A Changing Mosaic in SEC Regulation and Enforcement: Broker-Dealers and Investment Advisers

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I. INTRODUCTION

Bernie Madoff was an investment adviser registered with the SEC pursuant to provisions of the Investment Advisers Act of 1940. He was subject to across-the-board fiduciary standards. Yet Madoff embezzled $17 billion, or more, from his clients.

R. Allen Stanford, too, was a registered investment adviser. He was subject to across-the-board fiduciary standards. He embezzled over $7 billion from investors in his enterprise.

By contrast, broker-dealers, at least rank-and-file ones, are not subject to fiduciary duties of care and loyalty. Without more—such as making a representation or holding oneself out—a broker is not a fiduciary when giving personalized investment advice and making recommendations. But brokers do not commit large and glaring frauds such as those Madoff and Stanford perpetrated, or at least they have not done so in recent times.

Brokers may be subject to several discrete commands such as those emanating from the suitability ("know thy customer") and basis ("know thy security") doctrines as well as the dictates of the shingle theory (by

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1. Section 202(a)(11) of the Investment Advisers Act defines investment adviser to include “any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who . . . issues or promulgates analyses or reports concerning securities . . . .” 15 U.S.C. § 80b-2(a)(11) (2012). Thus both private wealth managers and publishers of market letters such as Value Line are included. Brokers are not if their advisory services are “solely incidental” to their securities business and they receive “no special compensation” for rendition of the advice. Id. § 80b-2(a)(11)(C).


5. FINRA Rule 2111(a) provides in part that a broker-dealer “must have a reasonable basis to believe that a recommended transaction or investment strategy . . . is suitable for the customer, based upon the information obtained through the reasonable diligence of the [broker-dealer] to ascertain the customer’s investment profile.” FINRA R. 2111(a), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=13390.

hanging out your shingle you impliedly promise to treat your customers honestly and fairly). But the shingle theory is as close as regulation has come, at least historically, to imposing an across-the-board, gap-filling standard such as fiduciary duties.

Now comes the Wall Street Reform and Consumer Protection Act of 2010, better known as the Dodd–Frank Act, which has now been enacted. Dodd–Frank does many things and is over 700 pages long, but for purposes of this Essay one section, Section 913, is particularly relevant. Section 913 requires the SEC to study and report on whether the Commission should impose an across-the-board fiduciary standard on brokers similar to that applicable to investment advisers. The Section further grants to the SEC the authority to adopt such a standard should the Commission decide to do so. The SEC staff conducted a study on this issue, rendering a 166 page report to the Commission in January 2011.

Predictably perhaps, the study recommended that the Commission impose such a standard. More than two years later, the SEC announced that it would promulgate the first draft of proposed rules on or about March 31, 2013 but, as this Essay nears completion, no proposed SEC rule has been forthcoming.

The purpose of this Essay is not to predict and then foretell consequences of the Commission’s probable actions, specifically whether enhanced standards will promote public and private enforcement. The purpose of this Essay also is not to rehash all the


8. See notes and accompanying text infra.


10. Id. § 913(g).


12. “[R]etail customers should be protected uniformly when receiving personalized investment advice or recommendations about securities . . . . Therefore, this Study recommends that the Commission exercise its rulemaking authority to adopt and implement . . . the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.” Id. at 165.

13. See Stephen Joyce & Yin Wulczek, SEC to Issue Unified Fiduciary Standard Guidance in Q1, SIFMA’s Bentsen Says, SEC. L. DAILY, Jan. 18, 2013. As of the date this is being submitted to the University of Cincinnati Law Review, the SEC has not promulgated proposed rules.
arguments pro and con for imposition of such a standard. Very able scholars have argued the issues, in exhaustive fashion.14

Rather this Essay seeks to draw on my twenty years’ experience as a FINRA (formerly NASD) arbitrator of customer–broker disputes; as an expert witness in countless arbitrations; as a litigator or consultant in court cases; and as counsel to compliance officers at several smaller and midsized financial services firms. As a legal scholar, I have also written about the financial services industry and individual investors.15

The upshot? Imposition of a fiduciary, or similar, standard on broker–dealers will not add much, or not nearly as much as observers believe, for several reasons:

- Because of the way brokers are compensated, which is not likely to change;
- Because of the futility of attempting by regulation to curb the uncappable (striving for larger pieces of the compensation pie) in human nature;
- Because of the numerous conflicts of interest occasioned by the creation of diversified financial services firms, and engagement by those firms in cross-selling, determined to ram the “one-stop financial shopping” concept down consumers’ throats;
- Because those conflicts will not go away simply because of the adoption of a newer, more exacting standard;
- Because brokers frequently are fiduciaries in many more instances than have heretofore been recognized; and
- Because of the relative powerlessness of financial firms’ compliance officers and their efforts, the new standard will receive much less attention where it counts. Such compliance officers’ efforts are the front line, the boots on the ground so-to-speak, in enforcement of any new standard, and if history is our guide compliance officers and departments will at most give lip service to the new regime.


Ah, though, the yin and the yang. Adoption of a new standard will add some new things and fill some gaps here and there. In the penultimate Part, this Essay also will attempt to outline several possible new additions brought about under a new standard. But rather than preview what those items may be, this Essay begins with a brief reprise of the past.

II. BACKGROUND

A. Dodd–Frank Section 913

The Section begins simply enough, ordering the SEC to conduct a study with two aims in mind.

First, the Commission shall study “the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers . . . and persons associated . . . for providing personalized investment advice and recommendations about securities to retail customers . . . .”16

Second, the Commission shall study “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 . . . .”17

Third, the Section then becomes more complex, listing twelve considerations the SEC is to have in mind as it conducts the study. Salient among those considerations are the following:

- “[W]hether retail customers understand that there are different standards of care applicable to brokers, dealers, [and] investment advisers;”18

- Whether, if they are cognizant of it, that difference is “a source of confusion for retail customers;”19

- What are the “regulatory, examination, and enforcement resources” which the Commission, the states, and self-regulatory securities organizations devote to “enforce the standards of care for brokers, dealers, and investment advisers,” including the frequency of examinations and the length of examinations;20

16. Dodd–Frank, supra note 9, § 913(b)(1).
17. Id. § 913(b)(2).
18. Id. § 913(c)(3).
19. Id. § 913(c)(4).
20. Id. § 913(c)(5)(B)–(C).
The potential impact on broker-dealers of imposing on them the standards and requirements applicable to investment advisers; and

Consider "the varying level of services provided by brokers, dealers, [and] investment advisers...and the varying scope of customer relationships..."22

B. The Landscape

Eleven thousand investment advisers are registered with the SEC.23 Registered advisers manage more than $38 trillion on behalf of individual investors, managed funds (including hedge funds), and institutional investors.24 More than 275,000 individuals are registered as advisers within state or federally registered firms.25 A further 15,000 investment advisory firms are registered with the states.26 Formerly, advisers who managed less than $25 million registered with the states only. As of July 21, 2011, Dodd-Frank raised the threshold to $100 million.27 Presumably then, the number of state-only registrations will have risen in the last few years.

Registered broker-dealers are more numerous than advisers, although the number of firms is smaller (5,100 versus 11,000). The Commission oversees those 5,100 broker-dealers who, in the aggregate, service 110 million customer accounts.28 There are over 600,000 registered representatives or registered principals (owners), "engaging in a variety of business activities, which may or may not include the provision of personalized investment advice or recommendations about securities to retail customers."29

C. The Commentary

No need exists to rehash the learned commentary that has debated the wisdom vel non of the SEC imposing a uniform fiduciary standard upon broker-dealers. There has been more than a modest amount of it.

21. Id. § 913(c)(9).
22. Id. § 913(c)(11).
23. IA/BD STUDY, supra note 11, at 6.
24. Id.
25. Id.
26. Id.
27. Dodd-Frank, supra note 9, § 410.
28. IA/BD STUDY, supra note 11, at 8.
29. Id.
One of the earliest and most learned of the commentators, Professor Don Langevoort of Georgetown University, observes that a fiduciary mantle seems antithetical to the role expected of registered representatives, that is, to be a sales person—albeit one whose sales pitch often is leavened by a dose of supposedly disinterested advice.\textsuperscript{30} Professor Arthur Laby of Rutgers University School of Law urges the holding out implicit, or often explicit, in brokerage firm advertising and the choice of titles used—"financial adviser"—as providing a policy basis for imposing a uniform fiduciary standard.\textsuperscript{31} This Essay, of course, argues that under precedents already existing in many states’ laws, a holding out is a \textit{legal} basis for stating that a fiduciary duty already exists.\textsuperscript{32}

A third commentator, James Wrona, is a senior official at FINRA. By means of a painstaking study of FINRA’s rules and their antecedents, as well as his knowledge of the industry, Mr. Wrona points out that the existing web of rules and institutional constrains comes very close to imposing upon most brokers a regime very similar to the one which a uniform fiduciary standard might produce.\textsuperscript{33}

Professor Barbara Black, Charles Hartsock Professor of Law at the University of Cincinnati, was among the earliest to write on the topic.\textsuperscript{34} In one early piece, she chided the SEC for interpreting the "solely incidental" exception to application of the Advisers Act as permitting brokers to charge asset based lump sum fees to customers without having to register as investment advisers.\textsuperscript{35} The Advisers Act contains exemptions from registration for advisers who service fewer than ten accounts, or whose provision of advice is solely incidental to provision of some other service such as legal services (probating a will, offering suggestions on investment of a personal injury settlement). The SEC "made a serious mistake in allowing broker-dealers to hold themselves out as financial advisers or financial consultants" without registration under and application of the Act.\textsuperscript{36}

\textsuperscript{30} See Donald Langevoort, \textit{Brokers as Fiduciaries}, 71 U. PITT. L. REV. 439, 440 (2010) ("Brokers have always offered advice, but usually in the context of selling products and services, and selling is not a fiduciary occupation.").

\textsuperscript{31} Laby, \textit{Selling Advice}, supra note 14, at 753–68.

\textsuperscript{32} See notes and accompanying text infra.

\textsuperscript{33} Wrona, supra note 7, at 17–36.

\textsuperscript{34} Barbara Black, \textit{Brokers and Advisers—What's in a Name?}, 11 FORDHAM J. CORP. & FIN. L. 31 (2005).

\textsuperscript{35} These are so-called WRAP, or "all-in" accounts, discussed in notes and accompanying text infra.

III. THE UNDERWELMING IMPACT OF ANY NEW STANDARD

A. Brokers’ Compensation

The mind’s eye picture of a broker is of an individual recommending the purchase and on occasion the sale, of common and preferred stocks, as well as fixed income instruments (bonds), and the subsequent execution of trades to which the customer has assented. Indeed, that is what many registered representatives, what colloquially we refer to as brokers, do. But execution of such trades usually will represent the lowest level of compensation for which the broker is eligible.

The usual commission of a trade by a full service broker hovers around 1.5% of the trade amount. Thus on the purchase of, say, 1000 shares of a $20 stock, the “ticket” will include a commission of $300. How much of that sum the individual broker receives is subject to a sliding scale. If the broker is a novice, or a low-level producer (say, less than $100,000 in gross commissions for the year), she may receive only 25% of the total commission, or $75. Moving up the scale, if the broker is a medium level producer (say, between $100,000 and $500,000 annually), she receives a larger share of the commission, 37.5% of the total commission, or $112.50 on the $20,000 trade. At the top of the food chain is the high level producer, who receives half of the total commission on every ticket she writes. In this case, she would receive $150.37

On other products, though, the commissions are much greater. More importantly here, perhaps, the low-level and middle-range producers receive a much greater share of the commission on products other than listed stocks or bonds. In fact, novice brokers may stand shoulder-to-shoulder with the high-end producers on these products; no sliding scale exists. For example, mutual fund sales used to sell with a 7.5% commission. With the advent and subsequent ubiquity of no-load funds, commissions on load fund sales have been reduced, but 4 to 4.5% is still greater than 1.5% on a stock transaction (which eventually will be doubled to 3% for a roundtrip, that is, a purchase and a later sale of a stock, but that may be far into the future; by contrast, there are no commissions on the subsequent sale of a mutual fund share, which will be back to the fund itself). So on a $20,000 mutual fund sale the upfront commission may be as high as $800 rather than $300.38

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37. Brokerage firms regard their compensation arrangements to be proprietary information. The examples used in the text are not based upon any single firm’s compensation schedule. Rather they are based upon the author’s extensive experience working with and in the broker-dealer field.

38. One frequently cited source uses 5% as a benchmark for load funds with a distribution between 4% and 8%. See No-Load Fund, INVESTOPEDIA.COM,
broker will receive half, $400, regardless of whether she is a low-level or a high-end producer.

Then there is the matter of A shares versus B shares. On A shares, the purchaser pays the commission up front, at the time of purchase. On B shares, the investor pays the commission over time, which seems preferable to a thrifty investor, at least until he finds out that he will pay a higher commission overall, a fact not easily ascertained. Traditionally, a FINRA arbitration has had one industry representative. The industry representatives with whom I have sat generally do not take issue with a broker selling mutual funds rather than stocks. They do, however, take issue, and do so universally, when a broker has put a customer into B shares.

Escalating, we come to the issue of proprietary products, that is, products devised and packaged internally by the financial services firms themselves. Limited partnership interests in mining, oil and gas, real estate, vineyards, Christmas tree farms, airplanes, long-haul trucks, wheat farms, and so on, come to mind, as do some annuity products. The commission on proprietary products may be as much as 7%, even as high as 10%. Firms give half, or more, even sometimes 100%, of the commission to the brokers who sell the products, regardless of their annual output. The firms can afford to do so because they rake in millions in terms of management fees, indirect overhead expenses, and other items they charge to the entities they create. So for a low or


39. "Class A shares typically charge a front-end sales charge. . . . Class A shares may impose an asset-based sales charge (often 0.25 per year), but it generally is lower than the charge imposed by other classes (often 1 percent per year for B and C shares)." FINRA, Understanding Mutual Fund Classes (Oct. 6, 2008), http://www.finra.org/investors/protectyourself/investoralerts/mutualfunds/p006022.

40. "Class B shares . . . normally impose a contingent deferred sales charge (CDSC), which you would pay if you sell your shares within a certain period, often six years," in addition to a charge on the original sale but paid over time. Id.

41. Effective February 1, 2011, claimants with a dispute involving more than $100,000 may elect an "all public arbitration panel . . . ." FINRA, Regulatory Notice 11-05 (Feb. 1, 2011), http://www.finra.org/Industry/Regulation/Notices2011/P122880. Formerly, at least one of the three arbitrators comprising an arbitration panel had to be an industry representative. Id.


43. See, e.g., KURT EICHENWALD, SERPENT ON THE ROCK 250 (2005) (8% commission at Prudential Bache). See also id. at 21 (8% for limited partnership participations versus 1% on sale of stock).

44. See id. at 144, 183 (sales commission plus one half of cash receipts to Prudential Bache if sales of product exceeded $25,000).

45. See id. at 152 (in investment partnerships more than 20% of investors' dollars went to fees for Prudential Bache and its affiliates); id. at 247–48 (as general manager of partnerships, brokerage
middle level producer, which would include the majority of all registered representatives, her take will range from $75–$112.50 on a stock sale, to $400 on a mutual fund transaction, to $700 on sale of an in-house, or proprietary, product. It is easy to surmise on which side of the ledger the average broker will overload her time and effort.  

In my experience, most of the sharp dealing and misrepresentation occurs when brokers sell nonstock products, such as mutual funds and proprietary products. Why? Because of the commission structure, and the significantly greater amounts of compensation selling brokers are in line to receive, brokers push too hard, making unsuitable or hard sales of products for which they often have no basis or an inadequate one.

B. Curbing the Uncurbable in Human Nature

In theory, introduction of a uniform fiduciary standard will mean that, at all times, brokers will have to keep ascendant the best interests of the customer rather than the best interests of the broker or of the firm for whom the broker works. In the old world, “the broker can recommend a high-load mutual fund to a customer,” or some other product, “without revealing that Vanguard [a low cost, no load fund complex] has a comparable product in terms of expected market returns that costs substantially less.” In the new world, at least on paper, the broker subject to an overriding fiduciary duty may not do so. Will anything really change? Probably not. Given the way in which firms compensate brokers, a subject over which the SEC has no direct power, adoption of a fiduciary standard for brokers will not accomplish more than an iota of what the uninitiated believe.

46. Somewhat oddly, I find that the old warhorses, and the high-end producers, have little or no interest in selling fund shares or proprietary products. Their interest is in their first love, which brought them into the business in the first place: the analysis and sale of stocks and bonds. Perhaps it is that at that stage of their careers experienced brokers are writing much larger tickets for higher net worth individuals and institutions. They make more money doing that than they could selling proprietary products or loaded funds, products in which their clients are likely to have very little interest.

47. Nonetheless, in spite of all of that, Dodd–Frank “provides that offering only proprietary products by a broker-dealer shall not, in and of itself, violate the uniform fiduciary standard” (if one is adopted). IA/BD STUDY, supra note 11, at 113. In all probability, knowing that some of the most egregious abuses occur on the sale of proprietary products, the brokerage industry sought inclusion of a very targeted provision in the legislation.

C. Broker's Compensation—Round II

Euphemistically, commentators distinguish between “fee-based” broker's compensation and “transaction-based” compensation. The later type compensation is the commission or, in the over-the-counter market, the markup. In contrast, commentators never seem to spell out what they mean by the former but, in the trade, the term used is “WRAP” accounts, rather than “fee-based.”

If the retail investor has no interest in mutual funds, or in proprietary products, or if the broker has no interest in selling them, the broker may then attempt to sell the customer a WRAP account. Financial services firms too pressure their “account executives” to sign up customers for WRAP accounts.

What precisely is a WRAP account? Taking their inspiration from hedge fund managers, who amass huge fortunes charging “2 and 20,” that is, an annual 2% of the amount under management plus 20% of any profits made under their management, brokers urge clients to sign up for accounts charged only an annual fee based upon the size of the account, rather than trade-by-trade commissions, as has been traditional. Typically, WRAP account agreements provide for an annual fee equal to 1.5% of the amount under management, although many firms permit their brokers to negotiate down from that level to 1% or 80–90 basis points. Most brokers do so, and rather quickly at that.

The reason brokers do so is that even at a reduced rate the WRAP account represents a higher compensation level than do trade-by-trade commissions, usually a much higher level. Take for instance an investor with a $1 million account. If she has a turnover rate of 25% in the account, which would be a high level of purchases and sales in an individual account, she would pay $3,750, or perhaps less, in commissions. If her broker persuaded her to sign up for a WRAP account, she would pay $9,000, $10,000, or even as much as $15,000 annually.

Brokers and the financial services industry vigorously defend the idea of WRAP accounts. For one, they say, a WRAP removes from the

49. See, e.g., Black, supra note 34, at 31–32.
50. The SEC study refers to this as an “all-in fee.” IA/BD STUDY, supra note 11, at 152.
52. Typical WRAP fees are 1.5% on equity holdings and .35% on bond holdings, according to one source. Asher Hawkins, WRAP Account Ripoff, FORBES.COM (Mar. 25, 2010, 1:40 PM), http://www.forbes.com/politics/2010/0412/investing-brokerage-commission-retirement-finra-ripping-you-off.html. According to another source, WRAP fees may be even higher. See JOHN C. BOGLE & DAVID SWENSEN, COMMON SENSE ON MUTUAL FUNDS 54 (10th Anniversary ed. 2010) (as high as 3% annually).
broker the conflict of interest which results when she is compensated only if a transaction ensues. That is hogwash. Individuals go to a full-service rather than discount broker such as Charles Schwab or E*Trade for a reason. The reason is that they expect a full service broker to provide them with a variety of advice and observation, such as "That's a stupid idea," which my broker has told me on more than occasion. "You realize that by making this trade you'll have more than 5% in railroad stocks," or "keep your powder dry because there may be better buying opportunities in the future," or "it's okay to buy some but I would just nibble here," or "our prediction is that this stock (or industry, or the market as a whole) will only move sideways for the next (6 months? Year?)" are examples of advice full service brokers give to their clients. You get what you pay for and what you pay for in a full-service broker is advice like that, not bare-bones executions. WRAP accounts seem like a bad deal, an escalation above the full commission level, making the investor pay extra for the receipt of what he already should be receiving for standard commissions. To an experienced investor WRAP accounts are simply beyond the pale.

D. Curbing the Uncurbable in Human Nature—Round II

Will the adoption of an across-the-board fiduciary standard curb brokers from hard sell of WRAP accounts, at least to their less sophisticated customers? As my Australian and English friends would say, "Not bloody likely!" The stakes and the temptations are simply too great. A broker who signs up a score of million dollar plus portfolios to

53. "In many cases the best advice [a broker] can give . . . is to 'do nothing.'" Report of the Committee on Compensation Practices, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85, 614, at 86,508 (Apr. 10, 1995). "Accordingly, fee-based accounts better align the customers' and the brokers' interests, because brokers are not financially motivated to give advice to generate a sales commission." Black, supra note 34, at 32 (footnote omitted).

54. The brokerage industry won this one, at least from a regulatory viewpoint. Under the long prevailing interpretation of the Investment Advisers Act (IAA), a broker was excluded from the IAA's definition of investment adviser only if both (1) his performance of advisory services was "solely incidental" to the conduct of his business as a broker-dealer; and (2) he received "no special compensation" for his services. 15 U.S.C. § 80b-2(a)(11)(C) (2012). In 1999, when brokerage firms had begun in large measure to sell WRAP accounts, a rule change was necessary so that brokers receiving WRAP fees did not become investment advisers because of the receipt of special compensation. So, after intense lobbying by the financial services industry, in 2005 the SEC changed the rule to accommodate the marketing of fee-based accounts. It adopted rule 202(a)(11)-1, eliminating the no special compensation aspect of the definition. 17 C.F.R. § 275.202(a)(11)-1 (reserved by Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950 (July 19, 2011)). See also Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 20,424 (Apr. 19, 2005). Professor Barbara Black has termed this change a "mistake" and a "serious mistake." Black, supra note 34, at 54, 56.
WRAP accounts has placed a comfortable floor, or cushion, underneath pursuance of her livelihood. Adoption of a new standard, not enforced, will not stop that.

E. The Myriad Conflicts of Interest in the Modern Financial Firm

Brokers used to sell stocks and bonds. In today’s firms, in addition to stocks, brokers can sell WRAP account services, money-market checking accounts, banking services of all types including home mortgages, mutual funds, annuities, accident and life insurance, and so on. Moreover, brokers have strong incentives to move customers into areas in which the broker’s compensation will be greater and residuals may ensure compensation in future years as well, as in the sale of mutual fund shares or life insurance policies.

That said and done, many brokers, particularly experienced ones, have little or no interest in selling anything other than their first love, stocks and bonds. Nonetheless, their superiors may attempt to force them to do so. Heedless of the myriad of conflicts involved, the financial services industry, and most of the firms within it, have been enamored of the “one stop financial shopping” for over thirty years now. CEO Brian Moynihan of Bank of America sees “cross-selling”

55. See, e.g., IA/BD STUDY, supra note 11, at 94 n.447 (“Years ago, I was pretty sure who I was dealing with . . . . Today, it’s a totally different story. All kinds of products such as securities, insurance, fee based products, bank accounts, loans, health insurance, auto/homeowners insurance, etc. are sold by people calling themselves: financial advisers; financial consultants; investment advisers; investment consultants; financial planners; asset managers; financial services advisors; [and] registered representatives . . . . It has come to the point that I really don’t know who I’m dealing with . . . .” (quoting Letter from Bert Oshiro (Aug. 29, 2010))). It is highly unlikely that imposition of a fiduciary standard will lessen the confusion.

56. Life insurance agents typically receive commissions of 6% per year of the premium paid on whole-life life insurance and 4% per year on term life insurance, plus a bonus for initiating a new policy. Bobbie Sage, How Much Money Does My Agent Make from My Life Insurance Purchases?, ABOUT.COM, http://www.personalinsurance.about.com/od/life/f/lifefac3.htm (last visited Dec. 31, 2013). Increasing the attraction for the selling agent, insurance premia typically are front-end loaded, with the selling agent receiving up to 70%, or even 85%, of the premia the insured pays in the first year, with correspondingly disproportionately smaller commissions on the policy’s back end, which usually ends with the policy’s tenth year. Thereafter the selling agent continues to receive a fee but only a small one, known as a “persistency fee.” See Jay MacDonald, How Much Does a Life Insurance Agent Make?, BANKRATE.COM (Aug. 15, 2011), http://www.bankrate.com/finance/insurance/life-insurance-agent-make-1.aspx (estimates commissions on life insurance at 7.5% overall and front-end loading up to 85%); Faizah Imani, What Kind of Commissions Do Insurance Agents Get?, ZipRECRUTER.COM, http://career.ziprecruiter.com/kind-commissions-insurance-agents-get-1406.html (last visited Dec. 31, 2013) (front end loading up to 70%).

57. And the SEC may aid and abet brokerage firms that want to move into the insurance area. See, e.g., Insurance Agencies Gain No-Action Relief For Plans to Network with Brokerage Firms, SEC. L. DAILY, Apr. 26, 2013 (SEC ruling green lights joint efforts to sell “variable annuity contracts, variable life insurance policies, and other life insurance policies and annuity contracts” to investors).

58. See, e.g., Branson, supra note 15, at 887 (industry emphasis on “one stop financial shopping”
as the solution to the near insoluble problems brought on by Bank of America’s acquisition of Countrywide Mortgage and Merrill Lynch. Sandy Weill blended brokerage, banking, insurance, and other financial firms into Citigroup because of the opportunities for “cross-selling” such a combination represented.

One stop financial shopping has not made nearly the inroads with consumers which gurus of the financial world predicted. It seems that while agreeing with the notion of a level playing field, consumers still want that field divided into several paddocks. Consumers want investments handled through a brokerage firm; their insurance needs handled by an insurance agent; and their commercial banking down the block from the local bank.

Nonetheless, the financial services industry continues its headlong pursuit of the cross-selling notion. Some persons who come through a firm’s front door wanting an investment in a blue chip stock or two will wind up with an annuity or a life insurance policy. Will adoption of a fiduciary standard applicable to broker–dealers change any of that? Somewhat but not appreciably.

F. The Low Priority Given Compliance in the Industry

If the SEC promulgates a new, uniform fiduciary standard, the task of implementing and enforcing it will in the first instance fall upon compliance officers at brokerage firms. The effort therefore will be a weak one—throughout the industry firms give only lip service to compliance. Nothing in any new or proposed rule will change this fact. My experiences are only anecdotal but extensive. Overall, broker–dealer firms give the compliance function to a relatively junior person. That junior person has the last office, at the end of the corridor, on the executive floor, or, indeed, on the floor below. Senior executives do not hear from, and do not expect to hear from, the compliance officer. The usual result is that to be heard at the top, the compliance officer “must shoot to kill.” If she does that, executives and managers in the firm will sit up and listen but one consequence may be that the compliance office

in 1980).

59. See Shayndi Raice & Corrie Driebusch, Bull Sees Red Over B of A Cross-Sales, WALL ST. J., May 21, 2013, at C1 (“Chief Executive Brian Moynihan’s strategy [is] to squeeze more revenue and profit from ‘cross-selling’ everything from stocks to mutual funds to credit cards to mortgages.”).

60. SANDY WEILL & JUDAH S. KRAUSHAAR, THE REAL DEAL: MY LIFE IN BUSINESS AND PHILANTHROPY 371 (2006) (Citigroup efforts at joint venture with AOL to extend cross-selling to “an online financial supermarket”); id. at 389 (Citigroup cross-selling of brokerage services, annuities and life insurance, bank credit cards, and home mortgages).

61. Discussed notes and text accompanying infra.
loses her job as well.62

I was a consultant to one of my former students who was one of two in-house attorneys at a sizeable regional broker–dealer firm in Seattle. He had to juggle compliance duties with the myriad other legal matters which he and his cohort were expected to deal, including the extensive underwriting of limited partnerships (tax shelters) sold in numerous private placements and most of which blew up soon after sale, much like IEDs (Improvised Explosive Devices).

Another compliance officer at another firm assumed the compliance role first, attending law school later, where I taught him in evening school and later became a consultant to him and his firm. His firm was another large, Los Angeles based regional firm which since that time has become a national firm. He was the only compliance officer, for the entire firm, which even at that time had offices on both coasts.

In arbitration cases, financial firms often have a compliance officer testify, to the effect that as a controlling person, the firm “had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person [the registered rep] is alleged to exist.”63 In other cases, the branch manager will proffer the testimony. Sometimes both individuals, compliance officer and branch manager, will testify.

When the witness is a compliance officer, invariably he or she is a very junior person. Good evidence would be that the firm had a written plan of supervision, written or at least extensively reviewed and revised at headquarters, and that the plan was in fact implemented. But the evidence offered almost always falls far short of the mark. One reason is that the compliance officer comes from corporate headquarters and may have never met the respondent registered rep until the morning the arbitration commences.64

One of the more recent case in which I was involved was a state court proceeding in Louisiana involving an institutional investor who had invested $62 million in a proprietary product of a regional financial


64. In cases against a particular firm, characterized by one and two person offices in smaller cities and towns, all supervision and compliance emanates from the home office in St. Louis. My estimate is that under such a supervision-from-afar setup, rogue brokers are brought to heel, and schemes nipped in the bud, only 90 or 120 days later than would have been the case at a more traditional shop, with 15 or 20 brokers under the watchful eye of a branch manager. My fellow arbitrators did not agree with me, or agree wholeheartedly.
firm. When the product, and its manager (a rogue in the extreme), began a precipitous downward slide, the compliance officer, a relatively junior person, drafted a bulletin for branch offices and “FAs.” The bulletin asked FAs and wealth managers to review all accounts holding the product, warning that the product no longer was suitable for discretionary or trust accounts or any other accounts over which firm employees had management responsibilities. The CEO of the entire organization intervened to quash release of the bulletin. He vetoed it instantaneously.

That the CEO did so is not surprising. Financial firms are about selling. Compliance and the details attendant to it are at most a necessary evil. “[S]tories from the financial crisis frequently tell of lower end institutions—small city or township pension funds, for example—who were easy prey for salespeople from securities firms peddling exotic debt instruments . . . .”65 We will never have complete knowledge but probably compliance officers did not, and could not, stop those sales efforts. “[P]ushing excessively costly investment strategies is profitable for the industry,”66 often extremely so. Firm managers are not likely to permit compliance officers to intervene in any but the most egregious cases. “The broker may spend time helping the customer with general asset allocation advice [or] basic financial education . . . . Of course, some (perhaps a lot) of the time there is little or no added value: the broker is simply pushing an inferior product on unsophisticated investors . . . .”67 The CEO may not approve of that but he does not want the compliance officer getting in the way of it.

The weak link that compliance officers and departments represent is a major factor in why any standard the SEC adopts will have much less force and effect than one might predict.68

G. Opacity of the Dispute Resolution Process

Traditionally the United States is a common law jurisdiction which operates by the common law method. General principles issue forth, either mouthed by authoritative courts or contained in legislation.

65. Langevoort, supra note 30, at 452.
66. Id. at 445.
67. Id. at 448.
68. The Commission staff has expressed a great deal of faith in brokerage firm compliance officers, a significant amount more than the author would. See, e.g., IA/BD STUDY, supra note 11, at 76 (“FINRA Rules [Rule 3130(a)] require broker-dealers to designate one or more principals to serve as CCO. At least annually, the CCO must meet with the broker-dealer’s chief executive officer (“CEO”) to discuss the compliance program, and the CEO must certify that, among other things, the firm has in place processes to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance . . . .”).
Through case-by-case adjudication, courts apply those general principles to actual disputes, adumbrating subprinciples or providing a factual and legal framework from which further broader principles may be deduced. Judges write and publish opinions, available in law libraries or on the Internet, making those opinions, general principles, and more discrete applications available to all.

The content of those opinions enable legal practitioners and citizens to “bargain in the shadow of the law,” as a famous law review article discussed.69 Either alone or in conjunction with our attorney–counselors, we also shape our conduct in the shadow of the law.

In this area, broker–dealer law, since 1987, we have had no law, or little law, in whose shadow we can bargain, or shape conduct. The reason is the Supreme Court’s reversal of its 1953 decision Wilko v. Swan.70 Wilko held that an agreement to arbitrate a securities law broker–customer dispute constituted an illicit waiver of the securities statutes’ protection which provisions of the Act expressly render void.71 Twin decisions in 1987 reversed Wilko v. Swan, holding that rather than a waiver of statutory protections an agreement to arbitrate constitutes merely a selection of the forum in which questions will be decided.72 Since that time, all customer agreements at brokerage firms contain an arbitration clause. All, or most all, customer dispute go to FINRA arbitration proceedings rather than to court.

Judges write opinions. Arbitrators seldom do, in part because the pay arbitrators receive is miniscule. So aside from an outlier or two, such as when a dispute against a bank or a small, less sophisticated broker makes it to court, the stage has gone dark. Broker–dealer disputes disappear into the arbitration black hole. In an earlier arbitration case in judgment of which I sat, my fellow arbitrators were incredulous when I opined that I might write an opinion.

Ordinarily, then, when the SEC, another agency, or a court enunciates a new general standard, such as a uniform fiduciary standard, further decisions will adumbrate subprinciples, case holdings, and valuable dicta. That process will not unfold here because arbitration has come to rule the roost and one of its salient characterizations ranges from “opaque” to “completely dark.”

Over time, though, the SEC and FINRA staffs could deduce and

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71. Securities Act of 1933 § 14 (Contrary Stipulations Void); Securities Exchange Act of 1934 § 29(a) (Validity of Contracts).
evolve more discrete rules from the general principle, that is, the uniform fiduciary standard. I have very little confidence in an SEC staff which shows itself largely unaware that most broker-dealer customer disputes go to arbitration rather than to court. Blissfully unaware, the SEC staff seems to believe that case-by-case court adjudications have continued and in the future will flesh out what the general standard requires in various sets of circumstances.\textsuperscript{73} Staff members further believe, apparently, that the determination of a fiduciary relationship’s existence is a matter of federal law. They delve not one iota into the state law which would govern such issues.\textsuperscript{74}

A famous juridical statement concerns fiduciary status: “But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry.”\textsuperscript{75} SEC staff authoring the Investment Adviser/Broker Dealer Study attribute the remark to Justice Benjamin Cardozo.\textsuperscript{76} The difficulty is that, as every lawyer should know, Justice Felix Frankfurter penned the statement when Justice Cardozo had been dead for five years.\textsuperscript{77} Though trivial, such gaffes do not inspire confidence in the SEC staff’s ability to take the laboring oar on the adumbration of subprinciples and rules for broker-dealers.

IV. BROKERS ALREADY MAY BE AND FREQUENTLY ARE FIDUCIARIES

A. Introduction

Thus the adoption of a fiduciary standard will not add much to the equation. Any new standard may add even less when one considers that many more broker–dealers have taken on the mantle of fiduciary, either voluntarily or inadvertently, or so it may be argued, than commentators previously have recognized. This may be discerned in part by a simple review of the labels brokers and firm place upon the position. In the ‘50s and ‘60s many brokers called themselves “customers’ men” (there were few women brokers then).\textsuperscript{78} In the ‘70s and ‘80s, brokers called

\textsuperscript{73} See, e.g., IA/BD STUDY, supra note 11, at 46–87 (Commission and Self-Regulatory Regulation of Broker–Dealers). The staff discussion fails to cite a single arbitration decision or to note that most of the cases which its study cites are relatively old, that is, of 1990 or older vintage.

\textsuperscript{74} See notes and accompanying text infra.

\textsuperscript{75} SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

\textsuperscript{76} IA/BD STUDY, supra note 11, at 110.


\textsuperscript{78} See, e.g., DOUGLAS M. BRANSON, THE LAST MALE BASTION: GENDER AND THE CEO SUITE IN AMERICA’S PUBLIC COMPANIES 43 (2010) (Marion Sandler, later to become CEO of Golden West Financial, in the 1950s said that as a woman she could never be made at partner at Dominick & Dominick, a leading Wall Street firm where she had spent 5 years as an analyst.).
themselves “account executives.”79 Today the vogue is, officially and unofficially, to call firm representatives who deal with the public “financial advisers,” or “FAs” for short.80 The choice of label is, (1) ubiquitous within the industry; (2) not inadvertent; and, (3) highly conducive to finding that today many brokers already are fiduciaries, at least in the eyes of the law.81

One aside: the SEC staff’s study of this issue is woefully insufficient. Absent a statute preempting state law, the creation of a fiduciary relationship is a subject for state, and not federal, law. That said and done, many federal decisions, including most of the later opinions, blithely gloss over this issue, citing and analyzing federal cases only.82 The better decisions, however, recognize and analyze the creation of a fiduciary relations vel non to be an issue of state law.83 Yet in discussing this subject, the SEC’s Study on Investment Advisers and Broker–Dealers neither cites nor inquiries into state law, at all.84

B. Holding Out by Broker–Dealers Make Them Fiduciaries

Professor Arthur Laby makes a case that reasonable expectations created both by brokerage firm advertising and by brokers’ own actions should justify a fiduciary obligation for broker–dealers.85 A strong argument can be made that such activities already do result in duties of the utmost care, loyalty, and good faith.

First, the “should” part, which borrows heavily from Professor Laby’s treatment. Merrill Lynch was among the first of the brokerage firms to

81. Claimants recognize this. Of 7,137 arbitrations filed with FINRA in 2009, 4,206 alleged that the respondent was a fiduciary who had breached fiduciary duties. IA/BD STUDY, supra note 11, at 81, 81 n.384. Misrepresentation (3,408), negligence (3,405), breach of contract (2,802), failure to supervise (2,691), and unsuitability (2,473) were the next most popular claims. Id.
82. See, e.g., United States v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (holding that a fiduciary duty is “[m]ost commonly” found when “a broker has discretionary authority over a customer’s account”); United States v. Szur, 289 F.3d 200, 211 (2d Cir. 2002) (“Although it is true that there is no general fiduciary duty inherent in an ordinary broker/customer relationship,” a relationship of trust and confidence may arise where there has been an entrustment by the customer.).
83. See, e.g., Associated Randall Bank v. Griffin, 3 F.3d 208, 212 (7th Cir. 1993) (“A broker-dealer in Wisconsin is not a fiduciary with respect to accounts over which the customer has the final say, and in the absence of unusual circumstances owes the customer only a duty of ordinary care.”); Midamerica Fed. Savings & Loan v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1257 (10th Cir. 1989) (existence of a fiduciary relationship is a matter of Oklahoma state law).
84. See IA/BD STUDY, supra note 11, at 52–84.
85. Laby, Selling Advice, supra note 14, at 753–74.
advertise, beginning in the 1940s. The New York Stock Exchange (NYSE) encouraged ersatz investors with its “Own Your Share of American Business” from 1954 to 1968. The NYSE encouraged investors to sign up with a broker for the Monthly Investment Plan (MIP), emphasizing “shirt sleeve capitalism.” One financial services firm advertised “service to every investor, including the little guy”; another promised “investment insight” tailored to “the individual needs” of the client.

The advertisements the industry published were replete with come-ons and holdings-out. One firm promised “[t]otal [f]inancial [p]lanning [which] requires a careful assessment of your entire financial situation.” “Talk to your financial consultant for straight answers” exhorted another. A third had the mantra in its advertising that “If you want to know What’s Going On On Wall Street, Ask Shearson Hammill.”

One argument for imposition of a fiduciary duty comes from agency law. If a third party reasonably believes an agent (the financial advisor) has authority to act, and that belief is traceable to the manifestations of the principal (the financial services firm), the agent will be deemed to have apparent authority. The numerous television and print advertisements of modern financial services firms create in would-be investors and clients the reasonable apprehension that the registered representative is a fiduciary and acts at all times in the best interests of the client, and many times has confidential or inside information. The representations which individual brokers make mirror what the firms’ advertisements state. Just use of the title “financial adviser” constitutes a holding out which should provide strong evidence that reliance is hoped for, and that a fiduciary relationship has come into being.

The use of advertising and of labels and titles “laden with the language of advice” providers surely supports imposition of a fiduciary duty. However, the advertisements and labels support the contention that a fiduciary relationship already exists in a great many cases.
Courts are quite firm in stating that creation of a franchisor-franchisee relationship does not result in the franchisor becoming a fiduciary.94 Courts state unequivocally that, without more, a franchisee is an independent contractor only, to whom no overriding duties of care, loyalty, and good faith are owed.95

Typically, the "more" is a holding out by the franchisor that it will assume responsibility for the overall financial and business health of the franchisee. "[Franchisor] Sabaro's representatives convinced their franchisees there was nothing to worry about, Sabaro would handle all."96 A fiduciary relationship exists if there exists "an understanding, held by both parties to the subject agreement, that a special trust and confidence has been reposed . . . ."97 In the words of a federal district judge, "[a] fiduciary relationship permits an individual to relax his or her guard and trust another to care for their interests."98 "Superior knowledge and assumption of the role of advisor and friendship are two factors that may contribute to establishment of a fiduciary relationship."99

Scenarios that fit those facts like a glove unfold in every brokerage firm and office in the country every business day. Most broker-dealers are fiduciaries already, as much as they may deny it.

### C. Entrustment

A broker-dealer may become a fiduciary by a holding out. Frequently, the holding out on the broker's side of the table induces a placement of trust and confidence by the customer seated on the opposite side of the table. The two, a holding out and an entrustment, frequently go hand-in-hand. Nonetheless, courts in some states...


96. In re Sabaro Holding Inc., 445 N.Y.S.2d 911, 914 (N.Y. Sup. Ct. 1981) (finding fiduciary relationship). See also Dunfee v. Baskin-Robbins, Inc., 740 P.2d 1148, 1151 (Mt. 1986) ("[T]he general rule [is] that under a franchise agreement a fiduciary relationship does not ordinarily develop. However, [the plaintiff franchisees] argue that special trust and confidence was reposed by [plaintiffs] in the expertise of the [defendant franchisor] and that . . . a fiduciary duty resulted. When a fiduciary duty exists the one in the stronger position owes an obligation, by virtue of that trust relationship, to act in the best interests of the beneficiary.").


99. Id. (internal quotation marks omitted) (finding that no fiduciary relationship existed in the case at bar).
emphasize the latter.

In *Butcher v. Newberger*, the investor received 100 shares of a utility stock in 1930. He never closely inspected it. Two years later the investor discovered that the certificate was for common shares rather than for the preferred shares which he had ordered and paid for, and which had twice the value of the common. The court upheld rejection of any notion that the plaintiff was barred by laches or by contributory negligence. Finding brokers' relation to their customers to be "in the nature of trust," the Supreme Court of Pennsylvania expounded on application of that principle:

Where, as here, the parties dealt on a basis of trust and confidence, the rule is to hold the party making a representation bound by it . . . [I]t is said that, if fiduciary relations obtain, nothing short of actual knowledge will prevent recovery of misrepresentations.

Illinois appears to be another entrustment state. In *Fischer v. Slayton & Co.*, a broker dealer had sold the plaintiff out of common stock, putting the funds in an in-house managed product which, *inter alia*, charged whopping 9% commissions. Referring to the broker as a "trustee," the appellate judge generalized: "[A] fiduciary relation is not limited to cases of trustee and cestui que trust, guardian and ward, attorney and client, or other recognized legal relations, but it exists in all cases where confidence is reposed on one side and a resulting superiority and influence on the other side arises . . .".

**D. Fiduciary in All Customer Dealings**

A surprising number of states fall into this category. Seemingly, Ohio falls into this group. *Silverberg v. Thompson McKinnon Securities Inc.* involves the all-too-frequent fact pattern in which a registered representative switches an investor from stocks and bonds into options trading. The court makes a flat and unequivocal statement on the status of broker–dealers in Ohio:

A broker–deal is a fiduciary who owes his customer a high degree of care in transacting his business. A fiduciary must disclose all material information which he learns concerning the subject matter of the fiduciary relationship. Good intent is not a defense to a breach of this

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101. *Id. at* 551 (internal quotation marks omitted).
103. *Id. at* 676.
Other Ohio cases contain similar flat, unequivocal statements. "A broker and client are in a fiduciary relationship and, therefore, the broker owes the client a duty to disclose material information concerning investments."106 Another Ohio appellate court concluded: "[T]here is general agreement that a broker or financial advisor is in a fiduciary relationship with his clients."107

Florida seems to be in this camp as well. A bank kept confidential adverse information the bank possessed about the Atlantic Peru Equity Fund into which it had put the plaintiff investor. The investor lost $300,000 when the negative information came to light. "In general, a stockbroker must deal with its clients in good faith and owes them a fiduciary duty of loyalty and care," the court flatly concluded.108

E. Fiduciary Duty in All Customer Dealings—California

Since at least 1962, California courts have held broker–dealers across-the-board fiduciaries, similar to the nationwide rule for which many contend. The leading case is Twomey v. Mitchun, Jones & Templeton.109 There the financial adviser told a widow to sell everything, give him the proceeds, and let him invest the funds. The stockbroker telephoned her daily. The firm duly sent to her confirmation slips, which she professed not completely to understand. She lost a great deal of money and sued for breach of fiduciary duty.

The defendant argued that across the board fiduciary duty obtained only in the case of discretionary accounts, which plaintiff's was not. The court rejected any such notion. The court then began as though it intended to put California in the entrustment camp, as outlined above:

Confidential and fiduciary relations are, in law, synonymous, and may be said to exist whenever trust and confidence is reposed by one person in the integrity of another. . . . An agent is a fiduciary. His [or her] obligation of diligent and faithful service is the same as that imposed upon a trustee.110

105. Id. at *4 (citations omitted).
107. Mathias v. Rossor, Nos. 01AP-768, 01AP-770, 2002 WL 1066937 (Ohio Ct. App. May 30, 2002). But see Ed Schory & Sons, Inc. v. Soc'y Nat'l Bank, 662 N.E.2d 1074, 1081 (Ohio 1996) ("[A] fiduciary relationship has been defined by this court as a relationship in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust." (internal quotation marks omitted)).
110. Id. at 235–36 (internal quotation marks omitted).
Switching horses in midstream so to speak, though, the California court transitioned from an entrustment approach to announcement of an unequivocal and universal principle:

The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal. . . . The duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity.\(^{111}\)

The cases are not plentiful because since 1987 most broker–customer disputes, in California as well as elsewhere, have gone to arbitration rather than to court. Nonetheless, the few judicial opinions which see the light of day invariably follow the \textit{Twomey} analysis, denoting the principle as "well-settled."\(^{112}\)

F. The Antipode—No Fiduciary Duty

The opposite end of the spectrum is found on the opposite coast, specifically, in New York. In their typically terse opinions, New York appellate courts state a flat, unequivocal principle, namely that, “[a] broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities.”\(^{113}\)

But the New York cases do not present quite as united a front as the California cases do. \textit{Saboundjian v. Bank Audi}\(^{114}\) revolved around an experienced currency trader’s allegation of breach of fiduciary duty. In finding a duty and then a breach of that duty, the court seemed to accept that a broker may become a fiduciary, based upon the entrustment principle: “The relationship between a customer and his stockbroker is that of principal and agent; the duty owed by the stockbroker is that of a fiduciary.”\(^{115}\)

But \textit{Saboubdjain} involved a muffled execution rather than the rendition of investment advice or another more substantive act. In the case of an execution, all courts, including those in New York, hold that a broker is an agent. As such, she owes fiduciary duties but those duties are limited to the scope of the agency, which tends to be quite narrow.

\(^{111}\) \textit{Id.} at 236 (internal quotation marks omitted).
\(^{115}\) \textit{Id.} at 260–61.
“Once an order for the sale [or purchase] of securities is accepted, a broker has a duty to execute it in accordance with the instructions given and is liable for the resultant loss if it fails to do so.” All courts agree with this limited application of fiduciary status to a broker. Some specifically adumbrate the nature of the duties fiduciary status brings with it in the execution of customers’ orders.

The New York cases negative statement may not only be flimsy, as some New York courts toy with notions of entrustment and holding out, but illusory nearly across the board. *Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* was filed as a purported class action seeking damages, or use of money foregone, occasioned by Merrill’s practice of paying East Coast customers with checks drawn on a West Coast bank, and vice versa. Merrill thus enjoyed an extra day or two of interest on the “float,” the period when the check was in transit back across the country. The court held that, indeed, a broker could become a fiduciary when it possessed customer’s funds or other property. “[T]he relationship between a stockbroker and his customer is one of principal and agent. The broker, once he has received his customer’s funds, is a fiduciary with respect to those fund[s] . . . .”

The New York court, though, saw the potential hole opening up in the traditional New York analysis. The court stuck its finger in the dike, limiting its holding to the handling of customer funds: “The obligation which a stockbroker owes to its customer with regard to advice and counsel in respect to investments is here immaterial. What is material is the broker’s possession of the funds belonging to the customer.”

**G. Does Any of It Matter?—Implication of Fiduciary-like Contract Terms Under the Implied Covenant of Good Faith and Fair Dealing**

Under the Alternative Entities Acts in Delaware, in organic documents, planners may limit, or eliminate altogether, fiduciary duties, provided that the entity is not a corporation. Thus, planners and promoters can and do limit fiduciary principles and their application in limited liability companies (LLCs), limited partnerships (LPs), limited liability partnerships (LLPs), and so on. What some of those planners did not contemplate, though, is that plaintiffs would contend for the

116. *Id.* at 260.

117. See, e.g., *Ward v. Atl. Sec. Bank*, 777 So.2d 1144, 1147 (Fla. Dist. Ct. App. 2001) (“the duty to perform the customer’s orders promptly in a manner best suited to serve the customer’s interests” and “the duty to transact business only after receiving approval from the customer” (emphasis omitted)).


119. *Id.* at 262 (citations omitted).

120. *Id.*
same sorts of duties and responsibilities on managers’ parts. They would do using the implied covenant of good faith and fair dealing which exists in Delaware as well as a number of other jurisdictions.121

V. RESULTS A NEW STANDARD MIGHT PRODUCE

A. Beyond Suitability

A broker need only recommend stocks suitable for the customer, given her age, financial resources, and investment objectives. As has been observed, faced with a choice between a no-load and a loaded fund, roughly equivalent to one another in all other material respects, a broker does not violate prevailing suitability standards by recommending the fund which brings him the greater commissions.122

By contrast, a fiduciary, including a broker who is a fiduciary, must at all times serve the best interests of the customer. He cannot favor his own interests or those of family, friends, business associates, or other businesses in which he may have an interest, over those of the customer. By choosing the fund with higher commissions, and thus feathering his own nest at the customer’s expense, the broker will have violated his duty.

Adoption of a uniform fiduciary standard will fill in some gaps and raise the standard of conduct expected of brokers, but not by as much as might be hoped. A majority of the cases claimants bring against brokers already posit the existence of a fiduciary relationship and further allege violations of the fiduciary duties flowing from that connection.123

B. Reverse Suitability

Most, if not all, invocations of the suitability mantra involve broker recommendations, urgings, and the like of riskier or more speculative stocks and other products. Thus, a broker urges a client to sell Dow Jones Industrial Average stocks to generate cash which the broker urges should then be used for options trading or, worse yet, trading in naked options.124 Another example might be the broker who advises and

122. Langevoort, supra note 30, at 445.
123. See notes and accompanying text supra.
124. A naked option is “[a] trading position where the seller of the option does not own any, or enough, of the underlying security to act as protection against adverse price movements.” Naked Option, INVESTOPEDIA.COM, http://investopedia.com/terms/n/naked option.asp (visited Dec. 31, 2013). “If the price of the underlying security moves against the trader . . .[the seller of a call] would be required to purchase the shares regardless of how high the price is. The potential for losses, then, can be
facilitates a sale of bank and utility shares in favor of investment in bio-
tech stocks.

Beginning in the ‘70s, and accelerating in this era of cross-selling and
“one stop financial shopping,” brokers have also available to them a
variety of more conservative products into which they can put their
customers. Moreover, brokers may well be tempted to do so because the
commissions on those products, such as life insurance, annuities or real
estate limited partnerships, will be significantly greater, say, 6 or 7%
versus a 1.5% or so.

Most arbitrators with whom I have sat do not see the issue as one of
suitability, having a mindset that suitability involves more risk, not less.
They might more clearly see the issue, and the inappropriateness of the
conduct, if the broker’s duty were not only to make recommendations
which are suitable but also in the client’s best interests.

The reverse suitability issue, though, is a tiny one, on the margin at
best. The reason is that even though they may do so, and the
commissions are much greater, most brokers I know or have met have
little or no interest in hawking more conservative products as, for
example, in selling life insurance. Their first love, and their last love,
tends to be markets, stocks, bonds, mutual funds, exchange-traded-
funds, and options.

Nonetheless, it would do no harm to have the shotgun well-oiled and
loaded but behind the door, so to speak, which adoption of a uniform
fiduciary standard would represent.

C. Comprehensive Introductory Disclosure Requirement

At the commencement of an adviser–client relationship, the adviser
must deliver to the customer an upfront generalized disclosure document
or pamphlet known in the trade as Form ADV. In its Investment
Advisor/Broker Dealer Study, the SEC staff recommended that, as part
of its adoption of a uniform fiduciary standard, the SEC “should
facilitate the provision of uniform, simple and clear disclosures to retail
customers about the terms of their relationships with broker–dealers and
investment advisers, including any material conflicts of interest.” The
proponents made specific reference to investment adviser requirements:
“the disclosures . . . should be provided (a) in a general relationship
guide akin to the new Form ADV Part 2A that advisers deliver at the

unlimited . . . Inexperienced traders . . . would not be allowed [by some brokerage firms] to place this
type of order.” Id. See also Douglas M. Branson, Nibbling at the Edges—Regulation of Short Selling:
Policing Fails to Deliver and Restoration of an Uptick Rule, 65 BUS. LAW. 67, 77–78 (2009)
(discussing the practice of naked short selling).

125. IA/BD STUDY, supra note 11, at 117 (internal emphasis omitted).
time of entry into the retail customer relationship . . . "126

Such a required disclosure would not hurt and on the contrary, may be of some value if brokers are required to disclose the conflicts of interests in selling proprietary products and in cross-selling, including not only the extra commissions but the favor with superiors which will be curried and gained by doing so. Over time, of course, many such disclosures will degenerate into meaningless boilerplate, at least if SEC staffers fail adequately to police the waterfront.

VI. CONCLUSION

Too much water has flowed over the damn for it to become a reality now but the SEC may have been better served by adopting a series of discrete, specific, and visible rules, such as a reverse suitability rule, than by adopting an across-the-board uniform standard.127 That is particularly true as the adoption of an opaque fiduciary duty standard will not be followed by a flow of cases and opinions as to what the standard calls for in various sets of circumstances. Instead, application of the uniform standard will take place after most disputes have submerged into the arbitration vortex. We may never obtain a good feel for what the standard requires or what changes its adoption has bought about.

Much of the effect of a new standard’s adoption also will, as prophylactic, be blunted or neutered altogether by the weakness in financial services firms’ compliance departments. A tension exists between two inconsistent aims: investor protection, on the one hand, and designing products, selling products, and making money, on the other, which exists at every firm. Until the SEC and FINRA figure out how to raise the stature and therefore effectiveness of brokerage firms’ compliance departments and personnel, a large gap will persist between the elevated standard on paper and its effect in reality. Conflicts of interest, abandonment of notions of loyalty, and conduct wholly in brokers’ and firms’ rather than customers’ interests is, in my opinion, the prime mover behind the most egregious cases and practices in the financial services area, as it probably always has been. The emphasis on cross-selling, on selling proprietary products, and the provision of significantly higher, alluring commissions, ratchet up the stakes.

Adopted in 1933, the Glass-Steagall Act required the separation of investment and retail banking.128 Banks could not sell securities

126. Id.
127. Langevoort, supra note 30, at 445.
products and financial firms could not offer banking services. In 1999, the Clinton administration caused the repeal of the Glass–Steagall Act, green lighting an unprecedented wave of proprietary investment, selling of proprietary products, and cross-selling. The excessive waves of leverage taken on by large financial firms, motivated by the greed of their executives, caused three of out the five largest financial firms to fail and ruined millions of individual investors, causing a near death experience for many of us. So my one alternative to adoption of a uniform fiduciary standard would be to re-enact the Glass–Steagall Act or, indeed, a beefed-up version of it. But that is not going to happen. Seeing themselves as “Masters of the Universe,” financial firms’ executives and lobbyists even are opposing a watered down version of Glass–Steagall, limiting proprietary investment to no more than 3% of Tier One (low risk) capital. The financial firms are opposing this “Volcker Rule” every step of the way and, in my judgment, ultimately will prevail in watering it down, or eliminating it altogether. It may take ten years, or even fifteen, but ultimately they will succeed. So I will return to my original point, made in the introduction: there exist a number of reasons why the SEC’s adoption of a uniform fiduciary standard, applicable to broker–dealers as well as to investment advisers, will not deliver very much. Expect some incremental improvements from rules the SEC promulgates but don’t expect too much. It may turn out to be little more than a nonevent, “Much Ado About Nothing.”