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Fiduciary Duties of Brokers-Advisers-Financial Planners And Money Managers

Tamar Frankel*

Abstract

Broker dealers and investment advisers form the lifeline of the financial markets. While in the past their functions were separate, and their regulation differed, throughout the years their functions were allowed to merge but their regulation remained separate. Advisers are their clients' fiduciaries. Brokers are not, with some exceptions. It is recognized that the law has to change, and the question is how. In this Article I argue for imposing the fiduciary duty of loyalty and limiting conflict of interest all financial intermediaries, including broker dealers, and suggest a process for establishing the details of the law that should apply to them. Section One of the Article outlines the principles on which fiduciary law is based. Section Two offers a short overview of the past and current practice of broker dealers. Section Three highlights the fiduciary aspects of broker dealers and the risks posed to their clients from their conflicts of interest. Section Four proposes changes in the current law and a process to achieve future changes. The law should impose principles; the financial intermediaries should seek the specificity.

On December 11, 2008, a well known broker dealer confessed to having conducted a long-term Ponzi scheme. As Ponzi schemes must, his scheme too came to an end when the source of new investors dried up and current investors demanded payment. Bernard Madoff was an ex-chair of NASDAQ¹ and owner of a broker dealership,² who registered as an adviser in 2006.³ Madoff was one of 5,308 registered broker dealers⁴ and one of 11,340 registered investment advisers.⁵ The number of broker dealers has shrunk during 2009 as the number of advisers has risen. Thus, the population of the market intermediaries that feed and nourish the securities markets is both large and flexible.

The regulation of broker-dealers (b/d) on the one hand, and advisers (and financial planners), on the other hand, differs in one fundamental respect. Advisers are deemed fiduciaries, with limited exceptions. B/ds are regulated as contract parties, who

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¹ Julie Creswell and Landon Thomas, Jr., *The Talented Mr. Madoff*, N.Y. TIMES, January 24, 2009, at BU1.

² Sec. Investor Prot. Corp. v. Bernard Madoff Inv. Sec. LLC, 401 B.R. 629, 632 (Bankr. S.D.N.Y. 2009) (“The Complaint arises in connection with the well-publicized Ponzi scheme allegedly perpetrated by Bernard L. Madoff through his investment company, BMIS. BMIS is a broker-dealer and investment advisor founded by Bernard L. Madoff”).

³ Binyamin Appelbaum and David S. Hilzenrath, *SEC Didn't Act on Madoff Tips*, WASH. POST, December 16, 2008, D01 (“The SEC said Madoff did not register with it as an investment adviser until September 2006.”).

⁴ Securities and Exchange Commission website, <http://www.sec.gov/foia/foiadocs.htm> (list of active broker-dealers).

⁵ *Id.* (list of registered investment advisers).

should treat their customers fairly. B/ds were exempt from the definition of advisers under the Advisers Act of 1940, subject to certain conditions.⁶ But throughout the years the exemption broadened and the conditions were relaxed.⁷ B/ds are regulated by a self-regulatory organization (FINRA)⁸ under the supervision of the Securities and Exchange Commission (SEC), while most advisers are subject to the Investment Advisers Act of 1940⁹ under the SEC regulation. To be sure, all actors are subject to antifraud provisions in the Securities Exchange Act of 1934¹⁰ and other laws.

It seems that b/ds do not object to be called fiduciaries, but seek relief from being regulated as such. They argue that b/ds are subject to many rules including the “suitability rule”¹¹ that require them to sell to clients only suitable investments. B/ds are also subject to additional court decisions that impose on them fiduciary duties for particularly egregious behavior.¹² Their regulation is therefore close enough to the regulation as fiduciaries. Nonetheless, b/ds’ excesses, the failure, or almost failure, of very large brokerage houses, and the changes in the political and financial environment have resulted in demands for imposing fiduciary law on b/ds.

It is not surprising that most b/ds clients do not understand the different regulation of the services they receive.¹³ Moreover, the current regulation is duplicate, ambiguous, and costly. It opens the door to regulatory arbitrage, contributes to fraud, and weakens the effect of, and respect for, the law. It is time to rationalize the regulation of brokers, dealers, advisers, financial planners, and other financial intermediaries who influence and direct investors in the purchase, sale, lending and other activities concerning securities.

In this Article I argue for imposing fiduciary duties on all financial intermediaries, including b/ds, and suggest a process for establishing the details of the law that should apply to them. Section One of the Article outlines the principles on which fiduciary law is based, and the two main differences between b/d regulation and fiduciary law: The prohibition on conflicts of interest and the difference between fiduciary law default rules and contract rules.

⁶ Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants and other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987).

⁷ Currently, b/ds that offers free financial planning and are paid commissions on transactions following the plan, are regulated differently from advisers-b/ds who offer precisely the same services and are similarly compensated.

⁸ NASDAQ, Inc., Conduct Rule 2310, *available at* <http://finra.complinet.com/finra/index.html> (last visited Jun. 3, 2008); NYSE, Inc., Rule 405, *available at* http://rules.nyse.com/NYSE/NYSE_Rules/ (last visited Jun. 3, 2008).

⁹ Investment Advisers Act of 1940, 15 U.S.C. §80b- (2008)

¹⁰ Securities Exchange Act of 1934, 15 U.S.C. § 78§ Oa (20008).

¹¹ See note 38. *infra*.

¹² See note 28 *infra*.

¹³ ANGELA HUNG ET AL., RAND CORP., TECHNICAL REPORT, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 29 (pre-publication ed., 2008).

Section Two offers a short overview of the past and current practice of b/ds and other financial intermediaries. Section Three highlights the fiduciary aspects of b/ds and advisory services, their interests that conflict with the interests of their investor clients, and the risk they pose for their clients and the financial system. The section concludes that society, the financial system and the involved parties need to trust b/ds and this trust must be strengthened by fiduciary law.

Section Four proposes changes in the current law and a process to achieve future changes. The Investment Advisers Act of 1940 should be amended to impose on all b/ds and financial intermediaries a fiduciary duty with respect to the services that they provide. B/ds who offer *no advice and no information* are not subject to fiduciary duties with respect to advice or information but they are fiduciaries with respect to the particular services that they offer, such as holding clients assets and execution of clients' transactions.

Legal changes should aim at creating "functional regulation" or rather "regulation by function" against the backdrop of fiduciary principles that apply to all b/d and advisers. Thus, regardless of the status of an actor (institution, employee) and regardless of what the actors are called (planners, advisers, brokers, experts, analysts) one would focus on *what they do*, and impose the same rules on them. To be sure, some distinctions can then be made among the actors. But the starting point is the functions they perform.

Advisers and b/ds should report to the SEC as well as to their clients the precise nature of the services that they offer and their fees, similar to form used currently by advisers. "Functional regulation" should develop by adjusting the regulation to the b/ds or advisers and any other service providers that involve securities market intermediation, and designing the rules for the particular functions, provided always that the principles of fiduciary law remain applicable.

Section One. An Overview of Fiduciaries, Fiduciary Law and Its Design and Structure

1. Who Is a Fiduciary?

All fiduciary relationships share the same features, even though their functions may differ, and even though they occupy various power positions towards their clients. At the center of fiduciary relationships is *entrustment of property or power* that clients hand over to their fiduciaries in order to enable fiduciaries to perform a service to them. These clients are the *entrustors*.¹⁴ The law reflects and deflects the risks that fiduciaries pose for entrustors.

* **Fiduciaries provide socially important expert services to "entrustors,"** such as professional services (law, medicine, financial services). The distinction between these services and other socially important service is the required high level of expertise and

¹⁴ See TAMAR FRANKEL, FIDUCIARY LAW ch. 1 (2008).

investment of time required to acquire the expertise. In contrast, for example, in the United States, fixing a car or hairdressing, or secretarial services are just as important, but do not require as high a level of expertise and investment. Therefore, it is in the interest of society to induce people to rely on experts rather than duplicate their efforts or avoid their services. While some situations of “information asymmetry” can be resolved by requiring disclosure of the information, in the case of most fiduciary services, the cost of understanding the information is too high and the education of the entrustors is wasteful to society.

* **In order to perform the services *and before they can perform the services*, the fiduciaries must be entrusted by entrustors with property or power.** For example, a b/d must be entrusted with the clients’ assets and power to bind clients to legal obligations before the b/d can trade for the clients. A publisher of an investment advisory letter (excluding newspapers) is entrusted with power of influencing subscribers to trade or hold certain securities. When people pay for advisory letters there is a high probability that they will follow the advice. Such an adviser’s power can affect the financial system and market prices if a large number of subscribers follow his or her advice and sell or buy simultaneously a large number of shares. Thus, entrustment differs from an exchange in two ways. First, its purpose is to enable the fiduciary to perform his services rather than to enjoy the entrusted property or power. And second, in most cases entrustment is a prior condition to the performance of the fiduciary’s service.

* **Controlling or monitoring fiduciaries in the performance of their services is either too costly or would undermine the very usefulness of the services.** For example, most entrustors do not have as much knowledge about the securities markets as b/ds have, and cannot control the b/ds in the use of their entrusted assets. More importantly, in various degrees fiduciary services must be left to the discretion of the fiduciaries. That is not only because of their expertise but also because the services may require discretion depending on varying conditions. If clients controlled their trades and their assets, b/ds may not be able to perform timely trades, and the cost of consulting the clients at every step of the transaction would be so great as to undermine the usefulness of the arrangement. Similarly, if clients controlled their b/ds, and had their expertise, clients would perform the services themselves (but would have no time and less expertise in another area).

* **Market controls of abuse of trust are not sufficiently effective to monitor fiduciaries.** After all, entrustors empower fiduciaries or hand over their assets to them, willingly, sometimes even eagerly. Information concerning fiduciaries’ true performance or violations of their duties is not publicly known. Therefore, markets react only after violations have occurred and publicized. For example, the public cannot easily identify analysts, who are compensated to provide glowing recommendations for worthless securities. It is only after public investors suffer losses that the market adjusted the securities’ prices. But by that time the investors have already sustained losses, and lost trust in analysts generally and perhaps began to doubt the market prices as well.

* **Entrustors' risks.** Entrustors bear the risks that their fiduciaries might misappropriate or misuse the entrusted property or power. In addition, entrustors bear the risks that their fiduciaries will perform their services negligently; fail to perform the services in accordance with the entrustors' directions; or fail to account for the entrusted property or the activities under entrusted power; or delegate the performance of the service to others.¹⁵ Thus, entrustors benefit from expert service but incur *risks from the very services*. Investors benefit from trading in the securities markets, and bear the risks and benefits of such trading. But needing brokers in order to trade, investors take another kind of risk as well. This risk stems from the very expert service (and the required entrustment) that they employ. Not only do investors pay for the expert services. They risk losing the entrusted money or securities (and receiving substandard services). Fiduciary law aims at reducing the risks from the very employment of expert services.

Entrustors are not the only ones who could risk losses in fiduciary relationships. Fiduciaries, who engage in offering fiduciary services for gain, would wish to convince potential clients of the fiduciaries' trustworthiness and expertise. If the costs of such convincing are higher than their benefits from the relationship, the fiduciaries are not likely to develop their business.

2. The Reach of Fiduciary Law

Law--and fiduciary law in particular--is designed to reduce entrustors' risks from entrustment, including reliance on b/ds' advice, financial planning and other services. The law interferes to entice investors to engage in fiduciary relationships, and help maintain the entrustors' trust in financial intermediaries and the viability of the financial system. But since these services involve conflicts of interests, they are inherently risky for investors, law limits the extent of these conflicts in various ways. The degree of law's intrusion into the relationship between b/ds and their clients differs depending on the (1) degree of the clients' risks from the relationship, the (2) extent of the cost of the clients' supervision, and their ability to exercise some of the b/ds discretion. The higher the risks and the costs—the higher the legal intrusion will be.

In addition, the law reduces competition among fiduciaries on actions that could undermine investors' trust, by creating a "monopoly on trustworthiness." Competition among fiduciaries can be beneficial to investors. However, if some fiduciaries gain short-term, before their abuse of trust is discovered, honest fiduciaries are at a competitive disadvantage, and are tainted by the dishonest colleagues. Law protects trustworthy fiduciaries from this type of competition.

Fiduciary law, however, has limits. The focus of fiduciary law is on entrustment, regardless of the type of services and relationship in which entrustment is made.¹⁶ This is an important point because fiduciary duties can arise in many contexts. The relationships may be embedded in contract, or in voting relationships, such as the

¹⁵ See TAMAR FRANKEL, *FIDUCIARY LAW* 52 (2008).

¹⁶ Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1229 (1995).

relationship among directors and shareholders, or in relationships between trustees and beneficiaries, established by third parties (trustors).

Therefore, while b/ds may not use their client's money or securities, except as directed and for the clients' benefit, b/ds may use as they please the commission they gain in exchange for their services. A gray area remains when the client is incapable of independently and freely agreeing to the exchange. Then the payment of the commission is an exchange in form but not in substance. Yet, contract law rather than fiduciary law, is likely to apply to the capacity of the client.

3. The Design of Fiduciary Law

A number of features are typical of fiduciary law.

a. The strictness of fiduciary law conflict of interest rules depends mainly on the level of the entrustors' risks from the fiduciaries abuse of trust

Agents' liabilities are less strict than those of trustees for the main reasons that the entrusted powers to agents are not as broad as those to trustees, and because agency involves a greater degree of control by the principal than the beneficiaries' control over the trustee.¹⁷ A secretary is not a fiduciary because the employer's level of control over the performance of the secretary's functions can be quite high without destroying the utility of the secretary's service. However, such a secretary may be a fiduciary with respect to confidential information that he acquires in the course of his services. That is because he could not perform the services without being entrusted with the information. It never belonged to the secretary and he cannot use it for his benefit.¹⁸

B/ds, however, are more similar to trustees than to agents. Investors cannot verify what is truly being done with their money. Generally, the "evidence" of this fact is provided by the b/d, unless the investors' money is in a bank account and they receive confirmation not from the b/ds but from the bank.

Non-discretionary b/ds services. Under the current law b/ds that do not have discretion in choosing transactions (non-discretionary accounts) are usually protected from liability for their voluntary or requested advice with respect to such transactions. Under fiduciary law, however, a different result might occur. To be sure, the order of the investors will generally relieve the b/ds from liability *with respect to that order*, provided, however that the b/ds did not express any opinion, or give any information, regarding the clients' choice and the clients are sophisticated and significantly wealthy.¹⁹

¹⁷ "Agency is the fiduciary relation which results from the joint manifestation of consent by one person that another shall act on his behalf and subject to his control, and of consent by that other so to act." *Nelson v. Serwold*, 687 F.2d 278, 282 (9th Cir. 1982) (citing *Grace Line, Inc. v. Todd Shipyards Corp.*, 500 F.2d 361 (9th Cir. 1974); RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958)); *see also* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("The agent acts for or on behalf of the principal . . . "); 687 F.2d at 282 (citing *NLRB v. United Brotherhood of Carpenters*, 531 F.2d 424 (9th Cir. 1976)).

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¹⁹ *KWIATKOWSKI v. BEAR, STEARNS & CO.*, 306 F.3d 1293; 2002 U.S. App. LEXIS 19274; *Comm. Fut. L. Rep. (CCH) P29,167* (2d cir. 2002).

Even under current law, however, b/ds remain liable in certain circumstances, for example, when the clients' trading demonstrates that the clients are "committing economic suicide,"²⁰ or when the clients direct the b/ds to trade in a highly irrational manner. Such actions may indicate that the clients did not have the capacity to give the directives, and their b/ds may have a duty to warn the clients to cease trading in this manner, or even to refuse to execute the orders.²¹ Arbitrators have also recognized fiduciary duties of a b/d (and an investment company) that were experts in high risk trading,²² if their clients have been self-destructing, or far less understanding than the b/ds.²³ The b/ds' expertise and the clients' lack of judgment may impose on the b/ds fiduciary duties even when b/ds say nothing. Therefore, even under today's law relief for b/ds offering non-discretionary execution of clients' orders might not be automatic. Therefore, the imposition of fiduciary law on b/ds in the case of non-discretionary transactions will therefore not be drastic. But a rule that b/ds are not fiduciaries in these circumstances may relieve b/ds from liability to which they are liable today.

b. Fiduciary law aims at reducing the fiduciaries' temptations to misappropriate entrustment

Most fiduciary rules are preventive rules that prohibit fiduciaries from acting as fiduciaries in conflict of interests with the interests of the entrustors. If the main interest of b/ds is to sell securities (and sometimes particular securities for which the b/ds receive

²⁰ See, e.g., Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 412-14 (2005); Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1041-42 (2002); Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U.L. REV. 189, 212-13 (1998). See generally Barbara Black, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483 (2003).

²¹ *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd without opinion*, 647 F. 2d 165 (6th Cir. 1981); *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 750 (Cal. Ct. App. 1989). *Contra Tatum v. Legg Mason Wood Walker, Inc.*, 83 F.3d 121, 123 (5th Cir. 1996) (Mississippi law imposes no duty upon broker-dealers of non-discretionary accounts to determine the prudence of requested trades); *Wasnick v. Refco, Inc.*, 911 F.2d 345, 350 (9th Cir. 1990) (Washington law imposes no duty upon brokers to prevent from trading clients who are emotionally or financially unsuitable). Cf. DAN B. DOBBS, *THE LAW OF TORTS* § 332, at 899 (2000) ("The traditional common law rule . . . was that those who provided alcohol to minors and intoxicated persons had no responsibility . . . for injuries inflicted by those drinkers."). Where such sales violated criminal statutes, courts refused to find "negligence per se" or "prima facie negligence" where the statutes were violated. *Id.* However, dram shop acts specifically provided for liability for alcohol providers, sometimes strict liability. *Id.* In about 1960, courts began reversing the common law rule, finding a duty of reasonable care for alcohol providers, regarding sale to a minor or intoxicated person. *Id.* at 900. Some courts have found liability to the *drinker* who injures himself; others have not. Some have held that the dram shop act provides an exclusive remedy and that it does not extend to the drinker. Some courts have found a duty of care to a minor drinker and not to an intoxicated adult. *Id.* at 901.

²² *THE GMS GROUP, LLC -v- NATHAN BENDERSON*, 191 F. Supp. 2d 318; 2001 U.S. Dist. LEXIS 24031 (UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK 2001); Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 *Ariz. St. L.J.* 535 (2005)

²³ There are arguments for keeping this protection for Brokers, even if they would be imposed with fiduciary duties. Arguably, with respect to advice these brokers are not fiduciaries.

higher commissions) fiduciary law would prohibit them from giving entrustors the impression of meting out expert advice, unless the conflicts of interest transactions are fully disclosed to the entrustors and receive their consent, as discussed below. And provided the client-entrustors are capable of giving free independent consent. Advisers, for example, must disclose to clients, if their fees are higher than the usual market fees.²⁴ These prohibitive and required rules apply even to actions do not necessarily injure the entrustors. These rules are designed not only to protect the entrustors but also to reduce the fiduciaries' temptation to act in conflict of interest.²⁵ Thus, a broker who receives payment from a third party to sell particular products must disclose the payment when he offers these products to a potential customer in a sales-advice. It is not enough for the broker to describe the product ("educate the client") or to determine that his offer is "suitable to the client, or inform the charges to client. He must disclose the payment of third parties to sell the particular securities. This disclosure will inform the client about the broker's conflicts of interests. Unfortunately, competition is unlikely to incentivize brokers to disclose their conflicts or the third party payments. In particular cases it might give them incentives to tell clients that they are not paid for recommending particular securities, while in fact they are.

c. Most fiduciary rules are default rules²⁶

While fiduciary rules prohibit conflicts of interest, not all conflict of interest activities harm the entrustors. Therefore, fiduciaries may engage in such transaction subject to certain conditions. They must disclose the details of the proposed transactions to the clients, and if the clients agree to the action, the fiduciaries may proceed and engage in the transactions. The default rules transform the clients-entrustors' legal right to rely and trust their fiduciaries, into a contract relationship,²⁷ in which the clients must fend for themselves and protect their own interests against those of the fiduciaries, knowing that their fiduciaries' interests conflict with their own.

Default rules are ineffective when the entrustors are incapable of independent and informed consent to conflict-of-interest transactions. B/ds may not buy securities from

²⁴ See 17 C.F.R. § 275.204-3 (2008) (brochure rule under the Investment Advisers Act); Charles Meyer, SEC No-Action Letter (Sept. 4, 1975) ("[T]he Division has taken the position in cases where fees are more than 3% of net asset value that there would be a violation of the anti-fraud provisions of Section 206 unless it were disclosed that such fees are substantially above the industry average and that investors may obtain similar services at lower fees.").

²⁵ See 17 C.F.R. § 275.206(4)-2 (2008) (requiring client funds to be maintained with qualified custodian). Note that trustees must earmark trust securities upon their deposit (to avoid the temptation to wait and find out whether the investments are successful first, and then determine whether to allocate the investments to the trust accounts or to the trustees' accounts). RESTATEMENT (THIRD) OF TRUSTS § 84 (2007) (duty to segregate and identify trust property); *id.* cmt. d (duty to earmark); *see also* RESTATEMENT (SECOND) OF TRUSTS § 179 (1959) (duty to keep trust property separate); *id.* cmt. d (duty to earmark).

²⁶ Frankel, *supra* note 12, at 1211-12.

²⁷ See Frankel, *supra* note 12, at 1237, 1240-41. When fiduciary rules are properly understood as default rules, contract laws regarding capacity to consent will undoubtedly apply. If fiduciary duties are important enough to enforce regardless of whether they have been bargained for, and are sometimes non-waivable even by a fully competent entrustor, then they surely cannot be waived by an entrustor with incomplete control over her actions.

clients that lack capacity to enter into a contract, or are under the influence of the b/ds, or are obviously incapable of making an investment decision.²⁸ In addition, fiduciaries are required to provide the entrustors with information that would enable the entrustors to protect themselves with respect to contracts with their fiduciaries.²⁹ Therefore, the clients' consent to future unspecified transactions is not binding because they are uninformed. Nor are the clients' consents to highly unfavorable conflict of interest transactions always binding. The terms of the transactions may indicate possible inherent fraud or misleading disclosure.³⁰ Clients' consents may be less binding when the fiduciaries are experts, and the clients are unlikely to form informed and rational decisions that require expertise.³¹

A broker may not execute an order that an unqualified person has made which is clearly against the client's interests.³² "The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal. With respect to stockbrokers it is recognized, [t]he duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity."³³ The California Court of Appeals held that "the stockbroker has a *fiduciary duty* (1) to ascertain that the investor understands the investment risks in the light of his

²⁸ Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) (stating that one of broker's duties associated with nondiscretionary account is "duty to refrain from self-dealing"), *affirmed without opinion*, 647 F.2d 165 (6th Cir. 1981); AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 170.1, at 317-18 (4th ed. 1987) (the sale of a trust will be invalid if any of the following is true: 1) the beneficiary is not sui juris, 2) the trustee failed to make a full disclosure, 3) the trustee induced the sale by taking advantage of his relation to the beneficiaries, or 4) the sale is not fair and reasonable)..

²⁹ See UNIF. TRUST CODE § 813(a), 7C U.L.A. 407, 609 (amended 2005) ("A trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests."); SCOTT & FRATCHER, *supra* note 19, §170.1, at 318-19 ("The trustee owes a duty of disclosure even though the relations between him and the beneficiary are such that the beneficiary is not likely to repose confidence in him.").

³⁰ See 26 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 69:4 (4th ed. 2000) ("Fraud may induce a person to assent to do something which he or she would not otherwise have done, or it may induce a person to believe that the act which he or she does is something other than it actually is."); *e.g.* *In re* Boone, 83 F. 944, 957 (N.D. Cal. 1897) (it is "grossly improbable" that a client would fully understand a consent releasing his attorney from all of his fiduciary duties). In the corporate context, a court might ask: Why would shareholders consent to directors' use of corporate information to enrich themselves without compensating the shareholders?

³¹ See *Meheula v. Hausten*, 29 Haw. 304, 312-14 (1926) (holding a deed invalid where an entrustor lacked business sophistication and knowledge of the English language, and her fiduciary failed to candidly inform her of the scope of the deed). *Compare, e.g.*, *McCracken v. Edward D. Jones & Co.*, 445 N.W.2d 375 (Iowa Ct. App. 1989) (broker owed a fiduciary duty to the customer, significantly relying on the customer's inexperience) *with* *Williams v. Edward D. Jones & Co.*, 556 So. 2d 914 (La. Ct. App. 1990) (finding no breach of duty when the client was sophisticated). See generally ROY LEWICKI ET AL., NEGOTIATION 179 (3d ed. 1999) ("Within the context of negotiation, information is perhaps the most common source of power."); CHARLES B. CRAVER, EFFECTIVE LEGAL NEGOTIATION AND SETTLEMENT 47 (1993) (it is a "simple fact that knowledge constitutes power in the bargaining context").

³² *Betz v. Trainer Worthman & Co.*, 236 Fed. App. 253; 2007 U.S. App. Lexis 11433 U.S. 9th Cir.(2007); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 709, 69 Cal. Rptr. 222 (Ct. App. 1968) (internal quotations and citations omitted); see *Duffy v. Cavalier*, 215 Cal. App. 3d 1517, 1533, 264 Cal. Rptr. 740 (Ct. App. 1989) (holding that "the relationship between a stockbroker and his or her customer is fiduciary in nature").

or her *actual* financial situation; (2) to inform the customer that *no* speculative investments are suitable if the customer persists in wanting to engage in such speculative transactions without the stockbroker's being persuaded that the customer is able to bear the financial risks involved; and (3) to refrain completely from *soliciting* the customer's purchase of any speculative securities which the stockbroker considers to be beyond the customer's risk threshold."³⁴

In sum, to determine the rules applicable to fiduciaries one should focus on the entrustment that the fiduciaries received, the use that they were expected to make of the entrusted power or property, the possible abuse of the entrustment, and the potential magnitude of the injury to the entrustors.

4. Conflicts of Interest and Multiple Roles

Combined different services may make good business sense for b/ds and other financial intermediaries as well as their clients. Often it makes good economic sense for brokers to play multiple roles.³⁵ For example, the brokers' main function is to minimize search costs by connecting buyers and sellers of securities. But when no buyers or sellers are immediately available for clients, Brokers can serve their clients by becoming dealers--buying or selling the clients' securities for the b/ds' own account.³⁶ Similarly, it makes sense for b/ds, who are usually more expert in financial matters than their clients are, to advise clients on investment matters, as they seek to persuade investors to buy securities which the b/ds offer. In a fierce competitive atmosphere it is smart for b/ds to offer free advice and free financial planning to attract clients.

But multiple roles can raise systemic, legal and practical issues. B/ds' different services and names can confuse and mislead clients. For example, "financial planners" are b/ds that offer free financial planning advice. If the clients accept the free plans, the planners turn into b/ds and profit by executing the planned transactions that they advised the clients to accept. Clients that are drawn to, and relied on, the free plan might tend to forget that the planners' profits are linked to the plans' choice of investments. Clients may overlook the fact that free planning poses conflicting interest for the planner, who benefits from the choice of recommended investments.

B/ds' advice can be tainted with conflicts of interest. What seems like the best investment for the client may hide higher commissions or added compensation for the b/ds, leading to hidden higher costs for the client. Had the client known about the b/d's incentives to recommend certain investments, the client may have viewed the advice as sales-talk, checked the investment more, and trusted the b/d less.

³⁴ *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 750 (Ct. App. 1989).

³⁵ When financial sector actors have the ability and freedom to adapt their offered services to changing market conditions, both the actors and the market are better off, because the same expertise can allow these actors to perform different functions, the gains of specialization can be realized, and the inefficiency of inactivity can be avoided.

³⁶ See TAMAR FRANKEL, *FIDUCIARY LAW* 102-03 (2008).

Clients may accept the fact that the b/ds' commissions equal the clients' costs, directly, or indirectly. Clients might understand that they will pay for the free lunches they receive. However, the price of these free lunches may be hard to judge when the price is embedded in other services that carry different prices, different names, and different conditions.

B/ds that offer information about mutual funds may be paid for listing particular mutual funds at the top of the lists. Among eight thousand mutual funds, the top twenty or thirty are the ones that the investors will examine. If clients do not know of the payments b/ds receive for putting particular mutual funds at the top of the list, the clients may choose these top listed funds on the assumption that they are the best in the b/ds' opinion. In fact, even the funds below the top may be better performers and cost the investors less (including the amount paid to the b/ds). Even though these b/ds may execute non-discretionary transactions, their information is sales information; not information for the investors' benefits. These b/ds are fiduciaries with respect to the information, and should disclose their conflict of interest in listing the funds.

Similarly, salespersons that represented to potential buyers that they were neutral financial advisers when they were not, could be liable for fraud. The salespersons called themselves Certified Elder Advisers or Certified Senior Advisers when, in fact, they were not objective advisers but salespersons of annuities.³⁷ A broker was held liable for fraud when he misrepresented to clients that he was an investment adviser, told clients that he worked for an hourly wage because he did not want commissions earned off of their investments to affect his advice but in fact was employed by a brokerage company and was paid commissions on the sale of stocks.³⁸ Thus, misrepresenting dual functions and conflicts of interest can amount to actionable fraud.

Section Two. Past Practices and Fee Structures of B/Ds and Advisers on Which the Current Law Is Based

In the 1930s, b/ds and advisory services were distinct. When the Securities Exchange Act of 1934 (1934 Act) and the Investment Advisers Act of 1940 (1940 Act) were passed, the financial markets were barely active. Congress invited the establishment of self-regulatory bodies of brokers, under the supervision of the Securities and Exchange Commission (SEC).³⁹ This invitation materialized as one organization: the National Association of the Securities dealers. Similarly, rules of stock exchanges were recognized as binding, subject to the SEC.⁴⁰

³⁷ *Gilmour v. Boehmeller*, No. 05-3588, 2007 U.S. Dist. LEXIS 64967 (E.D. Pa. Aug. 29, 2007)

³⁸ *Laird v. Integrated Res.*, 897 F.2d 826 (5th Cir. 1990). See also *SEC v. Omnigene Devs.*, 105 F. Supp. 2d 1316 (S.D. Fla. 2000) (broker was liable because he did not fully disclose his conflict of interest, and the fact that he acted as a broker and not just an investment adviser). See also *SEC v. Omnigene Devs.*, 105 F. Supp. 2d 1316 (S.D. Fla. 2000) (Radio show host told listeners he was a consultant whereas in fact he was a paid spokesman and "pumped and dumped" the securities he was recommending).

³⁹ 15 U.S.C. § 78 § Oa (2006)

⁴⁰ 15 U.S.C. § S (2006). See also William Birdthistle @@@

The number of advisers was quite small,⁴¹ and the Investment Advisers of 1940 Act was viewed essentially as a census mechanism.⁴² Throughout the years, however, advisers' obligations as fiduciaries were heightened and strengthened.⁴³ Initially, the distinction between broker-dealers and advisers was fairly clear. Advisers were always viewed and regulated as fiduciaries. B/ds were viewed as securities salespersons and the SEC imposed on them a duty of fairness in their contracts with their customers--the "shingle theory."⁴⁴ Therefore, b/ds were excluded from the definition of an investment adviser if they gave advice in connection with their brokerage business, and were not separately paid for the advice.⁴⁵ Presumably, under these conditions the "advice" was understood by all to be sales talk.

The Investment Advisers Act of 1940 excluded from its application brokers that gave free advice as part of their sales talk. The Securities and Exchange Commission has held that once b/ds hung their shingles and invite clients, B/ds should behave follow a *high ethical contract standard* and deal fairly with their clients. Since 1934, the b/ds' trade organization rules as well as the stock exchange rules were given legal recognition, subject to the Securities and Exchange Commission supervision. Based on this "fair contract image" these two self-regulating organizations passed specific rules including a rule that required b/ds who offer advice to determine the suitability of their advice to the advisee-client. Courts tightened brokers' regulations in egregious cases by imposing on them fiduciary duties. In contrast, advisers and financial planners were held to be advisers, subject to the Investment Advisers Act and *fiduciary law*.

During the past sixty years fundamental changes have occurred in the securities markets. These changes have occurred in part by law and in part without law's blessing.⁴⁶

Presently, b/ds execute clients' securities transactions, as they did in the past. They sell clients securities and insurance products. They engage as brokers or as parties in various derivatives transactions. Their brokerage services include bailment,⁴⁷ and agency, for securities transactions,⁴⁸ analysis of securities, as full service brokers used to

⁴¹ 1 TAMAR FRANKEL AND ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS (MUTUAL FUNDS AND ADVISERS)1-5 (2d ed. 2001)

⁴² *Id.* at 4-3.

⁴³ *Id.* ch 4

⁴⁴ 8 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3814 (3d ed. rev. 2004) (quoting Charles Hughes & Co., Inc., v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944)).

⁴⁵ Investment Advisers Act of 1940 § 201(11)(C). §80b-2(a)(11) (C) (2006).

⁴⁶ See e.g., Blaine Aikin, Can Brokers be Fiduciaries? New DOL guidelines say they can advise retirement plans — a problematic development

⁴⁷ See Energy Transport, Ltd. v. M.V. San Sebastian, No. 03 Civ. 4193 (PKL), 2003 WL 21415267, at *2 (S.D.N.Y. June 19, 2003) ("A bailee is a 'person who receives personal property from another as a bailment.' . . . [A] bailment [is] '[a] delivery of personal property by one person (the bailor) to another (the bailee) who holds the property for a certain purpose under an express or implied-in-fact contract.'")

⁴⁸ Agency is "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents to so act." RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

do for wealthy customers, and arranging financing for their clients' transactions.⁴⁹ They help clients borrow and lend securities,⁵⁰ help provide investors with funding to buy securities.⁵¹ In addition, b/ds offer free services,⁵² such as advice on investments, and financial planning.⁵³ They offer clients free advice on which stock to trade, and free financial planning for which they are compensated by brokerage business.⁵⁴

This trend was enhanced by the merger of large financial institutions that offer clients a broad array of experts' services.⁵⁵ These functions are not limited to specialized institutions. Banks no longer serve only banking functions. They offer advisory, management, brokerage, investment banking, and financial services. Investment bankers, such as Goldman Sacks, are no longer merely investment bank and b/ds. They are subject to bank regulation, which changes their image. On the one hand they provide brokerage customers with a sense of comfort. On the other hand, bank regulation puts emphasis on the banks' safety and soundness and less on investor interests. The safer and the sounder the banks' financial position is, the higher their fees they collect and the sounder their financial position will be. Therefore, the discussion of b/ds in this Article includes not only brokers that offer free advice and financial planning but also banks and securities dealers—all market intermediaries.

On the dealer side, b/ds make markets in certain securities, sometimes make “dark markets” among anonymous large traders, deal in derivatives, securitize loans and auction long-term notes to create short-term securities. This list is not exhaustive and many future possibilities are likely to emerge. In sum, b/ds have expanded their market services in traditional and new ways and there is no reason to assume that the pressure to continue this trend will ease up.

B/ds' employees exercise new and different functions as well. Who would have imagined that bank tellers will occupy the role of brokers? Yet, at least some bank tellers are being paid for developing relationships with depositors, some of whom may be elderly people, regularly cashing their monthly social security checks. The tellers have

⁴⁹ ANGELA HUNG ET AL., RAND CORP., TECHNICAL REPORT, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 29 (pre-publication ed., 2008).

⁵⁰ See, e.g., Gene D'Avolio, *The Market for Borrowing Stock*, 66 J. FIN. ECON. 271 (2002); Darrell Duffie, Nicolae Garleanu & Lasse Heje Pedersen, *Securities Lending, Shorting, and Pricing*, 66 J. FIN. ECON. 307 (2002).

⁵¹ See 15 U.S.C. § 78g (2006).

⁵² See HUNG ET AL., RAND CORP., *supra* note 3, at 54, 122, 159. See generally Certain Broker-Dealers Deemed Not to be Investment Advisers, Investment Company Act Release No. 50,980, Investment Advisers Act Release No.2340 (Jan. 6, 2005), 70 Fed. Reg. 2716, 2721 n.51 (Jan. 14, 2005) (adopted 2005) (codified at 17 C.F.R. § 275.202(a)(11)-1 (2008) (vacated 2007)).

⁵³ *Id.* at 33.

⁵⁴ Patrick McGeehan, *Merrill Lynch Catches the Spirit; A Traditional Brokerage Firm Spouts the On-Line Gospel*, N.Y. TIMES, Oct. 8, 1999, at C1, LEXIS, News Library, Nyt File (“Merrill executives are resolute about the important role the firm can play in helping customers . . . manage their daily finances.”).

⁵⁵ Kenneth Kehrer, *Broker Integration: What Some Banks Are Doing*, A.B.A. BANKING J., May 1, 2001, at 28, 28; Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 573 (1984).

the advantage of knowing the amount of cash in the depositors' bank accounts and continuous contacts with the depositors. The tellers might receive a fixed amount for every depositor they send to the b/d in the bank's other part of the building. Tellers may also receive benefits if they sell CDs or other investments, which the bank b/d desires to sell.

What is the status of the banks' tellers? Arguably, their sales services are permissible, so long as the depositors, who are not interested in these services, can refuse to discuss the proposed transactions with the tellers, without any argument. However, the tellers' function is ostensibly to receive and pay bank deposits. It is not to advertise b/ds' services or other financial assets. The tellers signal the depositors that the bank is not merely a bank but also a b/d and perhaps engaged in other financial services. In this case bank employees' roles have changed to include not only serving depositors but also selling brokerage services as well as banks' securities.

The variety of b/ds' fee structures has also multiplied and expanded throughout the years. Some b/ds charge the traditional commission, based on the amount of the transaction or the number of the traded securities, and some charge a percentage of the amount maintained in the client's account, and some also participate in the advisory fees of mutual fund managers, whose fund shares the b/ds sell. These may not be advisory fees. They derive from the mutual funds' advisers' fees that collect up to a certain percentage of the funds' assets for the purpose of selling fund shares. Therefore, the discussion of b/ds in this Article includes b/ds that charge all or some of these types of fees.

Thus, today, b/ds offer fiduciary services of various kinds together with non-fiduciary services. As experts in the financial markets they can perform these functions better than most of their clients can. Some of the functions are exclusively within the b/ds' domain, and no client can perform them (e.g., trading on a securities exchange). B/ds may offer some services free or at a discount, such as back-office services to money managers and ERISA Plan fiduciaries. B/ds may offer free or discounted retail sales of securities in order to attract mutual fund advisers and similar clients for other wholesale services (e.g., trading in large number of portfolio securities of mutual funds).

Today's market reality differs both in b/d services and public's trust in b/ds and other advisers. B/ds functions and fees cannot be distinguished from those of advisers and financial planners. Some advisers act as b/s and some do not, while most financial planners act as b/ds and very few do not. Today, the names of brokers, dealers, advisers, financial planners mean little when b/ds perform all or some of these functions and hold themselves out as trusted persons.

Today clients cannot distinguish the risks to which they are exposed from b/ds.⁵⁶ A view of the market financial intermediaries reveals at least one reason for the

⁵⁶ HUNG ET AL., RAND CORP., *supra* note 3, at 35. See also Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627 (1996).

flight of investors from the markets. B/ds are beset by conflicts of interest, yet seek to present themselves as trusted advisers and financial planners, whose interests identify with their clients' interest. When clients discover the fact, they trust less than if they were told of the conflicts freely and honestly.

Has the recent financial crisis changed this trend? In some respect it seems to have sharpened it. Some investors' escape the stock market and some are taking speculative risks. After all, the volatile market of today reflects the investors' and their advisers' actions. It also reflects the uncertainty of the traders. The other trend that may be caused by the current crisis is the exodus of brokers. Their numbers have dwindled. That suggests that investors are not flocking to the markets and that brokers cannot sell securities as they did in years past. Another change in the environment is the broker-dealer organizations' consenting, or even seeking to be called fiduciaries. This is remindful of the mutual fund advisers of the 1940s who consented to a regulatory regime though argued about the details. It seems that the broker dealers as a group -- not individually, is confessing that it went too far. The issue will be the extent of regulation that the broker dealers will accept without a fight. But these suggestions are speculative, as all predictions and attempts at causations are.

Section Three. Principles for Designing Fiduciary law

1. Principles for Legal Design

Theoretically, fiduciary law should reflect the reasonable level of investors' risk from abuse of trust. Arguably, b/ds who do not exercise discretion with respect to the clients' transactions (e.g., they execute "unsolicited clients' orders") should carry a lower level of risk. In practice, however, most investors trust their brokers, advisers, planners at about the same level. In other words, investors trust equally the persons who perform any of these functions. Or they do not trust any of these persons.

This result is not surprising. It makes good sense for someone who entrusts his money and assets to another to trust the other also in other aspects of the other's services, especially if the other is the expert. Further, it might be that these services have been offered by the same persons or the same organizations. Advice for pay, free advice, and "sales talk" advice are hard to distinguish. In addition, many brokers, advisers, and planners are under the same holding-company's roof. Besides, clients do not make legal distinctions nor weigh the risks they take from each type of service. They trust or do not trust.

2. Advisers Are Fiduciaries

Clients must rely on advisers. B/ds' and advisers' powers can be abused.⁵⁷ Regardless of how their fees are structured (fixed amounts, hourly rates, or percentage of

⁵⁷ See TAMAR FRANKEL, INVESTMENT MANAGEMENT REGULATION 68-69 (3d ed. 2005) (citing CLIFFORD E. KIRSCH, INVESTMENT ADVISER REGULATION §§ 4-1 – 4-3 (1998)) (For example, when advisers refer

the amount under consideration),⁵⁸ advisers are fiduciaries.⁵⁹ Advisory services do not necessarily include entrustment of property, but they include entrustment of power to act on behalf of clients or the power, like any other expert power, to affect the investment decisions of the clients. In that case, the clients entrust to the advisers the power to decide how to invest the clients' assets, although they may reserve the power to overrule the advice. Thus, even when they make the ultimate decision, clients must rely on advisers.

Advice, whether paid directly or by brokerage, is a fiduciary service. Regardless of how their fees are structured (fixed amounts, hourly rates, or percentage of the amount under consideration),⁶⁰ advisers are fiduciaries.⁶¹ The California Court held that "[t]he relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal. With respect to stockbrokers it is recognized, [t]he duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity."⁶²

3. B/ds are Fiduciaries

As listed above, b/ds offer fiduciary services of various kinds. They are always fiduciaries because they always hold the clients' assets. Sometimes their services involve hidden conflict of interest--as when they aim at selling clients certain securities; and sometimes their conflicts are clear, as when the b/ds act as the other party to the transaction. But in all cases they hold other people money and assets.

B/ds' Service as investment bankers. Investment bankers are advisers to institutions on various large transactions, such as mergers and acquisitions, private and public distribution of securities, and the creation of various markets in securities and other financial assets. In some cases the transactions are conducted among highly sophisticated institutions. In other cases the transactions spill over to individual investors or institutional investors. But in all these cases the investment bankers are the experts; and even sophisticated investors, whether institutions or individuals, depend on them. In

clients to b/ds, who pay the advisers for referrals, advice is tainted with conflicts. Referrals of this sort may not be benefit clients).

⁵⁸ KIRSCH, *supra* note 28, at §§ 20.9[1], 21.4[1][D]; HUNG ET AL., RAND CORP., *supra* note 3, at 74 (over 97% of investment firms receive compensation based on a percentage of assets under management, and the remainder receive fixed or hourly compensation)..

⁵⁹ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963); Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (2000) (investment adviser of registered investment company has fiduciary duty with respect to compensation or payments by investment company to adviser or affiliate).

⁶⁰ KIRSCH, *supra* note 28, at §§ 20.9[1], 21.4[1][D]; HUNG ET AL., RAND CORP., *supra* note 3, at 74 (over 97% of investment firms receive compensation based on a percentage of assets under management, and the remainder receive fixed or hourly compensation)..

⁶¹ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963); Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (2000) (investment adviser of registered investment company has fiduciary duty with respect to compensation or payments by investment company to adviser or affiliate).

Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 709, 69 Cal. Rptr. 222 (Ct. App. 1968) (internal quotations and citations omitted); see Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1533, 264 Cal. Rptr. 740 (Ct. App. 1989) (holding that "the relationship between a stockbroker and his or her customer is fiduciary in nature").

most cases, the clients entrust their assets to the investment bankers, and in some cases they follow their advice.

In principle, there is no difference between investment bankers' services and those of b/ds, except that investment bankers usually serve more sophisticated investors. The result is not that investment bankers are not fiduciaries. The result is that as fiduciaries they can resort to the consent of their sophisticated entrustors more than b/ds might. The importance of the investment bankers to the financial system cannot be exaggerated. In this respect they are more important to the financial system than the retail b/ds. Therefore, I would include investment bankers in the group of fiduciaries.

4. There is a Crying Need for Clients' Trust

Advisers, b/ds, investment bankers, and whatever other financial intermediaries we call them, are the life-line of the financial system. The financial system cannot exist without the entrustors' trust in them. Their business cannot exist without their clients' entrustors' trust. Clients must have a reasonable belief that their b/ds are telling the truth and will fulfill their promises.⁶³ Yet, clients risk the possibility that the b/ds they trust will not meet the expectations based on such a belief.

The clients' alternative to trust is to verify the b/ds' statements, and require guarantees for the b/d's promises.⁶⁴ This alternative increases the costs of interaction for both parties. Besides, verification and control of the b/ds' activities may undermine the very utility of their services. Mistrusting and suspicious parties are not likely to hand their money over to b/ds, or will demand verification and guarantees that will raise the costs of market transactions.⁶⁵

Gaining the clients' trust is not easy when the clients' risk of trusting and consequent losses might be very high.⁶⁶ Clients who recognize the risk before or after they have incurred losses might mistrust b/ds, or, might mistrust all b/ds by association. When a critical number of clients mistrust all b/ds, they might withdraw from the financial system altogether. These are the dangers which the law must address.

Section Four: Future Regulation

The time has come to amend the current law and establish a process to achieve future legal changes. The Investment Advisers Act of 1940 should be amended to impose on all b/ds (including investment bankers) a fiduciary duty with respect to all the services that they provide. B/ds who offer *no advice and no information* are not subject to fiduciary duties with respect to advice or information. However, they are fiduciaries with

⁶³ See TAMAR FRANKEL, TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49, 53 (2006).

⁶⁴ See *id.* at 50.

⁶⁵ Alan Greenspan, Address at the Harvard University Commencement (June 10, 1999), www.federalreserve.gov/boarddocs/speeches/1999/199906102.htm.

⁶⁶ See Peter Elkind, *Spitzer's Crusade*, FORTUNE, Nov. 15, 2004, at 129.

respect to the services that they do offer. It is time to establish federal fiduciary law principles to apply to b/ds, advisers, financial planners and any other intermediaries involved in the market system, no matter whether they carry familiar or unfamiliar names.⁶⁷

Legal changes should aim towards creating “functional regulation” against the backdrop of fiduciary principles that apply to all b/d and advisers. Advisers and b/ds should report the kind of services they offer to the Securities and Exchange Commission as well as to all clients. They should announce the precise nature of their services and their fees. “Functional regulation” should develop by adjusting the regulation to the b/ds or advisers or any other financial service providers that involve securities market intermediation, and seek different rules for the particular functions, provided always that the principles of fiduciary law remain applicable.

Harmonizing? In light of the confusing state of the law and the different treatment of b/ds, advisers, and financial planners, proposals have used the word “harmonizing” as the objective for rationalizing the current law. However, the word harmonizing has been used to apply to fiduciaries’ *duty of care rather than to the prohibition of fiduciaries’ conflict of interest*.⁶⁸ I believe that the emphasis on the duty of care diverts attention from the real problem of posed by b/ds and their activities that might lead to fraud. The two duties are fundamentally different. The duty of loyalty aims at preventing the abuse of entrusted property or power. The duty of care is aimed to ensuring expert services and avoiding negligence in the performance of the services.

Whether or not the entrustor suffered damages in the case of violating the duty of loyalty, the fiduciary may have to pay punitive damages. In the case of a duty of care he might not, even though he did not pay close attention to the deal. Mixing duty of loyalty and duty of care the duties of b/ds will significantly water down the duty of care. The focus would be on whether the b/ds attended to performing their tasks well. No moral turpitude will be considered. And the main problem, of conflict of interest, will be meshed together with evaluation of the results of the service. It is easier to show conflict of interest than to show the degree to which a task was imperfectly performed. Hence, the focus of the future regulation should be on conflicts of interest--stealing, misappropriation, fraud, and not on how well the b/ds have performed their services. We should then call the proposal by its real name: Reduction of regulation so that b/ds could become advisers but still engage in conflicts of interest transactions and behavior.

More plausibly, “harmonizing” could mean putting together as one the different registration and reporting forms that are now plaguing the financial intermediaries that are subject to more than one system of regulation. This solution is based on the assumption that the current law remains the same and that the cost of duplicate regulation will be reduced.

⁶⁷ See e.g., Barbara Black, *Transforming Rhetoric into Reality?: A federal Remedy for Negligent Brokerage Advice*, 8 *TRANSACTIONS* 101 (2006).

⁶⁸ Thomas P. Lemke & Steven W. Stone, *The Madoff “Opportunity” Harmonizing of Care for Financial Professionals Who Give Investment Advice*, *Wall Street Lawyer*, 3 (2009).

3. Amending the Law

Congress should amend the law to impose on b/ds all the duties imposed by the Advisers Act. B/ds should avoid conflicts of interest, as any fiduciary should. In addition b/ds' obligations under other laws should remain. These changes in the law should

* Erase the Shingle theory for b/ds, whether they give advice, sales talk, or keep silent, and impose on all b/ds fiduciary duties prohibiting conflicts of interest.

* Define advice broadly to include any information in connection with which b/ds are paid directly or indirectly, through other services, by clients or by third parties. Sales talk will be included in advice.

* Correct redundancies in reporting and forms of registration to avoid unnecessary costs.

4. Reducing Confusion

There is a 2005 proposal for the SEC to prohibit broker dealers from “holding themselves out as ‘financial consultants’ or ‘financial advisers.’”⁶⁹ I am concerned that the time for requiring financial intermediaries to specialize is over, since specialization has been dismantled for many years. Putting the genie into the bottle may be quite hard, especially since the various functions are now performed by the same institutions.

Therefore, I suggest a related similar approach to reduce the current confusion. This approach would require b/ds and advisers to choose and announce their functions. Once they do that, they will automatically be subject to the current regulation of such designation. B/ds should hang a notice stating: “I am a broker and not your adviser” and state the applicable law or laws. Or, in addition, b/ds should add to the notice: “I am also an adviser, subject to the Advisers Act of 1940 and fiduciary common law.” Or a broker may add in his notice: “I am a financial planner subject to the regulation of broker dealers and the Adviser Act of 1940.” This notice will establish the legal basis for the b/d's and advisers' liability. Each intermediary in the securities market should have both a name and a clear designation of the current law that applies to the name.

The new law should authorize the Securities and Exchange Commission to grant conditional exemptions for specific services. The model for such exemptions, both specific, by class, and by rule, has been available for seventy years of experience in the mutual fund area, under the Investment Company Act of 1940.⁷⁰ These exemptions can be supported by no-action letters of the Securities and Exchange Commission staff. The one suggested difference from the current exemption practice is to review exemptions

⁶⁹ Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31 (2005).

⁷⁰ See e.g., § 6(c), Investment Company Act of 1940, 15 I.S.C. § 80a-6(c) (2006).

and amend them for future applicants whenever the need arises.⁷¹ The most important aspect of the new law would be to allow and encourage the b/d profession to describe their functions in detail and thereby facilitate “functional regulation” in light of fiduciary law principles.

At least two difficulties arise in the case of re-regulation. One is habit. It costs to change and adjust to a new regulatory regime. This cost is imposed both on the regulated and on the regulators. The second difficulty is that the general and uniform trust of the clients-entrustors does not mean that the functions of b/d-advisers-planners are identical. Therefore, it is unclear where the problems lie with respect to each function that the broker-advisers-planners perform. It is one thing to establish that all of these service providers are, and should be, trusted and that all are fiduciaries. It is another matter to regulate their activities to ensure justified public trust in light of any differences that the services represent. Advisers are not subject to such a rule but rather to a disclosure regime, and a fiduciary law regime. Advisers to mutual funds are subject to a far more detailed structural and substantive regime, including a requirement to establish an internal ethics code.⁷² Besides, market actors are innovators. A prototype of relationships today may not fit a new one which arises tomorrow. For example, in their advisory function brokers are subject to a suitability rule.⁷³

The better approach to both difficulties may be a piecemeal approach. It differs from the experience of the 1930s. In the 1930s Congress passed a number of statutes that covered the entire financial system. However, during that period there was little financial system to speak of. Today, there is an extraordinarily large and active financial system that is changing constantly. A statute that revamps the entire system may be obsolete by the time it is passed or may not pass at all. Therefore, rather than aim at establishing a general statute to cover brokers-advisers-planners, Congress should authorize the regulators, including the Securities and Exchange Commission to unify the disparate existing laws. The Commission should change the law in a way that applies to today’s financial environment and appropriate for the market actors.

If a party is not satisfied with the regulators’ activities, it may apply to Congress, but the rules complained about remain intact until Congress acts. In light of some courts’

⁷¹ The exemption under Rule 3a-7 of the Investment Company Act of 1940 for Special Purpose Vehicles (SPVs) did not prohibit the creation of sliced and diced SPVs. Had these SPVs been subject to section 12(d)(1) of the Investment Company Act, the design would have been far harder to achieve.

⁷² 17 C.F.R. § 270.17j-1 (2008) (requiring adviser to mutual fund to adopt written code of ethics to prevent access persons from engaging in fraudulent conduct in connection with securities owned by fund) (pursuant to the Investment Company Act, 15 U.S.C. § 80a-1 to -65 (2006)). In addition, a registered adviser is required to adopt a code of ethics regarding the securities holdings and transactions of its access persons. 17 C.F.R. § 275.204A-1 (2008). A broker not required to register under the Advisers Act may avoid the costs of certain regulatory burdens including the code of ethics requirement regarding securities holdings and transactions. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 51,523, Investment Advisers Act Release No. 2376 (Apr. 12, 2005), 70 Fed. Reg. 20,424, 20,442-43 (Apr. 19, 2005) (codified at 17 C.F.R. § 275.202(a)(11)-1 (2008) (vacated 2007)).

⁷³ NASDAQ, Inc., Conduct Rule 2310, available at <http://finra.complinet.com/finra/index.html> (last visited Jun. 3, 2008); NYSE, Inc., Rule 405, available at http://rules.nyse.com/NYSE/NYSE_Rules/ (last visited Jun. 3, 2008).

hostility to the regulators' authority (presumably in deep respect for market solutions) the authority to the regulators should be very broad. At the same time, the process of the systemic changes should bind the regulators to require more time, attention, and specificity (to avoid broad brush changes). Then, after five years from the beginning of the process, the Commission's rules of unification must be approved by Congress and any changes to the rules could be made then.

The regulators should address particular issues reflected in the violations that have occurred by brokers-advisers-planners under existing law. A particular violation by brokers may then be governed prospectively by new rules or decisions that spell out in more detail the principles and standards on which the cases are grounded. In addition, the Commission may reduce the cost on those who offer the three services, for example, by unifying their registration statements, and eliminating other duplicative rules that are now plaguing the servicers that offer all services. These suggestions offer examples of what the Commission could do to alleviate the regulatory burdens on the three servicers, while raising the protections for entrustors. Most importantly, the suggestions emphasize the process of moving slowly and building a new system. This process may overcome the problem of changing habits and enlighten understanding of broker-adviser-planners and their clients. Changes little by little may be most effective. In light of the recent severe threats to the financial system, and the markets' instability, brokers might have to bear the burden of fiduciary duties or return to the way they used to sell securities in the past.⁷⁴

6. Does this Proposed Structure Endanger Market Freedom?

Arguably, this proposed legal process conflicts with the basic approach of the common law and endangers market freedom. At the extreme, one can view common law as prohibiting specific actions and any action that is not prohibited is permitted. In contrast, the civil law systems, for example are structured somewhat in the reverse.⁷⁵ The laws grant rights, permitting people to enjoy these rights,⁷⁶ and punishing those who threaten the enjoyment of the rights.⁷⁷ Implicitly, apart from the stated rights, people have none, unless they seek these rights from the government and draw their rights from the law.⁷⁸ Vague prohibitions under the common law leave the freedom to act uncertain while vague legal rights under civil law leave the awarded rights uncertain and other rights unavailable.

⁷⁴ See 8 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3814 (3d ed. rev. 2004) (stating that under the "shingle theory," "even a dealer at arm's length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public"). This is a contract theory, not a fiduciary theory. See *id.* ("[C]harging a price that does not bear [a reasonable relation to the market price] is a breach of the dealing of implied representation and works as a fraud on the customer.").

⁷⁵ JEREMY BENTHAM, *THE THEORY OF LEGISLATION*, 96 (Routledge & Kegan Paul Ltd. ed., Morrison and Gibb Ltd. 1950) (1931).

⁷⁶ *Id.*, at 100.

⁷⁷ *Id.* at 110; SHELDON AMOS, *THE HISTORY AND PRINCIPLES OF THE CIVIL LAW OF ROME*, 97 (Kegan Paul, Trench & Co ed., Wm. W. Gaunt & Sons, Inc. 1989) (1883)..

⁷⁸ JEREMY BENTHAM, *THE THEORY OF LEGISLATION*, 96 (Routledge & Kegan Paul Ltd. ed., Morrison and Gibb Ltd. 105-06 1950) (1931).SHELDON AMOS, *THE HISTORY AND PRINCIPLES OF THE CIVIL LAW OF ROME*, 97 (Kegan Paul, Trench & Co ed., Wm. W. Gaunt & Sons, Inc. 1989) (1883).

The proposal outlined above differs from the regulatory designs of the models described above and is similar to another form of lawmaking, found in the regulation of ethical behavior by mutual fund advisers. In this case the Securities and Exchange Commission provided a list of guidelines, and requires the advisers to fill-in the specific provisions within their organization. This format is appropriate in recognition of the differences between the different subject organizations and their sizes. Yet, it starts with the general principles and requires the subjects to these principles to articulate the specific prohibitions.

Similarly, the proposal in this Article imposes general prohibitions of fiduciary law on all actors, and requires the regulated actors to seek specificity or relief from some prohibition by proposing rules and justifying the clarifications or exceptions. The burden of balancing specificity and general principles is shared by the regulators and the financial intermediaries on an on-going basis, and the detailed legislation can be imposed piecemeal after public discussion. Yet, the details of the more specific regulation and the imposition of all prohibitions and duties on different actions as well as all permissions and releases from duties, should comply with the general principles established by the law.

Further, the duties relating to specific activities will apply to functions rather than to institutions in which the actions and functions are performed. They should not be subject to institutional manipulations.

This Article's proposal offers a regulatory system anchored in principles yet allows for flexibility. And while principles can and should be long-term, the details can and should be changed more often to fit shifting environments and innovations. Yet, as the recent past has shown, long-term principles must change as well, especially when they led to imbalance of power.

For years the government followed the principle that markets can do the job of the government, and do it better. Currently, this belief is seriously doubted.⁷⁹ Legislative focus should avoid the other extreme. It instead should be designed to lead to a balance, even though imprecise, between private market power and government power. A regulatory system should not be frozen in fixed principles and specific rules but should lead to flexibility. It should allow movement to maintain a balance between principles—fundamental norms and objectives without which no financial system can survive--and specific rule that can change more easily to reflect environmental movement, yet led by, and implement, the principles.

In fact, fiduciary law is the constitutional law of private power. Like constitutional law, fiduciary law covers many areas of life and involves similar issues. Like constitutional law, fiduciary law is anchored in one important principle of freedom. We recognize the need for entrusting property and power to others. But we must make

⁷⁹ See RECHARD A. POSNER, *THE FAILURE OF CAPITALISM* (2008).

sure that entrusted power will not be abused. It must be used for the purpose for which it was granted, and must be accounted for by a balancing power—the law.⁸⁰

⁸⁰ TAMAR FRANKEL, *FIDUCIARY LAW, EPILOGUE*, A draft of a book to be published by Oxford University Press (2009).