

THE REGULATION OF  
BROKERS, DEALERS, ADVISERS AND FINANCIAL PLANNERS

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**I. Introduction**

Congress has given the Securities and Exchange Commission (“Commission”) some serious homework in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>1</sup> First, the Commission is required to study the standards of care for brokers, dealers and advisers and consider the elimination of the broker exclusion from the Advisers Act of 1940 (“Advisers Act”).<sup>2</sup> In addition, the Commission must evaluate the impact of imposing on brokers the duties of the Advisers Act.<sup>3</sup> That imposition would include the duty of loyalty, acting for the best interests of the clients and avoiding conflicts of interest.<sup>4</sup> I will deal summarily with the differences between the duties currently imposed on advisers and brokers and their origins. I note that in today’s financial world there are individual brokers, broker-dealers, advisers and financial

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> *Id.* at §§ 913(b)(1)-(2) (“The Commission shall conduct a study to evaluate . . . the effectiveness of existing legal or regulatory standards of care for brokers, dealers, [and] investment advisers . . . [and] whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers.”).

<sup>3</sup> *Id.* at §§ 913(c)(9)-(9)(A) (stating that the Commission “shall consider” the “potential impact of imposing upon brokers, dealers, and persons associated with brokers or dealers . . . the standard of care applied under the Investment Advisers Act of 1940).

<sup>4</sup> *Id.* at §913(g)(1) (stating that the Commission may promulgate rules to establish a fiduciary standard for broker-dealers, including requirements to “act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice[, that] . . . any material conflicts of interest shall be disclosed[, and that the] . . . standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities . . .”).

planners, as well as large groups and networks of brokers, dealers, advisers, financial planners, underwriters, creators of securitized assets, managers of “dark exchanges,” and traders for their own account. I name the conglomerates and any parts of the conglomerate services “brokers, etc.”

Second, Congress authorized the Commission to establish a fiduciary duty for brokers in providing retail clients with personalized investment advice.<sup>5</sup> I understand this fiduciary duty to be similar to the fiduciary duty imposed on investment advisers under the Advisers Act and the common law, and will present the definition of investment advice and the general fiduciary duties of advisers under the Act.

Congress authorized the Commission to promulgate “additional rules, where appropriate, regarding sales practices, conflicts of interest and compensation schemes” with respect to brokers, “when providing personalized investment advice about securities to a retail customers (and such other customers as the Commission may by rule provide).”<sup>6</sup> The standard of conduct the Dodd-Frank Act requires for such brokers with respect to such customers “shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Advisers Act of 1940.”<sup>7</sup> I believe and will argue that it is crucial to impose such rules not only on brokers, etc., who advise “retail customers,” but also on brokers, etc. who advise institutional investors, even though these investors are what we call “sophisticated.”

Third, the Commission should establish rules that impose on brokers a duty to disclose to investors the terms of their relationships with investors, including conflicts of interest.<sup>8</sup> The clients’ consent after appropriate disclosure may relieve brokers, etc. from the prohibition on conflict of interest.<sup>9</sup> I will discuss the impact of this

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<sup>5</sup> *Id.* at § 913(f)-(g) (providing the Commission with rulemaking authority to “establish a fiduciary standard for brokers and dealers”).

<sup>6</sup> *Id.* at § 913(g)(1).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* (“The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers . . . [and] . . . [i]n accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer.”).

<sup>9</sup> *Id.* (“[A]ny material conflicts of interest shall be disclosed and may be consented to by customers.”).

disclosure when the client consents to the fiduciary's conflict of interest.

Fourth, Congress provided guidelines for the Commission's enforcement.<sup>10</sup> This provision raises a number of questions. Does enforcement include FINRA's enforcement on the one hand and state regulation of investment advisers (large and small) on the other hand? Will FINRA's rules and the Commission's rules preempt state laws? Currently, there are two entities that regulate brokers: FINRA and the Commission as its supervisor. There are two entities that regulate advisers: The Commission and the states (over advisers that advise small amounts). Would brokers and advisers be subject to the advisers' regime or would small advisers be subject to the brokers' regime? I consider these questions to be serious and will deal with them in the last part of this article.

## ***II. Who Are Fiduciaries?***<sup>11</sup>

A fiduciary may be defined as a person (or institution) that provides a service that requires expertise and is socially important. Moreover, the service[s] cannot be performed without the clients' entrustment of property or power or both. A broker cannot perform his services without entrustment of the clients' money and/or securities. Entrusted property and power are given to the fiduciary for the sole purpose of performing his duties. In addition, a fiduciary's services cannot be guided by itemized directives. Therefore, the fiduciary must have discretion. Brokers' clients bear a number of risks: One risk is misappropriation of entrusted property and power. The other, although lesser, risk is that fiduciaries will not perform their job well, as promised—this is the duty of care. Tight controls and even monitoring of fiduciaries can undermine the utility of the service. The cost of preventing abuse of entrustment may exceed the benefits from the relationships.

Therefore, the purpose of the law is to induce entrustors to enter into relationships with fiduciaries by reducing their risks. It should be noted that the remedies for breach of fiduciary duties

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<sup>10</sup> *Id.* at § 913(h) (defining the Commission's enforcement "with respect to violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer . . .").

<sup>11</sup> See Tamar Frankel, *Fiduciary Law* Ch. 1 (Oxford University Press) (2010).

include punitive damages, accounting for the fiduciary's profits (even if the investors were not damaged), injunction, constructive trust and specific performance. This is in contrast to a breach of contract, which involves mainly damages.

**There Is No Doubt That Brokers Are Fiduciaries.** Brokers are fiduciaries with respect to the money and power that is entrusted to them for trades. Brokers who manage “sweep accounts” are fiduciaries with respect to the management of the accounts as well.<sup>12</sup> When brokers present themselves and act as advisers, they are fiduciaries with respect to their advice. If they present themselves as experts, they are liable with respect to their expertise. A broker who tells the client that “auction of thirty year notes” are like cash must know precisely what these notes mean.

**What if brokers, etc. have conflicts of interest with their clients?** In such a case the law allows brokers, as for any fiduciary, to fully disclose the conflicting interests and enable the clients to consent to the conflicts or deny consent. Congress required the Commission to promulgate rules that impose on brokers a duty to disclose to investors the “terms of the investors’ relationships” with the brokers and advisers “(including conflicts of interest).”<sup>13</sup> If the investors understand the conflicts of interest and are not dependent on the adviser[s], the investors may rely on the advisers or bid them goodbye. Otherwise, advisers’ advice may not involve conflicting interests. Much depends on how these conflicting interests are disclosed. An effective disclosure must be in writing, short, clear and

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<sup>12</sup> *Nelson v. Serwold*, 687 F.2d 278, 282 (9th Cir. 1982) (“Agency is the fiduciary relation which results from the joint manifestation of consent by one person that another shall act on his behalf and subject to his control, and of consent by that other so to act.”) (citing *Grace Line, Inc. v. Todd Shipyards Corp.*, 500 F.2d 361 (9th Cir. 1974); *see id.* at 282 (“The agent acts for or on behalf of the principal and subject to his control, and his acts are those of the principal.”) (citing *NLRB v. United Brotherhood of Carpenters*, 531 F.2d 424 (9th Cir. 1976)); RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958) (“Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”); RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (“[T]he agent shall act on the principal’s behalf . . .”).

<sup>13</sup> Dodd-Frank Act § 913(g)(1) (“The Commission may promulgate rules [establishing a broker-dealer fiduciary standard, and] . . . [i]n accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer.”).

highlight the danger of the conflict to the client. The brokers must bear the burden of the client's understanding of the conflict.

**The duty to disclose may be viewed as the reversal of the contract principle of *caveat emptor*.** The law governing the distribution of securities presents a hybrid. The issuer or the brokers provide information about the proposed security and the client must decide whether to buy. However, attempts to educate investors in evaluating the offered securities have failed. Investors do not examine and often cannot understand the nature of the security that is being offered. Perhaps educating brokers, etc. and their registered representatives to give client advice for the clients' sole interests may be more successful.

In the context of fiduciary law, if fiduciary duties are default rules, then disclosure of the nature of the conflicts merely entitles the clients to consent to the conflicts and thereby change the prohibitions applicable to fiduciaries. In this context, congressional requirements would allow disclosing brokers, etc. to maintain their conflict of interest provided they disclose it.

However, disclosure of conflicts of interest must be delivered in a certain way: (1) The disclosure must be in writing, and (2) The disclosure in writing must be read to the client orally and other statements may not conflict with the written words. To this end the brokers, etc. ought to read to the client the statement. This can be done electronically as well. The purpose of the exercise is to ensure that the client gets the message. But it may well be that even such a process will not be effective if, for example, the broker, etc. jokes about the procedure and winks to the client to signal that this is a silly exercise imposed by the government. If, after a trial period, such communication proves futile, then other forms of effective communications must be tried. There are serious flaws concerning the disclosure solution. One enormous flaw is that clients who entrust their money and securities to advisers are hardly ever likely to mistrust their brokers' advice. The other flaw arising from disclosure is that such disclosure relieves brokers of self-limitations on conflicts of interest, especially when clients agree.

**III. What is “investment advice” under the Advisers Act? And what are the fiduciary duties of advisers under the Act?**

Under the Advisers Act, “investment advice” includes advice as to the advisability or the desirability “of investing in, purchasing or selling securities.”<sup>14</sup> “[I]t is sufficient that advice is generally concerned with investments in securities” and not “on particular securities.” Moreover, “an insurance agent who refers potential clients to an adviser for a fixed fee per client may be an adviser if the agent introduces the two [, as] [a]n introduction to an adviser implies advice that securities investment is desirable . . . .”<sup>15</sup>

A stock-charting service including data on high, low and closing prices, and volumes might constitute advice as to the value and advisability of investing in securities and analyses, or reports concerning securities. The inclusion of trend lines and corresponding recommendations of transactions in securities as part of the service constitutes investment advisory services. The service of periodically consolidating data of a subscriber’s own portfolio may be investment advice.”

Currently, registered representatives of a broker dealer “need not register as advisers for distributing materials describing a subscription bookkeeping system that monitors all assets of a particular subscriber, assisting potential subscribers in preparing financial input data, and receiving compensation from the operator of the services . . . .”<sup>16</sup> In fact, it is “the exercise of discretion by the adviser that gives rise to opportunity for abuse and consequently to fiduciary duties . . . .”<sup>17</sup>

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<sup>14</sup> 15 U.S.C. § 80a-2(20) (2006).

<sup>15</sup> TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS* §§ 3.01-12 (2d ed. 2001) (footnotes omitted).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* The definition of an adviser covers advice on any securities, except exempt securities specified in section 202(a)(11)(E). In the opinion of the staff, an adviser rendering advice concerning investments in certificates of time deposits, which are exempt from registration under the 1933 Act registration requirements, would probably have to register under the Advisers Act. This aspect of the definition may raise the question whether the instruments are securities. For example, the status of swaps, loan participations, and other derivatives is unclear. It may be that the time has come to clarify their status and since they are bought for investments they should not be treated differently from any other security.

**How will these definitions relate to brokers, etc.?** If they speak, orally or in writing, or through other communication means, and if they suggest, note, or render clients to notice specific securities, they are advisers. Thus, brokers, etc. that list thousands of mutual fund shares for clients “free” and receives benefits from those managed funds that were placed at the top would have been within the definition of an adviser.<sup>18</sup> An agreement such as the one in which Charles Schwab requires clients to sign should be held ineffective if the document allows Schwab to change the terms of the agreement and the customer consents in advance to these changes, especially if the customer is required to follow and be aware of the changes. It is an incredible document that presumably no one in his right mind would sign, and yet it seems that customers sign it. I doubt whether educating the customers not to sign any of such “disclosure” documents would be effective. Customers either trust or mistrust. And if they mistrust, they will no longer be customers.

**IV. *Should Fiduciary Duties be Imposed on Brokers’ Advice to Those Other Than “Retail Customers”? Such as Institutional Investors, Including Those Who May Be Sophisticated?***

Congress granted the Commission discretion to impose fiduciary duties on brokers that serve other than retail clients.<sup>19</sup> I believe that it is crucial to impose fiduciary duties on all brokers, etc. regardless of whether their clients are what we call sophisticated, and even if they manage millions of dollars of investors’ money, or the citizens’ money, and even if they are themselves fiduciaries.

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<sup>18</sup> Charles Schwab Corp. Managed Accounts, <http://www.aboutschwab.com/about/facts/managed-accounts.html> (last visited Nov. 7, 2010) (stating, for example, that “[m]ore than 14,500 funds are available in . . . [Charles Schwab’s] Mutual Fund Marketplace, including more than 11,000 with no loads or transaction fees.”).

<sup>19</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(f), 124 Stat. 1376, 1827 (2010) (“The Commission may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers . . .”).

Here are my reasons:

**First, institutions hold and manage the savings of millions of Americans, both investors and citizens.** Any harm done to a single institutional investor affects far more individuals than the harm to a “retail investor,” his family and business. Brokers, etc. that mislead one investor or a thousand individual investors cannot threaten the system as much as brokers, etc. that mislead one institutional investor representing thousands of citizens in a municipality or tens of thousands of savers whose money is in their pension funds.

**Second, institutional investors are not much better off than individuals with respect to understanding some complex investments.** And who knows what other investments are in the pipeline as we speak? In fact, while retail investors deal mostly with registered representatives, institutional investors deal with the truly large prestigious brokers, etc. that cover under their umbrella brokers, dealers, underwriters, creators of securitized assets, managers of “dark exchanges,” and various other services. So long as sophisticated investors do not know what else is being prepared in the factory of financial assets they may not be able to judge the value and right price of the financial assets that are being offered to them. And sometimes they might know but perhaps not understand.

**The example of the Deutsche Bank debacle is instructive.** This large bank engages in hedge fund activities. Yet, it bought from Goldman Sachs, as broker, a financial asset created by Goldman Sachs—the securitization expert and originator—which asset contained “junk” for which Goldman Sachs the expert was paid, and against which Goldman Sachs the trader placed a bet that it would fail. Goldman Sachs manages “dark exchanges,” yet according to its “business model” it may, and indeed must, trade on the information that it gathers from all these activities. Nonetheless, it claims not to be a fiduciary of its clients. They are, after all, sophisticated.

**Sophistication does not mean hiring private detectives to find out whether the seller is doing what Goldman Sachs did to Deutsche Bank.** And market price is not always an indication of the level of risk. The seller may know far more about the level of risk that the sold securities pose. More importantly, I am not sure that Deutsche Bank will do business with Goldman Sachs in the future. If it does, its managers may attempt to “pay Goldman back” in another transaction either directly or indirectly. Or it may avoid not only Goldman Sachs but any broker in the United States for sometime to



come. Other actors may adopt the same attitude. But the most dangerous case for investors and the financial system is when institutional investors flock to such an investment bank and are not aware and perhaps cannot be aware of its “business model” and the investors’ possible losses. Presumably, so long as the losses are not outrageous, they will be swept under the rug, as has happened quite often. A system of this sort is bound to crash.

**Third, humans are creatures of habit.** Brokers are no exception. Brokers should learn to have a knee-jerk reaction when faced with conflicts of interest and seek to avoid it. If brokers are given the choice depending on the type of client they serve, they will not fully reform their bad habit that some of them now possess.

**Fourth, the nature of trading has changed since the 1930s.** Market prices no longer represent the aggregate judgment of thousands of individuals.<sup>20</sup> Technology has enabled some brokers, etc. to trade faster than any human can. Some of these machine-and-automatic trading systems have created very different market prices. “Quote stuffing” was not known in the 1930s or even later.<sup>21</sup> This technique can cause market prices to fall steeply in a second. Investors, who trade directly or through their managers during that second, may sustain serious losses. This is not the market price that we understood it to be in the 1940s. Therefore, the time has come to focus not only on what the investors understand but also, and perhaps mainly, on what brokers, etc. do, their motivations and techniques, and in what kind of culture they live and work.

Institutional investors—those who represent thousands of investors—are in dire need of protection concerning their investments. Municipalities—those who represent both employees and citizens—are in dire need of protection concerning their investments. If institutional investors (which are non-retail investors)

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<sup>20</sup> Cass R. Sunstein, *Group Judgments: Deliberation, Statistical Means, and Information Markets*, 80 N.Y.U. L. REV. 962, 1023 (2005) ([T]he great advantage of the price signal is that it aggregates both the information and the tastes of numerous people, producing judgments that incorporate more material than could possibly be assembled by any central planner, even one who insists on deliberation with and among experts . . . their aggregate judgments are likely to be right . . .”).

<sup>21</sup> Tom Lauricella & Jenny Strasburg, *SEC Probes Cancelled Trades: Regulators Looking Into Role “Quote Stuffing” May Have Played in Flash Crash*, WALL ST. J., Sept. 2, 2010, at A1 (defining “quote stuffing” as “trading in which unusually large numbers of orders to buy or sell stocks are placed in a fraction of a second, only to be canceled almost immediately.”).

cannot fend for themselves and protect themselves against the conflicting interests of brokers, or if their cost of protection against abuse of entrustment is higher than the efficiencies for the brokers, etc., then the law should interfere and even induce the dismantling of the efficient “business model.”

In sum, brokers, etc. and their various actors are fiduciaries regardless of their clients’ nature. Brokers are subject to the duty of loyalty—to avoid conflicts of interest—unless clients receive full disclosure and give full and knowledgeable consent. Members of brokers, etc. are fiduciaries depending on their functions and their conflicting interests. Their clients—individuals or institutions—ought to know the details of these conflicts. In many cases, however, disclosure is not sufficient and clients’ consent is ineffective. Therefore, there should be a list of conflicts which are not subject to clients’ waivers. They should be prohibited without exceptions. Alternatively, the Commission or its staff, rather than the client, could render consent upon request.

**V. *The Main Issue: Enforcement. Who Will Write the Rules? Who Will Enforce the Rules and How?***

Three crucial issues are involved regarding enforcement: (1) Would the Commission write the rules or would FINRA continue to write the rules subject to the Commission’s supervision?; (2) will the Commission’s rules and FINRA rules preempt fiduciary laws under state laws?; and (3) how should the current enforcement systems of brokers and advisers be unified?

**A. *Who Would Write the Rules and How Should the Rules Be Structured?***

Under the current system, FINRA writes the rules and the Commission approves them. Congressional directives seem to suggest that the Commission should write the rules. This is a most important difference. The Commission could use this opportunity to impose fiduciary duties on brokers, etc.—who are also dealers, advisers, the creators of securitized financial assets, underwriters, organizers of auction notes and dark exchanges and investment bankers. The regulation of such actors is not difficult in principle: They should be required to disclose their conflicts to sophisticated clients and avoid such conflicts or seek the Commission’s consent for retail clients. Then these brokers, etc. can continue their business

as usual. But if they do not disclose all conflicts, and if they do not make sure that the clients (retail and otherwise) understand these conflicts and not only the proposed investments, they should be liable under the securities acts for fraud. In addition, they should be liable, as all fiduciaries are, to pay punitive damages, account for their ill-gotten profits and be subject to injunctions.

The Commission's rules can take two forms. The rules can be very general, in which case the judging authorities would be required to apply these general rules to the specific cases. The decision making power will then be split between the Commission and the judges or arbitrators that interpret the rules. In the case of groundbreaking new rules, parties may be concerned with this shift in the decision making power. To avoid this result, perhaps the rules' interpretations can be expressed as staff no-action letters or interpretative letters approved by the Commission. However, the process of "filling in the more detailed substance of a rule" is fraught with difficulties. Actors should know the details of the law and press for guidelines.

Alternatively, the Commission can follow a legislation structure, which has applied for many years under the Investment Company Act of 1940 ("Investment Company Act"). The rules can establish highly restrictive mode of behavior, similar to that of the Investment Company Act, which is tremendously detailed. In that case, the Commission should have authority to exempt with various conditions both the actors and their required activities. The exemption process can emulate that of the Investment Company Act. This system is valuable both to allow brokers, etc. to expand their activities, subject to the Commission's exemptions or staff no-action letters and to limit at the same time activities which are not to be permitted in light of congressional mandate and the lessons of the past years' disasters.

Finally, brokers, etc. should not be allowed to trade on non-public information that they gleaned from any of their clients, regardless of the capacity in which they served. This rule exists on the books today and the Commission is pursuing enforcements. Nevertheless, I thought this should be mentioned.

**Remedies. Rules without remedies are dead letter law.**

The Advisers Act contains many remedies, and the Commission can resort to them. One particularly effective remedy, because to some extent it is self-executing, is the principle of "skin in the game." Brokers, etc. are not guarantors. Nevertheless, they gain upon the completion of the transaction, while investors can sustain enormous

losses later on. Therefore, brokers, etc. should collect their benefits after a “cooling period.” One example of this approach was adopted in section 27 of the Investment Company Act. It was quite successful and effective. That section required brokers who sold mutual fund shares in installments to wait for their commissions until the investors covered not only the brokers’ commissions but also continued payment for some time. Brokers were then interested in selling these mutual funds only to people who[m], they believed, could afford to pay the installments. That, in fact, reduced the brokers’ ardor to sell to persons who could not afford the price of the shares. A similar rule should not be imposed on brokers, etc. Let brokers, etc. invest a small percentage—say 2%—in whatever they sell to customers. That would be evidence that they “put their money where their mouth is.” They should be permitted to cash these amounts after a period of time, say, a year.

### **B. Preemption**

The Securities Exchange Act of 1934 preserves state law on the subject matter and does not preempt state fiduciary law claims.<sup>22</sup> However, a number of state courts have declared that their state laws have been preempted by the federal securities acts, including FINRA rules, because they were established under the Securities Exchange Act of 1934. Once State courts have determined that state laws were preempted, they do not seek to enforce federal laws. For example, the Supreme Court of New York held that the SEC was the “appropriate regulatory agency” for the national securities exchange and its members. The legislative history suggested that Congress intended to preempt state interference with a self-regulating organization’s regulatory functions through implementing regulations of the SEC. The Exchange Act established a scheme of regulation of the securities marketplace that combined self-regulation by the securities exchanges with oversight and direct regulation by the SEC. Accordingly, to allow appellee’s claims against the national securities exchange arising out of its disciplinary functions would clearly

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<sup>22</sup> *Papic v. Burke*, 965 A.2d 633, 642 (Conn. App. Ct. 2009) (stating that “no language in the Securities Act” of 1933 or the Securities and Exchange Commission’s “Regulation D” preempted Connecticut State law, § 36b-4(a)). *See* 15 U.S.C. §78bb(a) (2006) (providing that generally “the rights and remedies provided by [the Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity.”).

“stan[d] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,” which was “essentially to encourage stringent self-regulation of the securities industry.”<sup>23</sup> It is interesting that the court did not note the specific section in the Securities Exchange Act, which expressly preserved state law, but rather implied congressional intent from the legislative history.

Similarly, the Supreme Court of Minnesota held that Minnesota state law regarding agency and statutory consumer protection provisions were impliedly preempted by the Commission’s rules when applied to broker.<sup>24</sup> The NASD (now FINRA) code was held to have preempted California state law.<sup>25</sup> In these cases the plaintiffs could not resort to state laws as well as to state courts.

If the Commission enacted a rule imposing fiduciary duties on brokers, would the rule preempt state law and state courts protection of clients unless otherwise expressly provided by the rules? Would the Commission-approved FINRA rules preempt not only state laws but also their state enforcement? The greatest care should be taken to assure that the imposition of fiduciary duties on brokers, etc. directly or by eliminating the exemptions of the brokers from the provisions of the Advisers Act or by creating a new enforcement method for brokers, etc. does not weaken or eliminate States’ enforcement of fiduciary law.

### C. Unification of the Enforcement System

**The main issue concerning brokers, etc. is not whether they are fiduciaries; they are and always were.** The crucial issue is how their duties will be enforced. The Commission has an opportunity to break through the wall of weak enforcement to a true and effective enforcement of brokers, etc.’s fiduciary duties.

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<sup>23</sup> *Bantum v. Am. Stock Exch., LLC*, 7 A.D.3d 551, 553-53 (N.Y. App. Div. 2004).

<sup>24</sup> *Dahl v. Charles Schwab & Co., Inc.*, 545 N.W.2d 918, 920-21 (Minn. 1996) (concluding that “the SEC rules impliedly preempt the application of Minnesota’s common law of agency and statutory consumer protection provisions.”).

<sup>25</sup> *Jevine v. Super. Ct. of Los Angeles*, 111 P.3d 954, 965 (Cal. 2005) (“SEC approval will have preemptive effect if the SEC intended that the rule prevail over conflicting state law and if the SEC’s decision was not arbitrary or in excess of its statutory authority.”).

I assume that unification of an enforcement system means that the duties of all brokers, etc. will be enforced in the same way, subject to the same type of “judge and jury.” Currently, there are two entities that regulate broker dealers: FINRA and Commission as its supervisor. There are two entities that regulate advisers: The Commission and the States (over advisers that advise small amounts). Would brokers and advisers be subject to the advisers’ regime or would advisers over \$25 million, currently regulated by the states, be subjected to the brokers’ regime? I consider these issues to be the most serious issues as compared to any of the topics discussed.

#### **VI. *Who should be the enforcer?***

**Arbitration.** One possible enforcement unification mechanism will lock all claims against brokers, etc. into a unified enforcement by arbitration. Public policy favors arbitration as a desirable form of dispute resolution. But in order to render it the only form of dispute resolution, one should be careful to make it an effective one. Otherwise the law would be meaningless.

One possibility is to establish an independent organization that would manage arbitrations of investors and brokers, etc., including class actions and other procedures determined by the Commission and let state laws fiduciary duties continue to be applied. Federal courts are likely to continue playing the current role and, since the Commission’s rules will not be open to private rights of action, the federal courts will have a small part in the enforcement. Time will tell whether this enforcement mechanism is effective.

But regardless of who manages the arbitration, that regime must be truly effective. There are three conditions that would strengthen the arbitration process and render it trustworthy. First, allow class actions. Right now there are no class actions in arbitration under the FINRA system. That is likely to allow brokers, etc. to recruit expensive legal talent that some plaintiffs who assert small claims (the ones that Congress seems to be concerned about most) cannot. Therefore, any arbitration system, no matter who manages it, must include the plaintiff’s right to a class action, excluding frivolous claims.

Second, publicize the arbitrators’ decision and their rationale. For arbitrations to obtain a semblance of law, the decisions and rationales of the arbitrators must be publicized in an accessible form. Note that Commission’s staff no-action letters have acquired a measure of precedent. Implied is the assumption that an arbitrary

deviation from a previous reasoning would not be approved by a higher authority, whether a court or congress.

Last, prohibit retroactive avoidance of existing decisions as precedents except in very special cases accompanied by good explanations. One reason for the added authority of no-action letters is the Commission's announced policy that it will not overrule the staff's no-action letters retrospectively. A similar rule that provides a semblance of a precedent should apply.

Arbitrations governing issues concerning brokers, etc.'s fiduciary duties towards their clients should comply with these three conditions.

### ***VII. Change the attitude.***

We should recognize that the year 2010 was fundamentally different from the 1930s and 1940s. The time has come to cease educating investors and instead educate brokers, registered representatives and large investment banks. They must be educated about fiduciary law and conflicts of interest and their own accountability to the country and the financial system.

A new segment in the broker-dealers examinations should be designed to teach future brokers, etc. not only what the law is and what the consequences of breaking the law could be. Brokers, etc. must be repeatedly taught that the money they hold does not belong to them and that their advice must be for the sole benefit of their clients. Brokers, etc. may disclose their conflicts to their clients by telling the clients the truth, the whole truth and nothing but the truth and ask whether the clients would follow their advice after this disclosure. In addition, and just as important, those who serve in truly diversified brokers, etc. should take a special exam that would teach them what fiduciary law is and what their role as fiduciaries in their organizations as well as the remedies for violations of these duties could be.<sup>26</sup>

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<sup>26</sup> Jim Ware, *The Challenge of Ethical Leadership*, CFA MAGAZINE, July-Aug. 2009, at 10 (acknowledging that "investment leaders are far too modest about their ability to make a difference in the ethical arena" and that "[l]eaders must realize their importance in providing a solution to the ethical dilemma").

### ***VIII. Conclusion***

Legal research would easily classify brokers, etc. as fiduciaries, even when they invest their own money in ventures such as dealerships. Like every type of expert fiduciary, these intermediaries have far more information and knowledge than most of their clients. Financial assets are sufficiently complex to require commitment to expertise. Therefore, regardless of the particular aspect of their service and “business model” which includes numerous activities, brokers, etc. are fiduciaries, no different from lawyers and physicians and far closer to trustees who hold other people’s money and affect other people’s financial fortunes.

Few beneficiaries can control their trustees. Few investors can truly understand their brokers, etc. and explore how the investors’ money is used. Moreover, brokers, etc. have become the creators of financial assets as well, thus leaving investors nothing to check by real assets (such as a business or manufacturing issuer). No investor, not even the most sophisticated one can truly evaluate any of these financial assets, and especially the documents that shift not merely promises to pay on a specific date but documents to pay if the other obligor have failed to pay.

Therefore the contract model with which we tinkered for sixty years should be eliminated. The burden can no longer be imposed on investors but must be differently balanced. Brokers, etc. have been affecting the financial system and the lives of too many millions for too long. The time has come to impose on them a duty to their customers and to the country. To be sure, others have contributed to the plight of us all. And each of us must bear the burden of correction. Brokers, dealers, underwriters, advisers and financial managers as well as institutional traders must bear their burden. Fiduciary law, in existence today, is the appropriate and tested tool. If agents, money managers, advisers, lawyers, doctors, teachers and corporate managements have lived well under this legal regime, there is no reason for financial intermediaries to live outside it, especially if they pretend to be part of the fiduciaries’ group.

Brokers, etc. should understand that they hold other people’s money, and can affect our financial and economic systems. They must exercise self-restraint as fiduciaries, rather than as contract



parties.<sup>27</sup> What requires the most fundamental change is the culture of the financial intermediaries. What can bring it about is of course their leadership.<sup>28</sup> But leadership can be helped in this mission by the law which would require them to match their purported behavior as trusted institutions with their real behavior as truly trusted institutions. The Securities and Exchange Commission's rules, its clear aim and its enforcement can introduce and induce this culture and strengthen it.

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<sup>27</sup> *Id.* at 12 (stating that “[p]eople tend to view ethical conflicts as aberrations—distractions from ‘real’ work”, but asserting that ethical conduct is part of the “job”).

<sup>28</sup> See JOHN C. BOGLE, ENOUGH. TRUE MEASURES OF MONEY, BUSINESS, AND LIFE 159 (John Wiley & Sons, Inc. 2009) (observing that most of the larger corporations are “overmanaged but underled” and it is accurate “not only with respect to our nation’s businesses, but to our financial institutions as well.”).