the SEC's authority to engage in “consumer testing,” and empowering the SEC to “gather information” and “communicate with investors or other members of the public” in furtherance of this testing). Section 7102 raises confidentiality and constitutional issues to the extent that statements and documents obtained by the SEC in a “consumer test” are used in customer arbitrations, SEC enforcement actions, or DOJ criminal prosecutions against a broker dealer.

¹⁹⁹ See *id.* § 7104(b)(2).

²⁰⁰ *Id.* § 7103(a)(1)(m)(2).

²⁰¹ This is a limited securities license that only permits a broker dealer registered representative to sell mutual funds, variable annuities, and insurance premiums. Series Six licensees are not permitted to sell corporate or municipal securities, direct participation programs, or options.

²⁰² *Aguilar Cites Doubts Regarding Progress of Regulatory Reform Effort*, Sec. Reg. & Law Rep. (BNA) No. 7, at 261-62 (Feb. 15, 2010).

a “consensus bill” after he and Senator Bob Corker (R-Tenn.) resumed negotiations that had stalled with ranking Republican member Richard Shelby (R-Ala.).²⁰³ A month after Senator Dodd’s expressed optimism about passage of the more business-friendly compromise bill, the potential serial amendments to the compromise Senate bill by Senator Dodd’s Democratic colleagues threatened to derail it.²⁰⁴ As a result, Senator Dodd cautioned that the compromise bill is “delicate and . . . could trip easily.”²⁰⁵

It did trip, and on March 15, 2010, Senator Dodd introduced a partisan overhaul bill without Republican support, styled the Restoring American Financial Stability Act of 2010 (Financial Stability Act).²⁰⁶ “The Senate Banking Committee voted along party lines March 22 to move the bill to the Senate floor” for a vote.²⁰⁷ Senator Dodd and his Democratic colleagues hoped to leverage the public’s frustration with Wall Street against congressional opponents of the bill.²⁰⁸

At the same time Congress was trying to pass this historic financial overhaul bill, it had just passed an arguably more historic health care reform bill. The partisan rancor over the health care reform bill poisoned Republican cooperation with the financial overhaul bill.²⁰⁹ Therefore, Senator Dodd and the Democrat majority in the Senate unilaterally introduced Dodd’s bill, hoping to rally public support.²¹⁰ On Friday, March

²⁰³ *Dodd to Negotiate With Corker in Effort to Clear Financial Services Reform Bill*, Sec. Reg. & Law Rep. (BNA) No. 7, at 265-66 (Feb. 15, 2010).

²⁰⁴ See Damian Paletta, *Amendments to Bipartisan Financial-Regulation Overhaul Bill Could Threaten Republican Cooperation and Scuttle Proposal*, WALL ST. J., Mar. 11, 2010, at A4 (noting that the Obama “White House took the unusual step of weighing in on the pending bill” and objecting to some more lenient provisions).

²⁰⁵ *Id.*

²⁰⁶ Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (as proposed in Senate, Mar. 15, 2010); see also Damian Paletta, *Corker Opposes Current Financial Overhaul*, WALL ST. J., Mar. 31, 2010, at A4 (quoting Senator Corker (R. Tenn.) as saying “I couldn’t support the bill in its current form,” noting that Democrats need the yes vote of at least one Republican senator to pass the bill, and that “[n]o Republican has yet signaled support for the bill . . .”).

²⁰⁷ See Paletta, *supra* note 204.

²⁰⁸ See Sewell Chan, *With Nods to Both Sides, Dodd Will Introduce Reform Bill*, N.Y. TIMES, Mar. 15, 2010, at B1, B10; see also S. 3217.

²⁰⁹ See Chan, *supra* note 208 (“Republicans have also said that the poisonous atmosphere over health care had seeped into the debate over financial regulatory reform.”).

²¹⁰ See Damian Paletta, *Dodd’s Proposed Wall Street Rules Would Toughen Scrutiny of Banks*, WALL ST. J., Mar. 15, 2010, at A2. Republicans asked all 41 Republican Senators to sign a letter committing to filibuster Senator Dodd’s proposed bill. In response, the Obama Administration has been courting individual

19, 2010, lawmakers filed “roughly” 400 amendments to the bill.²¹¹ On Monday, March 22, 2010, Senate Republicans withdrew the 200 amendments they had filed on Friday, realizing that the amendments would likely have been defeated, and could have “played into a burgeoning White House strategy of portraying Republicans as obstructionists” opposed to reforming financial rules.²¹²

The Obama Administration ratcheted-up anti-Wall Street sentiment on April 16, 2010, when the SEC charged Goldman Sachs with securities fraud over its role in creating and selling “synthetic collateralized debt obligations,” which were built out of risky sub-prime mortgage assets.²¹³ Both Democrats and Republicans sought to use the SEC charges against Goldman to support their respective positions on the contentious financial reform bill.²¹⁴ The SEC’s complaint against Goldman “appears to have supercharged Mr. Obama’s legislative push, just as the implosion of WorldCom all but ensured the passage of the Sarbanes-Oxley corporate governance law in 2002.”²¹⁵ Days later, President Obama gave a speech in Manhattan’s Cooper Union to top financial executives, urging them to “call off ‘the furious effort of industry lobbyists to shape this legislation to their special interests.’”²¹⁶

Republican Senators in hopes of finding the support of one Republican Senator that it needs to overcome a Republican filibuster of the bill. Damian Paletta & Victoria McGrane, *GOP Fights to Unify Opposition to Bill; White House Hopes Public Anger at Wall Street Compels Some Republicans to Join Financial Overhaul*, WALL ST. J., Apr. 15, 2010, at A6.

²¹¹ Michael R. Cirtenden & Damian Paletta, *Big Push to Overhaul Finance Rules, as Lawmakers Dig In*, WALL ST. J., Mar. 22, 2010 at A2.

²¹² See Damian Paletta, *Financial Overhaul Advances*, WALL ST. J., Mar. 23, 2010 at A2.

²¹³ See Gregory Zuckerman, Susanne Craig, & Srenena Ng, *Goldman Sachs Charged With Fraud: SEC Alleges Firm Misled Investors on Securities Linked to Subprime Mortgages; Major Escalation in Showdown With Wall Street*, WALL ST. J., Apr. 17, 2010, at A1; see also Sec. & Exch. Comm’n v. Goldman Sachs & Co. and Fabrice Tourre, 10 CV 3229 (S.D.N.Y. 2010) (Complaint).

²¹⁴ See Damian Paletta & Victoria McGrane, *Fraud Allegations Further Inflammate Fight Over Financial Regulation*, WALL ST. J., Apr. 17, 2010, at A5. In response to the Goldman case, Congress seeks to impose a fiduciary duty on investment banks like Goldman when they create and market securities to their customers, regardless of their customers’ size and sophistication. See John D. McKinnon, *Lawmakers Target Investment Banks*, WALL. ST. J., May 5, 2010, at C1.

²¹⁵ Jonathan Weisman & Damian Paletta, *Climax Looms for Finance Bill*, WALL ST. J., Apr. 23, 2010 at A1, A4. Interestingly, “President Barack Obama won’t return about \$1 million that employees of Goldman Sachs Group, Inc. donated to his 2008 presidential campaign . . .” Brody Mullins & Jean Spencer, *Obama to Keep Goldman Funds*, WALL ST. J., Apr. 21, 2010, at A5.

²¹⁶ Weisman, *supra* note 215.

ii. *The Senate Bill Strikes the Right Cord with
Fiduciary Duty Study*

Whatever dissention exists within Congress and the financial industry regarding the larger Financial Stability Act bill, neither Congress nor the financial industry should have a difficult time accepting the provisions relating to standard of care for brokers and advisers. Indeed, commentators opine that the Senate bill's proposal for the standard of care governing broker-dealers and investment advisers "is likely to survive the floor debate and the reconciliation with the House bill."²¹⁷ The final bill passed by the Senate on May 20, 2010 includes the study, as does the reconciled bill of June 26, 2010. The Senate bill takes a much-needed deep breath from H.R. 4173 and the Obama draft legislation by recommending against immediate enactment of a uniform fiduciary duty for both broker-dealers and investment advisers. Instead, the Financial Stability Act recommends that the SEC conduct a detailed study of all the potential benefits, problems, and conflicts that may arise with such a uniform standard.²¹⁸

Within one year after enactment of the Financial Stability Act, the SEC must deliver its report to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House.²¹⁹ The reconciled bill requires the SEC report in six months. The SEC report must identify, among other things, whether there exists any "legal or regulatory gaps or overlap . . . relating to the standards of care" for broker-dealers and advisers, and to what extent those gaps can be addressed

²¹⁷ *Hill Watch*, Sec. Reg. & Law Rep. (BNA), Apr. 5, 2010, at 645.

²¹⁸ See S. 3217, § 913. Title IX of the Financial Stability Act is dubbed "Investor Protections and Improvements to the Regulation of Securities." Subtitle A of Title IX is called "Increasing Investor Protection." It addresses the standard governing financial advisors, sets forth required disclosures to customers, creates an "Investor Advocate" within the SEC, requires a study on the "financial literacy among investors," requires a study of conflicts of interest between bankers and securities analysts in the same firm, a study on access to broker-dealer and investment adviser information, and a study of financial planners. See *id.* §§ 911-919B. Subtitle B of Title IX is called "Increasing Regulatory Enforcement and Remedies;" it gives the SEC authority to restrict or eliminate mandatory pre-dispute arbitration clauses, provides whistleblower rights, remedies, and protections, among other things. See *id.* §§ 921-929C.

²¹⁹ See S. 3217, § 913(d)(1). But see Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE's Power*, Sec. Reg. & Law Rep. (BNA), No. 13, at 571-72 (Mar. 29, 2010) (noting opinion of SEC Commissioner Aguilar that the mandated study is "unnecessary" because the existing fiduciary standard as developed under the Advisers Act is "a strong workable standard that has done its job for decades.").

by either SEC rule or with additional Congressional authority.²²⁰ If the SEC's report identifies gaps in the standard of care governing broker-dealers and advisors, it has two years from the date the Financial Stability Act is enacted to "commence a rulemaking" to address the gap.²²¹

While the Financial Stability Act bill is named and somewhat patterned after the draft legislation published by Senator Dodd back in November 2009, the provisions addressing the standard of care for broker-dealers are markedly different.²²² Section 913 in Dodd's November 2009 draft is short, and simply amends the Investment Advisers Act of 1940 by including brokers and dealers within the definition of "investment advisor" under the Advisers Act. The Dodd draft accomplishes this by eliminating the provision in the Advisers Act that excludes from the definition of investment adviser "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 therefore."²²³

The Dodd draft proposed to immediately treat broker-dealers exactly like investment advisors; this would have been disastrous for the entire financial services industry for all the reasons laid out in this Article. Such a rule would also be a disaster for the SEC because it would drown the SEC by adding to its responsibilities the registration and regulation of 4,900 brokerage firms, 174,000 brokerage branch offices, and over 650,000 registered representatives.²²⁴ Currently, the SEC registers and regulates 11,300 investment advisers.²²⁵

The Senate bill, like H.R. 4173, defines the constituency it is meant to protect as "retail customers."²²⁶ The Senate bill defines the "retail customer" as "an individual customer of a broker, dealer, investment adviser, person associated with a broker or dealer, or a person associated

²²⁰ See S. 3217, § 913(d)(2).

²²¹ See S. 3217, § 913(f)(1)(A).

²²² Compare Restoring Financial Stability Act of 2009, S. 1074, 111th Cong. (draft legislation introduced by Sen. Dodd on Nov. 10, 2009).

²²³ Compare 15 U.S.C. § 80b-2(a)(11)(C) (2006), with S. 1074, § 913(a)(1) (draft legislation introduced by Sen. Dodd on Nov. 10, 2009) (striking section 80b-2(a)(11)(B) from the current Investment Advisers Act). Some commentators and SEC Commissioners support the Dodd draft. See, e.g., Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE's Power*, Sec. Reg. & Law Rep. (BNA), No. 13, at 571-72 (Mar. 29, 2010) (noting opinion of SEC Commissioner Aguilar that the existing fiduciary standard as developed under the Advisers Act is "a strong workable standard that has done its job for decades."); Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisors*, 65 BUS. LAWYER, 412 (2010).

²²⁴ See Laby, *supra* note 223, at 398.

²²⁵ See *id.*

²²⁶ S. 3217, § 913(a)(2).

with an investment adviser.”²²⁷ The Senate’s definition of retail customer differs from the definition in H.R. 4173, and in the Obama draft legislation, as follows:

CHANGING DEFINITION OF “RETAIL CUSTOMER”

Obama Draft	H.R. 4173	S. 3217
“retail customers or clients (and such other customers or clients as the Commission may by rule provide.)” ²²⁸	“a natural person . . . who receives personalized investment advice about securities from a broker or dealer; and uses such advice primarily for personal, family, or household purposes.” ²²⁹	“an individual customer of a broker, dealer, investment adviser, person associated with a broker or dealer, or a person associated with an investment adviser.” ²³⁰

The Senate’s definition of a retail customer as “an individual customer,” rather than the House’s definition of a “natural person” who receives “personalized investment advice” for use “primarily for personal, family, or household purposes,” avoids some of the many practical and policy problems with the House’s definition, discussed *supra* Part III.A.3.a. However, the reconciled bill goes back to the House’s proposed definition. The Senate definition also expressly includes customers of “associated persons” of broker-dealers, such as the individual registered representatives that sell broker-dealer products and services. The Senate’s open-ended definition provides opportunities for varying interpretations by the courts and the SEC. However, any problems with the definition may be ameliorated by the results of the focused study mandated by the Senate.

iii. *The Senate’s Focused Mandate to Study
the Effects of a Uniform Fiduciary Duty
Highlights the Challenges of Implementing
This Standard*

The Senate bill provides a clear and specific mandate that the SEC conduct a study on standards of conduct in the retail financial industry. The mandate starts with a focused definition of the study topic, and then drills

²²⁷ *Id.*

²²⁸ Investor Protection Act, *supra* note 14, § 913(a)(k).

²²⁹ H.R. 4173, § 7103(a)(1)(m)(3).

²³⁰ S. 3217, § 913 (a)(2)

down with twelve specific “considerations” the SEC study must address. Thus, the SEC study that results from this bill will be more complete, practical, and user-friendly than the data collected by the SEC-commissioned study by the RAND Institute for Civil Justice, released in 2008 and titled “Investor and Industry Perspectives on Investment Advisers and Broker-Dealers.”²³¹ But the data collected and analyzed by RAND, cited throughout this Article,²³² will be a tremendous head start for the SEC.

The topic that Congress requires the SEC to study is the effectiveness of the various standards of care currently governing broker-dealers and investment advisers:

The Commission shall conduct a study to evaluate ----

- (1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with broker dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and FINRA, and other Federal and State legal or regulatory standards; and
- (2) whether there are legal or regulatory gaps 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 for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.²³³

The Senate mandate is refreshingly independent and objective, and does not presume that a fiduciary standard is the standard that will or should be adopted, or that a uniform standard should apply to all retail financial firms and professionals. To the contrary, as revealed by the twelve “considerations” that SEC is to study, it leaves open the possibility that investment advisers could be subject to FINRA’s suitability standard, which currently governs broker-dealers.

It will be the results of the study of the twelve considerations that will shape the future standards governing broker-dealers and investment advisers. These considerations touch upon many of the problems and inconsistencies identified in this Article as incumbent with an unwavering uniform fiduciary duty on all retail financial firms and professionals.

²³¹ RAND Study, *supra* note 88.

²³² *E.g.*, *supra* notes 88, 104, 108-13, 144-48, 167, and *infra* note 276.

²³³ S. 3217, § 913(b)(1)-(2).

The twelve considerations the SEC must study under the Senate mandate include:

- (1) the “regulatory, examination, and enforcement resources” that FINRA and the SEC expend to enforce the standards of care for broker-dealers and advisers “when providing personalized investment advice and recommendations about securities to retail customers,” including the frequency and length of time of examinations of broker-dealers and advisers;²³⁴
- (2) the “substantive differences” in the regulation of broker dealers and advisers, “when providing personalized investment advice and recommendations about securities to retail customers, including the differences in the amount of resources devoted to the regulation and examination of brokers, dealers, and investment advisers, by the Commission and FINRA;”²³⁵
- (3) “the specific instances in which the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers,” and when the regulations governing broker-dealers provides greater protection to retail customers than those governing investment advisers;²³⁶
- (4) “the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail customers;”²³⁷
- (5) the potential impact on the products and services available to retail customers of broker-dealers if broker-dealers were subject to the fiduciary duty standard of care imposed by the Investment Advisers Act of 1940, as well as the “other requirements” of the Advisers Act;²³⁸
- (6) the potential impact on investment advisers if they were subject to the standards of care imposed on broker-dealers by the SEC and FINRA, which includes the suitability standard of care, and also the impact of allowing the SEC to designate FINRA or

²³⁴See *id.* § 913(c)(1).

²³⁵*Id.* § 913(c)(2).

²³⁶See *id.* § 913(c)(3).

²³⁷*Id.* § 913(c)(4).

²³⁸See *id.* § 913(c)(5).

another self-regulatory organization to oversee investment advisers;²³⁹

- (7) the potential impact of implementing §913 of Senator Dodd's November 2009 draft legislation; namely "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, in terms of –
- (A) the potential benefits or harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;
 - (B) the number of additional entities and individuals that would be required to register under, or become subject to, the Investment Advisers Act of 1940, and the additional requirements to which brokers-dealers . . . would become subject including –
 - (i) any potential additional associated person licensing, registration, and examination requirements; and
 - (ii) the additional costs, if any, to the additional entities and individuals; and
 - (C) the impact on Commission resources to –
 - (i) conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and
 - (ii) enforce the standard of care and other applicable requirements imposed under the Investment Advisers Act of 1940.”²⁴⁰
- (8) “the ability of investors to understand the differences in terms of regulatory oversight and examinations between brokers, dealers, and investment advisers;”²⁴¹
- (9) “the varying level of services provided by brokers, dealers, [and] investment advisers, . . . and the varying scope and

²³⁹ See *id.* § 913(c)(6).

²⁴⁰ *Id.* § 913(c)(7).

²⁴¹ *Id.* § 913(c)(8).

terms of retail customer relationships of brokers, dealers, [and] investment advisers, . . . with such retail customers;”²⁴²

- (10) “any potential benefits or harm to retail customers that could result from any potential changes in the regulatory requirements or legal standards affecting brokers, dealers, [and] investment advisers . . . relating to their obligations to retail customers including any potential impact on –
 - (A) protection from fraud;
 - (B) access to personalized investment advice, and recommendations about securities to retail customers; or
 - (C) the availability of such advice and recommendations;”²⁴³
- (11) “the additional costs and expenses to retail customers and to brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, [and] investment advisers . . . relating to their obligations to retail customers;”²⁴⁴ and
- (12) “any other consideration that the Commission deems necessary and appropriate to effectively execute the study required under subsection (b).”²⁴⁵

The reconciled House and Senate bill provides that after the study the SEC “may” provide for a uniform fiduciary standard for broker dealers and investment advisers, unlike HR 4173 which required the SEC to do so. The reconciled bill also adds back some of the controversial “Harmonization of Enforcement” provisions of HR 4173, which creates some disparity in the

²⁴² *Id.* § 913(c)(9).

²⁴³ *Id.* § 913(c)(10).

²⁴⁴ *Id.* § 913(c)(11).

²⁴⁵ *Id.* § 913(c)(12). The reconciled bill contains essentially the same considerations. Section 919 requires the Comptroller General of the United States to conduct a study regarding the conflicts of interest between bankers and securities analysts in the same firm. Section 919A requires the SEC to conduct a study of ways to improve investor access to information for broker-dealers in the Central Registration Depository, and investment advisers in the Investment Adviser Registration Depository. Finally, § 919B requires the Comptroller General to study the effectiveness of regulations protecting consumers from financial planners.

treatment of broker-dealers and advisers, analyzed more fully in Part III.A.3.a.

4. *So What Will the Fiduciary Standard for Broker-Dealers Look Like? Likely the Same as It Has For Investment Advisers*

Because broker-dealers have traditionally not been held to a fiduciary standard, and because most of the claims by consumers alleging a violation of a fiduciary duty owed by broker-dealers managing discretionary or de facto discretionary accounts have been arbitrated and thus not published, there is limited and dated precedent as to what this fiduciary duty for broker-dealers will look like in modern practice.²⁴⁶ Some within the SEC suggest creating a brand new fiduciary standard by throwing out both the 1934 Act and Investment Advisers Act and creating a single piece of legislation that encompasses the best parts of both.²⁴⁷

But statements made by various other SEC Commissioners and commentators suggest adopting the proposal in Senator Dodd's November 2009 draft legislation — that regulators simply include broker-dealers within the Investor Advisers Act by repealing the current provision of that Act that expressly excludes broker-dealers from it. For example, on May 7, 2009, SEC Commissioner Luis Aguilar commented that “with the advent of fee-based brokerage accounts in the 1990's, broker-dealers have been increasingly selling programs that regularly provide ‘investment advice’ in exchange for ‘special compensation’ in the form of an asset-based fee.” Thus, Mr. Aguilar concluded that broker-dealers should no longer be excluded from the Investment Advisers Act and its concomitant fiduciary duties: “There is only one fiduciary standard and it means that a fiduciary has an affirmative obligation to put a client's interests above his or her

²⁴⁶ For example, the seminal fiduciary duty case for broker-dealers was issued in 1978. *See Leib*, 461 F. Supp. at 953. The court opined on general fiduciary standards for broker-dealers handling a discretionary or de facto discretionary account: 1) actively manage the account in accord with the customers interests and objectives; 2) keep himself informed of all changes in the market that affect the customer's investment interests; 3) keep the customer informed as to every transaction the broker completes; and 4) “explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.” *Id.*

²⁴⁷ *See* Elisse B. Walter, Sec. & Exch. Comm'r, Mutual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch050509ebw.htm> (“Congress should throw both statutes on the floor, select what is best in each, and cover any holes through which the floor boards show.”).

own.”²⁴⁸ On May 5, 2009, SEC Commissioner Elisse Walter commented that a “uniform standard of conduct” be created “and that standard should require all financial professionals to act as fiduciaries at all times.”²⁴⁹

On March 26, 2010, SEC Commissioner Aguilar reaffirmed his position that broker-dealers be treated as fiduciaries under the Advisers Act when he expressed disagreement with the Senate bill’s mandate to study the fiduciary standard of care.²⁵⁰ Mr. Aguilar remarked that “further study is unnecessary” because the fiduciary standard as developed under the Advisers Act is “a strong workable standard that has done its job for decades.”²⁵¹ “Aguilar described the [fiduciary] duty as a [sic] affirmative obligation to act in the best interests of clients ‘with undivided loyalty.’”²⁵²

This is consistent with the language used in the Obama Whitepaper that the broker-dealer standard of care be raised to the fiduciary duty standard “to align the legal framework with investment advisers.”²⁵³ As discussed *supra*, previous drafts of legislation from the Obama Administration, the House, and Senator Dodd essentially go the way Commissioner Aguilar suggests and simply adopt the same “standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940.”²⁵⁴ And the current Senate bill contemplates that such a uniform rule is possible. If this becomes the rule, broker-dealers already have a useful and realistic road map of what their new fiduciary duties may look like. So it makes sense to look at how fiduciary duties and standards have developed under the Investment Advisers Act and the Investment Company Act, SEC regulations implementing fiduciary duties under those Acts, and case law interpreting those regulations and standards.

²⁴⁸ Blaine F. Aikin, *SEC’s Aguilar Urges Fiduciary Standard*, INVESTMENT NEWS (June 7, 2009), <http://www.investmentnews.com/article/20090607/REG/306079996>.

²⁴⁹ See Walter, *supra* note 247, at 5.

²⁵⁰ See Malini Manickavasagam, *Aguilar Urges Congress to Extend Fiduciary Duty, Clarify OCIE’s Power*, Secs. Reg. & Law Rep. (BNA), No. 13, at 571-72 (Mar. 29, 2010).

²⁵¹ *Id.* at 572.

²⁵² *Id.* at 571.

²⁵³ Obama Whitepaper, *supra* note 3, at 71.

²⁵⁴ H.R. 4173, § 7103(a)(1)(m)(1).

a. *Fiduciary Duty as Defined in SEC Regulations*

Investment advisers have fiduciary duties in two contexts: 1) in the investment advice they provide;²⁵⁵ and 2) in the fees they charge for that advice.²⁵⁶ As discussed *infra*, the U.S. Supreme Court recently ruled that the fiduciary duty applicable when an adviser sets its fees differs from the fiduciary duty imposed when it provides advice.²⁵⁷

Section 206 of the Investment Advisers Act is the source of the adviser's fiduciary duty when providing investment advice.²⁵⁸ But section 206 says nothing about fiduciary duties. Instead, it makes it unlawful for investment advisers to defraud clients, or engage in any self-serving transactions without first obtaining the client's consent.²⁵⁹ It was not until the Supreme Court interpreted the Advisers Act in *S.E.C. v. Capital Gains*²⁶⁰ in 1963 that the current concept of fiduciary duty was imposed on investment advisers when providing investment advice.²⁶¹ Because the exact nature of an investment adviser's fiduciary duty was never expressly defined by Congress, the SEC has "expansive leeway" to create or redefine what obligations are imposed.²⁶² While an adviser's general duties involve promoting the client's financial goals, the fiduciary obligations regulated most by the SEC are those negative duties aimed at protecting investors.²⁶³

A review of various SEC regulations affecting investment advisers reveals that broker-dealers may be subject to some new and enhanced disclosure and compliance duties currently imposed on advisers. One

²⁵⁵ 15 U.S.C. § 80b-6 (2006); *Sec. & Exch. Comm'n v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

²⁵⁶ *See* 15 U.S.C. § 80a-35(b); *Jones et al. v. Harris Assoc. LP*, 559 U.S. ____ (Mar. 30, 2010).

²⁵⁷ *See Jones*, 559 U.S. ____ (2010); *see also* Brent Kendall & Daisy Maxey, *High Court Gives Leeway for Lawsuits On Fund Fees*, WALL ST. J., Mar 31, 2010, at C1.

²⁵⁸ *See* 15 U.S.C. § 80b-6.

²⁵⁹ *See id.*

²⁶⁰ *Capital Gains*, 375 U.S. at 192.

²⁶¹ *See id.* at 191-92, 194-95. (construing the legislative history and intent of the '40 Advisers Act as intending that customers would repose in their investment advisers their trust and confidence that the adviser would execute transactions only in their best interest, and that the relationship was not at arm's-length). *See infra* Part III.A.4.c.i.

²⁶² *See* Lemke & Stone, *supra* note 165, at 5 (explaining the SEC expands and updates investment advisers' fiduciary obligations frequently through informal methods such as settled enforcement actions or no-action letters as opposed to formal rulemaking).

²⁶³ *See Capital Gains*, 375 U.S. at 192 (explaining that the reason for finding a fiduciary duty requirement in the Investment Adviser's Act was congressional intent to protect consumers from investment advisers who "render advice which was not disinterested").

example is the requirement that each investment adviser adopt a written “code of ethics,”²⁶⁴ that, at a minimum, must include:

- Standards of business conduct that “must reflect your fiduciary obligations and those of your supervised persons;”²⁶⁵
- Requirements that the adviser and all supervised persons comply with applicable federal securities laws;²⁶⁶
- That any person who has access to a customer’s non-public information, or trades in an adviser customer’s account based on the customer’s non-public information (e.g., broker-dealers), report their securities transactions to the adviser;²⁶⁷
- That all supervised persons report any violation of the adviser’s code of ethics to the adviser’s chief compliance officer;²⁶⁸ and
- Requirements that the adviser provide his code of ethics along with any amendments to each supervised person, and a certification from each supervised person that they received the adviser’s code of ethics.²⁶⁹

Similarly, the SEC also requires advisers to “adopt and implement written policies and procedures reasonably designed to prevent a violation” by the adviser (or a supervised person) of the Adviser’s Act or any SEC rule adopted under the Act.²⁷⁰ At the same time it issued its regulation requiring written policies and procedures by advisers, the SEC issued a rule setting forth the minimum standards for the contents of an adviser’s written policies and procedures. These minimal standards include portfolio management processes, general and proprietary trading practices and activities, accuracy of disclosures, safeguarding client assets, creating and maintaining adequate records, marketing of advisory services, client asset

²⁶⁴ 17 C.F.R. § 275.204A-1(a) (2009).

²⁶⁵ *Id.* § 275.204A-1(a)(1).

²⁶⁶ *Id.* § 275.204A-1(a)(2).

²⁶⁷ *Id.* § 275.204A-1(a)(3). The regulation sets forth very demanding and specific details of the transactions and securities effected by the access person, which can include the adviser himself or any broker-dealer or other intermediary the adviser uses who trades on the adviser customer’s non-public information. See 17 C.F.R. § 275.204A-1(b) (2009).

²⁶⁸ 17 C.F.R. § 275.204A-1(a)(4) (2009).

²⁶⁹ *Id.* § 275.204A-1(a)(5).

²⁷⁰ *Id.* § 275.206(4)-7(a).

valuation processes and fees, privacy protection of client holdings and records, and “business continuity plans.”²⁷¹

The SEC also requires an adviser to review at least annually its written policies and procedures to ensure their “adequacy,” the “effectiveness of their implementation,”²⁷² and appoint a chief compliance officer to administer the adviser’s policies and procedures.²⁷³

Investment advisers currently have more onerous disclosure requirements to their customers than broker-dealers do to theirs. For example, an adviser must disclose to customers and prospective customers any “legal or disciplinary event that is material to an evaluation of the adviser’s integrity or ability to meet contractual commitments to clients.”²⁷⁴ The SEC creates through regulation a “rebuttable presumption” that an adviser must disclose as a material fact a finding of liability or guilt in any civil or criminal action involving any “investment-related business; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion.”²⁷⁵ In addition, investment advisers must file the voluminous Form ADV, which must be disclosed to both prospective and current customers.²⁷⁶

The requirements that advisers (and potentially broker-dealers) create and disclose personal ethics and trading policies and procedures subjects them to additional fiduciary duties of their own making, separate and apart from whatever duties Congress or the SEC create for them. For example, the Uniform Prudent Investor Act creates a duty on a trustee investing funds of the trust to employ any special skills or expertise the trustee advertises.²⁷⁷ Thus, a failure by the trustee to fulfill the special duty

²⁷¹ Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, Investment Advisers Act Release No. 2204, 81 SEC Docket 2775 (Dec. 17, 2003).

²⁷² 17 C.F.R. § 275.206(4)-7(b) (2009).

²⁷³ *Id.* § 275.206(4)-7(c).

²⁷⁴ *Id.* § 275.206(4)-4(a)(2).

²⁷⁵ *Id.* § 275.206(4)-4(b)(1)(i) (effective July 8, 1997). This regulation also contains disclosure requirements for any administrative action against the adviser brought by the SEC or FINRA. The Uniform Application for Broker-Dealer Registration, and the Form U-4 for registered representatives of broker-dealers, requires disclosure to the SEC and FINRA of similar criminal, civil, and regulatory convictions and findings of liability, but not customers. Investment advisers, however, are required by regulation to disclose this information to their customers.

²⁷⁶ See RAND Study, *supra* note 88, at 12; see also Form ADV, www.sec.gov/answers/formadv.htm (last visited Apr. 15, 2010).

²⁷⁷ See UNIF. PRUDENT INVESTOR ACT § 2(f) (1994) (“A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee’s representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.”).

he flouted is a violation of his fiduciary duty to his customers.²⁷⁸ Similarly, an adviser's failure to comply with his publicly-disclosed personal ethics and trading policies may violate his fiduciary duty.

b. *Fiduciary Duty as Implemented in SEC
Examinations*

In a February 27, 2006 speech, the SEC's Director of Compliance Inspections and Examinations, Lori Richards, sought to set forth a comprehensive yet practical definition of the fiduciary duties applicable to investment advisers by using concrete examples of how those duties were applied and sanctioned in SEC adviser examinations.²⁷⁹

Ms. Richards postured that fiduciary duty "is not difficult to define or to understand," explaining that "fiduciary comes from the Latin word for 'trust.' A fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest."²⁸⁰ Ms. Richards recognized that the area where complying with an adviser's fiduciary duty is most challenging is where the interest of the adviser or the firm conflict with that of the customer.²⁸¹ Ms. Richards said this was the "most frequently-found deficiency" in SEC examinations of advisers.²⁸²

Ms. Richards noted that the first duty of the adviser is to recognize the conflict, the second is to "disclose material conflicts of interest in a 'full and fair' manner and to ensure your clients understand any material conflicts of interest before taking action. Because you are a fiduciary, you should not allow your client to enter the advisory relationship without a

²⁷⁸ *See id.*

²⁷⁹ *See* Lori Richards, Dir. of Compliance Investigations & Examinations, SEC, *Fiduciary Duty: Return to First Principles*, Speech at the Eighth Annual Investment Adviser Compliance Summit (Feb 27, 2006). Ms. Richards frequently addresses compliance issues facing investment advisers in various speeches, which is a tremendous resource for investment advisers and their counsel. *See, e.g.*, Lori Richards, *Strengthening Examination Oversight: Changes to Regulatory Examinations*, Speech at SIFMA Compliance and Legal Division (June 17, 2009); Lori Richards, *Compliance in Today's Environment: Step Up to the Challenge*, Speech at Investment Adviser Compliance Best Practices Summit (Mar. 12, 2009); Lori Richards, *Focus Areas in SEC Examination of Investment Advisers: The Top 10*, Speech at Investment Adviser Compliance Best Practices Summit (Mar. 20, 2008).

²⁸⁰ Richards, *supra* note 279.

²⁸¹ *See id.*

²⁸² *See id.*

clear understanding of all material conflicts.”²⁸³ This indicates that the SEC may permit sales of broker-dealer securities products that pose a conflict of interest as long as the broker-dealer complies with the disclosure requirements applicable to advisers. But it remains to be seen what Congress and the SEC do with this issue in the current political and enforcement environment. As discussed *supra*, the current drafts of the investor protection legislation do not clearly define whether broker-dealer customers can waive certain material conflicts of interest.²⁸⁴

Half of the disclosure problems discovered in SEC adviser examinations “relate to inaccurate, incomplete, and even misleading information in Forms ADV.”²⁸⁵ And half of these include “problematic disclosure of business practices and fees charged to clients.”²⁸⁶ Examples of inadequate disclosures, and thus violations of the adviser’s fiduciary duty, found in SEC examinations include the following:

- Clients were not informed of the real method used to calculate the adviser’s fee. Fees appeared to be lower than they were in fact.
- An adviser failed to disclose that he recommends securities to clients in which he has a proprietary interest.
- An adviser failed to disclose the risks to clients that existed by having their assets invested in private investments.
- An adviser failed to disclose that clients with directed brokerage arrangements may not achieve best execution.
- An adviser does not accurately describe the types of products and services it obtains with clients’ soft dollars.
- Clients whose assets were invested in mutual funds were not told that they pay both a direct management fee to their adviser and an indirect management fee to the adviser of their mutual funds.

²⁸³ *Id.*

²⁸⁴ *See supra* Part III.A.3.

²⁸⁵ Richards, *supra* note 279. The SEC is currently accepting comments on a proposal to revise its Form ADV to add more “meaningful” disclosures of an investment adviser’s business practices and conflicts of interest. *See* SEC Release No. IA-2711, 34-57419; *Amendments to Form ADV*, 2008 SEC LEXIS 466 (Mar. 3, 2008).

²⁸⁶ Richards, *supra* note 279.

- An adviser stated that it did not have custody of client assets when in fact it did.
- An adviser did not disclose that it receives economic benefit from a non-client in connection with giving advice to clients.
- An adviser did not disclose that even if clients direct that their securities transactions be executed through a certain broker-dealer, the adviser did not actually execute most transactions through that firm.
- An adviser had not amended its ADV for several years although the rules require that it be amended at least annually and more frequently if required, information was therefore out-of-date.
- An adviser incorrectly stated that it did not have discretion to direct trades to specific broker-dealers, when in fact it did.
- Clients were provided with incorrect information about the adviser's review of their accounts, and the frequency of those reviews.²⁸⁷

A review of SEC examination procedures reveals how critical it is for advisers (and potentially broker-dealers) to accurately disclose to customers, and conduct business in conformity with, information that is contained in their Form ADV and their written policies and procedures.

Every SEC examination begins with a thorough review of the information the adviser disseminates to its customers and the public in parts I and II of its ADV.²⁸⁸ Then the examiners compare the adviser's actual business practices, services, and disclosures, to how those practices, services, and disclosures are described in the adviser's written policies and procedures and its Form ADV. "When discrepancies or omissions between the firm's written disclosures and its actual practice are identified, this will trigger heightened scrutiny by the exam staff. As a fiduciary, it is fundamental that what you tell your clients is, in fact, how you conduct your business."²⁸⁹

So how does an adviser guard against such violations? Do what the SEC examiners do — compare all the representations and disclosures in your written materials with the firm's actual business practices. The SEC recommends having firm employees knowledgeable in all aspects of the

²⁸⁷ *Id.* at 4.

²⁸⁸ *See id.* at 5.

²⁸⁹ *Id.*

adviser's business operations review the disclosures, "from compliance to portfolio management to trading desk to business operations."²⁹⁰ "This is important, because disclosures must reflect actual practice, and who better to know the nature of the firm's actual practices than those who are actually doing it. This practice also helps keep disclosures 'real,' and not simply aspirational or marketing literature."²⁹¹ Finally, it is important that the firm promptly rectify any problems identified in this review. Some firms perform the same type of comparative review to client portfolios "to ensure that portfolio transactions are consistent with disclosures to and instructions from the client."²⁹²

It is important for compliance officers to understand that the SEC examiners will ask about material weaknesses the firm has identified in its compliance procedures, and likely require a written response from the senior compliance officer before the exit interview. This enables the SEC to apply greater scrutiny to weaker compliance controls of the firm. It is also important to understand that the SEC's decision on whether to take enforcement action based on the examination will be determined by SEC lawyers and analysts back in the SEC office after the exam takes place.²⁹³ So any deficiency letter from the SEC after an examination must be carefully reviewed to ensure the information upon which it is based is accurate, and if so whether the legal analysis is based on the correct statute, regulation, or rule. And if not, a prompt, thorough, and measured response is essential. These SEC procedures highlight the need for the firm and the adviser to consider consulting counsel to assist with the SEC examination process.

c. Fiduciary Duties Defined and Interpreted by the Courts

As mentioned above, investment advisers have fiduciary duties in two contexts: 1) in the investment advice they provide;²⁹⁴ and 2) in the fees they charge for that advice.²⁹⁵ The duty is slightly different in each context; each of which is discussed separately below.

²⁹⁰ *Id.* at 6.

²⁹¹ *Id.*

²⁹² *Id.*

²⁹³ *See id.*

²⁹⁴ *See* 15 U.S.C. § 80b-6 (2006); *Sec. & Exch. Comm'n v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

²⁹⁵ *See* 15 U.S.C. § 80a-35(b) (2006); *Jones*, 559 U.S. ____ (2010).

i. *Supreme Court Definition of Fiduciary
Duty When an Investment Adviser Provides
Investment Advice — Higher Than For
Parties Acting at Arm's-Length*

As stated previously, the Investment Adviser's Act of 1940 does not actually contain the words "fiduciary duty."²⁹⁶ To the contrary, it only prohibits "fraud."²⁹⁷ Instead, the Supreme Court interpreted a fiduciary obligation from the "manifest purpose" of the Act in *Capital Gains*, where the Court addressed whether the SEC could compel an investment adviser to disclose certain practices to his clients.²⁹⁸ The case arose after the SEC discovered that an investment adviser had been purchasing shares of a company immediately before recommending that clients invest in the same company.²⁹⁹ After the price of the shares had increased after his clients had purchased them at his recommendation, the adviser would sell his shares at a higher price.³⁰⁰ The SEC attempted to file an injunction under the Investment Advisers Act that would require the adviser to inform clients of his interests in the companies he was recommending.³⁰¹

While the adviser argued that the Advisers Act did not require disclosure, the Court held that the SEC could compel such actions because the Act imposed a duty to deal with clients in good faith.³⁰² The Court explained that the Advisers Act "reflects congressional recognition of the delicate fiduciary nature of an investment advisory relationship," because the legislative intent and "manifest purpose" of the Act was to protect consumers from advice that "was not disinterested."³⁰³ Importantly, because the Supreme Court interpreted the Act's "manifest purpose" as protecting investors from biased advice regardless of whether it was

²⁹⁶ See *supra* notes 258-261 and accompanying text.

²⁹⁷ 15 U.S.C. § 80b-6.

²⁹⁸ See *Capital Gains Research Bureau*, 375 U.S. 180.

²⁹⁹ *Id.* at 183.

³⁰⁰ *Id.*

³⁰¹ *Id.* at 181.

³⁰² *Id.* at 194 (explaining that this duty stems from the "broad proscription" of the Advisers Act prohibiting any acts that could be "fraud or deceit").

³⁰³ *Id.* at 191 (finding that in order to protect consumers advisers should act in good faith, fully disclose all "material facts" and to take reasonable steps to "avoid misleading" prospective or current clients).

purposeful or unconscious,³⁰⁴ a violation of fiduciary obligations does not require proof of intent to injure.³⁰⁵

Thus, the Court held that the “fraud” proscribed by the Act was not the intentional and overt conduct to misrepresent as defined at common law, but rather the definition of fraud as it had been more broadly defined in courts of equity:

Fraud . . . in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.³⁰⁶

Therefore, adviser customers suing for breach of fiduciary duty in connection with investment advice do not have the high burden of proving the elements of fraud applicable in suits between parties to “an arm’s-length transaction.”³⁰⁷

Interestingly, as discussed in the next sub-section, the Supreme Court has recently created a paradox as it pertains to adviser conduct standards by reference to arm’s-length business standards. The Court recently ruled that adviser customers suing for breach of fiduciary duty in connection with the fees they were charged by the adviser (as opposed to the advice received) have the burden to “show that the fee is outside the range that arm’s-length bargaining would produce.”³⁰⁸ Thus, the Court holds advisers to a higher duty than a party to an arm’s-length transaction when assessing the advice provided, but holds advisers to the same duty as a party to an arm’s-length transaction when assessing the fees charged for that same advice.

There are two elements of an adviser’s general fiduciary obligation to act in good faith when providing advice that are particularly important: the requirements that advisers first make “full and fair disclosure of material information,” and second, “use reasonable care to avoid misleading clients.”³⁰⁹ These obligations deserve special attention because failure to fulfill them often results in a violation of the Advisers Act.³¹⁰

³⁰⁴ See *id.* at 192.

³⁰⁵ See *Morris v. Wachovia Sec. Inc.*, 277 F. Supp. 2d 622, 644 (E.D. Va. 2003) (analyzing *Capital Gains Bureau Research*, 375 U.S. at 194).

³⁰⁶ *Capital Gains Bureau Research*, 375 U.S. at 194.

³⁰⁷ *Id.* at 194-95.

³⁰⁸ *Jones*, 559 U.S. at ____ (2010).

³⁰⁹ *Capital Gains Bureau Research*, 375 U.S. at 191.

³¹⁰ See, e.g., *id.* (discussing how a failure to disclose material information regarding the investment adviser’s personal interest in shares was a violation of the Adviser’s Act).

The United States District Court for the District of Columbia provided insight about what constitutes “full and fair disclosure of all material facts” under the Advisers Act in *Sec. Exch. Comm’n v. Bolla*.³¹¹ In *Bolla*, defendants Steven Bolla and Robert Radano created an investment company that was a registered investment adviser.³¹² Mr. Bolla was later barred by the SEC from associating with or serving as an investment adviser for fraud.³¹³ The defendants continued to operate the company and give advice without informing any clients about Mr. Bolla’s bar by the SEC.³¹⁴ The court held that this information should have been disclosed to clients because it constituted material information.³¹⁵

The Court explained that the determination of what facts are material is based on whether a “reasonable investor” presented with the “total mix” of information would have considered it “important to any further decisions regarding their investment future.”³¹⁶ Investment advisers must disclose “complete, truthful and accurate information” that is relevant to the company and the client, even if the client may have already been aware.³¹⁷ Because the defendants did not disclose material facts regarding Mr. Bolla’s bar by the SEC, their actions constituted violations of the Advisers Act.³¹⁸

Investment advisers must also take reasonable steps to avoid making different disclosures to different clients. In *SEC v. Tambone*,³¹⁹ the First Circuit Court of Appeals held that senior executives of a company that managed mutual funds violated their fiduciary duty by knowingly allowing short-term investors to engage in round-trip trading that harmed the long-

³¹¹ *Sec. & Exch. Comm’n v. Bolla*, 401 F. Supp. 2d 43 (D.D.C. 2005).

³¹² *See id.* at 48.

³¹³ *See id.* at 50.

³¹⁴ *See id.* at 54.

³¹⁵ *Id.* at 67-69 (explaining that such a violation hinges on proof that the facts were material and that there was a duty to disclose which was not met or done fraudulently).

³¹⁶ *Id.* at 69.

³¹⁷ *See id.* (explaining that it would be “absurd and undermine” the statute if the court allowed investment advisers to breach their duty just because a client should have known about the material information or should have known the adviser would not truthfully provide such information).

³¹⁸ *See id.* at 67.

³¹⁹ *Sec. & Exch. Comm’n v. Tambone*, 550 F.3d 106 (1st Cir. 2008), *vacate in part en banc*, 597 F.3d 436 (1st Cir. Mar. 10, 2010) (vacating the previous panel’s opinion only as to the parties’ Rule 10b-5 claim under the Securities Exchange Act, but not the previous ruling on the claims under 15 U.S.C. § 80b-6 of the Investment Advisers Act).

term investors in a mutual fund.³²⁰ The company had adopted a strict prohibition against the practice of engaging in “roundtrips,” where investments are rapidly shuffled into and out of funds to benefit individual investors but often with harmful effects on the rest of the investors in the fund.³²¹ But the defendants continued to “approve or knowingly allow” short-term investors to engage in the practice contrary to the information they provided to the rest of their clients.³²²

While this type of investing was not illegal per se, the advisers violated their duty by misleading clients to believe the “roundtrip” investments were prohibited yet allowing short-term investors to make them at the expense of long-term investor clients.³²³ In failing to disclose this practice to long-term investors, the defendants did not take “reasonable” steps to avoid misleading clients, and instead actively deceived clients who believed the trading was prohibited.³²⁴ As a result, the investors ultimately failed to place their clients’ interests first or to act in good faith.³²⁵

ii. *Supreme Court Definition of Fiduciary
Duty When an Investment Adviser Charges
Fees for Its Advice — The Same As For
Parties Acting at Arm’s Length*

In 1970, Congress amended section 36 of the Investment Company Act to impose on investment advisers a fiduciary duty “with respect to compensation received . . . , and granted individual investors a private right of action for breach of that duty.”³²⁶ Prior to this amendment, investors in mutual funds managed by an investment adviser could only challenge the adviser’s fee under state-law corporate waste theories, which require a showing that the fee is “unconscionable or shocking.”³²⁷ While the amendment sought to provide shareholders with more protection against unreasonable fees by lowering the burden of proof, it also sought to avoid giving the SEC or the courts the power to effectively act as rate-setters by subjecting adviser fee agreements to a “reasonableness” standard as

³²⁰ See *id.* at 146.

³²¹ See *id.* at 112.

³²² See *id.* at 113.

³²³ See *id.* at 146.

³²⁴ See *id.* at 147 (explaining that the defendants distributed prospectuses which claimed “strict prohibitions” against “roundtrip” trading but allowed the practices to continue without making any effort to inform clients or adjust the prospectuses).

³²⁵ See generally Richards, *supra* note 279.

³²⁶ *Jones*, 559 U.S. ____ (2010) (citing 15 U.S.C. § 80a-35(b)).

³²⁷ *Id.* at Slip Op. at 3-4.

interpreted by the SEC and the courts.³²⁸ The compromise was the fiduciary duty amendment in section 36(b) of the Investment Company Act.³²⁹

Since 1970, lower circuit courts have provided differing interpretations of the fiduciary duty imposed by section 36. Some circuits, including the lower appellate court in *Jones*, held that the duty is satisfied as long as the adviser makes a full disclosure of the fee to customers and “plays no tricks.”³³⁰ These courts find that as long as full disclosure is made, there is no cap on the fee that an investment adviser can charge its customers.³³¹ The theory underlying this position is that the contemporary mutual fund market is robust, with thousands of funds competing for investors, and that “sophisticated investors” will shop for funds with the best results and avoid funds that charge excessive fees.³³² These courts find that any other interpretation of fiduciary duty as it applies to fees “relies too little on the markets.”³³³

A unanimous Supreme Court rejected this approach, and instead adopted the approach first articulated by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Mgt., Inc.*³³⁴ This standard looks not only to whether an adviser has fully disclosed the fee, but also looks to see whether the fee is commensurate with one that would result from “arm’s length bargaining.”

We conclude that *Gartenberg* was correct in its basic formulation of what §36(b) requires: to face liability under §36(b), 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.³³⁵

But this standard alone leaves many questions unanswered. So the Court went about trying to resolve some of them. In the process, the Court revealed several caveats or “sub-holdings” to its primary holding above.

³²⁸ See *id.* at Slip Op. at 4.

³²⁹ See *id.* at Slip Op. at 4.

³³⁰ See *id.* at Slip Op. at 5.

³³¹ See *id.* at Slip Op. at 5.

³³² See *id.* at Slip Op. at 5-6.

³³³ See *id.* at Slip Op. at 6 (quoting lower court in *Jones v. Harris Assoc.*, 527 F.3d 627, 632 (7th Cir. 2008)).

³³⁴ See *id.* at Slip Op. at 9 (adopting the approach in *Gartenberg*, 694 F.2d 923 (1982)).

³³⁵ *Id.* at Slip Op. at 9.

First, while the Court took its definition of fiduciary duty from trust law, it noted the Act's significant modification to the duty as it exists in trust law — the Act “shifts the burden of proof from the fiduciary to the party claiming breach to show that the fee is outside the range that arm's-length bargaining would produce.”³³⁶

Second, to avoid the danger that courts would second-guess adviser fees and act as de facto rate-setters for fund advisers, the Court held that lower courts must give “considerable weight” to an adviser fee negotiated with and approved by a disinterested fund board of directors that has “considered the relevant factors.”³³⁷ Less deference to a board-approved fee is reasonable when it is shown that an adviser failed to disclose to the board important information about the fee or how it was set.³³⁸ This comports with the deference Congress sought to provide mutual fund boards in the Act.³³⁹

Third, lower courts are not expected to “engage in a precise calculation of fees representative of arm's-length bargaining.”³⁴⁰ Congress rejected a “reasonableness” requirement for adviser fees expressly because such a requirement would charge courts with rate-setting responsibilities: “Congress’ approach recognizes that courts are not well suited to make such precise calculations.”³⁴¹

Finally, the Court declined to create a categorical rule when comparing adviser fees in other funds to determine whether the adviser's fee complies with the fiduciary standard in section 36.³⁴² The Court recognized that there “may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs.”³⁴³ When assessing whether a fee is commensurate

³³⁶ *Id.* at Slip Op. at 11.

³³⁷ *See id.* at Slip Op. at 15.

³³⁸ *See id.* at Slip Op. at 15-16.

³³⁹ *See* 15 U.S.C. § 80a-35(b)(2) (2006). *But see* Sam Mamudi, *The Unseen Figures in Charge of Your Funds*, WALL. ST. J., May 3, 2010, at R1 (noting charges of critics that fund boards are not doing their jobs because they oversee too many funds and do not replace underperforming fund managers with enough frequency).

³⁴⁰ *Jones*, 559 U.S. at ____ (2010), Slip Op. at 16.

³⁴¹ *Id.* at Slip Op. at 16.

³⁴² *See id.* at Slip Op. at 13.

³⁴³ *Id.* at Slip Op. at 13-14.

to an arm's-length fee, courts must reject comparables with "significantly different" services.³⁴⁴

But after this relatively clear guidance, the Court injects some unnecessary yet significant confusion into the analysis when it then says that even if the fees and services of a comparable mutual fund are similar, courts should not rely "too heavily" on this comparison because the comparable fund fees "may not be the product of negotiations conducted at arm's-length."³⁴⁵ So is the Court saying that an investor must not only prove that a fund adviser's fee is not commensurate with the fees of advisers managing comparable funds, but also that the adviser fees of the comparable funds are themselves at arm's-length? Are customers required to obtain discovery from comparable third-party fund advisers to meet this burden? If so, how does the customer overcome the various reasonable objections from third party advisers to producing this comparable information?

The sole basis for the Court's apparent assumption that mutual fund adviser fees are not at arm's-length is 28-year old dicta from the Second Circuit's 1982 *Gartenberg* opinion. This dicta says that just because funds may "vigorously" compete for shareholders, doesn't mean that advisers compete to manage funds, opining that adviser competition for fund business "is virtually non-existent."³⁴⁶ This opinion by the Court seems improvident given the age and veracity of its support, and the confusion it injects into the Court's fee-comparison framework.

It is even more improvident because after telling advisers that mutual fund adviser fees may not be apples-to-apples (even if the services and fees are the same), it then says that comparing adviser fees paid by mutual funds to those paid by by other "institutional clients" may also not be apples-to-apples.³⁴⁷ It's hard to find an unencumbered path for investors to conclusively prove that the fees charged by their fund advisers are not at arm's-length because it appears the Court's assumption is that one mutual fund cannot be reliably compared to another.

³⁴⁴ See *id.* at Slip Op. at 14.

³⁴⁵ *Id.* at Slip Op. at 14.

³⁴⁶ See *id.* at Slip Op. at 14 (quoting *Gartenberg*, 694 F.2d at 929).

³⁴⁷ See *id.* at Slip Op. at 14 ("Even if the services provided and fees charged to an independent fund are relevant, courts should be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients. . . . By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers.").

So while the press describes the Court's opinion as providing more "leeway for lawsuits on fund fees,"³⁴⁸ this Article concludes that the Court might have actually made it more difficult for fund investors to get lawsuits past summary judgment and to trial:

Comparisons with fees charged to institutional clients, therefore, will not 'doom any fund to trial.' First, plaintiffs bear the burden in showing that fees are beyond the range of arm's-length bargaining. Second, a showing of relevance requires courts [read investors] to assess any disparity in fees in light of the different markets for advisory services. Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate.³⁴⁹

5. The Uniform Prudent Investor Act — Another Potential Source for Defining a Broker-Dealer's New Fiduciary Duty

In 1994, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Investors Act, which sets forth definitions of the fiduciary duties facing trustees investing funds under private gratuitous, charitable, and pension trusts.³⁵⁰ Because trustees have traditionally been viewed as fiduciaries over investment funds and portfolios similar to those managed by investment advisers (e.g., pension, portfolio, and mutual fund management), a review of those standards is helpful to understand where broker-dealer duties may be heading. Indeed, the Supreme Court's most recent definition of an adviser's fiduciary duty is taken from trust law.³⁵¹

Trustees must comply with the "Prudent Investor Rule," which mandates in relevant part:

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the

³⁴⁸ See Brent Kendall & Daisy Maxey, *High Court Gives Leeway for Lawsuits On Fund Fees*, WALL ST. J., Mar 31, 2010, at C1.

³⁴⁹ *Jones*, 559 U.S. ____ (2010), Slip Op. at 14 n.8.

³⁵⁰ See UNIF. PRUDENT INVESTOR ACT, § 2(f), (drafted by the National Conference of Commissioners on Uniform State Laws, and approved by ABA on Feb. 14, 1995).

³⁵¹ See *Jones*, 559 U.S. ____ (2010), Slip Op. at 10-11.

trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.³⁵²

Compliance with the Prudent Investor Rule requires the trustee to consider various circumstances when investing and managing trust assets, including:

- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;
- (3) the expected tax consequences of investment decisions or strategies;
- (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) the expected total return from income and the appreciation of capital;
- (6) other resources of the beneficiaries;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.³⁵³

A trustee is also not entitled to rely on disclosures provided for management of the trust assets, but instead is required to make “a reasonable effort to verify facts relevant to the investment and management of the trust assets.”³⁵⁴ Moreover, a trustee is held to a heightened fiduciary duty commensurate with any special skills or expertise he has advertised and upon which the trust and its beneficiaries have relied.³⁵⁵ These duties to consider a transaction’s effect on the entire portfolio, and the effects of

³⁵² UNIF. PRUDENT INVESTOR ACT § 2(a)-(b).

³⁵³ *Id.* § 2(c)(1)-(8).

³⁵⁴ *Id.* § 2(d).

³⁵⁵ *See id.* § 2(f).

the tax laws, inflation, and deflation on a transaction and portfolio, are similar to those that investment advisers carry, duties that may be soon foisted upon broker dealers.

The Prudent Investor Rule also imposes a duty of loyalty on the trustee to manage and invest trust assets “solely in the interest of the beneficiaries.”³⁵⁶ This is similar to the language in the Investor Protection Act, which says a financial adviser “shall” act “solely in the interest of the customer,” and goes one step further to prescribe acting “without regard to the financial or other interest” of the financial adviser.³⁵⁷ But the commentary to the Prudent Investor Act duty also precludes any conflict the trustee has with third parties involved in a transaction involving trust assets.³⁵⁸

A categorical rule like this for broker-dealers may prohibit the sales of many products that benefit sponsors, underwriters, or other broker-dealer customers. This is especially troublesome because, based upon the strict language in both Acts, it appears this duty to avoid conflicts of interest is not waiveable. And as discussed at several points in this Article, the current version of the Senate bill is not clear about whether broker dealers can waive material conflicts of interest.

The Prudent Investor Act also requires the trustee to consider the interests of each beneficiary and “act impartially in investing and managing the trust assets.”³⁵⁹ There are many implications here for advisers or broker-dealers that manage portfolios or funds for multiple individuals or entities. Advising on securities or products suitable for one set of beneficiaries may be unsuitable to others, and subject the adviser to potential liability.³⁶⁰ The commentary to the rule notes that the most

³⁵⁶ *Id.* § 5.

³⁵⁷ *See, e.g., Investor Protection Act of 2009*, H.R. 3817, 111th Cong. § 103 (a)(2) (2009) (as introduced).

³⁵⁸ *See* UNIF. PRUDENT INVESTOR ACT § 5 cmt. (“The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. ‘The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust.’” (quoting RESTATEMENT (SECOND) OF TRUSTS 2d § 170, at 371 cmt. *q*, (1959))).

³⁵⁹ UNIF. PRUDENT INVESTOR ACT, § 6.

³⁶⁰ *See, e.g., Tambone*, 550 F.3d at 110-13 (finding that the misleading practices of the investment adviser in knowingly allowing short term mutual fund investors to engage in round-trip trading that harmed the long term investors in the fund were adequately alleged in the complaint and should not have been dismissed).

frequent conflict is between beneficiaries interested in income and those interested in principal investments.³⁶¹

6. Will a Uniform Fiduciary Standard on Broker-Dealers Exert Downward Pressure on the Brokerage Industry?

“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.”³⁶²

Versions of the proposed investor protection legislation require a broker-dealer offering investment advice to act solely in the customer’s best interest, but do not expressly provide broker dealers with the ability to waive this strict fiduciary duty.³⁶³ In addition, the proposed legislation contemplates providing the SEC with authority to prohibit compensation schemes and all conflicts of interest that the SEC “deems contrary to the public interest and the interests of investors.”³⁶⁴

Such an uncompromising prohibition on broker-dealers would prevent the marketing and sale of some of the most popular and suitable brokerage products, many of which are necessary investment vehicles for investors.³⁶⁵ This could “upend business practices at many large brokerage

³⁶¹ See UNIF. PRUDENT INVESTOR ACT § 6 cmt. (noting that the Prudent Investor Act does not prescribe any particular regimen to avoid this conflict, and instead refers to the Revised Uniform Principal and Income Act). See, e.g., *Tambone*, 550 F.3d at 106.

³⁶² *Meinhard v. Salmon*, 249 N.Y. 458, 464 (N.Y. 1928) (Cardozo, J.).

³⁶³ See Investor Protection Act, *supra* note 14, § 913(a)(k); Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 103 (a)(2) (2009); HR 4173, 111th Cong. § 7103(a)(3)(g)(1) (2010) (as introduced).

³⁶⁴ See H.R. 3817, § 103(a)(1)(2); H.R. 4173, § 7103(a)(1)(h)(2), (a)(1)(n)(2).

³⁶⁵ For example, under the prohibitions contained in versions of the Investor Protection Act, broker-dealers could not sell the following products because of the inherent conflicts of interest associated with them: fixed, variable, and equity indexed annuities; all forms of IRAs; mutual funds and insurance products for which the broker-dealer shares revenue with, and receives a commission from, the product sponsor; submitting client orders to market makers that are affiliated with the broker-dealer; matching buy and sell side clients where most suitable; orders to market makers where the broker-dealer receives order flow payments from the market maker for a certain volume of customer orders, among other products and practices.

firms.”³⁶⁶ The result could be that broker-dealers and investment advisers are only permitted to sell “plain vanilla” investment products and services,³⁶⁷ in which case there is no need for financial intermediaries like registered representatives and investment advisers because the broker-dealers and investment companies could market and sell these products directly on their web sites with patterned disclosures. Indeed, the current version of H.R. 4173 contemplates requiring the SEC to enforce rules that require broker dealers to make required disclosures “via the Internet.”³⁶⁸ This will ultimately negatively affect the bottom line of brokerage firms and the industry.³⁶⁹

In its testimony before Congress on the proposed fiduciary duty, SIFMA recognized that the uniform fiduciary duty outlined in the proposed financial legislation must be amended to permit investors the option to define and modify the standards which govern their brokerage relationships, lest the investing public lose the value of innovations to securities products and services to meet increasingly complex and demanding investor needs:

A new federal standard should also protect investors by respecting and preserving investor choice, which is part of putting clients first. This should include investor choice to select, contract for and receive any of the wide range of products and services offered by their financial services provider, and investor choice to define or modify

³⁶⁶ Aaron Lucchetti, *Wall Street Backs New Standards*, WALL ST. J., July 17, 2009, at C3 (noting that SIFMA supports the fiduciary standard proposed by the Obama Administration).

³⁶⁷ See Jonathan Weisman, *Economic Policy ‘Nudge’ Gives Way to a Shove*, WALL ST. J., Mar. 8, 2010, at A2 (noting that the Obama Administration is eschewing behavioral economic theory — economic policy can move people into more efficient economic behavior without “heavy-handed” regulation and legislation — for more “command and control” measures like pressing “the concept of the ‘plain vanilla’ financial products.”). However, “[t]hose ‘plain vanilla’ offerings aren’t included in the financial regulation legislation making its way through Congress.” *Id.*

³⁶⁸ H.R. 4173, § 7104(b)(1)(C).

³⁶⁹ “The ‘more stringent’ fiduciary standard could ‘exert downward pressure on revenue’” at some brokerage firms. See Lucchetti, *supra* note 366 (quoting an analyst report from Banc of America-Merrill Lynch analyst Guy Moszkowski). See also Maurice R. Greenberg, *Six Steps Toward Financial Reform*, WALL ST. J., Mar. 5, 2010, at A21 (noting that proposed Obama Administration “Volcker rule” to limit investment options of banks would create “unintended consequences of rendering our financial institutions unable to compete in today’s global marketplace.”). But see Michael R. Crittenden & Matthias Reiker, *Clash Over ‘Too Big to Fail,’* WALL ST. J., Mar. 5, 2010, at C3 (noting that Citigroup CEO Vikram Pandit testified before Congress that he embraces the Obama Administration’s “limits on banks’ ability to engage in proprietary trading.”).

relationships with their financial services provider based on the investor's preference. In light of the numerous, diverse and investor beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today's investment advisers, a new federal standard should also recognize and preserve product and service innovation and capital formation. . . . A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice and securities to individual investors.³⁷⁰

SIFMA has repeatedly cautioned "that brokers operate under very different business models than advisers," and that imposing an unalterable, uniform fiduciary duty on broker-dealers and advisers would be problematic for the industry and customers.³⁷¹ But the Obama Administration has indicated that it favors more "heavy-handed command-and-control measures" than does SIFMA, by for example pressing for the concept of compelling brokers to offer "plain vanilla" financial products, or requiring "retirement counselors to base their advice on computer models that have been certified as independent."³⁷² The administration has not indicated who it has in mind to act as the "independence certifier" under such a scenario.

*B. The Legislative Proposal to Empower the SEC to Abrogate
Mandatory Arbitration Provisions Threatens to Make FINRA
Irrelevant and Bring Retail Securities Disputes Back to Court*

Obama's draft Investor Protection Act, HR. 4173, and S. 3217 purport to provide the SEC with authority to "prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, [investment adviser], or municipal securities dealer to

³⁷⁰ *How Changes to the Financial Regulatory System could Affect Small Broker-Dealers: Hearing on H.R. 3817 Before the H. Comm. on Small Business*, 111th Cong. 7-8 (2009) (statement of E. John Moloney, President and CEO, Moloney Securities Company, Inc. and Chairman, Small Firms Committee, SIFMA), available at <http://www.sifma.org/legislative/testimony/pdf/John-Moloney-testimony-092309.pdf> [hereinafter SIFMA Testimony].

³⁷¹ *SEC Would Be Required to Develop One Fiduciary Rule Under New Plan*, Sec. Reg. & Law Rep. (BNA), No. 8, at 291 (Feb. 22, 2010).

³⁷² Jonathan Weisman, *Economic Policy 'Nudge' Gives Way to a Shove*, WALL ST. J., Mar. 8, 2010, at A2 (but also noting that for now the "'plain vanilla' offerings aren't included in the financial regulation legislation making its way through Congress.").

arbitrate any future dispute between them arising under the federal securities laws 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.”³⁷³

Interestingly, the drafts of the statutory provisions regarding abrogation of pre-dispute arbitration clauses from the Obama Administration, the House, Senator Dodd’s draft, and the final Senate bill went from a recommendation, to a strict-deadline mandate, and back to a recommendation as follows:

Investor Protection Act	HR 4173	Sen. Dodd Nov. ‘09 draft of the Financial Restoration Act	S. 3217
“The Commission, by rule, <u>may</u> prohibit, or impose conditions or limitations on the use of” pre-dispute arbitration agreements ³⁷⁴	“The Commission, by rule, <u>may</u> prohibit, or impose conditions or limitations on the use of” pre-dispute arbitration agreements ³⁷⁵	“Not later than 180 days after the date of enactment of this subsection, the Commission <u>shall</u> conduct a rulemaking to prohibit, or impose conditions or limitations on the use of” pre-dispute arbitration agreements. ³⁷⁶	“The Commission <u>may</u> conduct a rulemaking to reaffirm or prohibit, or impose <u>or not impose</u> conditions or limitations on the use of” pre-dispute arbitration agreements. ³⁷⁷

The final bill reconciling the House and Senate versions reverts back to the definition in HR 4173. Also interesting is that the Senate declined to include in its bill a provision contained in H.R. 4173 that required the Comptroller General of the United States to conduct a study of

³⁷³ S. 3217, §921(a)(1); H.R. 4173, § 7201(a)(p).

³⁷⁴ See Investor Protection Act, *supra* note 14, § 921(a)-(b) (emphasis added).

³⁷⁵ See H.R. 4173, § 7201(a)-(b) (emphasis added).

³⁷⁶ See Restoring American Financial Stability Act of 2009, S. 1074, 111th Cong. § 921(a)-(b) (2009) (draft legislation released Nov. 2009) (emphasis added).

³⁷⁷ Restoring American Financial Stability Act of 2010, S. 3217, § 921(a)-(b) (emphasis added).

the costs of arbitration compared with litigation, and the “percentage of recovery of the total amount of a claim in an arbitration proceeding. . . .”³⁷⁸

There are diverging opinions as to whether industry-sponsored arbitration favors customers over the securities industry, or vice versa. The Obama Administration has come down on the side of commentators that suggest industry-sponsored arbitration is “systematically biased” in favor of the securities industry.³⁷⁹ SIFMA took a contrary position in its testimony before Congress on the Investor Protection Act.³⁸⁰ The Financial Stability Act bill in the Senate begs off a mandatory rule, but does provide the SEC with discretion to bar pre-dispute arbitration provisions, and without a requirement that the SEC obtain empirical data to support such a prohibition, as was required by HR 4173.³⁸¹

SIFMA references its own 2007 whitepaper on mandatory pre-dispute arbitration provisions, and argues that arbitration provisions favor customers because arbitration is “faster and less expensive than litigation,” thus enabling small investors to bring claims they could not otherwise afford to litigate.³⁸² In addition, SIFMA recognizes the “relaxed pleading standards in securities arbitration,” juxtaposed against “[r]ecent Supreme Court decisions [that] make certain that investors are far more likely to have their claims dismissed in court” rather than in arbitration.³⁸³ SIFMA reports that “the percentage of claimants that recover in securities arbitrations . . .

³⁷⁸ H.R. 4173, § 7202.

³⁷⁹ See Gedicks, *supra* note 84, at 565 (noting “widespread criticism of the arbitration process as ‘pro-industry and anti-investor’” (quoting Renee Barnett, Comment, *Online Trading and the National Association of Securities Dealers’ Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1105 (2000))).

³⁸⁰ SIFMA Testimony, *supra* note 370, at 9-10. This is not the first time predispute arbitration agreements have been attacked. In 1988 the “Securities Arbitration Reform Act” was introduced as an amendment to the ’34 Act and would have prohibited broker-dealers from entering into predispute arbitration agreements with customers “so long as that agreement is a condition for establishing a customer account.” SIFMA Whitepaper, *supra* note 134, at 1-2. The proposal was subject to three hearings in the House of Representatives and was commented on by representatives and scholars from the securities industry, claimants bar, and legal community. Congress did not pass the legislation. See *id.*

³⁸¹ See H.R. 4173, §7202.

³⁸² See *Hearings*, *supra* note 138, at 25 (statement of Randolph C. Snook).

³⁸³ See SIFMA Whitepaper, *supra* note 134, at 3 (referencing *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). See also *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1954 (2009).

has remained constant in recent years and average inflation-adjusted recoveries have been increasing.”³⁸⁴

SIFMA argues that prohibiting pre-dispute mandatory arbitration provisions in exchange for voluntary post-dispute arbitration is “tantamount to doing away with securities arbitration” because claimants will seek “litigation to drive up costs and spur nuisance settlements,” to seek “jackpot justice,” or shop forums with anti-business jury pools.³⁸⁵ Securities firms, on the other hand, will seek litigation to drive up costs for claimants with extensive discovery and motion practice.³⁸⁶ Either way, SIFMA argues that eliminating mandatory pre-dispute arbitration provisions in exchange for voluntary post-dispute arbitration provisions will result in costlier and lengthier disputes for both sides.³⁸⁷ According to SIFMA, this will also “result in a complete denial of justice for individuals with smaller claims.”³⁸⁸

As mentioned above, the U.S. House, recognizing the debate, drafted a provision in H.R. 4173 that required the Comptroller of the United States to conduct a study to review the costs to parties of arbitration proceedings before FINRA compared to litigation, “the percentage of recovery of the total amount of a claim” in a FINRA arbitration, and any additional issues “raised during the course of the study.”³⁸⁹ The report was to be delivered to Congress no later than one year after the Investor Protection Act is enacted, and include any recommendations by the SEC on how to improve the arbitration system.³⁹⁰

Unfortunately, the Senate bill declined to require such a study, and instead provided the SEC with discretion to bar pre-dispute arbitration provisions. However, Congress did require the SEC to adopt such a bar

³⁸⁴ *Hearings*, supra note 138, at 25 (statement of Randolph C. Snook). *See also* SIFMA Whitepaper, supra note 134, at 4 (explaining that the percentage of claimants who recover by award or settlement “has held steady in recent years, and in 2006 was 66 percent. Between 1995 and 2004, investors’ average inflation-adjusted recoveries in securities arbitration have followed a generally increasing trend.”).

³⁸⁵ *See Hearings*, supra note 138, at 25-26 (statement of Randolph C. Snook).

³⁸⁶ *See id.* at 26.

³⁸⁷ *See id.*

³⁸⁸ *Id.* at 26. SIFMA notes in its 2007 Whitepaper, which studies empirical data on securities arbitration, that a 1998 study showed that average legal costs were \$12,000 less in arbitration compared to litigation. SIFMA notes the inflation-adjusted amount would be \$22,000 in 2007, and that the gap is likely to be “substantially wider” today because more recent studies show a “significant increase in litigation costs since 1988.” SIFMA Whitepaper, supra note 134, at 3.

³⁸⁹ H.R. 4173, § 7202.

³⁹⁰ *See id.* § 7202(b).

only after a formal SEC rulemaking process, which will require input, and presumably studies, from industry and customers.³⁹¹

*C. The Catch-22 of Statutory Whistleblower Rewards for Plaintiffs
— Do They Forecast the End of Big-Money Private Remedies
Under the Securities Acts in Exchange for the Modest Private
Remedies for Breaches of Fiduciary Duty Under the Investment
Advisers Act?*

The Investor Protection Act, H.R. 4173, and the Senate bill all propose to empower the SEC to financially reward, and protect from retaliation, securities fraud whistleblowers.³⁹² If the fraud exposed by the whistleblower results in a monetary sanction of \$1 million or more, the SEC may pay as an award to the whistleblower an amount not exceeding 30 percent of the total sanction.³⁹³ The Senate bill limits the award to not more than 30% “of what has been collected” of the total sanction, but also provides for a minimum award of “not less than 10%” of the total sanction collected.³⁹⁴ One of the factors the SEC may consider when determining an award amount is “the degree of assistance provided by . . . any legal representative of the whistleblower in such action.”³⁹⁵

Congress also provides a new cause of action for whistleblowers against an employer for retaliating against a whistleblower employee reporting under the statute, and provides statutory penalties of “two times the amount of back pay” due the employee “with interest,” and compensation for “litigation costs, expert witness fees, and reasonable attorneys’ fees.”³⁹⁶ The Senate bill did not include a provision in H.R. 4173 that also provided whistleblowers with any “special damages” incurred.³⁹⁷ Whistleblower claims receive a generous six year statute of limitations period.³⁹⁸

³⁹¹ See S. 3217, § 921.

³⁹² See Investor Protection Act, *supra* note 14, § 922(a) (draft legislation); H.R. 4173, *supra* note 16, § 7203(a).

³⁹³ See Investor Protection Act, *supra* note 14, § 922(a) (draft legislation); H.R. 4173, *supra* note 16, § 7203(a).

³⁹⁴ See S. 3217, § 922(b)(1)(B).

³⁹⁵ Investor Protection Act, *supra* note 14, § 922((b)(1); S. 3217, § 922(c)(1)(B)(ii); H.R. 4173, § 7203(b)(1).

³⁹⁶ Investor Protection Act, *supra* note 14, § 922(g)(1)(A)-(B); S. 3217, § 922(h)(1)(C); H.R. 4173, § 7203(g)(1)(C).

³⁹⁷ See H.R. 4173, § 7203(g)(1)(C).

³⁹⁸ See Investor Protection Act, *supra* note 14, § 922(g)(1)(C)(ii); S. 3217, § 922(h)(1)(B)(iii); H.R. 4173, § 7203(g)(1)(B)(iii).

Whistleblowers and their lawyers would be paid out of an Investor Protection Fund to be established by the Treasury Department and available to the SEC.³⁹⁹ The Investor Protection Fund will be funded by monetary and disgorgement sanctions collected by the SEC.⁴⁰⁰ In a bit of irony, the SEC is permitted to invest amounts from the Investor Protection Fund in guaranteed obligations of the United States, but only so long as the maturities are “suitable” to the needs of the Fund as determined by the SEC.⁴⁰¹

1. *Potential for Serial Litigants and Lawyers*

The obvious policy rationale of the Whistleblower provisions is to encourage employees and officers to report fraud, especially in situations where the SEC cannot otherwise detect it. While this is certainly a noble policy, the approach taken by the Obama Administration to achieve it may produce unintended and unwelcome collateral results, so much so the Administration may have cut off its nose to spite its face.

The primary issue to be addressed is the most obvious: will the incentive for large rewards for both reporting securities fraud, and a separate action for retaliation, produce scores of meritless or fabricated reports of securities fraud by would-be whistleblowers? If so, what affect will this have on the brokerage industry? An example of the potential pitfalls is the abuse that has occurred under the Americans with Disabilities Act of 1990 (ADA).⁴⁰² The ADA carries out the noble policy of ensuring people with disabilities have equal access to public buildings.⁴⁰³ To facilitate this policy, Congress provides a private right of action for disabled persons against owners of buildings that have barriers to equal access.⁴⁰⁴ The ADA permits the recovery of attorney fees and costs for prevailing in a lawsuit alleging barriers to access in violation of the ADA, and prohibits retaliation against employees that cooperate in reporting and removing barriers to access.⁴⁰⁵

The ADA has been abused by some litigants and lawyers. The scenario goes like this: a lawyer finds a named plaintiff that is disabled. The lawyer then files hundreds of complaints on behalf of the plaintiff

³⁹⁹ See Investor Protection Act, *supra* note 14, § 922(f); S. 3217, §922(g); H.R. 4173, §7203(f).

⁴⁰⁰ See Investor Protection Act, *supra* note 14, § 922(f)(2); S. 3217, §922(g)(3); H.R. 4173, § 7203(f)(3)(A).

⁴⁰¹ See Investor Protection Act, *supra* note 14, § 922(f)(3)(B); S. 3217, § 922(g)(4)(B); H.R. 4173, § 7203(f)(4)(B);.

⁴⁰² American with Disabilities Act of 1990, 42 U.S.C. §§ 12101-13 (1990).

⁴⁰³ 42 U.S.C. § 12101(b) (2006).

⁴⁰⁴ 42 U.S.C. § 12188 (2006).

⁴⁰⁵ 42 U.S.C. §§ 12203, 12205 (2006).

against businesses big and small alleging barriers to equal access. Sometimes the lawyers will incorporate a non-profit corporation with a catchy name, like the Disabled Patriots of America, through which plaintiffs will file lawsuits after joining the organization.⁴⁰⁶ The lawyers quickly settle with the building or business owner because the plaintiffs' lawyers do not want to spend too much money in discovery on one lawsuit, and the building owners do not want to spend money litigating in lieu of trying to cure the barriers as defined by the ADA and implementing regulations, if any barriers exist.⁴⁰⁷ Often times, the complaints filed by the lawyers are identical, and plaintiffs have no real interest in ensuring any barriers to access are actually removed.⁴⁰⁸

The abuse has caused much work for the federal courts, both in the volume of lawsuits and in policing lawyers who do not perform any pre-suit investigation and have no good faith basis for filing the claim. For example, a lawyer filed an ADA lawsuit against a gas station alleging in the complaint that plaintiff was a quadriplegic and a member of the named disability group plaintiff. At his deposition, the plaintiff walked into the deposition (clearly not a quadriplegic), testified he wasn't sure he was a member of the named disability group, he had never met the lawyer before the deposition, he had never seen the complaint filed on his behalf, and had no idea he had been identified as a quadriplegic in the complaint.⁴⁰⁹

The federal court handling this case and many others filed by the same lawyer had to appoint a special master to review all complaints filed by this lawyer to ensure that "proper pre-suit investigation had taken place."⁴¹⁰ In addition, some states enacted tougher ADA statutes providing additional remedies for emotional distress and punitive damages.⁴¹¹ These lawsuits have raised the costs of doing business in many communities, and caused some small businesses to simply close their doors.⁴¹² But the most

⁴⁰⁶ See Andrew Dietderich, *Advocates File ADA Suits Against Local Hotels, Malls*, CRAIN'S DETROIT BUS., June 28, 2004, at 1 (noting that the Disabled Patriots of America and its lawyers have filed over 600 lawsuits through the date of the article).

⁴⁰⁷ See, e.g., Keith Matheny, *ADA Violation Lawsuits: Legit or for profit?*, DESERT SUN, Aug. 9, 2009 at 1; Press Release, Sen. Tom Harman, ADA Compliance and Lawsuit Abuse (Apr. 9, 2007), <http://cssrc.us/web/35/news.aspx?id=1080&AspxAutoDetectCookieSupport=1>; Dietderich, *supra* note 406.

⁴⁰⁸ See *id.*

⁴⁰⁹ See Dietderich, *supra* note 406.

⁴¹⁰ *Id.*

⁴¹¹ See Harman, *supra* note 407.

⁴¹² See *id.*

deleterious effect of these “bogus claims” is that they undermine the credibility of “the legitimate disabled community.”⁴¹³

The circumstances are different between a private ADA plaintiff and a whistleblower under the financial overhaul legislation. But one need not think long to imagine how one or a group of would-be whistleblowers and their lawyers may organize efforts similar to those under the ADA. Brokerage firms will have incentive to quickly settle a bogus claim by a threatening whistleblower to avoid the costs and bad press generated by an SEC investigation or enforcement action, no matter how bogus the claim. Furthermore, if the would-be whistleblower remains employed by the broker-dealer, the broker-dealer will have to consider a retaliation lawsuit by the whistleblower in any future employment action involving the whistleblower (e.g., passed promotion, termination), even if cause exists in the form of deficient or risky job performance. This will raise the costs of doing business for both broker-dealers and their customers.

Congress should study ways to offset the potential abuses incumbent with the whistleblower reward provision in the financial reform legislation; perhaps create a requirement that a whistleblower notify the broker-dealer of the perceived fraud before filing suit. The House bill does pay lip service to this risk by drafting a provision that reminds whistleblowers they are subject to criminal penalties under 18 U.S.C. §1001 for making false claims.⁴¹⁴ But the ADA plaintiffs and lawyers are subject to the same penalties for false statements, testimony, and claims under 18 U.S.C. § 1621, and it has done little to stem the tide of bogus lawsuits. Failure to remedy this issue risks creating a series of bad faith whistleblower reports and retaliation lawsuits under the financial reform legislation that may undermine the credibility of whistleblowers reporting legitimate securities fraud concerns.⁴¹⁵

2. Is the Whistleblower Provision an Offset for Reduced Damage Remedies for Securities Fraud Plaintiffs?

The whistleblower provision is likely a response to the recent criticism that the SEC’s enforcement division has not historically “aggressively pursu[ed] tips and whistle-blower complaints,” citing the

⁴¹³ *Id.*

⁴¹⁴ See H.R. 4173, §7203(h).

⁴¹⁵ Even legitimate whistleblowers face legal dilemmas if they blow the whistle in the wrong manner or to the wrong agency. See, e.g., Arden Dale, *UBS Whistle-Blower Rues the Tack, Not Tune*, WALL. ST. J., Apr. 9, 2010, at C2 (noting that tax-fraud whistleblower was prosecuted for providing incomplete information to Congress, the SEC, and the Department of Justice, and documenting whistleblower-reward program the IRS created in 2006).

Bernie Madoff debacle as the agency's "biggest black eye."⁴¹⁶ But are the whistleblower reward and fee provisions enacted to offset the potential that securities plaintiffs will lose their implied private right to bring big-money damage lawsuits against broker-dealers and others under the '34 Exchange Act, in exchange for the limited private remedies afforded for an investment adviser's breach of his fiduciary duties under the Investment Advisers Act?⁴¹⁷

The Supreme Court reaffirmed the fiduciary duty required by the Investment Advisers Act in *Transamerica Mortgage Advisers, Inc. v. Lewis*.⁴¹⁸ Section 206 of the Advisers Act proscribes wrongful and fraudulent conduct similar to that which is proscribed under Rule 10b-5 of the '34 Exchange Act.⁴¹⁹ However, unlike Rule 10b-5, section 206 of the Advisers Act specifies that the fraud and wrongful conduct is prohibited against "any client or prospective client."⁴²⁰ Also, unlike Rule 10b-5, section 206 creates a fiduciary duty on the investment adviser towards his client.⁴²¹ Because of this fiduciary duty, a plaintiff need not plead or prove intent or scienter to impose liability on an investment adviser under section 206—negligence will suffice.⁴²²

Just as the liability standard is less onerous under the Advisers Act compared with the '34 Exchange Act, so are the remedies. The Supreme Court has interpreted section 206 as precluding private rights of action for damages.⁴²³ Instead, private plaintiffs are limited to recovering the right to rescind their investment adviser contact, enjoin the adviser's violation of section 206, and restitution of fees paid to the adviser.⁴²⁴ This is contrary to

⁴¹⁶ Scannell, *supra* note 51.

⁴¹⁷ See *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 19-24 (1979) (holding that private implied remedies under the Investment Advisers Act for violation of an adviser's fiduciary duties preclude monetary awards for diminution of the value of investments, and are limited to rescission of the adviser-customer agreement and restitution of any consideration paid for the agreement (fees) less "any value conferred by the other party." (quoted in *Morris v. Wachovia Sec.*, 277 F. Supp. 2d 622, 644 (E.D. Va. 2003))).

⁴¹⁸ *Lewis*, 444 U.S. 11.

⁴¹⁹ Compare 15 U.S.C. § 80b-6 (2006), with 17 C.F.R. § 240.10b-5 (2009).

⁴²⁰ 15 U.S.C. § 80b-6(1)-(3) (2006).

⁴²¹ See *Morris*, 277 F. Supp. 2d at 644 (citing *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 373 U.S. 180, 191-92 (1963)).

⁴²² See *Morris*, 277 F. Supp. 2d at 644.

⁴²³ See *Transamerica*, 444 U.S. at 24. The remedies for SEC enforcement actions—disgorgement, statutory penalties, and injunctive relief—are substantially the same under both the '33 and '34 Acts and the Advisers Act. Compare 15 U.S.C. § 77t (2006), with 15 U.S.C. § 77u (2006), and 15 U.S.C. § 80b-9 (2006).

⁴²⁴ See *Morris*, 277 F. Supp. 2d at 643 (citing *Transamerica*, 444 U.S. at 17-19).

the multi-million dollar securities fraud verdicts plaintiffs have received for violations of the '33 and '34 securities acts. So the trade-off appears to be that while plaintiffs may have an easier time proving liability against investment advisers, the payoff is commensurately smaller.

These facts beg the question: 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? Perhaps this is why the financial reform legislation provides handsome rewards and protections to whistleblowers and their lawyers; an olive branch for gutting big damage securities fraud cases, and another avenue to assist the SEC with discovering and investigating securities fraud.

D. It is a Mistake For Congress to Provide the SEC With Carte Blanche Regulatory Authority Because by Doing So Congress Fails to Heed the Lessons From the Troubles Caused by the SEC's Rule 10b-5

The fiduciary standards and supporting policies in the Obama Whitepaper and proposed legislation leave in their wake many serious questions about the SEC's ability to create workable, practical, and enforceable fiduciary standards for broker-dealers and investment advisers. These questions must be answered by Congress at the policy stage in order to avoid problems similar to the controversial and differing standards by the courts and the SEC in interpreting Congress' section 10(b) of the '34 Exchange Act and the SEC's implementing rule 10b-5. If not, the new financial legislation and the SEC's implementing regulations will be litigated in the courts for years, be subject to serious and substantial changes, and breed uncertainty and differing standards of liability for investment advisers and broker-dealers, effectively raising the costs of securities products for customers.⁴²⁵ Even President Obama's Treasury Secretary has reminded the SEC, in connection with the negotiations of financial regulatory reform, that "the administration and Congress set policy, not the regulatory agencies."⁴²⁶

The various versions and justifications of the proposed uniform fiduciary duty on broker-dealers and investment advisers by the Obama Administration do not provide enough guidance to the SEC and provide

⁴²⁵ See generally, *Stoneridge Inv. Part., LLC v. Scientific-Atlantic*, 552 U.S. 148, 163 (2008) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)).

⁴²⁶ Damian Paletta & Deborah Solomon, *Geithner Vents at Regulators as Overhaul Stumbles*, WALL ST. J., Jan. 23, 2009 at A4.

entirely too much authority to regulate this important issue, arguably subjecting the SEC to a *Chevron* challenge.⁴²⁷ Among other things, Congress must raise and address the many serious policy questions before enacting legislation that will provide the SEC with so much authority.⁴²⁸

- When will broker-dealers be considered to be “providing personalized investment advice”?
- What is the difference between “the public interest” and “the protection of investors” that provide the SEC power to regulate the merits of securities products?
- Who is a “retail” investor? Does this include sophisticated institutional investors?
- Does “aligning” the broker-dealer’s fiduciary standard with the “legal framework” of investment advisers mean that broker-dealers will be subject to the Investment Advisers Act? And if so, will broker-dealers have concurrent obligations under the ‘33 and ‘34 securities acts? Will broker-dealers be required to have both a brokerage and adviser chief compliance officer and back office?
- How does Congress and the SEC avoid with the Investor Protection Act and the SEC’s implementing fiduciary duty regulations the same problems encountered with courts

⁴²⁷ In *Chevron USA, Inc. v. Natural Res. Def. Counsel, Inc.*, 467 U.S. 837 (1984), the U.S. Supreme Court set forth a two-step analysis to determine whether a regulation of a governmental agency like the SEC is within the scope of the congressional statutory provision pursuant to which the regulation was issued. The Federal Court of Appeals in the District of Columbia rejected the SEC’s attempt to regulate an exception from the Advisers Act for broker-dealers offering brokerage fee accounts along with their traditional commission-based accounts. *See* Financial Planning Assoc. v. Sec. & Exch. Comm’n, 482 F.3d 481 (D.C. Cir. 2007). The court found that the SEC exceeded its authority using the *Chevron* analysis. And if the SEC is provided the broad and unguided authority contemplated by the Obama Administration, and to a lesser extent by Congress, there are certain to be many lawsuits challenging whatever new regulations the SEC issues.

⁴²⁸ After the Author sent a copy of the manuscript of this Article, including the questions below, to Congressman Barney Frank on August 24, 2009, Congressman Frank sponsored H.R. 4173, which includes various new provisions in the Investor Protection Act that attempt to address some of the questions raised below. Then the Senate bill went further and adopted one of the primary premises in this article and compelled the SEC to first conduct a detailed study to address some of these questions. *See* S. 3217, § 913(b). The efficacy of these new provisions is analyzed herein.

trying to interpret Congress' section 10(b) and the SEC's implementing rule 10b-5?

- What remedies if any will be available to private plaintiffs against broker-dealers for violations of the new fiduciary duty? Are private plaintiffs limited to the contract-rescission remedy of the Advisers Act? Or can they still sue for lost-investment value under the '33 and '34 securities acts?
- Will customers be able to waive the prohibition of broker-dealers and investment advisers selling profitable products that are "not in the investors' best interest"? What does it mean for a product to be "profitable" and thus subject to regulation under the Investment Advisers Act? And what is an investor's "best interest"? Can it ever be trying to obtain larger investment returns by purchasing riskier securities?
- Will broker-dealers and investment advisers be relegated to only selling simple, less profitable securities products to retail investors? Will this stymie creation of investment products that keep up with the increasing complexities of the global financial market? Will this drive investors to non-U.S. markets and exchanges to find riskier and thus more profitable products?
- If broker-dealers and investment companies are limited to selling only less profitable, "plain vanilla" securities products, will there be a future need for registered representatives or investment advisers since broker-dealers and investment companies could simply list these products for purchase via telephone or website with boilerplate disclosures?

Leaving these questions for the courts will create an avalanche of new securities lawsuits by the plaintiffs bar seeking to stretch the theories and limits of liability as far as possible, and create vastly different standards of liability in the thirteen federal circuits. This is just what happened and is happening with section 10(b) and rule 10b-5. The Obama Whitepaper makes this point by acknowledging the rift developed in the courts on what standards of conduct define primary liability under section 10(b) and rule 10b-5.⁴²⁹

But it is a mistake to leave rulemaking on the section 10(b) primary liability issue up to the SEC, as proposed by the Obama Administration, because the SEC will try to expand its power, authority, and liability

⁴²⁹ See Obama Whitepaper, *supra* note 3, at 73.

standards as far as the courts will let it. Indeed, the Supreme Court recently declared the SEC went too far with its definition of who could be primarily liable under section 10(b) when it rejected the SEC's theory of primary liability adopted by the Ninth Circuit.⁴³⁰ Why would the Obama Administration again leave it up to the SEC? These lessons reveal that it is Congress, and not the SEC, that must address these issues head-on at the policy stage, to avoid improperly subrogating the policy function to the courts and the SEC.

1. *Exhibit One: The Confusion Caused by the SEC's Attempts to Impose "Scheme Liability" Standards under Section 10(b) of the '34 Exchange Act*

At a time when private litigants and the SEC are searching for additional ways to charge defendants with securities fraud, the standards which govern the securities laws are in flux. Federal appellate courts across the country have reached vastly different conclusions when looking at what conduct can be prosecuted under Congress' section 10(b), and the SEC's implementing rule (rule 10b-5). Even though the Supreme Court recently weighed in with its opinion in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,⁴³¹ debate still rages about precisely what conduct is proscribed by section 10(b).

Section 10(b) prohibits any "manipulative or deceptive device" that contravenes SEC rules and regulations.⁴³² SEC rule 10b-5 proscribes the following in connection with the purchase or sale of securities: (a) employing any "device, scheme, or artifice to defraud;" (b) making untrue statements or omissions of material facts; (c) engaging in any act or practice that operates as a "fraud or deceit."⁴³³ Courts have struggled mightily over the years to determine what conduct subjects a defendant to liability under these standards.

The focal point of the debate is whether, to be primarily liable for securities fraud under rule 10b-5(b), a defendant must actually communicate a deceptive statement or act directly to the investing public in connection with the purchase or sale of securities—the "bright line test"—or whether primary liability may attach with a finding that a defendant participated in a "scheme to defraud," even if he didn't directly communicate alleged misinformation to investors in prospectuses, press

⁴³⁰ See *Stoneridge*, 552 U.S. 148, 162 (2008).

⁴³¹ *Id.* at 148.

⁴³² See 15 U.S.C. § 78j (2000).

⁴³³ 17 C.F.R. § 240.10b-5 (1951).

releases, SEC filings, or statements to analysts.⁴³⁴ Since the Supreme Court interprets the securities laws as precluding private rights of action for aiding and abetting liability,⁴³⁵ private plaintiffs and the SEC have been advocating a broader standard for primary liability.

Some courts follow the bright line test, which requires that a defendant actually make a direct statement to the investing public that contains a misstatement or omission of material fact.⁴³⁶ This limits the class of potential defendants. The bright line test is based on previous Supreme Court precedent that said Congress proscribed only two types of fraud in section 10(b): deception and manipulation.⁴³⁷ The Court holds that a “manipulation” under section 10(b) is a “term of art” that only applies to situations where a defendant manipulates the market with “wash sales, matched orders, or rigged prices”;⁴³⁸ while deception is a misstatement or omission by a defendant in statements to investors. Because the SEC is not empowered to extend liability beyond conduct proscribed in section 10(b),⁴³⁹ some courts and commentators reason that section 10(b) “manipulation” cases are governed by the “scheme” language in rule 10b-5(a) and (c), while deception cases under section 10(b) are governed by the misstatement or omission language in rule 10b-5(b). Thus, only rule 10b-5(b) is implicated in cases involving alleged misstatements or omissions to investors.⁴⁴⁰

The SEC and securities plaintiffs advocate a broader standard for primary liability in cases involving misstatements to the public, arguing that a defendant may be generally liable under rule 10b-5 for participating in a “scheme” to cause misrepresentations by other defendants to the investing public.⁴⁴¹ These courts and commentators find that application of rule 10b-5(a) and (c) is not limited to market “manipulation” cases, and may be applied with equal force in cases involving misrepresentations. The

⁴³⁴ See Daniel A. McLaughlin, *Liability Under Rules 10b-5(a) and (c)*, 31 DEL. J. CORP. L. 631, 655 (2006).

⁴³⁵ See, e.g., *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

⁴³⁶ See *City of Monroe v. Bridgestone Corp.*, 399 F.3d 651, 690 (6th Cir. 2005); *In Re Comshare*, 183 F.3d 542, 548 (6th Cir. 1999); *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990); *DE & J. Ltd. P’ship v. Conaway*, 284 F. Supp. 2d 719, 730 (E.D. Mich. 2003) (quoting *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)). The Sixth Circuit has also called this the “direct contacts” test. See *Sec. & Exch. Comm’n v. Washington County*, 676 F.2d 218 (6th Cir. 1982); *Sec. & Exch. Comm’n v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).

⁴³⁷ See *Cent. Bank of Denver*, 511 U.S. at 177.

⁴³⁸ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

⁴³⁹ See *U.S. v. O’Hagan*, 521 U.S. 642, 651 (1997).

⁴⁴⁰ See, e.g., McLaughlin, *supra* note 434, at 638-39.

⁴⁴¹ See *id.*

broadest scheme liability standard was adopted by the Ninth Circuit in *Simpson v. AOL Time Warner, Inc.*,⁴⁴² which was taken from the SEC's amicus brief in that case. The Ninth Circuit held that a defendant can be primarily liable if he "substantially participates" in a "scheme to defraud," and that "the challenged conduct of the defendant had a principal purpose, and not just an accidental effect, of creating a false appearance as part of a deceptive transaction or fraudulent scheme."⁴⁴³

The Supreme Court rejects the formulation of primary liability set forth in *Simpson*, finding that a defendant must communicate a deceptive misstatement or act to the investing public to be liable for a deception under rule 10b-5, otherwise "there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees. Our precedents counsel against this extension."⁴⁴⁴

The Court also notes that the SEC's "scheme liability" standard "would revive in substance" aiding and abetting liability in private actions that the Court previously ruled was prohibited in *Central Bank*.⁴⁴⁵ The Court noted that the SEC, by statute, can still pursue claims of aiding and abetting violations of section 10(b) against defendants who do not make direct statements to the investing public, as long as all the elements of the aiding and abetting statute are properly pled and proved.⁴⁴⁶ In other words, the primary "scheme" liability standard proposed by the SEC and the securities plaintiffs bar would render Congress' SEC aiding and abetting statute nugatory.

While *Stoneridge* seems to support the "bright line" test requiring a direct statement to the investing public to support securities fraud liability, the SEC and the securities plaintiffs' bar have latched on to a statement by the Court that "conduct itself can be deceptive."⁴⁴⁷ They argue this means deceptive acts are not limited to oral or written statements, leaving open the possibility that defendants that do not directly communicate anything to the investing public may still be subject to "scheme liability." Arguably, the Court's statement is dicta because it was conceded by the parties and neither briefed nor argued.⁴⁴⁸ But cases decided post-*Stoneridge* reveal

⁴⁴² *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).

⁴⁴³ *Id.* at 1048.

⁴⁴⁴ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 161 (2008).

⁴⁴⁵ *See id.* at 162-63.

⁴⁴⁶ *See id.* at 163-64, 166.

⁴⁴⁷ *Id.* at 158.

⁴⁴⁸ The Court is "not bound to follow [its] dicta in a prior case in which the point now at issue was not fully debated." *Cent. Virginia Comty. Coll. v. Katz*, 546 U.S.

courts are open to and debating ever-widening definitions of primary securities liability.⁴⁴⁹

The SEC is also jockeying with the Obama Administration to use its overhaul of financial regulation as a way to end-run *Stoneridge* and possibly legislate a scheme liability standard. Indeed, the Treasury Department's whitepaper on financial regulatory reform says that "[t]he SEC also proposes amending the federal securities laws to provide a single explicit standard for primary liability to replace various circuits' formulations of different 'tests' for primary liability."⁴⁵⁰ While the first drafts of the proposed Investor Protection Act from the U.S. Treasury and Congress do not yet take up this SEC cause, they do broaden the SEC's authority which could leave the SEC free to try and regulate around *Stoneridge* with the imprimatur of Congress.

Given the split in the circuits regarding the need for a direct statement by the defendant, the standard for establishing primary liability for participation in a scheme to defraud is currently uncertain. Congress should study and then legislate clear and specific rules regarding primary liability under the proposed legislation lest we repeat a debate similar to the "scheme liability" debate that still rages in the courts.

E. *The Senior Investment Protection Provision — Requiring the SEC to Oversee Individual State Implementation of FINRA's Suitability Rules for Annuities; A Jurisdictional Quagmire?*

As discussed in Part I.B.5 of this Article, H.R. 4173 creates the Senior Investment Protection Program ("the Program"). As drafted, the Program requires the SEC to establish and oversee a grant program that will provide certain states with federal funds to better protect seniors purchasing certain "financial products," defined as "securities" and "insurance products," the definition of which includes "insurance products which pay a return, whether fixed or variable."⁴⁵¹ The Act appropriates \$8 million to the SEC to fund this grant program,⁴⁵² but limits each State to \$500,000 per fiscal year, and only if that state complies with various requirements.⁴⁵³

356, 363 (2006). Moreover, the *Stoneridge* Court's resolution of this question was not relevant to or required for the Court's true holding: "[i]n this case . . . respondents' course of conduct included both oral and written statements." *Stoneridge*, 552 U.S. at 158.

⁴⁴⁹ See, e.g., *In re Mutual Funds Inv. Ltd.*, 566 F.3d 111 (4th Cir. 2009); Sec. & Exch. Comm'n v. Lucent Tech., Inc., 610 F. Supp. 2d 342 (D.N.J. 2009).

⁴⁵⁰ Obama Whitepaper, *supra* note 3.

⁴⁵¹ H.R. 4173, §7702(2).

⁴⁵² See *id.* §7706.

⁴⁵³ See *id.* §7703(b).

These grant requirements include that the State: 1) adopt “standard rules on the suitability requirements in the sale of securities,” which at a minimum must conform to FINRA’s suitability requirements; and 2) adopt suitability and supervision rules for “insurers and insurance producers” for all annuity products sold in the State that are at least as protective as FINRA Rule 2821, entitled “Members’ Responsibilities Regarding Deferred Variable Annuities.”

Thus, at the same time H.R. 4173 creates a federal fiduciary standard, it only requires States receiving federal grant money under the Act to adopt FINRA’s suitability rules for sales of securities and certain “insurance products,” with a focus on variable annuities. The Act requires states to “coordinate” FINRA’s rules “governing broker dealers” for “state insurance regulators to rely on.” Recognizing the tension on broker-dealers operating under a federal fiduciary standard while selling annuity products that are created by insurers operating under a state suitability standard, the Act permits states to grant “exemption from such rules only if such exemption is consistent with the protection of consumers.”⁴⁵⁴ In addition to the operational confusion for broker-dealers attempting to sell variable annuities to customers in 50 different states with potentially 50 different rules governing the sales of variable annuities, a more important and fundamental jurisdictional question is raised.

FINRA only has jurisdiction to regulate “securities” sold by securities brokerage firms.⁴⁵⁵ FINRA concedes that it does not have jurisdiction over insurance products “licensed and regulated by state insurance commissions.”⁴⁵⁶ *A fortiori*, FINRA rules only apply to securities sold by broker-dealers—they do not apply to insurance products sold by insurance agents governed by state insurance laws. By giving the SEC exclusive jurisdiction to create and oversee the Senior Investment Protection Program, and apply FINRA’s rules to states under the Program, Congress may have made the same mistake as FINRA by presuming that

⁴⁵⁴ *Id.* §7703(c)(5)(B)(vii)-(viii).

⁴⁵⁵ See FINRA, *About the Financial Industry Regulatory Authority*, www.finra.org/AboutFINRA/index.htm; see also FINRA, *Help Your Employees Achieve Their Retirement Dream: Tips for Spotting Early Retirement Scams*, <http://www.finra.org/investors/smartinvesting/retirement/p038341> (noting that FINRA only has jurisdiction over securities brokerage firms).

⁴⁵⁶ See FINRA, *Help Your Employees Achieve Their Retirement Dream: Tips for Spotting Early Retirement Scams*, <http://www.finra.org/investors/smartinvesting/retirement/p038341>.

“variable insurance products are securities.”⁴⁵⁷ In many, if not most states, they are not.

In Michigan, for example, the Insurance Code defines variable annuities as a “line of insurance,”⁴⁵⁸ and has express provisions dealing with variable annuities.⁴⁵⁹ Not only that, Michigan’s Uniform Securities Act expressly excludes all manner of fixed and variable annuity products from the definition of “security” under the Act.⁴⁶⁰ Therefore, variable annuities are regulated in Michigan as insurance products, and fall under the jurisdiction of the Michigan Office of Financial and Insurance Services and its Commissioner.⁴⁶¹ Because FINRA admittedly does not have jurisdiction over insurance products regulated by state insurance commissioners, it is interesting (and perhaps even unconstitutional) that the Act conditions federal grant funds to states on those states regulating their insurance products under rules that are not intended to regulate insurance products.⁴⁶² Indeed, Congress notes in a separate House bill, related to overall systemic risk to the financial system, that the “appropriate financial regulator” for “any financial institution engaged in providing insurance under State insurance law” is “[t]he State insurance authority of the State in which an insurance company is domiciled.”⁴⁶³ Congress may have its work cut out for it on completing and implementing the Senior Investment Protection Program; if not, the courts will.⁴⁶⁴

⁴⁵⁷ FINRA Investor Alert, *Seniors Beware: What You Should Know About Life Settlements*,

<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/P018469> (last visited June 23, 2010).

⁴⁵⁸ MICH. COMP. LAWS § 500.1206(e) (2010).

⁴⁵⁹ See, e.g., MICH. COMP. LAWS § 500.4073 (2010).

⁴⁶⁰ See MICH. COMP. LAWS § 451.2102c(c)(iii) (2010).

⁴⁶¹ See MICH. COMP. LAWS § 500.102, 202 (2010); see also Mark Maremont & Leslie Scism, *Investors Recruit Terminally Ill to Outwit Insurers on Annuities*, WALL ST. J., Feb. 16, 2010, at A1.

⁴⁶² A full constitutional analysis of this issue is outside the scope of this Article, the Journal’s space constraints, and this Author’s time constraints and intellectual bailiwick.

⁴⁶³ See Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong., § 1403 (1st Sess. 2009).

⁴⁶⁴ See, e.g., Tara Siegel Bernard, *Struggling Over a Rule for Brokers*, N.Y. TIMES, Feb. 16, 2010 (noting the insurance industry is opposed to the additional regulations proposed by Congress because their agents are already subject to various regulatory exams, including exams conducted by FINRA); see also Kimberley Strassel, *Carbon Caps Through the Backdoor*, WALL ST. J., Mar. 5, 2010, at A19 (opining that National Association of Insurance Commissioners (NAIC) and environmental special interest groups are creating regulations to impose cap and trade rules that otherwise cannot be passed by state governors or

IV. PENDULUM POLICY EFFECTS OF INCREASED REGULATION OF BROKER-DEALERS — A CALL FOR CONGRESSIONAL FORESIGHT OF MODERATION

Regulation of the U.S. securities industry has two seasons: 1) calls for increased regulation in the wake of corporate accounting or securities scandals; and 2) calls to relax regulation because of large judgments or companies fleeing U.S. exchanges.⁴⁶⁵

Now we have a call for increased securities enforcement and regulation in the wake of the market meltdowns and vulnerability caused by the failures of mortgage-backed securities and the Bernie Madoff fraud. And this brings us the proposals by the Obama Administration. There is no debate that securities regulation and enforcement standards require an overhaul. However, Congress should be the entity to do it, not the SEC. Congress has the ability to avoid again swinging the pendulum too far in one direction because it has the experience and expertise to carefully study, analyze, and draft policy that will strike the right medium between better regulation and enforcement of securities, and ensuring that the U.S. securities market offers the best and most competitive securities products available in the world.

SIFMA strikes the right chord in its suggestion to Congress. To strike the right balance between inaction and overregulation that will stifle product innovation and selection, and drive companies to off-shore exchanges, SIFMA recommends providing investors the choice and ability to modify their relationship with their financial adviser to enable the investor to purchase securities products suitable to the investor and his preferences.⁴⁶⁶ In other words, SIFMA proposes that investors have the ability to waive the prospective fiduciary duty owed them by their broker-dealers, and in exchange have access to the “diverse and investor-beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today’s investment advisers.”⁴⁶⁷ This will

legislatures, and noting that the SEC’s most recent climate change disclosure rules do the same thing).

⁴⁶⁵ See *supra* Part I.B.6; see also John D. McKinnon, *Lawmakers Target Investment Banks*, WALL. ST. J., May 5, 2010, at C1 (noting that Congress raising investment bank duties to customers from suitability to fiduciary in the wake of the Goldman investigation could “foster unintended consequences that harm business and investors alike.”).

⁴⁶⁶ See SIFMA Testimony, *supra* note 370, at 23.

⁴⁶⁷ *Id.*

“recognize and preserve product service and innovation and capital formation.”⁴⁶⁸

But the industry also carries some responsibility. Broker-dealers must ensure that the “waivers” are clear and understandable, and not hidden in account-opening forms. If not, broker-dealers open themselves up to liability that customers will neither notice nor understand what exactly they are waiving, or registered representatives will tell customers that the new federal regulations preclude them from making the customer “real money,” among other potential claims.

One suggestion is to modify the disclosure language proposed by the SEC in its 2005 rule and adapt it for the waiver of fiduciary duties:

We, as your registered representative and broker-dealer, have a legal obligation to treat you as our fiduciary. This means that the law requires us always to act solely in your interest and avoid conflicts of interest we may have in any transaction we execute for you, such as compensation we receive based on what products you buy.

However, acting as your fiduciary limits the choice of securities products and options we can offer you. Sometimes, securities and products that cause our interests to conflict are the most suitable products for the individual customer.

Because you understand the product limitations imposed by the fiduciary duty we owe you, you agree to waive that duty and agree that we will provide you with suitable investments that may in some respects cause conflicts between your interests and ours, including the fact that we may be paid by people who compensate us based on what you buy.

Please ask us questions to make sure you understand your rights and our obligations to you.

SEC Chairman Mary Schapiro has indicated that the Commission may agree with providing investors with the ability to waive conflicts when she noted in March 2010 that she thinks point-of-sale disclosures should extend beyond mutual funds. Ms. Schapiro remarked that the disclosures “need to broadly apply across financial products available to retail investors. . . . She cited equity-indexed annuities as an example of a product

⁴⁶⁸ *Id.*

where compensation and conflict-of-interest disclosures would be valuable to investors.”⁴⁶⁹

Another reason that Congress should specifically legislate new financial regulatory standards, and not permit the SEC to regulate them, is because it avoids the constitutional problems and arguments raised when the SEC and other regulatory bodies are seen to be regulating rules and standards that otherwise could not be legislated.⁴⁷⁰ For example, SEC Chairman Schapiro has remarked that if legislation regarding point-of-sale disclosures for mutual funds does not pass, “[the SEC] will work as best we can under our existing authority to try and maximize our ability to do real point-of-sale disclosure.”⁴⁷¹ Another example of the SEC perhaps stepping beyond its constitutional boundaries is when it interpreted existing disclosure rules to apply to various climate change disclosures, even while Congress has stalled in passing climate change legislation.⁴⁷² These actions by the SEC have caused uproars in Congress,⁴⁷³ with some in the public,⁴⁷⁴ and even within the SEC.⁴⁷⁵

⁴⁶⁹ *SEC Reviewing Point-of-Sale Disclosures Beyond Mutual Fund Industry, Schapiro Says*, Securities Reg. & Law Rep. (BNA) No. 7, at 261 (Feb. 15, 2010); see also *SEC Staff Mulling Recommendation for Custody Disclosures from Brokers*, Securities Reg. & Law Rep. (BNA) No. 7 at 263-64 (Feb. 15, 2010) (noting the SEC wants to impose advisor custody rules on brokers because Madoff held advisory clients’ assets in a related brokerage he owned).

⁴⁷⁰ See, e.g., Strassel, *supra* note 464 (taking issue with securities and insurance regulators imposing regulations that cannot otherwise pass as legislation).

⁴⁷¹ *SEC Reviewing Point-of-Sale Disclosures Beyond Mutual Fund Industry, Schapiro Says*, Sec. Reg. & Law Rep. (BNA) No. 7, at 261 (Feb. 15, 2010).

⁴⁷² See Strassel, *supra* note 464 (taking issue with securities and insurance regulators imposing regulations that cannot otherwise pass as legislation).

⁴⁷³ See Matthew P. Allen, *SEC Opens the Door for Climate Change-Related Shareholder Proposals and Disclosure Requirements, With Potential New Liabilities for Public Companies*, Sec. Reg. & Law Rep. (BNA) No. 9 at 359-60 & n.7 (Mar. 1, 2010) (referring to letter from Reps. Joe Barton (R-Texas) and Greg Walden (R-Ore.) from the US House Committee on Energy and Commerce to SEC Chairman Mary Schapiro slamming “the interpretive release as effectively functioning as a formal rule without the requirements and safeguards of the time-consuming formal rulemaking process.”).

⁴⁷⁴ See Allen, *supra* note 473, at 359-60 & 359 n.8 (citing Editorial, *Insecurity and Change Commission: Never Mind Madoff, SEC Gumshoes Are on the Climate Beat*, WALL ST. J., Jan. 25, 2010, at A14 (decrying SEC climate change disclosure guidance as a mechanism to promote the Obama Administration’s cap and trade bill, and “creating new litigation raw material for the plaintiffs bar”).

⁴⁷⁵ See Allen, *supra* note 473, at 359-60 & 359 n.9 (citing Kara Scannell, *SEC Discord Could Stymie Schapiro’s Efforts*, WALL ST. J., Feb. 6, 2010, at B1 (quoting SEC Commissioner Kathleen Casey, who accused the SEC of “placing ‘the

Respectfully, it is not the role of the unelected SEC to regulate standards that cannot be legislated by a Congress elected by the People. Congress strikes the right cord in its draft legislation by requiring the SEC to study these issues. Whether Congress then legislates, or permits the SEC to regulate, based on those studies remains to be seen.

V. CONCLUSION

There is need for change in the regulation and enforcement of broker-dealers under the securities laws. But Congress, not the SEC, should be the body to do it. Congress should study and analyze the proposals in the draft legislation affecting broker-dealers and investment advisers, determine the long and short-term policy effects, and enact detailed legislation that provides a clear guide on the rules and business practices governing broker-dealers.

imprimatur of the commission on the agenda of the social and environmental policy lobby.””).