
CURRENT ISSUES IN FIDUCIARY LAW

SEC v. CAPITAL GAINS RESEARCH BUREAU AND THE INVESTMENT ADVISERS ACT OF 1940

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INTRODUCTION

In the early 1960s, the United States Securities and Exchange Commission litigated an injunctive action against an unremarkable advisory firm located in Westchester County, New York, named Capital Gains Research Bureau, Inc. (Capital Gains), and its sole principal, Harry P. Schwarzmann.¹ Notwithstanding losses at the trial and appellate levels, the SEC persisted, taking the case all the way to the Supreme Court.² The agency's doggedness paid off. The SEC scored a major victory in a strongly-worded decision authored by Justice Arthur Goldberg, who sprinkled his prose with colorful phrases describing the high standards of business ethics that advisers owe their clients and urging those tempted by avarice to exercise restraint.³

The case, *SEC v. Capital Gains Research Bureau, Inc.*,⁴ was the Supreme Court's first interpretation of the Investment Advisers Act of 1940.⁵ Nearly fifty years later, the case remains the cornerstone of the regulatory scheme for advisers. It has been discussed and cited by the Supreme Court⁶ and countless lower federal courts.⁷ The SEC and SEC staff regularly rely on the case in enforcement actions, rulemaking proceedings, and no-action letters issued under the Act.⁸

¹ See *SEC v. Capital Gains Research Bureau, Inc.*, 191 F. Supp. 897, 898 (S.D.N.Y. 1961).

² See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 184-85 (1963).

³ See *id.* at 201.

⁴ *Id.*

⁵ 15 U.S.C. §§ 80b-1 to b-21 (2006); *Capital Gains*, 375 U.S. at 186-88.

⁶ See, e.g., *Lowe v. SEC*, 472 U.S. 181, 190 (1985); *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17-18, 22-23 n.13 (1979); *Burks v. Lasker*, 441 U.S. 471, 481-82 n.10 (1979); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977).

⁷ See, e.g., *SEC v. Wash. Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007); *SEC v. Wall St. Transcript Corp.*, 422 F.2d 1371, 1376 (2d Cir. 1970); *Shivangi v. Dean Witter Reynolds, Inc.*, 107 F.R.D. 313, 318-19 (S.D. Miss. 1985); see also Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L. J. 627, 634 (2008) (drawing on *Capital Gains* to explain that the SEC instituted actions against advisers over decades for conduct inconsistent with fiduciary duty).

⁸ See, e.g., *Political Contributions By Certain Investment Advisers*, 75 Fed. Reg. 41,018, 41,022 (July 10, 2010) (to be codified at 17 C.F.R. 275.206(4)-5, 275.204-2, 275.206(4)-3); *Valentine Cap. Asset Mgt., Inc.*, Exchange Act Release No. 63,006, Advisers Act Release No. 3090, 2010 WL 3791924 (Sept. 29, 2010) (settled enforcement action); Mayer Brown

The opinion is often cited for the proposition that the Advisers Act imposed a federal fiduciary duty on advisers.⁹ Building on this duty, the SEC and the courts have constructed a towering regulatory edifice for advisers. Courts address how this obligation bears on advisers in a variety of contexts, such as the duty of disclosure,¹⁰ whether scienter is required for a violation,¹¹ and the need to maintain high ethical standards when performing the advisory function.¹² Courts go so far as to analyze the contours of the federal fiduciary duty, disagreeing over what conduct it reaches.¹³

There is, however, a deep-rooted paradox in the regulatory structure. The federal fiduciary duty so tightly woven into the fabric of advisory law is a product of neither the Advisers Act nor the *Capital Gains* case. Rather, the doctrine developed through statements in subsequent Supreme Court decisions, which misread or simply disregarded Justice Goldberg's elegant disquisition in *Capital Gains*. In the opinion, the Supreme Court recognized that advisers typically were fiduciaries, which weighed on the Court's decision in several respects.¹⁴ The *Capital Gains* Court, however, did not hold that the Advisers Act created a fiduciary duty. The claim that Congress established a fiduciary duty appeared only in later courts' discussion of the *Capital Gains* decision. The distinction is important. Recognition of a pre-existing fiduciary duty is not tantamount to a congressional creation of a duty. But stare decisis has a strong pull on the law. A statement articulated by courts and repeated by regulators bears a stamp of accuracy and legitimacy regardless of its pedigree. This paper explains the genesis of the federal fiduciary duty for advisers and discusses implications of imposing fiduciary principles.

Development of a federal fiduciary duty has had important consequences for the regulation of advisers and, after passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),¹⁵ for the regulation of broker-dealers as well. One consequence is expanded liability for advisers. Under the Investment Advisers Act, advisers may not defraud a client or prospective client.¹⁶ Although negligence, as opposed to intent, is sufficient for a violation of the antifraud provision of the Act,¹⁷ the prohibited conduct

LLP, SEC No-Action Letter, 2008 WL 2908929 (July 28, 2008).

⁹ See *infra* notes 256-269.

¹⁰ See *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009).

¹¹ See *Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979).

¹² See *SEC v. Moran*, 922 F. Supp. 867, 896 (S.D.N.Y. 1996).

¹³ See *infra* Part III.A-B.

¹⁴ See *Capital Gains*, 375 U.S. at 194.

¹⁵ See Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824-30 (2010).

¹⁶ See Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (2006).

¹⁷ See *Capital Gains*, 375 U.S. at 195 ("Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure and actual injury to the client." (quoting Investment Advisers Act § 206(2))). Other courts have clarified that while negligence is sufficient for a violation of

still must be fraudulent. A fiduciary standard is more demanding and, therefore, liability for advisers is broader under a fiduciary regime.¹⁸ A second consequence is ambiguity; although a fiduciary standard expands liability, the standard is notoriously imprecise.¹⁹ Courts deciding cases under the Advisers Act have agreed on neither the source nor the content of fiduciary law. Some have looked to state common law doctrines, such as agency, while others have suggested that reference to state law is not required.²⁰ Courts that have tried to articulate precisely the conduct covered by a fiduciary obligation in other contexts, such as “honest services” cases or mutual fund fee litigation, have been frustrated in their attempts.²¹ This article does not argue that expanded liability and vagueness are necessarily positive or negative developments. Rather, the primary claim is that the assertion of a federal fiduciary duty raised issues and concerns, which those who expounded the duty in the 1970s may not have envisaged.

Recognition that the federal fiduciary duty arises neither from the Act nor from the *Capital Gains* decision raises additional questions regarding what, if anything, can be done to change or clarify the law. Must change come from Congress, or can the Supreme Court overrule its own precedent? One view is that only Congress can change the law because judicial interpretations effectively become part of a statute. Under this view, stare decisis in statutory interpretation cases is emboldened by legislative acquiescence. Another view is that stare decisis in these cases should be given no more weight than in other cases. Still others take a more nuanced approach and advocate strong stare decisis in statutory cases unless there is a reason to depart from that rule, such as where developments in the law have led to confusion or ambiguity. If that is the case for the Advisers Act, the Supreme Court, as well as Congress, could reverse prior rulings regarding a federal fiduciary standard.

Yet another possibility is that Congress has effectively endorsed a federal fiduciary duty for advisers in the Dodd-Frank Act. Dodd-Frank gave the SEC authority to impose duties on certain broker-dealer firms that are at least as stringent as those applicable to advisers under the antifraud provisions of the Advisers Act.²² By calling for brokers’ duties to be enhanced to the level currently applicable to advisers, perhaps Congress has affirmed that all

section 206(2) of the Advisers Act, section 206(1) requires a finding of intent. See *infra* note 138 and accompanying text for cases that substantiate the different mens rea requirements for the two sections of the Act.

¹⁸ See *infra* Part III.A.2.

¹⁹ See *infra* note 370.

²⁰ See *infra* notes 315-321 and accompanying text.

²¹ See *infra* notes 353-368 and 381-386 and accompanying text.

²² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(b), 124 Stat. 1376, 1824 (2010) (codified as amended at 15 U.S.C.A. § 78o (West 2011)) (directing the SEC to investigate and promulgate rules “regarding obligations of brokers, dealers, and investment advisers”).

advisers owe a mandatory federal fiduciary duty to clients. As I explain below, this argument is open to attack.²³

Any discussion of fiduciary duty raises definitional questions at the outset.²⁴ According to Tamar Frankel, a fiduciary is one who offers socially desirable services and is entrusted with property or power to carry out those services, although the entrustment poses risk to the principal.²⁵ According to another formulation, a fiduciary typically has discretion over the property or affairs of another and is capable of affecting the legal position of the other.²⁶ Others find fiduciary duties when parties are in a relationship of trust and confidence or a similar relationship.²⁷ Still others believe that most fiduciary duties are default contractual terms and can be negotiated at will.²⁸ There is little disagreement that a fiduciary, however defined, owes a strict duty of loyalty to the principal, including full disclosure of conflicts of interest and a duty to act in the principal's best interest.²⁹ What generally sets the fiduciary apart from other agents or service providers is a core duty, when acting on the principal's behalf, to adopt the objectives or ends of the principal as the fiduciary's own.³⁰

Part I of this Article reviews the *Capital Gains* case in the United States District Court, the Second Circuit Court of Appeals, and the United States Supreme Court. Part II explains when and how *Capital Gains* was interpreted to state that Congress established a federal fiduciary duty in the Advisers Act. This reading first occurred in *Santa Fe Industries, Inc. v. Green*, a Supreme Court case that interpreted section 10(b) of the Securities Exchange Act of 1934.³¹ It was repeated in *Transamerica Mortgage Advisers, Inc. v. Lewis*,³² the second significant Supreme Court case to interpret the Advisers Act. The last part of the paper discusses implications of this development, including the

²³ See *infra* Part III.B.2.c and III.C.

²⁴ See *infra* note 370 (emphasizing the unpredictability and changing nature of a fiduciary standard).

²⁵ TAMAR FRANKEL, *FIDUCIARY LAW* 6-42 (2011).

²⁶ See, e.g., Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 4 (1975) (explaining that fiduciary duty is necessary to control discretion and avoid conflicts of interest).

²⁷ See *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

²⁸ See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) for a standard formulation of the contractual theory of fiduciary duty.

²⁹ See RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006) (stating that the term fiduciary implies that an agent must act loyally); RESTATEMENT (SECOND) OF TRUSTS, § 170 cmt. a (1959) (stating that fiduciary must act solely in the interest of the beneficiary).

³⁰ See Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 129-37 (2008); Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 542 (1997) (describing the fiduciary duty as one of unselfishness).

³¹ See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977).

³² See *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979).

confusion provoked as Congress and the SEC grapple with whether to impose on broker-dealers a fiduciary duty commensurate with the duty imposed on advisers.

I. THE *CAPITAL GAINS* LITIGATION

In 1953, Harry Schwarzmann relinquished his position as a senior corporate officer and entered the world of investment management. He formed an advisory firm, Capital Gains, in Larchmont, New York, and was the President and sole shareholder.³³ Initially, Schwarzmann registered with the SEC as an investment adviser in his personal capacity, but, in 1959, he switched the registration to his firm.³⁴

The Bureau, as Schwarzmann liked to call the company, published two investment bulletins.³⁵ The first, not relevant to the SEC's lawsuit, was called "Facts on the Funds."³⁶ *Facts on the Funds* provided information regarding changes in mutual fund portfolios.³⁷ It was issued periodically to approximately 20,000 subscribers for twenty-four dollars per year.³⁸ The second bulletin was a monthly newsletter entitled "A Capital Gains Report," sometimes simply called "Special Bulletin."³⁹ This publication analyzed statistical data and other information on specific securities and typically concluded with a recommendation to purchase.⁴⁰ *A Capital Gains Report* had approximately 5,000 subscribers who paid eighteen dollars per year for the service.⁴¹

A. *Scalping*

Over a period of eight months during 1960, Capital Gains purchased certain securities for the firm's proprietary account and advised clients to buy those same securities without disclosing the firm's position.⁴² Then, soon after the price of these securities spiked, the firm sold its shares at a profit.⁴³ The dissent in a lower court opinion in the case referred to this practice as "scalping."⁴⁴ The origin of the term in this context is unclear; earlier

³³ Complaint at 1, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (No. 60 Civ. 4526).

³⁴ See Affidavit of Harry P. Schwarzmann at 26, *Capital Gains*, 375 U.S. 180 (No. 60 Civ. 4526).

³⁵ See *id.*

³⁶ See *SEC v. Capital Gains Research Bureau, Inc.*, 300 F.2d 745, 747 (2d Cir. 1961).

³⁷ See Affidavit of Schwarzmann, *supra* note 34, at 26.

³⁸ See *id.* at 26-27.

³⁹ See *id.* at 26; *Capital Gains*, 300 F.2d at 747.

⁴⁰ Affidavit of Schwarzmann, *supra* note 34, at 26.

⁴¹ *Id.* at 26-27.

⁴² See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 183 (1963).

⁴³ See *id.*

⁴⁴ *SEC v. Capital Gains Research Bureau, Inc.* 306 F.2d 606, 613 (2d Cir. 1962) (en

references to scalping suggest that it stood for generating gains from short-term fractional fluctuations in interest rates or the price of securities or commodities – more like modern references to ticket scalping.⁴⁵

The recommendations and trading took place in securities that were household names at the time: Continental Insurance Company; United Fruit Company; Creole Petroleum; Hart, Schaffner & Marx; Union Pacific; Frank G. Shattuck Company; and Chock Full O’Nuts.⁴⁶ The transactions generally proceeded in the following pattern: Capital Gains would purchase anywhere from several hundred to several thousand shares of the named companies; several days later, the firm would circulate a report recommending the company to subscribers for “gradual but substantial appreciation;”⁴⁷ trading generally increased after the report was issued; and, several days later, the firm sold its shares.⁴⁸

Schwarzmann contested the SEC’s version of the facts. He pointed out that in some cases, Capital Gains would purchase additional shares days after a report was issued, which the company sold at a loss, making total gains to the firm less than the amount calculated by the SEC.⁴⁹ There were some variations in the practice. In the case of Frank G. Shattuck Company, Capital Gains purchased call options shortly before making its recommendation. In another case, Chock Full O’Nuts, the firm sold short before advising clients that the stock was overvalued.⁵⁰ But the idea was always the same – buy (or sell short) for the firm’s own account, make a recommendation to subscribers, and sell (or cover) after the change in price.⁵¹ Profits on the transactions in the case totaled \$19,674 – about \$145,000 in today’s dollars.⁵²

banc) (Clark, J., dissenting) (“Thus we have evidence of a practice known on Wall Street as ‘scalping,’ by which an investment adviser makes a short-term profit on the direct or secondary market reaction to its advice.”).

⁴⁵ See, e.g., *White v. Barber*, 123 U.S. 392, 393-94 (1887) (“[T]he plaintiff testified . . . that he did a good deal of ‘scalping,’ deals made and closed the same day, on the turn of the market; that he did not let his deals run over night” (internal quotation marks omitted)); *Operation of the National and Federal Reserve Banking Systems: Hearings Before a Subcomm. of the Comm. on Banking and Currency Pursuant to S. Res. 71*, 72d Cong. 229 (1931) (statement of B. W. Trafford, Vice Chairman, First National Bank of Boston) (“[I]t is a temptation, certainly, to lend on collateral with the stock exchange houses and borrow at the Federal reserve bank at a lower rate. It is a scalping operation.”).

⁴⁶ See *SEC v. Capital Gains Research Bureau, Inc.*, 300 F.2d 745, 747 n.3 (2d Cir. 1961).

⁴⁷ *Capital Gains*, 306 F.2d at 612 (Clark, J., dissenting).

⁴⁸ *Id.* at 612-13.

⁴⁹ See Affidavit of Schwarzmann, *supra* note 34, at 27-28.

⁵⁰ See *id.* at 28-29.

⁵¹ See *Capital Gains*, 300 F.2d at 747.

⁵² See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 202 (1963); *Inflation Calculator*, DOLLARTIMES, www.dollartimes.com/calculators/inflation.htm (last visited Feb. 13, 2011) (showing that \$19,674 in 1960 is approximately \$145,000 in 2010).

B. *The SEC Action*

On November 17, 1960, the SEC filed a complaint in the United States District Court for the Southern District of New York against Schwarzmann and the firm.⁵³ The SEC alleged that Capital Gains violated sections 206(1) and 206(2) of the Investment Advisers Act of 1940 by making securities recommendations to clients before trading in those same securities absent disclosure.⁵⁴ Under section 206(1), it is unlawful for an investment adviser “to employ any device, scheme, or artifice to defraud any client or prospective client”⁵⁵ Under section 206(2), it is unlawful for an adviser “to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client”⁵⁶

The SEC sought a temporary restraining order (TRO), preliminary injunction, and permanent injunction to enjoin the defendants from further violation of the Advisers Act.⁵⁷ On that same day, United States District Judge Alexander Bicks issued both an order to show cause as to why a preliminary injunction should not be granted, and a TRO based on the SEC’s complaint and an affidavit from John R. Steinert, an SEC investigator located in the New York Regional Office.⁵⁸

C. *District Court Litigation*

The preliminary injunction was litigated before Judge Edward J. (“Ned”) Dimock.⁵⁹ The SEC offered no additional proof in the hearing; Schwarzmann, however, submitted a detailed affidavit.⁶⁰ In an opinion not two pages long, Judge Dimock denied the motion for a preliminary injunction and vacated the TRO.⁶¹ In his brief analysis, Judge Dimock prefigured the key arguments that would engage the lawyers, the Second Circuit, and the Supreme Court in the appeals to follow.

⁵³ Complaint, *supra* note 33, at 1.

⁵⁴ *See id.* at 1-2.

⁵⁵ Investment Advisers Act § 206(1), 15 U.S.C. § 80b-6(1) (2006).

⁵⁶ §80b-6(2).

⁵⁷ Complaint, *supra* note 33, at 3.

⁵⁸ Order to Show Cause and Temporary Restraining Order at 5-7, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (No. 60 Civ. 4526).

⁵⁹ *See* SEC v. Capital Gains Research Bureau, Inc., 191 F. Supp. 897, 898 (S.D.N.Y. 1961).

⁶⁰ There is confusion regarding the timing of Schwarzmann’s statement. The Second Circuit indicated that Schwarzmann submitted an affidavit opposing the application for a preliminary injunction. SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 607 (2d Cir. 1961). Schwarzmann’s statement is dated March 2, 1961. Affidavit of Schwarzmann, *supra* note 34. The District Court decision, however, bears a date of March 1. *Capital Gains*, 191 F. Supp. at 897.

⁶¹ *Capital Gains*, 191 F. Supp. at 899.

Judge Dimock concluded that Congress used the words fraud and deceit in section 206 of the Advisers Act in their technical sense.⁶² He reached that conclusion in part because section 206(4), later added to the Advisers Act, covers a “course of business” which is fraudulent, deceptive, or manipulative.⁶³ Thus, Judge Dimock reasoned, subsection (1), which uses the words “any device, scheme, or artifice,”⁶⁴ must be limited to conduct actually intended to defraud a client or prospective client.⁶⁵ In addition, subsection (2) must be limited to conduct which actually operates as a fraud on a client and, therefore, harms the client.⁶⁶ To attach a broader meaning to the terms, he added, would be impermissible when criminal sanctions for a violation are possible.⁶⁷

According to Judge Dimock, no proof was adduced that the defendants intended to harm any client or prospective client, or that any client or prospective client lost any money as a result of the defendants’ actions.⁶⁸ Judge Dimock determined that he did not have to decide the thorny question of whether the defendants intended to affect the price of the recommended securities. Unless the conduct resulted, or was intended to result, in a loss to clients or prospective clients, the conduct fell outside the scope of activity prohibited by sections 206(1) and 206(2) of the Act.⁶⁹ Accordingly, the court denied the motion for a preliminary injunction.⁷⁰

D. *The Second Circuit Opinions*

1. The Panel Decision

The SEC appealed to the Second Circuit.⁷¹ The court heard oral argument on October 13, 1961 and upheld the district court’s decision on December 18.⁷² Judge Leonard Page Moore authored the decision; Judge Sterry Robinson Waterman concurred and Judge Charles E. Clark dissented.⁷³ The Court of Appeals explained that through its enforcement action, the SEC would be creating a new rule that provided that failure to disclose an adviser’s trading in a recommended security constituted a scheme to defraud.⁷⁴ Judge Moore pointed out that a small advisory firm like Capital Gains was unable to

⁶² *Id.* at 898.

⁶³ Investment Advisers Act § 206(4), 15 U.S.C. § 80b-6(4) (2006).

⁶⁴ *Id.* § 206(1).

⁶⁵ *Capital Gains*, 191 F. Supp. at 898-99.

⁶⁶ *Id.* at 899.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ See *SEC v. Capital Gains Research Bureau, Inc.*, 300 F.2d 745, 746 (2d Cir. 1961).

⁷² *Id.* at 745.

⁷³ *Id.* at 746, 751.

⁷⁴ *Id.* at 749.

influence the market for large issuers, such as Union Pacific, Continental Insurance, and United Fruit, which had millions of shares outstanding.⁷⁵ Purchases by the subscribers, Judge Moore wrote, “would have been as the proverbial grain of sand is to the beach.”⁷⁶

Judge Moore agreed with the SEC that the securities laws should be “construed broadly to effectuate their remedial purpose.”⁷⁷ A broad interpretation, however, does not lead to liability. Judge Moore cited two cases, *SEC v. Torr*⁷⁸ and *Ridgely v. Keene*,⁷⁹ where advice was not disinterested because the adviser was being paid to tout a particular stock.⁸⁰ *That’s* the kind of conduct prohibited by sections 206(1) and (2). Judge Moore also agreed with the SEC that monetary loss need not be proven.⁸¹ “The test is not gain or loss,” he wrote, it is “whether the recommendation was honest when made.”⁸²

Judge Moore then turned to the 1960 amendments to the Advisers Act, adopted shortly after the relevant conduct occurred, to support his argument that scalping was not covered by the original Act.⁸³ In September 1960, Congress added section 206(4) to give the SEC authority to define fraudulent acts and prescribe means to prevent them.⁸⁴ No rule, the court explained, prohibited an adviser from owning shares of a security it recommends.⁸⁵ Although such a rule may be salutary, that decision is best left to the SEC, not the courts.⁸⁶

In his dissent, Judge Clark invoked morality and ethics to criticize the panel decision and cast aspersions on the conduct of Schwarzmann and Capital Gains.⁸⁷ The majority, he wrote, “endorses and in effect validates a distressingly low standard of business morality.”⁸⁸ Clark took issue with the majority’s view that Capital Gains was too small a fish to cause movements in the price of the recommended securities.⁸⁹ “But this defense,” he wrote,

⁷⁵ *Id.* at 748.

⁷⁶ *Id.*

⁷⁷ *Id.* at 749.

⁷⁸ 15 F. Supp. 315 (S.D.N.Y. 1936).

⁷⁹ 119 N.Y.S. 451 (1909).

⁸⁰ *Capital Gains*, 300 F.2d at 749.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.* at 750-51.

⁸⁴ Act to Amend Certain Provisions of the Investment Advisers Act of 1940, Pub. L. No. 86-750, 74 Stat. 885, 887 (1960) (codified as amended at 15 U.S.C. § 80b-6(4) (2006)).

⁸⁵ *Capital Gains*, 300 F.2d at 750.

⁸⁶ *Id.*

⁸⁷ *Id.* at 751 (Clark, J., dissenting).

⁸⁸ *Id.*

⁸⁹ *Id.* at 752.

“completely misses the point.”⁹⁰ The duty of a fiduciary is complete loyalty to the client.⁹¹ If an adviser is concerned with trading for its own account, the adviser cannot give a client completely disinterested advice.⁹² Clark then introduced the specter of a federal fiduciary duty, writing that the history of the Advisers Act “shows a Congressional intent to establish a fiduciary relationship on the part of the adviser to his client”⁹³

Regarding the 1960 amendments, the dissent explained that the majority misconceived the significance of the new grant of authority.⁹⁴ Congress declares policy and defines prohibitions, while the SEC adopts rules to assist in the execution of the policy, wrote Judge Clark.⁹⁵ The SEC, however, cannot vary the conduct the statute prohibits.⁹⁶ Thus, according to Clark, if the SEC could prohibit scalping by rule after adoption of the 1960 amendments, it also could bring an enforcement action to address this conduct absent such a rule.⁹⁷ Although this reasoning is sound, the majority, it seems, was not arguing that the SEC lacked the legal authority to bring the case. Rather, the majority observed that it would have been prudent to forbear until a specific rule were adopted, and Judge Clark does not address the argument to forbear.⁹⁸

2. The En Banc Decision

The SEC petitioned for and was granted a rehearing en banc, and the Second Circuit affirmed, five to four.⁹⁹ Once again, Judge Moore wrote for the majority and Judge Clark authored a spirited dissent.¹⁰⁰ The court began by conceding that Capital Gains would have violated section 206 if it had an improper motive for recommending a security.¹⁰¹ The SEC, however,

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* According to Clark, the fiduciary principle was “convincingly traced” by Louis Loss. *Id.* Loss’s treatise, however, does not support the proposition that Congress intended to establish a duty. *See infra* notes 133-138 and accompanying text.

⁹⁴ *Capital Gains*, 300 F.2d at 752-53.

⁹⁵ *Id.* at 753.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.* at 750-51 (Moore, J., opinion of the court).

⁹⁹ *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 607 (2d Cir. 1962) (en banc).

¹⁰⁰ Judge Moore was joined by Judge Waterman, who was with him on the earlier panel, as well as by Chief Judge Joseph Edward Lumbard and Judges Henry Friendly and Paul Raymond Hays. *Id.* The dissenters, along with Judge Clark, were Judges John Joseph Smith, Irving Kaufman, and Thurgood Marshall. *Id.* at 611.

¹⁰¹ *Id.* at 608-09.

demonstrated only that Schwarzmann profited from the predictable market effect of his advice – but there was no proof the advice was dishonest.¹⁰²

Moore then responded to claims by Clark regarding the scope and significance of the Advisers Act.¹⁰³ The statute, he wrote, “was not as comprehensive as the Securities Act of 1933 or the Securities Exchange Act of 1934;” it was thought to be a “modest beginning – not a great and final piece of legislation.”¹⁰⁴ Moore referred to legislative history stating that the SEC sought a “compulsory census” for advisers, and he quoted Louis Loss stating that for twenty years, the statute served precisely that function.¹⁰⁵ Moore spent much of the remainder of the opinion reviewing the history of the 1960 amendments, which, he believed, demonstrated the narrow scope of the initial legislation.¹⁰⁶

Clark began his dissent by recalling the context of the Advisers Act, enshrining it as the “last of the six great regulatory statutes of the era” and praising the “dramatic origin of these statutes as an outcome of the greatest stock market crash in history”¹⁰⁷ Clark struck a pose of deference to the Seventy-Sixth Congress that was in all likelihood not justified with regard to the Advisers Act. The Act, like the Investment Company Act passed at the same time, was a product of intense negotiation and compromise with the industry.¹⁰⁸ But Clark grouped the Advisers Act with the other Depression era securities laws, stating that they were “brilliantly successful” and demonstrated “the capacity of a democratic government to meet a social crisis skillfully and positively.”¹⁰⁹ Clark scolded the majority for “terminating all present regulation of investment advisers” and “casting doubt” on the other statutes framed with the same language.¹¹⁰

Clark crafted an argument based on the disclosure philosophy characteristic of the other securities laws.¹¹¹ Sellers of securities, he wrote, were required to disclose relevant information, and the laws’ antifraud provisions were passed to enforce that obligation.¹¹² The antifraud section of the Securities Act, Clark wrote, was not confined to common law fraud.¹¹³ Clark then drew a

¹⁰² *Id.* at 609.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 610.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 611 (Clark, J., dissenting).

¹⁰⁸ See *infra* notes 198-202 and accompanying text.

¹⁰⁹ *Capital Gains*, 306 F.2d at 611-12.

¹¹⁰ *Id.* at 612. *Capital Gains* was subsequently cited by courts that wished to broadly interpret parallel language in other statutes. See *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

¹¹¹ *Capital Gains*, 306 F.2d at 614.

¹¹² *Id.*

¹¹³ *Id.* at 614.

comparison between the Securities Act and the Advisers Act, which Congress indicated was needed as a result of the widespread activities of advisers, their influence on the markets, and their potential for abuse.¹¹⁴ He again dismissed the subsequent legislative history invoked by the majority as irrelevant to contemporaneous congressional intent.¹¹⁵

Toward the end of his dissent, Clark set forth in clear terms his view of the scheme to defraud in the case, which rested on Capital Gains's motives.¹¹⁶ Capital Gains held itself out as an adviser for long-term investors, he explained, and instilled in clients a belief that it was acting impartially.¹¹⁷ "Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice."¹¹⁸ Here Judge Clark presumably was referring to Capital Gains's short term trading while recommending that clients hold for the long term. For its success, Clark explained, Capital Gains depended on clients reacting to its advice.¹¹⁹ The firm, therefore, had a secret motive to encourage investors to purchase these securities, regardless of their intrinsic value.¹²⁰ Capital Gains's failure to disclose this motive while guaranteeing impartiality was a scheme to defraud advisory clients.¹²¹

E. *The Supreme Court Decision*

That the SEC managed to appeal the case to the Supreme Court was itself an achievement. In Supreme Court litigation, the SEC works closely with the Office of the Solicitor General and generally does not seek to appeal cases or file briefs without the Solicitor General's approval.¹²² Contemporaneous documents leave no doubt that the Solicitor General initially opposed filing a petition for certiorari in the case. Walter North, the SEC's Associate General Counsel, wrote that representatives from the Office of the Solicitor General took "a very dim view" of the case,¹²³ and William Cary, SEC Chairman, described Solicitor General Archibald Cox as having "grave doubts as to the wisdom" of seeking certiorari.¹²⁴ Notwithstanding his misgivings, Cox was

¹¹⁴ *Id.* at 614-15.

¹¹⁵ *Id.* at 616.

¹¹⁶ *Id.* at 617.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² See REBECCA MAE SALOKAR, *THE SOLICITOR GENERAL: THE POLITICS OF LAW* 83-84 (1992) (discussing the SEC and Solicitor General's general custom of cooperation in Supreme Court litigation).

¹²³ Memorandum from Walter P. North, Assoc. Gen. Counsel, Sec. and Exch. Comm'n, (Sept. 27, 1962) (on file with author).

¹²⁴ Letter from William L. Cary, Chairman, Sec. and Exch. Comm'n, to Archibald Cox,

willing to allow the SEC to proceed and the Commission voted unanimously to do so.¹²⁵

The Supreme Court sided with Judge Clark. It reversed the court of appeals, holding that scalping operates as a fraud and deceit upon clients or prospective clients.¹²⁶ Justice Goldberg explained that the decision turned on whether Congress “intended to require the Commission to establish fraud in the ‘technical sense,’ . . . or whether Congress intended a broad remedial construction of the Act which would encompass nondisclosure of material facts.”¹²⁷ In part I of the opinion, the Court traced the legislative history and purpose of the Investment Advisers Act to justify a broad construction of the statutory language.¹²⁸

The Court wrote that the purpose of the modern federal securities laws was to substitute a philosophy of caveat emptor with one of full disclosure.¹²⁹ Citing an SEC Report, which was part of the legislative history, Goldberg explained that an adviser could not fulfill his basic function of providing unbiased investment advice unless all conflicts of interest were eliminated.¹³⁰ Conflicts can arise from both conscious and unconscious motivations.¹³¹ Pointing to the legislative history, the Court specifically condemned advisers who trade in securities held by clients.¹³²

After quoting passages from legislative history, Justice Goldberg, quoting Louis Loss, concluded that the Advisers Act reflected a congressional recognition “of the delicate fiduciary nature” of the advisory relationship and a congressional intent to eliminate or expose conflicts of interest.¹³³ Goldberg wrote that it would defeat the purpose of the Act to hold that Congress meant to require proof of intent to injure, and actual injury, as conditions of liability.¹³⁴ Such requirements might be necessary in damages actions, but not in cases seeking equitable relief.¹³⁵ Nor was it necessary in a case against a fiduciary – which, the Court wrote, Congress “recognized” an investment adviser to be – to establish the elements of fraud that would be necessary in an action stemming from an arm’s length transaction.¹³⁶ Congress intended the Advisers Act to be construed “not technically and restrictively” but rather

Solicitor Gen. (Nov. 5, 1962) (on file with author).

¹²⁵ *Id.*

¹²⁶ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 181 (1963).

¹²⁷ *Id.* at 185-86.

¹²⁸ *Id.* at 186-95, 192.

¹²⁹ *Id.* at 186.

¹³⁰ *Id.* at 187 (citing H.R. DOC. NO. 76-477, at 28 (1939)).

¹³¹ *Id.* at 188.

¹³² *Id.* at 189.

¹³³ *Id.* at 191-92 (quoting 2 LOUIS LOSS, *SECURITIES REGULATION* 1412 (2d ed. 1961)).

¹³⁴ *Id.* at 192.

¹³⁵ *Id.* at 192-94.

¹³⁶ *Id.* at 194.

“flexibly to effectuate its remedial purposes.”¹³⁷ As a result of this reasoning, courts look to *Capital Gains* to demonstrate that section 206(2) of the Act, although an anti-fraud statute, is a *non-scienter-based* fraud statute; negligence suffices for a violation.¹³⁸

The Court then applied its analysis to the facts. In a critical passage echoing Judge Clark’s dissent in the en banc decision, the Court wrote that when an adviser trades on the market effect of his own recommendations, he might be motivated to recommend a particular security not on its merits, but for the potential for a short-term increase in price.¹³⁹ In that case, an investor should be permitted to evaluate the adviser’s “overlapping motivations.”¹⁴⁰ Courts, therefore, are empowered to require disclosure of the practice of trading on the effect of one’s own recommendations.¹⁴¹

In part III of the opinion, Justice Goldberg dispensed with three arguments respondents raised against a broad construction of the Advisers Act. The first was that Congress did not include a full disclosure provision in the Advisers Act, as it did in the Securities Act of 1933.¹⁴² Absent an express disclosure provision, one should not assume that Congress intended to characterize the failure to disclose information as a species of fraud.¹⁴³ Goldberg responded that seven years had elapsed between passage of the Securities Act and Advisers Act and courts had begun to merge the prohibition against non-disclosure and the prohibition against fraud.¹⁴⁴ Including a specific disclosure requirement, the Court wrote, would be mere “surplusage.”¹⁴⁵ Second, respondents argued that the 1960 amendments justified a narrow reading of the original statute.¹⁴⁶ According to the Court, there was no evidence that Congress in 1960 meant to narrow the prohibition adopted in 1940.¹⁴⁷ Moreover, Justice Goldberg wrote, subsequent legislative history cannot be considered evidence of Congress’s intent in 1940.¹⁴⁸ Finally, the respondents argued that their advice was honest.¹⁴⁹ The Court rejected this argument as “but another way” of arguing that respondents must prove intent and actual

¹³⁷ *Id.* at 195.

¹³⁸ *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992); *SEC v. Bolla*, 401 F. Supp. 2d 43, 67 (D.D.C. 2005); *SEC v. Moran*, 922 F. Supp. 867, 897 (S.D.N.Y. 1996).

¹³⁹ *Capital Gains*, 375 U.S. at 196.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 197.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 197-98.

¹⁴⁵ *Id.* at 198-99.

¹⁴⁶ *Id.* at 199.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 199-200.

¹⁴⁹ *Id.* at 200.

injury before an injunction can be granted.¹⁵⁰ Ultimately, regardless of whether the particular advice was honest, the Court was worried about conduct that “tempts dishonor.”¹⁵¹

As the sole dissenter, Justice Harlan argued that the conduct did not amount to fraud or breach of fiduciary duty.¹⁵² This was a case of an adviser “personally profit[ing] from the foreseeable reaction to sound and impartial investment advice.”¹⁵³ Harlan reviewed the cases on which the majority relied, pointing out that nearly all reflected obviously dishonest dealing necessary to carry out a disfavored transaction.¹⁵⁴ Harlan stated that the Court came to its result by construing the Advisers Act as a conflict of interest statute, but that’s not what it is.¹⁵⁵ Harlan was persuaded by the lack of an express disclosure provision in the Advisers Act, such as the one that exists in the Securities Act, and he remained unconvinced by Goldberg’s explanation that a disclosure provision would be mere surplusage.¹⁵⁶

II. ESTABLISHMENT OF A FEDERAL FIDUCIARY DUTY

In *Capital Gains*, the Court was confronted with two possible interpretations of the term “fraud.”¹⁵⁷ To settle the matter, the Court examined the legislative history of the Act and concluded that the term should be interpreted broadly.¹⁵⁸ The Court reached this conclusion in part because the SEC sought only equitable relief and, therefore, the Court looked to equitable definitions of the term.¹⁵⁹ Further, because Congress considered advisers to be fiduciaries to their clients, the Court concluded that the necessary elements to prove fraud were less burdensome than those necessary in an arm’s length transaction.¹⁶⁰

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.

¹⁵⁰ *Id.*

¹⁵¹ *Id.* 200-01 (quoting *United States v. Miss. Valley Co.*, 364 U.S. 520, 549 (1961)).

¹⁵² *Id.* at 203 (Harlan J., dissenting).

¹⁵³ *Id.* at 203-04.

¹⁵⁴ *Id.* at 204-06 (citing *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Norris & Hirschberg, Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949); *Arleen Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943); *Archer v. SEC*, 133 F.2d 795 (8th Cir. 1943); *SEC v. Torr*, 15 F. Supp. 315 (S.D.N.Y. 1936)). On the contrary, Harlan argued that “[i]n the case before [the Court], there is no vestige of proof that the reason for the recommendations was anything other than a belief in the soundness of the investment advice given.” *Id.* at 204.

¹⁵⁵ *Id.* at 206.

¹⁵⁶ *Id.* at 206-07, 206 n.4.

¹⁵⁷ *Id.* at 185-86 (majority opinion).

¹⁵⁸ *See supra* notes 142-151 and accompanying text.

¹⁵⁹ *Capital Gains*, 375 U.S. at 193-94.

¹⁶⁰ *Id.* at 194.

The Advisers Act, the Court explained, “reflects a congressional recognition” of the fiduciary nature of the advisory relationship.¹⁶¹ Similarly, the Court wrote, “[it is not] necessary in a suit against a fiduciary, *which Congress recognized the investment adviser to be*, to establish all the elements required in . . . an arm’s-length transaction.”¹⁶² This passage plainly states that the Court believed Congress recognized that advisers had a fiduciary duty to clients, a duty which pre-dated passage of the Act. Finally, the Court described committee hearings leading up to passage of the Act and wrote that prominent investment advisers emphasized their relationship of “trust and confidence” with advisory clients.¹⁶³ This testimony necessarily predated passage of the Act and therefore described a duty in existence before the Act was adopted.

A. *Santa Fe Industries v. Green*

What then was the source of the federal fiduciary duty if not the Act or the *Capital Gains* case? Subsequent courts understood *Capital Gains* to have said that Congress established this duty.¹⁶⁴ In *Santa Fe Industries v. Green*,¹⁶⁵ Justice White wrote that the Supreme Court in *Capital Gains* recognized that Congress intended the Investment Advisers Act to establish a federal fiduciary duty for advisers.¹⁶⁶ In *Santa Fe*, the Court addressed whether Congress intended to establish a fiduciary duty under a different statute – the Securities Exchange Act. The Court said *no* – but in doing so, it compared the Exchange Act to the Advisers Act and noted that the Court in *Capital Gains* recognized that Congress intended the Advisers Act to establish a federal fiduciary duty.¹⁶⁷

1. Justice White’s Position in *Santa Fe*

In *Santa Fe*, the Court was called on to interpret section 10(b) of the Exchange Act, the antifraud provision.¹⁶⁸ Over several years, *Santa Fe Industries* acquired ninety-five percent of Kirby Lumber Company.¹⁶⁹ Seeking to acquire the remaining five percent, Kirby took advantage of Delaware’s short-form merger statute.¹⁷⁰ The statute permits a parent owning at least ninety percent of a subsidiary to merge with the subsidiary on approval of the

¹⁶¹ *Id.* at 191.

¹⁶² *Id.* at 194 (emphasis added).

¹⁶³ *Id.* at 190 (citing *1940 Investment Trusts and Investment Companies: Hearings on S. 3580 Before the S. Subcomm. on Banking & Currency, 76th Cong. 719 (3d Sess. 1940)*).

¹⁶⁴ *See, e.g., Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11, 17 (1979).

¹⁶⁵ 430 U.S. 462 (1977).

¹⁶⁶ *Id.* at 471 n.11.

¹⁶⁷ *Id.* at 474.

¹⁶⁸ *Id.* at 464-65.

¹⁶⁹ *Id.* at 465.

¹⁷⁰ *Id.*

parent's board and payment to the minority shareholders.¹⁷¹ If shareholders are unhappy, they have appraisal rights and may petition the Chancery Court for a decree ordering the surviving corporation to pay fair value of the shares as determined by a court appointed receiver.¹⁷²

Kirby stock initially was valued at \$125 per share and minority shareholders were offered \$150.¹⁷³ The minority shareholders objected but did not pursue appraisal rights. Instead, they filed an action in federal court on behalf of the corporation and other minority shareholders to set aside the merger and recover the fair value of the shares; which they claimed was \$772 per share.¹⁷⁴ The minority shareholders alleged that the merger occurred without prior notice, that it was designed to freeze out the minority at an inadequate price, that Santa Fe obtained a fraudulent appraisal from an investment bank, and that Santa Fe offered \$25 above the amount of the appraisal to dupe the minority shareholders into thinking Santa Fe was being generous.¹⁷⁵

Minority shareholders alleged a violation of section 10(b) of the Exchange Act and Rule 10b-5. The district court dismissed, rejecting respondent's claim that the merger lacked a justifiable business purpose because no such purpose was required by Delaware law.¹⁷⁶ Also, the district court rejected the undervaluation claim because full disclosure of the appraisals was made to the shareholders eliminating any claim of misstatement or omission under section 10(b).¹⁷⁷ The court of appeals reversed based on the scope of misconduct covered by section 10(b). Although Rule 10b-5 covers material misrepresentations and nondisclosures in connection with the purchase or sale of securities, the court stated that neither is necessary to show a violation.¹⁷⁸ Rather, according to the court, section 10(b) prohibited a breach of fiduciary duty by majority shareholders even absent an alleged misrepresentation or omission.¹⁷⁹ A complaint alleges a Rule 10b-5 claim when it alleges that majority shareholders breached their fiduciary duty to deal fairly with the minority by effecting a merger without a legitimate business purpose.¹⁸⁰

Writing for the majority, Justice White disagreed and reversed the court of appeals.¹⁸¹ The language of Exchange Act section 10(b) does not prohibit conduct beyond manipulation or deception and legislative history reflects no

¹⁷¹ DEL. CODE ANN. tit. 8, § 253(a) (2001).

¹⁷² *Santa Fe*, 430 U.S. at 466-67.

¹⁷³ *Id.* at 466.

¹⁷⁴ *Id.* at 467.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 468-69.

¹⁷⁸ *Id.* at 470.

¹⁷⁹ *Id.* (quoting *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1287 (2d Cir. 1976)).

¹⁸⁰ *Id.* at 470.

¹⁸¹ *Id.* at 471.

such expansive intent.¹⁸² Thus, Justice White expressly disallowed a fiduciary duty standard under the section. The Court pointed out that the lower court construed the term “fraud” by advertent to its use in contexts other than the Exchange Act.¹⁸³ One of those contexts was the Investment Advisers Act. This gave Justice White occasion to note the following: “Although *Capital Gains* involved a federal securities statute, the Court’s references to fraud in the ‘equitable’ sense of the term were premised on its recognition that *Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.*”¹⁸⁴

The Court’s statement is puzzling. The reasons militating against a broad reading of section 10(b) to include liability for breach of fiduciary duty would also seem to apply to the Advisers Act. Indeed Justice White appeared concerned that interpreting section 10(b) to create a federal fiduciary duty would bring within Rule 10b-5 conduct traditionally left to state regulation.¹⁸⁵ If that happened, Rule 10b-5 would overlap and interfere with state regulation.¹⁸⁶ White concluded that there may well be a need for uniform federal fiduciary standards to govern mergers, but those standards should be imposed by the legislature.¹⁸⁷ Similarly, there may have been a need for federal fiduciary standards for advisers, but such standards as well should presumably be imposed by the legislature.¹⁸⁸

The Court’s statement that Congress intended the Advisers Act to establish federal fiduciary duties was not particularly well-grounded. As discussed next, neither the text of the Act nor the legislative history suggests Congress intended to establish a federal duty. Moreover, regardless of what Congress said, the Court in *Capital Gains* did not recognize or refer to a federal fiduciary duty for advisers.

2. The Investment Advisers Act and Legislative History

Neither the statutory text nor the legislative history supports the proposition that Congress intended to establish federal fiduciary duties for advisers. The statutory text is shorn of the word “fiduciary” or any similar term to describe advisers. As Justice Goldberg pointed out in *Capital Gains*, an early draft of the legislation, introduced by Senator Wagner on March 14, 1940, as S. 3580, contained language in the Declaration of Policy stating that advisers are

¹⁸² *Id.* at 473-74 (“[T]he claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as ‘manipulative or deceptive’ within the meaning of the statute.”).

¹⁸³ *Id.* at 471.

¹⁸⁴ *Id.* at 471 n.11 (emphasis added) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 194 (1963)).

¹⁸⁵ *Id.* at 478.

¹⁸⁶ *Id.* at 479.

¹⁸⁷ *Id.* at 480.

¹⁸⁸ *Id.* at 479.

fiduciaries.¹⁸⁹ The relevant passage read as follows: “the national public interest and the interest of investors are adversely affected – . . . (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients.”¹⁹⁰ A companion bill introduced in the House contained the same language.¹⁹¹ As Goldberg also pointed out, this provision was removed from the final language.¹⁹² Goldberg concluded that, although changes were made in the final bill, there was no intent to change the fundamental purpose behind the legislation.¹⁹³

Although the “fundamental purpose” of the legislation may not have changed, Justice Goldberg dodged the significance of removing this passage from the final bill. Goldberg stated that notwithstanding the expurgated language, the Act reflects a Congressional recognition of the fiduciary nature of the advisory relationship.¹⁹⁴ But this argument gets the presumption backward; removal of the passage suggests the opposite. According to a well-accepted principle of statutory construction, Congress’s silence should not be seen as intent to enact statutory language that it discarded from a previous draft.¹⁹⁵ The fiduciary language apparently was removed between April and June of 1940.¹⁹⁶ The Senate report to the subsequent bill stated only that the draft law recognizes that with respect to certain advisers, “a type of personalized relationship may exist with their clients” and that this relationship should be considered a factor when the SEC enforces the law.¹⁹⁷

Why was the fiduciary language expunged? The Advisers Act was a compromise bill carefully negotiated with the industry it was designed to control. When Senator Wagner brought House Bill 10065 to the Senate for

¹⁸⁹ *Capital Gains*, 375 U.S. at 189.

¹⁹⁰ *Id.* (alterations in original) (citing S. 3580, 76th Cong. § 202 (3d Sess. 1940)).

¹⁹¹ H.R. 8935, 76th Cong. (3d Sess. 1940).

¹⁹² *Capital Gains*, 375 U.S. at 191 n.34.

¹⁹³ *Id.* at 191. Even if the reference to fiduciary obligation had been included in the final bill, the passage does not *establish* a fiduciary duty for advisers; it merely refers to an adviser’s pre-existing fiduciary obligation to its clients.

¹⁹⁴ *Id.*

¹⁹⁵ *INS v. Cardoza-Fonseca*, 480 U.S. 421, 442-43 (1987) (“Few principles of statutory construction are more compelling than the proposition that Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded in favor of other language.” (quoting *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 392-93 (1980) (Stewart, J., dissenting))).

¹⁹⁶ A draft of S. 3580, dated April 2, 1940, contained the fiduciary language. *See* S. 3580, 76th Cong. § 202 (3d Sess. 1940). A superseding bill, S. 4108, dated June 6, 1940, omitted the fiduciary reference. *See* S. 4108, 76th Cong. (3d Sess. 1940). On the House side, H.R. 8935, dated March 14, 1940, contained the fiduciary language, *see* H.R. 8935, 76th Cong. (3d Sess. 1940), while H.R. 10065, the later house bill dated June 13, 1940, did not, *see* H.R. 10065, 76th Cong. (3d Sess. 1940).

¹⁹⁷ S. REP. NO. 76-1775, at 22 (1940).

approval, he stated that after lengthy hearings, the SEC and the industry “sat down together, and, after consideration for 3 weeks, agreed upon its terms and provisions.”¹⁹⁸ He similarly noted that there was opposition to the original bill, but the Commission conferred with the adviser community and together they agreed on the final version.¹⁹⁹ The report on S. 4108, which was identical to H.R. 10065, similarly explained that the revised bill was the result of the “cooperative efforts” of representatives of investment companies and the SEC.²⁰⁰ The report concluded that Title II (the Investment Advisers Act title) had the “affirmative support” of all advisers who appeared before the committee.²⁰¹ Perhaps the best evidence of compromise in the final language came from Representative Charles Wolverton from New Jersey’s First District. Shortly before the law was enacted, Wolverton said the following in a tribute to Representative William Cole:

[Cole] also was instrumental in inaugurating a new practice that will, in my opinion, whenever utilized, result in worth-while legislation, namely, that of having representatives of the business or industry to be affected by the legislation sit down with the regulatory body, and, around the table, discuss the problems and arrive at a fair and reasonable solution of them. That practice was pursued in formulating the present legislation.²⁰²

In all likelihood, the fiduciary language was unacceptable to the industry, and members of Congress or their staff agreed to strike it.

The legislative history to the Advisers Act did not suggest that Congress created a fiduciary duty when preparing the statute. Legislative history referred to advisers’ relationship of “trust and confidence” with their clients and to the “personalized character” of the services provided.²⁰³ Use of the phrases “trust and confidence” and “personalized character” suggested a special relationship existed between adviser and client in some cases, not that Congress intended to *establish* that relationship in all cases.

¹⁹⁸ 86 CONG. REC. 10069 (1940) (statement of Sen. Robert Wagner).

¹⁹⁹ *Id.*

²⁰⁰ S. REP. NO. 76-1775, at 1 (1940).

²⁰¹ *Id.* at 21.

²⁰² 86 CONG. REC. 9816 (1940) (statement of Rep. Charles Wolverton).

²⁰³ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 190-91 (1963) (citing *1940 Investment Trusts and Investment Companies: Hearings on S. 3580 Before the S. Subcomm. on Banking & Currency, 76th Cong. 719 (1940)* (statement of Alexander Standish, President, Standish, Racey, & McKay Inc.) (“The relationship of investment counsel to his client is essentially a personal one involving trust and confidence.”); H.R. REP. NO. 76-2639, at 28 (1940) (“The title also recognize[d] the personalized character of the services of investment advisers . . .”).

3. The *Santa Fe* Footnote and the *Capital Gains* Case

a. *Justice White's Proof*

Regardless of Congress's intent in the Advisers Act, the Supreme Court in *Capital Gains* neither found nor called for a federal fiduciary duty for advisers. To support his claim that the Court in *Capital Gains* acknowledged Congress's intention to establish federal fiduciary duties, Justice White referred to three pages of the *Capital Gains* decision.²⁰⁴ Those passages, however, do not impose, or demonstrate that Congress imposed, a federal fiduciary duty for advisers.

Justice White first referenced the portion of *Capital Gains* stating that the Act's legislative history indicates a desire to preserve the personalized character of an adviser's services and to eliminate conflicts of interest.²⁰⁵ This statement, however, did not establish a duty, it merely recognized the personal nature of advisory services. White's second reference was to the statement that the Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."²⁰⁶ This statement was a recognition of a pre-existing relationship; the Court did not hold or even suggest that the Advisers Act changed the relationship or established a duty.

A further look at the source of the "delicate fiduciary nature" language is instructive. The Supreme Court, like Clark's dissent below, quoted *Securities Regulation*, the classic 1961 treatise by Louis Loss, the leading authority in the field.²⁰⁷ One searches the relevant pages of the 1961 volume in vain, however, for any reference to a Congressional intent to "establish" a fiduciary duty in the Advisers Act. What exactly did Loss say? This section of the treatise covered the Advisers Act's prohibition against assignments of advisory contracts from one adviser to another without proper notice to clients.²⁰⁸ Loss wrote that the anti-assignment provision ruled out indefinite consent to future assignments when the contract is formed and, he went on, it has been the administrative policy (presumably referring to the policy of the SEC) to resolve doubts in favor of the client "in view of the delicate fiduciary nature of an investment advisory relationship."²⁰⁹ Again, Loss was describing a pre-existing fiduciary

²⁰⁴ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1976) (citing *Capital Gains*, 375 U.S. at 191-92, 194) (arguing that the Court's analysis was premised "on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers").

²⁰⁵ *Capital Gains*, 375 U.S. at 191.

²⁰⁶ *Id.* at 191-92.

²⁰⁷ *Id.* at 191 (quoting LOSS, *supra* note 133, at 1412).

²⁰⁸ LOSS, *supra* note 133, at 1411-12.

²⁰⁹ *Id.* at 1412.

relationship and the effect of the relationship on administrative policy; Loss was not suggesting that the Act established the relationship or created any duty.

Justice White's final reference was to the portion of *Capital Gains* where the Court wrote that in a suit against a fiduciary, "which Congress recognized the investment adviser to be," it is not necessary to establish all the elements required in a suit against a party in an arms' length transaction.²¹⁰ The statements on which White relied are all variations on a theme. Elsewhere in *Capital Gains*, Justice Goldberg pointed out that, in the legislative history, several advisers referred to the relationship of trust and confidence advisers have with their clients.²¹¹ Later he said that the statute required that advice be disinterested "in recognition" of the adviser's fiduciary duty.²¹² In each of these passages, Goldberg was explaining that Congress recognized or understood that an investment adviser is a fiduciary and was so before adoption of the Advisers Act. The Act did not create the fiduciary relationship.

b. Justice White's Move

Justice White's conclusion in Footnote 11 is doubly perplexing because at the time *Capital Gains* was decided there is at least some evidence to suggest that White understood that the Investment Advisers Act did *not* establish a fiduciary duty, but rather that the duty pre-dated passage of the Act. As the *Capital Gains* opinion was being drafted, Justice White prepared correspondence to Justice Goldberg, dated December 2, 1963.²¹³ In this letter, he referenced advisers as fiduciaries in a context suggesting that he believed the duty pre-dated passage of the Advisers Act. White wrote:

[O]n pages 12-14 where you speak of the developments in the law of fraud as a background for what Congress might have meant in using the language it did in the 1940 Act, it seems to me the treatment might be stronger if the investment adviser may be looked upon as a fiduciary as the Wagner Bill apparently recites that he is (see page 9 of your draft) and if the content of fraud and deceit as applied to a fiduciary is considered.²¹⁴

Although this letter is not conclusive, the phrase "as the Wagner Bill apparently recites that he is" suggests that White believed advisers had a pre-existing duty. Although one cannot rely too strongly on internal correspondence, which may have been prepared hastily and without careful

²¹⁰ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1976) (citing *Capital Gains*, 375 U.S. at 194).

²¹¹ *Capital Gains*, 375 U.S. at 190.

²¹² *Id.* at 201.

²¹³ Letter from Justice Byron R. White, Assoc. Justice, U.S. Supreme Court, to Justice Arthur Goldberg, Assoc. Justice, U.S. Supreme Court (Dec. 2, 1963) (on file with author).

²¹⁴ *Id.* at 1.

deliberation, the implication of this recitation is that Congress believed advisers were fiduciaries before the Act was passed.

Later in the letter, Justice White wrote: "If the fiduciary has a settled duty to disclose and if his failure to do so is termed fraudulent, there was little need for Congress in dealing with the fiduciary in the Investment Advisers Act to speak of anything but fraud in order to reach a failure to disclose."²¹⁵ Again, although one can only cautiously rely on such correspondence, the reference to Congress "dealing with the fiduciary" suggests that Justice White believed that the 76th Congress looked upon advisers as fiduciaries, not that the Act imposed fiduciary duties.

B. *Transamerica Mortgage Advisors, Inc. v. Lewis*

In 1979, four years after *Santa Fe*, the Supreme Court repeated the formulation in the *Santa Fe* footnote in *Transamerica Mortgage Advisors, Inc. v. Lewis*.²¹⁶ The issue in *Transamerica* was whether the Advisers Act created a private right of action for persons aggrieved by alleged violations of the Act.²¹⁷ Mortgage Trust of America (Trust) was a real estate investment trust advised by Transamerica Mortgage Advisors, Inc. (TAMA).²¹⁸ The case was a derivative action brought by a shareholder of the Trust on behalf of the Trust and also a class action brought on behalf of the Trust's shareholders. The defendants in the case were the Trust, TAMA, and two of TAMA's affiliates.²¹⁹

The *Transamerica* complaint alleged fraud and breach of fiduciary duty under the Advisers Act.²²⁰ The plaintiffs sought injunctive relief to bar further performance of the advisory contract, rescission, restitution of fees paid by the Trust, an accounting of allegedly illegal profits, and damages.²²¹ The trial court ruled that the Advisers Act did not confer a private right of action and dismissed the complaint.²²² The court of appeals held that implying a private right of action was necessary to achieve Congress's goals and reversed.²²³ The Supreme Court granted certiorari to resolve the issue.²²⁴

²¹⁵ *Id.*

²¹⁶ *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (citing *Santa Fe Indus., Inc., v. Green*, 430 U.S. 462, 471 n.11 (1977)).

²¹⁷ *Id.* at 13.

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.* at 14.

²²² *Id.*

²²³ *Id.*

²²⁴ *Id.* at 14-15.

1. The Federal Fiduciary Duty in *Transamerica*

In analyzing whether a private right of action existed, Justice Stewart writing for the Court looked to the statutory language and stated that section 206, the antifraud section, and section 215, which provides that contracts made in violation of the statute are void, were intended to benefit advisory clients.²²⁵ Justice Stewart then wrote that, as the Court previously recognized, section 206 “establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers.”²²⁶ For support, Stewart invoked *Capital Gains*, *Santa Fe*, and *Burks v. Lasker*, the last of which referenced *Santa Fe* and *Capital Gains* but provided no relevant substantive analysis of its own. Justice Stewart went further than the *Santa Fe* footnote, claiming that the Advisers Act’s legislative history “leaves no doubt that Congress intended to impose enforceable fiduciary obligations.”²²⁷

For support, Stewart referred to three items of legislative history.²²⁸ The first was House Report No. 2639 from 1940.²²⁹ The relevant passage from this Report stated only that the Advisers Act “recognizes” the personalized character of services performed by advisers and that the drafters took “especial care” to respect that relationship.²³⁰ Thus, this passage presents rather strong evidence that the Act *did not* establish a duty; rather, the drafters explained that they were respecting a previously existing duty. Similarly, recognizing the “personalized character” of the services does not necessarily describe a fiduciary relationship. Being a fiduciary means more than providing personalized services.

Next, Justice Stewart referenced Senate Report No. 1775 from 1940,²³¹ which does not directly support his claim. The cited page from this Report justified national regulation based on “increasing widespread” activity of advisers, their “potential influence on the markets,” and the “dangerous potentialities” of so-called tipsters imposing on unsophisticated investors.²³² The Report stated that the problems and abuses in the advisory profession could not be resolved absent federal regulation.²³³ Nothing in this passage, however, hinted at the establishment of a duty.

Third, Justice Stewart cited to the SEC’s *Report on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, which was part of the SEC’s broader study on Investment Trusts and

²²⁵ *Id.* at 16-17.

²²⁶ *Id.* at 17.

²²⁷ *Id.*

²²⁸ *Id.* at 17-18.

²²⁹ H.R. REP. NO. 76-2639 (1940).

²³⁰ *Id.* at 28.

²³¹ S. REP. NO. 76-1775 (1940).

²³² *Id.* at 21.

²³³ *Id.*

Investment Companies.²³⁴ The purposes of this report were to chart the growth, development, and size of the investment advisory profession and point out problems.²³⁵ There is no reference in the sixty-seven pages of the need or intent to establish a fiduciary duty in the Act. Justice Stewart specifically referenced a section of the Report regarding problems and abuses in the advisory profession.²³⁶ In drafting this section, the SEC relied on third party testimony, descriptions of the services advisers provided and the need they fulfilled for clients. A prominent example is the testimony of James N. White of Scudder, Stevens & Clark. According to this witness, there were individuals in the investment counsel profession who lacked appropriate qualifications and training, and who made exaggerated claims to investors.²³⁷ Regulation of advisers, James White agreed, should focus on these so-called tipsters.²³⁸

Later in the Report, the SEC stated that survey responders did not believe that advisers could provide personal, competent, unbiased, and continuous advice unless all conflicts between the adviser and the client were eliminated; the *Capital Gains* Court picked up this language.²³⁹ This statement was drawn directly from the testimony of Dwight C. Rose, President of the Investment Counsel Association of America.²⁴⁰ When discussing changes in control of advisory firms, this chapter concluded with a statement that the advisory contract was a "personal one."²⁴¹ Again, these statements described the existing advisory relationship. The lack of a reference to establish a fiduciary duty can be contrasted with the Report's later discussion of how Illinois law explicitly defined the standard of fiduciary obligation for investment advisers.²⁴²

Recall that, in *Transamerica*, Justice Stewart discussed legislative history in the context of a private right of action under sections 206 and 215 and his statement that those sections were designed to benefit advisory clients. In light of this review of legislative history, the *Transamerica* Court concluded that a private right of action existed under section 215 of the Advisers Act, which declares certain contracts to be void, but not under section 206.²⁴³

²³⁴ *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 18 (1979).

²³⁵ H.R. DOC. NO. 76-477, at 1 (1939).

²³⁶ *Transamerica*, 444 U.S. at 18 (citing H.R. DOC. NO. 76-477, at 27-30).

²³⁷ H.R. DOC. NO. 76-477, at 28.

²³⁸ *Id.*

²³⁹ See *supra* note 130 and accompanying text.

²⁴⁰ H.R. DOC. NO. 76-477, at 28 n.48.

²⁴¹ *Id.* at 30.

²⁴² *Id.* at 32 ("Investment counsel or advice . . . shall be strictly on the basis of fiduciary relationship between the counselor or advisor and the investor or prospective investor.").

²⁴³ *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 19, 24 (1979).

2. Justice White's Dissent

Justice White, author of the *Santa Fe* footnote, dissented in *Transamerica* and repeated his earlier statement about a federal fiduciary duty.²⁴⁴ White believed the Advisers Act should have been read more liberally to provide for a private right of action under section 206.²⁴⁵ In his analysis, he discussed the four factors of *Cort v. Ash* to determine whether a federal statute implies a private right of action.²⁴⁶ The fourth factor is whether “the cause of action [is] one traditionally relegated to state law,” in an area primarily of concern to the states, “so that it would be inappropriate to infer a cause of action based solely on federal law.”²⁴⁷ In analyzing the fourth factor, Justice White admitted that some practices prohibited by the Advisers Act would have been actionable as fraud at common law.²⁴⁸ He concluded, however, that “Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”²⁴⁹ For support, White cited *Capital Gains* and his own footnote in *Santa Fe*.²⁵⁰ The result of *Santa Fe*, crystallized in *Transamerica*, is that investment advisers owe a federal fiduciary duty to their clients.²⁵¹

Santa Fe and *Transamerica* thus set in motion a loop or chain reaction of reliance on previous cases for a particular proposition without acknowledging that the first decision to state a proposition was not as clear as subsequent courts might have thought. Frank M. Coffin summarized the dynamic well in *The Ways of a Judge*:

I recall one appeal where all of the case authority, some seven or eight cases, was unanimous that the legislative history behind a statute commanded a certain result. The result seemed to be at odds with national policy in this area. A search was indicated and proved productive. It revealed that the eighth case relied on the previous seven, the seventh on the previous six, and so on, back to the first decision, a rather conclusory lower court decision based on a few extracts from the

²⁴⁴ *Id.* at 25 (White, J., dissenting).

²⁴⁵ *Id.* at 27.

²⁴⁶ *Id.* at 26-27 (citing *Cort v. Ash*, 422 U.S. 66, 78 (1975)).

²⁴⁷ *Cort*, 422 U.S. at 78.

²⁴⁸ *Transamerica*, 444 U.S. at 36 (White, J., dissenting).

²⁴⁹ *Id.* (quoting *Santa Fe Indus, Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977)).

²⁵⁰ *Id.* Five years after *Transamerica*, the Court decided *Lowe v. SEC*, 472 U.S. 181 (1985), in which it held that the petitioners were subject to the statutory exclusion for publishers and, therefore, not covered by the Act. *Id.* at 211. Unlike *Santa Fe* and *Transamerica*, the *Lowe* Court referred to the “kind of fiduciary relationship the Act was designed to regulate,” *id.* at 202 n.45, and stated that advisory relationships can “develop into the kind of fiduciary, person-to-person relationships” discussed in the legislative history.” *Id.* at 210.

²⁵¹ *Transamerica*, 444 U.S. at 17.

legislative debates. Reading the entire debate placed the matter in quite a different light.²⁵²

One final point regarding Louis Loss is worth mentioning. Loss was unquestionably the preeminent national expert in the securities field during the time of *Capital Gains*, *Santa Fe*, and *Transamerica*.²⁵³ Had Loss pointed out the Court's error, he may have caused later courts to reconsider the "federal fiduciary standard" and arrested this development in the law. Instead, in the 1983 edition of his treatise, *Fundamentals of Securities Regulation*, Loss seemed to place his imprimatur on this formulation.²⁵⁴ In a discussion of *Capital Gains*, Loss pointed to footnote 11 of *Santa Fe* and referenced Justice White's language regarding Congress's intention to establish a federal fiduciary duty for advisers.²⁵⁵ Loss gave no hint that he disapproved, and courts and the SEC adopted White's interpretation with alacrity.

C. *The Modern Federal Fiduciary Duty for Advisers*

The advisers' federal fiduciary duty has become firmly entrenched in the law. The obligation appears in court decisions, SEC enforcement actions, and SEC administrative materials, such as rulemaking releases and decisions by administrative law judges.²⁵⁶ The principle appears unassailable.

*Financial Planning Association v. SEC*²⁵⁷ is a good example. The D.C. Circuit struck down an SEC rule excluding certain brokers that provide advice from application of the Advisers Act.²⁵⁸ In doing so, the court pointed out that the statutory scheme addressed problems that existed in the profession in two principal ways, one of which was by establishing a "federal fiduciary standard" to govern advisers' conduct.²⁵⁹ The court looked to *Transamerica* for

²⁵² FRANK M. COFFIN, *THE WAYS OF A JUDGE* 167-68 (1980).

²⁵³ Joel Seligman, *In Memoriam: Louis Loss*, 111 HARV. L. REV. 2135, 2141 (1998).

²⁵⁴ Louis Loss, *Fundamentals of Securities Regulation* 869 n.85 (1983).

²⁵⁵ *Id.*

²⁵⁶ See *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 490 (D.C. Cir. 2007) ("The overall statutory scheme of the IAA addresses the problems identified to Congress . . . by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined . . ."); *Political Contributions by Certain Investment Advisers*, 75 Fed. Reg. 41,018, 41,022 (July 14, 2010) (to be codified at 17 C.F.R. pt. 275) ("The Supreme Court has construed section 206 as establishing a Federal fiduciary standard governing the conduct of advisers."); *F.X.C. Investors Corp.*, SEC Release No. 218, 2002 WL 31741561 (ALJ Dec. 9, 2002) ("Section 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers."); *F.W. Thompson Co.*, Investment Advisers Act Release No. 1895, 73 SEC Docket 486 (Sept. 7, 2000) ("Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers to exercise the utmost good faith in dealings with clients.").

²⁵⁷ 482 F.3d 481 (D.C. Cir. 2007).

²⁵⁸ *Id.* at 483.

²⁵⁹ *Id.* at 490.

support.²⁶⁰ District courts have concluded the same, drawing, as expected, on *Transamerica*, *Santa Fe*, *Burks v. Lasker*, and *Capital Gains* itself.²⁶¹

Similarly, to justify new rules adopted under the Investment Advisers Act, the SEC relied on a federal fiduciary duty. In the SEC's pay-to-play rules, which prohibit an adviser from providing advice to a government client for two years after the adviser has made a contribution to certain elected officials or candidates, the SEC wrote that the "Supreme Court has construed section 206 as establishing a Federal fiduciary standard governing the conduct of advisers," with citations to *Transamerica* and *Capital Gains*.²⁶² The Commission has made similar statements in settled enforcement actions²⁶³ and administrative law judges have done the same.²⁶⁴

In a 2011 SEC staff study discussing whether to harmonize the law governing broker-dealers and investment advisers, the staff stated, "The Supreme Court has construed Advisers Act Section 206(1) and (2) as establishing a federal fiduciary standard governing the conduct of advisers."²⁶⁵ The staff also explained that the federal fiduciary standard applies to an adviser's "entire relationship" with clients and prospective clients.²⁶⁶ SEC staff no-action letters similarly summarize the law. A letter from 2006 stated that sections 206(1) and (2) of the Advisers Act "impose a federal fiduciary duty" on advisers.²⁶⁷ Ten years earlier, the staff wrote in another letter that a registered adviser, as an aspect of its federal fiduciary duty under section 206, must provide only suitable advice to clients and, therefore, "obtain and maintain sufficient information to evaluate each client from a suitability

²⁶⁰ *Id.* (citing *Transamerica Mortg. Advisers, Inc. v. Lewis*, 444 U.S. 11, 17 (1979)).

²⁶¹ *See, e.g.*, *SEC v. Treadway*, 430 F. Supp. 2d 293, 338 (S.D.N.Y. 2006) ("The extent of conduct subject to liability under the Advisers Act is broad. By enacting Section 206 of the Advisers Act, Congress 'establishe[d] 'federal fiduciary standards' to govern the conduct of investment advisers.'" (quoting *Transamerica*, 444 U.S. at 17)); *SEC v. Moran*, 922 F. Supp. 867, 895 (S.D.N.Y. 1996) ("Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers . . .").

²⁶² *Political Contributions By Certain Investment Advisers*, 75 Fed. Reg. 41,018, 41,022 (July 10, 2010) (to be codified at 17 C.F.R. 275.206(4)-5, 275.204-2, 275.206(4)-3).

²⁶³ *Battery Wealth Mgmt., Inc.*, Investment Advisers Act Release No. 2800A (Oct. 15, 2008) ("Section 206 establishes federal fiduciary standards to govern the conduct of investment advisers." (citing *Transamerica*, 444 U.S. at 17)).

²⁶⁴ Michael Flanagan, Release No. 160, 71 S.E.C. Docket 1415 (ALJ Jan. 21, 2000) ("Section 206 establishes federal fiduciary standards to govern the conduct of investment advisers." (citing *Transamerica*, 444 U.S. at 16-17)).

²⁶⁵ SECURITIES AND EXCHANGE COMMISSION STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 21 (2011) (citing *Transamerica Mortg. Advisors, Inc.*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963)).

²⁶⁶ *Id.* at 22.

²⁶⁷ *See Gardner Russo & Gardner*, SEC No-Action Letter, 2006 WL 1594207 (June 7, 2006).

perspective.”²⁶⁸ That would require an adviser, as an aspect of its federal fiduciary duty, to give advice to a client only after the adviser had “reasonably determined that the advice was suitable” to the client’s particular circumstances.²⁶⁹ This latter pronouncement, which appears to place particularized requirements on advisers in the course of performing their suitability analysis, raises the question of the implications of a federal fiduciary duty on the regulation of advisers. The next part takes up this question, discussing the consequences of a federal duty.

III. CONSEQUENCES OF A FEDERAL STANDARD

The federal fiduciary duty for advisers originated neither in the Advisers Act nor in the *Capital Gains* case, but rather in the *Santa Fe* footnote years after *Capital Gains* was decided. In the Investment Advisers Act, Congress recognized that advisers are fiduciaries to their clients, but Congress did not create that duty. Is this a detail interesting only to scholars of the history of financial regulation, or are there consequences to the way the law has developed? If Congress merely recognized advisers as fiduciaries, does it matter that courts and the SEC now state that the statute imposes a fiduciary duty?

There are at least three consequences to the Supreme Court’s declaration that the statute imposes a federal fiduciary duty on advisers. The first consequence is that the Court expanded the liability of advisers in two ways – by deeming all advisers to be fiduciaries, regardless of their business, and by imposing broader obligations on advisers than would be applicable under a fraud prohibition. The second consequence is that the imposition of a federal fiduciary duty makes the law governing advisers vaguer than a rule banning fraud. Unlike a rule prohibiting fraud, which applies to advisers that are often considered fiduciaries under state law, it is difficult to discern the source and the content of a federal fiduciary obligation. The final consequence relates to the remedy, if any, for this development. Now that the courts have repeatedly stated that the Act imposes a federal fiduciary duty, the rule has become well-established. One might ask which body – Congress or the Supreme Court – can change it.

A. *Expanded Liability for Advisers*

1. Scope of Coverage

The federal fiduciary duty for advisers expanded liability because all advisers under the Act are automatically considered fiduciaries to their clients. Absent a federal fiduciary duty, an investment adviser does not necessarily

²⁶⁸ Quest Advisory Corp, SEC No-Action Letter, 1996 WL 490692 (Aug. 28, 1996).

²⁶⁹ Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406, 56 SEC Docket 724 (Mar. 16, 1994).

owe a fiduciary obligation to clients.²⁷⁰ Moreover, looking back to the history of the enactment of the Advisers Act, not all advisory relationships were necessarily considered the personalized, confidential relationships that give rise to the fiduciary label.²⁷¹ Why was this so?

Although the legislative history refers to the personalized character of investment services, the record is equivocal. The House Report stated that the Advisers Act “recognizes the personalized character” of advisory services.²⁷² The Senate Report, however, was more guarded, stating that a “personalized relationship” exists, or may exist, only with respect to a “certain class” of advisers.²⁷³ Not all advisers, in other words, established a personalized relationship with clients. Providing services of a personalized character, therefore, was not a precondition to establishing an advisory relationship.²⁷⁴ Moreover, the Senate Report provided that this personalized relationship is a *factor to be considered* in connection with the SEC’s enforcement of the Act.²⁷⁵ The Report, in other words, instructed the SEC to decide whether a personalized relationship with a client existed when determining how vigorously to enforce the law, further suggesting that not all advisory relationships covered by the Act were personalized in nature.

Another indication that Congress did not impose federal fiduciary duties on all advisers, or even assume all advisers were fiduciaries, is the reference to “investment counsel” in section 208 of the statute. The Act as originally passed distinguished between “investment counsel” and other types of investment advisers.²⁷⁶ David Schenker, Chief Counsel of the SEC’s Investment Trust Study, explained that advisers comprise a broad category of persons, ranging from those who provide disinterested impartial advice to

²⁷⁰ *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992) (“We have given two examples of *categories* of relations in which fiduciary duties are imposed (lawyer-client, guardian-ward), and the relation between an investment advisor and the people he advises is not a third.”); *Caraluzzi v. Prudential Sec., Inc.*, 824 F. Supp. 1206, 1213 (N.D. Ill. 1993) (stating that “mere existence of broker-customer (or investment adviser-customer) is not proof of fiduciary character”). *But see* RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) (“A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.”).

²⁷¹ See *infra* notes 272-275 and accompanying text.

²⁷² H.R. REP. NO. 76-2639, at 28 (1940).

²⁷³ S. REP. NO. 76-1775, at 22 (1940).

²⁷⁴ See *Lowe v. SEC*, 472 U.S. 181, 221 (1985) (White, J., concurring) (“[T]he Senate Report does at least make clear that a personal relationship between adviser and client is not a *sine qua non* of an investment adviser under the statute: the Report states that the Act ‘recognizes that with respect to a *certain class* of investment advisers, a type of personalized relationship *may* exist with their clients.’” (quoting S. REP. NO. 76-1775, at 22)).

²⁷⁵ S. REP. NO. 76-1175, at 22.

²⁷⁶ Investment Advisers Act, ch. 686, § 208(c), 54 Stat. 847, 853 (1940) (codified as amended at 15 U.S.C. § 80b-8(c) (2006)).

those who send newsletters through the mail.²⁷⁷ The term “investment counsel” described those advisers that did have a personalized relationship with a client.²⁷⁸

Section 208(c) of the Act as originally passed prohibited any adviser registering with the Commission to represent that it was an investment counsel unless it was, or was about to be, primarily engaged in the business of providing investment supervisory services.²⁷⁹ “Investment supervisory services” was a defined term; it meant giving “continuous advice as to the investment of funds” on the basis of individual client needs.²⁸⁰ Thus, it was possible for an adviser to perform services other than providing ongoing advice of a personal fiduciary nature and still be considered an adviser under the Act. Unlike ERISA, under which investment advisers are a sub-class of fiduciaries,²⁸¹ under the Advisers Act as originally enacted, fiduciaries were a sub-class of advisers.

If Congress had wanted to impose fiduciary duties on all investment advisers in 1940, it knew how to do so. First, as discussed, early drafts of the Act described advisers as fiduciaries, but the drafters removed the reference from the final bill.²⁸² In addition, the Act as originally passed used the phrases “fiduciary powers” and “fiduciary capacity” in the definitions of banks and dealers.²⁸³ The Investment Company Act, the companion title to the Investment Advisers Act, contained the same references.²⁸⁴ Even earlier, in both the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress employed the term fiduciary.²⁸⁵

²⁷⁷ *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 47 (1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission Investment Trust Study).

²⁷⁸ See H.R. Doc. No. 76-477, at 5, 30 (1940).

²⁷⁹ Investment Advisers Act, ch. 686, § 208(c), 54 Stat. 847, 853 (codified as amended at 15 U.S.C. § 80b-8(c) (2006)).

²⁸⁰ *Id.* § 202(a)(13), 54 Stat. 847, 849 (codified as amended at 15 U.S.C. § 80b-2(a)(13) (2006)).

²⁸¹ 29 U.S.C. § 1002(38) (2006) (defining “investment manager” as “any fiduciary” who meets certain other requirements, including acknowledging “in writing that he is a fiduciary with respect to the plan”).

²⁸² See *supra* note 196 and accompanying text.

²⁸³ See Investment Advisers Act, ch. 686, § 202(a)(2), 54 Stat. 847, 848 (codified as amended at 15 U.S.C. § 80b-2(a)(2) (2006)) (defining bank); *Id.* § 202(a)(7), 54 Stat. 847, 848 (codified as amended at 15 U.S.C. § 80b-2(a)(7) (2006)) (defining dealer).

²⁸⁴ See Investment Company Act, ch. 686, § 2(a)(5), 54 Stat. 789, 791 (1940) (codified as amended at 15 U.S.C. § 80a-2(a)(5) (2006)) (defining bank); *Id.* § 2(a)(11), 54 Stat. 789, 792 (codified as amended at 15 U.S.C. § 80a-2(a)(11) (2006)) (defining dealer).

²⁸⁵ Securities Act, ch. 38, § 11(c), 48 Stat. 74, 83 (1933) (codified as amended at 15 U.S.C. § 77k(c) (2006)) (setting forth test for what constitutes “due diligence”); Securities Exchange Act, ch. 404, § 3(a)(5), 48 Stat. 881, 883 (1934) (codified as amended at 15

Congress's ability to craft a mandatory fiduciary obligation is even more apparent from the 1970 amendments to the Investment Company Act. The structure of an investment company raises inherent conflicts of interest.²⁸⁶ Investment companies are managed by investment advisers, who are paid to manage fund assets and who have duties to act in the best interest of their fund clients.²⁸⁷ Fund advisers, often structured as corporations, have shareholders of their own, however, and must act in their best interest as well.²⁸⁸ When negotiating an advisory contract with a fund, an adviser has a duty to the fund to keep fees reasonable, because higher fees subtract from investor returns.²⁸⁹ At the same time, the adviser has an interest in charging higher fees to enhance the adviser's profitability for shareholders.²⁹⁰

Before 1970, fund shareholders challenged advisory fees under state law, and courts held funds to a common law standard of corporate waste.²⁹¹ Challengers had to prove gross abuse of trust.²⁹² The SEC proposed an amended standard allowing it to bring an action, or intervene in a private action, if a fee was not "reasonable."²⁹³ This proposed amendment failed due to the concern that the SEC would get into the business of ratemaking.²⁹⁴ Instead, Congress amended the Investment Company Act explicitly to place on fund advisers "a fiduciary duty with respect to the receipt of compensation"

U.S.C. § 78c(a)(5)(B) (2006)) (defining dealer but excluding person that "buys or sells securities for his own account, either individually or in some fiduciary capacity"); Securities Exchange Act, ch. 404, § 3(a)(6), 48 Stat. 881, 883 (codified as amended at 15 U.S.C. § 78c(a)(6) (2006)) (defining "bank" and using phrase "fiduciary powers").

²⁸⁶ *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418, 1422 (2010).

²⁸⁷ See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1423-24 (2006) for an explanation of the structure of investment companies.

²⁸⁸ *Jones*, 130 S. Ct. at 1422 ("A mutual fund is a pool of assets consisting primarily of a portfolio of securities, and belonging to individual investors holding shares in the fund." (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979))).

²⁸⁹ *Cf. Daily Income Fund v. Fox*, 464 U.S. 523, 537-38 (1984) (describing SEC's efforts to amend Investment Company Act to require "reasonable" fees on fund "in light of the economies of scale realized in managing a larger portfolio" because even small percentages could result in enormous incomes for advisers).

²⁹⁰ See *Jones*, 130 S. Ct. at 1422-24; Birdthistle, *supra* note 287, at 1424.

²⁹¹ See, e.g., *Kleinman v. Saminsky*, 200 A.2d 572, 574 (Del. 1964) ("This action was instituted on behalf of the Funds and charged that the defendants had committed waste of the Funds' assets by causing the payment of excessive management fees and recurring charges . . ."); *Rome v. Archer*, 197 A.2d 49, 52 (Del. 1964) ("The original complaint alleged that the directors of The Fund had improperly paid excessive compensation to its investment advisor to an extent sufficient to amount to waste of corporate assets . . .").

²⁹² See *Jones*, 130 S. Ct. at 1423.

²⁹³ *Daily Income Fund*, 464 U.S. at 538.

²⁹⁴ *Id.*

that the adviser receives from a fund.²⁹⁵ There is no doubt that this language imposed a fiduciary duty on advisers in this particular context.

A final example of Congress's ability to impose federal fiduciary standards is the Dodd-Frank Act, which established a federal fiduciary duty for certain firms advising municipal clients.²⁹⁶ Dodd-Frank extended the authority of the Municipal Securities Rulemaking Board to municipal advisers. Municipal advisers include persons and firms that advise state and local governments on municipal bonds and those who solicit municipal bond business from issuers on behalf of others.²⁹⁷ In Dodd-Frank, Congress addressed head-on whether such advisers owe fiduciary obligations. The law provides that municipal advisers and persons associated with municipal advisors "shall be deemed to have a fiduciary duty" to any municipal client.²⁹⁸ The provision also states that no municipal adviser can engage in any act or practice that is not consistent with the municipal adviser's fiduciary duty.²⁹⁹

Thus, Congress has imposed federal fiduciary duties on multiple occasions. By contrast, the legislative history of the Advisers Act suggests that Congress believed only certain advisers had personalized fiduciary relationships with clients. By virtue of courts' holdings that the Advisers Act created a federal fiduciary duty, all advisers are now considered fiduciaries. The inquiry then becomes the content of the obligation – not whether it exists.

2. Substantive Obligations

In addition to expanding the set of advisers considered fiduciaries, a federal fiduciary duty enhances advisers' substantive obligations. Although precisely what a fiduciary obligation entails is ambiguous, expanding the prohibition on fraud to a prohibition on breach of fiduciary duty expanded advisers' potential liability under the Act.

Unlike a rule prohibiting fraud, even negligence-based fraud, a fiduciary standard includes an obligation to act in the "best interest" of the principal.³⁰⁰ An example of the breadth of the best interest standard for advisers is *SEC v. Moran*.³⁰¹ In that case, the SEC alleged that the adviser violated the antifraud

²⁹⁵ 15 U.S.C. § 80a-35(b) (2006); *see Jones*, 130 S. Ct. at 1423. Section 36(b) of the Investment Company Act reads in part as follows: "[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation . . . paid by such registered investment company . . . to such investment adviser" Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35 (2006).

²⁹⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 975, 124 Stat. 1376, 1915-23 (2010).

²⁹⁷ *Id.* § 975(e)(4), 124 Stat. at 1921.

²⁹⁸ *Id.* § 975(c)(2), 124 Stat. at 1920.

²⁹⁹ *Id.*

³⁰⁰ *See infra* notes 404-405 and accompanying text (discussing whether "best interest" standard is equivalent to fiduciary obligation or is something broader).

³⁰¹ 922 F. Supp. 867, 872 (S.D.N.Y. 1996).

provisions of the Advisers Act by improperly allocating securities to different accounts. The adviser purchased Liberty Media shares over two days as the price increased from \$26.256 to \$26.875 per share.³⁰² Moran inadvertently allocated lower cost shares to personal and family accounts and higher cost shares to client accounts.³⁰³ The error cost clients approximately \$7000 – although, in the case of another security, the adviser had made a similar mistake that worked to the clients’ benefit.³⁰⁴

In *Moran*, the court stated that section 206 of the Advisers Act established a fiduciary duty and required an adviser to act in the “best interests” of its clients.³⁰⁵ Applying this standard, the court reasoned that the adviser placed its own interests ahead of its clients (albeit inadvertently), which was a breach of fiduciary duty and, therefore, a violation of section 206(2).³⁰⁶ One can never know how the court might have ruled under the fraud language of section 206 as opposed to a “best interest” standard, but the fact that the error was an isolated incident and that another mistake *benefited* clients would appear to detract from a finding of fraud – even non-scienter based fraud.

Similarly, the SEC has stated that the Act incorporates common law fiduciary principles. Such principles typically include high standards of loyalty and care. In a settled enforcement action, *Brandt, Kelly & Simmons, LLC*, the Commission sued a registered adviser and its managing partner.³⁰⁷ The adviser negotiated with TD Waterhouse Investor Services (TDW) to move the adviser’s client accounts from another broker-dealer to TDW.³⁰⁸ The adviser’s managing partner told TDW that the other brokerage firm would charge the advisory clients a fee to terminate their accounts.³⁰⁹ To reimburse that fee, TDW offered to pay the adviser \$7500 and the adviser agreed that it would use the money to reimburse clients.³¹⁰ The adviser, however, did not tell clients about the reimbursement funds and used the money to cover operating expenses.³¹¹ When the SEC settled the case, it wrote that the adviser willfully violated sections 206(1) and (2) of the Advisers Act, “which incorporate common law principles of fiduciary duties.”³¹² Thus, the Commission’s view was that the fiduciary duty created by the Advisers Act encompassed state common law fiduciary obligations.

³⁰² *Id.* at 885-86.

³⁰³ *Id.* at 886.

³⁰⁴ *Id.* at 885-86.

³⁰⁵ *Id.* at 895-96.

³⁰⁶ *Id.* at 898.

³⁰⁷ *Brandt, Kelly & Simmons, LLC*, Admin. Proc. File No. 3-11672, 2004 WL 2108661 (SEC Sept. 21, 2004).

³⁰⁸ *Id.* at *3.

³⁰⁹ *Id.*

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² *Id.* (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 180 (1963)).

This enforcement action raises perhaps the most far-reaching consequence of a federal fiduciary duty for advisers. Advisers are generally subject to common law fiduciary duties, and, as discussed, Congress recognized that many advisers were subject to pre-existing fiduciary obligations.³¹³ A federal fiduciary duty located in the statute itself, however, gives the SEC, as the regulatory body responsible for administering and enforcing the Act, the authority to determine what conduct the fiduciary standard prohibits. The SEC can act through substantive rulemaking, enforcement actions, interpretive positions, SEC staff no-action letters, by taking positions in amicus briefs, and in other ways.³¹⁴ As a result of the *Santa Fe* footnote and the repeated incantation of the federal fiduciary duty, the SEC is no longer charged with implementing an anti-fraud prohibition. Rather, the Commission has a generalized mandate to address breaches of fiduciary duty and require advisers to act in the best interest of clients, as defined by the agency.

A federal duty has also led to enhanced liability for advisers under other laws. Fiduciary status was important in *Laird v. Integrated Resources, Inc.*, where the Fifth Circuit analyzed the standard of disclosure for advisers under Exchange Act Rule 10b-5.³¹⁵ In that case, three employees of LEM Construction Company served as trustees for the company's profit sharing plan. The trustees hired Jack Sorcic to assist with managing plan assets. Sorcic, however, failed to disclose that he also served as a registered representative of a broker-dealer and would earn commissions on any investments he recommended.³¹⁶ The plan suffered significant losses, and the plaintiffs sued Sorcic and other defendants when they learned that Sorcic was receiving commissions.

In determining whether disclosure, or lack of disclosure, constituted a breach of Rule 10b-5, the court asked whether the information disclosed would mislead a reasonable investor.³¹⁷ This inquiry turned on the status and sophistication of the parties, and it was important to the court that Sorcic was an investment adviser.³¹⁸ The court referenced Investment Advisers Act cases to illustrate an adviser's fiduciary status and the attendant duties of disclosure under the Advisers Act and the Exchange Act.³¹⁹ The court pointed out that

³¹³ See *supra* notes 161-163 and accompanying text.

³¹⁴ See Investment Advisers Act § 206(4), 15 U.S.C. § 80b-6(4) (2006) (providing Commission with broad authority to adopt rules reasonably designed to prohibit fraud); Advisers Act § 209, 15 U.S.C. § 80b-9(a)-(b) (2006) (providing Commission with broad authority to enforce the Advisers Act); JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIAL* 12-13 (2009) (listing mechanisms through which the SEC speaks).

³¹⁵ *Laird v. Integrated Res., Inc.*, 897 F.2d 826, 831-32 (5th Cir. 1990).

³¹⁶ *Id.* at 828-29.

³¹⁷ *Id.* at 832.

³¹⁸ *Id.*

³¹⁹ *Id.* at 833-34 & n.44.

other cases have also considered an adviser's fiduciary status when assessing liability under Rule 10b-5.³²⁰

The court could have held simply that the adviser violated Rule 10b-5 through misleading behavior. It went further, however, and stated that the adviser owed fiduciary duties. One consequence of considering an adviser's fiduciary status is that the court did not feel constrained by the state law of fiduciary relationships when assessing liability. Instead, the court referred to federal cases referencing the federal fiduciary standard, such as *Capital Gains* and *Transamerica*.³²¹ Courts may refer to these cases and not to state analogies when evaluating an adviser's conduct.

In a special concurrence, Judge Edith Jones observed the potential consequences of the court's statement that the adviser owed a fiduciary duty.³²² She questioned the significance of this approach, asking whether fiduciary status reduces the necessary threshold for scienter or materiality, or whether it might weaken the need to show that the conduct was "in connection with" the purchase or sale of securities, or that the plaintiff must show reliance.³²³ Judge Jones also warned that if courts created a separate category of cases for holding advisers liable under Rule 10b-5, they might effectively establish a private right of action for violations of the Advisers Act brought under the rubric of an Exchange Act challenge, a result disallowed by the Supreme Court in *Transamerica*.³²⁴

Congress has imposed a federal fiduciary duty in certain circumstances, but not for advisers. By holding that the Advisers Act imposed this duty absent a legislative mandate, the Court arguably breached the Constitution's division of authority between the legislative and judicial bodies.³²⁵ As a result of the rise of administrative agencies, Congress is no longer the exclusive federal lawmaker. Delegating power to administrative agencies, however, does not permit sharing power with the judiciary.³²⁶ Moreover, the fact that the Constitution permits sharing of legislative power with executive agencies does

³²⁰ *Id.* at 833-35 (discussing *SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985) and *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979), and stating that "*Blavin* and *Zweig* considered the investment adviser's fiduciary status in assessing liability under rule 10(b)-5").

³²¹ *Id.* at 837 & n.44.

³²² *Id.* at 844 (Jones, J., concurring).

³²³ *Id.*

³²⁴ *Id.*

³²⁵ U.S. CONST. art. I, § 1 ("All legislative Powers herin granted shall be vested in a Congress of the United States"); U.S. CONST. art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish.").

³²⁶ See Thomas W. Merrill, *The Common Law Powers of Federal Courts*, 52 U. CHI. L. REV. 1, 21 (1985).

not give the judiciary the ability to enhance Executive authority exercised by executive agencies.³²⁷

Aside from constitutional considerations, is placing a federal fiduciary duty on advisers desirable? A federal fiduciary duty has the advantage of predictability. There is little doubt that an investment adviser covered by the Act is considered a fiduciary. Arguments bearing on the advent of a fiduciary relationship, such as sophistication of the parties or communications between them, will be unavailing.³²⁸ All advisers are broadly considered fiduciaries. The federal fiduciary duty, however, lacks the flexibility of the common law.³²⁹ Courts implementing a common law fiduciary duty can respond to particular facts and modify the obligation as the industry develops.³³⁰ The danger of a federal duty, as mentioned, is that the agency in charge will acquire authority that is not clearly defined and that Congress did not necessarily intend. Indeterminate authority can result in vagueness in the law, the topic of the next section.

B. *Vagueness*

A second consequence of imposing a federal fiduciary standard is indeterminacy and vagueness regarding the source and content of fiduciary law. Vagueness might not be so baneful if the relief sought in adviser cases were only equitable in nature, such as the injunction sought in *Capital Gains*. Equitable relief, however, is rarely the sole remedy plaintiffs in these cases seek. In most actions brought under the Act, the SEC seeks monetary penalties,³³¹ and, on occasion, criminal penalties are sought by the United States Department of Justice as well.³³²

The vagueness doctrine articulated by the Supreme Court requires that a penal statute define offenses with sufficient clarity so that an ordinary person can understand what conduct is prohibited, and so that the statute does not lead

³²⁷ The SEC, as an independent agency, is not part of the Executive Branch. *See* 2 FEDERAL PROCEDURE, LAWYERS EDITION § 2:26 (2010). The same point, however, applies. The fact that the Constitution permits delegation of legislative power to the independent agencies does not give the judiciary the ability to enhance agencies' authority by rewriting the statutes they implement.

³²⁸ *See* Memorandum from Investor as Purchaser Subcommittee to Investor Advisory Committee 9 (Feb. 15, 2010) (on file with author).

³²⁹ *Id.*

³³⁰ *Id.*

³³¹ *See, e.g., SEC v. Wash. Inv. Network*, 475 F.3d 392, 398, 407 (D.C. Cir. 2007) (affirming district court's assessment of penalties of \$15,000 against individual and \$50,000 against advisory firm); *Geman v. SEC*, 334 F.3d 1183, 1196-97 (10th Cir. 2003) (discussing and upholding penalty of \$200,000).

³³² *See, e.g., United States v. Gilman*, 478 F.3d 440, 443 (1st Cir. 2007); *United States v. Elliott*, 62 F.3d 1304, 1307 & n.3, 1315 (11th Cir. 1995).

to arbitrary or discriminatory enforcement.³³³ The Investment Advisers Act has been a penal statute since enactment. According to the original law, any person who willfully violates the Act shall be fined not more than \$10,000, or imprisoned for not more than two years (now five), or both.³³⁴ Moreover, in 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act to include civil money penalties for advisers ranging from \$5,000 to \$500,000.³³⁵ The legislative history to the Remedies Act makes clear that monetary penalties were necessary to punish intentional violators and recidivists.³³⁶

1. Source of Fiduciary Law

Imposing a federal fiduciary duty on advisers introduces questions about the sources from which the content of the duty should be drawn. If the answer is state common law, one might draw fiduciary principles from tort, agency, or trust law, each of which contains its own background requirements with respect to fiduciary obligation. Tort law, for example, focuses on the duty of the fiduciary to give advice for the benefit of a principal.³³⁷ By contrast, agency law focuses on the principal's control over the agent.³³⁸ When analyzing an adviser's fiduciary duty, however, agency law might not be a good fit because the control dynamic is often reversed – the adviser exercises control over the investor, or at least over investor assets.³³⁹ Trust law, in contrast to tort and agency law, assumes a transfer of title of trust property and subjects the title-holder to equitable duties.³⁴⁰ If state law introduces too much ambiguity, one might ignore state law and draw the content of the fiduciary obligation strictly from Advisers Act cases and Commission and staff pronouncements in administrative materials. Yet another possibility is to look

³³³ *United States v. Williams*, 553 U.S. 285, 304 (2008); *Kolender v. Lawson*, 461 U.S. 352, 357 (1983).

³³⁴ Investment Advisers Act § 217, 15 U.S.C. § 80b-17 (2006) (mandating penalty of up to \$10,000 or two years incarceration, or both; the current version of the statute mandates the same financial penalty or five years incarceration, or both).

³³⁵ Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 402, 104 Stat. 931, 949 (codified as amended at 15 U.S.C. § 80b-9(e)(2) (2006)) (providing “tiers” of monetary penalties, from \$5,000 in first tier to \$500,000 in third tier).

³³⁶ H.R. REP. NO. 101-616, at 17-20 (1990) (“Providing authority to seek or impose civil money penalties would address the problem of recidivism by increasing the costs associated with repeated securities law violations.”); S. REP. NO. 101-337, at 10-11, 21 (1990).

³³⁷ *See, e.g., Grove v. Principal Mut. Life Ins. Co.*, 14 F. Supp. 2d 1101, 1112 (S.D. Iowa 1998); RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979).

³³⁸ *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (2006).

³³⁹ *See Laby, supra* note 30, at 131-32 (contrasting standard agency relationships with fiduciary relationships based on fiduciary's control over assets or affairs of the principal).

³⁴⁰ RESTATEMENT (THIRD) OF TRUSTS § 2 (2003).

to federal cases sketching fiduciary obligations in other areas with a strong fiduciary component, such as ERISA.³⁴¹

The ambiguity inherent in determining the source of the fiduciary duty was evident in *Geman v. SEC*.³⁴² In *Geman*, the court looked to state law of agency to ground section 206 liability and, at the same time, voiced frustration about the SEC's unwillingness to identify clearly the elements of a section 206 claim.³⁴³ Marc Geman was a registered investment adviser and CEO of Portfolio Management Consultants, Inc. (PCM). PCM offered wrap accounts, which are individualized managed accounts for which investors pay a single fee for brokerage, advisory, and custodial services, calculated as a percentage of assets in the account. Investors made investment decisions with the help of third-party portfolio managers who contracted with Geman's firm.³⁴⁴

As part of PCM's marketing materials, it held itself out as a fiduciary to customers.³⁴⁵ Sometime after the marketing campaign got off the ground, PCM changed its business practice. Instead of acting only on an agency basis executing transactions for customers with third parties, the firm began to act as principal, buying from or selling to customers from PCM's own inventory of securities when it was in the firm's interest to do so. Although the firm obtained customer consent for the change, the stated reasons for the change were new regulatory interpretations and technological improvements, neither of which was true. PCM failed to disclose that its real reason was to enhance profitability by trading as a principal.³⁴⁶

The court first turned to agency principles to hold that, regardless of whether PCM was acting as an adviser, a fiduciary relationship existed because customers were enticed by PCM's statement that it would act as a fiduciary.³⁴⁷ Then, in determining the duties PCM owed to customers, the court again invoked state law and the Restatement of Agency, which requires disclosure of all facts that have or are likely to have a bearing on the desirability of a transaction from the principal's point of view.³⁴⁸

Although the court referenced state law, it rejected Geman's argument the SEC was required, under the Advisers Act and other statutes, to prove the elements of common law fraud.³⁴⁹ The court, however, pointed out that the

³⁴¹ Sections 404 and 405 of ERISA establish fundamental fiduciary duties under the statute, such as loyalty, prudence, acting pursuant to relevant documents, and monitoring. Employee Retirement Income Security Act §§ 404, 405, 29 U.S.C. §§ 1104, 1105 (2006).

³⁴² 334 F.3d 1183 (10th Cir. 2003).

³⁴³ *Id.* at 1189-91.

³⁴⁴ *Id.* at 1185-86.

³⁴⁵ *Id.* at 1186.

³⁴⁶ *Id.* at 1186-87.

³⁴⁷ *Id.* at 1189.

³⁴⁸ *Id.* (quoting *Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 979 (10th Cir. 1996) (applying state law); RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)).

³⁴⁹ *Id.* at 1191.

Commission *has never stated* specifically what elements it *did* have the burden of showing.³⁵⁰ Instead, the SEC simply affirmed the administrative law judge's (ALJ) finding that the disclosures in the case violated the Investment Advisers Act and other securities law statutes.³⁵¹ The court seemed frustrated by this lack of clarity, but it affirmed the SEC's decision stating only that it was consistent with prior interpretations of the securities laws.³⁵²

One can analogize the vagueness concerns over the source of fiduciary law to concerns articulated in the "honest services" cases decided by the Supreme Court.³⁵³ This analogy requires a short detour into mail and wire fraud statutes. These laws criminalize use of the mails or wires in furtherance of any scheme or artifice to defraud.³⁵⁴ The phrase "'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services."³⁵⁵ In *Skilling v. United States*, the Government charged Jeffrey Skilling with, among other things, depriving Enron and Enron shareholders of the intangible right to his honest services.³⁵⁶ The defendant asked the Court to invalidate the "honest-services" provision of section 1346 in its entirety.³⁵⁷ The Court, however, searched for a limiting construction and held that the law covers only bribery and kickback schemes.³⁵⁸ Because Skilling's alleged misconduct did not include bribery or kickbacks, it did not fall within the prohibition of section 1346.³⁵⁹

In *Skilling*, the Supreme Court adopted a standard for honest services consistent with the standard that existed before the Court's decision in *McNally v. United States*.³⁶⁰ In *McNally*, the Court held that the mail and wire fraud laws were limited to the protection of property rights and could not be read to set standards of disclosure and good government.³⁶¹ Congress responded to *McNally* by amending the law to cover the intangible right to honest services.³⁶² Skilling challenged this honest services language from section 1346 for vagueness.³⁶³ In *Skilling*, the Supreme Court held that most pre-*McNally* cases involved fraudulent schemes to deprive one of honest services

³⁵⁰ *Id.*

³⁵¹ *Id.*

³⁵² *Id.* at 1192.

³⁵³ See *Skilling v. United States*, 130 S. Ct. 2896, 2925-26 (2010).

³⁵⁴ 18 U.S.C. §§ 1341, 1343 (2006).

³⁵⁵ 18 U.S.C. § 1346 (2006).

³⁵⁶ *Skilling*, 130 S. Ct. at 2908.

³⁵⁷ *Id.* at 2925.

³⁵⁸ *Id.* at 2933.

³⁵⁹ *Id.* at 2934.

³⁶⁰ 483 U.S. 350, 356-57 (1987); see *Skilling*, 130 S. Ct. at 2931.

³⁶¹ *McNally*, 483 U.S. at 359-60.

³⁶² *Skilling*, 130 S. Ct. at 2927.

³⁶³ *Id.*

through bribes or kickbacks, and according to the majority, if limited to these applications, the honest services language is not unduly vague.³⁶⁴

Skilling raised the issue of whether prosecutions under the honest services provision must be based on an underlying violation of state law.³⁶⁵ Similarly, one can ask whether an adviser's breach of the federal fiduciary standard must be based on an underlying violation of state law. The analogy to the honest services cases, however, gets its punch from Justice Scalia's concurrence. Scalia pointed out that *McNally* described the prior case law as holding that public officials owe fiduciary duties to the public and that misuse of public office for private gain is fraudulent.³⁶⁶ Justice Scalia was troubled by the emphasis on fiduciary law in this context. The pre-*McNally* cases, Scalia lamented, did not define the nature and content of the fiduciary duty in the fraud offense.³⁶⁷ There was no agreement, he wrote, regarding the source of the fiduciary duty. Possible sources include positive state or federal law, trust law, agency law, and general obligations of loyalty and fidelity inherent in the employment relationship.³⁶⁸ As a result, Scalia would have invalidated the law in its entirety as too vague under the Constitution to be enforced in a penal context.³⁶⁹

The federal fiduciary standard for advisers raises similar ambiguities in some cases. One can ask from where the SEC and the courts draw the content of the duty imposed. Possible sources include: (1) prohibitions against common law fraud, although this approach was rejected in *Capital Gains*; (2) prohibitions against fraud as defined by courts of equity – this was endorsed in *Capital Gains*, although most adviser cases today are penal; (3) general state law fiduciary obligations, although, as mentioned, these can vary; and (4) federal cases and statutes interpreting fiduciary duty with no input from state law. If *Capital Gains* were not read as stating that Congress imposed a federal fiduciary standard, courts would be restricted to interpreting the term fraud as encompassing (1) and (2).

2. Content of Fiduciary Law

In addition to confusion over the source of fiduciary law, a federal fiduciary standard raises similar questions over content. Courts disagree not only over where to look to find the law but also over the particular standard to impose in a given case. Application of a federal fiduciary standard also raises questions

³⁶⁴ *Id.* at 2932.

³⁶⁵ *Id.* at 2928 n.37.

³⁶⁶ *Id.* at 2936 (Scalia, J., concurring).

³⁶⁷ *Id.*

³⁶⁸ *Id.* at 2936-37. Justice Scalia was also troubled by the inability of the pre-*McNally* courts to determine who would be considered a fiduciary for purposes of applying the statute. *Id.* at 2937 n.1. This particular ambiguity is not a concern with regard to advisers because all are considered fiduciaries.

³⁶⁹ *Id.* at 2940.

about the extent to which the parties can agree to waive conflicts and other potential breaches. Finally, the ambiguity over the content of an adviser's federal fiduciary obligation raises questions under Dodd-Frank and the move to harmonize the law governing investment advisers and broker-dealers.

a. *The Scope of Fiduciary Obligation*

A federal fiduciary standard raises questions regarding the scope of duties it imposes. Because there is no laundry list of conduct covered by the term fiduciary obligation, the answer to this question is critical to help individuals and firms guide their conduct.³⁷⁰ The Fifth Circuit has held that the federal fiduciary duty for advisers does not include all breaches of fiduciary trust, although it did not say exactly what conduct was covered.³⁷¹ In *Steadman v. SEC*, the Commission wanted the court to consider violations of section 36(a) of the Investment Company Act when assessing sanctions for violations of the Investment Advisers Act.³⁷² Section 36(a) of the Investment Company Act gives the SEC express authority to bring an action against certain persons, including an investment adviser, for breach of fiduciary duty with respect to an investment company.³⁷³ The section, therefore, expressly establishes a federal fiduciary duty for certain persons with regard to their actions related to investment companies. The SEC sought to bootstrap the fiduciary duty of section 36(a) onto the fiduciary duty owed by advisers under the Advisers Act.³⁷⁴

The Fifth Circuit rejected the Commission's approach, stating that the federal fiduciary standard does not include all breaches of fiduciary obligation.³⁷⁵ Under *Steadman*, courts may not look to every fiduciary obligation to instantiate the duties imposed by the Investment Advisers Act, but the contours of the obligations imposed were not specified. The court said only this: "We do not think this overall purpose [of the Act] is a warrant to read sections 206(1) and (2) of the [Act] . . . as the vehicle to reach all breaches

³⁷⁰ See, e.g., Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1049 (1991) ("[I]n the constantly changing environment of a fiduciary relationship, the agent's obligations must be articulated in general and open-ended terms"); Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 456 (2010) ("My only point is that an open-ended broker fiduciary obligation is so loaded with unanswered questions that baseline predictability would come slowly, if at all."); Irit Samet, *Guarding the Fiduciary's Conscience – A Justification of a Stringent Profit-stripping Rule*, 28 OXFORD J. LEGAL STUD. 763, 780 (2008) ("The point of the open-ended locutions which are used in the formulation of fiduciary duties is to leave room for discretion in conditions of uncertainty, and to relieve the fiduciary from commitment to concrete results in such circumstances.").

³⁷¹ *Steadman v. SEC*, 603 F.2d 1126, 1141 (5th Cir. 1979).

³⁷² *Id.*

³⁷³ Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-35 (2006).

³⁷⁴ *Steadman*, 603 F.2d at 1141.

³⁷⁵ *Id.* at 1142.

of fiduciary trust The Commission may impose sanctions only for violations of the statutes assigned to its jurisdiction”³⁷⁶

A federal fiduciary standard is likely to differ from state law fiduciary principles and from state law principles of fraud; the question is how. The *Laird* case discussed above suggests that the federal fiduciary duty is not as far-reaching as the state common law of fiduciary obligation.³⁷⁷ But in *Santa Fe*, Justice White was concerned about the opposite: a federal fiduciary duty might be broader than state law because of the quest for uniformity. Justice White explained that federal courts applying a “federal fiduciary principle” under Rule 10b-5 might *depart* from state fiduciary standards to ensure uniformity within the federal system.³⁷⁸ This could lead to a stricter standard of fiduciary obligation than that required by some states.

The example Justice White provided is that some states require a valid corporate purpose before a short-form merger can occur; others do not. If Rule 10b-5 required a valid corporate purpose, then federal law would be stricter than that of some states.³⁷⁹ The same concern arises in the advisory context. Federal courts applying a federal standard might depart from state law fiduciary principles that would otherwise be applicable in order to mirror obligations imposed by another jurisdiction.

The Supreme Court struggled over the content of fiduciary duty for advisers in another context, section 36(b) fee litigation for investment companies, mentioned above.³⁸⁰ In *Gartenberg v. Merrill Lynch Asset Management, Inc.*, the Second Circuit described the duty as one to charge a fee “within the range of what would have been negotiated at arm’s-length in light of all the surrounding circumstances” and to avoid a fee “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”³⁸¹ The Supreme Court took up the *Gartenberg* standard in *Jones v. Harris Associates, L.P.*, where the plaintiffs challenged the advisory fees that Harris Associates charged three mutual funds it managed.³⁸² Although holding that *Gartenberg* was “correct in its basic formulation,” the Court pointed out that the meaning of section 36(b)’s reference to fiduciary duty with respect to the receipt of compensation was “hardly pellucid.”³⁸³

During oral argument, the Justices appeared frustrated with the lack of clarity to the term fiduciary. Justice Stevens asked, “Do you think the fiduciary status of the defendant in this case is different from the fiduciary

³⁷⁶ *Id.*

³⁷⁷ *See supra* Part III.A.2.

³⁷⁸ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977).

³⁷⁹ *Id.* at 479 n. 16.

³⁸⁰ *Jones v. Harris Assoc., L.P.*, 130 S. Ct. 1418 (2010).

³⁸¹ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

³⁸² *Jones*, 130 S. Ct. at 1424.

³⁸³ *Id.* at 1426.

status of a president of a corporation?”³⁸⁴ Justice Kennedy questioned, “Is the fiduciary standard the same for Jones, for a guardian, for a trustee, for a corporate officer or a corporate director, always the same?”³⁸⁵ Later he added, “[I]t seems to me an odd use of the term ‘fiduciary.’ I don’t know why Congress didn’t use some other word.”³⁸⁶ The irony of course is that Congress avoided the word fiduciary in the Investment Advisers Act, yet courts must abide the ambiguity of the fiduciary formulation as a result of *Santa Fe* and *Transamerica*.

Perhaps the most ubiquitous example where courts must apply a federal fiduciary standard with no direct legislative guidance is the law of insider trading. No federal statute directly prohibits insider trading. The SEC, starting in 1961, pursued insider trading cases under the general antifraud provision of the Securities Exchange Act, section 10(b), and Exchange Act Rule 10b-5.³⁸⁷ Insider trading cases rely heavily on fiduciary principles. Under the classical theory, company insiders, who have obtained material non-public information, owe a fiduciary duty to company shareholders and, therefore, must disclose the information or abstain from trading with the shareholders.³⁸⁸ Under the misappropriation theory, non-insiders, who do not necessarily owe a duty to company shareholders they trade with, are liable for insider trading if, by misappropriating material information, they breach a fiduciary duty to the source of the information.³⁸⁹

The law of insider trading, therefore, is arguably a shining example of the courts’ ability to live with the vagueness of federal fiduciary principles. The law of insider trading, however, is hardly an example of clarity, and its fiduciary foundation is unstable. Over the past several years, the SEC and the courts appear to be backing away from a reliance on fiduciary principles in insider trading cases.³⁹⁰ Professor Donna Nagy has explained that lower federal courts and the SEC have effectively concluded that the crux of the insider trading offense is simply wrongful use of information and the fiduciary obligation is relevant only to establish that a use is wrongful; it is not essential to an underlying violation.³⁹¹ In *SEC v. Dorozhko*, the Second Circuit stated explicitly that a computer hacker can engage in deceptive conduct under

³⁸⁴ Transcript of Oral Argument at 27, *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586).

³⁸⁵ *Id.* at 6.

³⁸⁶ *Id.* at 19.

³⁸⁷ See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010). The first SEC action was *In re Cady Roberts & Co.*, Exchange Act Release No. 8-3925, 1961 WL 59902 (Nov. 8, 1961).

³⁸⁸ *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

³⁸⁹ *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

³⁹⁰ See Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1320 (2009).

³⁹¹ *Id.*

section 10(b) and Rule 10b-5 and breach the prohibition against insider trading although the hacker did not breach a fiduciary duty in obtaining the information.³⁹²

There have long been questions about the fiduciary foundation of the insider trading prohibition. Under the classical theory, for example, it seems difficult to justify a duty to non-shareholders when a company insider is selling as opposed to buying shares.³⁹³ Under the misappropriation theory, there would arguably be no liability if a fiduciary disclosed to the source that he planned to trade on the information because disclosure would vitiate the deception required under the Exchange Act.³⁹⁴ Yet it is hard to imagine the SEC would not pursue an insider trading case just because the fiduciary notified the source that he was trading. The issue of waiver in insider trading cases raises a broader concern about waiver of a federal fiduciary duty by advisers. If the duty is statutory, waiver might not be an option.

b. *Waiver*

The establishment of a federal fiduciary obligation also raises questions regarding the ability to waive aspects of an adviser's duty. Unlike a duty based on state law enforced through application of the Advisers Act, a duty created by the Act itself is more difficult to waive. In the former case, a court would look to state law to decide whether waiver is appropriate. In the latter, waiver is also governed by an anti-waiver provision in the Act: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void."³⁹⁵ Thus, the Act contains a mandatory backdrop against which the effectiveness of any waiver or "hedge" clause must be evaluated.³⁹⁶ The

³⁹² SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) ("Having established that the SEC need not demonstrate a breach of fiduciary duty, we now remand to the District Court to consider, in the first instance, whether the computer hacking in this case involved a fraudulent misrepresentation that was 'deceptive' within the ordinary meaning of Section 10(b).").

³⁹³ Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951), quoted in *Chiarella*, 445 U.S. at 227 n.8 (stating that it would be a "sorry distinction to allow [the seller] to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one").

³⁹⁴ *O'Hagan*, 521 U.S. at 655 ("[I]f the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . .").

³⁹⁵ Investment Advisers Act § 215(a), 15 U.S.C. § 80b-15(a) (2006).

³⁹⁶ The SEC has long been skeptical about hedge clauses. In an Opinion of General Counsel from 1951, the SEC stated that the antifraud provisions, including section 206 of the Advisers Act, is violated by a hedge clause that is "likely to lead an investor to believe that he has in any way waived any right of action he may have . . ." Opinion of General Counsel, Relating to Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisers, and Others, Securities Act Release No. 231, 16 Fed. Reg. 3387 (proposed Apr. 10, 1951).

SEC would undoubtedly be skeptical of any provision of an advisory agreement that detracts from the substance of an adviser's obligation.³⁹⁷

Contrast this position with the state law of agency and trust.³⁹⁸ Under the Third Restatement of Agency, conduct that would otherwise constitute a breach of fiduciary duty is permitted as long as the principal consents and the agent acts in good faith, discloses material facts likely to affect the principal's judgment, and otherwise deals fairly with the principal.³⁹⁹ Similarly, the Third Restatement of Trusts provides that the terms of a trust may authorize the trustee, expressly or by implication, to engage in transactions that would otherwise be prohibited by the duty of loyalty. A trustee, for example, may personally purchase trust property, borrow trust funds, or sell or lend personal property or funds to the trust.⁴⁰⁰

A general federal fiduciary duty is akin to other duties already established under the Act, such as a duty to register with the SEC or to maintain books and records. Thus, a contract limiting an adviser's fiduciary duty raises questions under the anti-waiver provision in the statute. By contrast, if the Act were interpreted merely to prohibit fraud, an adviser and a client could more readily negotiate the scope of the adviser's fiduciary obligation. The question of whether advisers and clients can waive fiduciary duties is a highly charged issue in legal scholarship and turns in part on one's definition of fiduciary.⁴⁰¹

Although this Interpretive Release is entitled Opinion of General Counsel, it was a statement by the Commission itself. More recently, the SEC staff has relaxed its view. In a no-action letter from 2007, the staff stated that legality of a hedge clause limiting an adviser's liability to acts of gross negligence or willfulness would depend on all of the surrounding facts and circumstances. The staff suggested that it would examine several factors in its determination, such as the form and content of the hedge clause, communications about the hedge clause, and the circumstances of the client. *See* Heitman Capital Mgmt., LLC, SEC No-Action Letter, 2007 WL 789073 (Feb. 12, 2007).

³⁹⁷ An example of the SEC staff's skepticism is Auchincloss & Lawrence Inc., SEC No-Action Letter, 1974 WL 10979 (Feb. 8, 1974). The staff rejected an adviser's attempt to limit liability in an advisory contract to matters of "gross negligence or wilful malfeasance." *Id.* Thus, attempting to limit misconduct to gross negligence and willful malfeasance violates section 206 of the Act.

³⁹⁸ HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION 38 (2d ed. 2004) ("It is well-established, both in the law of trusts and the law of agency, that the informed consent of a beneficiary or principal makes conduct lawful that would otherwise be a breach of the duty of loyalty.")

³⁹⁹ RESTATEMENT (THIRD) OF AGENCY § 8.06 (2006).

⁴⁰⁰ RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(2) (2007).

⁴⁰¹ Compare FRANKEL, *supra* note 25, at 373 ("[C]ontract would relieve or water down fiduciaries of certain duties, for example, the duty to act solely for the benefit of the entrustors."), with Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 215 (2005) ("Fiduciary duties are a type of contract term that applies, in the absence of a contrary agreement, where an 'owner' who controls and derives the residual benefit from property delegates open-ended management power over property to a 'manager.'").

The introduction of a federal fiduciary duty, however, seems to militate against waiver and, therefore, leans toward a mandatory approach.

c. *Dodd-Frank and a Fiduciary Duty for Broker-Dealers*

The federal fiduciary approach for advisers presents ambiguities in implementing section 913 of the Dodd-Frank Act.⁴⁰² Section 913(g), entitled Authority to Establish a Fiduciary Duty for Brokers and Dealers, amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to authorize the SEC to establish enhanced duties for brokers. Section 913(g)(2) of Dodd-Frank amends section 211 of the Investment Advisers Act to allow the SEC to adopt rules providing that the standard of care for brokers, dealers, and advisers, shall be to act in the “best interest” of their customers.⁴⁰³

One question posed by this provision is whether it allows the SEC to establish a federal fiduciary duty for advisers (as well as brokers and dealers). The answer would surely be *yes* if a “best interest” standard were equivalent to a standard of fiduciary responsibility. According to some authority, a “best interest” standard is analogous to a fiduciary obligation.⁴⁰⁴ There is also reason to believe, however, that a duty to act in another’s “best interest” is not co-extensive with a fiduciary duty and is, rather, one component of a broader set of duties.⁴⁰⁵ In one common formulation, the fiduciary must act “with the highest degree of honesty and loyalty toward another person *and* in the best interests of the other person”⁴⁰⁶ One could imagine instances when a fiduciary might believe it is in the principal’s best interest for the fiduciary to lie to the principal. Lying, however, would be prohibited by the fiduciary obligation but not necessarily by a “best interest” standard. ERISA is another example of where fiduciary and best interest standards diverge. An ERISA fiduciary must investigate all decisions that will affect the plan *and* act in the beneficiaries’ best interest, suggesting that the duty to act in others’ best interests is only one of several fiduciary duties.⁴⁰⁷ If a best interest standard is not the same as a fiduciary standard, then Dodd-Frank section 913(g)(2) does not necessarily authorize the SEC to impose a fiduciary obligation on brokers, dealers, and advisers.

⁴⁰² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824-30 (2010).

⁴⁰³ *Id.* § 913(g)(2), 124 Stat. at 1828-29.

⁴⁰⁴ *See, e.g.,* Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 348-49 (1985).

⁴⁰⁵ In other cases, the fiduciary obligation might require one to act in a way that the fiduciary believes is not in the principal’s best interest. *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. b (2006). In that case, best interest would not be a sub-duty within fiduciary duty, but rather it would lie outside it.

⁴⁰⁶ BLACK’S LAW DICTIONARY 581 (9th ed. 2009) (emphasis added).

⁴⁰⁷ *Schaefer v. Ark. Med. Soc’y*, 853 F.2d 1487, 1491 (8th Cir. 1988).

Additional difficulty in understanding what Congress meant in Dodd-Frank arises from other amendments to section 211 of the Advisers Act. Section 913(g)(1) of Dodd-Frank amends the Exchange Act to allow the SEC to adopt rules providing that a broker or dealer, when giving personalized investment advice about securities to a retail customer, must follow the same standard of conduct that advisers follow under section 211 of the Advisers Act.⁴⁰⁸ According to amended section 211, new rules, if adopted, must provide that the standard of conduct applicable to broker-dealers be “no less stringent” than the standard applicable to advisers under sections 206(1) and 206(2) of the Advisers Act.⁴⁰⁹

The mischief worked by the *Santa Fe* footnote is now squarely before the SEC. The term fiduciary duty appears only in a title in Dodd-Frank.⁴¹⁰ Instead of referencing a fiduciary standard in the text of the statute, Congress referred to the standard applicable under sections 206(1) and (2).⁴¹¹ The question then is what is the meaning of the statutory cross-reference to sections 206(1) and (2). One possibility is that Congress simply cross-referenced the words contained in those provisions, which, as discussed, simply provide a prohibition on fraud and do not announce a federal fiduciary duty. Another possibility is that the cross-reference to sections 206(1) and (2) includes the Supreme Court’s gloss on those provisions in *Santa Fe* and *Transamerica*.

These two possibilities present a thorny question of statutory construction. On the one hand, one might be skeptical that any legislature is aware of judicial interpretations of a statutory provision that the legislature included in a cross-reference. On the other hand, in this particular case, a “fiduciary duty” for broker-dealers was the subject of discussion and debate that gave rise to the provision in the first place.⁴¹² Moreover, when Congress passed Dodd-Frank, it captioned the relevant provision “Authority to Establish a Fiduciary Duty for Brokers and Dealers.”⁴¹³ How much one can make of the title, however, is an open question. As long ago as 1892, the Supreme Court stated that courts can consider the title of an act when determining the legislature’s intent.⁴¹⁴ But titles are only relevant insofar as a statute is ambiguous. More recently, the

⁴⁰⁸ Dodd-Frank § 913(g)(1), 124 Stat. at 1828.

⁴⁰⁹ 124 Stat. at 1828-29.

⁴¹⁰ 124 Stat. at 1828.

⁴¹¹ *Id.*

⁴¹² See U.S. DEP’T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71 (2009), available at http://205.168.45.55/docs/regs/Final_Report_web.pdf (“We propose the following initiatives to empower the SEC to increase fairness for investors: *Establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers.*”).

⁴¹³ Dodd-Frank § 913(g), 124 Stat. 1828.

⁴¹⁴ *Church of the Holy Trinity v. United States*, 143 U.S. 457, 462 (1892) (“Among other things which may be considered in determining the intent of the legislature is the title of the act.”).

Supreme Court held that the title of a statute cannot limit its plain meaning, only to clarify ambiguity.⁴¹⁵ Because Congress avoided using the term “fiduciary duty” in the text of the statute, it is certainly possible that Congress also intended to avoid imposing a federal fiduciary duty on broker-dealers and instead intended for the SEC to impose duties consistent with those imposed under section 206 of the Investment Advisers Act. This discussion has shown that the duties owed by advisers under section 206 are vague, as to both source and content, as a result of the Court’s statements that the Advisers Act imposes federal fiduciary duties.

Is vagueness necessarily bad? Concerns over arbitrary or discriminatory enforcement can be balanced against arguments in favor of an optimal amount of vagueness in the law. According to Gillian Hadfield, vagueness may promote compliance with the law if, from an economic view, a decrease in the chance of liability achieved by overcompliance is significant enough to offset the cost of overcompliance.⁴¹⁶ From an institutional view, different individuals interpret a vague statute differently. This variability could be socially desirable because it can lead to variability in the types of cases heard by courts and regulators, giving them more information about the regulated activity and enhancing their ability to develop the law or to perform their regulatory function.⁴¹⁷ Jeremy Waldron has explained that the very debate over vague terms is itself socially valuable by putting forward diverse views, reviewing examples, developing arguments, and responding to opponents.⁴¹⁸ There is little doubt that courts’ and regulators’ understanding of the duties owed by lawyers, trustees, directors, partners, advisers, and other fiduciaries has been deeply enriched over the years through the multiplicity of views expressed in books, articles, symposia, and conferences on the nature of the fiduciary relationship.⁴¹⁹

C. *The Remedy*

Courts have held that the Investment Advisers Act imposes a federal fiduciary duty on advisers. This has expanded advisers’ obligations and created ambiguity in the law. Does the remedy for this development, if a remedy is sought, lie with Congress or the courts? Under a theory of legislative acquiescence, only Congress can change the precedent established by *Santa Fe* and *Transamerica*. Under this theory, the principle of stare decisis is strong in statutory interpretation cases because parties shape their

⁴¹⁵ Pa. Dep’t of Corr. v. Yeskey, 524 U.S. 206, 212 (1998) (quoting Bhd. of R.R. Trainmen v. Baltimore & Ohio R.R. Co., 331 U.S. 519, 528-29 (1947)).

⁴¹⁶ Gillian K. Hadfield, *Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law*, 82 CALIF. L. REV. 541, 544 (1994).

⁴¹⁷ *Id.* at 548-49.

⁴¹⁸ Jeremy Waldron, *Vagueness in Law and Language: Some Philosophical Issues*, 82 CALIF. L. REV. 509, 531-32 (1994).

⁴¹⁹ *Id.* at 532.

conduct based on courts' constructions of a statute but, unlike in Constitutional matters, Congress can correct judicial errors through additional legislation.⁴²⁰ Congress amended the Advisers Act several times after *Santa Fe* was decided but it did not correct the Court's interpretation.⁴²¹ Another reason for having strong stare decisis in statutory cases is consistency. A legislature might be unlikely to act if laws that fall out of favor can simply be interpreted away. Under this view, once a court has made a decisive interpretation, the construction effectively becomes part of the statute. A change to the interpretation is akin to amending the law and must be done by the legislature.⁴²²

Others reject legislative acquiescence and would accord statutory precedents normal stare decisis effect.⁴²³ Under this view, Congress may not be aware of the courts' interpretation. Or it might be aware of the interpretation and disagree, but lack the political will to change it.⁴²⁴ A leading case is *Girouard*

⁴²⁰ See *Patterson v. McLean Credit Union*, 491 U.S. 164, 172-73 (1989) ("Considerations of *stare decisis* have special force in the area of statutory interpretation, for here, unlike in the context of constitutional interpretation, the legislative power is implicated, and Congress remains free to alter what we have done."); *Monell v. Dep't of Soc. Servs. of N.Y.*, 436 U.S. 658, 714-15 (1978) (Rehnquist, J., dissenting) ("As this Court has repeatedly recognized, . . . considerations of *stare decisis* are at their strongest when this Court confronts its previous constructions of legislation. In all cases, private parties shape their conduct according to this Court's settled construction of the law, but the Congress is at liberty to correct our mistakes of statutory construction, unlike our constitutional interpretations, whenever it sees fit."); *Edelman v. Jordan*, 415 U.S. 651, 671 (1974) ("Since we deal with a constitutional question, we are less constrained by the principle of *stare decisis* than we are in other areas of the law.").

⁴²¹ See, e.g., Amendments to the Investment Advisers Act of 1940, Pub. L. No. 96-477, §§ 201-203, 94 Stat. 2275, 2289-90 (Oct. 21, 1980); Amendments to the Investment Advisers Act of 1940, Pub. L. No. 100-181, §§ 701-707, 101 Stat. 1249, 1263-64 (Dec. 4, 1987).

⁴²² See EDWARD H. LEVI, AN INTRODUCTION TO LEGAL REASONING 32 (1949) ("[O]nce a decisive interpretation of legislative intent has been made, and in that sense a direction has been fixed within the gap of ambiguity, the court should take that direction as given. In this sense a court's interpretation of legislation is not dictum. The words it uses do more than decide the case. They give broad direction to the statute."); see also Frank E. Horack, Jr., *Congressional Silence: A Tool of Judicial Supremacy*, 25 TEX. L. REV. 247, 251 (1947) ("After the decision, whether the Court correctly or incorrectly interpreted the statute, the law consists of the statute *plus* the decision of the Court.").

⁴²³ See, e.g., William N. Eskridge, Jr., *Overruling Statutory Precedents*, 76 GEO. L.J. 1361, 1409 (1988) ("In my view, statutory precedents are entitled only to normal stare decisis effect. Thus, the Supreme Court can overrule them if they are clearly wrong, produce bad policy consequences, and have not generated an undue amount of public and private reliance.").

⁴²⁴ See *id.* at 1405 (providing multiple reasons for Congressional failure to act when reviewing a court's interpretation of a statute). For a discussion of this and related topics, see OTTO J. HETZEL, MICHAEL E. LIBONATI & ROBERT F. WILLIAMS, LEGISLATIVE LAW AND

v. United States.⁴²⁵ In that case, the Supreme Court corrected a previous interpretation regarding a provision of the Nationality Act of 1940.⁴²⁶ The issue was whether the oath demanded by the Nationality Act required the oath-taker to bear arms in defense of the Constitution when Congress did not amend the law to change the rule of previous cases.⁴²⁷ The Court stated, “It is at best treacherous to find in congressional silence alone the adoption of a controlling rule of law. We do not think under the circumstances of this legislative history that we can properly place on the shoulders of Congress the burden of the Court’s own error.”⁴²⁸

Some courts have opted for a nuanced approach suggesting that even if one generally agrees with legislative acquiescence, there might be reasons in particular cases to overrule statutory precedent.⁴²⁹ One reason to overrule is the emergence of an intervening development in the law, through case law or further action by Congress, which weakens the conceptual foundation of the prior case.⁴³⁰ Another reason to overrule is that the precedent may be detrimental to “coherence and consistency” in the law because of “inherent confusion created by an unworkable decision.”⁴³¹ Both of these criteria appear relevant. *Santa Fe* and *Transamerica* were intervening developments in the law and led to confusion over what is covered by the Advisers Act.

A discussion of acquiescence might be irrelevant if, in Dodd-Frank, Congress effectively ratified a federal fiduciary standard for advisers. Does the reference to harmonizing the law and placing a fiduciary duty on brokers constitute an affirmance of a federal duty? Although this question cannot be answered with certainty, the reference in Dodd-Frank cannot be considered an adoption of the rule of *Santa Fe* and *Transamerica*. There are several reasons for this. As a preliminary matter, Congress avoided the substantive issue and instructed the SEC to study the matter and adopt rules if needed. Thus, the most one can say is that Congress authorized the SEC to impose a federal fiduciary duty, not that Congress did so.

In addition, as mentioned, Congress only used the phrase fiduciary duty in a title, referring to the authority to establish a fiduciary duty on brokers.⁴³² It is a strain to assume from this title alone, which touches only broker-dealers, that

STATUTORY INTERPRETATION: CASES AND MATERIALS 653-68 (4th ed. 2008).

⁴²⁵ 328 U.S. 61 (1946).

⁴²⁶ *Id.* at 69.

⁴²⁷ *Id.* at 63.

⁴²⁸ *Id.* at 69-70.

⁴²⁹ *Patterson v. McLean Credit Union*, 491 U.S. 164, 173 (1989).

⁴³⁰ *Id.* (“Where such changes [in the law] have removed or weakened the conceptual underpinnings from the prior decision . . . or where the later law has rendered the decision irreconcilable with competing legal doctrines or policies . . . the Court has not hesitated to overrule an earlier decision.”).

⁴³¹ *Id.*

⁴³² *See supra* Part III.B.2.c.

Congress agreed to a federal fiduciary duty for advisers. Third, the relevant provision gives the SEC authority to require advisers, as well as brokers and dealers, to act in clients' best interests. As indicated above, a "best interest" standard is not the same as a fiduciary standard.⁴³³ Fourth, the authority to place additional duties on brokers and advisers is limited to the context where they provide "personalized investment advice . . . to retail customers."⁴³⁴ Providing personalized advice to retail customers is only a segment of the business of brokers and advisers and, therefore, the argument for acquiescence based on Dodd-Frank does not include an argument that all advisers should be considered fiduciaries to their clients all of the time.

Finally, the fact that Congress avoided using the word fiduciary or the phrase fiduciary obligation in the statute is telling. It appears almost as if Congress went out of its way to use cross-references to sections 206(1) and (2) and alternative phrases, such as "best interest," just to avoid stating explicitly that the SEC had authority to impose a "fiduciary" duty on brokers and advisers. The omission of the fiduciary phraseology is at least as persuasive as the argument for ratification. Perhaps Congress felt no need to mention advisers' fiduciary duty because the SEC and the courts have repeated many times that the duty exists. If that were true, however, one would expect Congress to refer to advisers' fiduciary duty directly instead of sidestepping the question.

CONCLUSION

The *Capital Gains* case continues to have a profound influence on the law governing investment advisers nearly a half-century after the Court's decision. The case often is cited for the proposition that Congress established a federal fiduciary duty for advisers when it passed the Investment Advisers Act in 1940. A careful reading of the Act and its legislative history, however, demonstrates that although Congress recognized certain advisers to be fiduciaries, it did not create or impose a fiduciary duty on advisers.

Moreover, the *Capital Gains* case itself did not state that the Advisers Act created a fiduciary duty. Rather, the federal fiduciary duty was a creation of subsequent Supreme Court decisions, such as *Santa Fe Industries v. Green* and *Transamerica Mortgage Advisers v. Lewis*, which stated, in reliance on *Capital Gains*, that the Advisers Act created a federal fiduciary obligation.

After *Santa Fe* and *Transamerica*, the law governing advisers has developed against a backdrop of a federal duty, which has had important implications for advisers. The duty has expanded liability for advisers beyond liability for fraud, which is the prohibition adopted by Congress in the Advisers Act, and the duty has introduced vagueness into the law governing advisers with respect to both the source and the content of the duty imposed. Although these

⁴³³ *See id.*

⁴³⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g)(1)-(2), 124 Stat. 1376, 1828-29 (2010).

implications might not necessarily be negative, there is little question that the Court did not carefully consider them when it stated that the Act imposed a federal fiduciary obligation.

Because the duty is a creature of case law and not of Congress, one might ask what, if anything, must be done to change it. This inquiry raises difficult questions of the role of stare decisis in statutory cases. Those who believe the legislature has acquiesced in the law as expressed by the courts would require any change to come from Congress. Others do not believe in legislative acquiescence and maintain that courts should be free to overrule precedent. Finally, even those who accept the acquiescence argument might not employ strict stare decisis where precedent has created confusion and inconsistency in the law – and confusion has arisen as courts try to fathom what is required under the federal fiduciary standard. As a result, courts as well as Congress should be free to reexamine the federal fiduciary duty under the language of the Advisers Act.