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# STOCK BROKER FIDUCIARY DUTIES AND THE IMPACT OF THE DODD-FRANK ACT

THOMAS LEE HAZEN\*

*In recent years there has been concern about the sufficiency of broker-dealer regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandates the SEC to review and evaluate existing regulation and to adopt such rules as may be necessary to enhance existing regulation. Existing SEC and FINRA rulemaking addresses broker-dealer conduct, but by and large the regulation has been based on principles and standards rather than voluminous detailed rules specifying prohibited conduct. This article examines the extent to which additional regulation is warranted and whether to continue to rely on principles-based regulation, or whether there should be more explicit rules to heighten broker-dealer standards. The article concludes that although the existing framework for broker-dealer regulation is robust, it could be fine-tuned by possibly adding an express fiduciary duty requirement as well as more specific rule-based prohibitions.*

## I. INTRODUCTION

In the wake of the 2008 financial crisis,<sup>1</sup> after many months of proposals and legislative hearings, Congress cobbled together a compromise bill that emerged from both the House and the Senate. The final product was embodied in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).<sup>2</sup> Dodd-Frank is massive legislation, with its text exceeding eight hundred pages, and represents the most comprehensive financial regulation ever adopted by Congress when measured by the number of subjects, activities, and financial

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1. For an analysis of the financial crisis, see, e.g., 13 N.C. BANKING INST. 1 (2009) (including a series of articles analyzing causes and suggested solutions).

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

institutions that are covered by its provisions. A relatively small portion of Dodd-Frank covers broker-dealers<sup>3</sup> duties to their customers. Section 913 of Dodd-Frank<sup>4</sup> mandated an SEC study to examine broker-dealer and investment adviser obligations prior to engaging in any rulemaking activity. Section 913 explicitly gives the SEC rulemaking authority to require broker-dealers and investment advisers to meet a uniform fiduciary standard when they provide personalized securities-related investment advice to their retail customers.<sup>5</sup> More specifically, under Dodd-Frank's rulemaking authority, investment advisers providing personalized investment advice to retail customers may be required to act in the best interest of the customer without regard to the financial or other interest of the adviser providing the advice.<sup>6</sup> The SEC rulemaking authority also allows the SEC to subject broker-dealers to the same standard of care as investment advisers under the Investment Advisers Act.<sup>7</sup> Any such rule must require material conflicts of interest to be disclosed and consented to by the customer. Dodd-Frank also recognizes, however, that broker-dealers and investment advisers may be allowed to receive commissions without violating the fiduciary standard applicable to those industry professionals.<sup>8</sup> In addition the SEC's rulemaking authority over broker-dealers now includes the ability to adopt rules to require that broker-dealers who sell proprietary or a

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3. Section 15 of the Securities Exchange Act of 1934 addresses the regulation of "brokers" and "dealers." 15 U.S.C. § 78o (2006). A securities broker under section 3(a)(4)(A) of the Securities Exchange Act is "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A) (2006). A securities dealer under section 3(a)(5)(A) is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. § 78c(a)(5)(A) (2006). As used in this article, broker-dealer refers to a broker that is subject to 1934 Act regulation.

4. Dodd-Frank Act, § 913, 124 Stat. 1824-30 (to be codified at 15 U.S.C. §§ 78o, 80b-11).

5. *Id.*

6. *Id.* Any such standard would have to be at least as rigorous as investment advisers' existing obligations under section 206 of the Investment Advisers Act. 15 U.S.C. § 80b-6 (2006). This mandate already is embodied in the standards under existing law. *See id.*

7. Dodd-Frank Act, § 913, 124 Stat. 1824-30 (to be codified at 15 U.S.C. §§ 78o, 80b-11).

8. *Id.*

limited range of products provide notice to the customer and obtain the customer's consent or acknowledgement.<sup>9</sup>

As discussed later in this article, in January 2011, the SEC responded with a study on broker-dealer regulation and recommended a unified fiduciary duty standard for broker-dealers and for investment advisers.<sup>10</sup> The true impact of the study must await SEC rulemaking and or interpretations that may follow over the next year or two. Some observers had voiced concern that the SEC would respond with overbearing regulation. This article analyzes broker-dealer obligations and concludes that much of the concern over Dodd-Frank in this area is overblown, as broker-dealers are already subject to significant fiduciary-like obligations when acting as more than mere order takers for their customers.

Even without any enhancements that may be forthcoming as a result of Dodd-Frank, the existing law is clear that securities broker-dealers are held to various obligations when their activities consist of more than executing their customers' orders.<sup>11</sup> This is the case even in the absence of statutory or SEC rules specifically setting forth the types of conduct that are prohibited. Rather than being rooted in a specific statutory mandate, and beyond defining "just and equitable principles of trade,"<sup>12</sup> the obligations evolved out of SEC and self-regulatory rules adopted by the National

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9. *Id.*

10. See SEC STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS – AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011) [hereinafter SEC STUDY], <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

11. See generally 5 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION CH. 14 (6th ed. 2009 & Supp. 2011) (analyzing broker-dealer regulation under the federal securities laws); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710 (2010).

12. Prior to 1983, section 15(b)(9) of the Securities Exchange Act of 1934 referred to "rules and regulations as the Commission might prescribe designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." See Pub. L. No. 98-38, 97 Stat 205. Adherence to just and equitable principles of trade remains at the center of broker-dealer regulation. See, e.g., FINRA Manual Rule 2010 ("Standards of Commercial Honor and Principles of Trade"), available at [http://finra.complinet.com/en/display/display\\_viewall.html?rbid=2403&element\\_id=607&record\\_id=609](http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=607&record_id=609).

Association of Securities Dealers (the “NASD”)<sup>13</sup> and now by its successor, the Financial Industry Regulatory Authority (“FINRA”). In contrast to the approach to broker-dealers taken in the Securities Exchange Act of 1934 (“Exchange Act”),<sup>14</sup> investment advisers are regulated under the Investment Advisers Act of 1940,<sup>15</sup> which explicitly imposes on advisers a more stringent fiduciary duty standard. Investment advisers include professionals who render investment advice, but there is an exclusion for broker-dealers who are registered, and hence regulated, under the Exchange Act.<sup>16</sup>

Both the original House and Senate proposed bills for financial regulatory reform attempted to change the broker-dealer fiduciary standard.<sup>17</sup> The approach proposed by the House was “to harmonize the fiduciary standard for brokers, dealers, and investment advisers,”<sup>18</sup> while the Senate approach was “to have the SEC conduct a study to evaluate the effectiveness of existing standards of conduct for brokers, dealers, and investment advisers.”<sup>19</sup> As one observer put it, Dodd-Frank “forged a kind of compromise between the House and Senate approaches.”<sup>20</sup> The

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13. For years, the regulation of broker-dealers was carried out under a system of self-regulation spearheaded by the NASD.

14. 15 U.S.C. § 78a *et seq.* (2006).

15. Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* (2006). The Investment Advisers Act is discussed in 7 HAZEN CH. 21 (6th ed. 2009 & Supp. 2011), *supra* note 11.

16. Broker-dealers who render advice incidental to their broker-dealer operations are also excluded from the definition of investment adviser. 15 U.S.C. § 80b-2(a)(11)(A), (B) (2006).

17. MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R41381, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: STANDARDS OF CONDUCT OF BROKERS, DEALERS, AND INVESTMENT ADVISERS 5 (2010).

18. *See, e.g.*, Morrison Foerster News Bulletin, A Fiduciary Duty for Broker-Dealers? How Dodd-Frank May Change the Way Broker-Dealers Conduct Business 2 (July 19, 2010), <http://www.mofo.com/files/Uploads/Images/100719DoddFrank.pdf> [hereinafter Morrison Foerster] (“The Dodd-Frank Act represents a compromise between the House bill, which would have eliminated the exclusion for broker-dealers from the definition of investment advisers, and the Senate bill, which called for further study of the issue.”).

19. SEITZINGER, *supra* note 17, at 5.

20. *Id.*; *see also, e.g.*, Jennifer Martella, Baker & McKenzie Client Memo, Dodd-Frank Act Investor Protection Changes for Broker-Dealers and Investment Advisers (October 2010), *available at* <http://www.bakermckenzie.com/RRNADoddFrankActInvestorProtectionOct10/> (stating that Dodd-Frank requires the SEC to complete a study and make

compromise also brings focus on the current distinctions between securities broker-dealers and investment advisers.

## II. OVERVIEW OF DISTINCTIONS BETWEEN BROKER-DEALER AND INVESTMENT ADVISER REGULATION

The Investment Advisers Act defines an investment adviser as:

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[.]<sup>21</sup>

This definition of investment adviser excludes “any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.”<sup>22</sup> It has been suggested, however, “[t]he evolution of securities-related business practices essentially means broker-dealers and investment advisers currently engage in a single business.”<sup>23</sup> One of the commands emanating from Dodd-Frank is for the SEC to examine whether there should

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recommendations on ways to improve investor access to registration information on brokers and dealers available on the existing Central Registration Depository, as well as identify additional information that should be made available).

21. 15 U.S.C. § 80b-2(a)(11) (2006).

22. *Id.*; see also Morgan Clemons, *Harmonization vs. Demarcation: The Problems with a Broker Fiduciary Duty and the Benefits of the Merrill Rule* (October 28, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1699274>; James Hamilton, *SEC Regulation of Investment Advisers and Brokers in the Brave New World* (2008) (on file with Wolters Kluwer Law & Business), <http://business.cch.com/securitieslaw/news/03-26-08a.pdf>.

23. Stephen Joyce, *Ketchum Calls for Single Fiduciary Standard, Says FINRA May Have Role in Enforcement*, *Sec. L. Daily (BNA)* (Nov. 17, 2010), available at <http://news.bna.com/bcln>; James Hamilton, *supra* note 23, at 7 (“Some investment advisers, for example, may offer services that employ computerized trading programs and may take an active, discretionary management role over customer accounts. From the retail investor’s prospective [sic], these activities may not be obviously distinct from those in which brokers typically engage.”).

be more harmonization of broker-dealer and investment adviser regulation in terms of the duties that are owed to retail customers.

Currently, investment advisers regulated by the Investment Advisers Act are subject to statutory fiduciary standards.<sup>24</sup> As explained by the Supreme Court:

The Investment Advisers Act of 1940 thus reflects a congressional recognition “of the delicate fiduciary nature of an investment advisory relationship,” as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser— consciously or unconsciously— to render advice which was not disinterested.<sup>25</sup>

In contrast, under the Exchange Act, broker-dealers are not subject to an explicit fiduciary standard but are nevertheless required to comply with various other standards that include an obligation of suitability in making investment recommendations to their customers.<sup>26</sup> Some commentators have observed that the duties of broker-dealers fall short of a fiduciary obligation.<sup>27</sup> Notwithstanding the absence of an explicit fiduciary standard, broker-dealers are subject to substantially similar requirements when they act as more than mere order takers for their customers’ transactions. Under the Exchange Act, a variety of self-regulatory organizations (SROs), including national securities exchanges and

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24. See Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006). Specifically, section 206(3) addresses transactions in which the adviser acts as principal. The courts quite properly have characterized this as a fiduciary standard. See, e.g., *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (“Indeed, the Act’s legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.”); *United States v. Lay*, 612 F.3d 440, 445-447 (6th Cir. 2010) (upholding conviction based on investment advisers breach of fiduciary duty as embodied in Investment Advisers Act section 206).

25. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963) (footnote omitted).

26. *Joyce*, *supra* note 23.

27. See *Morrison Foerster*, *supra* note 18, at 1 (“Broker-dealers have a duty of fair dealing, duty of best execution, suitability requirements and various disclosure requirements. While such duties and requirements provide some degree of investor protection, they fall short of the ‘fiduciary’ standards described by the SEC.”).

FINRA, exercise extensive oversight over securities broker-dealers, stock exchange members and listed companies, and other market intermediaries.<sup>28</sup>

A recent Tenth Circuit decision points to the need to harmonize the rules relating to broker-dealers and investment advisers in at least some respects. In *Thomas v. Metropolitan Life Ins. Co.*,<sup>29</sup> a representative of an insurance company and a registered broker-dealer recommended a proprietary variable insurance product that qualifies as a security<sup>30</sup> without disclosing that sales of this product provided an incentive to make this investment recommendation. The court ruled that since the representative did not give investment advice generally the representative's advice was incidental to his role as a broker-dealer, and thus he was not acting as an investment adviser.<sup>31</sup> Moreover, because the representative was not giving general investment advice, the absence of special compensation for the advice rendered the advice incidental to his activities as a broker-dealer.<sup>32</sup> Had the sales representative been acting as an investment adviser, he would have been subject to disclosures regarding recommendations of proprietary products that are not applicable to broker-dealers. It seems anomalous to require conflict of interest disclosures by an investment adviser in this type of situation but not by a broker-dealer giving investment advice. It is situations like that in *Thomas* that reinforce the need to consider harmonizing invest adviser and broker-dealer duties.

Notwithstanding concern in some quarters over the different regulatory frameworks for investment advisers and securities broker-dealers, Congress did not alter the structural regulatory segmentation that continues to exist. Instead of

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28. Saule T. Omavora, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 693 (2010).

29. *Thomas v. Metropolitan Life Ins. Co.*, No. 09-6207, 2011 WL 310471 (10th Cir. Feb. 2, 2011).

30. The variable universal life insurance policy (VULP) that was recommended to the customer fits within the definition of security. See, e.g., SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (variable annuity was a security); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (same). See generally 1 HAZEN § 1.6[8], *supra* note 11.

31. *Thomas*, 2011 WL 310471, at \*11.

32. *Id.* at \*11-12.



mandating any specific changes in the regulation of broker-dealers, Congress punted and left to the SEC the decision of whether to enhance broker-dealer obligations. It did so through section 913 of Dodd-Frank, which directs the SEC to study various aspects of broker-dealer and investment adviser regulation.<sup>33</sup> Rather than attempt to paraphrase, the scope of the study is best understood by the terms of Dodd-Frank itself, which requires the SEC to study and evaluate:

(1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards; and

(2) 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, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.<sup>34</sup>

Section 913 of Dodd-Frank specifically sets forth the following considerations, in simplified terms, among others, to be included within the SEC report: the effectiveness of the current regulatory standards; the existence of shortcomings in protection of retail customers under current regulatory standards; the extent to which retail customers understand the different applicable

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33. Dodd-Frank Act, § 913, 124 Stat. 1824-30 (to be codified at 15 U.S.C. §§ 78o, 80b-11).

34. *Id.*

standards of care for brokers, dealers, and investment advisers in relation to retail customers; the question of whether the different standards are a source of confusion regarding the quality of investment advice to retail customers; and the substantive differences in regulation of brokers, dealers, and investment advisers.<sup>35</sup>

In addition to setting forth the items to be studied, Dodd-Frank amended Exchange Act section 15(k) to specifically empower the SEC to regulate broker-dealers providing personalized investment advice by imposing on them obligations that are applicable to investment advisers under the Investment Advisers Act.

Dodd-Frank thus makes it clear that the SEC has the authority to impose heightened standards of care on securities broker-dealers. Included in the SEC's discretionary authority granted by Dodd-Frank, the SEC may by rule require that a broker or dealer selling only a limited range of products provide notice to each retail customer and obtain consent.<sup>36</sup> The SEC shall also "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest[.]"<sup>37</sup> Dodd-Frank also mandates that the SEC consider promulgating rules that prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes.<sup>38</sup> Furthermore, the standard of conduct allowed is that the SEC may create rules which require brokers, dealers, and investment advisers to act in the best interest of the customer.<sup>39</sup> Dodd-Frank states that if the SEC does adopt rules imposing a best interest of the customer requirement, these "rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers . . . except the Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a

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35. *Id.*

36. *Id.* (amending Securities Exchange Act of 1934 section 15(k)(2)).

37. *Id.* (amending Securities Exchange Act of 1934 section 15(l)).

38. *Id.*

39. Dodd-Frank Act, § 913(g), 124 Stat. 1828-29 (to be codified at 15 U.S.C. §§ 78o, 80b-11).

private fund managed by an investment adviser[.]”<sup>40</sup> Congress thus focused on retail investors in the message it sent to the SEC in Dodd-Frank. Accordingly, the SEC must evaluate whether existing regulation is sufficient to provide protection to retail investors. If nothing else, this will give the SEC the opportunity to review the already robust regulation<sup>41</sup> that applies to broker-dealers when broker-dealers do more than merely execute customer orders. As pointed out more fully below, while broker-dealer regulation may need some fine tuning, a very firm base already exists. In addition, imposing a fiduciary duty when broker-dealers do more than execute customer orders would not by itself impose significantly higher burdens on them. Explicit recognition of fiduciary obligations would, however, provide a meaningful emphasis on the regulation that already exists.

### III. PRINCIPLES-BASED AND RULES-BASED REGULATION

The SEC, the NASD, and now FINRA developed their regulations in a piecemeal fashion. As noted above, a good deal of broker-dealer conduct is addressed under the umbrella of regulating according to fair and just principles of trade.<sup>42</sup> Also, much of the SEC’s rulemaking authority is based on the ability to prohibit fraudulent, manipulative, and deceptive devices.<sup>43</sup> One issue that has developed over the last decade is the extent to which principles-based regulation, or the setting of general standards, should be further supplemented by rulemaking addressing specific

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40. *Id.* (noting that “[t]he receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.”).

41. For a discussion of the robust regulation that exists see 5 HAZEN CH. 14, *supra* note 11.

42. *See, e.g.*, FINRA Manual Rule 2010 (“Standards of Commercial Honor and Principles of Trade”) (“A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”), *available at* [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=5504](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504).

43. Section 10(b) of the Exchange Act empowers the SEC to promulgate rules to outlaw manipulative and deceptive devices in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b) (2006). Section 15(c) of the Exchange Act gives the SEC similar rulemaking authority with respect to broker-dealer activities. 15 U.S.C. § 78o(c) (2006).

types of conduct. There has been an ongoing debate as to whether principles-based or rules-based regulation is preferable.<sup>44</sup> This article takes the position that broker-dealer regulation contains an appropriate mix of principles-based and rules-based regulation.

Following the financial crisis and frauds such as the ones perpetrated by Bernard Madoff,<sup>45</sup> there was considerable talk of creating explicit broker-dealer fiduciary duties. Although this inspired fear within the industry,<sup>46</sup> it is far from clear that such a mandate would significantly change the current law. These calls for heightened duties also arose in the context of the Goldman Sachs investigation. Goldman Sachs was investigated by the SEC and by Congress for its role in the over-the-counter derivatives markets. Specifically, there was concern over Goldman's role as fabricator of certain derivative instruments and the ways in which it marketed them to its customers.<sup>47</sup> Goldman maintained that it was merely acting as a market maker, and as such, had no disclosure duties to its customers in allegedly betting against the investments that it was marketing. This led many to suggest that it needed to be clarified that brokers are in fact fiduciaries.<sup>48</sup> The SEC brought charges against Goldman<sup>49</sup> claiming that Goldman breached its obligations as a broker of these privately placed derivatives. The SEC's long-standing implicit recognition of broker-dealer fiduciary duties even without the proposed more

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44. See, e.g., ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, *ADMINISTRATIVE LAW* 37 n.1 (2d ed. 2001). Cf. Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 *VAND. L. REV.* 1411 (2007) (suggesting that drawing a distinct dichotomy between rules and principles oversimplifies complexity).

45. Cf. *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 354 (S.D. N.Y. 2010) (upholding state law claims against defendants who steered investors to Madoff controlled investments).

46. See, e.g., Joe Rauch, *Retail Brokers Fear New Law Could Bring Sea Change*, *REUTERS* (Oct. 30, 2009, 4:39 PM), <http://www.reuters.com/article/idUSTRE59T4C120091030> (noting that the proposed fiduciary duty language was suggested by SEC Chair Mary Schapiro).

47. See, e.g., Andrew Ross Sorkin, *Goldman Acknowledges Conflicts with Clients*, *N.Y. TIMES DEALBOOK* (Jan. 12, 2010, 11:30 AM), <http://dealbook.blogs.nytimes.com/2010/01/12/goldman-executive-discloses-conflicts-policy/>.

48. See SEC STUDY, *supra* note 10, at 109.

49. See *SEC v. Goldman Sachs & Co.* (2010), <http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf>.

explicit recognition seems adequate to address Goldman's market maker defense. A more explicit fiduciary obligation would clearly address the obligations of those brokers who brought their clients to Bernard Madoff. Nevertheless, it is far from clear that these obligations do not exist under current law. The Goldman Sachs settlement<sup>50</sup> means, among other things, that the extent of Goldman's obligations to its clients was not clarified by the courts. As discussed below, there is plenty of authority under the existing law that recognizes heightened obligations of securities broker-dealers, at least when they are acting in a capacity beyond a mere order taker.

#### IV. FIDUCIARY OBLIGATIONS – ARE MORE EXPLICIT RULES NECESSARY?

The securities laws are primarily focused on disclosure and preventing fraud. The law of fraud itself raises the rules versus standards dichotomy. Since the nineteenth century, both courts<sup>51</sup>

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50. See SEC, Litigation Release No. 21592 (July 15, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21592.htm>; Patricia Hurtado & Christine Harper, *SEC Settlement with Goldman Sachs for \$550 Million Approved by U.S. Judge*, BLOOMBERG (July 21, 2010, 12:01 AM), <http://www.bloomberg.com/news/2010-07-20/goldman-sachs-settlement-with-sec-for-550-million-approved-by-u-s-judge.html>.

51. See, e.g., *McAleer v. Horsey*, 35 Md. 439, 452 (1872):

The common law not only gives no definition of fraud, but perhaps wisely asserts as a principle that there shall be no definition of it, for, as it is the very nature and essence of fraud to elude all laws in fact, without appearing to break them in form, a technical definition of fraud, making everything come within the scope of its words before the law could deal with it as such, would be in effect telling to the crafty precisely how to avoid the grasp of the law.

*Id.* See also, e.g., *Syracuse Knitting Co. v. Blanchard*, 43 A. 637, 639 (N.H. 1899):

It is difficult to define fraud, except in a very general way. It is variable, depending upon the circumstances of the case. Those who make use of it adopt ways that have the appearance of good faith. Great skill is often shown in the attempt to make that which is false and corrupt appear true and honest. Hard and fast rules of law would be a hindrance to the discovery of fraud.

*Id.* Accord *Arkansas Valley Compress & Warehouse Co. v. Morgan*, 229 S.W.2d 133, 164 (Ark. 1950) (“[C]ourts have always been reluctant to define ‘fraud’ (either actual

and commentators<sup>52</sup> have suggested that defining fraud provides unscrupulous actors with an invitation to find a way around the law. The law thus recognizes that it is sufficient to identify a principle rather than focusing on specific detailed definitions of the types of conduct to be prohibited.<sup>53</sup>

Particularly helpful to understanding the nature of the broker-customer relationship is the Restatement of Torts' explanation: "[a] fiduciary relation exists between two persons when one of them is under a duty to act or to give advice for the benefit of another upon matters within the scope of the relation."<sup>54</sup> It follows that even absent a specific statutory or rule-based mandate, broker-dealers are under heightened obligations when doing more than merely executing customer orders.

Supplementing the existing mandate that broker-dealers live up to just and equitable principles of trade with an explicit fiduciary obligation without specific rules explaining the conduct included would not add much if anything to existing law. Although there is no clear definition of fiduciary relationship,<sup>55</sup>

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or constructive) lest man's fertile mind invent a new scheme outside the definition but just as nefarious as previously denounced schemes." (footnote omitted)).

52. Dan M. Kahan, *Lenity and Federal Common Law Crimes*, 1994 SUP. CT. REV. 345, 410 (1994) ("[C]ommon law jurists . . . refused to 'lay down as a general proposition, what shall constitute fraud, or any general rule, beyond which they will not go upon the ground of fraud, lest other means of avoiding the equity of the courts should be found out.'" (quoting JOSEPH STORY, 1 EQUITY JURISPRUDENCE § 186 at 190 (10th ed. 1870))); *see also, e.g., id.* at 410 n. 316 ("Some lawyers talk as though they thought maximum clarity always desirable even though they wouldn't have to probe very deeply to find that fraud, and fiduciary obligation, and undue influence, have been carefully isolated from exact definition, because such exact definition would simply point out safe ways of immunity, and, to the birds of prey, make the law 'their perch and not their terror.'" (quoting CHARLES L. BLACK, JR., *THE HUMANE IMAGINATION* 33 (1986))).

53. *U.S. v. Bishop*, 825 F.2d 1278, 1280 (8th Cir. 1987) ("[T]he law does not define fraud; it needs no definition. It is as old as falsehood and as versatile as human ingenuity." (quoting *Weiss v. U.S.*, 122 F.2d 675, 681 (5th Cir. 1941))); *Greco v. State*, 499 A.2d 209 (Md. App. 1985) (stating that courts "have been reluctant to define fraud with any degree of preciseness"), *aff'd*, 515 A.2d 220 (Md. 1986).

54. RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979).

55. *See, e.g., Franklin Supply Co. v. Tolman*, 454 F.2d 1059, 1065 (9th Cir. 1972) ("A 'fiduciary relation' is an elusive status to define."); *Keenan v. D.H. Blair & Co., Inc.*, 838 F. Supp. 82, 89 (S.D.N.Y. 1993) ("The precise contours of a fiduciary relationship are incapable of expression."); *Farragut Mortgage Co., Inc. v. Arthur Andersen, LLP*, No. 95-6231-B, 1999 WL 823656, at \*14 (Mass. Super. 1999) (finding that there is no all-inclusive definition of a fiduciary relationship; the existence of such a relationship is a question of fact).

some important generalizations can provide good guidance. A fiduciary relationship consists of two parties, the fiduciary and the beneficiary. It is generally understood that in such a relationship, the fiduciary has the duty to be loyal and act in the interest of the beneficiary.<sup>56</sup> The beneficiary has entrusted the fiduciary with the power to oversee his well-being.<sup>57</sup> The beneficiary is dependent upon the fiduciary due to his reliance upon a specific service the fiduciary provides under the arrangement in question.<sup>58</sup> The beneficiary ordinarily has very little or no control over the relationship or its subject matter, and thus the beneficiary is forced to rely on the fiduciary's expertise in the specific area.<sup>59</sup> In other words, a fiduciary relationship often exists when one person places his trust and confidence in another. There is reliance upon the fiduciary that the fiduciary will not abuse this trust and confidence.<sup>60</sup> Described in yet another way, a fiduciary relationship is said to exist when any person instills a power of some type in another (the fiduciary) with the intention that the fiduciary act to further the beneficiary's best interests.<sup>61</sup>

## V. THE PRESENT STATE OF BROKER-DEALER REGULATION

In addressing broker-dealer obligations, the SEC proceeded with rulemaking largely under the general anti-fraud provisions of sections 10(b)<sup>62</sup> and 15(c)<sup>63</sup> of the Exchange Act, section 17(a) of the Securities Act of 1933,<sup>64</sup> and section 206 of the

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56. See, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879, 882 (1988); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 624 (1997).

57. See, e.g., Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 240 (2009).

58. See Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800 (1983).

59. See Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 241 (2009). See also, e.g., Frankel, *supra* note 58.

60. See Alces, *supra* note 59, at 240-42. See also, e.g., DeMott, *supra* note 56, at 902; D. Gordon Smith, *supra* note 56, at 1413.

61. See Alces, *supra* note 59, at 260.

62. 15 U.S.C. § 78j(b) (2006). See 3 HAZEN § 12.1, *supra* note 11.

63. 15 U.S.C. § 78o(c) (2006).

64. 15 U.S.C. § 77q(a) (2006).

Investment Advisers Act.<sup>65</sup> The SEC's attention has been focused on two broad areas: (a) conflicts between the firm's obligations to its customers and its own financial interests,<sup>66</sup> and (b) trading in or recommending securities in the absence of adequate information about the issuer.<sup>67</sup> Violation of the anti-fraud provisions in these two areas has given rise to lawsuits by aggrieved customers<sup>68</sup> as well as disciplinary actions by the SEC.<sup>69</sup> There is a wide range of approaches taken by the SEC, FINRA, and the courts in regulating broker-dealers with respect to (1) excessive prices for NASDAQ and over-the-counter securities;<sup>70</sup> (2) activities of market makers that deal directly with individual customers in a retail capacity;<sup>71</sup> (3) excessive trading in customers' accounts designed to generate brokerage commissions;<sup>72</sup> and (4) undisclosed interests of brokers and investment advisers in the stocks they recommend.<sup>73</sup>

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65. 15 U.S.C. § 80b-6 (2006).

66. See 5 HAZEN §§ 14.3, 14.10, *supra* note 11 (discussing applicable regulations).

67. See 5 HAZEN §§ 14.15-14.18, *supra* note 11.

68. See 5 HAZEN CH. 15 and § 14.26, *supra* note 11.

69. See 5 HAZEN § 14.3, *supra* note 11. The SEC's enforcement authority is generally discussed in chapter sixteen. See *id.*

70. See, e.g., *Lehl v. SEC*, 90 F.3d 1483, 1488 n. 4 (10th Cir. 1996):

To guide its members in determining when a price is "reasonably related to the current market price," the NASD surveyed industry pricing practices, concluding that the vast majority of transactions occurred at markups of 5% or less. It then issued guidelines setting 5% as a benchmark of reasonableness, to be considered with other relevant factors. The NASD cautioned, however, that the 5% policy "is a guide- not a rule"; that a "mark-up pattern of 5% or even less may be considered unfair or unreasonable"; and that "[i]n the case of certain low-priced securities, such as those selling below \$10.00, a somewhat higher percentage may sometimes be justified."

*Id.* (citation omitted); 5 HAZEN § 14.14, *supra* note 11.

71. See, e.g., *Eichler v. SEC*, 757 F.2d 1066 (9th Cir. 1985) (affirming the SEC's finding that a market maker's duty to execute customer orders meant that it could not base pricing and order execution on an orderly market without making full disclosure to its customers). See also 5 HAZEN § 14.10, *supra* note 11 (stating that market makers operate in the over the counter and Nasdaq markets and in essence operate as wholesalers of securities).

72. This is often referred to as "churning." See 5 HAZEN § 14.20, *supra* note 11.

73. This is sometimes referred to as "scalping." Scalping consists of material omissions from the recommendation- namely that the person making the recommendation has a position in the security being recommended. A variation on



Although much of broker-dealer regulation is principles-based, there are specific rules addressing certain types of conduct. There are various SEC and FINRA (formerly NASD) rules that address particular types of misconduct by broker-dealers. As a general standard, SEC Rule 15c1-2<sup>74</sup> generally prohibits fraudulent, manipulative, and deceptive practices in connection with securities brokerage transactions. The types of specific conduct that are addressed in other rules include market manipulation,<sup>75</sup> high pressure sales tactics,<sup>76</sup> deceptive recommendations,<sup>77</sup> generation of excessive commissions,<sup>78</sup> unauthorized trading,<sup>79</sup> improper order executions,<sup>80</sup> improper extension of credit for securities transactions,<sup>81</sup> and misuse of customer funds or securities.<sup>82</sup> In addition, broker-dealers and their employees are subject to a more standards-based approach under Rule 10b-5's general antifraud proscriptions relating to deceptive conduct in connection with a purchase or sale of a security.<sup>83</sup> Beyond these specific activities and the general anti-manipulation and deception rules, the SEC makes it clear that violation of its rules is not limited to violation of any specified SEC or SRO rules, but rather covers all conduct that operates as a deceptive or

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scalping occurs when the person making the recommendation affirmatively misrepresents that he or she does not own any of the securities recommended. *See, e.g.,* In re Snyder, Exchange Act Release No. 46108, 2002 WL 1364075 (June 25, 2002) (violation of Rule 10b-5 for stating that respondent did not have an ownership position through Internet communications made about a particular company); 5 HAZEN § 14.17, *supra* note 11.

74. 17 C.F.R. § 240.15c1-2 (2010).

75. *See* 2 HAZEN §§ 6.2-6.3, *supra* note 11 (manipulation in connection with public offerings); 3 HAZEN § 12.1, *supra* note 11 (manipulation generally); 5 HAZEN § 14.10[5], *supra* note 11 (manipulation by market makers).

76. *See* 5 HAZEN § 14.18, *supra* note 11; *see also, e.g.,* News Release, FINRA, NASD Hearing Panel Expels Yankee Financial for Fraud, Orders Payment of More Than \$3.8 Million in Restitution (Jan. 13, 2005), *available at* <http://www.finra.org/Newsroom/NewsReleases/2005/P012997> (boiler-room operator expelled from NASD membership and ordered to pay more than \$3.8 million in restitution).

77. *See* 5 HAZEN §§ 14.15-14.18, *supra* note 11.

78. *See id.* at § 14.20.

79. *See id.* at § 14.21.

80. *See id.* at § 14.13.

81. *See id.* at § 14.9.

82. *See id.* at § 14.8[2].

83. 17 C.F.R. § 240.10b-5 (2010).

manipulative device.<sup>84</sup> This broad coverage thus is not limited to specific SEC rules. The SEC has taken the position elsewhere that it can regulate conduct that would be manipulative even if the concern is not based on any specified violation of existing rules.<sup>85</sup>

As pointed out above, there is considerable regulation in place dealing with broker-dealer conduct. Although there may have been some serious enforcement lapses, the broker-dealer regulatory rules structure is not broken. This is not to say that the SEC cannot improve things. An explicit statement that broker-dealers are fiduciaries will add emphasis to the obligations under existing law but will not provide significant additional regulation. To the extent that the SEC finds existing rulemaking to be deficient in protecting retail investors, then specific rules may be necessary to fill the holes that the SEC identifies.

The study and inquiry mandated by Dodd-Frank provides the SEC with an opportunity to fine tune a regulatory system over broker-dealers that basically works. There is no need to significantly overhaul the nature of broker-dealer regulation. The clear mandate of Dodd-Frank is to focus the SEC on vigorous enforcement of broker-dealer obligations. The exercise of going through the mandated study in and of itself has the salutary effect of bringing these issues to the forefront even if no significant additional rulemaking is forthcoming. The SEC study that was released in January 2011 calls for a unified standard for broker-dealers and investment advisers.<sup>86</sup> At the same time, the study

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84. SEC Rule 15c1-2(c) reads:

The scope of this section shall not be limited by any specific definitions of the term “manipulative, deceptive, or other fraudulent device or contrivance” contained in other rules adopted pursuant to section 15(c)(1) of the act.

17 C.F.R. § 240.15c1-2(c) (2010).

85. See, e.g., *In re Trautman*, Securities Act Release No. 33-9088A, Exchange Act Release No. 34-61167A, 2009 WL 6761741 \*19 n.75 (Dec. 15, 2009) (noting that late trading of mutual funds violated the Exchange Act even in the absence of an SEC rule specifically addressing that activity); *In re Hazel Bishop, Inc.*, Securities Act Release No. 33-4371, 1961 WL 61528 (June 7, 1961) (wherein the Commission held up a registration statement because of the potential for manipulation in connection with an at market secondary offering); see generally 2 HAZEN CH. 6 and § 4.28, *supra* note 11.

86. See SEC STUDY, *supra* note 10. The SEC staff study’s recommendation

leaves it for another day to decide whether this requires additional rulemaking or whether the unified standard can be achieved through administrative interpretations and guidance. With respect to the chances of new rulemaking in the near future, a statement by two SEC commissioners signals their likely opposition.<sup>87</sup> The joint statement by two of the five commissioners points out that the views addressed in this and similar SEC studies represent those “of the Staff of the Commission and not necessarily those of the Commission as a whole or of individual Commissioners.”<sup>88</sup>

The 166 page SEC staff study went beyond Dodd-Frank’s recommendation in favor of a unified standard. As stated in the report:

*Implementing the Uniform Fiduciary Standard: The*

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garnered the support of state securities administrators as embodied in the statement of the North American Securities Administrators Association (NASAA):

The SEC staff recommendation to apply a fiduciary duty to broker-dealers who provide personalized investment advice about securities to retail customers will have a significant positive impact on investors.

State securities regulators routinely see the financial devastation caused when the interests of investors do not come first. That is why NASAA has consistently urged policymakers to protect investors by requiring all who provide investment advice about securities to be held to the fiduciary duty currently applicable to investment advisers under the Investment Advisers Act of 1940.

We look forward to assisting the Commission as it develops new rules to apply a fiduciary standard of care and loyalty to all who provide investment advice to ensure that this standard is as strong as the existing fiduciary duty of the Advisers Act.

Statement, NASAA, NASAA Statement on SEC Study on the Obligations of Brokers, Dealers and Investment Advisers (Jan. 24, 2011), *available at* [http://www.nasaa.org/NASAA\\_Newsroom/Current\\_NASAA\\_Headlines/13868.cfm](http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/13868.cfm) (quotations omitted).

87. *See* Statement, SEC, Statement by SEC Commissioners: Statement Regarding Study On Investment Advisers And Broker-Dealers (Jan. 21, 2011), *available at* <http://www.sec.gov/news/speech/2011/spch012211klctap.htm> (“[W]e oppose the Study’s release to Congress as drafted. We do not believe the Study fulfills the statutory mandate of Section 913 of the Dodd-Frank Act to evaluate the ‘effectiveness of existing legal or regulatory standards of care’ applicable to broker-dealers and investment advisers.”).

88. *See id.*

Commission should engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: the duties of loyalty and care. In doing so, the Commission should identify specific examples of potentially relevant and common material conflicts of interest in order to facilitate a smooth transition to the new standard by broker-dealers and consistent interpretations by broker-dealers and investment advisers. The Staff is of the view that the existing guidance and precedent under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply.

*Duty of Loyalty:* A uniform standard of conduct will obligate both investment advisers and broker-dealers to eliminate or disclose conflicts of interest. The Commission should prohibit certain conflicts and facilitate the provision of uniform, simple and clear disclosures to retail investors about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.

...

*Principal Trading:* The Commission should address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

*Duty of Care:* The Commission should consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking and/or interpretive guidance. Minimum baseline

professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor.

*Personalized Investment Advice About Securities:* The Commission should engage in rulemaking and/or issue interpretive guidance to explain what it means to provide “personalized investment advice about securities.”<sup>89</sup>

The study also makes specific recommendations regarding what the harmonization of broker-dealer and investment adviser regulation likely would entail.<sup>90</sup> It is clear from the staff report that complete harmonization would involve substantial revision of existing rules.<sup>91</sup> If it is to be achieved, complete harmonization

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89. See SEC STUDY, *supra* note 10, at vi-vii (recommending a consideration of additional investor education)(bullets omitted).

90. *Id.* at viii-x.

91. *Id.* at viii-ix:

*Harmonization of Regulation:* The Staff believes that a harmonization of regulation—where such harmonization adds meaningful investor protection—would offer several advantages, including that it would provide retail investors the same or substantially similar protections when obtaining the same or substantially similar services from investment advisers and broker-dealers. The following recommendations address certain other areas where investment adviser and broker-dealer laws and regulations differ, and where the Commission should consider whether laws and regulations that apply to these functions should be harmonized for the benefit of retail investors:

*Advertising and Other Communications:* The Commission should consider articulating consistent substantive advertising and customer communication rules and/or guidance for broker-dealers and investment advisers regarding the content of advertisements and other customer communications for similar services. In addition, the Commission should consider, at a minimum, harmonizing internal pre-use review requirements for investment adviser and broker-dealer advertisements or requiring investment advisers to designate employees to review and approve advertisements.

*Use of Finders and Solicitors:* The Commission should review the use of finders and solicitors by investment advisers and broker-

would likely take a number of years of rule-making and implementation.<sup>92</sup>

Even in the absence of new rules and regulations harmonizing broker-dealer regulation, the study supports the thesis of this article. The study includes an extensive analysis of existing broker-dealer regulation and interpretations, recognizing,

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dealers and consider whether to provide additional guidance or harmonize existing regulatory requirements to address the status of finders and solicitors and their respective relevant disclosure requirements to assure that retail customers better understand the conflicts associated with the solicitor's and finder's receipt of compensation for sending a retail customer to an adviser or broker-dealer.

*Supervision:* The Commission should review supervisory requirements for investment advisers and broker-dealers, with a focus on whether any harmonization would facilitate the examination and oversight of these entities (e.g., whether detailed supervisory structures would not be appropriate for a firm with a small number of employees) and consider whether to provide any additional guidance or engage in rulemaking.

*Licensing and Registration of Firms:* The Commission should consider whether the disclosure requirements in Form ADV and Form BD should be harmonized where they address similar issues, so that regulators and retail investors have access to comparable information. The Commission also should consider whether investment advisers should be subject to a substantive review prior to registration.

*Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers:* The Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

*Books and Records:* The Commission should consider whether to modify the Advisers Act books and records requirements, including by adding a general requirement to retain all communications and agreements (including electronic information and communications and agreements) related to an adviser's "business as such," consistent with the standard applicable to broker-dealers.

92. See, e.g., Bruce Kelly, *Fiduciary Standard Not Happening Until Mid-2012: Ketchum*, INVESTMENT NEWS (Feb. 1, 2011, 12:10 PM), <http://www.investmentnews.com/article/20110201/FREE/110209981> (FINRA CEO predicting that any rulemaking implementing a fiduciary duty standard for broker-dealers will be a slow process).

as pointed out above, that SEC and self-regulatory decisions and interpretations as they currently exist provide a rich basis for holding broker-dealers accountable beyond mere anti-fraud rules. Accordingly, the absence of an immediate regulatory response consistent with the SEC staff study should in no way impede vigorous enforcement of broker-dealer obligations. In particular, this includes vigorous enforcement of fiduciary principles when broker-dealers are acting in a capacity beyond that of a mere order taker.