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Broker-Dealer: A Fiduciary By Any Other Name?

William Alan Nelson II*

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William Alan Nelson II

Abstract

This article contends that even with the inconsistent regulatory and statutory framework governing financial service providers, under common law, brokers have historically been held to a fiduciary standard of care when providing personalized investment advice to retail customers or when holding themselves out to the public as trusted financial advisors who provide unbiased investment advice. The Article examines the historical origins of broker-dealers as fiduciaries; uses statutory construction to give effect to the clear intent underlying Congress' enactment of the Investment Advisers Act of 1940; and analyzes judicial treatment of broker-dealers, including the legal reasoning of why the Securities Exchange Act of 1934 provides a lower level of protection and was never meant to regulate personalized investment advice. Having two different standards of care regulating identical conduct is harmful to consumers; to alleviate this harm, the article provides solutions for the SEC to move forward including the removal of the broker-dealer exemption from the Investment Advisers Act of 1940 and the creation of a new uniform fiduciary duty for broker-dealers and investment advisers under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

KEYWORDS: Broker-Dealer, Fiduciary Duty, Finance, Investing

*Professorial Lecturer in Law, George Washington University Law School; Public Policy Counsel, Certified Financial Planner Board of Standards, Inc. (CFP Board). The views and opinions expressed in this article are solely those of the author and do not necessarily represent the views and opinions of, and should not be attributed to, the CFP Board.

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INTRODUCTION

“The relation between a broker and his principal is a fiduciary one, calling for the exercise of the utmost good faith. It is the duty of the broker to serve his principal to the latter’s best advantage”¹

Broker-dealers, unlike investment advisers, are not regulated as fiduciaries when providing investment advice, even though broker-dealers often hold themselves out as financial advisors and offer virtually identical services to investors. The lack of consistent regulation of financial service providers arises from the structure in which advice historically has been delivered. Financial services regulation since the Great Depression has developed along roughly dual tracks: laws governing the sale of financial products, which may or may not require that the products be suitable for the customer, and laws governing investment advice, which impose a fiduciary requirement on the adviser to act solely in the best interests of the client. Even with the inconsistent regulatory and statutory framework, under common law, brokers have historically been held to a fiduciary standard of care when providing personalized investment advice to retail customers or when holding themselves out to the public as trusted financial advisors who provide unbiased investment advice.

This Article begins by examining the historical origins of broker-dealers as fiduciaries; it uses statutory construction to give effect to the clear intent underlying Congress’ enactment of the Investment Advisers Act of 1940 (Advisers Act), specifically the broker-dealer exemption included in Section 202(a)(11); and provides a history of the SEC’s interpretation of the broker-dealer exemption in the Advisers Act. The Article then analyzes judicial treatment of broker-dealers, including the legal reasoning of why the Securities Exchange Act of 1934 (Exchange Act) provides a lower level of protection and was never meant to regulate personalized investment advice, and examines a broker’s right to use of “puffery” and “sales talk”, and discusses the issue of financial advisors’ ability to “switch hats” and provide services under different standards of care. The Article concludes by opining how two different standards of care regulating identical conduct is harmful to consumers and provides solutions for the SEC to move forward. Those solutions include the removal of the broker-dealer exemption from the Advisers

1. *Easterly v. Mills*, 54 Wash. 356, 359 (Wash. 1909).

Act and the creation of a new uniform fiduciary duty for broker-dealers and investment advisers under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).²

I. HISTORICAL ANALYSIS: BROKERS AS FIDUCIARIES

A. PRE-EXCHANGE AND ADVISERS ACT COURT CASES

Throughout the history of the financial services industry, brokers who provided anything more than transactional assistance were deemed to be acting as fiduciaries towards their clients. It is important to look at the legal landscape before enactment of the Advisers Act to see how brokers have historically been treated.

As far back as 1875, brokers were seen as fiduciaries when providing advice to customers. In *Crosby v. Watts*, an action was brought by the plaintiff against the defendant, a broker, for an accounting on the purchase of shares of stock.³ The Superior Court of New York held that “a broker acting in such a case, in a fiduciary capacity, should be able to show from his books when referring to them not only the purchase, but on whose account and by whom made. The party relying upon the trusted action of his agent is entitled to this, the best evidence of fair dealing.”⁴ In *Gallagher v. Jones*, the U.S. Supreme Court found that brokers are held to a higher standard because the client trusts and relies on the advice provided.⁵

In *Kennedy v. Budd*, the Supreme Court of New York opined that when a broker’s duties “as to the further performance of the contract after the purchase has been made, and recollect that he has no interest in the contract, except the commissions which he earns; that he is bound to act solely for the benefit of his customer, and bound to give her his best judgment, and to take no advantage of her,—it is quite clear that to that extent he acts in a fiduciary capacity.”⁶ In *Haight v. Haight & Freese*

2. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1824-30 (2010) (codified as enacted in 15 U.S.C. § 78o (2012)).

3. *Crosby v. Watts*, 49 How. Pr. 364, 364 (N.Y. Sup. Ct. 1875).

4. *Id.* at 365.

5. *Gallagher v. Jones*, 129 U.S. 193, 201 (1889) (“... cases in which a trust relation exists between the parties,—a relation which would probably be deemed to exist between a stock-broker and his client.”).

6. *Kennedy v. Budd*, 5 A.D. 140, 143-44 (N.Y. App. Div. 1896) (citing *Gallagher*, 129 U.S. at 198).

Co., the Supreme Court of New York held that “defendant in this action was acting as plaintiff’s agent and broker. Such a relationship is a fiduciary one, and an action will lie for an accounting therein, wherein the burden will lie upon the agent to show that his trust duties have been performed, and the manner of their performance.”⁷

In *Easterly v. Mills*, the Supreme Court of Washington held that “[t]he relation between a broker and his principal is a fiduciary one, calling for the exercise of the utmost good faith. It is the duty of the broker to serve his principal to the latter’s best advantage, and all profits which are the result of the relation belong to the principal.”⁸ In *Clark v. Pratt*, the plaintiffs brought an action for the cancellation of an oil and gas lease against the defendant, who was a real estate agent and oil lease broker.⁹ The Supreme Court of Oklahoma held that “in a suit to cancel the lease so surreptitiously obtained by the broker, the court will decree a cancellation of the lease, and refuse to permit the broker to take advantage of his fiduciary relations.”¹⁰

In *Lavers v. Hutton*, the plaintiff requested an accounting from the defendants, his stock-brokers.¹¹ The New York Supreme Court held that “undoubtedly the relation between customer and broker is fiduciary, and the customer’s proper action is for equitable accounting.”¹² In *Goodman v. Wann*, the Tennessee Court of Appeals held that “[a] broker occupies a fiduciary relationship to his customer and is trustee of money coming into his hands as profits on his customers’ transactions.”¹³ In *Rubin v. Salomon*, the New York Supreme Court held that “[a] fiduciary relation exists between the broker and the customer.”¹⁴ In *Warwick v. Addicks*, the Superior Court of Delaware held that “[t]he relation of an agent to his principal is ordinarily that of a fiduciary, and, as such, it is his duty in all dealings concerning or affecting the subject matter of his agency to act with the utmost good faith and loyalty for the furtherance and advancement of the interests of his principal. A broker with the power to buy and sell securities for another is an agent for such person and . . . is bound to do only that which good business men of the same grade and

7. *Haight v. Haight & Freese Co.*, 92 N.Y.S. 934, 936 (N.Y. Sup. Ct. 1905).

8. *Easterly v. Mills*, 54 Wash. 356, 359 (Wash. 1909).

9. *Clark v. Pratt*, 220 P. 903, 903 (Okla. 1923).

10. *Id.* at 904.

11. *Lavers v. Hutton*, 203 N.Y.S. 235, 235 (N.Y. Sup. Ct. 1924).

12. *Id.*

13. *Goodman v. Wann*, 11 Tenn. App. 560, 567 (Tenn Ct. App. 1930).

14. *Rubin v. Salomon*, 241 N.Y.S. 495, 529 (Mun. Ct. 1930).

locality are accustomed to do under similar circumstances; or, that which a prudent man would do in regard to his own affairs.”¹⁵

In *Oliver Brothers v. Federal Trade Commission*, the Federal Trade Commission directed petitioners to cease and desist from payment or receipt of fees or commissions in violation of Section 2(c) of the Robinson-Patman Act.¹⁶ The order was entered in a proceeding instituted against Oliver Brothers, Inc.; the charge was that, while acting as agent for the buyers, Oliver received brokerage commissions from the sellers that it credited or passed on to the buyers.¹⁷ Oliver Brothers petitioned to the Fourth Circuit Court of Appeals for review. The Fourth Circuit held that “[t]he relation of the broker to his client is a fiduciary one. To collect from a client for service rendered in the interest of a party adverse to him, is a violation of that relationship; and to protect those who deal in the streams of commerce against breaches of faith in its relations of trust, is to foster confidence in its processes and promote its wholesomeness and volume.”¹⁸

Based upon the cited cases above, since the late 19th century, brokers have been found to occupy a position as a fiduciary when providing anything more than transactional assistance to a client. This reflects that regardless of any “broker-dealer exemption” found in the Advisers Act,¹⁹ brokers should still be viewed as fiduciaries, because that is how they were viewed before the Advisers Act was enacted. For example, nowhere in the Advisers Act does it state that brokers are not fiduciaries; it only states that brokers, who only provide investment advice that is “solely incidental” to their brokerage activities and do not receive special compensation, do not have to register as investment advisers. This is a significant distinction. The Advisers Act did not remove any fiduciary responsibility for brokers, it only provided that they did not have to register as investment advisers.

15. *Warwick v. Addicks*, 157 A. 205, 206-07 (Del. Super. Ct. 1931).

16. *Oliver Bros. v. FTC*, 102 F.2d 763, 764 (4th Cir. 1939). The Robinson-Patman Act “forbade discrimination in price when the effect of such discrimination was to substantially lessen competition or tend to create monopoly.” *Id.* at 767.

17. *Id.* at 764.

18. *Id.* at 768.

19. 15 U.S.C. §§ 80b-1 to -21 (2012).

II. CONGRESSIONAL INTENT: BROKER-DEALER EXEMPTION IN ADVISERS ACT

A. STATUTORY CONSTRUCTION: GIVING EFFECT TO THE INTENT OF THE LEGISLATURE

The Advisers Act includes an exemption from investment adviser registration for broker-dealers. The language of the Advisers Act exempts from the definition of investment adviser a broker or dealer who provides investment advice incidental to its broker-dealer business and who receives no special compensation.²⁰

A basic canon of statutory construction is that words should be interpreted as taking their ordinary and plain meaning.²¹ However, although words should generally be given their plain and ordinary meaning, that meaning must be in accord with the intent of the legislature.²² Courts must always construe a federal statute so as to give effect to the intent of Congress.²³ The Supreme Court has been clear on this point by stating that when courts construe a statute, the objective “is to ascertain the congressional intent and give effect to the legislative will”²⁴ and that “[s]tatutory construction . . . is a holistic endeavor.”²⁵

In *United States v. Fisk*, the Court stated that “[i]n the construction of statutes, it is the duty of the court to ascertain the clear intention of the legislature. In order to do this, courts are often compelled to construe ‘or’ as meaning ‘and’ and again ‘and’ as meaning ‘or.’”²⁶ The Court further stated that “[a]s is often the case in statutes, though the intention is clear, the words used to express it may be ill chosen.”²⁷ In *Peacock v. Lubbock Compress Co.*, the Fifth Circuit interpreted the phrase “ginning and compressing of cotton” to mean “the performance of either or

20. 15 U.S.C. § 80b-2(a)(11)(C).

21. See, e.g., *Perrin v. United States*, 444 U.S. 37, 42 (1979) (stating that “[a] fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning”).

22. *United States v. Cook*, 384 U.S. 257, 262-63 (1966).

23. *Train v. Colo. Pub. Interest Research Grp., Inc.*, 426 U.S. 1, 9-10 (1976).

24. *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975).

25. *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988).

26. *United States v. Fisk*, 70 U.S. 445, 447 (1865); see also *United States v. Mullendore*, 30 F. Supp. 13, 15 (N.D. Okla. 1939) (construing “and” as “or”).

27. *Fisk*, 70 U.S. at 447.

both.”²⁸ Subsequently, in *Bruce v. First Federal Savings & Loan*, the Fifth Circuit held that “the word ‘and’ is therefore to be accepted for its conjunctive connotation rather than as a word interchangeable with ‘or’ except where strict grammatical construction will frustrate clear legislative intent.”²⁹ The Court in *Bruce* specifically held that “to read the word ‘and’ in the disjunctive is to give the word its clearly intended effect. To read it in the conjunctive would nullify legislative intent.”³⁰

A strict grammatical construction of the Investment Advisers Act of 1940, where both of the elements (“solely incidental” and “special compensation”) must be met to exclude a broker from having to register, nullifies its clear legislative intent. Congress enacted the Investment Advisers Act of 1940 to “protect the public and investors against malpractices by persons paid for advising others about securities”³¹ and because “virtually no limitations or restrictions exist[ed] with respect to the honesty and integrity of individuals who may solicit funds to be controlled, managed, and supervised.”³² When it recommended the Advisers Act to the House, the Committee on Interstate and Foreign Commerce reported that “[t]he essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts.”³³ Courts will have a much more difficult time effectuating true Congressional intent of the Advisers Act if they employ the conjunctive “and.” The reading of “and” as “or” in the broker-dealer exemption under Section 202(a)(11) of the Advisers Act is the “only . . . permissible meaning[] [that] produces a substantive effect that is compatible with the rest of the law.”³⁴

Courts’ and the SEC’s current construction of the broker-dealer exemption in the Advisers Act effectively nullifies Congressional intent. For example, under the current reading of the Advisers Act, a broker-dealer could provide a financial plan for “free” and only be paid by the commissions on the products sold to the investor. The broker-dealer

28. *Peacock v. Lubbock Compress Co.*, 252 F.2d 892, 893-95 (5th Cir. 1958).

29. *Bruce v. First Fed. Sav. & Loan Ass’n of Conoe*, 837 F.2d 712, 715 (5th Cir. 1988).

30. *Id.* at 717.

31. S. REP. NO. 86-1760, at 1 (1960).

32. *Sullivan v. Chase Inv. Servs. of Boston, Inc.*, 434 F. Supp. 171, 175 (N.D. Ca. 1977) (quoting S. REP. NO. 1775, 76th Cong., 3d Sess. 21 (1940)).

33. H.R. REP. NO. 76-2639, at 28 (1940).

34. *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988).

could argue that since he did not receive any compensation outside of commissions, even though he provided the investor with substantial investment advice in the form of a “financial plan,” he would not be required to register as an investment adviser. Broker-dealers could also hold themselves out as financial advisors providing unbiased investment advice, but then subsequently state that they were only providing that advice as part of their brokerage activities and only charged commissions on products sold to the investor.

These actions undermine the Congressional intent underlying the Advisers Act, that it was, in part, proposed due to “organizations using the descriptive title of investment counsel [who] were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice.”³⁵ To effectuate the true legislative purpose of the Advisers Act, a broker-dealer would not qualify for an exemption if he or she provided investment advice that was not solely incidental to his or her brokerage practice *or* received special compensation for that advice.

This construction of the Advisers Act is further supported by Supreme Court jurisprudence that promotes a remedial and flexible view of the Advisers Act. In *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court held that “Congress intended the [Advisers Act] to be construed like other securities legislation ‘enacted for the purpose of avoiding frauds,’ not technically and restrictively, but flexibly to effectuate its remedial purposes.”³⁶ Lower courts take the same view of the Advisers Act, for example, in *SEC v. Myers*, the Federal District Court for the District of Maryland held that the Advisers Act “should properly be construed to provide the widest possible protection consistent with legislative purpose and the power of Congress. Restricted interpretations of the [Advisers] Act . . . would substantially limit the protection afforded the investing public.”³⁷

B. LEGAL CONTEMPORARY CONTEXT AND LEGISLATIVE HISTORY

It is important to look at the context surrounding the enactment of the Advisers Act of 1940. The Supreme Court has consistently stated that when reviewing Congressional action, courts must take into account

35. S. REP. NO. 76-3580, at 736 (1940).

36. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

37. *SEC v. Myers*, 285 F. Supp. 743, 747 (D. Md. 1968).

the “contemporary legal context” of the legislation.³⁸ It is important to note that the “contemporary legal context” may only be employed to “buttress[] a conclusion independently supported by the text of the statute” and that “[contemporary] legal context matters only to the extent it clarifies text.”³⁹

At the time the Advisers Act was being debated, there was no regulation of financial service providers outside of registration for “stockbrokers” who only bought and sold securities.⁴⁰ As late as 1939, “little was known about the number of investment advisers operating at the time or the amount of assets they managed.”⁴¹ In a 1934 Harvard Law Review article, Supreme Court Justice Harlan Stone stated that, “I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that ‘a man cannot serve two masters.’”⁴²

Based upon the financial excesses of the 1920’s and the great market crash of 1929, Congress passed multiple financial services bills in the early to mid-1930’s. One of those bills, The Public Utility Holding Company Act of 1935, authorized the SEC “to make a study of the functions and activities of investment trusts and investment companies.”⁴³ The study reflected that “investment advisers could not ‘completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed.’”⁴⁴ Congress subsequently held hearings to elicit testimony on the issue of investment adviser registration.

38. See, e.g., *Cannon v. Univ. of Chicago*, 441 U.S. 677, 699 (1979).

39. *Alexander v. Sandoval*, 532 U.S. 275, 288 (2001).

40. See Arthur Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 403 (2010).

41. *Id.* at 403 (citing H.R. Doc. No. 76-477, at 2, 8 (1939)).

42. Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934).

43. Letter from Comptroller Gen. McCarl, GAO, to the Chairman, SEC, 15 Comp. Gen. 951, 951 (May 2, 1936).

44. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 187 (1963) (quoting *Investment Trusts and Investment Companies*, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. 28 (1940)).

During the Congressional Hearings on the Advisers Act in 1940, Congress heard testimony concerning how “[t]he relationship of investment counsel to his client is essentially a personal one involving trust and confidence. The investment counselor’s sole function is to render to his client professional advice concerning the investment of his funds in a manner appropriate to that client’s needs.”⁴⁵ The witnesses at the Senate hearing made clear that investment counselors limited “their efforts and activities to the study of investment problems from the investor’s standpoint, not engaging in any other activity, such as security selling or brokerage.”⁴⁶

The witness testimony reflects that at the time the Advisers Act was passed, industry members believed that investment counselors and brokers operated in completely separate industries. There was no fear, on the part of the witnesses or Congressional members that the functions would overlap. The Code of Professional Practice for the Investment Counsel Association of America (ICAA), predecessor to the current Investment Adviser Association (IAA), stated that “[i]t is the function of the profession of investment counsel to render to clients, on a personal basis, competent, unbiased and continuous advice regarding the sound management of their investments. An investment counsel firm should devote its time exclusively to the performance of this function and services incidental thereto; it should not engage in the business of security merchandising, brokerage, banking, the publication of financial services, or acting as custodian of the securities or funds of clients.”⁴⁷

The legislative history of the Advisers Act reflects that the drafters recognized that brokers were already subject to a fiduciary duty when providing investment advice. The legislative record reflects that Congress reviewed state regulation of financial service providers, including regulations asserting that “[i]nvestment counsel or advice, whether by one specializing solely in rendering investment counsel or advice, or by a dealer or broker, incidental to usual transactions in securities, shall be strictly on the basis of fiduciary relationship between the counselor or advisor and the investor or prospective investor.”⁴⁸ This knowledge reflects an understanding by members of Congress that by

45. S. REP. NO. 76-3580, at 719 (1940) (Statement of Alexander Standish).

46. *Id.* at 724 (Statement of Dwight C. Rose, President, Investment Counsel Association of America).

47. *Id.* at 726 (Code of Professional Practice entered in the record).

48. H.R. Doc. No. 76-477, at 32.

implementing the Advisers Act, Congress was not removing any previous fiduciary duty owed by broker-dealers, it was only providing that those individuals would not have to also register as investment advisers.

The legislative history reflects that Congress also believed special compensation to be any other form of remuneration outside of commissions. In the Senate Report, members opined that brokers would not have to register as investment advisers when providing investment advice “insofar as [the] advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.”⁴⁹ This bright-line test was workable under the circumstances when enacted in 1940; however, even though the exclusion made sense in an era when broker-dealers provided only commission-based transactional services, the activities and business models have been blurred since the drafting of the Advisers Act and have rendered this reasoning outdated.⁵⁰

III. REGULATORY TREATMENT OF BROKER-DEALERS

A. SEC INTERPRETATION: ADVISERS ACT SECTION 202(A)(11)

It is informative to look at how the SEC has interpreted the broker-dealer exemption under the Advisers Act. The SEC is the agency charged with implementing and enforcing the Advisers Act.⁵¹ Therefore, courts generally have to defer to the SEC’s interpretation if it is embodied in a rule or regulation that has the force of law.⁵² The SEC promulgated a final rule interpreting the broker-dealer exemption;

49. S. REP. NO. 76-1775, at 22.

50. The blurring of the lines was amplified as a result of the SEC’s May 1975 elimination of fixed commission rates on securities transactions. *See* Exchange Act Release No. 11203 (Jan. 23, 1975), 40 Fed. Reg. 7394 (Feb. 20, 1975).

51. *See generally* 15 U.S.C. § 80b-11(a) (2012) (“The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission.”).

52. *See* *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984) (holding that courts should defer to agency interpretations of such statutes unless they are unreasonable); *see also* *United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001) (“[A]dministrative implementation of a particular statutory provision qualifies for Chevron deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.”).

however, the D.C. Circuit Court vacated that rule in 2007.⁵³ The SEC subsequently promulgated an interpretive rule; however, that rule was never finalized and does not carry the force of law.⁵⁴ Because there is no current final rule with the force of law, courts only consider the SEC's rationale for its interpretive value, with no requirement of *Chevron* deference.⁵⁵

1. Solely Incidental

The language of the Advisers Act exempts from the definition of investment adviser a broker or dealer who provides investment advice incidental to its broker-dealer business. It is important to note that the Advisers Act does not define "solely incidental." In its Investment Adviser Release No. 1 in September 1940, the SEC stated that the Advisers Act did not encompass "security dealers whose investment advice is given solely as an incident of their regular business."⁵⁶ The SEC has interpreted the "solely incidental" provision through the lens that the exemption amounts to "a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business."⁵⁷

In a January 1972 No-Action letter, the SEC provided guidance to a registered broker-dealer who distributed statistical surveys relating to securities issued by New Jersey banks to many of its customers, free of charge.⁵⁸ The SEC opined that "the reports [are] investment advisory in nature, and, if Ryan received any special compensation therefor [sic], Ryan's registration as an investment adviser would be required."⁵⁹ In an

53. Certain Broker-Dealers Deemed Not To Be Inv. Advisers, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 2716, 2726 (Jan. 14, 2005), *vacated on other grounds in* Fin. Planning Ass'n. v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

54. Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Investment Advisers Act Release No. 2652, 72 Fed. Reg. 55127 (Sept. 28, 2007) [hereinafter 2007 SEC Interpretative Rule].

55. *Christensen v. Harris County*, 529 U.S. 576, 587 (2000).

56. Investment Company Act Release No. 1, 1940 WL 7439 (Sept. 23, 1940).

57. Op. of Gen. Counsel Relating to Section 202(a)(11)(c) of the Inv. Advisers of 1940, Investment Advisers Act Release No. 2, 1940 WL 975 (Oct. 28, 1940) [hereinafter SEC IA Release No. 2].

58. John J. Ryan & Co., SEC No-Action Letter, 1972 WL 12209 (Jan. 26, 1972).

59. *Id.* at *2.

April 1972 No-Action letter, the SEC addressed a company that was a registered broker-dealer that was compensated under a “directed brokerage” fee arrangement, where “the client agrees to instruct its investment manager to utilize the services of the Company as a broker-dealer in connection with the purchase or the sale of a portion of the securities for the client’s portfolio.”⁶⁰ The SEC opined that the “exemption provided broker-dealers in Section 202(a)(11)(C) is not available to the Company because in receiving directed brokerage for its evaluating services it would not be performing its broker-dealer activities in a manner which is ‘solely incidental’ to the conduct of its business as a broker-dealer.”⁶¹

In a 1975 interpretive release, the SEC opined that the following activities may not be solely incidental to the conduct of a broker-dealer’s business: (1) advisory services offered as part of an overall plan that assesses the financial situation of a customer and formulates a financial plan; and (2) performance of investment supervisory services or other investment management services tailored to the specific long-term investment needs of individual clients.⁶²

In its 2007 Interpretative Rule, the SEC defined solely incidental as “when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account.”⁶³ The Interpretive Release provided two situations where advice would not be solely incidental to a brokerage business: separate contract or fee for advisory services and discretionary investment advice. The SEC found that “a broker-dealer that separately contracts with a customer for, or separately charges a fee for, investment advisory services cannot be considered to be providing advice that is solely incidental to its brokerage.”⁶⁴ The SEC further found that “discretionary investment advice is not ‘solely incidental to’ the business of a broker-dealer.”⁶⁵

60. William Bye Co., SEC No-Action Letter, 1972 WL 8513 (Apr. 26, 1972).

61. *Id.* at *2.

62. Adoption of Amendments to Rule 206A-1(T) Under the Inv. Advisors Act of 1940 Extending the Duration & Limiting the Scope of the Temp. Exemption from the Advisors Act for Certain Brokers & Dealers, Investment Advisors Act Release No. 471, 1975 WL 174562 (Aug. 20, 1975).

63. 2007 SEC Interpretative Rule, *supra* note 54, at *55127.

64. *Id.* at *55128.

65. *Id.*

The SEC No-Action letters and interpretive guidance reflect that the SEC, until recently, had a narrow view of when broker-dealers could legitimately rely on the “solely incidental” exemption. Based upon changing business models and a strong lobbying effort from the industry, the SEC has expanded its view of the “solely incidental” exemption to include almost all brokers providing investment advice, except for those who have discretionary power over a client’s account.

2. *Special Compensation*

The language of the Advisers Act exempts from the definition of investment adviser a broker or dealer who does not receive special compensation for the provision of investment advice. It is important to note that the Advisers Act does not define “special compensation.” The SEC has found a “clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.”⁶⁶ The SEC further stated that “[t]he essential distinction to be borne in mind . . . is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.”⁶⁷

In its Investment Adviser Act Release No. 626 in 1975, the SEC stated that “special compensation” for investment advice is “compensation to the broker-dealer in excess of that which he would be paid for providing a brokerage or dealer service alone.”⁶⁸ The SEC further stated that special compensation only exists where there is a clearly definable charge for investment advice and that “a client who perceives that he is paying a charge specifically for investment advice is entitled to the protection of the Advisers Act.”⁶⁹

In an April 1985 letter, the SEC shed light on what they believed constituted “special compensation.”⁷⁰ Their belief was that the

66. SEC IA Release No. 2, *supra* note 57, at *2.

67. *Id.*

68. Final Extension of Temp. Exemption from the Inv. Advisors Act for Certain Brokers & Dealers, Investment Advisors Act Release No. 626, 43 Fed. Reg. 19224, 19226 (May 4, 1978) [hereinafter IA Release No. 626].

69. *Id.*

70. Am. Capital Fin. Servs., SEC No-Action Letter, 1985 WL 54220 (Apr. 29, 1985).

“qualifying term ‘special’ in the broker-dealer exemption clearly indicates that Congress was concerned with compensation other than that received by a broker-dealer in the ordinary course of its brokerage activities, i.e., commissions.”⁷¹ The SEC believed “the essential distinction between a commission which includes special compensation and one which does not is whether the [registered representative of a broker-dealer] is being specifically compensated for investment advice itself or for brokerage or other services to which the advice is merely incidental.”⁷² “It is evident from the discussion above that determining whether [a registered representative] (or its firm) is being compensated in any particular case for investment advice or for brokerage or other services is an inherently factual determination.”⁷³ The SEC made clear that

a non-segregated charge is special compensation because . . . that phrase includes any clearly definable charge for investment advice, regardless of whether the charge is separate from or included within commissions. If we did not follow this interpretation, [a broker-dealer] could circumvent Congress’ intent to exclude from the Act only a broker-dealer receiving bona fide commissions by merely incorporating an advisory charge into commissions.⁷⁴

This letter is important, because it reflects the SEC’s view that broker-dealers can still be required to register as investment advisers even if they only charge commissions.

Another obstacle when determining whether the financial service provider is being paid “special compensation” is that many financial service providers obfuscate their compensation structures. This can be seen clearly in a North American Securities Administrators Association (NASAA) survey from 2012, which found that broker-dealers put the onus on consumers to discover when they are acting in a fiduciary capacity and how they are compensated, rather than providing that information up-front in an easily accessible manner.⁷⁵ For the consumer

71. *Id.* at *2.

72. *Id.*

73. *Id.*

74. *Id.* at *3.

75. See N. AM. SEC. ADM’RS ASS’N, BROKER-DEALER FEE SURVEY 2 (2012), available at <http://www.nasaa.org/wp-content/uploads/2014/04/NASAA-Fee-Survey-4-24-14.pdf> (finding that “[w]hile broker-dealers may comply with the technical requirements governing fee disclosures, their disclosures lose effectiveness when

perspective, a 2012 study of 7,500 U.S. households by Cerulli Associates,⁷⁶ in conjunction with Phoenix Marketing International, found that nearly two-thirds of investors either believed the advice was free (29 percent) or did not understand how the financial service provider was paid (31 percent).⁷⁷ This empirical evidence reflects that consumers are often unclear on how their financial service providers are compensated. Until compensation disclosure is made more transparent to consumers, gathering evidence to support the “special compensation” prong of the exemption will be an almost insurmountable obstacle.

B. SEC AND NASD / FINRA ENFORCEMENT PROCEEDINGS - BROKER-DEALERS ARE FIDUCIARIES WHEN PROVIDING PERSONALIZED INVESTMENT ADVICE

The record reflects that the agencies that have enforcement power over brokers have historically found brokers to have fiduciary responsibilities. This analysis is important, because under the current regulatory regime, brokers are judged by a “suitability” standard of care, which is, under the law, a lower standard of care than a fiduciary standard.⁷⁸

The SEC has historically viewed brokers-dealers as fiduciaries that occupy a position of trust with a client. As far back as 1935, interestingly five years before enactment of the Advisers Act, the SEC held that “[t]he fiduciary obligation which a broker owes to his customer is dealt with in the rules.”⁷⁹ The SEC has viewed brokers who provide personalized investment advice differently than those who just take orders from clients.

In *In re Allender Co.*, the SEC held that the advisor occupied a position as a fiduciary and found that “[t]he conduct of the customers, too, was based on their expectation that [the advisor] would act in their

hidden in small print, embedded in lengthy account opening documents, or vague in terminology that does not define the service provided”).

76. A leading research firm that specializes in data collection related to the financial services industry.

77. Cerulli *Quantitative Update: Retail Investor Advice Relationships 2012*, CERULLI ASSOCIATES (2012), at 224 (on file with author).

78. See FINRA, Rule 2111, Sustainability (2014), http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9859.

79. Securities Exchange Act of 1934, Release No. 179, 1935 WL 29075 (Apr. 17, 1935).

best interests, an expectation fostered by [the advisor's] own conduct and words."⁸⁰ In *In re William J. Stelmack Corp.*, the SEC held that "the very function of furnishing investment counsel, learning the personal and intimate details of the financial affairs of customers, and making recommendations as to purchases and sales of securities, constitutes, in our opinion, a fiduciary function. If a broker, who merely executes a transaction on a principal's order, is an agent, it is anomalous to exclude from that category one whose relationship to a customer is much more intimate and confidential."⁸¹ In *In re Linder, Bilotti & Co., Inc.*, the SEC held that the

record contain[ed] overwhelming evidence of serious misconduct, complete disregard of the financial welfare of customers and the utter abdication of the fiduciary duties which a broker-dealer owes to his customers."⁸² A "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces [to them]."⁸³

The SEC has also viewed brokers as fiduciaries regarding the disclosure they provide and the fees charged to clients. In *In re Russell L. Irish*, the SEC held that "[a] broker-dealer fiduciary's affirmative duty to make adequate disclosure under these circumstances is not satisfied by merely furnishing the customers with a prospectus which describes the break points."⁸⁴ In *In re Thomson & McKinnon and Walter T. O'hara*, the SEC "stressed the importance of the broker's fiduciary obligation to get the best price for his customers."⁸⁵

The important point to note is that throughout these administrative proceedings, the broker has established a relationship with the customer, beyond a buyer-seller relationship. This view was confirmed in a 1994 SEC Release, which stated that "[i]n cases where a broker-dealer has

80. *In re Allender Co.*, Exchange Act Release No. 2992, 9 SEC 1043, 1053 (Aug. 27, 1941).

81. *In re William J. Stelmack Corp.*, Exchange Act Release No. 3261, 11 SEC 601, 618 (June 9, 1942).

82. *In re Linder, Bilotti & Co.*, 1964 SEC LEXIS 2329, at *56-57 (Jul. 29, 1964).

83. *In re Dane S. Faber*, Exchange Act Release No. 49216, 57 SEC 297, 310-11 (Feb. 10, 2004).

84. *In re Russell L. Irish*, Exchange Act Release No. 7687, 42 SEC 735, n.15 (Aug. 27, 1965).

85. *In re Thomson & McKinnon & Walter T. O'Hara*, Exchange Act Release No. 8310, 43 SEC 785, at *3 (May 8, 1968).

established a customer relationship based upon trust and confidence, and the customer depends upon and follows the broker-dealer's advice, a fiduciary relationship is established between the broker-dealer and customer."⁸⁶ The enforcement proceedings and regulatory releases cited above reflect that the SEC has held brokers to a fiduciary standard of care when providing more than mere transactional assistance.

Additionally, even though FINRA generally only holds brokers to a lower "suitability" standard of care, the National Association of Securities Dealers (NASD), which was the precursor to FINRA, historically viewed brokers as fiduciaries that occupied a position of trust with the client. In June 1940, over 70 years ago, the NASD stated that "a broker or agent is a fiduciary and he thus stands in a position of trust or confidence with respect to his customer or principal The law will not permit a broker or agent to put himself in a position where he can be influenced by any considerations other than those to the best interests of his customer or principal."⁸⁷ Further, recent FINRA pronouncements have provided for a "suitability" standard that increasingly looks like a fiduciary standard of care.⁸⁸ The new FINRA suitability rule⁸⁹ contemplates evaluating broker-dealer conduct in the context of the kind of comprehensive, ongoing advisory relationship with customers that is more akin to a fiduciary relationship. FINRA expanded the suitability rule to cover not only recommendations, but also "investment strategies," which include situations in which a security or strategy is recommended, regardless of whether a transaction takes place.⁹⁰

FINRA's January 2011 guidance on the new suitability rule states that the broker-dealer must "know its customers not only at account

86. Confirmation of Transactions, Exchange Act Release No. 34-33743, 56 SEC Docket 558, n.48 (Mar. 9, 1994).

87. *Questions and Answer*, N.A.S.D. NEWS (NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.), June 22, 1940, at 2.

88. Dep't of Enforcement v. Bendtsen, Complaint No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs.").

89. Order Approving Proposed Rule Change, Exchange Act Release No. 34-63325, 75 Fed. Reg. 71479 (Nov. 23, 2010) (SEC release approving FINRA Rule 2111, effective July 9, 2012).

90. FINRA, Regulatory Notice 12-25, Suitability: Additional Guidance on FINRA's New Suitability Rule (2012).

opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts."⁹¹ This new suitability rule moves the rule closer to a fiduciary rule and should ease broker-dealers' transition to any newly promulgated uniform fiduciary standard. For example, FINRA Rule 2111 (suitability) requires firms and associated persons to seek to obtain information about the customer's:

age; other investments; financial situation and needs, which might include questions about annual income and liquid net worth; tax status, such as marginal tax rate; investment objectives, which might include generating income, funding retirement, buying a home, preserving wealth or market speculation; investment experience; investment time horizon, such as the expected time available to achieve a particular financial goal; liquidity needs, which is the customer's need to convert investments to cash without incurring significant loss in value; and risk tolerance, which is a customer's willingness to risk losing some or all of the original investment in exchange for greater potential returns.⁹²

Recently, in its 2015 "Exam Priorities Letter", FINRA stated that "[i]rrespective of whether a firm must meet a suitability or fiduciary standard, FINRA believes that firms best serve their customers—and reduce their regulatory risk—by putting customers' interests first. This requires the firm to align its interests with those of its customers."⁹³

This movement towards a higher standard of care for brokers reflects that the transition of providing services under a suitability standard to a fiduciary duty will not be an insurmountable obstacle and in fact may be the de facto standard required, regardless of the legal standard applied.

91. FINRA, Regulatory Notice 11-02, Know Your Customer and Suitability: SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations, n.5 (2011).

92. *Suitability: What Investors Need to Know*, FINRA, <http://www.finra.org/Investors/ProtectYourself/BeforeYouInvest/P197434>.

93. Regulatory and Examinations Priorities Letter, FINRA (Jan. 6, 2015), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf>.

C. FINRA ARBITRATION – BROKER-DEALERS SUED FOR BREACH OF
FIDUCIARY DUTIES

In addition to the recent FINRA pronouncements of a quasi-fiduciary duty for broker-dealers, the empirical data provides that broker-dealers are subjected to fiduciary claims in private securities arbitration. Broker-dealers are not regulated under the Advisers Act, therefore, they are generally not subject to a fiduciary standard of care.⁹⁴ However, since 2010, there have been over 11,000 claims brought against broker-dealers for violation of a fiduciary standard of care.⁹⁵ The empirical data reflects that a majority of clients believe that their broker-dealers owe them a fiduciary standard of care and are alleging a violation of that duty through the arbitration process. It will be difficult for the brokerage industry to argue that they are not subject to a fiduciary standard of care when a violation of that duty is the most frequently brought claim against its members in securities arbitration.

The empirical data also explains the dearth of case law regarding broker-dealers' fiduciary standard of care. As noted by this Author in a previous article, "[a]n overwhelming majority of retail brokerage and many investment advisory agreements include language requiring that all disputes between the customer and the broker-dealer/investment adviser be resolved through arbitration."⁹⁶

94. SEC STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (Jan. 2011), <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> [hereinafter SEC Staff Study].

95. *Dispute Resolution Statistics*, FINRA <http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/index.htm>.

96. William Alan Nelson, *Take It or Leave It: Unconscionability of Mandatory Pre-Dispute Arbitration Agreements in the Securities Industry*, 17 U. PA. J. BUS. L. 573, 574 (2015) (citing Luis A. Aguilar, Commissioner, SEC, Speech before the Annual NASAA/SEC 19(d) Conference: Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections (Apr. 16, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1365171515400#.UfmMIZWdzdk> ("Currently, almost all customer agreements with brokerage firms include an arbitration clause requiring customers to arbitrate their claims in an arbitration forum—and they're now popping-up in the investment advisory industry.")).

D. MUNICIPAL ADVISORS

Broker-dealers currently have fiduciary duties in certain circumstances when advising on municipal securities. Section 15B of the Exchange Act, as amended by the Dodd-Frank Act, granted the Municipal Securities Rulemaking Board (MSRB) regulatory authority over municipal advisors and imposes a fiduciary duty on municipal advisors when advising municipal entities.⁹⁷ In recent guidance, the SEC makes clear that “[i]f a broker-dealer acts as a municipal advisor to a municipal entity with respect to an issuance of municipal securities, it owes a fiduciary duty to the municipal entity with respect to that issue and must not take any action inconsistent with its fiduciary duty to the municipal entity.”⁹⁸ The SEC also stated that “broker-dealer[s] must comply with MSRB Rule G-23, which prohibits persons from switching from the role of financial advisor to the role of underwriter with respect to the same issuance of municipal securities.”⁹⁹ This can be analogized to the “hat-switching” and regulatory arbitrage issues discussed below. Essentially, a broker-dealer who is a registered municipal advisor must choose either to give advice to a government client as an adviser and follow strict fiduciary guidelines, or to act as an underwriter and have a lower duty of care with regard to his or her municipal client.

E. ERISA

An increasingly significant portion of the assets managed by brokers-dealers belongs to employee benefit and pension plans subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).¹⁰⁰ ERISA is a Federal law that sets standards of protection for individuals in most voluntarily established, private-sector retirement

97. 15 U.S.C. § 78o-4(c) (2012). Exchange Act Section 15B(c)(1) provides that: “A municipal advisor and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor’s fiduciary duty or that is in contravention of any rule of the Board.” 15 U.S.C. § 78o-4(c)(1).

98. *Registration of Municipal Advisors: Frequently Asked Questions*, SEC OFFICE OF MUNICIPAL SECURITIES (May 19, 2014), <http://www.sec.gov/info/municipal/mun-advisors-faqs.pdf>.

99. *Id.* at 19.

100. Pub. L. No. 93-406, 88 Stat. 829 (codified in part at 29 U.S.C. ch. 18).

plans. When debating ERISA, Congress found that employee benefit plans required greater protection because the “continued well-being and security of millions of employees and their dependents are directly affected by these plans.”¹⁰¹ Specifically, ERISA seeks to protect employees “by establishing standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans.”¹⁰²

In general, there are two main categories of pension plans—defined benefit plans and defined contribution plans Defined benefit plans are generally funded by the employer, guaranteeing a specified monthly or other periodic retirement benefit to the employee based on the employee’s age, salary, and/or years of service Defined contribution plans, also called individual account plans, may be funded by employers, employees or both. Employee contributions may be on an after-tax basis, or in the case of a “401(k) plan” (and other plans such as 403(b) and 457(b) plans), on a pre-tax basis. These plans often permit employees to select their own investment choices, generally from a prescribed menu of options.¹⁰³

Many financial intermediaries manage assets for pension plans. Brokers must be aware that “ERISA is an extremely complex piece of legislation that deals with the establishment, operation, and administration of pension plans and is designed to protect plan participants and beneficiaries from certain potential abuses.”¹⁰⁴ Broker-dealers need to exercise particular care when managing assets subject to ERISA, as it imposes high fiduciary standards of conduct on those who operate and manage plans, including those who provide brokerage and related services to plans.¹⁰⁵

IV. JUDICIAL TREATMENT OF BROKERS

A. COMMON LAW: FUNCTION OVER FORM

Based upon the cases and enforcement proceedings above, courts and regulators look to the substance of the relationship rather than relying on titles to discern fiduciary responsibility. Historically,

101. 29 U.S.C. § 1001(a).

102. 29 U.S.C. § 1001(b).

103. 19 THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF FINANCIAL PLANNERS § 3:494 (West 2013).

104. *Id.*

105. *Id.*

regardless of whether an individual described themselves as an investment adviser, investment consultant, financial advisor, financial planner, broker or dealer, the courts and regulators have looked to what services they were providing and also how the client perceived those services. This is an important distinction that many opponents of a uniform fiduciary standard seem to ignore.

The enforcement proceedings cited above also reflect how narrowly the SEC viewed the “solely incidental” exemption for brokers under the Advisers Act. These proceedings reflect that once the broker goes beyond just buying and selling securities and furnishes investment counsel and learns the personal and intimate details of the financial affairs of customers, they are acting in a fiduciary capacity.

Conflicting standards of care have arisen, in part, due to each branch of the financial services industry being regulated separately. Scandals involving Madoff Investment Securities, the Stanford Financial Group, and other Ponzi schemes have confirmed doubts over the murky demarcation among brokerage, dealing and advisory services.¹⁰⁶ This blurring of the lines is readily apparent in the case law. Because there is no uniform standard of care for broker-dealers and investment advisors, courts have differing views on when a fiduciary duty is owed. A review of authorities shows division within the courts regarding the fiduciary duties of broker-dealers. This division arises, because the application of the fiduciary duty at common law, as noted above, depends on the actual financial sophistication of the client or the specific communications between the financial service provider and the client.

It is important to note that not all common law and state securities laws are preempted by Federal securities laws and regulations. In *Baker, Watts & Co. v. Miles & Stockbridge*, the Fourth Circuit held that “[i]t is well-settled that federal law does not enjoy complete preemptive force in the field of securities State securities laws exist in every state, the District of Columbia, and Puerto Rico, and, ‘far from preempting the field,’ Congress has expressly preserved the role of the states in securities regulation.”¹⁰⁷ The court further held that “states enjoy broad powers to regulate such diverse subjects as: the registration of securities;

106. See FINRA SPECIAL REVIEW COMMITTEE, REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA’S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES (Sept. 2009), <http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf> (last visited Jan. 6, 2015).

107. *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1107 (4th Cir. 1989).

the registration of broker-dealers, agents, and investment advisers; and fraud in the sale or purchase of securities and the rendering of investment advisory services.”¹⁰⁸ The court also stated that States also “may provide additional rights and remedies which do not conflict with federal securities law.”¹⁰⁹

Additionally, a financial advisor may be liable for breach of fiduciary duty even though no violation of federal or state securities laws is found. Because there is no preemption of state securities laws, even though a financial advisor is only registered as a broker-dealer, he or she still may face fiduciary liability under common law. In *Gochnauer v. A.G. Edwards & Sons, Inc.*, the Eleventh Circuit held that:

Since not every instance of financial unfairness or breach of fiduciary duty will constitute a fraudulent activity under § 10(b) or Rule 10b-5, federal courts should be wary of foreclosing common law breach of fiduciary duty actions which supplement existing federal or state statutes The fiduciary concept derives from trust and agency principles. Actions contrary to the duties of loyalty and care are remedied by giving the beneficiary of the relationship the right to recover for the fiduciary’s breach.¹¹⁰

1. Generally

When analyzing whether a fiduciary duty exists, courts and regulators look to the substance of the relationship rather than relying on titles to discern fiduciary responsibility. It is informative to look at examples of cases throughout the country where the fiduciary duty was at issue. A number of courts have found that brokers are held to be fiduciaries for provision of investment advice given on a regular basis; when investors rely on brokers’ fraudulent misrepresentations; or when there is a “special” relationship between the broker and customer, generally defined by unequal bargaining power and trust and confidence placed in the broker by the customer.¹¹¹

108. *Id.*

109. *Id.* (citing *Underhill Assocs., Inc. v. Bradshaw*, 674 F.2d 293, 295-96 (4th Cir. 1982)).

110. *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987).

111. *See, e.g., Daniels v. Nat’l Emp. Benefit Servs., Inc.*, 858 F. Supp. 684, 690 (N.D. Ohio 1994) (“The term ‘fiduciary’ is to be given a broad construction . . . an individual is to be considered a fiduciary only as to those functions over which he has

As stated by the United States Bankruptcy Court for the District of New Hampshire in *Clarkeies Market*, “[a] fiduciary relation does not depend on some technical relation created by or defined in law It may exist under a variety of circumstances and does exist in cases where there has been a special confidence placed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence.”¹¹² Additionally, in *ARA Automotive Group v. Central Garage*, the Fifth Circuit held that “[a] fiduciary relationship may arise from a variety of relationships where the parties are ‘under a duty to act for or give advice for the benefit of another upon matters within the scope of their relation.’”¹¹³ The court further noted that the “existence of a fiduciary relationship, outside of formal relationships that automatically give rise to fiduciary duties, is usually a fact intensive inquiry.”¹¹⁴

a. Brokers With No Fiduciary Obligations

Courts have generally found that brokers do not have fiduciary obligations when providing purely transactional assistance. In *Farm King Supply, Inc. Integrated Profit Sharing Plan v. Edward D. Jones & Co.*, the defendant was held to not be a fiduciary. Even though Jones selected a few securities from its limited pool of commissionable securities and proposed to the trustees that they should purchase from among this select group, the court found he was only acting as a broker.¹¹⁵ Courts in other jurisdictions have also found that the “mere

discretionary control or authority, whether that authority be conferred *de facto* or pursuant to agreement.”); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981) (“[I]f 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.”).

112. *In re Clarkeies Mkt., LLC*, 322 B.R. 487, 495 (Bankr. N.H. 2005) (quoting *Lash v. Cheshire Cnty. Sav. Bank*, 124 N.H. 435, 439 (1984)); *see also* *SEC v. Ridenour*, 913 F.2d 515 (8th Cir. 1990) (broker-dealer owed fiduciary duty to clients with whom he had established a relationship of trust and confidence).

113. *ARA Auto. Grp. v. Cent. Garage, Inc.*, 124 F.3d 720, 723 (5th Cir. 1997).

114. *Id.*

115. *Farm King Supply, Inc. Integrated Profit Sharing Plan v. Edward D. Jones & Co.*, 884 F.2d 288, 294-95 (7th Cir. 1989).

existence of a broker-customer relationship is not proof of its fiduciary character.”¹¹⁶

In *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, the Second Circuit held that “there is no general fiduciary duty inherent in an ordinary broker/customer relationship.”¹¹⁷ In *Press v. Chemical Investment Services. Corp.*, the Second Circuit held that a broker-customer relationship is not ordinarily a fiduciary relationship and that a broker’s fiduciary obligation, if any, is generally limited to completion of the transaction.¹¹⁸ The court went on to state that even in “[c]ases that have recognized the fiduciary relationship as evolving simply from the broker-client relationship have limited the scope of the fiduciary duty to the narrow task of consummating the transaction requested.”¹¹⁹

In *Arst v. Stifel Nicolaus & Co.*, the Tenth Circuit held that the broker did not have a fiduciary duty to investigate or disclose information about securities a customer wanted to sell.¹²⁰ In *Sewell v. Great North Insurance Co.*, the Tenth Circuit held that “absent a special relationship between the insured and the insurer’s agent, that agent has no affirmative duty to advise or warn his or her customer of provisions contained in an insurance policy.”¹²¹

b. Brokers With Fiduciary Obligations

A majority of courts have found that when brokers are providing anything other than purely transactional assistance, they owe a fiduciary duty to their clients. In *Maybank v. BB&T Corp.*, the court held the agent to a fiduciary duty because the client engaged the agent to devise a retirement investment plan that reflected the client’s goals of diversification, steady income, tax sheltering, and ability to protect

116. See, e.g., *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988) (quoting *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974)).

117. *Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.* 157 F.3d 933, 940 (2d Cir. 1998).

118. *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999).

119. *Id.*

120. *Arst v. Stifel Nicolaus & Co.*, 871 F. Supp. 1370, 1384 (D. Kan. 1994), *aff’d in part, rev’d in part*, 86 F.3d 973 (10th Cir. 1996).

121. *Sewell v. Great N. Ins. Co.*, 535 F.3d 1166, 1171 (10th Cir. 2008).

wealth for heirs.¹²² In *Tonzi v. Nichols*, the court found a fiduciary relationship existed because the defendant, who was the client's accountant and financial advisor for over twenty years, advised him to roll over his 401(k) and invest in viatical contracts.¹²³

Courts will look at both the sophistication of the investor and the level of trust and confidence placed in the broker-dealer. In *Belmont v. MB Investment Partners*, the Third Circuit held that "a plaintiff alleging a fiduciary breach must first demonstrate that a fiduciary or confidential relationship existed . . . a fiduciary relationship does not exist merely because one party receives, or even relies on advice from another, but rather requires that 'the parties do not deal with each other on equal terms.'"¹²⁴ In *MidAmerica Federal Savings and Loan Association v. Shearson/Am. Express Inc.*, the Tenth Circuit held that "a fiduciary relationship springs from an attitude of trust and confidence and is based on some form of agreement, either expressed or implied, from which it can be said the minds have been met to create a mutual obligation."¹²⁵ In *Lee v. Hasson*, a Texas Court of Appeals found that the "facts of [the] case present a rare example of the type of close personal relationship of trust and confidence that gives rise to a legally cognizable fiduciary duty."¹²⁶

In *Mathias v. Rosser*, Mathias advised Rosser to invest money in three nursing homes he owned.¹²⁷ The Court found that "the evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and

122. *Maybank v. BB&T Corp.*, No. 6:12-cv-00214-JMC, 2012 U.S. Dist. LEXIS 108480, at *7-12 (D.S.C. Aug. 3, 2012).

123. *Tonzi v. Nichols*, 899 N.Y.S.2d 63, slip op. 51924(U) at *2-4 (N.Y. Sup. Ct. 2009).

124. *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 506 n.44 (3d Cir. 2013) (quoting *In re Estate of Clark*, 359 A.2d 777, 781 (Pa. 1976)).

125. *MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Ex. Inc.*, 886 F.2d 1249, 1257 (10th Cir. 1989).

126. *Lee v. Hasson*, 286 S.W.3d 1, 19 (Tex. Civ. App. 2007).

127. *Mathias v. Rosser*, Nos. 01AP-768, 01AP-770, 2002 WL 1066937, at *1 (Ohio Ct. App. 2002).

expertise in seeking his advice.”¹²⁸ Based upon these facts, the court found a fiduciary relationship existed between Mathias and Rosser.¹²⁹

In *Nat'l Western Life Ins. Deferred Annuities Litig.*, the U.S. District Court for the Southern District of California noted that under California law, an insurer does not owe a strict fiduciary duty to its insured.¹³⁰ However, because the sales agents held themselves out as objective financial planners, the court found that a special relationship, fiduciary in nature, was created between Plaintiffs and Defendants.¹³¹ The court also stated that the deferred annuities being offered were “complex financial instruments which the average person cannot understand.”¹³² In *Johnson v. John Hancock Funds*, the Tennessee Court of Appeals held that

[i]f the transaction is non-discretionary and at arm's length, i.e., a simple order to buy or sell a particular stock, the relationship does not give rise to general fiduciary duties However, if the client has requested the broker or advisor to provide investment advice or has given the broker discretion to select his or her investments, the broker or advisor assumes broad fiduciary obligations that extend beyond the individual transactions When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client.¹³³

In *Patsos v. First Albany*, the Massachusetts Supreme Court found that the broker owed a fiduciary duty to the client who lacked investment acumen, because a naïve client is more likely to place special trust in the broker.¹³⁴

The courts will also look at the relationship of the broker and the customer outside of the financial service being provided. In *Kalb v. Norsworthy*, a Texas Court of Appeals found a fiduciary relationship

128. *Id.* at *5.

129. *Id.*

130. *In re Nat'l W. Life Ins. Deferred Annuities Litig.*, 467 F. Supp. 2d 1071, 1086 (S.D. Cal. 2006).

131. *Id.* at 1087.

132. *Id.*; see also *Estate of Migliaccio*, 436 F. Supp. 2d 1095, 1107 (C.D. Cal. 2006) (“[A] deferred annuity is not merely a life insurance policy but a ‘complex investment product’ which requires a purchaser to rely on the agent for superior knowledge.”).

133. *Johnson v. John Hancock Funds*, 217 S.W.3d 414, 428-29 (Tenn. Ct. App. 2006).

134. See *Patsos v. First Albany Corp.*, 741 N.E.2d 841 (Mass. 2001).

where, “[b]y reason of appellant’s long association with appellee in a business relationship, as well as the close personal friendship existing between them, appellant was justified in placing confidence in the belief that appellee would act in his best interest.”¹³⁵ In *Leib v. Merrill Lynch*, the Eastern District of Michigan held that “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.”¹³⁶ This is an important point, when one considers the multitude of financial services advertising where financial service providers profess to be our “neighbors and friends.”

In *Burdett v. Miller*, the Seventh Circuit held that “if a person solicits another to trust him in matters for which he holds himself out as expert and trustworthy, and if the other, who is not an expert, accepts the offer and reposes her trust in the first, a fiduciary relationship is established.”¹³⁷ In *EBCI Inc. v. Goldman, Sachs & Co.*, the New York Court of Appeals held that, when an arm’s length relationship becomes advisory and one person was induced to and did repose confidence in another, the relationship becomes fiduciary.¹³⁸ In *United States v. Williams*, a self-employed insurance seller took advantage of his position as a financial advisor to gain the trust of an 87-year-old man and convinced him to grant power of attorney, with which the financial planner stole about \$400,000.¹³⁹ The court held that the financial advisor was employed as a fiduciary, specifically noting that the elderly man relied upon the fiduciary as his trusted advisor.¹⁴⁰ In *Hatleberg v. Norwest Bank Wisconsin*, the Wisconsin Supreme Court held that when a broker holds himself or herself out as either an “investment planner,” “financial planner,” or “financial advisor,” a fiduciary duty may arise.¹⁴¹

The above cited cases reflect that courts look to the nature of the product or services being delivered, the manner in which the financial

135. *Kalb v. Norsworthy*, 428 S.W.2d 701, 705 (Tex. Civ. App. 1968).

136. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1978).

137. *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992).

138. *EBCI Inc. v. Goldman, Sachs & Co.*, 832 N.E.2d 26 (N.Y. Ct. App. 2005).

139. *United States v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006).

140. *Id.*

141. *Hatleberg v. Norwest Bank Wisconsin*, 700 N.W.2d 15 (Wisc. 2005).

service providers hold themselves out and clients' perceptions to determine whether the financial service provider is a fiduciary.¹⁴²

Even though a majority of courts have held that, under common law, brokers are fiduciaries when providing personalized investment advice or holding themselves out as trusted advisors, a minority of courts have followed the SEC's expansive view of when advice is "solely incidental" to a broker's practice. For example, in *Thomas v. Metropolitan Life Insurance Co.*, the plaintiffs purchased a Metropolitan Life Insurance Company ("Met Life") variable universal life insurance policy, based upon the advice of their registered representative, an employee of Met Life's affiliated broker-dealer, Metropolitan Securities, Inc.¹⁴³ The court held that the broker-dealer exemption rendered the fiduciary standard inapplicable to Met Life and its affiliated broker-dealer, because Met Life's investment adviser service was "solely incidental to" its brokerage function.¹⁴⁴ The court reasoned that "solely incidental to" meant "solely in connection with" and it was undisputed that the registered representative's advice was solely connected to the plaintiff's purchase of the insurance policy.¹⁴⁵ Even though the court found that "[w]here the product being sold is a sophisticated financial product . . . it would seem that the need for unbiased advice—or at least for the disclosure of those things that might tend to skew the salesman's 'advice'—would seem to be every bit as great as in a conventional advisory relationship," the court still held that the broker-dealer exemption applied.¹⁴⁶

It is important to note that the *Thomas* case is in the minority and, more importantly, directly contradicts the Congressional intent underlying the enactment of the Advisers Act.¹⁴⁷ As reflected in the discussion above, a majority of courts view brokers as fiduciaries when

142. *But see* Noveletsky v. Metro. Life Ins. Co., 2013 U.S. Dist. LEXIS 83762, at *7 n.13 (D. Me. June 14, 2013) (The financial service provider "admitted in his deposition that he provided wealth, estate, and insurance planning for Noveletsky [He] also stated that he did not provide financial planning services to Noveletsky. . . . Noveletsky provides no authority for the proposition that fiduciary duties may attach to someone providing wealth, estate, or insurance planning.").

143. *Thomas v. Metro. Life Ins. Co.*, No. CIV-07-0121-F, 2009 WL 2778663, at *2 (W.D. Okla. Aug. 31, 2009).

144. *Id.* at *3.

145. *Id.* at *7.

146. *Id.* at *9.

147. *See supra* Part II.B.

providing personalized advice to customers or holding themselves out as trusted advisors.¹⁴⁸

2. Commissions and Principal Trading

The areas of commissions and principal trading are hot-button issues and are also areas where the courts and regulators have put function over form. These are the two oft-cited arguments put forth by opponents of a uniform fiduciary standard of care, namely that under such a standard, they will not be allowed to receive commissions or trade as a principal. This Author respectfully disagrees and provides below that the regulatory agencies do as well.

It is important to note that Section 913 of the Dodd-Frank Act states that, under any newly implemented uniform fiduciary standard of care, commission-based products will not, in and of themselves, violate the uniform fiduciary standard of conduct.¹⁴⁹ These products will be evaluated on a case-by-case basis under a principles-based “best interest” fiduciary standard.¹⁵⁰

The courts can look to the standard currently employed by regulators concerning commission-based advice and products that, in some situations, may be in the best interest of the customer. A good example where commission-based products may be in the best interest of the client is in a “reverse churning” situation. Reverse churning occurs when “compensation is based upon the amount of assets in the account and trades are uncompensated, which often leads to under-trading or an account being ignored altogether.”¹⁵¹

In *In re A.G. Edwards & Sons, Inc.*, the New York Stock Exchange, LLC (“NYSE”) Division of Enforcement found that there were

148. See *supra* Part III.B.

149. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824-30 (2010).

150. Melanie Waddell, *SEC Chief White Backs Fiduciary Rule for Brokers*, THINKADVISOR (Mar. 17, 2015), <http://www.thinkadvisor.com/2015/03/17/sec-chief-white-backs-fiduciary-rule-for-brokers> (quoting SEC Chair Mary Jo White as stating that “the SEC should act under Section 913 of Dodd-Frank to implement a uniform fiduciary duty for broker-dealers and investment advisors’ where the standard is to act in the best interest of clients when giving advice to retail investors”).

151. Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1067 n.31 (2011) (citing Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 740 (2010)).

numerous non-managed fee-in-lieu of commission customer accounts that had “zero trades in either two consecutive years, three consecutive years, or in some instances, four consecutive years.”¹⁵² Such customers paid substantially more in fees than they would have had they been paying on a commission basis.¹⁵³ In *In re Raymond James & Associates, Inc.*, the NYSE Division of Enforcement found that between April 2001 and December 2004, Raymond James recommended to, and opened for, customers fee-based accounts without properly determining whether the account structure was suitable; of the nearly 3,000 Raymond James customers who opened fee-based accounts, almost 200 never traded at all, yet paid aggregate fees of \$138,000.¹⁵⁴ Raymond James also was found to have used advertising and sales literature that emphasized the benefits of fee-based accounts without adequately discussing their fees and restrictions.¹⁵⁵

In *In re Morgan Stanley DW, Inc.*, the NYSE Division of Enforcement found that the firm failed to create and maintain a supervisory system to ensure that fee-based accounts continued to be suitable for its customers who held such accounts; and as a result, between January 2001 and December 2003, more than 3,500 customers maintained fee-based accounts (with a minimum annual fee of \$1,000), despite the fact that they conducted no trades in their accounts for two consecutive years and/or maintained assets less than \$25,000 for at least one year.¹⁵⁶ In February 2009, FINRA fined Robert W. Baird & Co. \$500,000 for fee-based account violations.¹⁵⁷ FINRA found that the company allowed numerous customers to remain in fee-based accounts

152. *In re A.G. Edwards & Sons, Inc.*, 2006 NYSE Disc. Action LEXIS 143, at *11-12 (Jul. 10, 2006).

153. *Id.* at *9-14.

154. *In re Raymond James Fin. Servs., Inc.*, 2005 NASD LEXIS 11, at *71-73 (May 1, 2005).

155. *Id.* at *75.

156. See NASD Orders Morgan Stanley to Pay Over \$6.1 Million for Fee-Based Account Violations, FINRA (Aug. 2, 2005), available at <http://www.finra.org/newsroom/2005/nasd-orders-morgan-stanley-pay-over-61-million-fee-based-account-violations> (last visited Apr. 13, 2015).

157. See FINRA Fines Robert W. Baird & Co. \$500,000 for Fee-Based Account, Breakpoint Violations, FINRA (Feb. 18, 2009), available at <https://www.finra.org/newsroom/2009/finra-fines-robert-w-baird-co-500000-fee-based-account-breakpoint-violations> (last visited Apr. 27, 2015).

despite conducting no trades for at least eight consecutive quarters; these accounts paid over \$269,000 in fees during the inactive quarters.¹⁵⁸

These enforcement actions reflect that the compensation structure employed by a financial service provider should be based upon the best interest of the customer, rather than a strict adherence to a single form of compensation. This Author is not suggesting that financial service providers may use this argument as a strategy to avoid mitigating conflicts of interest; it just amplifies the fact that financial service providers must take action in the best interest of the customer, regardless of the interests of the financial service provider.

The courts can look to the standard currently employed by regulators, specifically the SEC, concerning principal trading where, in some situations, it may be in the best interest of the customer. This Author agrees with the SEC and believes that “[d]epending on the circumstances, clients may benefit from principal trades, but only in the context of a fiduciary relationship with the best interests of the client being paramount In favorable circumstances, advisers may obtain access to a broader range of investment opportunities, better trade execution, and more favorable transaction prices for the securities being bought or sold than would otherwise be available.”¹⁵⁹

Case law and SEC enforcement actions render the distinction as a “principal” as meaningless for purposes of avoiding a fiduciary duty to the client. For example, in *Opper v. Hancock Securities Corp.*, the broker claimed that since he was a “principal,” he did not have any fiduciary duty towards the client.¹⁶⁰ The Southern District Court of New York (confirmed on appeal by the Second Circuit) held that “the confirmation-slip label ‘as principal’ or ‘as broker’ was as a practical matter for defendant’s unilateral determination. Conforming to SEC requirements, it served only to show whether the broker in the particular trade had chosen to buy from plaintiff or sell to him for its own account. While the disclosure served, and serves, as an obviously desirable protection for the customer, it is equally obvious that the choice of function in this respect cannot be (and was never intended to be) a means by which the broker may elect whether or not the law will impose

158. *Id.*

159. Temp. Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. IA-2653, File No. S7-23-07 (Sept. 24, 2007).

160. *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 674 (S.D.N.Y. 1966).

fiduciary standards upon him in the actual circumstances of any given relationship or transaction.”¹⁶¹

Subsequently, the SEC, in *In re EF Hutton & Co.*, relying on the holding in *Opper*, found that

[a] broker-dealer’s determination to execute an order as principal or agent cannot be ‘a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.’ Our aim is to give effect to the reasonable expectations of the parties to the relationship.¹⁶²

Courts have also found that the Advisers Act applies to full-service broker-dealer firms who provide personalized investment advice to their customers.¹⁶³

3. *De Facto Discretion and Control*

When analyzing the existence and extent of brokers’ fiduciary obligations, courts have considered the degree of control the broker exercised over the customer’s account to be a determinative factor.¹⁶⁴ In *Adams*, the Colorado Supreme Court held that “[i]f a broker has acted as an investment advisor, and particularly if the customer has almost invariably followed the broker’s advice, this is an indication that the broker exercises functional control of the account and that the broker-customer relationship is fiduciary.”¹⁶⁵ In *Leboce v. Merrill Lynch*, the

161. *Id.* at 674-75.

162. E.F. Hutton & Co., Exchange Act Release No. 25887, 49 SEC 829, 835 (1988).

163. *Smith v. Oppenheimer Funds Distrib., Inc.*, 824 F. Supp. 2d 511, 516 (S.D.N.Y. 2011).

164. *See Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508, 516-18 (Colo. 1986).

165. *Adams*, 718 P.2d at 516 (citing *Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 709 F.2d 605, 607 (9th Cir. 1983)); *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107, 113 (N.D. Ala. 1971) (“Where the broker-dealer is also an investment advisor he does occupy a fiduciary relationship”); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 433 (N.D. Cal. 1968) (“A degree of control sufficient to warrant protection may be inferred from evidence that the customer invariably relied on the dealer’s recommendations, especially when the customer is relatively naive and unsophisticated”); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 709 (Cal. Ct. App. 1968) (“The relationship between broker and

Ninth Circuit held that “it is where the agent ‘for all practical purposes’ controls the account that [the] law imposes fiduciary obligations.”¹⁶⁶ In *Davis v. Keyes*, the Eastern District of Michigan held that a broker who assumes effective control over a non-discretionary account owes the customer fiduciary duties.¹⁶⁷ It is important to note here that courts do not look at the “incidental” nature of the services, they analyze the interaction between the broker and the customer to determine the level of control.

An additional “factor in the determination of whether a broker controls a customer’s account is the financial sophistication of the customer, since an inexperienced or naive customer is more likely to leave the control of an account in the broker’s hands.”¹⁶⁸ In *Beckstrom v. Parnell*, a Louisiana Appellate Court found that the broker should have known of client’s impairment due to age and alcohol use and although the client had once been financially sophisticated, the issue was the client’s “capabilities as an investor at the time [of] the investment decisions.”¹⁶⁹

If a broker is simply taking orders and buying and selling securities, fiduciary responsibility will generally not be imposed. However, if that broker provides personalized investment advice to his or her clients and forms a relationship where the client relies on and trusts that advice, under common law and principles of *stare decisis*, a broker will be held to a fiduciary standard of care.¹⁷⁰ Broker-dealers cannot have it both ways; if they want to be seen as trusted advisors, they must submit to the obligation of a fiduciary standard of care when providing personalized investment advice.

principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal.”).

166. *Leboce*, 709 F.2d at 607.

167. *See Davis v. Keyes*, 859 F. Supp. 290, 294 (E.D. Mich. 1994).

168. *Adams*, 718 P.2d at 517 (citing *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 536 (D. Md. 1978); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1978); *Hecht*, 283 F. Supp. at 433).

169. *Beckstrom v. Parnell*, 730 So. 2d 942, 950-52 (La. Ct. App. 1998).

170. *See supra* Part II.A.

B. BROKER'S RIGHT TO LIE: THE "PUFFERY DEFENSE"

Even though courts have overwhelmingly found that broker-dealers who have a special relationship of trust and confidence with the client are deemed to be fiduciaries, brokers have used the "puffery" defense to avoid liability. It is important to note that the securities laws do not recognize a distinct "puffing" exception.¹⁷¹ It is a common law creation that has been used in the securities, antitrust, torts, contracts, and even criminal areas of law. For example, the Second Restatement of Torts states that "loose general statements made by sellers in commending their wares . . . are commonly known as 'puffing' or 'sales talk.'"¹⁷² In *Hoxworth*, the Third Circuit held that "[t]o say that a statement is mere 'puffing' is, in essence, to say that it is immaterial, either because it is so exaggerated ('You cannot lose.') or so vague ('This bond is marvelous.') that a reasonable investor would not rely on it in considering the 'total mix' of [available] information."¹⁷³

It is informative to look at cases where the courts have opined on the breadth of the "puffery" defense. In *Newman v. Rothschild*, the Southern District of New York held that a broker-dealer's statement that "I'm the best in the business" was not actionable.¹⁷⁴ In *Frota v. Prudential-Bache Securities*, the same court held that a broker-dealer's assurance that the account would be managed properly and that he was not only the client's broker, but their "friend, confidant and financial advisor" was mere puffery.¹⁷⁵

These decisions do seem to conflict with SEC enforcement actions that seem to take a more narrow view of "puffery." In *In re B. Fennekohl & Co.*, the SEC found that the registrant

was engaged in a 'boiler-room' operation The brochures containing false, misleading and highly optimistic statements concerning the company were mailed to prospective customers, and . . . [t]hese salesmen knew of course that no financial information appeared in the sales literature, and that no reasonable basis was given for the highly optimistic representations made therein. It

171. *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 200 (3d. Cir. 1990).

172. RESTATEMENT (SECOND) OF TORTS § 542 (1977).

173. *Hoxworth*, 903 F.2d at 200-01 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

174. *Newman v. L.F. Rothschild*, 651 F. Supp. 160, 163 (S.D.N.Y. 1986).

175. *Frota v. Prudential-Bache Sec., Inc.*, 639 F. Supp. 1186, 1190 (S.D.N.Y. 1986).

should have been apparent to them that they were participating in a fraudulent, high-pressure sales campaign.¹⁷⁶

The SEC also found that “[t]he concept of ‘puffing’ is derived from the doctrine of caveat emptor and . . . can have little application to the merchandising of securities.”¹⁷⁷

With these conflicting views, how does an individual tell whether they are making material misrepresentations or just “sales” talk? From an analysis of the above-cited actions, there seems to be a distinction between quantitative and qualitative information. For example, if the financial service provider tells the client that his or her rate of return on a stock will be 8%, when the verifiable information shows it will only be 4%, this would generally be seen as a material misrepresentation.¹⁷⁸ However, if the financial service provider simply said that the client could not lose with the stock or that its value was “red hot,” this would generally be seen as “puffery” or mere “sales talk.”¹⁷⁹

What if the financial service provider informs the client that he is a trusted advisor and will work in the client’s best interest? Would these statements be seen as mere “puffery”? In support of this view, the financial service provider could say that any investor would understand that these are just aspirational goals and that the investor would not rely on those representations. However, the counter argument would be that by informing the client that you will work in his or her best interest includes a legal obligation to operate as a fiduciary and that an investor would rely on the representation.

Financial services advertising is important because empirical evidence reflects that consumers are unaware that there are differences in the standard of care provided by financial advisors and that some financial advisors do not have to provide advice and services in their best interests. For example, a May 2006 survey conducted by TD Ameritrade surveyed 1,000 U.S. investors concerning the differences in awareness of investment advice and the protections associated with stockbrokers and Registered Investment Advisors.¹⁸⁰ The study found that 43% of investors were unaware that stockbrokers and investment

176. *In re* B. Fennekohl & Co., 41 SEC Docket 210, 216-17 (Sept. 18, 1962).

177. *Id.* at 216.

178. *See id.*

179. *See Newman*, 651 F. Supp. at 163.

180. TD AMERITRADE INC., TD AMERITRADE INVESTOR PERCEPTION STUDY (2006), available at <http://www.tdainstitutional.com/pdf/InvestorPerceptionStudy.pdf>.

advisors offer different levels of investor protection.¹⁸¹ A January 2008 study conducted by the RAND Center for Corporate Ethics, Law, and Governance, sponsored by the SEC, found that individual investors were not aware of the differences between broker-dealers and investment advisors.¹⁸² The study found that “[e]xisting studies suggest that investors do not have a clear understanding about the distinction between broker-dealers and investment advisers and their different levels of fiduciary responsibility.”¹⁸³

These studies reflect that consumers are either unclear on the duty owed to them by financial service providers or believe that financial service providers provide advice in their best interest. Regardless of which one of these categories the consumer falls under, the implementation of a uniform fiduciary standard of care would make the confusion irrelevant and would focus on the harm to consumers, which arises in part by allowing financial service providers to hold themselves out as trusted fiduciaries, but then not providing that level of service.¹⁸⁴

Informing the client that you will act in his or her best interest goes beyond “puffing” and “sales talk” and deceives the client into thinking that they are receiving a level of service that the financial service provider is not legally obligated to provide. Informing the client that the broker will work in his or her best interests should legally obligate the broker to do so (*i.e.* by providing services under a fiduciary standard of care).

181. *Id.*

182. Angela Hung et al., *Technical Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND CORP., (Jan. 3, 2008), available at http://www.rand.org/pubs/technical_reports/TR556.html (last visited Jan. 6, 2015) [hereinafter 2008 RAND Study].

183. *Id.* at 33.

184. Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries*, 87 WASH. L. REV. 707, 770 (2012) (“[A]n adviser that holds itself out as an expert assumes fiduciary obligations.”). As stated eloquently by prior SEC Commissioner Elisse B. Walter, “retail investors should not bear the burden of understanding distinctions between financial professionals that have become increasingly less relevant over the years.” Elisse B. Walter, Comm’r, SEC, Address at the Mutual Fund Directors Forum: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch050509ebw.htm>.

C. DIFFERING PURPOSES AND LEVELS OF PROTECTION: ADVISERS ACT VS.
EXCHANGE ACT

Opponents of a uniform fiduciary duty contend that Advisers Act precedent should not be applied under any newly created fiduciary duty imposed on broker-dealers.¹⁸⁵ Opponents claim that the Advisers Act was not meant to regulate brokers.¹⁸⁶ This Author agrees wholeheartedly with the contention; however, once the broker-dealer provides personalized investment advice to retail customers, they are no longer providing brokerage services, they are providing investment advisory services.

The Supreme Court has held that the Advisers Act “was designed to apply to those persons engaged in the investment-advisory profession—those who provide personalized advice attuned to a client’s concerns, whether by written or verbal communication.”¹⁸⁷ The Court found the Advisers Act didn’t apply in that case because the “publications [did] not fit within the central purpose of the Act because they [did] not offer individualized advice attuned to any specific portfolio or to any client’s particular needs.”¹⁸⁸

Courts have held that the Exchange Act “was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.”¹⁸⁹ This is an important distinction that the courts have provided, mainly based upon a review of the legislative history leading up to the Exchange and Advisers Acts. In summary, courts have held that the purpose of the Exchange Act “is to regulate and control ‘*transactions*’ in securities commonly conducted upon securities exchanges and over-the-

185. See Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Mary L. Schapiro, Chairman, SEC, *Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act* (July 14, 2011), available at <https://www.sec.gov/comments/4-606/4606-2952.pdf>.

186. *Id.* at 15-16.

187. *Lowe v. SEC*, 472 U.S. 181, 208 (1985).

188. *Id.*; see also *SEC v. Terry’s Tips, Inc.*, 409 F. Supp. 2d 526, 531 (D. Vt. 2006) (stating that “[t]he Investment Advisers Act was primarily intended to regulate the business of rendering personalized investment advice”).

189. See, e.g., *Abrahamson v. Fleschner*, 568 F.2d 862, 873 (2d Cir. 1977) (quoting S. REP. NO. 1760, 86th Cong., 2d Sess. 1 (1960)).

counter markets,”¹⁹⁰ while the purpose of the Advisers Act is “to protect the public and investors against malpractices by persons paid for *advising* others about securities.”¹⁹¹

The Advisers Act also provides greater protections for consumers than the Exchange Act. It is important to note that this is a long-held SEC staff opinion. In May 1978, the SEC provided a final extension of a temporary exemption from the Advisers Act for broker-dealers that decided, as a result of the May 1975 elimination of fixed commission rates on securities transactions, to impose charges for their investment advisory services that might have caused such broker-dealers to lose their exemption from the Advisers Act.¹⁹² In the Release, the SEC specifically states, “the Advisers Act provides individuals with certain protections not available under the Exchange Act.”¹⁹³ The SEC also stated that “the protections afforded investors under 10b-5 (17 CFR 240.10b-5) the general antifraud rule adopted pursuant to Section 10(b) (15 U.S.C. § 78j(b)) of the Exchange Act, may not be so broad as those afforded under the comparable provisions in Section 206 (15 U.S.C. 80b-6) of the Advisers Act.”¹⁹⁴

Courts have also held that the suitability obligation does not equate to a fiduciary “best interest” obligation. In *Emerson Electric Co. v. Marsh & McClellan Co.*, the Supreme Court of Missouri held that “[w]hile a broker has a duty to act with reasonable care, skill and diligence in procuring insurance . . . a broker has no duty to advise the insured about what insurance he needs or what insurance to buy unless it specifically undertakes to do so This Court, therefore, rejects Emerson’s claim that brokers have an additional duty to find insureds the lowest possible cost insurance available to meet their needs.”¹⁹⁵ In *Castillo v. Dean Witter Discover & Co.*, the Southern District of New York held that broker-dealers have “no duty to make comparisons to the products of [their] competitors.”¹⁹⁶

190. SEC v. Gruss, 859 F. Supp. 2d 653, 662 (S.D.N.Y. 2012) (citing *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247 (2010)) (emphasis added).

191. S. Rep. No. 1760, 86th Cong., 2d Sess. 1 (1960).

192. IA Release No. 626, *supra* note 68.

193. *Id.* at 19224.

194. *Id.* at 19225.

195. *Emerson Elec. Co. v. Marsh & McLennan Co.*, 362 S.W.3d 7, 9 (Mo. 2012).

196. *Castillo v. Dean Witter Discover & Co.*, No. 97 Civ. 1272(RPP), 1998 WL 342050, at *9 (S.D.N.Y. June 25, 1998).

The heightened fiduciary duty which must be adhered to by an investment adviser is derived from centuries-old common law finding that the law will intervene to protect a vulnerable party from the dominant party acting on conflicts of interest.¹⁹⁷ The U.S. Supreme Court, in its 1846 holding in *Michoud v. Girod*, held that:

The disability to purchase is a consequence of that relation between them which imposes on the one a duty to protect the interest of the other, from the faithful discharge of which duty his own personal interest may withdraw him. In this conflict of interest, the law wisely interposes. It acts not on the possibility, that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty. It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells.¹⁹⁸

Michoud reflects that as far back as the mid-19th Century, courts were wary of conflicts of interest and how they would affect the relationships between the dominant and more vulnerable party.

Based upon the discussion above, it would not be proper to apply Exchange Act precedent to conduct that is more properly regulated under the Advisers Act. Opponents are correct when they argue that the Advisers Act was not designed to regulate broker-dealer activity;¹⁹⁹ however, as noted above, when broker-dealers are providing personalized investment advice, they are no longer acting as broker-dealers. To emphasize this point, the Third Circuit in *Belmont* stated that “[b]roker-dealers are exempted from [the Advisers Act], provided that

197. See *supra* Part IV.A.

198. *Michoud v. Girod*, 45 U.S. 503, 555 (1846).

199. See Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Mary L. Schapiro, Chairman, SEC, *Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act* (July 14, 2011) at 11, available at <https://www.sec.gov/comments/4-606/4606-2952.pdf> (“The Advisers Act was not intended or designed to apply to the incidental advice offered by broker-dealers.”).

they are not otherwise acting as investment advisers.”²⁰⁰ This is a critical distinction that a majority of courts rely upon when finding that a broker-dealer owes a fiduciary obligation to his or her client when providing personalized investment advice.²⁰¹ Advisers Act precedent has developed over the past 75 years to address the specific conduct that would be regulated under a uniform fiduciary standard of care.²⁰²

D. CONFLICTING STANDARDS: REGULATORY ARBITRAGE

Under the current regulatory system, financial advisors are able to “switch hats” and provide services under different standards of care. This issue of regulatory arbitrage “consists of those financial transactions designed specifically to reduce costs or capture profit opportunities created by differential regulations or laws.”²⁰³ Regulatory arbitrage “undermines the efficiency of regulatory competition, shifts the incidence of regulatory costs, and fosters a lack of transparency and accountability that undermines the rule of law.”²⁰⁴ In the context of financial service providers, individuals will hold themselves out as financial planners to exploit the difference between the ways different regulatory regimes treat a transaction.

The SEC staff has also previously taken positions that appear to authorize regulatory arbitrage. In a January 1986 No-Action letter provided to a registered representative of a broker-dealer, the SEC stated that it would not “take any enforcement action if you, a registered

200. Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 501 n.36 (3d Cir. 2013).

201. See *supra* Part IV.B.

202. Daniel M. Gallagher, Commissioner, SEC, Speech at the 2015 Virginia Law and Business Review Symposium: Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers (Apr. 10, 2015), available at <http://www.sec.gov/news/speech/041015-spch-cdmg.html> (“For more than seven decades, the 1940 Acts have enabled the SEC to fairly and effectively oversee the asset management industry in a manner consistent with our statutory mission.”).

203. Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997).

204. Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230 (2010) (“[W]hen new forms are chosen because they reduce regulatory costs and increase transaction costs compared to the old structure, we lose twice: efficiency is reduced by the increase in transaction costs, and the regulatory burden is shifted onto those who cannot engage in arbitrage. Worse yet, if everyone engages in the arbitrage, all we have done is increased transaction costs with no net change in the incidence of the regulatory burden.”).

representative of a registered broker-dealer, hold yourself out to the public as a financial planner without registering as an investment adviser under the Investment Advisors Act of 1940, so long as your financial planning activities are conducted solely in your capacity as a registered representative of your broker-dealer.”²⁰⁵ In a December 2005 No-Action letter provided to the Securities Industry and Financial Markets Association (SIFMA), the SEC wrote that:

As a general matter, a broker-dealer/investment adviser may discontinue its advisory relationship with its client and then assume a brokerage relationship. An advisory contract, for example, may contain a provision under which both parties agree to terminate the advisory relationship, or either party may initiate the termination of the advisory relationship The extent to which the broker-dealer/investment adviser would thereby limit the scope of its fiduciary obligations to the client would turn, in our view, on whether the broker-dealer/investment adviser has provided the client full disclosure about the change in the relationship and any consequent change in the obligations assumed by the broker-dealer.²⁰⁶

The letter also stated that SEC rules do “not require a broker-dealer to treat as an investment advisory client a customer to whom the broker-dealer merely makes it known that financial planning or other investment advisory services are available but to whom the broker-dealer does not provide such services.”²⁰⁷

In *In re IFG Network Securities, Inc.*, the SEC found that there was “no case precedent that holds that an associated person of an investment adviser cannot change hats . . . and act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser.”²⁰⁸ In that case, a registered representative differentiated

205. Elmer D. Robinson, SEC No-Action Letter, 1986 SEC LEXIS 1610, at *1 (Jan. 6, 1986).

206. SIFMA, SEC No-Action Letter, 2005 WL 3526529, at *3 (Dec. 16, 2005).

207. *Id.* at *1.

208. *In re IFG Network Securities, Inc.*, Initial Decision Release No. 273, SEC File No. 3-11179 (Feb. 10, 2005), <http://www.sec.gov/litigation/aljdec/id273cff.htm> [hereinafter Initial Decision Rel. No. 273]. This decision was overturned on appeal by the SEC’s Division of Enforcement, and a Commission opinion was rendered on July 11, 2006. See *In re IFG Network Securities, Inc.*, Exchange Act Release No. 54127, Investment Advisers Act Release No. 2533, Admin. Proc. File No. 3-11179 (July 11,

between his advisory and broker-dealer services and explained to customers that he charged a fee for advisory services and was paid by a commission for brokerage services when he sold mutual funds to them.²⁰⁹ The SEC further held that “[e]ach customer had sufficient education and cognitive skills to ask questions and to study and understand mutual fund prospectuses had he or she made the effort In short, each customer, based on the information available to him or her and his or her ability to interpret, could have independently evaluated his or her broker’s recommendations.”²¹⁰ It is important to note the departure of this reasoning from other case law. As discussed previously, consumers are generally not aware of the difference in the standards of care of broker-dealers, investment advisers, wealth managers, or financial planners and do not have the requisite education and financial literacy.²¹¹

In its 2007 Interpretive Rule Release (IA-2652), published after the *FPA v. SEC* decision, the SEC specifically states that a dually registered advisor is only an investment adviser with respect to those accounts for which it provides advice or receives compensation that would subject the advisor to the Advisers Act.²¹²

The blurring of the lines is most apparent for dual registrants, those who are registered as both an investment adviser and broker-dealer. In *Western Reserve Life Assurance Co. of Ohio vs. Graben*, the Texas Court of Appeals found that a dual registrant crossed the line in holding itself out as a financial advisor, by stating that ongoing advice would be provided. In doing so the dual registrant was found to have formed a relationship of trust and confidence with the customers to which fiduciary status attached.²¹³ The court reasoned that:

[W]hen a person . . . is acting as a financial advisor, that role extends well beyond a simple arms’-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his

2006). However, the SEC opinion does not address the issue of conversion from an advisory relationship to a non-advisory relationship.

209. Initial Decision Rel. No. 273.

210. *Id.*

211. *See supra* Part IV.B.

212. SEC Release No. IA-2652, 17 C.F.R. 275, 16 (2007).

213. *W. Reserve Life Assurance Co. of Ohio v. Graben*, 233 S.W.3d 360 (Tex. App. 2007).

investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties.²¹⁴

In *Safer v. Nelson Financial Group*, plaintiffs entered into various agreements with defendant, an independent registered investment advisor ("RIA") based in Ohio who was affiliated with a broker-dealer.²¹⁵ The Advisory Agreement specifically stated that it "terminate[d] upon the delivery of the Written Financial Plan."²¹⁶ The plaintiffs, who lost 50 percent of their portfolio value over a three-year period, argued that they had no problem with the trades, or implementation of the financial plan, but it was the advice that was flawed.²¹⁷ The court held that the "Advisory Agreement, which pertained to investment advice, was separate and distinct from the New Account Information Forms, which pertained to the execution of that advice" and that the advisory agreement terminated upon delivery of the financial plan.²¹⁸ Even though the court does not specifically discuss fiduciary duties arising under common law, it indirectly discusses the question of when the advisory part of a financial planning relationship ends and a brokerage relationship designed to implement the plan begins.²¹⁹ States have attempted to tackle this issue, but there is no consensus on when a fiduciary duty is owed.

Ron Rhoades, Assistant Professor in the Alfred State Department of Business Studies, has analyzed broker-dealer / RIA firms which primarily market their services as undertaking "financial plans." Professor Rhoades states that:

[W]hen it comes to implementation of the plan, many (if not most) of the representatives of this firm 'switch hats' to a non-fiduciary role and sell products (which are often proprietary mutual funds). In reality, under fiduciary law the requirements to 'remove the fiduciary hat' and switch to a non-fiduciary role are very stringent. Indeed, the disclosures required (if switching hats would be permitted at all) are such that no client of sound mind and understanding—if they were informed of all of the facts relating to such a switch (as would be required of a fiduciary) would provide

214. *Id.* at 374.

215. *Safer v. Nelson Fin. Grp., Inc.*, 422 F.3d 289, 291-92 (5th Cir. 2005).

216. *Id.* at 295.

217. *Id.* at 294.

218. *Id.* at 293.

219. *Id.* at 297.

informed consent to the switch. This practice exists commonly in [the industry]. It's a travesty that bait and switch occurs in such a widespread fashion.²²⁰

Michael Chamberlain, principal of Chamberlain Financial Planning LLC, has posed the question that when financial advisors are dual registrants, “how are clients ever to know if the representative is wearing the [investment adviser] hat and giving advice or the [broker-dealer] hat and selling a product?”²²¹ As dual registrants, broker-dealers, acting as “financial planners”, can develop the financial plan under the affiliated investment adviser, while implementing certain financial planning recommendations, such as the purchase or sale of investment and insurance products, under other financial services laws.²²² Investors are harmed when financial advisors are able to “switch hats” and provide services under different standards of care.²²³

V. REGULATORY AND POLICY SOLUTIONS

The cases cited above underscore investor confusion regarding the differences between broker-dealers and investment advisers and demonstrate why having two different legal duties for broker-dealers and investment advisers diminishes investor protection.²²⁴ These cases also provide a guide for how broker-dealers may push proprietary products without disclosing the incentive to the consumer “so long as the product being sold is suitable and the incentive is tied to its sale, a broker may quietly put his or her own interests above those of the

220. Ron A. Rhoades, *Fiduciary Duties: What Policymakers and the Public Need to Know*, BROKER AND BROKER (June 22, 2009), <http://www.brokeandbroker.com/index.php?a=blog&id=203> (last visited Jan. 6, 2015).

221. Michael Chamberlain, *Let's Call a Spade a Spade and a Salesperson a Salesperson*, INVESTMENTNEWS (Oct. 4, 2009), <http://www.investmentnews.com/article/20Vi091004/REG/310049996> (last visited Jan. 6, 2015).

222. See generally GAO, REGULATORY COVERAGE GENERALLY EXISTS FOR FINANCIAL PLANNERS, BUT CONSUMER PROTECTION ISSUES REMAIN 11 (JAN. 2011) available at <http://www.gao.gov/assets/320/314684.pdf> (“The regulatory system for financial planners covers most activities in which they engage. However, enforcement of regulation may be inconsistent and some questions exist about consumers’ understanding of the roles, standards of care, and titles and designations that a financial planner may have.”).

223. See Fleischer, *supra* note 202.

224. See *supra* Part IV.D.

consumer.”²²⁵ They also provide a guide for how brokers can avoid being regulated as a fiduciary by only providing occasional advice to clients.²²⁶ This section will provide possible solutions for the SEC to combat these abuses.

A. RULEMAKING UNDER THE ADVISERS ACT: NARROWING THE SOLELY INCIDENTAL EXEMPTION FOR BROKER-DEALERS

The cleanest solution for reducing harm to investors would be to narrow the “solely incidental” exemption for broker-dealers under the Advisers Act. This method avoids having to craft regulation for both investment advisers and broker-dealers under the Advisers Act and Exchange Act, respectively. This would also align the regulations with common law, where broker-dealers have been traditionally held to a fiduciary standard of care when providing personalized investment advice.

This method was also recommended by the SEC Investment Advisory Committee²²⁷ in November 2013. The Committee wrote that it

favors an approach that involves rulemaking under the Investment Advisers Act to narrow the broker-dealer exclusion from the Act while providing a safe harbor for brokers who do not engage in broader investment advisory services or hold themselves out as providing such services By significantly narrowing of [sic] the broker-dealer exclusion from the Investment Advisers Act, such an approach would restore the functional regulation intended by Congress when it adopted the ‘34 and ‘40 Acts. Under such an approach, broker-dealers who choose to offer personalized investment advice to retail investors, such as retirement planning or investment planning, that goes beyond the buy/sell recommendations inherent to securities transactions would be regulated in the same

225. Jeremy Liles, *Thomas v. Metropolitan Life Insurance Co.: Semantics, Fiduciary Duty, and an Outdated Distinction*, 89 DENV. U. L. REV. 457, 471 (2012).

226. See *supra* Part IV.A.1.a.

227. *Investment Advisory Committee*, SEC, <http://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml> (“Section 911 of the Dodd-Frank Act established the new Investor Advisory Committee to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the committee to submit findings and recommendations for review and consideration by the Commission.”).

fashion as other investment advisers when they engage in those advisory activities.²²⁸

The Committee went on to note that “[b]roker-dealers who ‘hold themselves out’ as advisers, based either on the titles they use or the manner in which they market their services, would be precluded from relying on the exclusion.”²²⁹

This approach aligns with the state legislation that was reviewed by Congress during passage of the Adviser Act.²³⁰ That language stated, “investment counsel or advice, whether by one specializing solely in rendering investment counsel or advice, or by a dealer or broker, incidental to usual transactions in securities, shall be strictly on the basis of fiduciary relationship between the counselor or advisor and the investor or prospective investor.”²³¹

B. SEC POLICY STATEMENT: PROVIDE PROSPECTIVE ENFORCEMENT
GUIDANCE FOR BROKER-DEALERS

As an alternative to narrowing the broker-dealer exemption under the Advisers Act, the SEC could issue a policy statement that provides guidance on the broker-dealer exemption in the Advisers Act, and how the SEC will enforce its provisions moving forward.

There are generally three types of agency action: legislative rules, interpretive rules, and policy statements. Based upon varied analysis from the courts, the distinction between these actions has been described as “‘tenuous,’ ‘fuzzy,’ ‘blurred,’ and, perhaps most picturesquely, ‘enshrouded in considerable smog.’”²³² These actions were stated most clearly in a recent D.C. Circuit decision:

[a]n agency action that purports to impose legally binding obligations or prohibitions on regulated parties—and that would be the basis for an enforcement action for violations of those

228. Investment Advisory Committee, *Recommendation of the Investor as Purchaser Subcommittee Broker-Dealer Fiduciary Duty 2*, 5 (SEC, Draft, Nov. 22, 2013), <http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation.pdf>.

229. *Id.*

230. *Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. (1940).

231. *Id.* at 1006.

232. *Cnty. Nutrition Inst. v. Young*, 818 F.2d 943, 946 (D.C. Cir. 1987).

obligations or requirements—is a legislative rule (As to interpretive rules, an agency action that merely interprets a prior statute or regulation, and does not itself purport to impose new obligations or prohibitions or requirements on regulated parties, is an interpretive rule.) An agency action that merely explains how the agency will enforce a statute or regulation—in other words, how it will exercise its broad enforcement discretion or permitting discretion under some extant statute or rule—is a general statement of policy.²³³

An important distinction is that “the case law is clear that [courts] lack authority to review claims under the APA ‘where an agency merely expresses its view of what the law requires of a party, even if that view is adverse to the party.’”²³⁴ A recent decision from the D.C. District Court stated that the CFTC action concerning cross-border swaps did not qualify as “final agency action” because, as part interpretive rule and part policy statement, it is not “finally determinative of the issues or rights to which [it is] addressed.”²³⁵

The SEC can make a general policy statement that they will be enforcing such a provision. This will put financial advisors on notice and provide them with guidance on if and when they may need to register as an investment adviser. The SEC can provide guidance on when a financial advisor is providing personalized investment advice that is not solely incidental to their broker-dealer practice. Under the Exchange Act, a broker is defined as an individual who is “engaged in the business of effecting transactions in securities for the account of others.”²³⁶

The SEC should use the “holding out” standard that has been developed over the past thirty years. For example, in SEC Release IA-1092, the SEC provided guidance on the applicability of the Advisers Act on financial planners and pension consultants. The staff considered a “person to be ‘in the business’ of providing advice if the person: (i) holds himself out as an investment adviser or as one who provides

233. Nat'l. Mining Ass'n. v. McCarthy, 758 F.3d 243, 251-52 (D.C. Cir. 2014).

234. Ctr. for Auto Safety v. Nat'l Highway Traffic Safety Admin., 452 F.3d 798, 808 (D.C. Cir. 2006) (quoting *Indep. Equip. Dealers Ass'n. v. EPA*, 372 F.3d 420, 427 (D.C. Cir. 2004)).

235. SIFMA v. CFTC, No. CV 13-1916 (PLF), 2014 WL 4629567, at *71 (D.D.C. Sept. 16, 2014) (quoting *Am. Tort Reform Ass'n v. Occupational Safety & Health Admin.*, 738 F.3d 387, 395 (D.C. Cir. 2013)).

236. 15 U.S.C. § 78c (2012).

investment advice.”²³⁷ Recently, in March 2013, the staff of the Investment Adviser Regulation Office provided guidance concerning when to register as an investment adviser. The staff viewed

a person as holding himself out as an adviser if he advertises as an investment adviser or financial planner, uses letterhead indicating activity as an investment adviser, or maintains a telephone listing or otherwise lets it be known that he will accept new advisory clients, or hires a person to solicit clients on his behalf.²³⁸

The SEC could also look to the common law usage of “holding out.” For example, courts have held that when a bank holds itself out as an “investment planner,” “financial planner,” or “financial advisor,” “a fiduciary duty may arise in such circumstances.”²³⁹ Courts have also found that by holding oneself out as a disinterested adviser, a broker-dealer must act in the customer’s best interest, disclosing conflicts of interest and recommending the best investment among alternatives.²⁴⁰

To be exempt from investment adviser registration, the broker-dealer must also not receive any special compensation. Generally, both the SEC and the courts have found that by charging any type of fee specifically for investment advice, outside of brokerage commissions, the broker would be receiving special compensation and therefore not qualify for the exemption. The legislative history of the Advisers Act speaks to this prong. In the Senate Bill, the Senate interprets investment advice as qualifying for the exemption if the only compensation the broker receives is comprised of commissions, *i.e.*, compensation for closing the sale as opposed to compensation, such as advice fees, for providing investment advice.²⁴¹ The SEC has also weighed in upon this issue. In a 1978 Release, the SEC Division of Investment Management found that

237. Applicability of the Inv. Advisers Act to Fin. Planners, Pensions Consultants, and Other Persons Who Provide Inv. Advisory Services as a Component of Other Fin. Servs., Investment Advisers Act Release No. 1092, 52 Fed. Reg. 38400 (Oct. 8, 1987).

238. SEC INVESTMENT ADVISER REGULATION OFFICE, DIVISION OF INVESTMENT MANAGEMENT, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 13 (Mar. 2013), *available at* https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

239. *Hatleberg v. Norwest Bank Wisconsin*, 283 Wis.2d 234, 252-53 (Wisc. 2005).

240. *Burdett v. Miller*, 957 F.2d 1375 (7th Cir. 1992).

241. S. REP. NO. 76-1775, at 22.

'special compensation' for investment advice is compensation to the broker-dealer in excess of that which he would be paid for providing a brokerage or dealer service alone The Division of Investment Management regards special compensation as existing only where there is a clearly definable charge for investment advice. This reflects the Division's position that a client who perceives that he is paying a charge specifically for investment advice is entitled to the protections of the Advisers Act.²⁴²

This language is important, because it discusses the perception of the client, which also folds into the "holding out" discussion. For example, if a broker is holding him or her self out as an investment adviser, it would follow that the client would believe that the advisor was at least in part compensated for investment advice.

The SEC Notice would be a two-prong guideline. The first prong would provide guidance on how the SEC will be enforcing the "solely incidental" provision. The SEC can provide that any broker-dealer who holds themselves out as an investment adviser, financial planner or other term (e.g. investment counsel) that would lead a client to believe that they were in the business of providing investment advice, would generally have to register as an investment adviser. The guidance would also provide that if the broker provides advice not related to the sale of securities or provides continuing advice and guidance on securities to the client, the broker-dealer would generally have to register as an investment adviser. The second prong would provide guidance on enforcement of the "special compensation" provision. The SEC can provide that if a broker receives a fee for providing investment advice or markets their services in a way that the client would believe they were getting paid for investment advice, the broker-dealer would generally have to register as an investment adviser. For example, if the broker received any compensation in addition to the commissions they would earn on the sale of product, the broker would generally have to register as an investment adviser. If nothing else, this could lead to more transparency and a clearer description of how broker-dealers are compensated.

Importantly, these determinations would still be made by the SEC on a case-by-case basis.²⁴³ They would not be imposing any new

242. SEC IA Rel. No. 626, *supra* note 68.

243. See Lori A. Richards, Director, Office of Compliance Inspections and Examinations, SEC, Address at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006) ("Probably no statute or set of rules could contemplate the

regulatory burden on brokers, they would only be providing guidance on existing regulations. The notice would hopefully spur broker-dealers to either stop providing investment advice as their primary function or in the alternative, prompt the broker-dealer to register as an investment adviser and be subject to the fiduciary standard of care for the advice they are providing.

Further, this notice would not be subject to judicial review based upon the recent CFTC holding from the D.C. District Court and D.C. Circuit. The SEC would not have to go through Congress or even go through the notice and comment process under the APA. Policy statements announce standards that an agency intends to apply in future enforcement actions. As noted above, the courts “lack authority to review claims under the APA ‘where an agency merely expresses its view of what the law requires of a party, even if that view is adverse to the party.’”²⁴⁴

Even if an interest group argues that the guidance will have a negative impact on the financial services industry, the courts have held that “the mere fact that [an agency action] may have a substantial impact does not transform it into a legislative rule.”²⁴⁵ Furthermore, the D.C. District Court recently found that an agency’s decision to provide a policy statement actually benefits market participants and provides clarity on how the agency will enforce regulation.²⁴⁶

C. DODD-FRANK SECTION 913 UNIFORM FIDUCIARY STANDARD

The alternative to removing the broker-dealer exemption from the Advisers Act is rule-making under Section 913 of the Dodd-Frank Act.²⁴⁷ Section 913 of Dodd-Frank directed the SEC to conduct a study

variety of factual situations and decisions that an advisory firm faces. Can you imagine the number of rules and releases and regulations that this would require? Instead, the Advisers Act incorporates an adviser’s fiduciary duty under Section 206, and envisions that, in whatever factual scenario, the adviser will act in the best interests of his clients.”).

244. *Ctr. for Auto Safety v. Nat’l. Highway Traffic Safety Admin.*, 452 F.3d 798, 808 (D.C. Cir. 2006) (quoting *Indep. Equip. Dealers Ass’n. v. EPA*, 372 F.3d 420, 427 (D.C. Cir. 2004)).

245. *SIFMA v. CFTC*, No. CV 13-1916, 2014 WL 4629567, at *68 (D.D.C. Sept. 16, 2014) (citing *Cent. Texas Tel. Coop. v. FCC*, 402 F.3d 205, 214 (D.C. Cir. 2005)).

246. *Id.*

247. *Dodd-Frank Act*, Pub. L. No. 111-203, 124 Stat. 1376, 1824–30 (2010) (codified as enacted in 15 U.S.C. § 78o (2012)).

to evaluate the effectiveness of the legal and regulatory standards for broker-dealers and investment advisers and persons associated with those firms.²⁴⁸ It includes the discretionary rule-making provision regarding a uniform fiduciary standard of conduct for investment advisers and broker-dealers.²⁴⁹ Section 913 gives the SEC specific authority to establish a fiduciary duty for broker-dealers. The rule states that:

Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities 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 section 211 of the Investment Advisers Act of 1940.²⁵⁰

Section 211 of the Investment Advisers Act of 1940 states that:

The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.²⁵¹

Significantly, the SEC also made clear that any fiduciary rule applied to broker-dealers shall be no less stringent than the current fiduciary standard under Section 206 of the Advisers Act.²⁵² Section 913 also states that the receipt of commission-based compensation and the sale of proprietary or other limited ranges of products will not, by itself, violate the standard.²⁵³

248. See SEC Staff Study, *supra* note 94.

249. 15 U.S.C. § 80b-11(g)(1) (2012).

250. 15 U.S.C. § 78o(k)(1).

251. 15 U.S.C. § 80b-11(g)(1).

252. Section 206 of the Advisers Act contains provisions prohibiting fraud and deceit upon clients and also contains provisions discussing the practice of principal transactions. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6.

253. Pub. L. No. 111-203, 124 Stat. 1376, 1828 (2010).

1. Core Principles

This Article outlines the core principles that will provide the foundation for implementation of a uniform fiduciary standard of conduct for investment advisers and broker-dealers as authorized by Section 913 of Dodd-Frank.

The first, and most important, core principle is that the uniform fiduciary duty must include a “best interest” obligation as stated in Dodd-Frank Section 913.²⁵⁴ Section 913 states that the SEC “may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.”²⁵⁵ Per Section 913, the uniform fiduciary standard of conduct will be no less stringent than the fiduciary standard currently applicable to investment advisers under the Advisers Act, which at a minimum includes the duties of loyalty and care as interpreted and developed under Sections 206(1) and (2) of the Advisers Act.²⁵⁶

Any uniform fiduciary duty should be business-model neutral, meaning that the standard of conduct will be neutral as to the business-model and compensation structure of the financial service provider. The uniform fiduciary standard of conduct should also be principles-based.

Given the equitable nature of fiduciary law, it is not tenable to set forth a fiduciary’s responsibilities in a detailed manner or to specify a convention to govern their activity. Nor would it be in the public interest to do so. And it certainly would not be consistent with the

254. “Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients’ interests to its own.” Amendments to Form ADV, Investment Advisers Act Release No. 3060, 17 C.F.R. 275, 279, 3 (July 28, 2010). The fiduciary standard has also been summarized as a “prudent investor” standard: the fiduciary “shall invest and manage [client] assets as a prudent investor would” and “shall exercise reasonable care, skill, and caution.” National Conference of Commissioners on Uniform State Laws, Uniform Prudent Investor Act, § 2 (1994), *available at* http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf.

255. 15 U.S.C. § 80b-11.

256. *Id.*

way fiduciary law has evolved and been interpreted for hundreds of years.²⁵⁷

To this end, existing guidance and precedent under the Advisers Act regarding a fiduciary standard of care, as developed primarily through SEC interpretive pronouncements, numerous enforcement actions and case law, will continue to apply to investment advisers and be extended to broker-dealers, as applicable, under the uniform fiduciary standard of care.²⁵⁸ It is also important to note that while increased disclosure of conflicts of interest is a beneficial step, is not necessarily sufficient by itself to meet a fiduciary duty standard.

The uniform fiduciary duty would apply to broker-dealers and investment advisers under the new authority in Exchange Act Section 15(k) and Advisers Act Section 211(g), respectively.²⁵⁹ Any promulgated uniform fiduciary rule will have to provide further guidance to financial service providers, but should be based upon the principles listed above.

CONCLUSION

The problem of conflicting standards has plagued the financial services industry for far too long. Over the past four decades, the role of brokers has changed to where they operate in a similar fashion to investment advisers and hold themselves out to the public as trusted financial advisors who provide unbiased investment advice. The current conflicting standards harm consumers by allowing financial service providers to present themselves as impartial and unbiased advisors, while in actuality they are salesman that are only providing advice as a way to sell more expensive and complex products. An overwhelming majority of retail customers are further harmed because they are unable to determine which financial service providers are legally obligated to provide advice and services in their best interests.

257. Letter from David G. Tittsworth, Exec. Director, Investment Adviser Association, Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Rel. No. IA-3058; File No. 4-606, n.15 (Aug. 30, 2010) (quoting Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 SEC. REG. & LAW REP. 776 (Apr. 27, 2009)).

258. It is important to note that this view is supported by the SEC staff. SEC Staff Study, *supra* note 94, at 165.

259. See SEC Staff Study, *supra* note 94, at 109.

As this article shows, there is ample evidence that, under common law, brokers who provide services beyond buying and selling are held to a fiduciary standard of care. The SEC has the authority to conduct a rulemaking, which would codify the long-standing common law fiduciary duty, and abolish the arcane overlapping system that is currently in place. To date, no such action has been taken.²⁶⁰

260. See Waddell, *supra* note 150. SEC Chair Mary Jo White has stated publicly that she believes that a uniform fiduciary rule should be promulgated under Section 913 of Dodd-Frank; however, there has been no official agency action.