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BOOK 1

The Flawed State Of Broker-Dealer Regulation And The Case For An Authentic Federal Fiduciary Standard For Broker-Dealers

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Abstract

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I. INTRODUCTION

The 2008 financial crisis revealed that the American financial industry's regulatory scheme is broken and in desperate need of reform. The modern American financial system operates under an antiquated regulatory structure developed in the 1930s and 1940s that is ill-equipped to deal with the intricacies and risks of modern finance. Accordingly, reforming financial industry regulation is necessary to deal with the complexities of the 21st century financial services industry. President Obama championed financial industry reform during his campaign and stressed the importance of passing legislation during his first year in office. The House of Representatives recently passed a comprehensive piece of legislation reforming the financial industry and the Senate will begin working on its version of the bill in early 2010.[1] Tucked into the extensive House bill is the Investor Protection Act of 2009 ("IPA"), which significantly changes the federal securities laws.[2]

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1. Carle Hulse, *House Approves Tougher Rules on Wall Street*, N.Y. TIMES, Dec. 12, 2009, at A1.

2. Posting of Peter J. Henning to DealBook Blog, http://dealbook.blogs.nytimes.com/2009/12/15/what-the-sec-gains-from-the-financial-bill/?scp=1&sq=investor%20protection%20act%20of%202009&st=cse (Dec. 15, 2009).

This Note addresses a critical section of the IPA: its proposal that broker-dealers be held to a new, higher standard of conduct towards customers modeled on the Investment Advisers Act of 1940 (the "'40 Act"). Currently, broker-dealers are regulated under the Securities Exchange Act of 1934 (the "'34 Act") and sometimes held to a fiduciary standard of conduct towards customers, whereas investment advisers are regulated under the '40 Act and always held to a fiduciary standard. This bifurcated regulatory scheme—the product of another era when broker-dealers and investment advisers were distinct entities—results in two different regulatory standards and enforcement mechanisms for broker-dealers and investment advisers. Today, however, broker-dealers and investment advisers offer virtually identical services to investors, resulting in considerable confusion for both investors and regulators. Thus, the IPA seeks to harmonize the regulation of broker-dealers and investment advisers by holding both groups to a consistent standard of conduct.

Part II of this Note discusses the history of broker-dealer and investment adviser regulation, including the development of different legal duties and regulatory schemes for each group. Part III identifies and analyzes the different contexts in which broker-dealers and investment advisers are held to a fiduciary standard. Part IV examines the central problems within the current regulatory framework for broker-dealers and investment advisers. Part V analyzes the IPA and concludes that it is too vague and does far too little to protect broker-dealer customers. Part VI proposes an alternative to the IPA: the adoption of an authentic, federal fiduciary standard for broker-dealers that preserves a private right of action for investors. Finally, Part VII concludes that this Note's proposal is a superior alternative to the IPA that would better regulate broker-dealers and offer better protection for broker-dealer customers.

II. THE FLAWED STATE OF BROKER-DEALER REGULATION: HOW WE GOT HERE

SEC Commissioner Elisse Walter describes the current federal securities laws, enacted by Congress in the 1930s and 1940s, as a "badly worn patchwork quilt" in desperate need of reform.[3] Indeed, the

3. Elisse B. Walter, Comm'r, SEC, Speech at the Mutual Fund Directors Forum

regulation of broker-dealers and investment advisers is "balkanized" and reflects antiquated notions about the functions of broker-dealers and investment advisers that are virtually obsolete.[4]

A. The Origins of Broker-Dealer Regulation: The '34 Act

The Securities Exchange Act of 1934[5] (the "'34 Act") and its implementing rules "comprise the most central regulatory apparatus for broker-dealers."[6] Section 15(a) of the '34 Act requires broker-dealers engaged in interstate securities transactions to register with the Securities and Exchange Commission (the "SEC").[7] The '34 Act gives the SEC broad authority to set rules regarding broker-dealers, including the ability to revoke or suspend broker-dealer registration if the broker-dealer violates federal law or engages in other misconduct.[8]

An interesting and unique aspect of broker-dealer regulation is the SEC's reliance on self-regulatory organizations ("SROs") to regulate the broker-dealer industry. Although the SEC has the authority to establish rules for broker-dealers, it delegates most of this authority to SROs, with the primary SRO being the Financial Industry Regulatory Authority ("FINRA").[9] Accordingly, FINRA and its predecessor, the National Association of Securities Dealers (the "NASD"), have been most responsible for establishing the applicable rules and standards for broker-dealers.

The '34 Act requires broker-dealers to become a member of at least one SRO.[10] Pursuant to this requirement, the NASD was founded in 1939 and charged with regulating broker-dealers. FINRA, the contemporary successor to the NASD, was created in July 2007 through the consolidation of the NASD and the enforcement arm of the New York

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Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch050509ebw.htm) [hereinafter Walter Speech].

4. *See id.*

5. 15 U.S.C. §§ 78a-78nn (2006).

6. ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 7 (RAND Corp. 2008), *available at* www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

7. *See* 15 U.S.C. §§ 78a-78nn.

8. *See id.*

9. *See* Stuart Kaswell et al., *Broker Dealer Regulation—An Overview, Outline*, 1673 PLI/CORP. 9, 17-20 (2008).

10. *See* 15 U.S.C. §§ 78a-78nn.

Stock Exchange ("NYSE").[11] Accordingly, all broker-dealers, barring certain narrow exceptions, are required to register with FINRA.[12] FINRA's membership statistics demonstrate its considerable mandate: it oversees nearly 4,800 brokerage firms, approximately 171,000 branch offices, and roughly 644,000 registered securities representatives.[13]

Under its broad authority from the SEC, the NASD (and now FINRA) developed a comprehensive set of rules regulating broker-dealers, its Rules of Conduct.[14] These rules govern virtually every aspect of broker-dealer regulation: registration requirements, supervision requirements, record-keeping requirements, and most importantly for this Note's purposes, standards regarding broker-dealer duties to customers.[15]

NASD Rule 2310 establishes the standard for a broker-dealer making a recommendation regarding a security to a customer: suitability.[16] Rule 2310 specifies that a broker-dealer making a recommendation to a retail customer must have grounds for believing that the recommendation is suitable for that customer based on the customer's portfolio, financial situation, and needs.[17] Moreover, before making a recommendation, the broker-dealer must make reasonable efforts to discover:

> [T]he customer's financial status;
> [T]he customer's tax status;
> [T]he customer's investment objectives;
> [S]uch other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[18]

Unlike investment advisers, broker-dealers "are not categorically bound—by statute, regulation, or precedent—to a per se rule imposing

11. About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited Dec. 19, 2009) [hereinafter About FINRA].

12. *See* 15 U.S.C. §§ 78a-78nn.

13. About FINRA, *supra* note 11.

14. *See* Kaswell et al., *supra* note 9, at **17-20.

15. *See id.*

16. *See* FINRA Manual, NASD Rule 2310 (eff. Aug. 20, 1996), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638.

17. *See id.*

18. *Id.*

fiduciary obligations toward clients."[19] Instead, as discussed below, courts and arbitrators determine the applicable standard for a broker-dealer on a case-by-case basis depending on the circumstances of the broker-dealer's relationship with the client.

B. THE '40 ACT AND INVESTMENT ADVISER REGULATION

The '40 Act "regulates the collection of financial professions that typically includes financial planners, money managers, and investment consultants."[20] It defines "investment adviser as "any person who, for compensation, engages in the business of advising others" about investing in or selling securities, or who issues reports or analysis about securities for compensation.[21] The '40 Act has two aspects that distinguish it from the '34 Act and directly impact broker-dealer regulation.

1. Broker-Dealer Exception

The '40 Act regulates financial professionals who offer investment advice to customers for compensation. Thus, it would seem that broker-dealers, who regularly provide investment advice to their customers in connection with their broker-dealer business, are subject to the '40 Act. The '40 Act, however, contains a broker-dealer exception: pursuant to Section 201, a broker-dealer providing investment advice to a customer is not subject to the '40 Act if the advice is "*solely incidental* to the conduct of his business as a broker or dealer and *who receives no special compensation therefore*."[22] The exception recognized that broker-dealers traditionally provided varying degrees of investment advice to their customers in support of their primary function as broker-dealers.[23]

In recent years, the '40 Act's broker-dealer exception has created widespread confusion amongst broker-dealers about whether their services were exempt under the '40 Act. This confusion stems from the widespread "migration of stockbrokers into the advisory arena."[24]

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19. HUNG ET AL., *supra* note 6, at 10.
20. *See id.*
21. 15 U.S.C. § 80b-2(a)(11) (2006).
22. *Id.* (emphasis showing exception).
23. *See generally* Curtlan R. McNeily & John P. Moriarty, *Regulation of Financial Planners*, 19 REG. FIN. PL. § 3:9, p. 6. (2009).
24. *See* Rachelle Younglai, *Congress Told to Toughen up Broker Standards*,

Specifically, in the 1990s a growing number of broker-dealers began offering fee-based accounts to their customers. In a fee-based brokerage account, broker-dealers "provide customers a package of brokerage services—including execution, *investment advice*, custodial and record-keeping services—for a fee based on the amounts of assets on account with the broker-dealer."[25] Thus, the concern for broker-dealers is whether providing investment advice in the context of collecting a fee violates the broker-dealer exception's "no special compensation" provision.

Over the last decade, the SEC has repeatedly, and unsuccessfully, tried to provide a clear interpretation of the '40 Act's broker-dealer exception. In 1999, in response to the growing trend of broker-dealers offering fee-based accounts, the SEC proposed a rule entitled "Certain Broker-Dealers Deemed Not To Be Deemed Investment Advisers."[26] After this rule sparked considerable debate and comment from broker-dealers, the SEC proposed a further clarification of the broker-dealer exception: any broker-dealer providing investment advice that is solely incidental to its brokerage services would be exempted from the '40 Act, regardless of whether it charges a wrap or fixed fee, or transaction-based commissions, mark-ups, and mark downs.[27] Thus, under the SEC's proposed rule, a broker-dealer would still be exempt from the '40 Act, even if they received special compensation for their investment advice.

The SEC adopted its final rule regarding the broker-dealer exception in April 2005.[28] Under the 2005 "final rule," a broker-dealer receiving special compensation would not be deemed an investment adviser if the given advice was solely incidental to brokerage services and a specific disclosure was given to the customer.[29] Thus, the rule would have exempted broker-dealers from the '40 Act, even when the

REUTERS, Oct. 6, 2009, *available at* http://www.reuters.com/article/idUSTRE5954M020091006 (testifying before the U.S. House Financial Services Committee, Texas Securities Commissioner Denise Richards observed that, "[t]he migration of stockbrokers into the advisory arena . . . has fueled confusion among investors as to the services provided by stockbrokers and investment advisers as well as the level of protection").

25. Clint A. Corrie, *Investment Advisers and Brokers: When is a Broker Subject to Fiduciary Duties?* 1755 PLI/Corp 81, 107 (2009) (emphasis added).

26. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 34-51523, 70 Fed. Reg. 240424-01 (Apr. 19, 2005).

27. *Id*.

28. *See generally* Corrie, *supra* note 25, at 97-101.

29. *See id.*

broker-dealer received special compensation for investment advice. The D.C. Circuit Court of Appeals, however, struck down this rule in 2007.[30] In *Financial Planning Ass'n v. SEC*, the court held that the SEC rule was inconsistent with the '40 Act's text because the '40 Act expressly provides an exception for broker-dealers giving incidental investment advice when no special compensation is paid for the advice.[31] Since a fee-based account is not transaction-based, it necessarily includes compensation for the services rendered—which may include investment advice. Accordingly, the D.C. Circuit Court held that the SEC's rule was beyond the scope of the '40 Act and that the SEC had exceeded its authority under the statute.[32]

The SEC declined to appeal the D.C. Circuit's decision and instead proposed a new interpretative rule[33] providing a three-part analysis for determining whether a broker-dealer is subject to the '40 Act: (1) advisory status should be determined on account-by-account basis; (2) a broker-dealer does not receive "special compensation" simply because it charges different commissions for different brokerage services; and (3) a broker-dealer exercising investment discretion, other than limited or temporary discretion, is subject to the '40 Act.[34]

The foregoing demonstrates the confused state of broker-dealer regulation regarding whether broker-dealers are investment advisers. The SEC's inability to offer clear guidance on the '40 Act's broker-dealer exception, coupled with the D.C. Circuit decision, demonstrates that even the SEC does not have a firm handle on the interplay between broker-dealers and investment advisers regarding their respective functions and regulatory schemes.

2. SEC Regulation and No Private Right of Action

The '40 Act establishes a markedly different regulatory framework for investment advisers in comparison to the '34 Act's regulation of broker-dealers. Unlike the '34 Act, the '40 Act does not establish an SRO to regulate investment advisers; instead, it retains that authority

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30. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

31. *See id.* at 488, 492-93.

32. *Id.* "The final rule's exemption for broker-dealers is broader than the statutory exemption for broker-dealers under [the '40 Act]." *Id.* at 488.

33. *See* Corrie, *supra* note 25, at 100-01.

34. *Id.*

within the purview of the SEC.[35] The '40 Act requires investment advisers, unless exempt, to register with the SEC and complete a disclosure document, Form ADV.[36] Moreover, unlike the '34 Act, the '40 Act does not provide a private cause of action for damages.[37] Instead, the SEC enforces the '40 Act via administrative and civil actions.

III. THE '34 ACT AND THE '40 ACT: WHO IS A FIDUCIARY?

As discussed herein, the '34 Act and the '40 Act impose different rules and duties upon broker-dealers and investment advisers. The most important distinction between the two involves duties to customers. Specifically, investment advisers always owe their customers a fiduciary duty pursuant to the '40 Act.[38] In contrast, broker-dealers abide by FINRA rules (including the suitability standard) and only owe their customers a fiduciary duty in limited circumstances. Nevertheless, customers bringing complaints against their broker-dealers will often argue that their broker-dealer owed them a fiduciary duty as it requires a "heightened duty to act on another's behalf, in good faith, with honesty, with trust, with care, and with candor."[39] A broker-dealer found to owe a fiduciary duty to a customer is more likely to have violated the duty and be held liable to the customer because it is such a high standard, and as a result, is often liable to the customer.

The question of whether a broker-dealer owes a fiduciary duty to a client has been extensively litigated over the years, and thus a rich body

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35. *See generally* 15 U.S.C. § 80b-3(a), (b) (2006) (describing the circumstances under which investment advisers are either required or exempt from registration).

36. *See* 17 C.F.R. § 275.204-3(a) (2009). Among the required disclosures, Form ADV requires information regarding the adviser's basic fee structure, the nature of the adviser's services, client base, and broker discretion, its basic fee structure and whether it is negotiable, and the adviser's business activities that may engender conflicts of interest. *See* SEC, Form ADV: Part II, Uniform Application for Investment Advisor Registration, *available at* http://www.sec.gov/about/forms/formadv-part2.pdf.

37. *See, e.g.*, Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) (holding that the '40 Act provides only a limited private remedy to void an investment advisers contract but no other private cause of action).

38. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("[The] fundamental purpose [of the '40 Act was] to achieve a high standard of business ethics in the securities industry.").

39. HUNG ET AL., *supra* note 6, at 10.

of case law has developed on the subject. Part A of this section discusses the development of the fiduciary duty standard for investment advisers under the '40 Act. Part B then analyzes the substantial body of case law addressing the circumstances in which broker-dealers owe their customers a fiduciary duty.

A. INVESTMENT ADVISERS: ALWAYS FIDUCIARIES

Under the '40 Act, an investment adviser is a fiduciary with respect to its clients and has an affirmative duty to act in their best interests.[40] "Although the specific standards for fiduciary obligations are not laid out clearly in the statute, they are unambiguously a centerpiece of the ['40 Act's] differential treatment of investment advisers."[41] The Supreme Court held that the '40 Act creates a fiduciary duty for investment advisers in its landmark 1963 decision, *SEC v. Capital Gains Research Bureau*.[42] In *Capital Gains*, the Court engaged in a lengthy analysis of the '40 Act, and observed that its fundamental purpose, in the aftermath of the 1929 stock market crash and the Great Depression, was to "achieve a high standard of business ethics in the securities industry."[43] The Court further held that because the '40 Act recognized an investment adviser's "fiduciary relationship to his clients," it requires investment advisers to act in their clients' best interests; avoid conflicts of interest; and fully disclose to their clients all unavoidable conflicts of interest.[44] Federal and state courts have uniformly held that the '40 Act includes a fiduciary duty in the over four decades since *Capital Gains* was decided; thus, there is no doubt that investment advisers registered under the '40 Act are held to a fiduciary standard.

B. BROKER-DEALERS: FIDUCIARIES? IT DEPENDS

The case law concerning broker-dealers and fiduciary duties is a morass. In contrast to the uniform case law regarding the '40 Act's fiduciary duty standard, the case law on broker-dealers and fiduciary duties is complex and fact-specific. Unlike investment advisers, "broker-dealers are not categorically bound—by statute, regulation, or

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40. *See Capital Gains Research Bureau*, 375 U.S. at 194.
41. HUNG ET AL., *supra* note 6, at 13.
42. *See Capital Gains Research Bureau*, 375 U.S. at 191-92.
43. *Id.* at 186.
44. *Id.* at 201.

precedent—to a per se rule imposing fiduciary obligations toward clients."[45] The case law is generally divisible into two broad categories: (1) the more common situation, where the broker-dealer and the customer have a principal/agent relationship in which the broker simply executes the customer's orders (nondiscretionary accounts); and (2) the situation where a broker-dealer exercises control over the customer's account (discretionary accounts).[46]

1. Nondiscretionary Accounts

In nondiscretionary accounts, broker-dealers and their customers have principal/agent relationships with their clients in which the broker-dealer does not have discretion or control of client assets.[47] In this context, the courts and the SEC generally have concluded that broker-dealers do not owe fiduciary duties to their clients."[48] Several recent cases demonstrate this point. In *Welch v. TD Ameritrade*, customers brought a putative class action against broker-dealers TD Ameritrade and Merrill Lynch, asserting a variety of claims, including a common law claim for breach of fiduciary duty, relating to the broker-dealers' "cash sweep programs."[49] The court, however, dismissed the customers' suit. Addressing their fiduciary duty claim, the court held that under New York law, the "mere existence of a broker-customer relationship is not proof of its fiduciary character."[50] The court further held that when parties deal in arms-length commercial transactions, "no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances."[51] Thus, the court ruled that because the plaintiffs held ordinary, nondiscretionary accounts with their broker-dealers, they failed to allege any facts establishing that the broker-dealers had breached the "*limited duties* that they owed to Plaintiffs in regard to their brokerage accounts."[52]

45. HUNG ET AL., *supra* note 6, at 10.
46. *Id.*
47. *See* Corrie, *supra* note 25, at 85.
48. *Id.*
49. Welch v. TD Ameritrade Holding Corp., No. 07 Civ. 6904(RJS), 2009 WL 2356131 (S.D.N.Y. July 27, 2009).
50. *Id.* at *41.
51. *Id.* at *40.
52. *Id.* at *44 (emphasis added).

In its ruling, the *TD Ameritrade* court relied heavily[53] on *DeKwiatkowski v. Bear Stearns & Co.*,[54] a landmark 2002 Second Circuit case that closely examines the extent of a broker-dealer's duties to its customer in the context of a unique fact pattern. In that case, Plaintiff Henryk de Kwiatkowski ("Kwiatkowski") was a wealthy individual who made and lost hundreds of millions dollars trading currency futures through his broker-dealer, Bear Stearns ("Bear").[55] Ultimately, Kwiatkowski lost $215 million and sued Bear Stearns, and his individual broker, for common law negligence and breach of fiduciary duty. Kwiatkowski alleged that Bear and his broker failed to adequately warn him of risks, failed to keep him apprised of certain market forecasts, and gave him negligent advice concerning the timing of his trades.[56] The trial court found Bear negligent and awarded Kwiatkowski $111.5 million in damages.[57]

The Second Circuit Court of Appeals reversed the trial court's decision, holding that Bear did not owe Kwiatkowski a fiduciary duty and that Bear competently, rather than negligently, fulfilled the limited duties it owed to Kwiatkowski as a nondiscretionary brokerage account customer. The court of appeals, in its thorough analysis of the broker-dealer/customer relationship, provides a concise description of the limited duties a broker-dealer owes to a customer with a nondiscretionary account:

> [A] broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments . . . . On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention.[58]

Kwiatkowski argued that Bear "undertook a substantial and

53. *Id.* at **41-44.
54. 306 F.3d 1293 (2d Cir. 2002).
55. *Id.* at 1295-96.
56. *Id.*
57. *Id.*
58. *Id.* at 1302.

comprehensive advisory role" with respect to his account that triggered an ongoing duty on Bear's part to offer advice and warnings between transactions.[59] Because Bear undertook this duty, Kwiatkowski argued that Bear had assumed an ongoing duty to provide advice, which it violated when it did not inform him of several internal Bear reports containing information critical to Kwiatkowski's trading positions.[60] The court of appeals, however, found this argument meritless: a broker's "giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to advise in the future (or between transactions) or to monitor all data potentially relevant to a customer's investment."[61]

The Court of Appeals also addressed an issue raised at the trial court level, but not on appeal: the "special circumstances" argument. Specifically, the district court alluded to the "special circumstances" surrounding Kwiatkowski's account,[62] although it is unclear to what extent the district court relied on "special circumstances" as a basis for imputing an ongoing duty of reasonable care to Bear. Interestingly, the court of appeals acknowledged that there are "transformative special circumstances" that create a special duty for broker-dealers beyond the duty of reasonable care normally applicable to a broker's actions in nondiscretionary accounts. These include, *inter alia*, cases in which a client has impaired faculties; cases where the client and broker have a closer than arms-length relationship; or scenarios where the customer is so lacking in sophistication that the broker has de facto control over the account.[63] In sum, the law "imposes additional extra-contractual duties on brokers who can take unfair advantage of their customers' incapacity or simplicity."[64] Accordingly, the court of appeals found the special circumstances theory inapplicable to Kwiatkowski, the "very opposite of the naïve and vulnerable client" protected by the special circumstances theory.[65]

59. *Id.* at 1307.
60. *DeKwiatkowski*, 306 F.3d at 1303.
61. *Id.* at 1307.
62. Stating that the special circumstances being "[i]ts massive scale, the frequency of Kwiatkowski's contacts with Bear executives, and the 'unique risk' run by a private individual speculating in currency on a scale known only to governments of large countries." *See id.*
63. *Id.*
64. *Id.* at 1308.
65. *Id.* at 1309.

2. Discretionary Accounts

In contrast, brokers handling discretionary accounts can execute trades on their clients' behalf and generally owe a fiduciary duty to these clients.[66] The logic behind this heightened duty is straightforward: the client's delegation of control to the broker gives the broker considerable power, and that power is accompanied by new obligations to their customer, i.e. fiduciary duties. Thus, broker-dealer customers holding discretionary accounts enjoy the heightened protection of a fiduciary standard.

IV. PROBLEMS WITH THE CURRENT FRAMEWORK: INVESTOR CONFUSION AND DIFFERING LEGAL STANDARDS FOR BROKER-DEALERS AND INVESTMENT ADVISERS

As seen above, the contemporary distinction between broker-dealers and investment advisers is complex and increasingly blurred. Indeed, although broker-dealers and investment advisers are regulated by different statutes and different regulatory bodies, they "provide practically indistinguishable services to retail investors and direct them to the same [financial] products."[67] Unsurprisingly, this complexity creates considerable confusion for investors, who are generally uncertain about the distinction between investment advisers and broker-dealers. Moreover, investors are largely unaware of the different legal duties of broker-dealers and investment advisers. These problems—investor confusion and differing legal duties—diminish investor protection, a principal goal of the '34 and '40 Acts. Accordingly, any new regulation of the financial industry must alleviate investor confusion about the different functions and legal duties of broker-dealers and investment advisers. As one SEC commissioner put it, "[i]nvestors should receive the same level of protection when they purchase comparable products

66. *See*, *e.g.*, Marchese v. Nelson, 809 F. Supp. 880 (D. Utah 1993); *see also* Lautenberg Found. v. Madoff, Civil Action No. 09-816 (SRC), 2009 WL 2928913, at *7 (D.N.J. Sept. 9, 2009) (holding that "under both New York and New Jersey law, a fiduciary duty exists between a broker and a client where the customer has delegated discretionary trading authority to the broker") (internal citations and quotations omitted).

67. Walter Speech, *supra* note 3.

and services, regardless of the financial professional involved."[68]

Part A of this section discusses investor confusion regarding broker-dealers and investment advisers, while Part B analyzes a recent case that encapsulates the problem with having different legal standards for broker-dealers and investment advisers.

A. INVESTOR CONFUSION REGARDING THE DISTINCTION BETWEEN BROKER-DEALERS AND INVESTMENT ADVISERS

In 2008, the SEC enlisted the Rand Institute to analyze current broker-dealer and investment adviser business practices and investigate investor understanding about the differences between, and relationships among, broker-dealers and investment advisers.[69] After a comprehensive industry review, the Rand Institute issued a detailed, 204-page report, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* ("Rand Report").[70]

The Rand Report's statistical data highlights the blurred line between broker-dealers and investment advisers. Specifically, it notes that roughly "40% of all broker-dealers either directly or indirectly control, are controlled by, or are under common control with a firm engaged in the securities or investment advisory business."[71] Furthermore, 69% of "large" broker-dealers "reported affiliations with securities or investment advisory businesses."[72] These statistics underscore the complexity of relationships in the financial services industry. Thus, it is unsurprising that "the typical retail investor finds it difficult to understand the nature of the business" that is providing them with investment advisory or brokerage services.[73] Indeed, the Rand Report concludes that most investors do not understand general distinctions between broker-dealers and investment advisers, including their different legal duties.[74]

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68. *Id.*
69. HUNG ET AL., *supra* note 6, at xiv.
70. *See id.*
71. *Id.* at xvii.
72. *Id.*
73. *Id.* at xviii.
74. *Id.* at 118.

B. Different Standards Result in Less Investor Protection

A recent case, *Thomas v. Metropolitan Life Insurance Co.*, underscores investor confusion regarding the differences between broker-dealers and investment advisers.[75] More importantly, however, it demonstrates why having two different legal duties for broker-dealers and investment advisers diminishes investor protection.

The *Thomas* case is straightforward. In June 2003, the Thomases purchased a Metropolitan Life Insurance Company ("Met Life") variable universal life insurance policy.[76] In doing so, they acted on the advice of their registered representative, an employee of Met Life's affiliated broker-dealer, Metropolitan Securities, Inc. ("Metropolitan Securities").[77] The Thomases subsequently filed suit, arguing that Met Life and Metropolitan Securities owed them a fiduciary duty under the '40 Act. They argued that their registered representative violated this duty when he failed to disclose that he received considerable benefits when selling Met Life financial products (including the Met Life insurance policy bought by the Thomases). The court dismissed this argument and held that the '40 Act's broker-dealer exception rendered its fiduciary standard inapplicable to Met Life and its affiliated broker-dealer.

The *Thomas* court provides an insightful analysis of the broker-dealer exception's three requirements. First, it was clear that Met Life was a broker.[78] Second, the court held that Met Life's investment adviser service was "solely incidental to" its brokerage function because it read this provision of the statute to mean "solely *in connection* with" and it was undisputed that the registered representative's advice was solely connected to the Thomases purchase of the insurance policy.[79] Finally, the court held that the Thomases did not provide their registered representative with any "special compensation" for his investment advice. Nevertheless, the *Thomas* court noted the incongruity of exempting Met Life from the '40 Act's fiduciary standard in spite of its inherent conflict of interest:

> Where the product being sold is a sophisticated financial product . . .

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

76. *Id.* at *2.

77. *Id.*

78. *Id.* at *3.

79. *Id.* at *7.

> it would seem that the need for unbiased advice—or at least for the disclosure of those things that might tend to skew the [registered representative's] "advice"—would seem to be every bit as great as in a conventional advisory relationship.[80]

With this observation, the *Thomas* court struck upon the central problem within the broker-dealer/investment adviser regulatory dichotomy: broker-dealer customers are afforded less protection than investment adviser customers because broker-dealers are generally not held to a fiduciary standard. Indeed, the judicial interpretation of broker-dealer duties has consistently held that, because broker-dealers are not fiduciaries, they owe their clients a limited set of obligations. Thus, even though FINRA has extensive rules in place regarding broker-dealer conduct, they do not collectively rise to a fiduciary standard. In the end, investors suffer the consequences of this broken regulatory scheme.

V. THE INVESTOR PROTECTION ACT OF 2009

In response to the inefficient and ineffective state of broker-dealer and investment adviser regulation, there is widespread support for reforming broker-dealer regulation. Indeed, the majority of SEC Commissioners, including Chairwoman Mary Schapiro, support the adoption of a fiduciary standard for broker-dealers and the "harmonization" of regulation between broker-dealers and investment advisers.[81] Similarly, FINRA Chairman Richard Ketchum argues that a consistent fiduciary standard for investment advisers and broker dealers is necessary to improve investor protection and eliminate the regulatory gap between broker-dealers and investment advisers.[82] Even the

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80. *Id.* at *9.

81. *See* Mary Schapiro, Chairman, SEC, Speech Before the SIFMA Annual Conference: The Road to Investor Conference (Oct. 27, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch102709mls.htm) [hereinafter Schapiro Speech]; Luis A. Aguilar, Comm'r, SEC, Speech Before the Investment Advisers Association Annual Conference: SEC's Oversight of the Adviser Industry Bolsters Investor Protection (May 7, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch050709laa.htm) [hereinafter Aguilar Speech]; Walter Speech, *supra* note 3.

82. *See* Kathleen M. McBride, *FINRA's Ketchum Speaks of Fiduciary Duty*, INVESTMENT ADVISOR, Oct. 29, 2009, http://www.investmentadvisor.com/News/2009/

Securities Industry and Financial Markets Association ("SIFMA"), Wall Street's main lobbying group, began calling for a fiduciary standard for broker-dealers, abandoning its long-held opposition to such a measure.[83]

In light of these widespread calls for reform, it is unsurprising that the IPA amends the '34 and '40 Act provisions regarding the conduct and regulation of broker-dealers and investment advisers.[84] Part A of this section describes these amendments and Part B argues that they are flawed and do not do enough to protect investors.

A. THE IPA'S PROVISIONS REGARDING BROKER-DEALER REGULATION

Section 103 of the IPA seeks to reform broker-dealer regulation via several amendments to the '34 and '40 Acts.[85] First, the bill seeks to harmonize broker-dealer and investment adviser standards of conduct by amending the '34 Act so that broker-dealers offering investment advice are subject to the same standard of conduct as investment advisers under the '40 Act.[86] Second, the IPA gives the SEC the authority to promulgate rules establishing a uniform standard of conduct for broker-dealers and investment advisers offering investment advice. The bill contains guidelines for the standard of conduct: broker-dealers and investment advisers offering investment advice to retail customers "shall . . . act in the best interest of the customer without regard to[their]financial or other interest."[87] Finally, the IPA attempts to harmonize the enforcement and remedy options for violations of this new conduct standard. Specifically, it mandates that the enforcement

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10/Pages/FINRAs-Ketchum-Speaks-of-Fiduciary-Duty.aspx.

83. *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office*: *Hearing Before the H. Fin. Services Comm.*, 111th Cong. (2009) (statement of John Taft, Chairman, Securities Industry and Financial Markets Association (SIFMA)). Nevertheless, some believe that SIFMA supports a "less than fiduciary standard" that would favor the brokerage industry. *See* Alexis Leondis & Jeff Plungis, *Financial Planners Say Fiduciary Debate May Favor Brokers*, BLOOMBERG, Aug. 7, 2009, http://www.bloomberg.com/apps/news?pid=20603037&sid=aDRJvkh6IQGk.

84. *See* Investor Protection Act of 2009, H.R. 3817, 111th Cong. (2009).

85. *See id.* § 103.

86. *See id.* § 103(a) ("[W]ith respect to a broker or dealer that is providing investment advice to a retail customer . . . the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940.").

87. *Id.*

and remedy options for violations of this new standard of conduct will be the same as the '40 Act's enforcement and remedy options,[88] i.e. no private right of action and SEC enforcement. In sum, the IPA establishes a uniform standard of conduct for broker-dealers and investment advisers; delegates to the SEC the task of establishing this standard; and strips investors of their right to sue in the event that broker-dealers violate this new standard of conduct.

B. THE IPA'S SHORTCOMINGS

The IPA contains two critical flaws that hinder its ability to fully protect investors from unscrupulous broker-dealers. First, because the IPA delegates power to the SEC to establish the specific elements of broker-dealer/investment adviser conduct, it leaves open the possibility that a "real" fiduciary standard will not be adopted. Second, by eliminating a private right of action for broker-dealer customers, the IPA takes a powerful enforcement tool out of investors' hands.

1. The IPA Does Not Establish a True Fiduciary Standard

Although promising at first glance, the IPA's language regarding a uniform standard of conduct for broker-dealers and investment advisers is weak for two reasons. First, although it references "the best interests of the customer," the IPA only applies to broker-dealers "giving investment advice" to retail customers. This exception leaves the door wide open for broker-dealers not offering investment advice to be exempt from the new standard. In theory, this potential loophole would allow unscrupulous broker-dealers to offer their clients minimal or no investment advice to avoid the new standard and engage in conflicts of interest and other conduct prohibited by a fiduciary standard. This illogical result—a lower standard of care for broker-dealers taking less of an interest in their customers—is untenable.

The second, and more important, issue regarding the IPA's supposed fiduciary standard is that it does not actually establish the standard, instead delegating that responsibility to the SEC. This raises the concern that the SEC will ultimately establish a less than fiduciary

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88. *See id.* § 103(b) ("[T]he enforcement options and remedies available for violations of the standard of conduct applicable to a broker or dealer providing investment advice to a retail customer are commensurate with those enforcement options and remedies available for violations" of the '40 Act.).

standard that favors broker-dealers.[89] As one investor advocate notes, the fear is that "if the SEC [decides] what the fiduciary duty is, it would lower the standard in order to accommodate [broker-dealer] business practices."[90] Here, some investment advisers worry that because SEC Chairwoman Schapiro and Commissioner Walter both spent years working at the NASD (now FINRA), they may be inclined to adopt a lower standard for broker-dealers.[91] This would be unacceptable.

Fortunately, Chairwoman Schapiro and Commissioner Walter support adopting a strong fiduciary standard for broker-dealers. Chairwoman Schapiro has warned against implementing a "watered-down, 'fair and reasonable' commercial standard" for broker-dealers offering investment advice.[92] Commissioner Walter has stated that a "fiduciary standard should apply uniformly to all financial professionals."[93] Similarly, SEC Commissioner Luis Aguilar has noted that the fiduciary relationship is the "foundation" of the adviser-client relationship, and that any attempt to establish a new standard of conduct for broker-dealers must "keep sacrosanct a real fiduciary standard."[94] Commissioner Aguilar further remarked that he did not consider it a "real question" whether or not broker-dealers should be subject to a fiduciary standard.[95] Nevertheless, public support does not ensure that the SEC will ultimately implement a strong fiduciary standard.

2. No Private Right of Action for Customers

The IPA is also problematic for investor protection because it eliminates their ability to bring a cause of action against broker-dealers for alleged violations of the new standard of conduct. As discussed herein, there is no private right of action for investors under the '40 Act. By harmonizing the enforcement remedies of the '34 Act with those of the '40 Act, the IPA leaves enforcement of the new standard of conduct to the SEC. This is flawed because "regulation without enforcement lacks teeth" and the SEC is already unable to monitor and investigate the

89. *See* Jane J. Kim, *Fiduciary Duty Hits the Street—Sort Of*, WALL ST. J., Aug. 31, 2009, at A23.

90. Leondis & Plungis, *supra* note 83.

91. *See id.*

92. Schapiro Speech, *supra* note 81.

93. Walter Speech, *supra* note 3.

94. Aguilar Speech, *supra* note 81.

95. *Id.*

approximately 5,500 broker-dealers and 11,000 investment advisers under its purview.[96] By leaving enforcement of a new conduct standard to an already overstretched SEC and stripping investors of their private remedy, the IPA ensures that the new conduct standard will lack the "teeth" necessary to adequately protect investors.

VI. AN ALTERNATIVE PROPOSAL: AN AUTHENTIC FEDERAL FIDUCIARY STANDARD FOR BROKER-DEALERS WITH A PRIVATE RIGHT OF ACTION

In light of the IPA's flaws, this Note presents an alternative approach to regulating broker-dealer conduct: a federal law establishing an authentic fiduciary standard for all registered broker-dealers that preserves an investor's private right of action. Specifically, this Note favors the adoption of an "authentic" fiduciary standard for broker-dealers modeled on the five principals outlined by the Committee for the Fiduciary Standard, an investor advocacy group lobbying Congress "to ensure investors' best interest are number one in financial reform legislation."[97] Part A of this section outlines the "authentic" fiduciary standard's five components, and argues why their adoption is in investors' best interests. Part B advocates maintaining a private right of action for investors to remedy alleged broker-dealer violations of the new standard. Part C analyzes how this new standard would affect broker-dealers and investors in practice.

A. AN AUTHENTIC FEDERAL FIDUCIARY STANDARD FOR ALL REGISTERED BROKER-DEALERS

Congress should adopt an authentic federal fiduciary standard for all registered broker-dealers. Specifically, this federal standard should contain the following five principles:

> 1. Put the client's best interests first;
> 2. Act with prudence—that is, with the skill, care, diligence and good judgment of a professional;
> 3. Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts;

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96. *See* Walter Speech, *supra* note 3.

97. *See generally* Committee for the Fiduciary Standard, http://www.thefiduciarystandard.org/ (last visited Dec. 20, 2009).

> 4. Avoid conflicts of interest;
> 5. Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.[98]

Adopting this standard is beneficial for two reasons. First, it contains all of the elements of a true fiduciary standard, offering strong protection for investors and holding broker-dealers to a high standard of conduct. As the chairwoman of the National Association of Personal Financial Advisors puts it, "[f]rom the perspective of regulation, the big issue is how you define fiduciary" and any broker-dealer attempt to redefine the fiduciary standard could water it down at investors' expense.[99] Establishing a fiduciary standard with these five core principles would ensure a robust, rather than watered-down, fiduciary standard for broker-dealers. Moreover, establishing the fiduciary standard at the federal level avoids the danger of the SEC establishing a less-than fiduciary standard for broker-dealers.

B. PRESERVING A PRIVATE RIGHT OF ACTION

Regulation without enforcement is ineffective. To offer true investor protection, this new federal fiduciary standard must give investors a private right of action to seek redress for alleged broker-dealer violations. A private right of action would have two benefits. First, and most obviously, it would allow investors to seek damages for alleged broker-dealer violations. A less apparent, but still important, benefit would be the collective effect a private right of action would have on broker-dealer conduct. Broker-dealers would be less likely to violate their fiduciary duty to a customer if that customer could bring a cause of action against the broker-dealer. Without a private right of action, however, a broker-dealer, confident in the SEC and/or FINRA's inability to investigate nearly 5,000 broker-dealers, would be more likely to engage in prohibited conduct.

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98. *Id.* ("The authentic fiduciary standard refers to the well-developed body of fiduciary law established by ERISA, UPIA, the Advisers Act, and other laws and regulations. The Committee is opposed to any effort to redefine a fiduciary standard in a manner that would dilute the authentic standard.").

99. Leondis & Plungis, *supra* note 83.

C. The Practical Effects of this Note's Proposal

This Note acknowledges that any new broker-dealer regulation has several potential drawbacks, namely, burdensome costs (that would undoubtedly be passed on to customers); adverse effects on broker-dealer compensation; and cumbersome implementation resulting in excessive "red-tape," rather than actual benefits to investors. Nevertheless, this Note concludes that the practical benefits of this proposed federal fiduciary standard outweigh the potential drawbacks.

An authentic fiduciary standard for all broker-dealers would end "the era of regulating brokers under a commercial standard that treats advice as a byproduct without fiduciary accountability."[100] Indeed, an authentic fiduciary standard would foster an increase in the level of professionalism and client services throughout the broker-dealer industry by forcing broker-dealers to increase their standards in accordance with the new law. Regarding increased costs, there could very well be a short-term cost increase to broker-dealers because of increased litigation costs (defending larger amounts investor claims) and compliance costs (training employees regarding the new standard). Over time, however, an authentic federal fiduciary standard would probably *decrease* costs to broker-dealers and customers by lessening the number of broker-dealer/customer disputes (and litigation expenses) as broker-dealers begin to abide by the newly instituted fiduciary duty to their clients. Likewise, this standard would also weed out unscrupulous broker-dealers who prove unable to meet their fiduciary obligations to customers. Thus, this Note's proposal has the potential to usher in a "new era of fiduciary responsibility and accountability."[101]

Critics of a broad fiduciary standard for broker dealers question how such a standard would affect broker-dealer compensation. For instance, could brokers still earn commissions or sell their firms proprietary products?[102] Would the broker-dealer industry need to shift towards charging percentage-of-assets fees?[103] Former SEC Chairman

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100. Blaine F. Aiken, *How a "Universal" Fiduciary Standard Would Change How Financial Advisers Do Business*, INVESTMENT NEWS, May 10, 2009, http://www.investmentnews.com/article/20090510/REG/305109993.

101. *Id.*

102. *See* Suzanne Barlyn, *Investing in Funds: A Monthly Analysis—Adviser Alert: News for Brokers, Wealth Managers, and Their Clients*, WALL ST. J., Aug. 3, 2009, at R6.

103. *See id.*

William H. Donaldson describes the compensation question as a "tough area" to deal with.[104] Nevertheless, these criticisms miss the mark. Commissions can exist in a fiduciary relationship, provided that the broker-dealer provides full disclosure to the customer about the commissions and fees, in particular those received by other parties.[105] So in the context of the *Thomas* case discussed earlier, the Met Life broker-dealer, under this Note's proposed fiduciary standard, would not have been liable to the Thomases if he fully disclosed any extra commissions/compensation he received from Met Life for selling their product, and presented comparable annuity policies from other insurance companies. Moreover, full disclosure would eliminate unsavory compensation practices. Indeed, "[h]ow many people would buy a variable annuity if the broker had to reveal that he stands to win a flat-panel TV if he sells enough of them?"[106]

VII. CONCLUSION

Established almost 80 years ago, the current regulatory framework for broker-dealers and investment-advisers is outdated. Since the 1990s, the broker-dealer industry has undergone considerable changes, with an increasing number of financial professionals offering a vast array of financial products and services. These changes render the regulatory distinction between broker-dealers and investment advisers obsolete. Instead of protecting customers, the regulatory scheme established by the '34 and '40 Acts actually diminishes investor protections and increases investor confusion regarding financial professionals. The Investor Protection Act of 2009 recognizes the flawed state of broker-dealer regulation and represents a decent attempt at reform. Nevertheless, it is flawed because it does not guarantee that broker-dealers will be held to a fiduciary standard when dealing with all of their clients. This Note's proposal is superior to the IPA because it holds broker-dealers to an authentic fiduciary standard. An authentic fiduciary standard for broker-dealers would raise industry standards and offer true protection for broker-dealer customers.

104. *Id.*
105. *See id.*
106. *Id.*