NOTES

DEFINING A NEW PUNCTILIO OF AN HONOR: THE BEST INTEREST STANDARD FOR BROKER-DEALERS

Nicholas S. Di Lorenzo[*]

[*] J.D. Candidate, Boston University School of Law, 2012; B.S. Leonard N. Stern School of Business, New York University, 2009. I would like to dedicate this Note to my family. Without their love and support, I would not be where I am today. A sincere thanks to William Bussiere and the *Boston University Law Review* for their thoughtful input and dedicated editing.

In response to the recent financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) required the SEC to conduct a six-month study and report to Congress on the effectiveness of existing standards of care imposed on broker-dealers and investment advisers. Following this study, the SEC is authorized to create new rules governing the duties a broker-dealer owes when providing personalized investment advice about securities to a retail customer. Mirroring prior statements by SEC Chairman Mary Schapiro, as well as the general outcry for banking reform, the SEC Staff recommended that the Commission harmonize the duties owed by broker-dealers and investment advisers.

The mere imposition of a heightened fiduciary duty, however, is unlikely to foster the change that Dodd-Frank intended to produce. As interpreted by the SEC, the Investment Advisers Act of 1940 currently requires investment advisers to act in their clients' best interests. Although defined by certain requirements, this standard is vague. Therefore, I suggest a two-part proposal that will help to support the development of a robust best interest standard. First, the best interest standard as applied to broker-dealers should be based on analogous trust law concepts and not the current best interest standard applicable to investment advisers. Second, the SEC should exercise its authority under Dodd-Frank to eliminate mandatory arbitration agreements in client contracts in order to support the transparency necessary to develop a robust doctrine. I show that these suggestions would not only effectuate the policy goals of Dodd-Frank by reducing the potential for conflicts of interest between investment professionals and their clients, but they would also be less cost-prohibitive and more practical than other alternatives.

INTRODUCTION

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] Driven by many of the same concerns that underlie common law fiduciary duties,[2] Dodd-

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank] (to be codified in scattered sections of U.S.C.).

[2] Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 723-24 ("Under common law, fiduciary duties were imposed in situations where one party's knowledge or expertise was far vaster than that of another party who may rely upon this expertise. . . . [W]hen a party holds oneself out as having special knowledge, a fiduciary duty is even more likely to exist."). As will be discussed in Part II, although brokers, dealers, and investment advisers began as entities with distinct roles in the securities markets, their roles have blended over time, leading to retail investor confusion. *Id.* at 738. The mental merger of investment advisers and broker-dealers by retail clients – largely the result of broker-dealers' providing increasingly personal investment advice – has led to calls for enhanced duties to be imposed on broker-dealers. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71 (2009),

Frank gave the Securities and Exchange Commission (SEC) the authority to harmonize the standard of conduct between broker-dealers and investment advisers.[3] Broker-dealers not only compete with investment advisers but also "solicit investors' business on the basis of the quality of their investment advice and advertise that they provide ongoing advice tailored to meet their customers' changing needs."[4] Specifically, § 913 of Dodd-Frank required the SEC to report to Congress, following a six-month study, on (1) "the effectiveness of existing . . . standards of care" for broker-dealers and investment advisers, and (2) the existence of "legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care."[5] The SEC could then "issue rules to 'address' the standard of care applicable to broker-dealers and investment advisers when giving personalized investment advice to retail customers."[6] In particular, "the SEC may choose to create a rule requiring

available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[3] Dodd-Frank § 913 (authorizing the SEC to impose a fiduciary standard of care on broker-dealers). Currently, only investment advisers are under a fiduciary duty to act in their clients' best interests. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, at iii (2011) [hereinafter STUDY ON INVESTMENT ADVISERS], *available at* http://sec.gov/news/studies/2011/913studyfinal.pdf. This standard encompasses duties of loyalty and care, requiring an adviser with a material conflict of interest either to eliminate the conflict or disclose it to the client. *Id.* In contrast, broker-dealers currently owe their clients a duty of fair dealing and are subject to fiduciary standards only in certain circumstances. *Id.* at iv. This duty of fair dealing requires a broker-dealer to make suggestions which are suitable given an analysis of the client's financial position. *Id.*

[4] Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 60 (2010).

[5] Dodd-Frank § 913(b), (d). On July 27, 2010, as required by the Act, the SEC began requesting "input, comments, and data on issues related to the effectiveness of existing standards of care for broker-dealers and investment advisers" and overlaps in the regulatory system. Press Release, U.S. Sec. & Exch. Comm'n, SEC Publishes Public Request for Comment to Inform Study of Obligations of Broker-Dealers and Investment Advisers (July 27, 2010), *available at* http://sec.gov/news/press/2010/2010-134.htm. This comment period remained open for thirty days before the official study began. Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, 75 Fed. Reg. 44,996, 44,996 (July 30, 2010), *available at* http://sec.gov/rules/other/2010/34-62577.pdf. The SEC delivered a report of the results of its study to the Committee on Banking, Housing, and Urban Affairs for the U.S. Senate, and the Committee on Financial Services for the U.S. House of Representatives, on January 21, 2011. *See supra* note 3.

[6] *Changes to the Regulation of Broker-Dealers and Investment Advisers under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, CADWALADER, WICKERSHAM & TAFT LLP (Aug. 12, 2010), *reprinted in The Dodd-Frank Act: How It Impacts Specific Industries, Entities and Transactions*, CADWALADER, WICKERSHAM & TAFT LLP, pt. IX, at 6 (June 22, 2011) [hereinafter CADWALADER], *available at* http://www.

broker-dealers offering personalized investment advice to retail customers to act in the best interest of the customer, as well as requiring broker-dealers to disclose certain conflicts of interest."[7] Following the study, the SEC Staff recommended harmonizing the standards of conduct applicable to broker-dealers and investment advisers.[8] In doing so, the Staff expressly rejected a "sole interest" standard that would prohibit a broker-dealer from engaging in any transaction tainted by self-interest. As explained *infra* Part III, the "best interest" standard better accomplishes Dodd-Frank's goal of increasing investor protection.

While it is "uncontroversial . . . that the securities laws enhance disclosure and prohibit fraud,"[9] it is unclear that merely harmonizing the standards of care between broker-dealers and investment advisers will have any appreciable effect in the marketplace. Since the Investment Advisers Act of 1940,[10] investment advisers have been subject to fiduciary duties.[11] Scholars have argued, however, that the scope of an investment adviser's duties is vague, aside from the duty of disclosure.[12] But this vagueness is not necessarily problematic in practice. Historically, broker-dealer "regulation has been based on principles and standards rather than voluminous detailed rules specifying prohibited conduct."[13] This helps implement the basic purpose of the securities laws – namely, increasing "'truth in securities' so that after full disclosure of material facts investors can make their own decisions"[14] – by injecting flexibility into the regulatory structure.[15]

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cadwalader.com/assets/client_friend/062211DoddFrankActImpact.pdf.

[7] Hazen, *supra* note 2, at 717 (citing Dodd-Frank § 913(g)(2)). In fact, SEC Chairperson Mary Schapiro endorsed such harmonization, stating, "I have long advocated such a uniform fiduciary standard and I am pleased the legislation would provide [the SEC] with the rulemaking authority necessary to implement it." Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals (July 9, 2010), *available at* http://www.sec.gov/news/speech/2010/spch070910mls.htm.

[8] STUDY ON INVESTMENT ADVISERS, *supra* note 3, at v-vi ("[T]he Staff recommends the consideration of rulemakings that would apply expressly and uniformly to both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, a fiduciary standard no less stringent than currently applied to investment advisers . . . .").

[9] Hazen, *supra* note 2, at 918.

[10] 15 U.S.C. §§ 80b-1 to -21 (2006).

[11] Melanie L. Fein, The Fiduciary Duty of Securities Brokers and Investment Advisers: Sole Interest or Best Interest? 5 (Aug. 25, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1646938.

[12] *Id*. at 6.

[13] Hazen, *supra* note 2, at 710.

[14] *Id.* at 727-28 (citing 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2[3][A], at 36 (6th ed. 2009)).

[15] *Id.* at 718.

Further, in practice, it is not clear that broker-dealers are not already subject to fiduciary duties. Where a broker acts in his traditional role as an order taker, the broker is not subject to fiduciary duties.[16] Heightened duties apply, however, when a broker exceeds this role by recommending securities or exercising discretion with a client's account.[17] Thus, while there is no inherent fiduciary duty imposed on broker-dealers, the facts of a particular client relationship may impose such duties.[18] Dodd-Frank is necessary, therefore, to impose uniform duties on broker-dealers in order to help eliminate uncertainty in the duties broker-dealers owe to their clients, and thereby increase investor protection.

In light of these concerns, I posit that the SEC is correct to impose a "best interest" standard of care, instead of a "sole interest" standard, on broker-dealers when they provide investment advice to retail clients. Further, I believe that coupling a best interest standard with the elimination of industry-norm mandatory arbitration clauses[19] would provide the necessary backstop to ensure adequate investor protections. To support these contentions, I draw

[16] *Id.* at 738 ("When a broker acts as a mere order taker, most courts say that the only duty is to find the best and most prompt execution for that order.").

[17] *Id.* (citing United States v. Laurienti, 611 F.3d 530, 540-41 (9th Cir. 2010), *cert. denied*, 131 S. Ct. 969 (2011); SEC v. Pasternak, 561 F. Supp. 2d 459, 499, 506 (D.N.J. 2008)) (stating that, when a broker-dealer exceeds his traditional role, the broker-dealer "will be subject to heightened disclosure requirements").

[18] *Id.* at 742-43. Professor Hazen suggests that determining precisely which fiduciary duties apply turns on "the particular broker-customer relationship and the functions performed by the broker." *Id.* at 741. Among the factors to consider is whether there is "a reposing of faith, confidence and trust." *Id.* at 743 (quoting McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989)) (internal quotation marks omitted). He cites various state and federal case law to show that such a relationship is often evidenced by (1) a broker-dealer having either de facto control or "prior authorization to trade for the client's account on a discretionary basis" and (2) representations by the broker-dealer, express or implied, amounting to "shingle theory" liability. *Id.* at 743, 749-55. Generally, Professor Hazen finds that "[a] broker-dealer is more likely to have a duty to make a full disclosure when recommending a security, but is less likely to have an unqualified duty to provide the client with useful market information concerning the client's present portfolio even when the broker-dealer is aware of such information." *Id.* at 745 (footnote omitted). Further, although having broad discretion over a client's account will likely trigger fiduciary obligations, "honesty and good faith are basic obligations of broker-dealers." *Id.* at 745-46.

[19] Generally, when clients open accounts with a broker-dealer, they sign agreements stating that any disputes with the broker-dealer will be resolved only through arbitration. Steven T. Stern, *Mandatory Arbitrations of Disputes with Financial Advisors*, STEVEN T. STERN, ESQUIRE (Sept. 21, 2010), http://www.steventstern.com/archives/23. Arbitration is conducted by a panel of three arbitrators through the Financial Industry Regulatory Authority (FINRA). *Id.* "[T]wo of the arbitrators have no affiliation with the financial services industry . . . ." *Id.* The third is either a current or former securities professional. *Id.* The parties select arbitrators from a list provided by FINRA. *Id.* Arbitration decisions are not appealable. *Id.*

parallels to trust law. Given the analogous issues underlying duties trustees owe to their beneficiaries, I believe it is informative to contrast standards of care in that area with standards of care owed by broker-dealers. I utilize recent scholarship advocating the abandonment of the sole interest standard in trust law to support the implementation of a best interest standard for broker-dealers.[20] Given the financial crisis's shock to the American investment community, a return to the core concept of accountability would foster disclosure while maintaining regulatory flexibility.

This Note shows that the current regulations governing broker-dealers are no longer sufficient in relation to broker-dealers' role in the financial markets. Part I gives an overview of financial regulation in the United States. It begins with a description of the historic reasons for adopting the Securities Act of 1933 and the Securities Exchange Act of 1934. Part I then describes the development of U.S. securities laws, from the Investment Advisers Act of 1940 to the Securities Act Amendments of 1964 and the Private Securities Litigation Reform Act. Part I concludes with a description of the current status of Dodd-Frank. Part II analyzes how broker-dealers no longer fulfill only their traditional role – order-takers who do not provide investment advice – and now perform increasingly similar functions to investment advisers. The increasing similarity between investment advisers and broker-dealers, however, is not solely due to similar product offerings. Instead, I argue from empirical data that broker-dealers are increasingly engaging in marketing practices designed to suggest a relationship of trust and confidence with clients – the very relationship that led Congress to impose fiduciary duties on investment advisers in 1940. In light of this, I explain the need for harmonizing the standards of care. Part III analyzes the trust law sole interest standard. It explores that standard's benefits and pitfalls. Specifically, I examine a widely accepted exception to the sole interest rule: advance judicial approval. In practice, this standard requires a court to determine whether it should allow a conflicted transaction to proceed because the transaction is in the client's best interest. Part IV extrapolates one possible definition of the best interest standard that would serve the policy goals of Dodd-Frank. It then goes further, suggesting that the SEC should exercise its authority to eliminate mandatory arbitration agreements to develop a robust doctrine. Part V seeks to clarify this proposal by way of two examples. The first example is taken from a recent case in the Central District of California. The second example, a hypothetical scenario set in the current volatile market conditions, illustrates a recommendation that teeters on the borderline of a client's best interest.

[20] *See, e.g.*, John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 932 (2005) (arguing that, because the purpose of the sole interest standard is to advance the best interests of the client, a transaction in which there is a conflict of interest "should be sustained if the trustee can prove that the transaction was prudently undertaken in the best interest of the beneficiaries").

I. ORIGINS OF BROKER-DEALER AND INVESTMENT ADVISER REGULATION

President Roosevelt, in response to the 1929 stock market crash, called for "legislation that would protect the investing public and elevate business standards in the securities brokerage industry."[21] Before the crash, "federal regulation of the securities industry was virtually non-existent."[22] Following the crash, industry self-regulation was no longer the norm.[23] Specifically, Congress passed the Securities Act of 1933 (Securities Act)[24] and the Securities Exchange Act of 1934 (Exchange Act)[25] in an effort to regulate the industry.[26] The Securities Act regulates the public offering and sale of securities in interstate commerce, while the Exchange Act regulates secondary trading markets and their participants.[27] Roosevelt saw these Acts as raising the standard of care owed by securities professionals from caveat emptor[28] to "a clearer understanding of the ancient truth that those managing other people's money should be subject to trustee duties."[29] In exchange for raising the standard of care, and acting on the belief that industry participants could better regulate the financial industry, Congress created the SEC to impose such rules as are appropriate to ensure investor protection and fair dealing in the securities industry.[30]

To effect this legislation, "[self-regulatory organizations (SROs)] were empowered under the [Exchange] Act to create and enforce rules and standards

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[21] Matthew P. Allen, *A Lesson from History, Roosevelt to Obama – The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty*, 5 ENTREPRENEURIAL BUS. L.J. 1, 19-20 (2010).

[22] Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 401 (2010) ("Although the Interstate Commerce Commission exercised some regulation over common carriers' issuance of securities, investor protection legislation was limited to the states.").

[23] *See, e.g.*, Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 527 (2002).

[24] Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-aa (2006)).

[25] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-pp (2006)).

[26] Allen, *supra* note 21, at 19.

[27] *Id.* at 19-20 (quoting DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 56 (2008), *available at* http://.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf).

[28] BLACK'S LAW DICTIONARY 252 (9th ed. 2009) (defining "caveat emptor" as a Latin phrase meaning "let the buyer beware"); *see also* Allen, *supra* note 21, at 20 n.77 ("Caveat emptor is an old property law doctrine under which a buyer could not recover from the seller for defects in the property that rendered it unfit for ordinary purposes. The only exception was if the seller actively concealed latent defects.").

[29] Ramirez, *supra* note 23, at 534 (quoting H.R. REP. NO. 73-85, at 2 (1933)) (internal quotation marks omitted).

[30] *Id.* at 535 (citing H.R. REP. NO. 73-1383, at 15 (1934)).

governing the securities and brokerage industry."[31] The goal was to minimize Congress's role in forming the standards of conduct that would protect investors in the future.[32] Ultimately, Congress charged the SROs with promoting regulation that would ensure adequate disclosure of material facts relating to the securities sold.[33] Nowhere in the Exchange Act, however, did Congress impose a fiduciary duty. In fact, legislative history suggests an intent to avoid invoking such a term for fear that "[i]mposing broad fiduciary obligations or detailed statutory mandates [on broker-dealers] would frustrate the foundations of self-regulation."[34]

A. *Subsequent Legislation Regulating the Securities Industry*

In 1938, Congress continued to professionalize the securities brokerage industry when it passed the Maloney Act.[35] The Act served two purposes. First, it extended the SEC's authority by allowing the SEC to regulate both exchange members and over-the-counter brokers.[36] Second, the Maloney Act created the National Association of Securities Dealers (NASD), "the only 'Securities Association' ever registered pursuant to section 15A of the [Exchange] Act."[37] By creating the NASD, Congress effectively nationalized the standards of conduct applicable to broker-dealers.[38]

In the mid-1930s, the SEC issued the Investment Counsel Report, which contained the results of a study commissioned by the Public Utility Holding Company Act of 1935.[39] The report concluded that little was known about the investment advisory industry and that significant problems surrounded it.[40] Specifically, at public hearings following the report, industry representatives presented two issues: "harm to the public inflicted by unscrupulous advisers . . . [and] reputational harm inflicted on legitimate investment advisers

[31] Allen, *supra* note 21, at 20.

[32] *Id.*

[33] *Id.* at 20-21 ("[T]he government did not want to prohibit or encourage the sale of any specific securities, and instead sought only to ensure that the people or entities selling them adequately disclosed the appropriate facts and terms of the product being sold.").

[34] Ramirez, *supra* note 23, at 548.

[35] Pub. L. No. 719, ch. 677, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)).

[36] Ramirez, *supra* note 23, at 536.

[37] *Id.* at 537. The NASD, now called FINRA, is the primary regulator of broker-dealers. *Id.* In fact, all registered broker-dealers must register with the organization. *Id.* The NASD, however, was not thrust upon the industry. Instead, "[t]he privilege of self-regulation was actively sought by the securities business . . . ." *Id.* (quoting NASD Manual (CCH) at 160 (2000)) (internal quotation marks omitted).

[38] *Id.*

[39] Laby, *supra* note 22, at 402.

[40] *Id.* at 403.

when the public could not spot the bad apples in the profession."[41] As a result, Congress passed the Investment Advisers Act of 1940.[42] Because the term "investment adviser" was defined broadly, the statute would have regulated broker-dealers absent exemption.[43] To avoid this result, Congress excluded from the Act broker-dealers who met two requirements: (1) the broker's advice must be "solely incidental" to brokerage services, and (2) the broker must not receive "special compensation" for advising the client.[44] This exemption effectively legislated the distinction between investment advisers and broker-dealers by subjecting investment advisers to fiduciary obligations, but not broker-dealers.[45]

The '33 and '34 Acts effectively ended a period in the securities industry where the only regulation of publicly traded firms came from rules imposed by the securities exchanges themselves.[46] Over-the-counter (OTC) securities remained unregulated, however, and the Acts imposed regulations only on publicly traded companies.[47] As a result, a double standard emerged whereby an investor holding stock in a listed company was afforded those protections created by the reporting requirements, while any investor holding unlisted securities had no protections under the securities laws.[48]

In response to regulatory arbitrage by traded companies and attendant fraud and manipulation in the securities markets, Congress passed the 1964

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[41] *Id.*

[42] Pub. L. No. 768, ch. 686, tit. II, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. §§ 80b-1 to -21 (2006)).

[43] Laby, *supra* note 22, at 403.

[44] Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006). The Act only permitted exemption if a broker met both provisions. Although the Act did not define "solely incidental," legislative history suggested that "special compensation" denoted "non-commission-based compensation" and that brokers could "receive only brokerage commissions." Laby, *supra* note 22, at 403 (quoting S. REP. NO. 76-1775, at 22 (1940)) (internal quotation marks omitted).

[45] Allen, *supra* note 21, at 25 (citing ANGELA A. HUNG ET AL., RAND INST. FOR CIV. JUST., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 12-14 (2008) [hereinafter RAND Report], *available at* http://rand.org/pubs/technical_reports/TR556.html). Although the term "fiduciary duty" does not appear in the Act, "the Supreme Court interpreted the Act's 'manifest purpose' to impose a fiduciary duty on investment advisers." *Id.* at 25 n.108 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192, 283 (1963)).

[46] *See* Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q. J. ECON. 399, 407 (2006).

[47] *Id.* at 408-09.

[48] *Id.* at 409 ("[T]he relatively lax disclosure requirements for OTC firms helped to create an environment where shareholders of these companies were often poorly informed and had few avenues available to penalize management for failing to maximize shareholder value.").

Securities Acts Amendments[49] to raise business standards among securities brokers.[50] The Amendments compelled the NASD to promulgate rules heightening the professional standards of conduct applicable to investment professionals.[51] Acting with the complete support of the securities industry, the NASD "adopted rigorous standards of character and fitness requiring that members and associated persons be 'capable of complying with' all laws and regulations and of 'observing high standards of commercial honor and just and equitable principles of trade.'"[52]

Finding the SEC's regulatory abilities sufficient, Congress in 1975 acted to bolster the Commission's enforcement abilities. First, Congress gave the SEC direct authority to enforce SRO rules and regulations.[53] Second, the SEC could now "disapprove changes in an exchange's rules and . . . review disciplinary actions taken by an exchange so as to provide for more uniform sanctions and standards."[54] As a result, industry self-regulation continued as the norm for determining professional standards of conduct.

Congress's most recent attempt to regulate the securities brokerage industry came in 1995 when it passed the Private Securities Litigation Reform Act (PSLRA).[55] Responding to concerns that private securities litigation was often "vexatious," Congress raised the bar for bringing private securities claims.[56] However, "Congress did not change the [SEC's ability] to mandate industry standards[,] . . . did not alter the method or procedure by which customer broker disputes were arbitrated, and evinced no intent to allow enforcement means other than private statutory claims to be diluted."[57]

[49] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) (codified as amended at 15 U.S.C. §§ 77d, 78c, 78l to 78o, 78o-3, 78p, 78t, 78w, 78ff (2006)).

[50] Ramirez, *supra* note 23, at 537 (stating that the amendments were designed "to give specificity to the '34 Act's 'general objective' of protecting 'investors against malpractices in the securities and financial markets'" (quoting H.R. REP. NO. 88-1418, at 4 (1964))).

[51] Specifically, Congress "required the NASD to promulgate rules mandating that any person associated with a member broker-dealer meet standards of 'training, experience, . . . and such other qualifications' as the NASD may prescribe." *Id.* at 537-38 (quoting 15 U.S.C. § 78o(b)(7) (2000)).

[52] *Id.* at 538 (quoting NASD Manual (CCH) Rule 1014(a)(3), at 3122 (2008)).

[53] *Id.* at 538 (citing 15 U.S.C. § 78u(a)(1) (2000)).

[54] *Id.* at 538-39 (citing 15 U.S.C. § 78s(b)-(c) (2000)).

[55] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.); *see also* Ramirez, *supra* note 23, at 539.

[56] Ramirez, *supra* note 23, at 539.

[57] *Id.* Overall, the PSLRA showed a commitment to the SEC's "role of imposing professional standards in lieu of caveat emptor in the securities industry." *Id.* (emphasis in original omitted).

B. *Historic Roles of Brokers, Dealers, and Investment Advisers*

When Congress adopted the Exchange Act, brokers and dealers performed distinct functions. A broker was "any person engaged in the business of effecting transactions in securities for the account of others."[58] A dealer was "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[59] Brokers serviced client demand by entering the market to purchase securities, while dealers "filled a customer's order by selling the customer securities from the dealer's own inventory."[60] As a result of these differences, courts prior to the Exchange Act imposed a fiduciary duty of loyalty on brokers, but not dealers.[61]

Concurrent with the development of broker and dealer regulation, Congress sought to regulate another group of financial actors – investment advisers.[62] This group, unlike brokers and dealers, historically provided investment advice to unsophisticated retail investors.[63] Because investment advisers held themselves out to have special knowledge of the securities markets when advising clients, Congress sought to regulate investment advisers separately.[64] As mentioned in Part I.A, *supra*, the Investment Advisers Act of 1940 directly regulated investment advisers and subjected them to fiduciary duties.[65] Even though the SEC has conceded that the standard's requirements are vague, an investment adviser must act in the best interests of his clients.[66] In addition, investment advisers are subject to heightened registration, bookkeeping, reporting, and other requirements.[67]

Given a broker-dealer's traditional role as an arm's-length salesman, rather than an agent providing advice, broker-dealers were not held to fiduciary standards.[68] Consistent with Congress's goal "to further professionalize the

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[58] 15 U.S.C. § 78c(a)(4)(A) (2006).

[59] *Id.* § 78c(a)(5)(A).

[60] Allen, *supra* note 21, at 21.

[61] *See id.*

[62] *Id.* at 24.

[63] *Id.*

[64] *Id.*

[65] *Id.* The Investment Advisers Act defines an investment adviser as

> any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities.

15 U.S.C. § 80b-2(a)(11) (2006). Although technically within the scope of the definition, brokers and dealers were excluded from regulation under the Act. *See id.* § 80b-2(a)(11)(C) (excluding from the definition of investment adviser "any broker or dealer whose performance of such services [as stated in § 2(a)(11)] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor").

[66] Fein, *supra* note 11, at 6.

[67] Allen, *supra* note 21, at 25 (citing RAND Report, *supra* note 44, at 12-14).

[68] *Id.* at 21-23.

securities brokerage industry,"[69] however, the Securities Acts Amendments required the NASD to promulgate specific rules and standards of conduct governing broker-dealers.[70] Ultimately, the NASD created NASD Rule 2310,[71] which introduced a new standard of care for broker-dealers: the suitability standard.[72] Suitability at its core requires a broker-dealer to have reasonable grounds for believing that a particular investment is "suitable" for the client.[73] Suitability requires an inquiry into the client's current investments and other factors affecting the client's current financial status.[74] But this standard only applies when a broker-dealer recommends securities, and it does not impose a fiduciary duty on broker-dealers.[75] Broker-dealers receive this special treatment because of their historic role as order-takers, not investment

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[69] Ramirez, *supra* note 23, at 537.

[70] *Id.* at 537-38.

[71] NASD Rule 2310. The NASD Rules are available at http://finra.complinet.com/ (follow "NASD Rules" hyperlink).

[72] Allen, *supra* note 21, at 22 ("[T]he NASD created NASD Rule 2310 to govern the conduct of broker-dealers: if a broker-dealer recommends that a customer purchase, sell, or exchange a security, he must have a reasonable belief that his recommendation is suitable for the customer by informing himself of the customer's financial and tax status, investment objectives, risk tolerances, and such other information used or considered to be reasonable . . . in making recommendations to the customer. This has been called 'customer-specific' suitability." (internal quotation marks omitted)). The current suitability standard requires the following of a broker-dealer:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. (b) Prior to the execution of a transaction recommended to a non-institutional customer . . . a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

NASD Rule 2310. In practice, suitability exists in two forms. "Product suitability" "requires that broker-dealers recommend only those financial products that are suitable for a particular customer," while "transaction form suitability" refers to "the manner in which securities are financed and the process by which a securities transaction is structured." Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 814-15 (2009). This Note proposes imposing a best interest standard applicable to all broker-dealers providing personalized investment advice to retail clients that takes into account both forms of suitability. *See infra* Parts IV-V.

[73] *See* Macey et al., *supra* note 72, at 815.

[74] *Id.*

[75] Allen, *supra* note 21, at 23. In fact, a broker-dealer may suggest a securities transaction that triggers a conflict of interest or is not in the client's best interests, so long as the security is suitable for the given client. *Id.*

advice purveyors.[76] This functional distinction has eroded over time, such that the investing public now has little basis for distinguishing between broker-dealers and investment advisers.[77] In light of this development, the SEC is warranted in imposing fiduciary duties on broker-dealers.

II. CONVERGENCE OF BROKER-DEALERS AND INVESTMENT ADVISERS IN THE INVESTING PUBLIC'S MIND

Over time, public perception of the distinctions between broker-dealers and investment advisers has slowly eroded. With substantive and technological developments in the securities industry, the two groups can no longer be clearly defined as giving or not giving investment advice. Court decisions, changes in broker-dealer compensation models, and overall growth in the brokerage industry have contributed to a melding of broker-dealers and investment advisers in the investing public's mind. Despite this shift, there has not been a concurrent harmonization of the duties owed by broker-dealers and investment advisers. This mental merger, unaccompanied by concurrent harmonization of fiduciary duties, is at odds with the original Exchange Act goal of investor protection and thus should serve as the basis for imposing fiduciary duties on broker-dealers.

A. *Broker-Dealers Begin Offering Fee-Based Accounts*

For a long time, broker-dealers and investment advisers "distinguished themselves from one another largely through the type of compensation they charged."[78] Some firms registered to provide both services, but the SEC "regulated those firms on an account-by-account basis."[79] This division between broker-dealers and investment advisers would not last. In the 1980s, brokers began offering financial planning services.[80] At that time, charging a commission on trades was not "special compensation" that could trigger fiduciary duties under the Advisers Act.[81] As broker-dealers shifted away from commission-based compensation, however, concerns arose as to whether this exemption still applied.[82]

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[76] *Id.*

[77] *See, e.g.*, RAND Report, *supra* note 45, at 113.

[78] Laby, *supra* note 22, at 404.

[79] *Id.* In practice, the brokerage firm or adviser would classify the account according to the types of services attached to it. *Id.* Regulators would respect such designations as long as they were correct. *Id.* This allowed a firm to be registered as an adviser while overseeing particular accounts in a non-advisory manner. *Id.* "From an investor protection standpoint, what matters most is the regulatory treatment of a particular account, not the registration status of the firm." *Id.*

[80] *Id.*

[81] *Id.* at 403-04.

[82] *Id.* at 405.

Beginning with the Buttonwood Tree Agreement in 1792,[83] the amount of commission paid in connection with the purchase or sale of a security was non-negotiable.[84] This structure persisted for many years, until in the mid-twentieth century the development of a supply-side cartel led to the conclusion that price-fixing in the brokerage context was no longer in investors' best interests.[85] In 1975, the SEC took action and "prohibit[ed] any exchange from requiring its members to charge fixed commissions."[86] Years later, in 1994, the SEC again took action to combat abuses relating to abuses in brokerage commissions. This time, the SEC formed the Tully Committee to address "churning" in the brokerage industry.[87] Charged with identifying conflicts of interest in the industry, the Committee ultimately concluded that "firms should base at least a portion of a registered representative's compensation on assets held in an account regardless of whether any transactions occur."[88] These updates brought about significant change in the brokerage industry and ushered in a new wave of fee-based brokerage accounts.[89] Concerns rose over time, however, that because brokers were no longer charging commissions, they might be receiving special compensation that would subject a broker to investment adviser duties.[90]

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[83] The Buttonwood Tree Agreement was signed on May 17, 1792. RICHARD J. TEWELES ET AL., THE STOCK MARKET 97 (6th ed. 1992). The agreement between twenty-four brokers created what became the New York Stock Exchange. New York Stock Exchange: Bicentennial – Proclamation, Pub. L. No. 102-296, 106 Stat. 215 (1992) (commemorating the New York Stock Exchange's founding by joint resolution of Congress). The agreement had two practical implications for the securities industry. First, members of the agreement could only deal with each other, effectively eliminating auctioneers. TEWELES ET AL., *supra*, at 97. Second, and more pertinent to this discussion, commissions charged by brokers were set at 0.25%. *Id.*

[84] Laby, *supra* note 22, at 405.

[85] Arie Melnick & Aharon R. Ofer, *Competitive Commission Rates, Execution Quality, and Customer's Market Power*, 12 J. MONEY, CREDIT & BANKING 221, 221 (1980).

[86] Laby, *supra* note 22, at 405.

[87] *Id.* at 406. Churning is the practice of engaging in high volume trades within a brokerage account to artificially inflate a broker's commissions rather than to benefit a client. *Id.* at 406 n.89. This practice tends to occur when broker compensation is directly tied to customer trading volume. *Id.*

[88] *Id.*

[89] *Id.* In order to compete with discount brokers like Charles Schwab, broker-dealers began instituting multiple levels of service. *Id.* at 405-06. "Full-service brokerage would include execution, advice, delivery, and payment services, as well as custody and recordkeeping. Discount brokerage would include use of an electronic trading platform and the ability to trade online." *Id.* at 406 (footnote omitted).

[90] *Id.* at 407 ("Brokers were in a quandary. Although they changed only their method of compensation and not their services, brokers were faced with application of the Advisers Act in addition to the full panoply of broker-dealer regulation to which they were already subject.").

In April 2005, in an attempt to resolve this conflict, the SEC issued the Merrill Lynch Rule.[91] The rule was designed "to address the increasingly popular fee-based accounts offered by broker-dealers"[92] and to exempt broker-dealers from fiduciary duties.[93] The Merrill Lynch Rule exempted broker-dealers from the Investment Advisers Act[94] when offering fee-based brokerage accounts if the broker-dealer "1) [did] not charge a separate fee for advisory services; 2) [did] not provide advice as part of a financial plan or in connection with financial planning services; 3) [did] not exercise investment discretion over any customer accounts; and 4) [included a specified disclosure] statement in any advertisements or account-related documents."[95] Despite acknowledging that such a structure blurred the lines "between full-service

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[91] Fein, *supra* note 11, at 3-4.

[92] Allen, *supra* note 21, at 32. These accounts allowed a broker-dealer to be compensated based on assets under management, rather than transaction volume. *Id.* Mr. Allen provides a brief account of fee-based brokerage accounts:

> The rise of fee-based brokerage accounts was the result of three things: 1) increased competition in the brokerage industry; 2) decrease in transaction-based commissions; and 3) a 1995 report commissioned by the SEC that identified fee-based accounts as a best practice to avoid conflicts of interest because they decreased incentives to churn accounts, recommend unsuitable yet profitable securities, or use high-pressure sales tactics.
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> . . . .
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> Fee-based brokerage programs typically offered a suite of services for which a customer paid a fee based on the total assets in the account, including services like execution, investment advice, arranging for delivery and payment, and custodial and recordkeeping services.

Id. (footnotes omitted) (citing RAND Report, *supra* note 45, at 2).

[93] Certain Broker-Dealers Deemed Not to Be Investment Advisers, 70 Fed. Reg. 20,424, 20,433 (Apr. 19, 2005) ("In some cases, such as when broker-dealers assume positions of trust and confidence with their customers similar to those of advisers, broker-dealers have been held to similar standards. . . . [H]owever, broker-dealers often play roles substantially different from investment advisers and in such roles they should not be held to standards to which advisers are held.").

[94] As discussed in Part I.A, *supra*, the Act exempted broker-dealers from the definition of "investment adviser," and thus from fiduciary duties to the client, if their services were solely incidental to their brokerage offerings and if they did not receive special compensation for those services. Allen, *supra* note 21, at 32. The primary concern with fee-based brokerage accounts was "whether broker-dealers offering them were being paid 'special compensation' for advisery services, and thus satisfying the definition of an investment adviser." *Id.*

[95] Allen, *supra* note 21, at 33 (quoting RAND Report, *supra* note 45, at 1) (internal quotation marks omitted) ("In short, the SEC would permit broker-dealers offering incidental investment advice to sell securities that conflicted with the customer's interest as long as the broker-dealer tells the customer in clear terms that they are not fiduciaries of the broker-dealer.").

broker-dealers and investment advisers," the SEC rejected proposals to employ a uniform fiduciary standard on the two groups.[96]

Ultimately, the rule was overturned by the D.C. Circuit Court of Appeals.[97] Following this case, it became clear that the "courts were not going to honor any artificial or non-statutory-based distinctions between broker-dealers and advisers in order to absolve broker-dealers from the plain language and incumbent duties intended by Congress in enacting the Investment Advisers Act."[98] In so ruling, the court agreed with professional criticisms of the exemption.[99] Specifically, the broker-dealer exemption (1) was likely to lead to *even more confusion* among consumers regarding the difference between broker-dealers and investment advisers, and (2) it would allow broker-dealers to provide investment advice and sell brokerage products that would violate the fiduciary duties attached to investment advisers.[100] Although the D.C. Circuit Court of Appeals ultimately upheld the distinction between broker-dealers and investment advisers, it highlighted, perhaps for the first time, that in practice there was minimal distinction between the services offered by the two groups.

B. *Compensation Becomes "Special" and Advice Is No Longer "Solely Incidental"*

The utilization of asset-based compensation, in lieu of a commission structure, has altered the relationship between broker and customer such that the relationship should be considered advisory and regulated accordingly.[101] As early as the 1995 Tully Report, the SEC was concerned that charging asset-based fees may change investor expectations of a broker's duties.[102]

[96] *Id.* at 32 (quoting Certain Broker-Dealers Deemed Not to Be Investment Advisers, 70 Fed. Reg. at 20,434).

[97] Fin. Planning Ass'n v. SEC, 482 F.3d 481, 492 (D.C. Cir. 2007) (holding that the 2005 rule exceeded the SEC's rulemaking authority by improperly expanding the broker-dealer exception in the Advisers Act beyond a reasonable interpretation of the exception contained in the Act).

[98] Allen, *supra* note 21, at 34.

[99] *Id.*

[100] *Id.*

[101] Laby, *supra* note 22, at 417. In his article, Professor Laby argues that changes in the compensation structure "vitiate[]" the need to abandon the Investment Adviser Act broker-dealer exception entirely. *Id.* He points out that those broker-dealers who receive asset-based commissions are not covered under the exception following the ruling in *Financial Planning Ass'n v. SEC*. *Id.* I take Professor Laby's contentions at face value to support the contention that investment advisers and broker-dealers have become so similar in terms of the services they provide that a decision not to harmonize the standards of conduct imposed on each would be irresponsible. However, the question of whether the regulatory scheme should be flipped – namely, imposing a blanket fiduciary duty on broker-dealers and exempting those solely performing traditional functions – is beyond the scope of this Note.

[102] *Id.* at 419 (citing DANIEL P. TULLY, THOMAS E. O'HARA, WARREN E. BUFFETT, RAYMOND A. MASON & SAMUEL L. HAYES III, REPORT OF THE COMMITTEE ON

Specifically, according to the SEC, asset-based fees led investors to believe that their brokers owed them a duty to monitor their accounts actively.[103] A commission payment is a one-time event that requires best execution on that transaction but requires no continuing duty to monitor an account for further action.[104] This aligns with a broker's traditional role as order-taker. Because the broker is compensated only when the client trades, there is no incentive to suggest that the client "do nothing."[105] When a broker begins charging asset-based fees, however, the broker can now recommend that the client "do nothing."[106] This structure suggests "an ongoing relationship – keeping the customer 'constantly advised' as to what changes, in the opinion of the firm, should be made in the customer's holdings."[107] This duty to monitor is akin to the duties traditionally owed by investment advisers, not broker-dealers. Thus, there is currently a disjoint between the traditional role on which current broker-dealer regulation is premised and the role that broker-dealers play in the financial markets today. To remedy this disjoint, a heightened duty should be imposed on broker-dealers.

In the late twentieth century, broker-dealers not only began receiving "special compensation," but they also started providing non-incidental investment advice to clients.[108] According to the SEC, advice is incidental when it "is a side occurrence that arises along with brokerage as the main occurrence."[109] In light of technological advances in order execution, however, brokerage services can no longer be considered the primary function of broker-dealers.[110] "In the Depression era and before, trade execution was a vital function performed by Wall Street firms."[111] Trade execution required a customer to place an order with a NYSE member-firm's branch office clerk.[112] The clerk then wired the order to the firm's main office.[113] The main office then wired it to another clerk on the NYSE floor who prepared an order slip and summoned a floor broker.[114] That clerk then analyzed the bid-ask spreads

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COMPENSATION PRACTICES 10 (1995) [hereinafter TULLY REPORT], *available at* http://.sec.gov/news/studies/bkrcomp.txt).

[103] *Id.*

[104] *Id.* at 417.

[105] *Id.* at 419.

[106] *Id.*

[107] *Id.* at 417 (quoting TWENTIETH CENTURY FUND, THE SECURITY MARKETS 469-70 (4th prtg. 1938)).

[108] *Id.* at 404.

[109] *Id.* at 420.

[110] *Id.* at 423-24.

[111] *Id.* at 421.

[112] *Id.*

[113] *Id.*

[114] *Id.*

and determined the best price to execute the transaction.[115] Once the order was placed, the entire communication process reversed itself.[116] In light of the many steps required to place an order, brokerage services were considered primary while advice loomed in the background.[117] Technological advances in the securities industry, though, have eliminated many of these steps.[118] Thus, the traditional dividing line between broker-dealers and investment advisers has been breached. One can no longer seriously consider trade execution the primary function of a modern broker – especially when modern brokers tout themselves as "advisers."[119]

As mentioned in Part I.A, *supra*, the primary basis for not imposing fiduciary duties on broker-dealers is that they are exempted by the Investment Advisers Act of 1940. The Act, however, eliminates the exemption if the broker-dealer receives "special compensation" or provides investment advice which is not "solely incidental" to the brokerage activities.[120] Because the modern broker-dealer does not meet either standard, it seems imprudent not to harmonize the standards of care. Disregarding the underlying statutory distinction's relevance, the investing public can no longer distinguish between broker-dealers and investment advisers. As the primary function of the securities laws is to promote investor protection, this mental shift alone should be sufficient to warrant harmonization.

C. *Marketing Tactics Facilitate a Mental Merger*

While changes in compensation structure might imply that broker-dealers and investment advisers are becoming increasingly similar entities, it cannot be disputed that broker-dealers want to be perceived as providers of investment advice. In the 1990s, "brokerage firms began to use titles such as 'adviser' or 'financial adviser' for their broker-dealer registered representatives and even encouraged customers to think of the registered representative more as an adviser than a stockbroker."[121] This rebranding is particularly significant because "[m]arketing methods used by financial services providers bear on the level of protection afforded by the federal securities laws."[122] This contention

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[115] *Id.*

[116] *Id.* at 421-22.

[117] *Id.* at 422.

[118] *Id.* Most notably, electronic communication networks (ECNs) now offer "fully automated transaction execution services." *Id.* at 423.

[119] *Id.* at 424.

[120] *See supra* notes 42-45 and accompanying text.

[121] *Id.* at 404 (citing Letter from Barbara Roper, Dir. of Investor Prot., Consumer Fed'n of Am., to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 4 (Sept. 20, 2004), *available at* http://.sec.gov/rules/petitions/4-507/4507-2.pdf).

[122] *Id.* at 413. Professor Laby highlights the private adviser exemption to the Advisers Act. *Id.* at 414. Under this exclusion, an adviser otherwise required to register is exempt if, among other things, he does not hold himself out to the public as an investment adviser. *Id.*

is supported in a RAND Institute for Civil Justice report, which found that "[i]nvestors tend to believe that professionals who use the title of financial adviser or consultant are more similar to advisers than they are to brokers in the services they provide and the duties they owe."[123] Emphasizing marketing tactics to determine whether professional services are "solely incidental" is consistent with the SEC's treatment of other actors under the Investment Advisers Act.[124] Where advice is intended to lure customers to the firm, it seems contradictory to say that a broker-dealer's investment advice is "solely incidental" to its brokerage activities.

In fact, the SEC authorized the RAND Institute to "evaluate investors' understanding of the differences between investment advisers[] and broker-dealers[]."[125] Interestingly, RAND found that most investors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers.[126] Most "experienced" investors saw "financial advisors and financial consultants as being more similar to investment advisers than to brokers in terms of services and duties."[127] Irrespective of the type of service received (advisory or brokerage), many investors refer interchangeably to broker-dealers and investment advisers as adviser, financial adviser, or financial consultant.[128] Ultimately, many of the people interviewed did not understand the difference between the duties owed by broker-dealers and investment advisers, particularly where generic titles like "financial adviser" were used.[129] Overall, these findings suggest a shift in the minds of the investing public. No longer do the historic distinctions between financial professionals exist. No longer can customers easily distinguish which type of financial professional acts in a fiduciary capacity and which type does not. Thus, customers can no longer make informed decisions about whether they plan to contract away fiduciary obligations by choosing a broker-dealer over an investment adviser. For these reasons, and to promote investor protection, the harmonization of duties owed by broker-dealers and investment advisers is due.

(citing Investment Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3) (2006)).

[123] *Id.* at 415 (citing RAND Report, *supra* note 45, at 90).

[124] *Id.* at 416. The SEC utilized marketing tactics to interpret the "solely incidental" exclusion in several other contexts, including lawyers, accountants, teachers and engineers. *Id.* The most relevant factor in this analysis was "whether the professional holds himself or herself out as an investment adviser." *Id.*

[125] RAND Report, *supra* note 45, at iii.

[126] *Id.* at xix.

[127] *Id.*

[128] *Id.*

[129] *Id.*

D. *Is a Fiduciary Duty Appropriate?*

In the preceding sections, the implicit assumption is that it is both necessary and appropriate to impose a fiduciary duty on broker-dealers. This view is not without its critics. Specifically, Professor Larry Ribstein recently argued the opposite. According to Professor Ribstein, fiduciary duties are only appropriate where there is a delegation of "open-ended management power over property without corresponding economic rights."[130] Under this view, the delegator not only seeks advice from the delegatee but also "ceases to make her own decisions concerning whether and how much to rely on each of the [delegatee's] judgments."[131] Although a broker-dealer may give investment advice, it is the client who ultimately decides whether or not to invest, and thus Professor Ribstein finds no open-ended delegation of power.[132] In the same article, Professor Ribstein also questions whether a fiduciary duty for broker-dealers and advisers is truly appropriate.[133]

Interpreting § 913 of Dodd-Frank, the SEC Staff called for a harmonization of the duties owed to investment advisers and broker-dealers.[134] Following *SEC v. Capital Gains Research Bureau, Inc.*,[135] the courts found investment advisers to be fiduciaries.[136] This finding rested on an interpretation of § 206 of the Investment Advisers Act of 1940.[137] Dissecting the opinion, Professor Ribstein argues that the holding is based on an interpretation of common law fraud requiring disclosure rather than a duty of unselfishness.[138] From this he concludes that the court never intended a true fiduciary duty, and therefore a fiduciary duty is inappropriate under Dodd-Frank.[139]

In fact, Professor Ribstein goes so far as to say that the SEC should not impose a default rule "allowing disclosed conflicts as long as [a] fiduciary can show she nevertheless acted in the beneficiary's best interests."[140] While

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[130] Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 901 (2011).

[131] *Id.* at 913.

[132] *Id.* at 917 ("Brokers, dealers, and advisers usually lack authority to commit the customer's property without further instructions.").

[133] *Id.*

[134] *Id.* at 916.

[135] 375 U.S. 180 (1963).

[136] Ribstein, *supra* note 130, at 917.

[137] Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006).

[138] Ribstein, *supra* note 130, at 917.

[139] Scholars disagree over the origin of the fiduciary duty of investment advisers with regard to the Supreme Court's interpretation of the Investment Advisers Act. *See, e.g.*, Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1066 (2011) ("The *Capital Gains* Court neither stated nor implied that the Investment Advisers Act created a fiduciary duty governing advisers – the Act merely *recognized* that a fiduciary duty existed between advisers and their clients.").

[140] Ribstein, *supra* note 130, at 904. Professor Ribstein cites, among other reasons, limited judicial capacity to rule on anything less than a strict rule of selflessness, the

Professor Ribstein's views are not without merit, I argue that his narrow view of the conditions precedent to the imposition of fiduciary duties is ill-suited to the retail brokerage context.

SEC v. Capital Gains was decided in 1963. For forty-seven years, the prevalent view held investment advisers as fiduciaries. As described in this Part, retail clients came to rely on this distinction when deciding whether to contract for the services of a broker-dealer or investment adviser.[141] Undoubtedly Congress was aware of this interpretation when drafting the Dodd-Frank Act. If there was no intent to establish fiduciary duties for broker-dealers, Congress could have refrained from expressly employing such language in § 913. Reliance on statutory interpretation alone, however, would be misguided.

Although there is no pure open-ended delegation of management authority, the relative inequalities in financial acumen between retail brokerage clients and their broker-dealers practically amount to such a delegation.[142] In fact, recent research may even suggest that the goal of any good salesman in the financial space is to remove the impulse to question investment advice.[143]

In his article *Psychological Perspectives on the Fiduciary Business*, Donald Langevoort explains this tension between sales and fiduciary behavior.[144] He finds that "the study of consumer behavior leads quickly to lessons about how to manipulate emotions and expectations to make people part more readily with their money."[145] Langevoort goes one step further, stating that there may be an institutional role in desensitizing the sales force and changing its

interaction of fiduciary duties with other contractual and market constraints on agents, and litigation costs. *Id.* at 904-05.

[141] *See* Donald C. Langevoort, *Psychological Perspectives on the Fiduciary Business*, 91 B.U. L. REV. 995, 995 (2011).

[142] Not all fiduciary law scholars would remove broker-dealers from the fiduciary context. *See, e.g.*, Tamar Frankel, Essay, *Fiduciary Law in the Twenty-First Century*, 91 B.U. L. REV. 1289, 1290 & n.3 (2011); Ribstein, *supra* note 130, at 912 ("Professor Frankel sees professionals like physicians, lawyers, brokers and dealers as fiduciaries."). In addition, not all scholars would impose such restrictive conditions precedent to imposing a fiduciary duty. *See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1040 (2011) ("The law tends to impose a fiduciary obligation in circumstances that present what economists call a *principal-agent* or *agency problem*. . . . [A]n agency problem arises whenever one person, the *principal*, engages another person, the *agent*, to undertake imperfectly observable discretionary actions that affect the wealth of the principal.").

[143] *See* Langevoort, *supra* note 141, at 996 ("The problem is that the brokerage business evolved in the last century as a sales business – generating transactions that, through commissions or mark-ups, produce a revenue stream for the registered representatives and their firms. This process requires good salesmanship, and that salesmanship usually comes in the form of 'advice' and recommendations given to the customer.").

[144] *Id.* at 997.

[145] *Id.*

perceptions.[146] In fact, firms may go so far as to actively recruit individuals more likely to respect authority and avoid critical thinking.[147] Presented with a genuine front-office face, the subject of a sales pitch is more likely to be persuaded to buy.[148] Although I do not disagree with Professor Ribstein's view that the provision of advice, by itself, is insufficient to trigger fiduciary duties, deceptive influences in the selling process present a much more compelling reason to trigger fiduciary duties.

Even assuming that broker-dealers are not preconditioned by their institution, the practical realities of the broker-client relationship necessitate the imposition of fiduciary duties. As described in Part V, *infra*, many retail clients take their broker-dealers' investment advice at face value. Few possess the financial acumen to dissect the advice in any meaningful way to distinguish that which is truly in their interests.[149] Functionally, therefore, any advice by a broker-dealer amounts to the sort of open-ended management power requisite for a fiduciary duty under Professor Ribstein's analysis.[150]

III. TRUST LAW'S "BEST INTEREST" STANDARD PROVIDES A WORKABLE FIDUCIARY STANDARD FOR BROKER-DEALERS

In the face of economic scandal and the perceived decline of accountability in the retail securities industry, one might call for the SEC to impose the harshest fiduciary standard on broker-dealers. While § 913(f) of the Investment Advisers Act of 1940 "authorizes the SEC to issue rules to 'address' the standard of care applicable to broker-dealers and investment advisers when giving personalized investment advice to retail customers,"[151]

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[146] *Id.* at 1000 ("When a product is complex, the salespeople have to be educated about it, a situation that invites the developers to 'sell' the salespeople in ways that produce perceptions – and probably misperceptions – about the product, that can then genuinely and without doubt be transmitted in the actual sales interaction with the customer.").

[147] *Id.*

[148] *Id.*

[149] In fact, "[a]gents are often retained because the principal lacks the specialized skills necessary to undertake the activity on his own. In such a case, the skill deficit that prompted the principal to engage the agent will limit the principal's ability to monitor the agent." Sitkoff, *supra* note 142, at 1041. Although the brokerage context is not strictly a principal-agent relationship, the skill deficit between retail clients and broker-dealers and the rationale for contracting are similar.

[150] I do not dispute that a given retail client's financial sophistication may vary. Certainly, not all clients will effectively delegate investment decisions to their broker-dealer due to an inability to actively assess investment advice. Further, an empirical analysis of those retail clients who can and cannot distinguish the merits of various investments is beyond the scope of this Note. One of the purposes of the securities laws, however, is to foster investor protection, particularly where there are information asymmetries. Where a professional takes advantage of a retail client's ignorance, the securities laws must step in for the client's protection.

[151] CADWALADER, *supra* note 6, at 7.

this authorization is not without limitation. Any rule imposing a standard of care on broker-dealers (1) must be "at least as strict as the standard applicable to investment advisers" and (2) "must require that broker-dealers operate in the best interest of their customers and disclose any material conflicts and obtain consent thereto from the customer."[152] There is, however, no precedent defining a best interest standard as it pertains to broker-dealers.[153] As mentioned in the Introduction, investment advisers are already under a duty to act in their clients' best interests. In practice, however, this standard is vague at best. In light of commonalities in purpose and practical use, I believe that courts and arbitration forums should seek to develop the best interest standard by analogizing to its current use in trust law.

A. *Common Concerns Underlie Trust Law and Securities Regulation*

From the outset of his New Deal regulatory initiatives, President Franklin D. Roosevelt believed that the securities acts should proceed from the "ancient truth that those managing other people's money should be subject to trustee duties."[154] From these early words, the securities laws have been inextricably tied to trust law. The reason for this link is not trivial. On a basic level, both involve an individual entrusting assets to a fiduciary who, ideally, will manage those assets in the beneficiary's best interests. Stemming from this arrangement, both bodies of law are primarily concerned that the fiduciary does not unduly benefit at the expense of the beneficiary.[155] Perhaps more significantly, trust law and securities regulations are applicable to individuals who purchase or sell securities for the account of another. Although trusts were once "primarily a tool for conveying ancestral lands," they are now

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152 *Id.* at 8.

153 Although there is no clearly defined standard for "best interest," the standard must encompass something more protective of investors than the current "suitability" standard discussed *supra* notes 72-76 and accompanying text.

154 Ramirez, *supra* note 23, at 534 (internal quotation marks omitted).

155 In fact, the current "sole interest" rule developed to counter a significant potential for concealment of abuses by a trustee. Langbein, *supra* note 20, at 945. Concealment of trust abuse could be achieved in any number of ways. First, because the English Court of Chancery was overburdened and almost entirely without procedure for equity fact-finding, it was difficult for a beneficiary to gain access to records chronicling such abuses. *Id.* Second, even if there had been procedures for fact-finding, there were no substantial norms requiring fiduciary recordkeeping that would leave a paper trail should a plaintiff gain access to a fiduciary's records. *Id.* at 947-48. Thus, the sole interest standard, although harsh, acted to raise the standards of care owed by trustees. Similarly, the securities laws as promulgated under President Roosevelt were designed in response to the colossal failure of self-regulation. Ramirez, *supra* note 23, at 527. Specifically, the Securities and Exchange Acts were meant to mandate "just and equitable principles of trade in the securities brokerage industry with the specific intent of raising industry standards for the protection of investors." *Id.* (internal quotation marks omitted).

"device[s] for the active management of a portfolio of financial assets."[156] In fact, wealth transfer now resembles the ordinary conduct of business.[157] It cannot be disputed that investment advisers and broker-dealers increasingly provide similar services. Therefore, because of the inextricable similarities in policy concerns and the base the laws regulate, trust law provides an apt area of law from which to inform the best interest standard.

B. *Sole Interest Standard Boils Down to a Client's Best Interests*

The sole interest standard, widely regarded as the most fundamental rule of trust law, states that a trustee must carry out his duties in the sole interest of the beneficiary.[158] Under this standard, any conflict of interest will invalidate the transaction and subject the trustee to a host of beneficiary remedies.[159] It is a non-rebuttable presumption of invalidity that applies where a trustee is conflicted, including "cases in which the trust incurred no loss or in which actual benefit accrued to the trust."[160] This is a hard-line rule which admits no room for conflicts of interest, at least in theory.[161]

In practice, the sole interest rule is riddled with exceptions that reduce it to an inquiry into whether the transaction is in the beneficiary's best interest. First, a willing settlor can contract around or even ignore the rule if he so chooses.[162] Second, a "beneficiary cannot hold the trustee liable for an act or omission of the trustee as a breach of trust if the beneficiary . . . consented to it."[163] Finally, a conflicted transaction will be allowed if the trustee first obtains judicial approval.[164] Under this exception, the court asks whether the

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[156] Langbein, *supra* note 20, at 941.

[157] *Id.* at 941-42.

[158] *Id.* at 931 ("The duty of loyalty requires a trustee 'to administer the trust solely in the interest of the beneficiary.'" (quoting RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959))).

[159] *Id.* This standard "prohibits a trustee from plac[ing] himself in a position where his personal interest . . . conflicts or possibly may conflict with the interests of the beneficiary." *Id.* (internal quotation marks omitted).

[160] *Id.* (internal quotation marks omitted). In practice, the court will likely identify a conceivable yet conjectural evil and presume that it occurred. *See id.*

[161] *Id.* ("[E]quity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests." (internal quotation marks omitted)).

[162] *Id.* at 963 ("It is well established that a trustee may occupy conflicting positions in handling the trust where the trust instrument contemplates, creates, or sanctions the conflict of interest." (quoting Dick v. Peoples Mid-Ill. Corp., 609 N.E.2d 997, 1002 (Ill. App. Ct. 1993))).

[163] *Id.* at 964 (quoting RESTATEMENT (SECOND) OF TRUSTS § 216(1) (1959)).

[164] *Id.* at 965. Professor Langbein argues that "[t]he procedure for securing advance judicial approval of a conflicted transaction resembles the conflict-of-interest regime of the law of corporations, because it interposes an impartial decisionmaker (there the disinterested directors, here the court) between the conflicted fiduciary and the transaction." *Id.* at 966.

transaction is in the beneficiary's best interest.[165] There is no longer a presumption of invalidity. Instead, this exception allows the court to decide whether the transaction is in the beneficiary's best interest.[166] Therefore, although the overarching theoretical standard in trust law is sole interest, the applicable standard in practice is often best interest. Given the extensive case law chronicling the development of this doctrine, as well as judicial experience applying it, this trust law concept should inform the best interest standard applied to broker-dealers offering personalized investment advice to retail customers.

C. *Advance Judicial Approval Exception in Practice*

Under § 802 of the Uniform Trust Code (UTC), a trustee must administer the trust solely in the interests of the beneficiary.[167] Any transaction entered into by the trustee that is tainted by a conflict of interest is voidable by the beneficiary unless one of five exceptions is met, including whether the transaction was approved by the court in advance.[168] Good faith or fair consideration are insufficient, by themselves, to rebut this presumption of fraud,[169] but a court will approve the transaction when it is in the beneficiary's best interest.[170] As of 2005, fourteen states and the District of Columbia have adopted the UTC approach.[171] Given the already widespread use of the best interest standard in trust law, judges could easily evaluate potential conflicts of interests involving broker-dealers under this standard.

In practice, the best interest standard requires the court to engage in a fact-specific inquiry to determine whether the trustee violated his fiduciary duty by taking advantage of his position.[172] The court may consider factors such as

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[165] *Id.* at 966 (quoting RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f (1959)).

[166] *Id.* at 966-67. The advance judicial approval exception is case-specific. Namely, it "requires litigation to establish to the satisfaction of the court that the particular transaction is indeed in the best interest of the beneficiary." *Id.* at 968 (internal quotation marks omitted).

[167] UNIFORM TRUST CODE § 802(a) (2000).

[168] *Id.* § 802(b); *see also* RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. f (1959) ("The trustee can properly purchase trust property for himself with the approval of the court. The court will permit a trustee to purchase trust property only if in its opinion such purchase is for the best interest of the beneficiary.").

[169] UNIFORM TRUST CODE § 802 cmt.

[170] Langbein, *supra* note 20, at 966-67.

[171] Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 WM. & MARY L. REV. 541, 544 n.9 (2005) (listing Arkansas, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Utah, Virginia, and Wyoming as adopting states). In addition, several other states have statutes in place that require a trustee to gain court approval before entering into a conflicted transaction: Arizona, Florida, Hawaii, Idaho, Michigan, and Mississippi. *Id.* at 544 n.7.

[172] *See, e.g.*, Charles Bryan Baron, *Self-Dealing Trustees and the Exoneration Clause:*

whether the trustee paid fair consideration and whether the transaction terms mirror what would be agreed upon in an arm's-length transaction.[173] In addition, a conflict of interest may not be allowed without full and complete disclosure[174] or where the trustee had purely personal reasons for engaging in the conflicted transaction.[175] In general, the court will ask whether the conflict of interest so controls the trustee's actions that the trustee is rewarded by holding the dual interests, thus making it appropriate to strike down the potential transaction.[176] Where the conflict is too remote or insubstantial, it will not be sufficient to restrain a trustee.[177] Although the broker-dealer context would require a slightly different inquiry – whether the broker-dealer's investment recommendation is in the client's best interest – several of these benchmarks would be applicable for approving or disapproving a recommendation.

Can Trustees Ever Profit from Transactions Involving Trust Property?, 72 ST. JOHN'S L. REV. 43, 49 n.37 (1998) (noting that self-dealing can be defined as "any conduct by the trustee which violates fiduciary duty by taking advantage of the trustee's position as a trustee to benefit the trustee." (quoting InterFirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882, 899 (Tex. App. 1987))).

[173] UNIFORM TRUST CODE § 802 cmt.; *see also* Daub v. Daub, 1995 Mont. Dist. LEXIS 617, at *5 (Mont. Dist. Ct. 1995) ("It is . . . clear that the statutes stress that all proceedings which the [trustee] is party to are to be for the best interests of successors to the estate and *all sales must be fairly conducted and made for the best price obtainable*. These requirements are all consistent with a [trustee's] duties as a fiduciary." (emphasis added) (internal quotation marks omitted)).

[174] *See, e.g.*, Stilwell v. Estate of Crosby, 519 So. 2d 68, 70 (Fla. Dist. Ct. App. 1988) ("There was a conflict of interest which should not have been tolerated by the court without a full and complete disclosure."); GEORGE GLEASON BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES, § 543 (2d rev. ed. Supp.) (citing Wachovia Bank & Trust Co. v. Johnston, 153 S.E.2d 449 (N.C. 1967), for the proposition that "[s]ometimes a court will authorize a self-dealing transaction on the grounds that there had been full disclosure and that the transaction was in the best interests of the trust").

[175] *See In re* Trust Created by Inman, 693 N.W.2d 514, 520-21 (Neb. 2005).

[176] *In re* Estate of Nelson, 657 P.2d 427, 430 (Ariz. Ct. App. 1982) (holding that it would be unduly harsh to strike down a transaction where the trust is "in no way diminished and the apparent conflict of interest does not manifest itself by controlling the guardian's actions" (quoting Fielder v. Howell, 631 P.2d 249, 251 (Kan. Ct. App. 1981))); *see also Wachovia*, 153 S.E.2d at 460 (finding that a trustee may rebut the presumption of fraud in a self-dealing transaction by showing that there was "no undue influence or moral duress exerted").

[177] BOGERT ET AL., *supra* note 174, at § 543 (citing Cosden v. Mercantile-Safe Deposit & Trust Co., 398 A.2d 460 (Md. Ct. Spec. App. 1979), for the proposition that a transaction does not violate the best interest standard when "the conflict was too remote or insubstantial").

IV. DEFINING A BEST INTEREST STANDARD FOR BROKER-DEALERS

Since the enactment of the Securities Act and the Exchange Act, securities regulation has developed piecemeal in response to industry advancements and financial crises. For that reason, it makes sense to continue this tradition by regulating broker-dealers via principles, rather than via a rules-based approach. Fundamentally, the distinction is simple. While rules provide indisputable guidance on what is or is not permissible, principles-based regulation allows for greater flexibility to address future concerns and scenarios which could not be predicted at drafting.[178] Although rules-based regulation provides clear lines of what is legal, it invites actors to find a way to avoid those rules.[179] Alternatively, principles-based "rulemaking focuses on the goal toward which conduct should be oriented."[180] Thus, in order to work towards the ultimate goal of investor protection while continuing to professionalize the securities brokerage industry, a functional definition of "best interest" is appropriate.

A. *Best Interest as Applied to Broker-Dealer Regulation*

I propose a practical definition of "best interest" based on the principle that conflicts of interest should be allowed when beneficial to the retail customer. This would require courts to conduct a cost-benefit analysis, undertaking a fact-intensive inquiry measuring the cost or danger of the conflicted transaction against the prospect of benefit. While the trust law best interest concept focuses on an individual customer, differences in the fiduciary-client relationship necessitate approaching this balancing from the perspective of a reasonable investor in the beneficiary's position. This approach would be particularly useful in light of the many connections a given customer might have with the financial sector. The standard would eliminate the need to approach multiple brokers simply to avoid a conflicted transaction. Perhaps more importantly, this principle would allow courts to develop the best interest standard over time, updating it in light of its successes and failures in practice, in order to best serve the investment community.[181] Further, unlike the trust law standard, this would not be a default rule that could be contracted around. Allowing brokers and customers to do so would only inhibit the development of a robust doctrine, leading to a hobbled standard approximating the current suitability standard governing broker-dealers.

Several core principles, including the advance judicial approval exception surveyed in Part III.C, *supra*, should inform a court's analysis of whether a broker-dealer's recommendation is in his client's best interest. As a threshold question, the court should ask whether a conflict of interest so governs the

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[178] Hazen, *supra* note 2, at 718.

[179] *Id.* at 719.

[180] *Id.* at 719-20 (internal quotation marks omitted).

[181] Sitkoff, *supra* note 142, at 1044 ("[T]he normal accretive process of the common law has produced a rich body of interpretive authority on fiduciary matters . . . . This mass of authority improves predictability . . . [and] the remedies available . . . .").

broker-dealer's judgment that the broker-dealer cannot possibly make a recommendation based on the client's needs. Where the broker-dealer, by the nature of the conflict, is predisposed to suggest certain securities regardless of the client's financial position, such a transaction cannot be in the client's best interest absent some further showing. Full and complete disclosure of the conflict may help to alleviate such pressures by putting the client on notice. Disclosure alone, however, is unlikely to protect sufficiently a client lacking the financial sophistication to assess various investment alternatives to any appreciable degree.

Only where a broker-dealer passes this threshold should the court engage in balancing the harms and benefits of the conflicted transaction to the customer. Insubstantial conflicts of interest should not be a sufficient reason to deem a recommendation improper. The securities industry is highly interconnected. Frequently, broker-dealers are employed by companies that also employ investment advisers and operate investment banking departments.[182] In this setting, conflicts of interest are bound to occur. Only those conflicts that adversely affect a broker-dealer's recommendations to his customers, however, should be deemed material.

Undoubtedly, some will question whether courts have the institutional competency to determine whether a particular recommendation is in a client's best interest. This is particularly relevant where the broker-dealer's recommendation is based on an assessment of the client's current financial position and risk tolerance. The inquiry, although fact-specific, should not turn on a case-by-case financial analysis. This is certainly beyond the scope of the courts. Judges, however, *are* in the position to ask whether the transaction is one that would be recommended by a reasonable broker-dealer not affected by a conflict of interest. If answered in the affirmative, the conflict is unlikely to so control a broker-dealer that the recommendation is not in the client's best interest.

A more serious critique of imposing a best interest standard is that it raises the cost of monitoring.[183] "Because trust agreements are private, the beneficiaries become the sole monitors of the trustee's behavior."[184] Many beneficiaries are, however, poorly situated to evaluate the financial decisions made by a professional trustee.[185] To do so accurately would require a level of skill approximating that of the trustee, something unlikely to be true.[186] This concern is less worrisome in the broker-dealer context. Often an individual becomes a trust beneficiary because he or she is deemed incapable of

[182] *See* STUDY ON INVESTMENT ADVISERS, *supra* note 3, at iii.

[183] Leslie, *supra* note 171, at 555.

[184] Melanie B. Leslie, *Common Law, Common Sense: Fiduciary Standards and Trustee Identity*, 27 CARDOZO L. REV. 2713, 2717 (2006).

[185] *Id.*

[186] *Id.*

"managing large sums of money."[187] Yet, while the financial sophistication of a broker-dealer's clients will vary, it would be inappropriate to presume a complete absence of such sophistication. Not only do the securities laws mandate greater disclosure of publicly traded shares, but there also are industry benchmarks by which to compare stock performance. A retail investor reviewing such disclosures or deviations from benchmarks would have access to information that could support an inquiry into whether the recommended transaction was in the client's best interest.

B. *Eliminating Mandatory Arbitration Agreements Will Facilitate Doctrinal Development*

As mentioned in Part III.A, *supra*, the primary rationales for imposing a strict sole interest rule are the high costs of monitoring and the relative difficulty involved in bringing suit against a trustee. Similar concerns attend lawsuits against broker-dealers. Currently, actions against broker-dealers for improper investment advice are brought under the doctrine of suitability[188] in one of two ways. First, an SRO can sanction a member firm for violating the SRO's rules relating to suitability.[189] But this action provides limited benefit to the investor who receives improper investment advice.[190] Second, the SEC and federal courts may find a broker-dealer personally liable under the antifraud provisions of § 10(b) by implying a private right of action for the client.[191] In order to successfully exercise this right, the client must show that (1) the securities were unsuited to the client's needs, (2) the broker-dealer knew or reasonably believed the securities were unsuited to the client's needs, (3) the broker-dealer recommended or purchased the unsuitable securities for the client anyway, (4) with scienter, the broker-dealer made material misrepresentations relating to the suitability of the securities, and (5) the client justifiably relied to his detriment on the broker-dealer's recommendation.[192] This showing is often difficult.[193] Further, the ability of retail customers to

[187] Leslie, *supra* note 171, at 558 ("Trust beneficiaries tend to be uniquely poor monitors. Often, the very reason that beneficiaries received an inheritance in trust is because the settlor did not believe they were capable of managing large sums of money on their own, either because they are minors or because they lack financial sophistication.").

[188] *See supra* notes 72-75 and accompanying text.

[189] Macey, *supra* note 72, at 816.

[190] *Id.* at 816-17.

[191] *Id.* at 817.

[192] Brown v. E.F. Hutton Grp., Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) (outlining the five elements a plaintiff must prove in order to sustain a § 10(b) unsuitability claim).

[193] *See* Macey, *supra* note 72, at 819 ("The existence of rules ensuring suitability is meant to be an ex ante protection against improper investment, not a way for investors to recoup losses from investing . . . ." (footnote omitted)). Sophisticated investors "are generally unsuccessful in asserting a suitability claim." *Id.* at 820. Suitability claims are further limited by a court's definition of whether a broker-dealer "recommended" a security.

bring suits against broker-dealers is often limited by mandatory arbitration agreements that resign customers to trial by industry insiders. Such an outcome stifles the development of a robust regulatory scheme designed to protect consumer interests – particularly where the vast majority of arbitration settlements are unpublished. Therefore, the imposition of a best interest standard should be accompanied by heightened private enforcement mechanisms.

The two most effective ways to develop a robust law defining "best interest" would be through (1) a private right of action, or (2) the elimination of mandatory arbitration agreements.[194] The policy and legal requirements for imposing a private right of action in this arena are beyond the scope of this Note. Dodd-Frank adds § 15(o) to the Exchange Act and § 205(f) to the Advisers Act, however, which "authorize the SEC to issue rules limiting or prohibiting the use of contractual clauses requiring customers and clients to submit any dispute arising under securities laws to mandatory arbitration."[195] Again, by eliminating closed arbitration proceedings and allowing customers an outlet for resolving disputes in the courts or in other arbitration forums, we would allow a robust best interest doctrine to evolve alongside market developments. Such principles-based regulation, working with a broad policy

Id. at 820-21.

[194] *See supra* note 19 and accompanying text (explaining the role mandatory arbitration agreements usually play in relations and potential disputes between clients and financial advisors or broker-dealers). Currently, FINRA operates the largest arbitration forum in the securities industry. *What Is Dispute Resolution?*, FINRA, http://.finra.org/ArbitrationMediation/AboutFINRADR/Overview/ (last visited Sep. 26, 2011). A client who opens an account with a broker-dealer must sign an arbitration agreement. Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174, 1180 n.35 (2010). Arbitral tribunals for disputes in excess of $100,000 are heard by a panel of three arbitrators – one industry insider and two arbitrators not associated with the securities industry. *Id.* at 1180 n.36. "Industry arbitrators include individuals who have been associated within the past five years with, or who are retired from, the securities or commodities industry, as well as professionals who have devoted at least twenty percent of their professional work in the past two years to clients in the securities and commodities industry." *Id.* (citing FINRA CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, Rule 12401(c) (Mar. 30, 2009) [hereinafter CUSTOMER CODE], *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4139). The primary dispute is whether industry insiders are biased towards the securities industry or whether their presence is necessary to provide valuable industry expertise. *Id.*

[195] CADWALADER, *supra* note 6, at 10. The relevant Dodd-Frank text reads as follows:

> The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.

Dodd-Frank § 921(a).

goal in mind, would best help meet President Roosevelt's initial vision of promoting investor protection through industry self-regulation.

Some critics believe that the complete abolition of mandatory arbitration agreements would be contrary to investor interests. In a recent article, Professor Jill Gross outlines several defenses of mandatory arbitration agreements in the securities arbitration context.[196] First, the SEC oversees the Financial Industry Regulatory Authority (FINRA) dispute resolution arm, ensuring that FINRA's rules are "fair and protect investors."[197] Second, FINRA Conduct Rules prescribe language for use in customer agreements to promote fairness in the agreement.[198] Third, FINRA's Code of Arbitration Procedure for Customer Disputes provides for customer protections which are not readily available in other arbitration settings.[199] Fourth, FINRA promotes access to its dispute resolution forum, "subsidiz[ing] forum fees by charging securities industry parties a greater percentage of its costs than investors."[200] Finally, FINRA's dispute resolution process promotes transparency by maintaining a user-friendly website and by ensuring that any damage awards are promptly paid to the customer.[201] Additionally, several law firms have condemned abandonment of mandatory arbitration clauses, citing concerns that this would increase costs by lengthening the arbitration process and by requiring brokers to amend all current customer agreements.[202]

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[196] Gross, *supra* note 194, at 1185 (arguing that the SEC should not eliminate mandatory arbitration agreements because "securities arbitration, which takes place primarily in FINRA's dispute resolution forum, is fair to investors, when measured against hallmarks of procedural fairness").

[197] *Id.* at 1186.

[198] *Id.* at 1187 ("FINRA Conduct Rule 3110(f) prescribes language that member firms must include in their customer agreements . . . which discloses to customers that the agreement contains an arbitration clause . . . [and] also precludes brokerage firms from including unfair provisions, or provisions that limit a customer's rights and remedies . . . ."). *But see* Leslie, *supra* note 184, at 2715 (arguing that in trust law, provisions reducing the trustee's fiduciary duties or exculpating the trustee are inconsistent with the "essence of the relationship" and are unlikely to be detected by an unrepresented settlor, especially where the settlor chose as the trustee a professional with whom she had a preexisting relationship, such as her investment adviser).

[199] *See* Gross, *supra* note 194, at 1187 (stating that the Customer Code "contains provisions that expressly contradict the types of unfair consumer arbitration provisions that the [Arbitration Fairness Act] targets, including required notice of the claim, an opportunity to be heard, a right to be represented, a hearing location convenient for the customer, and decision by neutral arbitrator(s)" (footnotes omitted)).

[200] *Id.* at 1188.

[201] *Id.* at 1188-89 ("The Customer Code mandates that '[a]ll monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction.'" (quoting CUSTOMER CODE, Rule 12904(j) (Apr. 17, 2009), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4192)).

[202] *See, e.g.*, *President Obama's Plan for Harmonization of Broker-Dealer and*

Despite these criticisms, the elimination of mandatory arbitration agreements is necessary to foster a robust doctrine underlying the best interest standard. Although FINRA publishes all award amounts, it does not require arbitrators to explain their rationale unless both parties expressly request an explanation.[203] Such a request is unlikely. In fact, Professor Gross conceded in a prior article that "[d]espite FINRA's commendable efforts to improve the process, these efforts will likely prove unsuccessful in winning customers' confidence so long as they are required to accept both an industry arbitrator and an unexplained award."[204] Absent explanation, the best interest standard will likely remain largely undeveloped – leaving clients and broker-dealers wondering when the standard engenders compliance. In fact, because broker-dealers would be repeat players in this system, information asymmetries might develop over time as broker-dealers gauge their past successes and failures at arbitration. This might lead to a net reduction in investor protection. Finally, eliminating mandatory arbitration agreements promotes investor choice. FINRA Customer Code 12200 permits customers to "demand that a FINRA member firm and/or associated person of that firm arbitrate disputes arising 'in connection with the business activities of the member or the associated person.'"[205] Thus, broker-dealer clients would still be able to elect for arbitration and its associated benefits in the absence of mandatory arbitration agreements.

V. ILLUSTRATING THE BEST INTEREST STANDARD

The prior Parts of this Note are dedicated to the ideological development and implementation of regulations imposed on broker-dealers and investment advisers. The analysis is primarily doctrinal in nature and does not include concrete guidance for implementing the proposed best interest standard in practice. Therefore, this Part will proffer two examples for illustration. The first scenario is based on a 2008 case in the Central District of California. The second scenario contemplates a securities recommendation in current market conditions – more specifically, conditions of market volatility resulting from potential U.S. national debt default. Based on this hypothetical, in which it is not clear that a broker-dealer has or has not violated the best interest standard, I

Investment Adviser Regulation and Increased Federal Reserve Authority over Clearing and Settlement Systems, WILLKIE FARR & GALLAGHER LLP (June 19, 2009), http://willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3007%5CPresident_Obama_Plan_for_Harmonization.pdf.

[203] Gross, *supra* note 194, at 1181 n.37.

[204] Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349, 400.

[205] Gross, *supra* note 194, at 1189 (quoting CUSTOMER CODE, Rule 12200 (Apr. 17, 2009), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106).

consider the relevant principles necessary to make a determination in these close cases.

A. SEC v. Ainsworth*: Violating a Client's Confidence*

On September 29, 2008, the SEC filed suit against a group of securities brokers in California.[206] In the complaint, the SEC alleged that these broker-dealers, working for World Group Financial (WGF), persuaded customers to refinance their homes through a related mortgage company (Ainsworth Mortgage).[207] The broker-dealers then recommended that the clients use the proceeds from refinancing to purchase securities[208] – specifically, variable universal life insurance (VUL) policies.[209] In one instance, Gabriel Paredes, marketing director of WGF and branch manager at Ainsworth Mortgage, recommended that a client refinance his home with a negative amortization loan[210] and use the proceeds to purchase VUL securities.[211] The client was a forty-one-year-old truck driver who barely spoke English, had four young children, and had a combined family income of $15,000 in the year he purchased the VUL.[212] The transaction required a $9000 upfront payment and $500 monthly premiums thereafter.[213] In addition, the subprime mortgage used to finance this purchase contained a substantial prepayment penalty and variable interest payments.[214] In light of all this, "[t]he SEC alleged that the

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[206] Complaint, SEC v. Ainsworth, No. EDCV 08-1350 (C.D. Cal. 2008), *available at* http://sec.gov/litigation/complaints/2008/comp20768.pdf.

[207] *Id.* at 2-4.

[208] Macey, *supra* note 72, at 790-91.

[209] The Ainsworth Complaint explains the mechanics of VUL policies:

> VUL policies are hybrid investments containing both securities and insurance features. VUL policies are life insurance policies that offer a death benefit to a designated beneficiary combined with an investment in the securities markets. Amounts paid into the VUL beyond the cost of insurance and fees are placed into sub-accounts that are invested into a range of securities funds. The sub-accounts are subject to market risk and build value based upon the performance of the customers' investment choices.

Complaint, *supra* note 206, at 8. "Because VUL policies also impose substantial surrender charges, a VUL policy surrendered in the first ten years after purchase would be unlikely . . . to break-even." *Id.* at 17. The risk of surrender increases when the holder uses monthly savings from a mortgage refinancing on a subprime loan to pay the monthly premium associated with the VUL policy. *Id.*

[210] The minimum monthly payment on a negative amortization loan is inadequate to cover the entire interest charge for that period. This difference between interest paid and interest owed is then added to the principal amount owed by the mortgage-holder. The complaint alleges that this fact was not disclosed to Mr. Paredes's client. *Id.* at 15-16.

[211] *Id.* at 37-38.

[212] *Id.* at 36-37.

[213] *Id.* at 38.

[214] *Id.* at 37-38. Although there is some scholarly research analogizing mortgages to securities, *see* Macey, *supra* note 72, at 806-13, a mortgage broker who invites a client to

subprime mortgage was an unsuitable way for [the client] to purchase securities that themselves were unsuitable for him."[215]

As derived from the trust law standard, the overarching inquiry should be whether the broker-dealer took advantage of his position and as a result violated a duty owed to the retail client. Relevant to this inquiry is whether the conflict of interest so controlled the broker-dealer's actions that the broker-dealer is actually rewarded by recommending the transaction. Compensation and promotions at WGF were based on a point system.[216] Brokers received points for sales of financial products, including mortgage originations, with mortgage originations and VUL sales generating the most points for a broker.[217] Brokers also received a percentage of the monthly VUL premiums.[218] With this incentive structure in place, it is no wonder why WGF broker-dealers would suggest debt financing (a dubious enough proposition for any securities purchase) for the purchase of an exotic security offering minimal prospects for return. Given that the mortgages were immediately sold off to be securitized, the subprime mortgage originations did not even expose the firm to default risk. From an initial inquiry, it would appear that WGF brokers were controlled by the prospects of promotion and compensation, not the clients' interests, when making recommendations. Because these broker-dealers were predisposed to recommend the subprime mortgage-financed purchase of VUL securities, the court should presume the recommendation was not in the client's best interest absent further showing.

Under the proposed standard, a broker-dealer is not prohibited from making a recommendation solely because he or she might also benefit from the transaction. In this instance, the court must consider (1) the extent to which the broker-dealer did, in fact, research the "fit" between security and client, and (2) whether the broker-dealer disclosed any conflict to the customer before recommending the security.[219]

refinance into a subprime mortgage would not necessarily trigger the analysis proposed by this Note. This case, however, involved a special relationship between WGF and Ainsworth Mortgage – namely, overlaps in client-facing personnel – that led to suggestions that clients use refinancing proceeds to purchase exotic securities. As a result, I use this case as the paradigm of a broker-dealer acting outside his client's best interest in recommending securities.

[215] Macey, *supra* note 72, at 791 (citing Complaint, *supra* note 206, at 38).

[216] Complaint, *supra* note 206, at 11.

[217] *Id.*

[218] *Id.* at 11-12.

[219] This Note is not intended to provide an exhaustive analysis of all possible ways that the proposed standard should be applied. Instead, it is intended to propose an analytical framework of the principles and policy concerns that should drive a court's determination of whether a broker-dealer's recommendation is in the best interest of a retail client. For a detailed explanation of how risk disclosure by a broker-dealer might mitigate a finding that a recommendation was not in the client's best interest, see the example in Part V.B, *infra*.

In *Ainsworth*, Mr. Paredes recommended that a man with little understanding of English, $15,000 in annual income, and four children to support, purchase an exotic security with minimal prospect of generating any return for at least ten years. When the transaction occurred, the retail customer had no investment experience. Mr. Paredes would have known all of this information before recommending the security. Even knowing that his client had little understanding of the transaction at issue, Mr. Paredes still misrepresented the terms of the loan in order to make it appear more favorable. Compounding this issue, Mr. Paredes convinced his client to purchase five VULs by removing home equity four times greater than his annual income.[220]

VULs do have some benefit for investors in certain scenarios, and this example is not intended to be a blanket critique of the instrument. Perhaps Mr. Paredes had good reason to suggest that his client purchase the VUL. At the time, however, Mr. Paredes's client did not have the necessary capital to purchase the VUL. So Mr. Paredes, incredibly, advised the debt-financed purchase of not one but five securities that his client did not understand. Viewing the circumstances in their totality, no court could find that Mr. Paredes had his client's best interest in mind when recommending this transaction. Because the risk of harm – mortgage default risk along with the fact that VULs generally do not pay out earlier than ten years – clearly outweighs any potential benefit to the retail client, a court would be warranted in holding the broker-dealer liable in this kind of scenario.

B. *Walking the Line of a Client's Best Interest*

The *SEC v. Ainsworth* example is intended to provide an illustration of a broker-dealer recommendation that is clearly not in the retail client's best interest. The majority of cases, however, will not present such clear instances of abuse. Grounding the proposed best interest standard in principles-based regulation and allowing it to develop transparently by eliminating mandatory arbitration agreements permit the standard to operate effectively even in more ambiguous circumstances.

In early August 2011, the U.S. equity markets experienced extreme volatility. Awaiting a potential Standard & Poor's downgrade of the U.S. debt rating, markets swung violently. When the downgrade in fact occurred, the Dow Jones Industrial Average rose or fell by at least 400 points in each of the first four days of the following week.[221] All told, the decline eliminated $1.94 trillion of market value from U.S. equities.[222] Stocks were cheaply priced, but

[220] Complaint, *supra* note 206, at 38.

[221] Stan Choe, *U.S. Stocks Rise After More Strong Earnings Reports*, ASSOCIATED PRESS, Aug. 17, 2011, *available at* http://news.yahoo.com/us-stocks-rise-more-strong-earnings-reports-133940589.html.

[222] Rita Nazareth, *U.S. Stocks Fall as S&P 500 Has Biggest Slump Since November '08*, BLOOMBERG, Aug. 8, 2011, *available at* http://bloomberg.com/news/2011-08-07/u-s-stock-futures-fall-amid-concern-s-p-cut-may-worsen-economic-slowdown.html.

investors drove the market on emotion. In the face of uncertainty, many professional investors and hedge fund managers pulled out of equities and ironically moved into the recently downgraded U.S. Treasuries.[223] Corporate stocks continued to decline in line with the markets, but corporate profits were up from recent filings. In such an environment, would a broker-dealer be acting in the best interest of a retail investor by recommending any security?

Consider a hypothetical investor in retirement who invests solely to maintain income levels, and not for growth prospects. He is not a sophisticated investor but has been a client of a particular broker-dealer for ten years. The broker-dealer is fully informed of the investor's goals, financial situation, and other factors relevant to an informed investment recommendation. Unlike the *Ainsworth* scenario, the question here turns on the quality of the broker-dealer's recommendation and not the circumstances surrounding that recommendation.

In this case, there is no clear answer whether the broker-dealer acts in the client's best interest by recommending securities. A court would have to look at all of the available facts in context and ask whether the recommendation was reasonable. Was there a conflict of interest? If there was a conflict, did the conflict so govern the broker-dealer that he would make the recommendation regardless of any inquiry into the client's status? If there was no immediately ascertainable conflict, did the broker-dealer inquire into the retail client's financial situation to assess whether the recommendation is a good fit, or is the broker-dealer churning the account to generate commissions? If the recommendation is in accordance with the client's financial position, does the recommendation's potential benefit outweigh the risk of harm from investing? These are all questions that will necessarily turn on the facts of a given case. Here, the court might look more favorably, for example, on a broker-dealer who took extra time to educate the client on the risks of investing in a turbulent market. Consent alone should not eliminate a broker-dealer's duty to act in the client's best interest, but the circumstances surrounding consent may be evidence of the care we want broker-dealers to exercise when making a recommendation. By answering these questions in light of the purposes of the securities laws – namely investor protection and further professionalization of the securities industry – the courts will help create a robust doctrine governing the duties owed by broker-dealers to their retail clients when providing personalized investment advice.

CONCLUSION

Following the financial crisis that crippled many financial institutions and forced many storied investment banks to shut their doors, concerns for investor protection have been raised. In response, Congress passed the Dodd-Frank Act to give appropriate oversight to the various industry regulatory bodies, hoping to minimize the risk that such a disaster will occur in the future. Specifically,

[223] *Id.*

Congress gave the SEC authority to harmonize standards of conduct between broker-dealers and investment advisers. At Congress's direction, the SEC conducted a study into broker-dealer regulation, concluding that such harmonization is appropriate. Although the traditionally divergent roles of brokers and investment advisers called for varying treatment, recent changes have necessitated harmonization. First, broker-dealers no longer offer personalized retail investment advice merely incidental to their brokerage activities. Second, changes in broker-dealer compensation make such compensation look increasingly "special" and outside the statutory exception contained in the Investment Advisers Act of 1940. Because these two distinguishing factors no longer apply, I argue that harmonization is appropriate. I then draw on shifting marketing practices and cite confusion in the investing public to support this conclusion.

The best solution would be to apply the best interest standard to broker-dealers. The standard does not automatically disregard all conflicted transactions, instead imposing a scheme akin to that in corporate law governing conflicted directors. Nor does it allow brokers to escape with minimal review of a client's financial position as in the current suitability standard. Ultimately, the best interest standard is most likely to bolster investor protection while not unduly burdening the securities industry. A standard without definition, however, would be of little value. For this reason, I then turned to trust law to define the best interest standard from a practical perspective. Here, the advance judicial approval doctrine proves especially helpful. Although technically under the auspices of a sole interest test, courts actually inquire whether the conflicted transaction is in a beneficiary's best interests before granting approval. This type of standard would provide the necessary flexibility to meet the complex demands of the securities industry.

The mere imposition of a fiduciary duty, without more, is unlikely to foster the changes that Dodd-Frank intended. This is necessarily so because even in trust law, the best interest standard can be vague. Therefore, to improve accountability, I argue for the use of a best interests standard alongside the abandonment of industry-wide mandatory arbitration agreements. I believe that this return to the core concept of accountability will foster disclosure while maintaining sufficient regulatory flexibility, ultimately providing sufficient pressure on the securities industry to ensure that future abuses are minimized and investors are adequately protected.