FIDUCIARY DUTY AND INVESTMENT ADVICE: WILL A UNIFORM FIDUCIARY DUTY MAKE A MATERIAL DIFFERENCE?

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INTRODUCTION

Debate continues over whether stockbrokers ("Brokers") should be bound by the same fiduciary duties as registered investment advisers ("Advisers") when advising their clients about which securities to purchase.[1] Although both advise retail clients about securities, their duties

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1. Numerous scholars and practicing lawyers have weighed in on whether and when Brokers should be bound by fiduciary duties. *See* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1 (2012); Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U.L. Rev. 1265 (2011); Christine Lazaro, *Fiduciary Duty - Now and in the Future*, 17 PIABA B.J. 129,

and compensation structures differ. These different standards and compensation structures affect the advice and guidance investors receive. At the individual level, different standards may cause an investor to purchase one product and not another. At the macroeconomic level, the advice investors receive about how to allocate their capital will ultimately influence how financial markets allocate large amounts of capital. Despite this, most ordinary investors do not understand the different standards applicable to Brokers and Advisers and often do not even know whether their personal financial adviser is one or the other.[2]

To be sure, Brokers and Advisers do differ in material ways. At present, Brokers receive commission compensation and must comply with the suitability rule created and enforced by the Financial Industry Regulatory Authority ("FINRA").[3] Although FINRA's suitability rule imposes meaningful duties upon Brokers, it does not explicitly require that Brokers provide advice in the best interests of their clients or obligate them to monitor their clients' accounts on an ongoing basis.[4] Unlike Brokers, Advisers receive fees for their advice.[5] Decisions interpreting the Investment Advisers Act of 1940 (the "Advisers Act") have found that it creates a federal fiduciary duty and requires them to advance their clients' best interests and monitor their clients' accounts on an ongoing basis.[6]

What does this mean in more practical terms? When giving advice, an Adviser's fiduciary duty obligates her to advance her clients' best interests by selecting suitable securities for an account, taking into consideration the price of those securities and management fees. Because the Adviser

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132 (2010); Steven D. Irwin et. al., *Wasn't My Broker Always Looking Out for My Best Interests? The Road to Become A Fiduciary*, 12 DUQ. BUS. L.J. 41 (2009); Donald C. Langevoort, *Brokers As Fiduciaries*, 71 U. PITT. L. REV. 439 (2010); Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 713 (2012); Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59 (2010); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 10 COLUM. BUS. L. REV. 710 (2010); Tamar Frankel, *The Regulation of Brokers, Dealers, Advisers and Financial Planners*, 30 REV. BANKING & FIN. L. 123 (2010); Graham Ravdin, *One Step Forward, Two Steps Back: Arguing for A Transatlantic Investor Protection Regime*, 50 COLUM. J. TRANSNAT'L L. 490, 524 (2012).

2. *See* Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 FORDHAM J. CORP. & FIN. L. 203, 215 (2011) ("Investors . . . are generally uncertain about the distinction between investment advisers and broker-dealers.")

3. *See* Wrona, *supra* note 1, at 5 (discussing different fee structures). Of course, state law may impose additional requirements.

4. *See* Lazaro, *supra* note 1, at 132 ("[T]he suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer's best interest.").

5. *See* Wrona, *supra* note 1, at 5.

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

receives compensation for giving advice, she does not make more or less money depending on which security her customer purchases. Brokers, on the other hand, receive commission compensation and may make more money for selling one product over another. Nonetheless, Brokers must also take cost into account when determining what securities might be suitable for a particular client and must seek to minimize the cost of transactions when possible.[7] For example, a Broker might recommend a mutual fund with a 3% initial sales charge and annual management fees of 0.65% even if a low-cost index fund might also be suitable. Many such index funds may be purchased online for an $8 fee and an ongoing management fee of 0.09%. If both products are suitable for a customer, should we expect Brokers to advise their clients to purchase index funds online and give advice for free?

To protect investors and reduce confusion, many advocates now press to extend to Brokers a form of the fiduciary standard governing Advisers.[8] Indeed, a portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") attempts to address these concerns by requiring the Securities and Exchange Commission (the "Commission") to consider harmonizing the standards of conduct for Brokers and Advisers by creating a uniform fiduciary standard.[9] Notably, Dodd-Frank approved the commission-based compensation structure by providing that a Broker's commission "shall not, in and of itself, be considered a violation of [any fiduciary duty] applied to a broker-dealer" and that a broker-dealer would not be required to have a "continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."[10] This raises a practical question. Can a standard truly be uniform with differing compensation structures and no continuing duties? The scope of Dodd-Frank's contemplated uniform obligations appears quite narrow. It will also undoubtedly lead to uneven outcomes for investors as the disparate incentive structures will lead to different advice.

Joining the fray, the Department of Labor, which administers the Employee Retirement Income Security Act ("ERISA"), has also proposed that a strict fiduciary standard be applied to all recommendations concerning assets held within retirement accounts.[11] Industry voices object that binding Brokers with fiduciary duties will increase the cost of their

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7. *See* Wrona, *supra* note 1, at 28.

8. *See* Laby, *supra* note 1.

9. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 913 addresses the regulation of Brokers and Advisers.

10. *Id.*

11. *See* Tara Siegel Bernard, *Seeking To Toughen The Rules For Brokers,* N.Y. TIMES, Nov. 2, 2013, at B1.

services and might cause many of them to stop taking smaller clients, making it more difficult for the public to secure investment advice.

This Essay explores current law and suggests reforms to craft a more equitable system. To provide context, Part I overviews the current legal frameworks governing Advisers and Brokers and explains the circumstances in which Brokers may already be bound by continuing fiduciary duties when giving advice. Part II examines what behavior "fiduciary duty" may actually require and explores different meanings of the term. Part III discusses the Commission's proposal for a uniform fiduciary duty and argues that more meaningful investor protection could be achieved by flattening Broker commissions across products.

I. CURRENT LEGAL FRAMEWORKS

Although they both serve retail investors, two different, overlapping Depression-era regulatory schemes govern Advisers and Brokers.[12] The Advisers Act, as interpreted by the Supreme Court, imposes a federal fiduciary duty.[13] A different statute, the Securities Exchange Act of 1934 (the "Exchange Act"), regulates Brokers and broker-dealers and requires Brokers to provide "suitable" advice to retail customers about securities transactions.[14]

As explained by Professor Arthur Laby, the distinctions between Brokers and Advisers may have made more sense in the Depression era.[15] At that time, Brokers primarily "performed their standard functions of executing trades, selling securities, making loans, maintaining custody of client funds and securities, arranging for delivery of certificates, performing record-keeping functions, and providing advice incidental to the performance of brokerage services."[16] In other words, Depression-era Brokers were often order-takers. In contrast, Advisers, in that period as today, provided "investment advice, including portfolio selection, asset allocation, portfolio management, selection of other advisers, and financial planning."[17] As technology and time have transformed the securities industry, these tidy distinctions have collapsed.[18] Today, a Broker's business revolves around giving investment advice and proposing transactions which serve their clients' needs.

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12. *See* Lazaro, *supra* note 1, at 131-32.
13. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-94 (1963).
14. *Id.* at 186-87.
15. *See* Laby, *supra* note 1, at 729–35.
16. *Id.*
17. *Id.*
18. *See id.*; *see also* Nicholas S. Di Lorenzo, *Defining A New Punctilio of an Honor: The Best Interest Standard for Broker-Dealers*, 92 B.U. L. REV. 291, 303-09 (2012) (tracing the convergence of Brokers and Advisers).

A. Advisers

In the aftermath of the 1929 stock market crash and the Great Depression, Congress passed a series of laws intended to regulate the securities markets and prevent the abusive practices which many felt had caused the crash and the Depression. Immediately after the Pecora hearings which cast light on corrupt practices leading up to the Great Depression, Congress passed the Securities Act of 1933 (the "Securities Act") to require public disclosure of material facts in the initial offerings and sales of securities.[19] A year later and still in the crisis, it passed the Exchange Act to regulate broker-dealers and Brokers.

Passed in 1940, the Advisers Act differs from other Depression-era legislation. Unlike the Securities Act or the Exchange Act, the Advisers Act emerged after a period of study and reflection and not in response to crisis and industry scandal.[20] In passing it, Congress sought to protect the public and to protect Advisers from the "stigma" generated by "unscrupulous tipsters and touts."[21] Still, the Advisers Act does share some relevant characteristics with earlier legislation because it also seeks "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[22]

The Advisers Act's provisions reach broadly to include both registered and unregistered Advisers. Although certain exceptions exist, it defines the term "investment adviser" to include:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities….[23]

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19. For a lively description of the Pecora hearings, see Michael Perino, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE (2011). The Securities Act is codified at 15 U.S.C.A. § 77a (West 2014).

20. S. REP. NO. 76-1775, at 1 (1940).

21. *Id.* at 21.

22. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). Some authors have begun to question whether disclosure alone will suffice to adequately protect investors. *See* Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1105 (2011) ("There are now many, many studies which tend to indicate that mandated disclosure as a remedy—whether one addresses physicians' disclosures to patients, lenders' disclosures to borrowers, broker-dealers' disclosure to investors, or cops' disclosures to criminals (the Miranda warnings)—is often ineffective.").

23. 15 U.S.C.A. § 80b-2 (West 2014). As discussed below, the definition does contain some exemptions, including one for Brokers.

The Advisers Act requires Advisers to eliminate or disclose conflicts of interests. Its drafters believed that Advisers "could not 'completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed.'"[24] In particular, the Advisers Act sought to prohibit or force the disclosure of any "conflicts of interest which might incline an investment adviser consciously or unconsciously to render advice which was not disinterested."[25]

Despite these broad principles, conflicts of interest may also bias Advisers and influence the advice they provide. Advisers charging a flat yearly fee per account or an asset-based fee do not necessarily receive additional compensation for doing additional work. This raises the risk that an Adviser may simply ignore a customer's account and continue to collect yearly fees—a practice known as "reverse churning." Similarly, Advisers compensated through a percentage of the assets may face incentives to embrace more risks than their clients would prefer in hopes of increasing the amount of capital under management.

Although the Advisers Act does not explicitly provide for a federal fiduciary duty, numerous court decisions recognize that it "establishes 'federal fiduciary standards' to govern the conduct of investment advisers."[26] At the least, these fiduciary standards impose "on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients."[27]

B. Brokers

In contrast to Advisers, who are always bound by a continuing federal fiduciary duty, a variety of factors impact whether a Broker owes a fiduciary duty or merely the transactional duty to recommend "suitable" securities. This complexity may arise because many entities regulate Broker conduct—FINRA, the Commission and the states all have authority over Brokers.[28] The Commission's authority comes from the Exchange Act, which requires Brokers or dealers effecting or attempting to induce securities transactions to register with the Commission and join a self-

24. *Capital Gains*, 375 U.S. at 187.

25. *Id.* at 191-92.

26. Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (quoting Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 471, n.11 (1977)).

27. *Id.* at 194.

28. For a discussion of different regulatory oversight mechanisms, *see* Wrona, *supra* note 1, at 2-3.

regulatory organization ("SRO") such as FINRA.[29] Although state regulation plays a significant role, in most circumstances, FINRA serves as the primary regulator. To provide a useful analytic framework for understanding Broker regulation, this section overviews FINRA's suitability requirements before detailing some common ways in which Brokers may be bound by general fiduciary duties under current law.

1. Suitability and Close Supervision

In most instances, FINRA Rules define the scope of a Broker's obligations to her clients.[30] As a starting point, FINRA requires broker-dealer firms to "observe high standards of commercial honor and just and equitable principles of trade."[31] This catch-all provision has been interpreted as broadly prohibiting any unethical conduct.[32] Other rules provide more specific guidance.

FINRA Rule 2111 (the "Suitability Rule") directly governs the advice Brokers give their clients and provides that:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[33]

No portion of the Suitability Rule explicitly provides that the advice a Broker gives a customer must be in a customer's best interests.[34] It does, however, explicitly provide meaningful limitations and require a certain level of professionalism.[35] Additionally, interpretive guidance clarifies that FINRA's Suitability Rule already requires Brokers to make recommendations that are "consistent with the best interests of their

29. *See* 15 U.S.C.A. § 78eee (West 2010).

30. *See infra* Part I.B.2. As discussed below, Brokers may owe fiduciary duties in a variety of different circumstances.

31. FINRA Rule 2010 *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

32. *See* Wrona, *supra* note 1, at 33.

33. FINRA RULE 2111 *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1.

34. *Id.*; *see* Lazaro, *supra* note 1, at 132 ("the suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer's best interest.").

35. *See* Black, *supra* note 1, at 79-82.

clients."[36] In exchange for these professional recommendations, Brokers receive commission compensation.

Yet professionalism has its limits and requires constant supervisory vigilance to constrain conflicts of interest. To check the corrupting influence of Brokers' commission-driven compensation, FINRA routinely updates its Rules and provides additional guidance.[37] Indeed, FINRA recently updated its Suitability Rule in 2010 to explicitly state many suitability requirements, which had previously been required by logical extension and interpretation.[38]

In addition to the Suitability Rule, FINRA and the Commission also require broker-dealers to supervise Brokers robustly to ensure that they follow FINRA Rules and the securities laws.[39] As overseen by the Commission, FINRA requires broker-dealers to create supervisory systems and written supervisory procedures which, among other things: (i) designate principals to execute supervisory functions; (ii) assign all Brokers to supervisors; (iii) regularly inspect offices and branch offices in accordance with written procedures; and (iv) meet annually with each Broker to discuss compliance matters.[40] FINRA rules also require that a broker-dealer's chief executive officer certify annually that supervisory procedures have been designed to achieve actual compliance with securities laws and rules.[41]

2. Brokers Already Bound by Fiduciary Duties

In addition to the ever-present suitability obligation, Brokers already owe continuing fiduciary duties in many circumstances.[42] Yet determining when a Broker owes these fiduciary duties or what those duties actually

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36. FINRA, Regulatory Notice 12-25, 2012 (May 21, 2012) ("In interpreting FINRA's suitability rule, numerous cases explicitly state that a broker's recommendations must be consistent with his customers' best interests.") (internal quotation omitted), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf.

37. *See, e.g.*, Wrona, *supra* note 1, at 29 ("FINRA's Rule 2330, which covers recommendations of variable annuities, offers a good example of FINRA's approach to supplementing its general suitability rule to address particularly complex securities that have been the subject of sales abuses.").

38. *Id.* at 21-28.

39. *Id.* at 37.

40. NASD RULE 3010 *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717.

41. FINRA RULE 3130 *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286.

42. *See* Frankel, *supra* note 1, at 126 (explaining that Brokers are already fiduciaries in many circumstances).

require may be extraordinarily difficult.[43] As Professor Laby has explained, "[t]his sliver of securities law doctrine comprises a bewildering inconsistency of judicial decisions."[44] A few different areas where courts may recognize fiduciary duties for giving advice are set forth below.

a. Certain Brokers Bound by Advisers Act

If Brokers charge fees specifically for investment advice or provide more than incidental investment advice, the Advisers Act and a federal fiduciary duty applies to Brokers—effectively converting them into Advisers. As mentioned above, the Advisers Act excludes Brokers from its scope so long as: (i) their performance of investment advisory services is "solely incidental" to their business as a broker; and (ii) the Broker receives no "special compensation" for providing investment advice, e.g. a payment expressly for investment advice.[45] A Broker must satisfy both elements to fall within the exception.

As to the first requirement, the Commission historically interpreted the phrase "solely incidental as "in connection with and reasonably related to the brokerage services provided to that account."[46] Limited judicial authority has followed the Commission and interpreted the phrase "solely incidental" broadly as meaning advice "in connection with the sale of a product."[47]

Despite the first prong's broad interpretation, the special compensation prong, has been interpreted more narrowly. Congress may have viewed differences in compensation structure as significant in 1940 because Brokers primarily provided execution services and gave less advice about securities.[48] Moreover, Brokers were already regulated by the Exchange Act at that time.[49]

As time passed and Brokers began to provide more financial advice, the Commission sought to use its authority to read "special compensation"

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43. *See* Varnavides, *supra* note 2, at 211 ("The case law concerning broker-dealers and fiduciary duties is a morass.").

44. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 704 (2010). *See also* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 676 (1996) ("the issue is more problematic, and the case law decided under both common law and federal securities regulation becomes almost completely unpredictable.").

45. 15 U.S.C.A. § 80b-2(a)(11)(c).

46. *See* Certain Broker–Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 2340, 70 Fed. Reg. 2716, 2726 (Jan. 14, 2005), *vacated on other grounds*, Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir 2007).

47. Thomas v. Metro. Life Ins. Co., 631 F.3d 1153, 1162 (10th Cir. 2011).

48. *See* Laby, *supra* note 1, at 723.

49. *Id.*

expansively to allow Brokers to accept fees for advice without being bound by the Advisers Act.[50] A group of Advisers successfully challenged the Commission's move and won a decision finding that Commission could not expand the existing exception for Brokers—meaning that Brokers accepting special compensation for investment advice become bound by the Advisers Act.[51] Thus, at present, Brokers owe Advisers Act fiduciary duties if they accept any special compensation, which the Tenth Circuit has interpreted as: (i) compensation "received specifically in exchange for giving advice, as opposed to some other service;" and (ii) "the compensation takes a form other than a commission or analogous transaction-based compensation received for the sale of a product."[52]

b. Brokers as "Inherent" Fiduciaries

Certain states, such as California, already impose fiduciary duties on Brokers and broadly declare that they are fiduciaries.[53] Yet these decisions do not often discuss the extent of Brokers' duties and whether it pertains to all instances in which a Broker gives investment advice.[54] Still, merely categorizing Brokers as fiduciaries does not end the inquiry because much uncertainty remains about the scope of Brokers' fiduciary obligations.

c. Discretionary Accounts Create Fiduciary Duty

At present, most courts and commentators comfortably find that a Broker owes continuing fiduciary duties if she possesses discretionary control over an account.[55] Discretionary accounts, also known as "managed

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50. *Id.* at 732.

51. *See* Fin. Planning Ass'n v. SEC., 482 F.3d 481, 493 (D.C. Cir. 2007) (striking down attempt to allow Brokers to accept fee-based compensation for advice without being bound by the Advisers Act).

52. *Thomas*, 631 F.3d at 1165.

53. Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 235 (Ct. App. 1968); Hobbs v. Bateman Eichler, Hill Richards, Inc., 210 Cal. Rptr. 387, 403 (Ct. App. 1985) ("The relevant law is clear. 'The relationship between a broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal."); E.F. Hutton & Co. v. Weeks, 304 S.E.2d 420, 422 (Ga. Ct. App. 1983) ("The broker's duty to account to its customer is fiduciary in nature, resulting in an obligation to exercise the utmost good faith."); Roth v. Roth, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

54. *See* Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407, 419 (1989) (explaining that "these decisions [recognizing fiduciary duties] provide little or no explanation of why the relationship must be considered to include fiduciary duties.").

55. SEC v. Zandford, 535 U.S. 813, 823 (2002) (recognizing that broker managing discretionary account owed fiduciary duties); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) *aff'd*, 647 F.2d 165 (6th Cir. 1981) ("[T]he

accounts," allow Brokers to buy and sell securities without first obtaining client consent. Courts recognize broad fiduciary duties in these contexts because a customer's decision to allow a Broker to make discretionary trades in her account clearly signals that she trusts the Broker and expects her to manage her account with skill and diligence.[56]

d. Relationships of Trust and Confidence

State law will sometimes impose fiduciary duties on a Broker if a customer reposes faith, confidence and trust in the Broker.[57] This type of relationship may be clearly established if the customer shows that the Broker enjoyed de facto control over her account.[58] In *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*, an often cited case, a court articulated many factors, which may indicate whether a Broker possessed de facto control over a non-discretionary account including: (i) age; (ii) education; (iii) intelligence; (iv) investment experience; (v) whether the Broker is "socially or personally involved with the customer;" (vi) whether the customer approved the transactions; and (vii) how frequently the Broker and customer spoke about the account.[59]

In any event, the relationship between a Broker and her customer today necessarily involves a great deal of trust. The customer entrusts her assets to her Broker even if she does not necessarily trust all of the advice she receives from her Broker.

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broker handling a discretionary account becomes the fiduciary of his customer in a broad sense."); Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005) (stating that broker-dealers generally do not owe fiduciary duty unless operating with discretion).

56. *See* Laby, *supra* note 44, at 724 ("[A]s a practical matter, investment discretion is a useful proxy for measuring trust and confidence, a badge of the fiduciary relationship.").

57. *See* Petroleum Enhancer, LLC v. Woodward, 690 F.3d 757, 765 (6th Cir. 2012) ("[A] fiduciary relationship arises from the reposing of faith, confidence, and trust and the reliance of one on the judgment and advice of another."); Kleer v. Tactical Allocation Grp., LLC, No. 298915, 2011 WL 4375237, at *2 (Mich. Ct. App. Sept. 20, 2011) ("A fiduciary duty exists when there is a relationship that involves trust, confidence, and reliance on another for judgment and advice."); McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989).

58. A non-discretionary account requires the Broker to obtain permission from the customer before making any trades. *Investor's Best Practices*, FINRA, http://www.finra.org/Investors/ProtectYourself/BeforeYouInvest/AvoidCommonInvestorProblems/ (last visited Mar. 20, 2014).

59. Leib, 461 F.Supp. at 954-55 (citations omitted).

e. Special Circumstances Require Fiduciary Duties

In addition to all of the foregoing instances where a Broker may be bound by ongoing fiduciary duties, courts may also impose fiduciary duties if special circumstances exist. In these circumstances, something renders the client dependent on the Broker. The client may have "impaired faculties" and not be able to protect her own interests.[60] These special circumstances may exist if the client is "so lacking in sophistication that de facto control of the account is deemed to rest in the [B]roker."[61]

II. FIDUCIARY DUTY

When considering whether Brokers should be bound by fiduciary duties when advising customers, what exactly do we mean? Justice Cardozo characterized fiduciary duty as "the duty of the finest loyalty," and declared that fiduciaries are "held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[62] Similarly, Black's Law Dictionary defines a "fiduciary" as:

> A person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor. One who must exercise a high standard of care in managing another's money or property.[63]

Still, these general definitions do not give us the particulars. As Justice Cardozo famously explained, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"[64]

Cardozo's quotation reflects the modern academic consensus that the fiduciary label is more of a conclusion than a precise framework.[65] Because Dodd-Frank contemplates harmonizing Brokers' duties with the fiduciary duties owed by Advisers, I will first examine the fiduciary duties Advisers

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60. *See* de Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293, 1308 (2d Cir. 2002).

61. *Id.*

62. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

63. FIDUCIARY, BLACK'S LAW DICTIONARY (9th ed. 2009).

64. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

65. Langevoort, *supra* note 1, at 442; Black, *supra* note 1, at 78 ("Because of its vague and amorphous quality, the fiduciary duty concept does not promote the development of clear and workable standards that investment advice providers can incorporate into their business practices, regulators can consistently enforce, and courts and arbitration panels can apply in resolving investors' claims against their broker-dealers.").

actually owe before briefly overviewing the Department of Labor's ability to impose a different set of fiduciary duties.

A. Fiduciary Duty under the Advisers Act

The Supreme Court spoke about Advisers' duties in *SEC v. Capital Gains Research Bureau, Inc.* and found that an Adviser's fiduciary duties require her to act in "good faith," give "full and fair disclosure of all material facts," and "employ reasonable care to avoid misleading" customers.[66]

Expounding these duties more comprehensively, the Commission recently published a study on Advisers and Brokers as required by Dodd-Frank.[67] As the primary regulator for Advisers, it explained that the federal fiduciary standards governing Advisers bind them with continuing duties of loyalty and care.[68] An Adviser's duty of loyalty requires her to act in her clients' best interests and to refrain from subordinating her clients' interests above her own.[69] This duty of loyalty also includes a duty to disclose all conflicts of interest.[70]

An Adviser's duty of care includes a duty to provide suitable investment advice after investigating the customer's financial situation and investment objectives.[71] Although an Adviser's suitability obligations call to mind FINRA's Suitability Rule, the Commission has not crafted a rule explicitly codifying a framework for evaluating whether an Adviser's recommendations were suitable at the time given.[72] Thus, the law governing Advisers' fiduciary duties of care may be less developed than FINRA's Suitability rule.[73]

Given that Advisers and Brokers must recommend only suitable securities, what material differences—other than their compensation structures—actually exist between their duties? The Commission explains that a rules-based regulatory regime governs Brokers, while Advisers operate under a principles-based approach.[74] Advisers must strive to eliminate or at least disclose all conflicts of interest.[75] In contrast, Brokers

66. 375 U.S. 180, 194 (1963).
67. SEC & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALER (Jan. 2011), (the "Fiduciary Study"), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf..
68. *Id.* at 22.
69. *Id.*
70. *Id.*
71. *Id.* at 27-28.
72. *See* Wrona, *supra* note 1, at 12–13.
73. *Id.*
74. Fiduciary Study, *supra* note 67, at 102-04.
75. *Id.*

have not been required to eliminate or disclose their conflicts of interests in the same ways as Advisers.[76]

This is not to say that Brokers have been less regulated than Advisers. On the whole, a much more rigorous oversight and enforcement regime polices Broker behavior.[77] Brokers are subject to registration, qualification, licensing, continuing education, record keeping, and a host of other requirements that do not all apply or apply in lesser forms to Advisers.[78]

B. ERISA Fiduciary Duties

As mentioned above, the Department of Labor has been considering whether to propose a rule extending ERISA's fiduciary standard to all persons providing advice about assets in retirement accounts.[79] While the proposal has not yet been made public, it may impose an even higher standard than the fiduciary duty created by the Advisers Act; the ERISA fiduciary standard has been characterized as "the highest fiduciary duty known to the law."[80] Although the precise contours of an ERISA fiduciary duty fall beyond the scope of this Essay, the Department of Labor could add another complication to the mix.

III. MORE MEANINGFUL REFORM NEEDED

At present, the law requires both Brokers and Advisers to recommend suitable securities for their clients.[81] Ultimately, the difference between Brokers' recommendations and Advisers' advice boils down to the differences in their compensation structures and enforcement regimes. These differences undoubtedly drive different outcomes for investors.

Although not addressing the underlying incentive structures, the Commission and many others advocate creating a so-called uniform fiduciary standard governing both Brokers and Advisers. Importantly, the scope of proposed uniformity appears quite narrow because Dodd-Frank does not permit the Commission to rule that commission-based compensation violates any fiduciary duty or to impose a continuing duty of

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76. *Id.* at 114-17; Wrona, *supra* note 1, at 46 ("[B]roker-dealers do not have a broad disclosure obligation comparable to the one imposed on advisers. That should change.").

77. *See* Wrona, *supra* note 1, at 17-42 (detailing extensive regulatory requirements).

78. *Id.*

79. *See* Bernard, *supra* note 11.

80. Haviland v. Metro. Life Ins. Co., 730 F.3d 563, 575 (6th Cir. 2013).

81. *See* Christine Lazaro, *The Future of Financial Advice: Eliminating the False Distinction between Brokers and Investment Advisers*, 86 ST. JOHN'S L. REV. (forthcoming 2014) (arguing against false distinctions between Advisers and Brokers).

care on Brokers. Given these limitations, the Commission's staff proposes that a new uniform fiduciary standard of conduct provide that:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be 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.[82]

How does this proposal differ from the current regime? The crux of the Commission's recommendation is that persons providing investment recommendations to any customer be required "to act in the best interests of the customer *without regard to the financial or other interest of the broker*" or Adviser.[83] Because FINRA rules already require Brokers to act in a manner consistent with the best interests of their clients, the proposed uniform rule may simply restate the existing FINRA Suitability Rule with a different emphasis.[84] Indeed, Professor Mercer Bullard has characterized the FINRA Suitability Rule as "closest cousin in broker-dealer regulation" to the proposed uniform standard.[85]

This mild linguist reform seems unlikely to generate meaningful change. Real concerns about retail investor confusion and outcomes do exist. More meaningful changes are necessary to reduce investor confusion and to ensure that investors receive investment advice actually in their best interests. As discussed below, changes to the entire regulatory framework, compensation structures, and enforcement regimes would reduce confusion and change outcomes.

A. A More Unitary Framework

Because Brokers and Advisers both provide personalized investment advice, one statutory framework should govern their activities. Presently, too many overlapping regulatory frameworks govern the same activity—giving investment advice. Although the Commission has regulatory options to increase uniformity, Congressional action could offer a superior solution.

The Commission's Investor Advisory Committee (the "Advisory Committee"), which was created by Dodd-Frank, has proposed a regulatory response.[86] It recommends that the Commission increase uniformity through rulemaking under the Advisers Act by significantly narrowing the

82. Fiduciary Study, *supra* note 67, at 109-10.
83. Fiduciary Report, *supra* note 67, at 110 (emphasis added).
84. FINRA, *supra* note 36, at 1-4.
85. Mercer Bullard, *The Fiduciary Standard: It's Not What It Is, But How It's Made, Measured and Decided*, 86 ST. JOHN'S L. REV. (forthcoming 2014).
86. Dodd-Frank § 911.

current exception for Brokers.[87] The Advisory Committee proposes that Brokers "who choose to offer personalized investment advice to retail investors, such as retirement planning or investment planning, that goes beyond the buy/sell recommendations inherent to securities transactions would be" deemed Advisers.[88]

While this regulatory response might solve many problems, it only addresses investment advice in connection with the sale of securities and leaves other products unaddressed. Although this Essay focuses on advice given by Brokers and Advisers, insurance agents selling purely insurance products, such as whole life insurance or fixed annuities, also cast themselves as financial advisers and offer investment advice. A single Investment Advice Act would much more elegantly provide for a tiered framework where retail investors could select the level of service they desired from their financial professional. Such an act would structure financial professionals' duties to vary based on the services being offered, rather than their compensation structure.

A well-crafted Investment Advice Act would establish that transactional financial counseling still deserves a place. A new framework would allow limited advice in connection with a single transaction—the service traditionally dispensed by Brokers—as an appropriate level of guidance for some investors. To ensure that retail investors understand that the transactional nature of the advice, clear disclosures about the scope of duties at a particular level of service would be mandated. To be sure, for many buy-and-hold investors, paying ongoing management fees to an Adviser makes little sense because they may not need to revisit asset allocation for a decade or more. A single shot commission or transactional fee would compensate the financial professional fairly and ensure that the investor received suitable guidance without creating expectations of ongoing care and oversight.

Additionally, investors desiring more assistance should be able to create an ongoing fiduciary relationship with a financial professional who would be appropriately compensated for monitoring the investor's account and providing ongoing guidance. This arrangement would largely track the current Adviser model.

87. Investor Advisory Committee, *Recommendation of the Investor Advisory Committee Broker-Dealer Fiduciary Duty*, *available at* http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf.

88. *Id.* at 5.

B. Flattened Commissions

The proposed uniform standard is unlikely to make any material difference so long as the current commission structure remains in place.[89] At present, Broker commissions vary by financial product sold and not simply by the amount of the transaction. These distorting incentives have long been recognized as creating material conflicts between the Broker's interests and the client's interests. In 1995, the Commission released the "Report of the Committee on Compensation Practices," which recognized that differentiated compensation by product raised questions as to whether a Broker rendered "objective advice or simply maximize[ed] commission income."[90] Similarly, in 2013, FINRA released a report on conflicts of interest that echoed these concerns and praised internal policies designed to mitigate the financial incentive to recommend one product over another.[91]

Although the proposed uniform standard requires a Broker to give advice without regard to her own compensation, more must be done to remedy the conflict than to simply prohibit acting in response to a strong economic incentive. Financial institutions pay higher commissions to incentivize sales. The proposed uniform fiduciary standard will not eliminate these incentives or the tendency of Brokers to be swayed by them. Indeed, it is well understood that a financial intermediary's fee structure will influence its advice.[92]

A simple solution to clean up commission structures is to flatten Brokers' incentives across products entirely by requiring broker-dealers to pay their Brokers uniform commissions regardless of which products they sell. This would reduce the incentive for a Broker to push one product over another and make it more reasonable to expect them to render advice in the best interests of their clients without differential commissions, knowingly or unknowingly, tainting their judgment.

Unsurprisingly, most recent regulatory enforcement actions have focused on abusive sales practices in connection with the unsuitable sale of

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89. A number of authors have commented on how differential commissions may skew Brokers' incentives. *See* Robert T. Greene, *Differential Commissions As A Material Fact*, 34 EMORY L.J. 507, 509 (1985) ("The purpose of this Comment is to analyze the problems which are created when a brokerage firm offers its stockbrokers a disproportionately high commission to effectuate sales of a security.").

90. SEC, *Report of the Committee on Compensation Practices* 7 (1995), *available at* http://www.sec.gov/news/studies/bkrcomp.txt.

91. FINRA*, Report on Conflicts of Interest* 26-30 (Oct. 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.

92. For a more thorough discussion of fee effects, see Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517, 1519 (2013) ("as profit-maximizing entities, we can expect that intermediaries will use their influence in a way that serves their bottom line.").

high commission products. In a recent Essay, Professor Barbara Black detailed five products that had drawn enforcement crackdowns for unsuitable recommendations leading to staggering investor losses: (i) auction rate securities; (ii) private placements; (iii) non-traded real estate investment trusts; (iv) proprietary mutual funds; and (v) variable annuities.[93] These products share at least two common attributes. First, they all attract capital by paying above average commissions to Brokers. Second, the actual fees and expenses involved can be more easily misrepresented to customers because customers do not directly pay the outsized commissions—they may not even be aware of the conflict.

Eliminating these skewing conflicts by flattening commissions would offer material benefits to individual investors and the economy as a whole. Flat commissions may allow individual investors to trust their Brokers, knowing that a commission differential has not influenced their advice to buy one product over another. Flat commissions would also likely improve capital allocation by improving the quality of investment advice rendered and allocating assets more efficiently.

C. More Effective Enforcement

To offer meaningful uniformity, any governing standard must be evenly and effectively enforced. At present, too many differences exist between Broker and Adviser enforcement. On the public side, more resources focus on Brokers than Advisers. Indeed, FINRA brings a high volume of proceedings and regularly examines Brokers and broker-dealers.[94] In contrast, the Commission has not vigilantly protected the clients of Advisers by regularly examining Advisers with anything near the frequency with which FINRA examines Brokers.[95] As Securities and Exchange Commission Commissioner Elise B. Walter stated, the Commission examines 9% of Advisers each year, while FINRA examines 43% of broker dealer firms—a significant enforcement and oversight gap.[96]

Private enforcement could be more effective as well. At present, investors lack a meaningful private right of action specifically focused on investment advice.[97] To be sure, investors may pursue fraud-based claims

93. Barbara Black, *Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer A Better Approach?*, 48 WAKE FOREST L. REV. 771, 775-82 (2013).

94. *See* Wrona, *supra* note 1, at 4.

95. Elisse B. Walter, *Statement on Study on Enhancing Investment Adviser Examinations* 8 (Jan. 2011), available http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

96. *Id.* at 3.

97. The Supreme Court has recognized a limited private right of action under § 205 of the Advisers Act. *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24

under Rule 10b-5 of the Exchange Act, yet these provisions do not provide any remedy for investors harmed by incompetent advice because they require the plaintiff to establish scienter. Accordingly, the Congress or the Commission should also create a private cause of action for persons harmed by unsuitable investment advice, whether given by Brokers or Advisers and exempt it from many of the onerous pleading standards created to limit securities actions against issuers.

Forum differences also shape private enforcement options for investors seeking to recover their losses. By contract, nearly all customer disputes involving Brokers and broker-dealers go to FINRA arbitration—the arbitration forum overseen by FINRA for disputes involving Brokers or broker-dealers. Indeed, it may be difficult to discern what standards actually govern Broker conduct because arbitration decisions do not ordinarily reveal the arbitrators' rationales or create precedent.[98] Similarly, many Advisers also sign arbitration agreements with their clients, which may specify different arbitration forums.[99] Although opinions vary on whether arbitration helps or hurts retail investors, retail investors should enjoy the same loss-recovery options regardless of whether the financial professional is a Broker or an Adviser.

CONCLUSION

Much of the debate about whether Brokers should be held to the same standard as Advisers has been ill informed. The standards governing Brokers and Advisers' investment recommendations overlap so much as to be nearly indistinguishable. The more significant differences come in other areas—compensation structure, oversight, private and public enforcement differences, and different regulatory frameworks.

Sadly, the current proposal appears likely to do little to meaningfully alter outcomes for investors. Merely restating existing standards—while leaving the underlying causes untouched—will not improve outcomes or reduce investor confusion. As such, Congress and the Commission should seriously consider more extensive changes to the regulations governing the industry.

(1979) ("[W]e hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable.").

98. *See* Mercer Bullard, *The Fiduciary Study: A Triumph of Substance over Form?*, 30 REV. BANKING & FIN. L. 171, 179 (2010) (arguing that the standards actually applied in FINRA arbitration may be unknowable).

99. *See* Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 § 921(b) (2010) (giving the Commission power to prohibit Advisers from using pre-dispute arbitration agreements).