

WASN'T MY BROKER ALWAYS LOOKING OUT FOR MY BEST INTERESTS? THE ROAD TO BECOME A FIDUCIARY

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INTRODUCTION

Recently, a call for public change has been heard for the brokerage business. Is it time for a broker to have the same legal duty to his or her client as the investment adviser? Many in society are unaware that there is a distinction between the duties owed by a broker and the duties owed by an investment adviser to clients. This article summarizes the current status of the suitability standard for brokers and the fiduciary duty applicable to investment advisers and what change aligning the two standards may bring. We will discuss the origins of

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the fiduciary duty rule as well as the “suitability” rule, how these standards differ, and the differing proposals put forth by the Obama Administration, various interest groups and regulators. And we will address considerations for any proposed legislation or regulation that would impose a fiduciary duty on broker-dealers.

To begin, one must ask what is so compelling about the status as a “fiduciary” under the law. The definition of a “fiduciary” is the following:

1. holding, held, or founded in trust or confidence;
2. of, having to do with, or involving a confidence or trust : of the nature of a trust;
3. resting upon public confidence for value of currency¹
 1. A person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor
 2. One who must exercise a high standard of care in managing another’s money or property²

The fiduciary duty can arise in a variety of contexts, including, for example, a corporate officer’s duty to the corporation or an attorney’s duty to a client. Yet, no context has yielded more debate in recent years than the area of financial services. At this writing, the debate over equating the legal requirements for a broker and an investment adviser has moved from the White House to the halls of Congress. At the debate’s core are two concepts: first, the fact that investment advisers owe a fiduciary duty to their clients but broker-dealers and their agents generally abide by a lower “suitability” rule when advising their clients; and second, the fact that the investing public generally does not understand the difference between the services provided by, and the legal standards governing, investment advisers and broker-dealers.

A consensus appears to be growing in Washington to apply the fiduciary duty standard to all professionals who provide financial services to customers. The Obama Administration has recently proposed that the fiduciary duty rule be expanded to broker-dealers who provide

1. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED (1986).

2. BLACK’S LAW DICTIONARY 658 (8th ed. 2004).

investment advice about securities to retail customers.³ Yet the gulf between articulating a broad policy and actually drafting specific legislation can prove to be wide indeed. For example, if a fiduciary duty were to be imposed, would it be defined, and if so, how? Would anyone be exempt—for example, brokers with only institutional investors as clients? What would be the ramifications of such a standard—for example, would insurance rates increase or compensation structures change? Would the standard apply to discount broker-dealers?

1. *Broker-Dealers and the Suitability Rule*

Section 3 of the Securities Exchange Act of 1934 (“1934 Act”) defines a “broker” as a “person engaged in the business of effecting transactions in securities for the account of others,”⁴ and a “dealer” as a “person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”⁵

Although the United States Securities & Exchange Commission (SEC) has the authority to set rules regarding broker-dealers, it has delegated this authority to the Financial Industry Regulatory Authority (FINRA), formerly the National Association of Securities Dealers (NASD). Broker-dealers must also abide by applicable state laws.

The SEC first adopted the concept of the “suitability” rule for broker-dealers in the 1930s.⁶ The rule, now codified in NASD Rule 2310, provides:

- (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
- (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mu-

3. U.S. DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71 (June 30, 2009), <http://financialstability.gov/roadtostability/regulatoryreform.html>.

4. Securities Exchange Act of 1934 § 3(4)(A), 15 U.S.C. § 78c(4)(A) (2006).

5. Securities Exchange Act of 1934 § 3(5)(A), 15 U.S.C. § 78c(5)(A) (2006).

6. *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943).

tual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.⁷

In addition, state securities laws have their own "suitability" rules. For example, rules promulgated under the Pennsylvania Securities Act of 1972⁸ include a slightly different suitability rule, the breach of which forms a basis for sanctioning a broker-dealer or agent:

Recommending to a customer the purchase, sale or exchange of a security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs and other relevant information known by the broker-dealer.⁹

Determining whether a breach of the suitability rule has occurred generally requires a fact-specific analysis. However, it is important to note the difference between regulatory actions brought by the SEC or state securities regulators, and private actions brought on behalf of individual investors for the purposes of recovering monetary damages. Generally, regulatory rules of conduct do not provide investors with a direct cause of action against broker-dealers.¹⁰ This means that an investor who has lost money as a result of an unsuitable securities recommendation by a broker cannot use this regulatory violation as a direct legal cause of action in a civil suit or arbitration against a broker and/or the broker-dealer. Instead, legal actions by individual investors for suitability violations are couched in claims under Section 10(b) of

7. FINRA Manual, NASD R. 2310, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638 (last visited Dec. 22, 2009).

8. Pennsylvania Securities Act of 1972, 70 PA. STAT. §§ 1-101-705 (2004).

9. 64 PA. CODE § 305.019(c)(1)(iii) (2009).

10. *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 681 (9th Cir. 1980); *Kwiatkowski v. Bear Stearns & Co.*, 306 F.2d 1293 (2d Cir. 2002).

the 1934 Act¹¹ and Rule 10b-5¹² promulgated thereunder at the federal level or in negligence claims at the state level.¹³

In itself, the regulatory violation does not state an independent claim for economic relief in a civil proceeding for the investor who suffered a loss at the hands of a broker who has made an unsuitable trade recommendation. Instead, the aggrieved investor must state a valid claim under Rule 10b-5. The plaintiff must allege, in connection with the purchase or sale of securities, the misstatement or omission of a material fact, made with scienter, upon which the plaintiff justifiably relied and which proximately caused the plaintiff's injury.¹⁴

The U.S. Supreme Court has defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud."¹⁵ Scienter can also include recklessness, which courts have defined as:

highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known it.¹⁶

Private investor actions under federal securities laws must overcome additional hurdles. For example, Congress in 1995 amended the 1934 Act through the passage of the Private Securities Litigation Reform Act (PSLRA),¹⁷ which heightened the standard for pleading scienter in a securities case. The PSLRA amendment provides that in a private action, the complaint shall "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹⁸

11. 15 U.S.C. § 78j(b) (2006).

12. 17 C.F.R. § 240.10b-5 (2009).

13. It should also be noted that the doctrinal guidance generally provided by judicial decisions is somewhat truncated in investor cases due to mandatory arbitration. Because the standard of review on appeal from a FINRA arbitration award is whether the decision was a "manifest disregard of the law," courts which may affirm an award in one situation may have decided the case the opposite way if heard *de novo*.

14. *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999).

15. *Ernst & Ernst v. Hockfelder*, 425 U.S. 185, 193 n.12 (1976).

16. *Mansbach v. Prescott, Ball & Turber*, 598 F.2d 1017, 1025 (6th Cir. 1979).

17. 15 U.S.C. § 78u-4 (2006).

18. § 78u-4(b)(2).

The recent case of *South Cherry Street, LLC. v. Hennessee Group, Inc.*¹⁹ illustrates the difficulty in bringing a private securities fraud lawsuit. In *South Cherry*, investors purchased a large interest in a hedge fund, which was later determined to be a Ponzi scheme. The investors brought an action under Rule 10b-5 against defendant adviser who recommended the investment, alleging that the adviser would have discovered the Ponzi scheme had it conducted the due diligence it promised the investors.

The court affirmed the district court's dismissal of the case, finding that plaintiffs' complaint failed to plead facts which give rise to a strong inference that the facts relating to the hedge fund were known to the defendants and that defendants had an actual interest either to relay false information or to aid in the fraud being perpetrated by the fund.²⁰

Investor private actions under Rule 10b-5 face other hurdles as well. For example, Rule 10b-5 prohibits fraud in the purchase or sale of a security. However, what if the broker's advice was to hold a security? In *Blue Chip Stamps v. Manor Drug Stores*,²¹ the U.S. Supreme Court barred non-purchasers or sellers from suing under Rule 10b-5 to recover money damages. Since then, federal courts have consistently barred "holder" claims.²² A fraud or negligence claim based on a recommendation to hold may be valid under state law, however.²³

Although a broker generally may not be a fiduciary in the typical, non-discretionary brokerage account, that broker still owes various duties to the customer. Among those duties are:

- (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;

19. *South Cherry Street, LLC. v. Hennessee Group, Inc.*, 573 F.3d 98 (2d Cir. 2009).

20. *South Cherry*, 573 F.3d at 112.

21. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

22. *See, e.g. Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002).

23. *See, e.g. Small v. Fritz Companies, Inc.*, 65 P.3d 1255 (Cal. 2003).

- (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; and
- (6) the duty to transact business only after receiving prior authorization from the customer.²⁴

Just as important as what is included in the above duties is what is *not* included. For example, the list does not include a duty to monitor the account.

[T]he broker's responsibility to his customer ceases when the transaction is complete. A broker has no continuing duty to keep abreast of financial information which may affect his customer's portfolio or to inform his customer of developments which could influence his investments. Although a good broker may choose to perform these services for his customers, he is under no legal obligation to do so.²⁵

Although the fiduciary duty standards generally do not apply to broker-dealers, in situations courts have applied such a duty. For example, many courts distinguish between non-discretionary accounts (where the broker-dealer simply carries out specific orders on behalf of the client) and discretionary accounts (where the client gives consent to the broker-dealer to purchase and sell securities without consent for each transaction). Because brokers who handle discretionary accounts for their clients have significantly more freedom to exercise judgment on behalf of the client, such brokers usually owe a fiduciary duty to the client.²⁶

The *Leib* court was specific in detailing the duties of a broker handling a discretionary account:

Unlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comports with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's in-

24. *Leib v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F.Supp. 951, 953 (E.D. Mich. 1978) (citations omitted).

25. *Leib*, 461 F. Supp. at 953.

26. *Id.*

vestment and trading history; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests; (3) keep his customer informed as to each completed transaction; and [(4)] explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.²⁷

The case of *Stevens v. Abbott*²⁸ is illustrative. There, an unsophisticated investor who inherited a portfolio of securities from her mother brought an action for churning against the stockbroker with whom she had opened a discretionary account. The court found that a fiduciary relationship existed and articulated the duties owed by the broker in that situation:

The defendant, Winston's relationship with his uninformed customer was one of special trust and confidence, and the Court finds that he was, because of this position, under a duty to frankly and forthrightly explain to plaintiff the nature of the commissions, concessions, losses and profits which were being generated in her account.²⁹

In sum, there are weaknesses in the current suitability rule. In particular, the inability to directly correlate a suitability violation into an economic recovery for a plaintiff in a civil suit, and the overlay of PSLRA and Rule 10(b)-5 standards limit the utility of the current FINRA Rule. In effect, suitability and negligent recommendation cases have all but been eliminated from federal court.

2. *Investment Advisers and the Fiduciary Duty Rule*

Larger investment advisers are subject to federal regulation under the Investment Advisers Act of 1940 ("1940 Act").³⁰ Where broker dealers have a self-regulatory organization (FINRA), there is no self-regulation for investment advisers. As a result, the rules for investment advisers have less structure and specificity as compared to the

27. *Id.* (citations omitted).

28. *Stevens v. Abbott*, 288 F. Supp. 836 (E.D. Va. 1968).

29. *Stevens*, 288 F. Supp. at 846.

30. Investment Advisers Act of 1940 §§ 201-22, 15 U.S.C. §§ 80b-1-18a (2006). Investment advisers with less than \$25 million under management are primarily regulated by the securities administrator of the state in which they conduct business. Moreover, all state securities administrators retain anti-fraud jurisdiction over federal registered investment advisers.

guidance for broker dealers through FINRA interpretative materials. However, pursuant to judicial interpretation of the 1940 Act, investment advisers are considered “fiduciaries” to their clients.

The 1940 Act defines an “investment adviser” as any person who, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.³¹ The SEC has interpreted this definition rather broadly, and typically includes financial planners, money managers, investment consultants, and any other “title” where investment advice is being provided for compensation.

Ironically, the 1940 Act itself does not use the terms “fiduciary” or “fiduciary duty.” However, fiduciary standards were a building block of the 1940 Act, as reaffirmed by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*³² The *Capital Gains* Court found the fiduciary duty inherent in Section 206(2) of the 1940 Act:³³

The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.³⁴

31. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11). The 1972 Act defines Investment Adviser as:

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

70 PA. STAT. § 102(j) (2004).

32. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

33. Section 206 of the 1940 Act provides:

Prohibited Transactions by investment advisers – It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly –

. . . .

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client

Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6.

34. *Capital Gains Research*, 375 U.S. at 191-92 (footnote omitted).

No statute defines “fiduciary duty” to inform its application to investment advisers. Instead, courts have interpreted the phrase in specific circumstances. What is clear, however, is that a fiduciary duty sets a higher standard than the “suitability” rule.

The centerpiece of the fiduciary duty is the requirement that investment advisers act in the best interest of their clients. For example, in *SEC v. Tambone*,³⁵ the SEC alleged that the defendant violated its fiduciary responsibilities by allowing preferred clients to engage in short-term and excessive trading in particular funds, and that such trading harmed the interest of non-preferred clients. The court denied the defendant’s motion to dismiss the complaint.

The case of *SEC v. Slocum, Gordon & Co.*,³⁶ illustrates how an alleged breach of fiduciary duty translates into an SEC regulatory case. In *Slocum*, the SEC alleged, *inter alia*, that the defendant investment adviser commingled client funds in a single account and failed to disclose this practice to its clients. The court found that “[t]he fiduciary duty imposed on Defendants compelled disclosure of this commingling to firm clients,” and that by failing to disclose this fact to clients, it had violated Section 206(2) of the 1940 Act.³⁷

The Supreme Court in *Capital Gains* also articulated the duty of advisers to disclose all material facts to their clients. While this requirement may sound similar to that under Rule 10b-5 under the 1934 Act,³⁸ in practice the difference is substantial. For example, in *SEC v. Bolla*,³⁹ the SEC brought an action under Section 206 of the 1940 Act alleging that defendant failed to disclose that a principal of the firm had been barred by the SEC. The court found that the SEC’s burden of proof was lower than in a 10b-5 case:

In contrast to Section 206(1), a simple finding of negligence will satisfy a finding of liability under Section 206(2). . . . “[Section] 206(2) is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers.” Under Section 206(2), Congress created “a fiduciary duty on the part of investment advisers to exercise good faith and fully and fairly disclose all material facts to their clients, and an affirmative obligation ‘to employ reasonable care to avoid

35. *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008).

36. *SEC v. Slocum, Gordon & Co.*, 334 F.Supp. 2d 144 (D. R.I. 2004).

37. *Slocum*, 344 F.Supp. 2d at 184.

38. 17 C.F.R. § 240.10b-5 (2009).

39. *SEC v. Bolla*, 401 F.Supp. 2d 43 (D. D.C. 2005).

misleading [their] clients.”” As such, in order to establish a violation of Section 206(2), the SEC is not required to show “intent and actual injury to clients” as required by Section 10(b). Rather, the SEC must prove by a preponderance of the evidence that: (1) Defendants are investment advisers; (2) Defendants used the mails or any other means or instrumentality of interstate commerce, directly or indirectly (3) to make a misstatement or omission of material fact to a client or prospective client; and (4) Defendants acted negligently.⁴⁰

It should be noted that no private right of action is expressly provided under Section 206 of the 1940 Act. Private rights of action under the 1940 Act are limited to voiding an investment advisory contract and for rescission or restitution of any consideration paid (such as advisory fees) under the contract.⁴¹ Consider though that suitability rule violations currently do not directly translate into an opportunity for rescission or restitution to a client in a federal private action.

Private investors may have an action against their advisers under Section 10(b) and Rule 10b-5 thereunder, subject of course to the pleading standard and burden of proof set forth in case law interpreting that rule.

3. *Ambiguous Distinctions*

While the general rule of law is that the suitability rule applies to broker-dealers and the fiduciary duty rule applies to investment advisers, the evolving nature of the brokerage business has raised questions concerning where to draw the line between the two.

Under the 1940 Act, broker-dealers are excluded from the definition of investment adviser when 1) any advice that the broker-dealer gives clients is “solely incidental” to its business as a broker-dealer and 2) the broker-dealer does not receive any “special compensation” for rendering such advice.

Defining “solely incidental” with any precision has proven to be increasingly difficult. In the mid-1970’s, fixed commission rates were “de-regulated,” leading to increased competition among firms and

40. *Bolla*, 401 F.Supp. 2d at 67 (citations omitted).

41. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 n.14 (1979).

lower commission rates for customers, which in turn caused many brokers to seek out alternative sources of income.⁴²

Similarly, over the past twenty years, the number of discount brokerage accounts – both online and traditional discount relationships-- has risen dramatically. These accounts were attractive to many investors who wanted to trade securities at lower commission rates and did not want assistance from broker-dealer representatives. Consequently, many full-service broker-dealers began expand offerings, such as wrap accounts, discretionary management over customer accounts, and fee-based, rather than transaction-based services.

In response, the SEC promulgated a rule in April 2005 that exempted broker-dealers offering fee-based accounts from being deemed to be investment advisers under the 1940 Act so long as the broker-dealer 1) did not exercise investment discretion over the accounts, 2) any “advice” was incidental to the brokerage services provided, and 3) disclosure was made that the account was not an advisory account.⁴³

Shortly after adoption of the rule, the Financial Planning Association challenged the new SEC rule in court. In *Financial Planning Ass’n v. SEC*,⁴⁴ the U.S. Court of Appeals for the District of Columbia Circuit struck down the rule, holding that the SEC had exceeded its authority in adopting the rule in the first place. The SEC’s exercise may have been an attempt by the SEC to clarify the two standards of suitability and fiduciary duty and the business activities associated with each standard at a rule making level. The inability of the SEC to successfully promulgate standards which are not subsequently stricken down by a court points to the need for a Congressional enactment.

Traditionally, confusion of the suitability and fiduciary duty standards has arisen with respect to discretionary accounts. As discussed above, broker-dealers who have discretionary trading authority generally owe a fiduciary duty to those clients. However, courts have also found a “de facto” discretionary account may exist when the level of

42. Indirectly, one such ripple effect of deregulation of commission pricing from the 1970s ultimately provided Bernard Madoff with a platform to financial prominence. Madoff and his firm participated in payment for order flow—whereby a dealer pays brokers for the rights to execute trades. In the 1980s, Bernard L. Madoff Investment Securities began offering to pay brokers a penny per share to execute certain smaller orders. This niche has been criticized over the years as one that flies in the face of the requirement for “best execution” for customer transactions.

43. See *Certain Broker-Dealers Deemed Not to be Investment Advisers*, 70 Fed. Reg. 20,424 (Apr. 19, 2005).

44. *Financial Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

dependence on the broker becomes high enough that the broker has assumed control over the non-discretionary account and the account is in essence a discretionary one. Brokerage relationships that are deemed to be discretionary are held to a fiduciary duty standard.

In *Leib*, the court set forth factors for determining whether the broker has assumed control and discretion over a non-discretionary account.

First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, old, or naive with regard to financial matters, the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts will usually find that the customer, by maintaining such active interest in the account, thereby maintained control over it.⁴⁵

Discretionary accounts are the exception and not the rule in terms of how brokerage business is conducted.

4. *Public Perception*

Recent surveys concerning investors' understanding of the distinctions between broker-dealers and investment advisers indicate an understandable confusion. In 2006, the SEC commissioned the RAND Corporation to study the current business practices of broker-dealers and investment advisers, as well as investor understanding regarding distinctions between broker-dealers and investment advisers. The study found that 42% of investors believed that brokers were

45. *Leib*, 461 F.Supp. at 954-55 (citations omitted).

required by law to act in their clients' best interest, and 63% believed that brokers provide advice about securities as part of their regular business.⁴⁶ The RAND findings demonstrate that customers' expectations do not comport with current legal standards but are understandable based on the manner in which the financial services industry operates.

Other surveys provide similar findings. In a 2006 survey of 1,000 U.S. investors, TD Ameritrade found that 43% of individuals are unaware that stockbrokers and investment advisers offer different levels of investor protection, and that 54% believe both stockbrokers and investment advisers have a fiduciary responsibility to their client. Only 26% of investors knew that only investment advisers provide this protection.⁴⁷

5. *One Rule For All?*

In the Financial Regulatory Reform ("Framework"),⁴⁸ the Obama Administration proposed that the SEC be given an expanded authority to establish the same fiduciary duty for broker-dealers providing investment advice as for investment advisers. "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."⁴⁹

The Treasury Department quickly moved to effect legislation of the reforms set forth in the Framework, proposing the "Investor Protection Act of 2009" in early July 2009. Section 913 of the proposed legislation provides that the SEC *may* promulgate rules to provide:

that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients . . . shall be to act solely in the interest of the customer or client without regard to the

46. ANGELA A. HUNG, NOREEN CLANCY, JEFF DOMINITZ, ERIC TALLEY, CLAUDE BERREBI & FARRUKH SUVANKULOV, RAND CORP. TECHNICAL REPORT: INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 89 (2008), http://www.sec.gov/news/press/2008/2008-1_randiabdreports.pdf.

47. TD AMERITRADE, WHAT YOU NEED TO KNOW ABOUT FINANCIAL ADVICE 1 (Sept. 2006), <http://www.tdwaterhouseinst.com/pdf/FinancialAdvice.pdf>.

48. U.S. DEPARTMENT OF THE TREASURY, *supra* note 3.

49. U.S. DEPARTMENT OF THE TREASURY, *supra* note 3, at 71.

financial or other interests of the broker, dealer or investment adviser providing the advice.⁵⁰

On October 15, 2009, the most recent version of the Investor Protection Act of 2009 was introduced and referred to the House Committee on Financial Services. The bill provides that the SEC:

shall promulgate rules to provide that, with respect to a broker-dealer that is providing investment advice to a retail customer (and such other customers as the Commission may by rule provide), 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 1940.⁵¹

The “retail customer” is defined as an individual who “receives personalized investment advice from a broker-dealer” and “uses such advice primarily for personal, family, or household purposes.”⁵²

While the consensus has been growing to support a new fiduciary standard for broker-dealers and investment advisers who provide investment advice,⁵³ the practicalities of such a rule remain somewhat unclear. Does “personalized investment advice” mean that this advice is ongoing or, do these words mean that the advice is transaction specific? Moreover, can institutional investors receive “personalized investment advice?”⁵⁴ Would they be covered under the new proposed standard?

During the summer and fall of 2009, key players in the debate have given their positions on what a fiduciary standard should look like. The following is a summary of these positions:

A. SEC

In a June 18, 2009 speech, SEC Chairman Mary Shapiro discussed her view of the fiduciary duty standard:

50. Additional Improvements to Financial Markets Regulation, Title IX § 913(a), <http://www.treas.gov/press/releases/docs/tg205071009.pdf>.

51. The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103 (2009) (as passed by House, Dec. 11, 2009).

52. H.R. 4173 § 7013.

53. See Press Release, Securities Industry and Financial Markets Association (SIFMA) (July 17, 2009).

54. Considering that the great bulk of middle-class assets are held in mutual funds, it would be ludicrous to insulate investment fund managers from this higher standard of care.

I believe that, when investors receive similar services from similar financial service providers, they should be subject to the same standard of conduct – regardless of the label applied to that financial service provider. I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients.

The fiduciary duty means that the financial service provider must at all times act in the best interest of customers or clients. In addition, a fiduciary must avoid conflicts of interest that impair its capacity to act for the benefit of its customers or clients. And if such conflicts cannot be avoided, a fiduciary must provide full and fair disclosure of the conflicts and obtain informed consent to the conflict.

A fiduciary owes its customers and clients more than mere honesty and good faith alone. A fiduciary must put its clients' and customers' interest before its own, absent disclosure of, and consent to, conflicts of interest.

While I believe that a consistent fiduciary standard of conduct should be applied to all financial professionals providing personalized investment advice, I also understand that the fiduciary standard is not a panacea to deter all fraud against individual investors.⁵⁵

B. *FINRA*

FINRA currently regulates the practices of brokerage firms with SEC oversight. In a June 17, 2009 speech, FINRA Chairman Rick Ketchum suggested that a fiduciary standard should include the following principles:

- Every person who provides financial advice and sells a financial product is tested, qualified and licensed;
- Advertising for financial products and services is not misleading;
- Every product marketed to them is appropriate for recommendation to that investor;

55. Mary Shapiro, Chairman, SEC, Address at the New York Financial Writers Ass'n Annual Awards Dinner (June 18, 2009), <http://www.sec.gov/news/speech/2009/spch061809mls-2.htm>.

- A full and comprehensive disclosure for the services and products being marketed that address, in plain English, the risks, including the worst-case risks, of the product; and
- Every person who is in the business of regularly providing financial advice is subject to a federally crafted fiduciary standard.”⁵⁶

C. *State Regulators and Investment Adviser Groups*

In an October 26, 2009 letter to members of the House Financial Services Committee, the North American Securities Administrators Association (NASAA)⁵⁷ joined five other groups expressing support for H.R. 3817. While the group supported the bill’s improvements made to the original Investor Protection Act, it articulated the following concerns:

First, we are concerned that when describing standards of conduct, the phrase “when providing personalized investment advice” might be used to argue that “hat switching” by brokers is allowed. By “hat switching” we are referring to the common practice where the same financial intermediary provides investment advice under a fiduciary duty and then executes the transactions under the lower suitability obligation. Second, the language requiring rulemaking by the Securities and Exchange Commission (“SEC”) references personalized advice to retail clients. Currently, an adviser’s fiduciary duty under the Advisers Act does not vary depending on the type of client served. We do not believe it is appropriate to have different standards for different types of clients. All investors receiving personalized investment advice should benefit from the protections of the Advisers Act fiduciary duty.

Third, we are concerned that the clarifying language which states that the standards adopted under the legislation should be “at least as high” as those currently applied under the Adviser Act is only included in that portion of the legislation

56. Rick Ketchum, Chairman & CEO, FINRA, Remarks From the Exchequer Club (June 17, 2009), <http://www.finra.org/newsroom/speeches/ketchum/p119009>.

57. NASAA is the oldest international organization devoted to investor protection. Organized in 1919, its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico, and Puerto Rico.

that amends the Advisers Act. This could lead some to conclude that the rules for brokers could meet a lower threshold, undermining the intent to ensure that, where the advisory services are comparable, the standards will be the same.⁵⁸

D. SIFMA

In October 6, 2009 testimony before the House Committee on Financial Services, John Taft, Chairman of the Private Client Group Steering Committee of the Securities Industry and Financial Markets Association (SIFMA), embraced the idea of a harmonized fiduciary standard for broker-dealers and investment advisers when they are engaged “in the identical service of providing *personalized investment advice* about securities to individual investors.”⁵⁹ In this testimony, Mr. Taft stated that the federal fiduciary standard “should be applied exclusively, and should supersede existing state common law-based fiduciary standards.”⁶⁰

6. Considerations for the Proposed Fiduciary Duty Standard

It is beyond the purview of this paper to recommend a specific fiduciary duty standard to apply to broker-dealers. Suffice to say, the complexities of such a task are limitless. That said, any proposed legislation or regulation that would impose a fiduciary duty rule on broker-dealers should address the considerations below.

A. The Issue of Fairness (to Broker-Dealers)

As noted above, the fiduciary duty standard for investment advisers has been judicially created and defined over the years since the

58. Letter from Certified Financial Planner Board of Standards, Inc., the Consumer Federation of America, the Financial Planning Association, the Investment Adviser Association, the National Association of Personal Financial Advisers, and NASAA, to U.S. House of Representatives Fin. Serv. Comm. (Oct. 26, 2009), http://www.nasaa.org/content/files/NASAA_IPA_Letter102609.pdf.

59. *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office*, Hearing Before the H. Comm. on Fin. Serv., 111th Cong. 3 (Oct. 6, 2009) (testimony of John Taft, Chairman of the Private Client Group Steering Committee of the Securities Industry and Financial Markets Association (SIFMA)), http://www.house.gov/apps/list/hearing/financialsvcs_dem/taft_testimony.pdf.

60. *Id.*

1940 Act was enacted. In the nearly half-century since *Capital Gains*, courts have collectively defined certain standards for the fiduciary duty, such as disclosure (or the prohibition) of conflicts of interest, and keeping informed of changes in the market which may affect customer accounts and acting responsibly to protect those interests.⁶¹

Where investment advisers have at least 46 years of judicial pronouncements as a guidepost for their conduct, broker-dealers, should the fiduciary standard apply to them, would have none. If the same fiduciary standard should apply to broker-dealers, without further definition, questions would undoubtedly arise concerning its application in specific situations. Would broker-dealers need to monitor their clients' non-discretionary accounts? Would the standard apply to broker-dealers whose only customers are institutional clients? How should a broker handle recommendations of securities held in the firm's inventory?

Recognizing that there are still some differences between brokers and advisers, perhaps the SEC should offer guidance to the brokerage industry, by rule or staff opinion, to clarify how fiduciary obligations should apply in various circumstances.

B. *The Issue of Fairness (to Investors)*

The Obama Administration's proposal is to authorize the SEC to promulgate rules to provide "that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients . . . shall be to act solely in the interest of the customer or client"⁶²

While it may be perfectly appropriate, and even preferable, to leave regulation to the SEC, it is likely that any rule or regulation promulgated by the SEC would not create a private right of action for customers. Therefore, customers who have suffered a breach of fiduciary duty would need to bring their action, if in federal court, under Rule 10b-5 and would thus need to satisfy the restriction and heightened pleading requirements under the PSLRA. Fixing this system lies in not just promulgating a rule enabling investors to bring actions against their financial advisers for investment negligence in federal court.

61. *Leib*, 461 F.Supp. at 953.

62. Title IX, *supra* at note 50.

Private lawsuits are important not only to give redress to victims of fraud but also as a significant deterrent effect. The SEC and the state securities administrators are charged with enforcing the law, deterring securities fraud, and protecting investors. Aggrieved investors must be able to protect themselves by bringing private actions. Consequently, the securities regulators and the courts have long considered private lawsuits as a supplement to SEC enforcement actions.⁶³

Yet, the heightened pleading standards under the PSLRA make it *more* difficult for victims to bring private cases, resulting in a lessening of the deterrent effect on securities fraud and most definitely on securities negligence and suitability matters. Some consideration should be given to lessening of the pleading standards under the PSLRA through amendment of PSLRA.

Likewise, SIFMA's proposal that any federal fiduciary standard supersede state common-law based fiduciary standards is cause for concern. In essence, it appears that SIFMA may wish to do away with long-standing state common-law fiduciary duty standards in favor of what may be a weaker federal fiduciary standard. What is more troubling, however, is the impact such preemption would have on state law claims. Currently, claims for breach of fiduciary duty brought under state statutory or common law are not required to meet the pleading standards of the PSLRA nor the burden of proof of Rule 10b-5. Preemption of state fiduciary duty standards may in effect force investors to sue in federal court under federal pleading standards, making it *more* difficult for investors to obtain relief.

While the implementation of a fiduciary duty standard through rulemaking is a positive step, let us not be confused by what it will or will not accomplish. At the time of this writing, the authors do not see language in the proposals appearing in Washington that will unfreeze the chilling effect of the standards of PSLRA for plaintiffs in civil cases.

C. *Additional Regulatory Considerations*

Extending the fiduciary duty standard to broker-dealers has agreement; however, we must acknowledge at the same time the many benefits of the suitability rule that should not be left behind. Where the fiduciary duty standard is generally undefined and left up to judi-

63. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

cial determination for interpretation, the suitability rule is specific and facilitates guidance to brokers and compliance personnel, as well as courts and arbitration panels adjudicating these claims. Moreover, many of the interpretative FINRA materials are quite informative in practice. Any legislation or rule imposing a fiduciary duty on broker-dealers should acknowledge the continuance of the suitability rule.

CONCLUSION

The imposition of the fiduciary duty on all those providing financial services to customers is long overdue. The lines of distinction between the services provided by broker-dealers and investment advisers continue to blur, and investor trust in our financial institutions has diminished since the current economic crisis began in fall 2008. A consistent fiduciary duty standard would likely help to increase investor trust. Will the business models in the industry change? Will broker dealers convert themselves into investment advisers due to the rule change? Will more or less “personalized investment advice” be offered to the investing public by more or fewer brokerage companies? Will more 401(k)s be self managed? What will the costs of doing business under these new rules be—will the price points for trading increase for the ordinary investor?

Despite the plethora of unanswered questions, simple enactment of a fiduciary standard is an important step in restoring confidence in our financial markets. But it is a first step. Because it is likely to afford greater protection for the Main Street investor, it is a most worthy reform. But to ensure that it is efficiently embraced by industry and effectively enforced, if enacted, regulators will need to regulate, so that customers have expectations that their investment professionals will meet.

