SELLING ADVICE AND CREATING EXPECTATIONS: WHY BROKERS SHOULD BE FIDUCIARIES

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Abstract: Investors face a dizzying array of choices regarding where to invest their funds and increasingly rely on experts for advice. Most advice about securities is provided by investment advisers or broker-dealers, legal categories with little meaning to most people but fraught with consequences. Although advisers and brokers often perform the same function, advisers are subject to a strict fiduciary standard to act in their clients' best interest while brokers are subject to a less rigorous standard of suitability to ensure that their recommendations are suitable for customers. In 2010, the Dodd-Frank Act authorized the U.S. Securities and Exchange Commission (SEC) to harmonize the regulation of advisers and brokers and impose a fiduciary duty on brokers that give advice. This Article is about whether the SEC should exercise its authority. After explaining the historical context of the debate over a fiduciary standard, the Article critiques common arguments for a fiduciary duty, concluding that they are incomplete and do not alone justify a change in the law. The Article then puts forth a better justification, based on the reasonable expectations of investors. Reasonable expectations arise from brokers marketing their services as advisory and using titles, such as financial advisor and financial consultant. Reasonable expectations provide a stronger justification for a fiduciary standard than the conventional arguments.

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INTRODUCTION

Consider an individual who, with a modest amount of money to invest, visits a financial services professional to decide where to place the funds. The investor will face a dizzying array of choices and must decide among stocks, bonds, mutual funds, annuities, commodities, insurance policies, and other investment products. Because most people are unable to make investment decisions on their own, the individual will likely turn to the professional sitting across the desk for help. The professional's legal status under the federal securities laws will be of little importance to the investor. "Just tell me what to do," is his likely sentiment.

The professional across the desk is typically a representative of either a broker-dealer or an investment adviser—legal forms that are meaningless to most people but fraught with consequences. A broker-dealer engages in numerous activities, such as executing trades, selling securities, lending money to investors to invest on margin, maintaining custody of funds and securities, and advising about investment decisions.[1] When recommending securities, a broker-dealer owes a duty of suitability, which is a duty to ensure that an investment recommendation or strategy is suitable for a particular individual at a particular time.[2] An investment adviser, by contrast, engages primarily in advisory activities, including portfolio selection, asset allocation, portfolio management, selecting and monitoring other advisers, and financial planning.[3] An adviser owes a fiduciary duty to act in an investor's best interest, which includes a duty to avoid, or at least to disclose, material conflicts of interest.[4]

There is a significant difference between a suitability standard and a fiduciary standard of conduct.[5] Assume the investor in the example above would like to buy shares of a mutual fund that focuses on global technology companies. Assume further that the professional advising the investor is aware of six similar global technology funds with nearly identical performance, each of which is suitable for the investor. If the professional is a representative of a broker-dealer, he could consider any number of factors when deciding which fund to recommend, including the broker's own compensation from the transaction. By contrast, if the professional is an investment adviser representative, he would be required to determine which of the six funds is in the best interest of the investor, taking into account which of the funds has the lowest overall fees and costs. Thus, although the investor is unlikely to think twice about legal categories, such as broker-dealer and investment adviser,[6] the differences between them have important consequences.[7]

1. *See* SEC. & EXCH. COMM'N STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 10 (2011) [hereinafter SECTION 913 STUDY].

2. *See infra* Part I.C.

3. SECTION 913 STUDY, *supra* note 1, at 6–7.

4. *See infra* Part I.C.

5. *See infra* Part I.C.

6. In this Article, I generally use "e" when referring to advisers, consistent with the Investment Advisers Act, unless referring to broker-dealers or their registered representatives, which often refer to themselves as advisors, using "o" not "e." *See* Investment Advisers Act, 15 U.S.C. § 80b–2(a)(11) (2006).

7. *See* Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 445 (2010) (explaining that a broker can recommend a high-load mutual fund without revealing the existence of a less costly comparable product). There is abundant evidence that lower fees enhance returns. *See, e.g.*, Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 80 (1997) ("[E]xpense ratios, portfolio turnover, and load fees are significantly and negatively related to performance."); D. K. Malhotra & Robert W. McLeod, *An Empirical Analysis of Mutual Fund*

An outside observer might be mystified by the disparate regulation of broker-dealers and investment advisers when both provide advice to retail customers about securities. This state of affairs did not arise overnight.[8] For many years the line separating broker-dealers and investment advisers has blurred, and brokers have moved into territory traditionally occupied by advisers. The U.S. Securities and Exchange Commission (SEC or Commission) attempted to address this move through an administrative rule proposed in 1999[9] and adopted in 2005.[10] However, the Financial Planning Association (FPA) successfully challenged that rule in *Financial Planning Ass'n v. SEC*,[11] reigniting confusion regarding the responsibilities of broker-dealers and investment advisers and the proper regulatory treatment of brokers that give advice.[12]

Before the SEC was able to prepare a new rule, the financial crisis of 2008 overtook events, and the Obama Administration embraced the regulation of broker-dealers and investment advisers as one plank in its financial regulatory reform agenda.[13] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) addressed the regulation of brokers and advisers but did not resolve the issue definitively.[14] In the Dodd-Frank Act, the U.S. Congress required

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Expenses, 20 J. FIN. RES. 175, 189 (1997) (concluding that investors should select no-load funds with no 12b-1 plan); *see also Calculating Mutual Fund Fees and Expenses,* SEC, http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm (last visited Aug. 15, 2012).

8. *See* Certain Broker-Dealers Not Deemed to Be Investment Advisers, Exchange Act Release No. 42099, Advisers Act Release No. 1845, 64 Fed. Reg. 61226, 61227 (proposed Nov. 4, 1999) [hereinafter 1999 Proposing Release]; *see also* Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 34 (2005); *Financial Advisers Group Sues SEC Over Broker-Dealer Exemption*, 10 NO. 20 ANDREWS DERIVATIVES LITIG. REP. 10 (Aug. 20, 2004).

9. 1999 Proposing Release, *supra* note 8. As discussed below, this proposal was intended to exclude broker-dealers from application of the Investment Advisers Act of 1940, not to place a fiduciary duty on brokers that give advice to retail customers. *See infra* Part I.E.

10. Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 51523, Advisers Act Release No. 2376, 70 Fed. Reg. 20424 (Apr. 12, 2005) [hereinafter Adopting Release].

11. 482 F.3d 481 (D.C. Cir. 2007). The Financial Planning Association is a membership organization for personal financial planning experts. *Who We Are*, FIN. PLANNING ASS'N, http://www.fpanet.org/AboutFPA/WhoWeAre/ (last visited Sept. 17, 2012).

12. Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Advisers Act Release No. 2652, 72 Fed. Reg. 55126, 55127 (proposed Sept. 24, 2007).

13. U.S. DEP'T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71 (2009) [hereinafter TREASURY WHITE PAPER], *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

14. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7, 12, 15, 18, 22, 31, and 41 U.S.C. (Supp. IV 2010)) [hereinafter Dodd-Frank Act].

the SEC to conduct a study (the *Section 913 Study*) on whether to harmonize the regulation of brokers and advisers and authorized the Commission to impose a fiduciary duty on broker-dealers when providing personalized advice about securities to retail customers.[15] This Article is about whether the SEC should exercise its authority to impose a fiduciary duty.

The issue of regulatory harmonization is highly charged. In January 2011, the five-member Commission itself split on whether to release the *Section 913 Study*.[16] Since the publication of the Study, lobbying in Washington on this matter has been intense. Advisers generally line up in favor of a fiduciary obligation for brokers.[17] Broker-dealers, by contrast, either provide tepid support or oppose a fiduciary standard altogether.[18] The decision over whether to impose a fiduciary duty on

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15. *Id.* § 913; *see* SECTION 913 STUDY, *supra* note 1, at i–ii.

16. *See* Kathleen L. Casey & Troy A. Paredes, Comm'rs, U.S. Sec. & Exch. Comm'n, Statement Regarding Study On Investment Advisers And Broker-Dealers (Jan. 21, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch012211klctap.htm).

17. The Financial Planning Coalition, for example, has campaigned actively for a fiduciary standard. The Coalition was formed to advocate on issues related to financial planners, and it is composed of the Financial Planning Association, the Certified Financial Planner Board of Standard, Inc., and the National Association of Personal Financial Advisors. Another informal coalition, composed of seven groups in favor of the fiduciary standard, has advocated for harmonization through comment letters and other activities. The groups are Consumer Federation of America, Fund Democracy, AARP, Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, and National Association of Personal Financial Advisors. Letter from Barbara Roper, Dir. of Investor Protection, Consumer Fed'n of Am., et al., to Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n (March 28, 2012). Two other organizations, the Committee for the Fiduciary Standard and the Institute for the Fiduciary Standard, are both urging Congress to impose a fiduciary obligation on brokers. *See About Us*, COMMITTEE FOR FIDUCIARY STANDARD, http://www.thefiduciarystandard.org/about-us (last visited Sept. 9, 2012); *Why an Institute for the Fiduciary Standard?*, INST. FOR FIDUCIARY STANDARD, http://www.thefiduciaryinstitute.org/about/why-an-institute (last visited Sept. 9, 2012).

18. The Securities Industry and Financial Markets Association (SIFMA) has stated that it supports a fiduciary standard but opposes a fiduciary obligation of the variety now applied to investment advisers. Letter from Ira D. Hammerman, Senior Man. Dir. and Gen. Counsel, SIFMA, to Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n 4 (July 14, 2011) [hereinafter SIFMA Framework Letter]. SIFMA is a trade association for broker-dealer firms. Insurance industry representatives, many of whom are also licensed as securities brokers, have voiced strong opposition to a fiduciary duty. The National Association of Insurance and Financial Advisors (NAIFA), a trade group for the insurance industry, has argued that a fiduciary standard will increase costs and that there is no evidence it will provide investors with additional protection. *See* Press Release, Nat'l Ass'n of Ins. & Fin. Advisors, NAIFA President Terry K. Headley Says Suitability Standard of Care Serves Consumers with 'Rules-Based, Objective' Approach (May 11, 2011), *available at* http://www.naifa.org/newsevents/releases/20110511_rulesbased.cfm; *see also* Tara Siegel Bernard, *Struggling Over a Rule for Brokers*, N.Y. TIMES, Feb. 16, 2010, http://www.nytimes.com/2010/02/16/business/16adviser.html?pagewanted=all.

brokers has engendered discussion in academia as well.[19] Writers have discussed reasons to place a fiduciary duty on brokers, but they have not systematically analyzed the merits of the arguments used to support a fiduciary standard. This Article fills that gap. It assesses the arguments in support of a fiduciary duty, concluding that although some have merit, they do not by themselves justify a change.

Although a fiduciary duty for brokers is warranted, it is not warranted for the reasons generally expressed. Instead, a fiduciary obligation should be imposed on brokers that give advice based on investors' reasonable expectations. Reasonable expectations are not the same as empirical expectations based on survey data or other inquiries into epistemic expectations. Reasonable expectations are based not only on actual expectations, but also on normative considerations that ground a right. Through advertising and titles, broker-dealers hold themselves out as purveyors of impartial advice, which gives rise to reasonable expectations that they will act in a fiduciary capacity. The primary thrust of this Article is that these actions broadly support imposing a fiduciary standard. The point is not that individual brokers through advertising or use of titles have created individualized fiduciary contracts with particular investors. Rather, it is the way the industry holds itself out broadly that creates reasonable expectations that brokers giving advice will act in a fiduciary capacity. These reasonable expectations provide a justification for imposing a federal fiduciary duty.

Part I of this Article provides historical background regarding the debate over whether to impose a fiduciary duty on brokers. The debate

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19. A small body of literature has developed, fueled by the court's opinion in *Financial Planning Ass'n* and the Administration's decision to press for harmonization in financial regulatory reform. *See generally* Matthew P. Allen, *A Lesson from History, Roosevelt to Obama – The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty*, 5 ENTREPRENEURIAL BUS. L.J. 1 (2010); Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265 (2011); Kristina A. Fausti, *A Fiduciary Duty For All?*, 12 DUQ. BUS. L.J. 183 (2010); Thomas Lee Hazen, *Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*, 15 N.C. BANKING INST. 47 (2011); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710 (2010); Steven D. Irwin, Scott A. Lane & Carolyn W. Mendelson, *Wasn't My Broker Always Looking Out For My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41 (2009); Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395 (2010); Langevoort, *supra* note 7; Nicholas S. Di Lorenzo, Note, *Defining a New Punctilio of an Honor: The Best Interest Standard for Broker-Dealers*, 92 B.U. L. REV. 291 (2012); Symposium, *Papers on a Fiduciary Duty for Broker-Dealers*, 30 REV. BANKING & FIN. LAW. 119 (2010); Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059 (2011); Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 FORDHAM J. CORP. & FIN. L. 203 (2011).

has a long history, starting with decisions made when the federal securities laws were passed in the 1930s and in 1940, and through developments in the 1970s, 1980s, and 1990s. This history explains why different standards are imposed on broker-dealers and investment advisers. Part I also demonstrates that concerns animating the debate today are surprisingly similar to concerns that were prevalent when the securities laws were enacted. The concern today is that broker-dealers, which historically sold securities and profited when a sale was made, have assumed a role that causes investors to believe that brokers provide impartial advice. Brokers, therefore, should be regulated as advisers. In the 1930s, there was a similar concern that brokers with a product to sell could disguise themselves as impartial advisers. Regulation was urged as a means to separate the two groups. Understanding this parallel provides historical context to the modern debate over harmonization.

Part II reviews and analyzes arguments put forth by advocates for a fiduciary standard. Although some of the claims overlap, the arguments can be delineated as follows: (i) investors are confused about the standards imposed on brokers and advisers, (ii) the standards currently imposed on brokers and advisers are inconsistent, (iii) the standards currently imposed on brokers are ineffective, (iv) the benefits of imposing a fiduciary standard on brokers outweigh the costs, and (v) investors expect a fiduciary standard for brokers. The first four arguments do not, by themselves, support a fiduciary standard; the last argument, investor expectations, comes closest to providing a sound justification, but it is not cast in a compelling manner. Thus, none of the conventional arguments provides a sufficient justification to adopt a fiduciary standard.

Part III extends and develops the last of the five arguments discussed in Part II, investor expectations, and asserts that reasonable expectations provide a more compelling justification for change than actual expectations. Part III begins by reviewing three possible foundations for reasonable expectations: the contract terms, empirical expectations, and normative expectations. Part III then explains that advertisements and titles emphasizing advice used by many broker-dealers induce investors to engage brokerage firms to do business. This inducement provides a normative foundation for a reasonable expectation that brokers will be providing advice. Part III then demonstrates that a reasonable expectation that a broker will give advice is tantamount to a reasonable expectation that the broker will act in a fiduciary capacity. Part III concludes by discussing the implications of reasonable expectations under both regulatory and common law.

The need to articulate a justification for a fiduciary standard is timely.[20] There is a definite trend toward the adoption of a fiduciary duty for brokers. This trend is evidenced by the following measures: the Obama Administration's inclusion of a fiduciary standard in its 2008 and 2009 reform agendas,[21] Congressional action in the Dodd-Frank Act authorizing the SEC to impose a fiduciary duty on broker-dealers,[22] the *Section 913 Study*, which recommended the adoption of a fiduciary rule,[23] and statements from SEC Chairman Mary Schapiro in support of a fiduciary obligation.[24] The Securities Industry and Financial Markets Association (SIFMA), the trade association for broker-dealers, has also agreed that a fiduciary duty should be adopted in some form.[25] Most recently, the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization (SRO) for brokers, suggested that the suitability requirement entails making recommendations that are consistent with a customer's best interest—a fiduciary standard—and offered guidance on fulfilling such a fiduciary responsibility.[26] Although all roads point to the adoption of a fiduciary standard for brokers that give advice, the SEC has not yet acted. As a result, a sound justification for a fiduciary obligation is more important than ever.

20. *See, e.g.*, Tara Siegel Bernard, *A Fancy Financial Adviser Title Does Not Ensure High Standards*, N.Y. TIMES, July 7, 2012, at B1, *available at* http://www.nytimes.com/2012/07/07/your-money/beware-of-fancy-financial-adviser-titles.html; Susanne Craig & Jessica Silver-Greenberg, *Former Brokers Say JPMorgan Favored Selling Bank's Own Funds Over Others*, N.Y. TIMES, July 2, 2012, http://dealbook.nytimes.com/2012/07/02/ex-brokers-say-jpmorgan-favored-selling-banks-own-funds-over-others; Susanne Craig & Jessica Silver-Greenberg, *Many Regulators Put Their Attention on How JPMorgan Marketed its Funds*, N.Y. TIMES, July 11, 2012, http://dealbook.nytimes.com/2012/07/11/jpmorgan-pushed-sales-of-its-funds-even-at-clients-expense-brokers-say; Editorial, *Want to Buy a Mutual Fund?*, N.Y. TIMES, July 4, 2012, at A22, *available at* http://www.nytimes.com/2012/07/04/opinion/want-to-buy-a-mutual-fund.html.

21. U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 121, 125–26 (2008) [hereinafter TREASURY BLUEPRINT], *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp896.aspx; TREASURY WHITE PAPER, *supra* note 13, at 15, 71–72.

22. Dodd-Frank Act, *supra* note 14, § 913.

23. SECTION 913 STUDY, *supra* note 1, at 109.

24. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the CCOutreach National Seminar (Feb. 8, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch020811mls.htm).

25. SIFMA Framework Letter, *supra* note 18, at 11.

26. FINRA, Regulatory Notice 12-25, at 3–4 (May 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf.

I. DISPARATE REGULATION OF INVESTMENT ADVISERS AND BROKER-DEALERS THAT PROVIDE ADVICE IS ROOTED IN HISTORY

The debate over whether to place a fiduciary duty on broker-dealers that provide advice is rooted in the 1930s, when Congress first imposed federal regulation on the securities industry. Certain regulatory decisions from seventy-five years ago, understandably, have not withstood the test of time. This Part discusses the advent of the regulation of broker-dealers and investment advisers and explains historical shifts that have led to the dilemma over brokers' obligations.

A. Early State Regulation of Brokers and Advisers Was Minimal

Before the 1930s, there was little federal regulation of the securities industry. The Interstate Commerce Commission exercised some regulation over common carriers' issuance of securities, but investor protection regulation, if it existed at all, was generally done at the state level.[27] States regulated the securities industry in three ways.[28] One type of regulation was securities registration or licensing, whereby securities sold to the public had to be registered with a state authority. A second type of regulation was registration and licensing of persons engaged in the securities business. A third type was anti-fraud regulation, whereby state authorities investigated and prosecuted individuals or firms that caused injury to state residents when marketing, selling, or advising about securities.[29] State securities laws were known as "blue sky" laws. Blue sky laws permitted scrutiny over the merits of an investment as opposed to merely requiring disclosure of relevant information.[30]

During this early era, broker-dealers and investment advisers were subject to state regulation.[31] In 1911, Kansas was the first state to pass a state securities law, which included a licensing requirement applicable to persons in the securities business.[32] Over the next two years, twenty-three states followed by enacting some form of securities regulation.[33]

27. *See* RALPH F. DE BEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 3–4 (1964).

28. LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 19 (1958).

29. *Id.*

30. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 306 (6th ed. 2009).

31. *See generally* H.R. DOC. NO. 76-477, at 57–64 (1939) (advisers); JOHN M. ELLIOTT, THE ANNOTATED BLUE SKY LAWS OF THE UNITED STATES (1919) (brokers); ROBERT R. REED & LESTER H. WASHBURN, BLUE SKY LAWS: ANALYSIS AND TEXT (1921) (brokers).

32. LOSS & COWETT, *supra* note 28, at 7.

33. *Id.* at 10.

Although some states, like Kansas, required registration of securities or market professionals, the Investment Bankers Association (IBA), a trade association for the securities industry, prevented registration in the states that mattered most.[34] In New York, for example, the IBA encouraged the state legislature to pass the Martin Act, which gave the Attorney General authority to investigate and prosecute fraud in the sale of securities, though registration was not required. Working with the New York Stock Exchange (NYSE), the IBA resisted efforts to register broker-dealers in New York until 1932, well after the onset of the Great Depression.[35]

During this period, there was even less regulation of investment advisers than broker-dealers. Before World War I, investment advice was typically provided by lawyers, banks, trust companies, brokers, and dealers, but not by dedicated investment advisory professionals.[36] After the stock market crash of 1929, there was greater demand for advice as investors sought to avoid the trauma of another Great Crash. As a result, the dedicated profession of investment counsel (as it was once called) developed more rapidly during the 1930s than during previous decades.[37] Still, even by the late 1930s, only seven states, including California, Connecticut, and Illinois, required adviser registration.[38] Some, such as Michigan and Rhode Island, included within the term "broker" or "dealer" any person who acted as investment counsel and advised on the purchase or sale of securities. Consequently, many individuals giving advice were regulated because they were considered brokers or dealers, not due to intentional regulation of advisers.[39]

State regulation during this early period was limited in both scope and effectiveness. In 1933, only eight states had a dedicated securities commission. In most cases, securities administrators were overworked and underpaid bank, insurance, audit, or railroad superintendents. Many were short-term political appointees who lacked relevant expertise. Moreover, many securities offerings occurred interstate, allowing the parties to avoid regulation if the transaction closed in a non-blue sky state. Interstate offerings provided perhaps the greatest impediment to effective state regulation at the time.[40] The advent of a national securities market called for national regulation, and the Great Depression was the

34. MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 21–22 (1970).

35. *Id.* at 22.

36. H.R. DOC. NO. 76-477, at 3 (1939).

37. *Id.* at 5.

38. *Id.* at 31–32.

39. *Id.* at 32–33.

40. PARRISH, *supra* note 34, at 28–29.

impetus for reform.

B. Federal Securities Regulation Was First Enacted During the Great Depression

After the Great Crash of 1929, the securities markets were moribund. For President Franklin Delano Roosevelt, federal securities legislation was necessary as a moral matter as well as an economic one.[41] The first comprehensive federal law to regulate the securities industry was the Securities Act of 1933, known as the Truth in Securities Act and passed by Congress as part of FDR's First Hundred Days.[42] The fabled authors of the Securities Act, Tommy Corcoran, William Landis, and Ben Cohen—protégés of Felix Frankfurter—rejected merit-based regulation and opted instead for a philosophy of full disclosure modeled on the English Companies Act. The Securities Act required companies offering and selling securities to the public to make detailed disclosures and register offerings with the Federal Trade Commission, which would initially administer the law.[43] The Securities Act was signed into law on May 27, 1933, and federal regulation of the securities industry was born.[44] Although the Securities Act regulated broker-dealers in their securities underwriting capacity,[45] it did not impose comprehensive regulation on brokers, and it imposed no regulation on advisers.

1. Broker-Dealer Regulation Was Enacted in 1934

Broker-dealers were first subject to detailed federal regulation in the Securities Exchange Act of 1934. After the Securities Act was enacted, reformers turned their attention from the primary market, where issuers sell securities to raise capital, to trading in the so-called secondary market, where securities are traded among investors. Passage of the Exchange Act was far more challenging than the Securities Act. Regulating the secondary market required oversight of the powerful

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41. *Id.* at 43.

42. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

43. ANTHONY J. BADGER, FDR: THE FIRST HUNDRED DAYS 130–31 (2008).

44. The Landis-Cohen Bill passed easily in the House. The Senate, however, passed a different version. Sam Rayburn, the powerful chairman of the House Interstate Commerce Committee, favored the House version. He secured the support of FDR as well as Senate Majority Leader Joseph Robinson, and the House version prevailed in the Senate. *See id.* at 132.

45. Securities Act of 1933, ch.38, § 2(11), 48 Stat. 74, 75 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)) (defining underwriter); *id*. § 11(a)(5), 48 Stat. at 82 (establishing underwriter liability).

exchanges and broker-dealer firms. Moreover, although the Securities Act passed with relative ease, the legislative environment had changed by 1934. The air of crisis had evaporated, and the legislative pace had slowed, giving industry more time to marshal opposition against proposed reforms.[46] Draft bills contained numerous flashpoints, such as the ability to set margin requirements, the role of specialists and floor traders, regulation of proxies, and the composition of the new SEC.[47] After months of painful compromise, the Exchange Act was enacted on June 6, 1934.[48]

The Exchange Act set forth clear definitions for the terms "broker" and "dealer." It defined a broker as a person who effects transactions in securities for another[49] and a dealer as a person who buys and sells securities for one's own account.[50] The Act also required registration of securities exchanges and broker-dealer firms. It limited the amount of credit one could use to purchase securities, required periodic reporting for securities issues that were already registered, and prohibited manipulation and fraud in the purchase and sale of securities. Perhaps most importantly, the Exchange Act established the SEC to implement and enforce the securities laws.[51] The first slate of SEC commissioners took office in July 1934, with Joseph P. Kennedy as Chairman.[52]

As passed, the Exchange Act did not provide for a self-regulatory structure for broker-dealers. Shortly after passage, an industry organization for securities dealers, the Investment Bankers Conference, together with the SEC, sought an amendment to the Exchange Act to authorize the formation of a self-regulatory organization (SRO) for broker-dealer firms.[53] The amendment passed in 1938 as the Maloney

46. *See* PARRISH, *supra* note 34, at 113.

47. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 85–100 (3d ed. 2003).

48. Securities Exchange Act of 1934, ch. 404, § 1, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78 (2006)).

49. *Id.* § 78c(a)(4)(A).

50. *Id.* § 78c(a)(5)(A).

51. *See generally id.* 15 U.S.C. § 78a–78oo (2006).

52. RICHARD J. WHALEN, THE FOUNDING FATHER: THE STORY OF JOSEPH P. KENNEDY 143–46 (1993).

53. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 390 (1970); Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 23 (2001). The National Industrial Recovery Act (NIRA), part of Roosevelt's New Deal, permitted industry self-regulatory groups to establish codes of conduct to eliminate unfair competitive practices, enforceable by the federal courts. BADGER, *supra* note 43, at 74; Mahoney, *supra*, at 22–23. The IBA created the Investment Bankers Code Committee and drafted a Code of Fair Competition for Investment Bankers approved in 1934. In 1935, the NIRA was declared unconstitutional, *Schechter Poultry v. United States*, 295 U.S. 495 (1935), but the investment banking industry continued to

Act, which authorized an SRO.[54] Thus, as early as 1939, broker-dealers were subject to direct SEC regulation under the Exchange Act and regulation by an SRO, which was the National Association of Securities Dealers (NASD) at the time.[55]

2. *Investment Adviser Regulation Was Enacted in 1940*

Unlike the Securities Act and the Exchange Act, the Investment Advisers Act was not a response to crisis. By 1940, when the Advisers Act was passed, the Great Crash was over a decade old and the country was well past the statistical lows of 1933, which marked the nadir of the Great Depression.[56] Nor was the Advisers Act a response to scandal in the investment advisory profession. The Advisers Act instead grew out of study and reflection.[57]

In 1935, the SEC embarked on a comprehensive analysis of investment trusts and investment companies, which was required by Congress in the Public Utility Holding Company Act of 1935. Among the thirteen volumes comprising the study was a slim report entitled, *Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*.[58] The Commission's jurisdiction to investigate advisers was incidental to its authority to study investment trusts and investment companies.[59] The investment counsel report was little more than a survey of advisory firms that responded to the Commission's request for information.

The report identified two concerns bedeviling advisory firms. The first was that so-called "tipster" organizations were disguising

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follow its Code of Fair Competition on a voluntary basis. Mahoney, *supra*, at 23. The Code Committee reorganized into the Investment Bankers Conference and in 1939, the Investment Bankers Conference reorganized into the National Association of Securities Dealers (NASD). WALLACE H. FULTON, HISTORY OF NASD 1 (undated monograph) (on file with author).

54. Maloney Act of 1938, Pub. L. No. 719, 52 Stat. 1070 (codified as amended at 15. U.S.C. § 78o-3 (2006)) (adding § 15A to Securities Exchange Act).

55. In 2007, the NASD reorganized yet again as FINRA. FIN. INDUS. REGULATORY AUTH., 2007 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT: SHAPING THE FUTURE OF REGULATION 8 (2007), *available at* http://www.finra.org/AboutFINRA/AnnualReports/index.htm.

56. U.S. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970, BICENTENNIAL EDITION, PART 1, at 126 (1975) (unemployment statistics); U.S. BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970, BICENTENNIAL EDITION, PART 2, at 1004 (1975) (bond and stock prices).

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

58. H.R. DOC. NO. 76-477 (1939).

59. *Id.* at 1.

themselves as legitimate advisory organizations.[60] Certain firms providing advice were affiliated with investment banks or brokerage firms and, therefore, had a vested interest in recommending particular securities. Investment banks were securities merchants; they were paid based on the spread between their purchase price and the sale price to the customer. Such institutions were unable to provide objective advice. As one adviser stated, "[A] merchant in securities to be sold at a profit is primarily concerned with moving the wares he has on the shelf that he will make money out of, and therefore is not in a position to give unbiased advice, which we have stated to be the function of the professional investment counsel."[61] The report emphasized that an adviser cannot provide unbiased advice unless conflicts of interest were removed. This concern over biased advice presages the current debate over whether to place a fiduciary duty on brokers and will be revisited shortly.

The second concern identified was that advisory firms had to contend with numerous problems in their organization and operation.[62] Although many advisory firms did not assume custody of client securities, they were not prohibited from doing so. The report pointed out that those firms with custody had no requirements with respect to protecting client assets, minimum net capital, or auditing of client securities by an independent authority.[63]

In 1940, the U.S. Senate held hearings on a bill to regulate investment companies and investment advisers.[64] When the hearings were over, the Senate report identified at least two reasons for federal regulation. One was to protect the public from "fraud and misrepresentations of unscrupulous tipsters and touts," and the other was to protect bona fide investment advisers from the "stigma" of associating with unscrupulous members of the profession.[65] The Act that emerged was the product of compromise. The Senate report stated that the final bill resulted from "cooperative efforts" on the part of the industry and the SEC, and the bill had nearly unanimous bipartisan support.[66]

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60. *Id.* at 28.

61. *Id.* at 29.

62. *Id.* at 27.

63. *Id.* at 30.

64. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the S. Comm. on Banking and Currency, Part 1*, 76th Cong. 1 (1940) [hereinafter *Hearings on S. 3580*].

65. S. REP. NO. 76-1775, at 21 (1940).

66. *Id.* at 1–2. When describing the legislative process, Representative Charles Wolverton

The Advisers Act defined "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."[67] The Act required registration and annual reporting, and it prohibited fraud perpetrated on any client or prospective client. As part of the prohibition on fraud, the Act proscribed advisers from trading as principals with their clients absent advanced written disclosure and consent. The Act contained few other substantive requirements and was considered to be little more than a compulsory census.[68] It made no attempt to determine who could act as an adviser or evaluate their qualifications.[69] And it did not provide for an SRO structure; the SEC alone would implement the statute, unless criminal enforcement was called for.[70]

Unlike the Exchange Act, which focused on securities transactions, the Advisers Act focused on the relationship between an adviser and client. Advisers who testified before the Senate in 1940 emphasized the personal nature of the advisory relationship. One witness described the profession as "a personal-service profession [that] depends for its success upon a close personal and confidential relationship between the investment-counsel firm and its client. It requires frequent and personal contact of a professional nature between us and our clients. We must know them well."[71] Another stated, "The relationship of investment counsel to his client is essentially a personal one involving trust and confidence."[72] Even the Supreme Court has noted the "delicate fiduciary nature" of the investment advisory relationship.[73]

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proudly observed that industry representatives were able to "sit down with the regulatory body, and, around the table, discuss the problems and arrive at a fair and reasonable solution of them." 86 CONG. REC. 9816 (1940).

67. Investment Advisers Act § 202(a)(11), 15 U.S.C. § 80b–2(a)(11) (2006).

68. *Hearings on S. 3580*, *supra* note 64, at 48 (statement of David S. Schenker, Chief Counsel, SEC).

69. *Id.*

70. Criminal enforcement was part of the Advisers Act since its passage. Investment Advisers Act of 1940, ch. 686, § 209(e), 54 Stat. 847, 853 (codified as amended at 15 U.S.C. § 80b-9(d) (2006)).

71. *Hearings on S.* 3580, *supra* note 64, Part 2 at 713 (statement of Charles M. O'Hearn, Vice President and Director, Clarke, Sinsabaugh & Co.).

72. *Id.* at 719 (statement of Alexander Standish, President, Standish, Racey & McKay, Inc.).

73. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (quoting 2 LOUIS LOSS, SECURITIES REGULATION 1412 (2d ed. 1961)).

3. Certain Broker-Dealers Were Excluded from the Advisers Act

As passed, the definition of investment adviser encompassed a broker-dealer that advised a brokerage customer. In response, Congress included a special exclusion from the Advisers Act for broker-dealers as long as two conditions were met. First, the advice must be "solely incidental" to the conduct of business as a broker or dealer. Second, the broker-dealer must receive no "special compensation" for providing advice.[74] The Act defined neither "solely incidental" nor "special compensation," although a Senate report provided guidance on the meaning of "special compensation." The report clarified that the exclusion applied only to broker-dealers that were paid on commission.[75] If brokers were compensated in another manner, the compensation would be deemed special compensation, abrogating application of the exclusion.

There are at least two possible explanations for the broker-dealer exclusion from the Advisers Act. One explanation is that it avoided duplicative oversight. Because brokers were already subject to SEC and NASD regulation under the Exchange Act, there was little need for an additional layer of regulation under the Advisers Act. The SEC ascribed this explanation to the exclusion in 2005,[76] and this explanation has support in legislative history.[77] Another explanation is that Congress was largely unconcerned with advice that was insignificant in amount. Congress, therefore, excluded advice by broker-dealers, but only if it was "solely incidental" to brokerage and only if the customer did not pay special compensation for the advice. Paying separately for advice would suggest the advice was not insignificant.[78] The proper interpretation of the phrase "solely incidental"—and the correct explanation for the exclusion—are unsettled, but neither is important to this Article.[79] A

74. Investment Advisers Act § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006).

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

76. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 50980, Advisers Act Release No. 2340, 70 Fed. Reg. 2716, 2719 n.40 (proposed Jan. 6, 2005) [hereinafter 2005 Proposing Release].

77. *See Hearings on S.* 3580, *supra* note 64, Part 2 at 1008.

78. The phrase "solely incidental" was also used to exclude lawyers, accountants, engineers, and teachers. Legislative history suggests that the lawyers' exclusion was meant for advice that was insignificant in amount. *Id.* at 766 (statement of Prof. E. Merrick Dodd, Jr., Harvard Law School); *see also Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 76th Cong. 90 (1940). The broker-dealer exclusion, therefore, might be explained the same way.

79. Elsewhere I have given reasons why the most likely interpretation of "solely incidental" is "insignificant" and, therefore, why the most likely explanation for the exclusion was to permit

new fiduciary duty would apply to brokers even if the brokers' advisory activities continue to be otherwise excluded from the Advisers Act.

C. *The Regulation of Brokers and Advisers Differs*

Differentiating between the legal standards applicable to brokers and advisers when they provide advice to retail customers is a challenging task.[80] According to some sources, brokers that executed securities transactions as agents for their customers were considered fiduciaries. Both the *Restatement (Second) of Agency* and the *Restatement (Third) of Agency* make plain that an agency relationship is fiduciary.[81] In a 1936 report discussing the roles of brokers and dealers, the SEC wrote that the relationship between a broker and a customer is fiduciary in nature and consistent with obligations imposed on other agents.[82]

Notwithstanding early statements by the SEC regarding brokers' fiduciary duties, courts have been inconsistent regarding whether brokers are fiduciaries.[83] Today, the consensus view is that brokers are subject to a standard of suitability whereas advisers are subject to a higher fiduciary standard.[84] There is a significant difference between the

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advice that was insignificant in amount. *See* Laby, *supra* note 19, at 419–20 (citing historical sources). Although the proper interpretation of the phrase is important to the SEC and the courts as they apply the exclusion, it is not important for the argument in this Article justifying a fiduciary duty for brokers that give advice.

80. *See* Langevoort, *supra* note 7, at 443–44.

81. RESTATEMENT (SECOND) OF AGENCY § 1 (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

82. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER xiv (1936). Dealers trade securities with customers from the dealers' own accounts and, therefore, they are not agents in the same sense as brokers. Notwithstanding the distinction between brokers and dealers, the SEC has invoked the "shingle theory" in dealer cases, prohibiting conduct such as charging excessive mark-ups. *See* Hughes v. SEC, 139 F.2d 434 (2d Cir. 1943). Although the shingle theory was first applied in excessive mark-up cases, it is not limited to those cases. HAZEN, *supra* note 30, at 608. Under the shingle theory, a broker implicitly represents, by figuratively hanging out a shingle, that it will conduct its business in an equitable and professional manner. *Id*. at 607.

83. *See, e.g.*, SEC v. Pasternak, 561 F. Supp. 2d 459, 499 (D.N.J. 2008) (holding that the "weight of the authority" is that a broker owes a fiduciary duty when a brokerage account is discretionary); Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1536 n.10 (Cal. Ct. App. 1989) ("[T]here is in all cases a fiduciary duty owed by a stockbroker to his or her customers; the *scope* of this duty depends on the specific facts and circumstances presented in a given case.") (emphasis in original). The inconsistency is exacerbated by several factors, such as a dearth of litigated cases (most brokerage disputes are arbitrated), the contractual nature of the duties imposed, and substantial variations in state law. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 704–16 (2010).

84. SECTION 913 STUDY, *supra* note 1, at iii–iv; ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 10 (2008) [hereinafter

brokers' suitability rule and the advisers' fiduciary standard. The suitability rule requires that a broker-dealer have a reasonable basis to believe a recommendation or investment strategy is suitable for a customer based on information the broker must obtain through reasonable diligence.[85] A fiduciary standard is far more exacting. A fiduciary standard is a "best interest" standard. Under a fiduciary standard it is not sufficient to determine whether advice is suitable, rather the adviser must act in the client's best interest.[86] Fiduciaries are subject to a distinctive duty of loyalty,[87] which, absent disclosure, prohibits conflicts of interest when the fiduciary's personal interest conflicts with the principal's interest,[88] and conflicts of duty when the interests of two or more principals conflict with one another.[89] According to *SEC v. Capital Gains Research Bureau, Inc.*,[90] the leading Supreme Court case applying the Advisers Act, an adviser has a duty of utmost good faith, a duty of full and fair disclosure of all material facts, and a duty to use reasonable care to avoid misleading clients.[91] There is

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RAND REPORT], *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf; Jane J. Kim & Aaron Lucchetti, *Big Changes in Store for Brokers in Obama's Oversight Overhaul*, WALL ST. J., June 19, 2009, at C1; David Serchuk, *Suitability: Where Brokers Fail*, FORBES, June 24, 2009, http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html. In certain circumstances, brokers are held to a higher standard. For example, when a broker has discretion over an account, the broker owes a fiduciary duty. U.S. v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (a fiduciary duty is most commonly found when a broker has discretionary authority over an account); *Pasternak*, 561 F. Supp. 2d at 499. Discretion is authority akin to a power of attorney to trade without a customer's prior approval. Moreover, individual facts and circumstances can change the rule. If a relationship of trust and confidence has developed between the parties, a court may impose a fiduciary obligation. The classic case is *Arleen W. Hughes*, 27 S.E.C. 629 (1948), *aff'd sub nom*. *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (noting that fiduciary duties are imposed on brokers who place themselves in a position of trust and confidence).

85. FINRA Regulatory Notice 11-02, at 2 (Jan. 2011), *available at* http://www.finra.org/Industry/Regulation/Notices/2011/P122779.

86. The Advisers Act contains a general antifraud provision, which courts have interpreted to impose a federal fiduciary duty on advisers. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11 (1977) (stating that Congress intended section 206 of the Advisers Act, the antifraud provision, to establish "federal fiduciary standards" for advisers); *see also* SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008) ("Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors . . . ."), *reh'g granted & opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009); United States v. Lay, 568 F. Supp. 2d 791, 812 (N.D. Ohio 2008) (an adviser must "act in good faith and in the best interests of its client").

87. *See* Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049 (2007).

88. *See, e.g.*, Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989).

89. *See, e.g.*, Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75 (2004); Steven L. Schwarcz, *Fiduciaries with Conflicting Obligations*, 94 MINN. L. REV. 1867 (2010).

90. 375 U.S. 180 (1963).

91. *Id.* at 194 (quoting WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 534–35 (2d ed.

no analog to the *Capital Gains* case for broker-dealers.

Let us review the relatively stable state of affairs in the mid-twentieth century as to the roles and regulation of brokers and advisers as compared to the uncertainty and inconsistency of today. At that time, brokers performed their standard functions of executing trades, selling securities, making loans, maintaining custody of client funds and securities, arranging for delivery of certificates, performing record-keeping functions, and providing advice incidental to the performance of brokerage services.[92] They were generally paid on commission, and they were regulated under the Securities Exchange Act, subject to a duty of suitability enforced by the SEC and FINRA.[93] Investment advisers generally limited themselves to providing investment advice, including portfolio selection, asset allocation, portfolio management, selection of other advisers, and financial planning. They typically charged an asset-based fee, and they were regulated under the Investment Advisers Act, subject to a fiduciary standard of conduct enforced by the SEC.[94] Some firms were dual registrants, registered as both broker-dealers and investment advisers. In those cases, the SEC regulated the firms on an account-by-account basis.[95] The elegance of this regulatory scheme, however, would not last. During the 1970s, changes in the securities industry called into question the adequacy and logic of the regulatory scheme constructed forty years earlier.

D. Changes in the Securities Industry Disrupted the Coherency of Broker and Adviser Regulation

Beginning in 1975, the financial services industry underwent rapid

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1955) and 1 FOWLER V. HARPER & FLEMING JAMES, THE LAW OF TORTS 541 (1956)). Advisers must disclose material information, including conflicts of interest, and information about fees, recommendations, and disciplinary information about the advisory firm and firm personnel. *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, Hearings Before the H. Subcomm. on Capital Mkts. & Gov't Sponsored Enter.*, 112th Cong. 9 (2011) (statement of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=258252.

92. *See* 2005 Proposing Release, *supra* note 76, at 2719–20.

93. Brokers were also subject to liability in private actions, generally subject to arbitration in accordance with pre-dispute arbitration agreements signed by most investors. *See generally* Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349 (2008).

94. There were few private actions brought under the Advisers Act because the Supreme Court ruled in 1979 that there is only a very limited private right of action under the Advisers Act. Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 24 (1979).

95. Adopting Release, *supra* note 10, at 20,440 n.165.

change, leading to today's dilemma over whether to harmonize the regulation of brokers and advisers. Some of the changes were related to brokers' compensation; others were related to marketing and advertising. In both cases, the events challenged the theory that brokers offered advice "solely incidental" to brokerage and received no "special compensation" for the advice.

1. The Elimination of Fixed Commissions Resulted in Two-Tier Pricing

For many years brokerage commissions in the United States were fixed by government fiat.[96] The system of fixed commissions, in place since 1792, was advantageous to broker-dealer firms. For example, in the years 1961 to 1968, fixed commissions resulted in a six-fold increase in income for brokerage firms.[97] The system of fixed commissions, however, officially ended on May 1, 1975—known as May Day—when the SEC prohibited any exchange from requiring members to charge fixed rates.[98] Although it is unlikely that anyone noticed at the time, commission rate deregulation launched a series of events that called into question the ability of broker-dealers to take advantage of the broker exclusion in the Advisers Act.

Deregulation led to rapidly declining rates and the advent of discount brokerage for customers who preferred lower commissions over the amenities of full service brokerage.[99] For example, in September 1975, Charles Schwab opened its first branch office in Sacramento, California.[100] Established brokerage firms, not about to cede the discount market to Schwab, followed its lead.[101] Several began to offer two tiers of service: a discount brokerage tier, which was effectively "execution only," and a full service tier, which included advice. Two-tier pricing jeopardized application of the broker exclusion. Recall that a broker could not take advantage of the exclusion if it received special

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96. SELIGMAN, *supra* note 47, at 301–02.

97. *Id.* at 411; *see also* Janice M. Traflet & Michael P. Coyne, *Ending a NYSE Tradition: The 1975 Unraveling of Brokers' Fixed Commissions and Its Long Term Impact on Financial Advertising*, 25 ESSAYS IN ECON. & BUS. HIS. 131, 132 (2007).

98. *See generally* MARSHALL E. BLUME ET AL., REVOLUTION ON WALL STREET: THE RISE AND DECLINE OF THE NYSE 128–42 (1993).

99. Traflet & Coyne, *supra* note 97, at 136.

100. *See History*, CHARLES SCHWAB CORP., http://www.aboutschwab.com/about/schwab_history (last visited Aug. 17, 2012).

101. Traflet & Coyne, *supra* note 97, at 138.

compensation for advice.[102] If a broker offered one fee for "execution-only" service and a higher fee for full service, the difference between the two fees might be attributable to advice, vitiating application of the exclusion.[103]

2. *Certain Broker-Dealers Began to Charge Asset-Based Fees*

The advent of a two-tier pricing model was not the only development that endangered application of the broker exclusion. In the 1990s, many brokers migrated from charging commissions to charging asset-based fees. This migration had its own history, propelled by Arthur Levitt, Jr., SEC Chairman from 1993 until 2001. Levitt's roots were in the brokerage industry. In 1963, he joined Carter, Berlind & Weill, and eventually became President of its successor firm, Shearson Hayden Stone.[104] Levitt also served as an American Stock Exchange governor and was its president from 1978 to 1989.[105] Levitt understood as well as anyone the conflicts of interest inherent in broker-dealer compensation. In fact, he had previously nettled some of his partners by calling on brokers to be paid based on client returns as opposed to commissions.[106]

Years later, broker compensation remained one of Levitt's priorities. In a 1994 speech before the NASD, he criticized the broker who "churns and burns a client and then bounces to the next firm."[107] Levitt applauded creative ideas being tested in the industry and noted that some firms offered investors a choice between paying commissions or an annual fee.[108] Levitt welcomed such innovation and announced that the SEC would take a "fresh look" at compensation.[109]

To that end, Levitt established a Committee on Compensation Practices, led by Daniel Tully, then Chairman and CEO of Merrill Lynch, to examine compensation and incentive practices. The Committee's report (The *Tully Report*) concluded that at least a portion of a registered representative's compensation should be based on the

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102. *See supra* Part I.B.3.

103. Adopting Release, *supra* note 10, at 20,448.

104. SELIGMAN, *supra* note 47, at 626.

105. *Id.* at 627.

106. ARTHUR LEVITT, TAKE ON THE STREET 7 (2002).

107. Arthur Levitt, Chairman, SEC, Remarks Before the National Association of Securities Dealers (May 19, 1994) (transcript available at http://www.sec.gov/news/speech/speecharchive/1994/spch005.txt).

108. *Id.*

109. *Id.*

amount of assets held in the account so that the broker would be paid even if his advice were to "do nothing."[110] The *Tully Report's* recommendations persuaded several firms to begin offering fee-based brokerage accounts.[111] The SEC understood that some brokers would be reluctant to offer fee-based services because receiving non-commission-based compensation could abrogate application of the broker exclusion.[112] The twin developments of two-tier pricing and asset-based fees applied pressure on the legacy application of the broker exclusion's "special compensation" prong and necessitated a solution.[113]

3. The Focus of Brokerage Services Moved from Execution to Advice

Stock brokerage looked very different in the 1990s than it did in the 1930s and 1940s.[114] In the 1930s, order execution was a complicated process.[115] Orders to buy and sell securities were first communicated to the exchange floor. A floor broker would then carry orders to a specialist who made a market in a given security. For liquid stocks, a floor broker would match orders with another floor broker standing at the specialist's post, or against an order previously entered in the specialist's book. If an order could not be matched, the specialist might act as a dealer and trade out of his own account to maintain liquidity. The floor broker could also enter a limit order in the specialist's book to be executed at a specified price.[116] One contemporaneous source referred to the "skill, care, and probity" by which execution of orders was accomplished.[117]

The broker's advisory function, by contrast, was of less importance.[118] When the Advisers Act was enacted, broker-dealers employed salesmen, who, in many cases, lacked the expertise to perform a true advisory

110. DANIEL P. TULLY ET AL., REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES (Apr. 10, 1995), *available at* www.sec.gov/news/studies/bkrcomp.txt.

111. 1999 Proposing Release, *supra* note 8, at 61,228.

112. *Id.*

113. *Id.*

114. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 655 (1995) (noting that "to modern eyes, the trading mechanisms of the early 1930s were quite primitive").

115. Mildred Adams, *A Portrait of the Wall Street Broker*, N.Y. TIMES, Nov. 5, 1933, at SM8 (explaining that the process of brokerage is more complex than imagined).

116. SELIGMAN, *supra* note 47, at 487.

117. RUDOLPH L. WEISSMAN, THE NEW WALL STREET 6 (1939).

118. This state of affairs where brokers' advisory role was of secondary importance was itself a shift from the late 1800s, when brokers performed a true advisory function. *See* ROBERT SOBEL, INSIDE WALL STREET 100 (Beard Books 2000) (1977). That older history, however, is not relevant to this Article.

function. Securities salesmen typically made a decision early in their careers to concentrate on either research analysis or customer contact, but not both.[119] Although salesmen dispensed some advice, they generally only did so by passing along information from the research department or other partners at the firm.[120] Many securities salesmen were so-called "customers' men." Customers' men functioned much like order clerks, accepting orders from customers, transmitting them for execution, and reporting back to the customer once the execution was complete.[121] Although brokers did provide advice to customers before the mid-twentieth century, execution was the main task. The idea that advice could be "solely incidental" to brokerage was befitting of the time.

Developments in the ensuing decades tilted the balance of brokers' activity away from execution and toward advice. The birth of electronic markets and the development of electronic trading automated much of the day-to-day enterprise of transaction execution without the use of specialists, floor brokers, runners, and messengers.[122] Electronic trading eased the difficulties of execution and simultaneously increased the speed by which information could be communicated, making timely information and analysis a vital commodity. As securities execution receded in importance, brokers enhanced their value by providing high quality advice. In today's market, advice is what investors value most.[123] As early as 1991, broker-dealers began to explicitly tell customers that they should consider the broker-dealer registered representative more of an adviser than a stockbroker.[124] The 1995 *Tully Report* concluded that the "most important role" of the registered representative is providing investment advice to clients.[125]

As will be discussed in Part III, by the 1990s, there were many examples where leading wire houses advertised their services as advisory, with one firm stating that advice and not execution is the core of the customer relationship.[126] Similar to how the advent of two-tier

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119. *Id.* at 9.

120. *Id.* at 9, 154.

121. *Id.* at 12; WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 110 (Kennikat Press 1969) (1940).

122. Andre E. Owens & Christie Farris Öberg, *Rise of Electronic Trading, in* BROKER DEALER REGULATION, PLIREF-BDR § 18.3 (2011); Seligman, *supra* note 114, at 665.

123. *See* Laby, *supra* note 19, at 423–24.

124. Letter from Barbara Roper, Dir. of Investor Prot., Consumer Fed'n of Am., to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n, 7–8 (Jan. 13, 2000).

125. TULLY ET AL., *supra* note 110, at 3.

126. *See infra* Part 3.A; Roper, *supra* note 124, at 8.

pricing and asset-based fees applied pressure on application of the "special compensation" prong of the broker exclusion, the importance of the broker's advice and the manner in which he held himself out to the public put pressure on the application of the "solely incidental" requirement.

E. The SEC Addressed Changes in Compensation Through an Administrative Rule

Change often leads to uncertainty, and such was the case with the developments discussed here. Brokerage firms were concerned that fee-based or full service brokerage accounts would become subject to the Advisers Act, which would have imposed a fiduciary duty on each account. As a result, brokers sought relief from the SEC to continue taking advantage of the broker exclusion with respect to those accounts.[127] Chairman Levitt, nearing the end of his term, was eager to see firms comply with his long-desired reforms and was willing to meet them halfway with a new exemptive rule.[128] In 1999, the SEC proposed a rule with the apt title, "Certain Broker-Dealers Deemed Not To Be Investment Advisers."[129] The rule prevented application of the Advisers Act to brokerage accounts solely because the firm instituted a two-tier pricing structure or charged fee-based compensation.[130] The rule would have effectively eliminated the "no special compensation" prong of the broker exclusion and permitted brokers to benefit from the exclusion regardless of the type of compensation received. Perhaps because brokers were already offering fee-based accounts, raising the concern that they were in violation of the Advisers Act, the SEC's proposing release, in a rare twist, contained "no action" language that allowed firms to conduct business as if the rule had already been adopted.[131]

127. Letter from Ira D. Hammerman, Senior Vice President & Gen. Counsel, Sec. Indus. & Fin. Mkts. Ass'n, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n 3 (Feb. 7, 2005), *available at* http://www.sec.gov/rules/proposed/s72599/sia020705.pdf ("[A]n Exchange Act-registered broker-dealer's offering its customers the alternative of paying a fee rather than a commission for brokerage services should not result in the broker-dealer's becoming subject to the provisions of the Advisers Act.").

128. *See generally* Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, Financial Self-Defense: Tips From an SEC Insider (Oct. 16, 1999) (transcript available at http://www.sec.gov/news/speech/speecharchive/1999/spch305.htm); Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, Common Sense Investing in the 21st Century Marketplace (May 23, 1999) (transcript available at http://www.sec.gov/news/speech/speecharchive/1999/spch280.htm).

129. 1999 Proposing Release, *supra* note 8.

130. *Id.* at 61,228.

131. *Id.* at 61,227.

As expected, the industry splintered over the merits of the proposal. Brokerage firms supported the rule while advisers were firmly opposed.[132] Just as advisers were concerned about so called tipsters in 1939 and 1940, advisers in the 1990s maintained that under the proposed rule, brokers could disguise themselves as advisers in all material respects while avoiding the onerous responsibilities of the Advisers Act. Advisers argued that the rule would both allow brokers to compete unfairly and deny investors important protections under the Advisers Act.[133] The Commission proposed a modified rule in January 2005[134] and adopted the final version in April 2005.[135] The FPA challenged the rule in *Financial Planning Ass'n v. SEC* before the U.S. Court of Appeals for the D.C. Circuit.[136] The court sided with the FPA and vacated the rule.[137]

Removal of the rule left an unsettling gap for investors, regulators, firms, and their lawyers. By vacating the rule, the court effectively eliminated the SEC's "no action" position, under which brokers were already acting as if the rule had been adopted, placing customers into fee-based brokerage accounts. Absent the new rule, every fee-based

132. 2005 Proposing Release, *supra* note 76, at 2718.

133. *Id.*

134. 2005 Proposing Release, *supra* note 76.

135. Adopting Release, *supra* note 10.

136. Fin. Planning Ass'n v. SEC, 482 F.3d 481, 493 (D.C. Cir. 2007). According to the Government Accountability Office, financial planning involves several services, such as preparing financial plans for clients based on their financial circumstances and objectives, making specific recommendations to clients, and helping to implement those recommendations. Implementation could include providing insurance, securities, or other financial products. Individuals who provide financial planning might be associated with an investment adviser or a broker-dealer or both. GAO, REGULATORY COVERAGE GENERALLY EXISTS FOR FINANCIAL PLANNERS, BUT CONSUMER PROTECTION ISSUES REMAIN 2 (2011).

137. *Fin. Planning Ass'n*, 482 F.3d at 493. The FPA first challenged the rule in 2004. After the final rule was adopted in 2005, the FPA filed another petition for review and the cases were consolidated and decided in March 2007. *See generally id.* Although the case raised policy issues, the court decided the matter on technical legal grounds, holding that the SEC lacked the statutory authority to adopt the rule. The decision turned on the SEC's authority in the definitional section of the statute. Section 202(a)(11) of the Act defined the term investment adviser. As discussed, section 202(a)(11)(C) excluded broker-dealers whose advice was solely incidental to brokerage and that did not charge special compensation for advice. Section 202(a)(11)(F) contained authority for the SEC to exclude "such other persons not within the intent of this paragraph." *Id.* at 485. The SEC argued that section 202(a)(11)(F) enabled it to exclude brokers that *do* receive special compensation because such brokers provide advice in much the same way as brokers that are already excluded; only their method of compensation has changed. The FPA argued that the authority to exclude "other" persons referred to persons other than a category of persons already subject to an exclusion, namely brokers. Thus, any administrative exclusion for brokers adopted by the SEC was impermissible under the grant of statutory authority. The majority agreed with the FPA and vacated the rule. *Id.* at 493.

brokerage account was arguably an advisory account, subject to the full panoply of investor protections in the Advisers Act, including the strict limitations on principal trading discussed above.[138]

F. *The Obama Administration and Congress Sought a Political Solution to Changes in the Securities Industry*

The SEC's ill-fated regulatory response attempted to relieve brokers charging special compensation from application of the Advisers Act. As might be expected, Congress took a broader view, responding to a wider array of constituencies and seeking a more comprehensive solution to the conundrum presented by changes in the industry.[139] Like the SEC's response, the political response addressed brokers' compensation, but it went further and took into account shifts in the broker's role and patterns of marketing of brokerage services.

When the D.C. Circuit vacated the SEC's rule in 2007, the time was ripe for regulatory harmonization to be taken up in legislation. In 2007, the housing bubble collapsed and by 2008, the Obama Administration, acting through the United States Department of Treasury (Treasury), was considering comprehensive regulatory reforms to address the unfolding financial crisis.[140] Although the division between brokers and advisers played little role in the collapse, political capital to address financial regulatory reform was high, and impending legislation provided a rare opportunity to address regulatory harmonization in a comprehensive fashion. In its 2008 *Blueprint for a Modernized Financial Regulatory Structure*, Treasury stated that an important factor distinguishing advisers from brokers was that advisers are fiduciaries and owe their clients a duty of "undivided loyalty."[141] By contrast, Treasury said, brokers are subject to a duty of suitability.[142] The *Blueprint* noted the convergence of services provided by brokers and advisers. Treasury found that the failure to adjust to market developments had led to

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138. *See supra* section I.B.2. To address the predicament regarding principal trading, the SEC passed a temporary rule relieving such brokers from the strictures of the principal trading requirements. Principal Trades with Certain Advisory Clients, Advisers Act Release No. 3128, 75 Fed. Reg. 82236 (Dec. 30, 2010). The temporary rule was extended through December 31, 2012. *Id*.

139. Under the separation-of-powers doctrine, agencies refine standards or apply them to particular cases while Congress sets policy and drafts broad principles. Indus. Union Dep't, AFL-CIO v. Am. Petroleum Inst., 448 U.S. 607, 675 (1980) (Rehnquist, J., concurring).

140. THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 233 (2011); TREASURY BLUEPRINT, *supra* note 21.

141. TREASURY BLUEPRINT, *supra* note 21, at 121.

142. *Id.*

investor confusion. The Blueprint recommended statutory changes to harmonize the regulation of brokers and advisers offering similar services.[143]

In 2009, Treasury issued a white paper on reform that echoed the 2008 *Blueprint*.[144] According to the white paper, an investment adviser and a broker providing incidental advice are identical from an investor's vantage point, and investors repose the same degree of trust in brokers as they repose in advisers.[145] Treasury recommended new legislation to require that broker-dealers providing advice "have the same fiduciary obligations" as advisers.[146]

Treasury's recommendations in 2008 and 2009 marked an important shift from earlier reform efforts. Whereas the SEC's approach was exemptive and permissive, Treasury's was regulatory and restrictive. The SEC focused on compensation and on whether brokers might inadvertently become subject to the Advisers Act. The SEC had sought to exempt brokers from being regulated as advisers. Treasury's approach, by contrast, recognized developments in the financial services market, including the enhanced role brokers play in dispensing advice. As a result of these developments, Treasury sought to place additional duties on brokers. The SEC, in other words, tried to limit the number of brokers that would be subject to the Advisers Act and to a concomitant fiduciary duty; Treasury sought to expand the number of brokers that would be subject to a fiduciary obligation.[147]

After months of wrangling, the Dodd-Frank Act was enacted in July 2010.[148] Among other things, the law addressed systemic risk in the financial system, enhanced the regulation of derivatives, established the new Consumer Financial Protection Bureau, increased federal deposit insurance, and eliminated the registration exemption for hedge fund advisers.[149] Congress addressed regulatory harmonization of broker-

143. *Id.* at 125–26. Treasury also recommended that advisers be subject to a self-regulatory regime similar to the one for broker-dealers. *Id.* at 126. The SRO issue is still timely but it is not addressed in this Article.

144. TREASURY WHITE PAPER, *supra* note 13, at 71–72.

145. *Id.* at 71.

146. *Id.* at 72.

147. *Compare* Adopting Release, *supra* note 10, at 20,434–36, *with* TREASURY WHITE PAPER, *supra* note 13, at 72.

148. Dodd-Frank Act, *supra* note 14, § 913.

149. *See generally* DAVID SKEEL, THE NEW FINANCIAL DEAL (2011); SIMPSON THACHER & BARTLETT LLP, REFLECTIONS ON DODD-FRANK: A LOOK BACK AND A LOOK FORWARD (2011), *available at* http://www.stblaw.com/google_file.cfm?TrackedFile=
6956153B528CAE9F89BB6C7C98B376BB57B9049AD88C05BC9BAD&TrackedFolder=4B5715

dealers and investment advisers in Section 913 of the Act.[150] Section 913 has two parts. First, it required the SEC to study the effectiveness of existing legal or regulatory standards for brokers, dealers, and investment advisers when providing personalized investment advice about securities to retail customers, and any potential gaps in the regulatory standards.[151] Second, the Act authorized the SEC to impose a fiduciary duty on brokers that give advice to retail customers about securities.[152] Congress did not impose a fiduciary obligation; it handed the baton to the SEC.

The SEC released the *Section 913 Study* in January 2011.[153] The Study contained two principal recommendations. First, it recommended that the Commission consider adopting a rule that applied a uniform fiduciary standard to broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.[154] Second, the Study recommended that regulatory protections be harmonized, especially when brokers and advisers are performing the same or similar functions.[155] The staff identified several areas where regulation of brokers and advisers differs and suggested how they could be brought into accord.[156] In light of the *Section 913 Study*, the decision of whether to impose a fiduciary duty on brokers that give advice rests squarely on the SEC's shoulders. Therefore, a key question is whether the Commission will be persuaded by arguments in favor of a new fiduciary rule. Part II critiques those arguments.

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150. Dodd-Frank Act, *supra* note 14, § 913(b).

151. *Id.* § 913(b).

152. Section 913 amended the Exchange Act to give the SEC authority to adopt rules to provide that a broker or dealer, when providing personalized investment advice about securities, has the same standard of conduct as an adviser. *Id*. § 913(g)(1). New rules, if adopted, must provide that the standard of conduct applicable to broker-dealers be "no less stringent" than the standards applicable under sections 206(1) and 206(2) of the Advisers Act, which hold advisers to a fiduciary duty. *Id.* § 913(g)(2). Section 913 also provided the SEC with authority to establish a standard of care for brokers, dealers, and advisers to act in the "best interest" of their customers—the traditional fiduciary standard. *Id*.

153. SECTION 913 STUDY, *supra* note 1. The Section 913 Study was authored by the staff, although the Commission authorized its release.

154. The Study left certain details to be worked out in the future. For example, at a later date, the Commission would have to address conflicts of interest and decide how broker-dealers would fulfill their fiduciary obligation when engaging in principal trading. SECTION 913 STUDY, *supra* note 1, at vii.

155. *Id.* at 129.

156. *Id.* at 130–39.

II. CONVENTIONAL ARGUMENTS THAT SUPPORT A FIDUCIARY DUTY FOR BROKERS ARE INADEQUATE

The Dodd-Frank Act gave the SEC legal authority to adopt a fiduciary duty for brokers, but the Act did not mandate a fiduciary standard, leaving the decision in the SEC's hands. As a result, after over a decade of deliberation and quarrelling over this issue—including a contested administrative rule,[157] controversial federal legislation,[158] and numerous surveys and studies[159]—the question of whether to impose a fiduciary duty has returned to the SEC. Academics, interest groups, and policy makers have propounded several justifications for the change. This Part of the Article critiques the most commonly asserted reasons.

Although some of the arguments supporting a fiduciary standard are stronger than others, they are all incomplete in important respects and do not alone provide a justification for a fiduciary duty. The conventional arguments put forth to support a fiduciary standard include the following: (i) investors are confused about applicable standards for brokers and advisers, (ii) obligations currently imposed on brokers and advisers are inconsistent, (iii) obligations currently imposed on brokers are weak and ought to be enhanced, (iv) the economic benefits of a fiduciary standard will exceed the costs, and (v) investors expect brokers to operate under a fiduciary standard.

Some of these reasons overlap. For example, investors might be confused about which standard applies *because* the standards are inconsistent. Similarly, investors might be confused because they expect brokers to operate under a fiduciary standard. Despite this overlap, I distinguish each argument as much as possible. The last reason, investor expectations, comes closest to providing a strong foundation for imposing a fiduciary duty on brokers. As explained below, however, this argument is not sufficient because expectations must be *reasonable* to ground a fiduciary obligation; empirical expectations are not enough. Before delving into reasonable expectations, let us first examine each argument in more detail.

157. *See supra* Part I.E.

158. Dodd-Frank Act, *supra* note 14, § 913.

159. SECTION 913 STUDY, *supra* note 1; RAND REPORT, *supra* note 84, at 90.

A. Investor Confusion Is an Insufficient Basis to Support a Fiduciary Standard

1. Advocates of a Fiduciary Standard Claim Investor Confusion Justifies Regulatory Harmonization

A common justification for placing a fiduciary duty on brokers that give advice is investor confusion, which in large part stems from titles that broker-dealer registered representatives use, such as "financial advisor" and "financial consultant."[160] Investor confusion was highlighted in a Rand Institute for Civil Justice report (*Rand Report*) from 2008.[161] When the SEC adopted its exemptive rule in 2005, it recognized the complexity of the issues it was addressing and directed the SEC staff to prepare recommendations for a study. The resulting report, not to be confused with the *Section 913 Study*,[162] was intended to compare protections provided to retail customers under the Exchange Act[163] and the Advisers Act,[164] and to recommend ways to address concerns arising from any differences.[165] The SEC engaged the Rand Institute to complete the report and released it in January 2008. The *Rand Report* described brokerage and advisory services and examined whether investors understood the differences between them.[166]

The *Rand Report* found a great deal of investor confusion regarding the roles of brokers and advisers.[167] The Report documented that investors are confused about job titles, types of firms, and legal

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160. RAND REPORT, *supra* note 84, at 90; *see also* Fausti, *supra* note 19, at 191 (explaining that the Administration's recommendation for a uniform fiduciary standard is "based on the widespread recognition that retail investors are often confused about the differences between investment advisers and broker-dealers"); Irwin, Lane & Mendelson, *supra* note 19, at 53 ("Recent surveys concerning investors' understanding of the distinctions between broker-dealers and investment advisers indicate an understandable confusion."); Di Lorenzo, *supra* note 19, at 295 ("Dodd-Frank is necessary, therefore, to impose uniform duties on broker-dealers in order to help eliminate uncertainty in the duties broker-dealers owe to their clients, and thereby increase investor protection."); Knut Rostad, *Strengthen Disclosures by Limiting Their Role in the Delivery of Investment and Financial Advice*, 30 REV. BANKING & FIN. L. 141, 144–46 (2011) (reviewing studies regarding investor confusion about brokers and advisers); Varnavides, *supra* note 19, at 204 ("[B]roker-dealers and investment advisers offer virtually identical services to investors, resulting in considerable confusion for both investors and regulators.").

161. RAND REPORT, *supra* note 84, at 90.

162. *See supra* Part I.F.

163. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78oo (2006).

164. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006).

165. Adopting Release, *supra* note 10, at 20,442.

166. SECTION 913 STUDY, *supra* note 1, at i.

167. RAND REPORT, *supra* note 84, at 87.

distinctions between financial services professionals. According to Rand, 49% of respondents believed advisers must act in a customer's best interest, while 42% believed that brokers must act in a customer's best interest.[168] Surprisingly, more people thought that brokers (as opposed to advisers) were required to disclose conflicts.[169] Some respondents did not understand the term "fiduciary" and did not know that a fiduciary standard is higher than a suitability standard.[170] Another study conducted by TD Ameritrade in 2006 found that 74% of investors did not understand the respective duties imposed on brokers and advisers.[171]

The ubiquity of investor confusion became a justification for reform. The Treasury Department referenced the *Rand Report* in 2008 to demonstrate that investors did not understand the differences between brokers and advisers or the standards under which they operated.[172] Treasury stated that the regulatory system had "failed to adjust to market developments, leading to investor confusion," and thus recommended legislative changes to harmonize the standards.[173] Treasury again invoked this justification in 2009, repeating that retail investors were confused over differences between brokers and advisers, and placed the same degree of trust in brokers as they did in advisers.[174] Treasury concluded that the SEC should be permitted to harmonize brokers' and advisers' duties and that brokers that provide advice to retail customers should be governed by the same fiduciary standard as advisers.[175]

The SEC staff made the same argument in the *Section 913 Study*. The Study showed that retail customers are confused by the role of brokers and advisers, and customers of both should be uniformly protected.[176] Industry and public interest groups advocating a fiduciary standard similarly point to confusion, arguing that it leads to the inability to make

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168. SECTION 913 STUDY, *supra* note 1, at 89.

169. *Id.*

170. *Id.* at 111; *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, Hearings Before the H. Subcomm. on Capital Mkts.& Gov't Sponsored Enters.*, 112th Cong. 3 (2011) (statement of The Financial Planning Coalition), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=258252.

171. TD AMERITRADE, WHAT YOU NEED TO KNOW ABOUT FINANCIAL ADVICE 1 (2006) (on file with author).

172. TREASURY BLUEPRINT, *supra* note 21, at 125.

173. *Id*. at 125–26.

174. TREASURY WHITE PAPER, *supra* note 13, at 71.

175. *Id*.

176. SECTION 913 STUDY, *supra* note 1, at 101, 107.

an informed decision when selecting a financial intermediary. In Congressional testimony, proponents of the fiduciary standard stated that if all or a large majority of investors understood the differences between brokers and advisers, the case for harmonization would diminish.[177] Moreover, these advocates argued that confusion cannot be solved through disclosure or investor education.[178]

2. *Investor Confusion Is Not a Compelling Argument for Regulatory Harmonization*

Although it seems investor confusion should be eliminated whenever possible, there are at least three reasons why investor confusion alone does not justify a fiduciary standard. First, changing the standard may simply switch the population that is confused, alleviating confusion for some while causing it for others. Recall that 42% of respondents mistakenly believed that brokers must act in a customer's best interest.[179] Many investors, all or part of the remaining 58%, may be well aware that brokers owe no such obligation. By changing the rule, those who wrongly believed that brokers are fiduciaries would now be correct, while ironically the other group might become confused.[180]

Second, enhancing the standard of care seems to get the solution backward. Instead of addressing the cause of confusion by correcting investors' misunderstanding, imposing a fiduciary obligation alters the state of affairs, bringing reality into accord with investors' confused perceptions regardless of whether the change is necessary or appropriate independent of confusion. As an analogy, if the speed limit on a highway were 65 m.p.h. but drivers were confused and believed it was 55 m.p.h., confusion alone would not be a reason to lower the speed limit to 55. There are many areas where consumers could be confused about professional roles and standards, yet it would be illogical to harmonize

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177. *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, Hearings Before the H. Subcomm. on Capital Mkts. and Gov't Sponsored Enters.*, 112th Cong. 4 (2011) (statement of Barbara Roper, Director of Investor Protection, Consumer Federation of America), *available at* http://financialservices.house.gov/ Calendar/EventSingle.aspx?EventID=258252.

178. *Id.* at 5.

179. *See supra* Part II.A.1.

180. It is no response that investors could be educated as to the applicable standard because those making the claim about confusion also state that no amount of investor disclosure or education can resolve it. *See* Roper, *supra* note 177, at 5. That said, the 58% who now correctly understand brokers' duties may be more highly educated or more sophisticated than the 42% who are confused and, therefore, the 58% might become aware of regulatory changes and avoid confusion. Even so, some portion of the 58% may become confused if the standard changes.

those roles and standards simply to eliminate confusion.[181]

There might be some instances where confusion alone justifies a change in the law. For example, if a single state were to allow motorists to drive on the left, driver confusion might be a reason to prohibit the change and require everyone to drive on the right. In this example, confusion would justify a change because the decision to drive on the right is largely arbitrary. It does not really matter on which side of the road one drives so long as it is the same side as everyone else. In the broker-dealer context, however, the respective responsibilities of brokers and advisers are not arbitrary. The responsibilities are tied closely to the different roles they play in the markets, which should not be overlooked merely to avoid confusion.[182]

Third, a fiduciary standard would not necessarily solve investor confusion because a fiduciary standard for brokers authorized by the Dodd-Frank Act would itself vary from other fiduciary standards.[183] The fiduciary obligation is notoriously ambiguous.[184] The *Section 913 Study* noted this ambiguity and stated that the Commission would have to specify what is required by a new fiduciary obligation.[185] Although the Dodd-Frank Act requires that if a fiduciary standard is imposed on brokers it must be at least as strong as the standard imposed on advisers,

181. Consider an example from health care. Physician Assistants (PAs) and nurses perform different functions and operate under different standards, and consumers may be confused about their respective roles and obligations. PAs perform certain functions of physicians and cannot delegate their duties or supervise others. PETER PRATT & LISA KATZ, SCOPE OF PRACTICE OF HEALTH PROFESSIONALS IN THE STATE OF MICHIGAN 16, 39 (2001). PAs must renew their license every six years. *Id.* at 60. By contrast, nurses focus on prevention, health promotion, education, and patient assistance. *Id.* at 20. They are permitted to delegate duties and supervise other nurses, and they must renew their license every two years. *Id.* at 39, 65. If patients were confused about the responsibilities of PAs and nurses, it would be illogical to harmonize their obligations, such as by requiring PAs to renew their license every two years, or by prohibiting nurses from delegating tasks, merely to eliminate patient confusion. One would inquire into whether the changes were justified for reasons other than eradicating confusion.

182. *See infra* Part II.B.2.

183. The two SEC Commissioners who disagreed with the publication of the Section 913 Study questioned whether a new rule would achieve its desired outcome. Casey & Paredes, *supra* note 16.

184. *Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations, Hearings Before the S. Subcomm. on Crime and Drugs*, 111th Cong. 1 (2010) (statement of Larry E. Ribstein, Mildred Van Voorhis Jones Chair, University of Illinois College of Law) ("'Fiduciary duty' is one of the most amorphous concepts in the law."); Langevoort, *supra* note 7, at 456 ("[A]n open-ended broker fiduciary obligation is so loaded with unanswered questions that baseline predictability would come slowly, if at all."). The 2009 edition of Black's Law Dictionary includes an observation after the definition of fiduciary that the term is a "vague term, and it has been pressed into service for a number of ends." BLACK'S LAW DICTIONARY 702 (9th ed. 2009) (quoting D.W.M. WATERS, THE CONSTRUCTIVE TRUST 4 (1964)).

185. SECTION 913 STUDY, *supra* note 1, at 121–22.

the fiduciary standard is not monolithic and can vary depending on the type of relationship.[186] The Department of Labor regulates advice by financial services professionals to employee benefit plans, participants, and beneficiaries, with respect to plans sponsored by private-sector employers under the Employment Retirement Income Security Act of 1974 (ERISA). The ERISA fiduciary standard is higher than the Advisers Act standard.[187] As a result, total clarity would not be achieved by applying a fiduciary duty to broker-dealers.[188]

B. Inconsistent Standards Are an Insufficient Basis to Support Regulatory Harmonization

1. Advocates of a Fiduciary Duty Claim Inconsistent Standards Justify Regulatory Harmonization

As discussed in Part I, brokers' roles have transformed over the past decades.[189] The importance of trade execution has receded and advice has become predominant. As a result, many brokers have become the functional equivalent of investment advisers. They hold themselves out as advisers, provide investment advice, and charge an asset-based fee.[190] According to the 2009 Treasury Department White Paper, "investment

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186. *See* Chi. Title Ins. Co. v. Runkel Abstract & Title Co., 610 F. Supp. 2d 973, 979 (W.D. Wis. 2009) (explaining that fiduciary duties vary depending on the type of relationship).

187. The duty of loyalty under ERISA, for example, is a duty to act for the exclusive purpose of providing plan benefits. Definition of the Term "Fiduciary," 75 Fed. Reg. 65263, 65264 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510) (temporarily withdrawn on Sept. 19, 2011). This is a "sole interest" test similar to the test in trust law. The standard in the Advisers Act is a "best interest" standard. Another difference is the scope of prohibited conduct. Under the Advisers Act, potentially harmful conduct is generally not prohibited, it must be disclosed. By contrast, Congress in ERISA supplemented general duties placed on ERISA fiduciaries with certain categorical prohibitions on their activity, which no amount of disclosure can cure. *Id.* If a person selling securities to a plan were a plan fiduciary, the sales transaction would generally be prohibited, absent an exemption. Under the Advisers Act, however, principal transactions are permitted with appropriate disclosure and consent. Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(3) (2006).

188. Professor Thomas Hazen has written that an explicit declaration of a fiduciary duty without more would merely *add* confusion to existing law. Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, *supra* note 19, at 715. The U.S. Department of Labor is currently working on a fiduciary standard for advisers to accounts governed by ERISA. The DOL standard will likely differ from the standard imposed on advisers under the Advisers Act. *See Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, Hearings Before the H. Subcomm. on Capital Mkts. & Gov't Sponsored Enters.*, 112th Cong. 6 (2011) (statement of Financial Services Roundtable), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=258252.

189. *See supra* Part I.D.3.

190. *See* Roper, *supra* note 177, at 3.

advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective."[191] In fact, the financial media often refer to "investment advisers" when writing about both broker-dealers and advisers.[192] Under a functional approach to regulation, two groups of people performing the same function should be regulated by the same standard.

Consistent regulation has particular appeal for brokers and advisers. 88% of investment adviser representatives are also registered representatives of broker-dealer firms.[193] It makes little sense, one might argue, to apply two sets of rules to individuals who both provide advice in a similar manner. If an individual can wear an adviser hat one moment and a broker hat the next, even though his activity has not changed, regulation ought not to change either. Advocates argue that inconsistent regulation for what appears to be the same activity justifies harmonizing the regulation.

2. *Existence of Inconsistent Standards Is Not a Compelling Argument for Regulatory Harmonization*

The plea for consistency assumes that it makes no difference who is performing a given function—the function itself matters most. This assumption is not always valid. In the case of brokers and advisers, although they both provide advice, they perform other activities too, and these differences justify different treatment. In the *Section 913 Study*, the SEC staff noted that differences in the regulation of brokers and advisers reflect differences in function.[194] Dealers, for example, accumulate inventory in their own accounts to make markets in securities. Making markets is critical to liquidity and encourages investment.[195] An investor's knowledge that a future buyer for a security exists increases his willingness to enter the market. The fact that broker-dealers are willing to assume this market-making role might justify imposing a lower duty, particularly if an enhanced duty might inhibit dealers from assuming the role.[196] Investment advisers cannot perform this market-

191. TREASURY WHITE PAPER, *supra* note 13, at 71.

192. Michael A. Pollock, *How to Find Low-Cost Investment Help*, WALL ST. J., June 4, 2012, at C10.

193. SECTION 913 STUDY, *supra* note 1, at 12.

194. *Id.* at iii.

195. Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 342 (2011).

196. *See* SECTION 913 STUDY, *supra* note 1, at 119.

making function because, as mentioned above, their ability to trade from their own accounts is strictly limited.[197] The disparate regulatory treatment of brokers and advisers recognizes the different roles they play and helps ensure that brokers will continue to perform functions that advisers do not or cannot perform.

Moreover, as with investor confusion, imposing a fiduciary duty on brokers is unlikely to resolve the problem of inconsistent regulation. Multiple regulators supervise financial institutions at both the federal and state level. Even with harmonization, securities, insurance, and bank regulators will each supervise advice about products falling under their jurisdiction. Moreover, as mentioned, the ERISA fiduciary standard is higher than the Advisers Act standard. Imposing a fiduciary duty on brokers that give advice will not streamline inconsistent regulation.

Finally, the goal of consistency does not justify raising brokers' standards any more than it justifies lowering advisers' standards. An argument for consistency is an argument for the *same* standard to be applied to both brokers and advisers. This justification alone, like the others, is not sufficiently compelling to raise the standard applicable to brokers.

C. Ineffective Standards Are an Insufficient Basis to Support a Fiduciary Obligation

1. Advocates of a Fiduciary Duty Claim that Ineffective Standards Justify Regulatory Harmonization

Advocates of regulatory harmonization maintain that the standard of conduct imposed on broker-dealers is too weak and should be strengthened.[198] Imposing a fiduciary standard would provide more investor protection than a suitability standard.[199] According to this

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197. *See supra* Part I.B.2.

198. Letter from David G. Tittsworth, Exec. Dir., Investment Adviser Ass'n, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 8 (Aug. 30, 2010) [hereinafter Tittsworth Letter] (on file with author) ("The suitability standard falls short of the breadth of the fiduciary duty."); Reza Dibadj, *Brokers, Fiduciaries and a Beginning*, 30 REV. BANKING & FIN. L. 205, 213 (2010) (justifying enhanced standard for brokers based on loyalty); Varnavides, *supra* note 19, at 218 ("[B]roker-dealer customers are afforded less protection than investment adviser customers because broker-dealers are generally not held to a fiduciary standard.").

199. *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, Hearings Before the H. Subcomm. on Capital Mkts. & Gov't Sponsored Enters.*, 112th Cong. 8 (2011) (statement of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=258252.

argument, the fiduciary standard is the highest standard under the law and, if applied to broker-dealers, it would strengthen investor protection. Advocates of a fiduciary standard have argued that differences between the duties imposed on brokers and advisers are significant. They argue that advisers' obligations under the Advisers Act, which flow from a fiduciary duty, include the following: (i) have a reasonable basis for providing advice, (ii) seek best execution, (iii) provide advice that is suitable, (iv) avoid placing the adviser's interests before the client's, (v) avoid using client assets for the adviser's own purposes, (vi) maintain client confidentiality, and (vii) disclose all material facts, including material conflicts of interest.[200] In addition, advisers are regulated more extensively than broker-dealers in other areas, such as disclosure, use of solicitors, pay-to-play, proxy voting, and registration and licensing.[201]

The regulation of broker-dealers is arguably less demanding. Unlike advisers, brokers generally do not operate under a federal fiduciary duty and are not subject to the strictures of *SEC v. Capital Gains Research Bureau, Inc.*[202] Although brokers may be deemed fiduciaries in certain situations,[203] the duty is contingent upon the actual relationship. Absent a special relationship, brokers are held to a standard of suitability. According to advocates of a fiduciary standard, this difference is important because a broker can recommend a security that is suitable though not necessarily in the customer's best interest.[204] Regulators, academics, and industry groups concur that the fiduciary standard provides more investor protection than a suitability standard.[205]

2. Existence of Ineffective Standards Is Not a Compelling Argument for Regulatory Harmonization

There are at least three reasons why the claim that a broker's standard of conduct is weaker than an adviser's does not alone justify imposing a fiduciary duty. First, the duties and obligations imposed on brokers are not insubstantial. Although advisers regulated under the Advisers Act are held to a fiduciary standard, the Act's regulation is not *necessary* for imposing a fiduciary duty and some courts hold that brokers are

200. *Id.*; Tittsworth Letter, *supra* note 198, at 5.

201. Tittsworth Letter, *supra* note 198, at app. A.

202. *See supra* Part I.C.

203. *See supra* Part I.C.

204. Tittsworth, *supra* note 199, at 10; *see supra* Introduction.

205. Tittsworth, *supra* note 199, at 10–11; Tittsworth Letter, *supra* note 198, at 8 n.23 (collecting citations to Congressional testimony).

fiduciaries.[206] Moreover, the suitability standard referenced above is only one example of brokers' duties. Under Section 15 of the Exchange Act, brokers must register with the SEC and most broker-dealers must register with FINRA. Section 15 also contains detailed antifraud provisions. The antifraud rules applicable to broker-dealers include prohibitions on market manipulation, high-pressure sales tactics, deceptive recommendations, generation of excessive commissions, unauthorized trading, and abuse of customer funds.[207] Brokers are also subject to the shingle theory.[208] And FINRA rules provide a catch-all, requiring that brokers adhere to "just and equitable principles of trade."[209] According to Professor Thomas Hazen, an authority on securities regulation, imposing a fiduciary duty on brokers without more is unlikely to impose significantly greater duties on brokers.[210] Of the seven adviser obligations specified above, all but two (avoiding using client assets for the adviser's own purposes and disclosing material conflicts of interest) are generally applicable to brokers.

Second, assuming that the suitability standard is lower, the mere existence of a lower standard is not a basis to raise it. To the extent brokers and advisers perform different functions as discussed above,[211] there may be good reasons why the standard of liability for brokers is weaker. Imposing a fiduciary obligation would raise the standard of conduct, but it would also hinder brokers' ability to engage in certain activity, such as principal trading. Even strong supporters of a fiduciary standard have recognized that applying the prophylactic rules in the Advisers Act, particularly those governing principal trading, raises concerns when applied to brokers.[212] As the persistence of the principal trading issue demonstrates, imposing a suitability standard as opposed to a fiduciary standard might be an acceptable tradeoff between market efficiency and investor protection.[213] This point is one instantiation of

206. MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1258 (10th Cir. 1989); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026 (6th Cir. 1979).

207. Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, *supra* note 19, at 733–34.

208. *See supra* note 82 and accompanying text.

209. Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, *supra* note 19, at 735.

210. *Id.* at 715–16.

211. *See supra* Part II.B.2.

212. Roper, *supra* note 17, at 6.

213. The ability to trade as a principal is essential to the activity of broker-dealers. At the same time, trading as a principal absent express disclosure and consent is fundamentally inconsistent with acting as a fiduciary. *See* Laby, *supra* note 19, at 425–29. After years of discussing regulatory

the broader principle that determining the optimal level of investor protection is a matter of finding a tolerable level of investor dissatisfaction. At some point, the benefit from imposing additional safeguards does not outweigh the additional costs.[214]

Finally, a higher standard is not necessarily a better standard. If higher were always better, then one ought to raise the standard of conduct applicable to brokers and advisers to the highest possible level. This makes little sense. Compare the standards imposed on advisers under the Advisers Act to those under ERISA. Although advisers face a high standard under the Advisers Act, an ERISA standard would be higher still.[215] If a higher standard were necessarily a better standard, it would follow that the Advisers Act standard should be enhanced to an ERISA standard. Even proponents of a fiduciary duty for brokers would not recommend a change to an ERISA standard.

D. *Purported Economic Benefits Are an Insufficient Basis to Support a Fiduciary Standard*

1. *Advocates of a Fiduciary Standard Claim Economic Benefits Justify Regulatory Harmonization*

Advocates claim a fiduciary standard will benefit investors more than it will cost them.[216] This argument, unlike the others, is strictly utilitarian. Although supporters of a fiduciary standard admit that benefits to investors are difficult to quantify, one such supporter has estimated that economic harm from advice given under a suitability standard could amount to tens of billions of dollars per year if not more.[217] Imposing a fiduciary standard, therefore, could yield significant

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harmonization, there remains a dearth of proposals on how to address principal trading if a fiduciary duty were imposed on broker-dealers. Broker-dealers seek to preserve their ability to engage in principal trading. SIFMA Framework Letter, *supra* note 18, at 23. In response, adviser groups state that the SEC should examine the approach for brokers and advisers alike. Roper, *supra* note 17, at 15. The SEC staff indicated in the SECTION 913 STUDY that this issue would have to be settled by the Commission itself. SECTION 913 STUDY, *supra* note 1, at 120.

214. This type of analysis was implicit in *Mathews v. Eldridge*, 424 U.S. 319 (1976), where the Supreme Court held that the optimal level of due process before a deprivation of property could occur turned on the value of the property, the cost of the procedural safeguard, and the chance of a wrongful deprivation because of the lack of the safeguard. *Id.*

215. *See supra* note 187.

216. *See, e.g.*, MERCER BULLARD, AARP PUB. POLICY INST., PROTECTING INVESTORS—ESTABLISHING THE SEC FIDUCIARY DUTY STANDARD 19 (2011), *available at* http://assets.aarp.org/rgcenter/ppi/cons-prot/rr2011-02.pdf.

217. Roper, *supra* note 177, at 19.

investor savings. Under a fiduciary standard, a broker must choose an investment product in the investor's best interest. For example, where several mutual funds are similar in risk, performance, and other characteristics, and all could be suitable for the customer, a broker would be required to consider which fund has the lowest fees and expenses.[218] Investors would benefit from a fiduciary standard if it led sponsors of financial products to compete on the basis of merit as opposed to permitting consideration of which products resulted in more generous compensation to the broker.[219]

A recent case that illustrates the potential benefits of a fiduciary standard is *Thomas v. Metropolitan Life Insurance Co.*[220] This case is a good example of personalized investment advice provided by a broker to a retail customer.[221] In *Thomas*, a broker-dealer registered representative, who was also a representative of an insurance company, advised a customer to purchase a proprietary variable life insurance policy.[222] A variable life insurance policy is regulated as a security because the investment risk falls on the annuitant.[223] MetLife compensates its representatives to sell proprietary products and can terminate employees when they fail to meet a sales target.[224] The plaintiffs in *Thomas* alleged that the MetLife representative breached his fiduciary duty by failing to disclose the conflicts of interest created by the company's commission

218. *Id.* at 10; *see supra* Introduction.

219. Roper, *supra* note 177, at 9, 18. Certain brokers allegedly favor their own firm's products even when competitors offer better options. *See* Craig & Silver-Greenberg, *Former Brokers Say JPMorgan Favored Selling Bank's Own Funds Over Others*, *supra* note 20; Craig & Silver-Greenberg. *Many Regulators Put Their Attention on How JPMorgan Marketed its Funds*, *supra* note 20. In addition, several studies and reports suggest that conflicts of interest harm investors. *See* GAO, 401(K) PLANS: IMPROVED REGULATION COULD BETTER PROTECT PARTICIPANTS FROM CONFLICTS OF INTEREST (2011); GAO, PRIVATE PENSIONS: CONFLICTS OF INTEREST CAN AFFECT DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS (2009); Mercer Bullard, Geoff Friesen & Travis Sapp, Investor Timing and Fund Distribution Channels (June 2008) (unpublished), *available at* http://ssrn.com/abstract=1070545; Xinge Zhao, The Role of Brokers and Financial Advisors Behind Investments Into Load Funds (Dec. 2005) (unpublished), *available at* http://www.ceibs.edu/knowledge/papers/images/20060317/2845.pdf. A fiduciary standard would address conflicts of interest and, therefore, might reduce or eliminate the harms discussed. These studies and reports, however, are not specifically tied to implementing a fiduciary duty for brokers that give advice to retail customers, and one cannot assume that the harms set forth would be eliminated by adopting a new fiduciary standard under Section 913 of the Dodd-Frank Act.

220. 631 F.3d 1153 (10th Cir. 2011).

221. *Id.* at 1157.

222. *Id.*

223. SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 71 (1959).

224. *Thomas*, 631 F.3d at 1157.

structure, fees, job-retention policies, and other incentives.[225] The plaintiffs sought restitution of commissions and fees allegedly paid in exchange for advice, including insurance premiums insofar as the premiums included commissions and fees.[226] The court, however, held that the representative's advice was solely incidental to brokerage.[227] He was not acting as an investment adviser and not subject to a fiduciary duty.

Thomas presents precisely the situation that would be covered by a new fiduciary duty. Had the representative in this case been subject to a fiduciary standard, he would have been required to disclose conflicts of interest regarding his incentive to sell a proprietary product and the customer may have avoided the investment.[228]

2. Economic Benefits of a Fiduciary Standard Do Not Necessarily Outweigh Costs

Although investor benefits from a fiduciary standard may be significant, they are unsubstantiated. In opposing the release of the *Section 913 Study*, two Commissioners stated that the Study did not account sufficiently for the potential cost of imposing a fiduciary standard, and insisted instead that the *Section 913 Study* should be a starting point for further research.[229] The Commissioners explained that the Study discounted the concern that, as a result of new burdens imposed on brokers, investors would have fewer professionals to choose from, would have fewer products and services available to them, and may have to pay more for the services they receive. They argued that without additional data on investor preferences, the SEC was unable to assess the costs of imposing a fiduciary standard.[230] The dissenting Commissioners were not opposed to a fiduciary obligation, but thought more data was essential before moving forward.

Some argue that the costs of a new fiduciary duty would outweigh the benefits.[231] A 2010 study prepared by Oliver Wyman, a management consulting firm, assessed the impacts of a new fiduciary standard on

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225. Thomas v. Metro. Life Ins. Co., No. CIV-07-0121-F, 2008 WL 4619822, at *1 (W.D. Okla. Oct. 16, 2008).

226. *Id.*

227. *Thomas*, 631 F.3d at 1167.

228. Hazen, *Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*, *supra* note 19, at 53.

229. Casey & Paredes, *supra* note 16.

230. *Id*.

231. *See* Allen, *supra* note 19, at 12 (noting potential costs to implementing a fiduciary standard).

consumer choice, product access, and affordability of advisory services.[232] The study found that a new fiduciary obligation on brokers could result in reduced access to investment advice, to products distributed primarily through brokers, and to other affordable investment options.[233] The study found that the additional compliance costs could cause twelve to seventeen million small investors to lose access to their current level of advisory services.[234] Investor returns could also be negatively affected. According to the study, a current expected return on a customer account would fall from 4.06% to 3.63% if a fiduciary standard were imposed.[235] Harmonization proponents strongly criticized Oliver Wyman's analysis and regard it with little weight.[236]

To date, there is no clear consensus on the economic benefits of a fiduciary standard. Costs and benefits of proposed rules are difficult to measure, data is scarce, and studies are open to critique.[237] As a result, economic benefits alone are an insufficient basis thus far to support a

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232. OLIVER WYMAN, STANDARD OF CARE HARMONIZATION: IMPACT ASSESSMENT FOR SEC (2010), *available at* http://www.sifma.org/issues/item.aspx?id=21999.

233. *Id.* at 4.

234. *Id.*

235. *Id.* at 28.

236. Fiduciary proponents argue that the Oliver Wyman analysis assumed elimination of the broker-dealer exclusion from the Advisers Act. Financial Planning Coalition, *supra* note 170, at 7. Eliminating the broker-dealer exclusion in its entirety—an event which is unlikely to occur—would subject brokers to all of the Investment Advisers Act, not only a fiduciary duty. The Senate Committee considered such an action in draft legislation. This language, however, was not enacted as part of the final bill. Senate Committee on Banking, Housing & Urban Affairs, 111th Cong., Restoring American Financial Stability Act of 2009: Chairman's Mark Text (2009) (on file with author). Moreover, in the Section 913 Study, the SEC staff recommended that Congress not repeal the exclusion. SECTION 913 STUDY, *supra* note 1, at 139–40. The analysis also assumed that brokers would be disabled from charging commissions, even though a fiduciary standard does not itself prohibit doing so. Finally, the Wyman analysis assumed that a fiduciary standard would restrict the sale of proprietary products and prohibit the sale of products on a principal basis. The Dodd-Frank Act, however, did not prohibit principal transactions or the sale of proprietary products. Indeed, the latter was explicitly permitted. Dodd-Frank Act, *supra* note 14, § 913(g)(1).

237. In a recent Department of Labor (DOL) rule proposal to expand the definition of the term investment adviser "fiduciary" under ERISA rules, the DOL acknowledged the difficulty of quantifying the benefits associated with the eradication of conflicts of interest. Instead, under a heading of qualitative benefits, the DOL wrote that given the magnitude of the assets at stake in ERISA plans, even a small value improvement in a moderate number of plans could result in economically significant benefits. Definition of the Term "Fiduciary," 75 Fed. Reg. 65263, 65270 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510) (temporarily withdrawn on Sept. 19, 2011). SEC Chairman Mary Schapiro outlined steps the SEC is taking to understand the economic effects of imposing a fiduciary duty on brokers. Chairman Schapiro stated that the SEC staff is drafting a public request for information to obtain data on regulatory alternatives. Letter from Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, to Representative Scott Garrett, Chairman, Subcomm. on Capital Mkts. & Gov't Sponsored Enters. (Jan. 10, 2012), *available at* http://www.mfdf.org/images/uploads/blog_files/Garrett_1-10-12.pdf.

fiduciary standard. Although the SEC is under pressure to give more consideration to the economic costs and benefits of proposed rules, it is unlikely that economic benefits alone will serve as a complete justification to implement a new fiduciary standard.[238] The justification will have to be based largely on non-economic grounds.

E. Empirical Expectations Are an Insufficient Basis to Support a Fiduciary Standard

1. Advocates of a Fiduciary Standard Claim that Investor Expectations Justify Regulatory Harmonization

The investor expectations claim is similar in some respects to the investor confusion claim. Although brokers are held to a standard of suitability, investors expect that brokers are held to a fiduciary standard. The *Section 913 Study* opened by stating that investors rely on brokers and advisers for advice and expect advice to be in investors' best interest.[239] That brokers are not held to a fiduciary standard may be disclosed in the fine print. Investors, however, should not have to parse through legalese to learn that they are receiving advice inconsistent with their expectations.[240]

The investor expectations claim appears to rely on empirical evidence about their actual expectations.[241] Supporters of the fiduciary standard

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238. Although no statute requires the SEC to engage in a cost-benefit analysis, it has done so since the 1980s as a matter of good regulatory practice. *Economic Analysis in SEC Rulemaking: Hearings Before the H. Subcomm. on TARP, Financial Services and Bailouts of Public and Private Programs*, 112th Cong. 4–5 (2012) (statement of Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n), *available at* http://oversight.house.gov/wp-content/uploads/2012/04/4-17-12-Schapiro-Testimony.pdf. Where benefits cannot be monetized, agencies are expected to account for compliance costs with proposed rules and compare them with qualitative benefits. Robert Litan, *Regulation, in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *available at* http://www.econlib.org/library/Enc/Regulation.html (last visited Aug. 8, 2012). When engaged in certain types of rulemaking, the SEC must consider whether the action will promote efficiency, competition, and capital formation. Securities Act § 2(b), 15 U.S.C. § 78b(b) (2006); Securities Exchange Act §§ 3(f), 23(a)(2), 15 U.S.C. §§ 78c(f), 78w(a)(2) (2006); Investment Company Act § 2(c), 15 U.S.C. § 80a-2(c) (2006). Some in the financial services industry have successfully argued that the SEC acted arbitrarily in adopting certain rules because it failed to determine their likely economic consequences and to connect those consequences to efficiency, competition, and capital formation. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 179 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005). These decisions have placed pressure on the SEC to provide a robust cost-benefit analysis to support its rules.

239. SECTION 913 STUDY, *supra* note 1, at i.

240. *Id.* at 101, 107; *see also* Financial Planning Coalition, *supra* note 170, at 3.

241. SECTION 913 STUDY, *supra* note 1, at 101.

point to a survey by ORC International,[242] which showed responders were as likely to believe that financial advisors (a title used by broker-dealer registered representatives) were fiduciaries as they were to believe that financial planners and investment advisers were fiduciaries.[243] Similarly, the *Rand Report* referred to a TD Ameritrade survey, which found that more than 60% of respondents believed brokers have a fiduciary duty and 90% of respondents believed that advisers owe a fiduciary duty.[244]

The expectations argument is related to the confusion argument in the sense that if investors *expect* brokers are fiduciaries, then investors are *confused* about brokers' actual responsibilities. One proponent of a fiduciary standard has joined the confusion claim and the expectation claim, stating that brokers have marketed themselves as advisers, resulting in customer confusion and, at the same time, vitiating customer expectations.[245] Although it might be tempting to group the confusion and the expectations arguments together, the expectations argument is different from the confusion argument and merits a separate response. Investors who expect brokers to be fiduciaries may not view their beliefs as confused at all. Investor expectations, the argument goes, justify a change in the law to align it with their expectations regardless of whether the expectations are a source of confusion.[246]

2. Empirical Expectations Do Not Themselves Justify a Fiduciary Duty for Brokers

Empirical expectations alone do not justify a fiduciary duty. First, just as with investor confusion, it would be illogical to change the status quo so that it became consistent with investors' expectations, absent an independent reason that one's expectations should be met.[247] In other words, before determining that expectations are a reason to change the

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242. Roper, *supra* note 177, at 5.

243. *Id.*

244. RAND REPORT, *supra* note 84, at 31.

245. Tittsworth Letter, *supra* note 198, at 10.

246. Other survey data cited to support the claim about investor expectations is less persuasive. ORC Survey responders also stated that if a broker and adviser provide the same services, they should have to follow the same rules. The person providing advice, survey responders said, "should put your interests ahead of theirs." Roper, *supra* note 177, at 5 (quoting INFOGROUP/ORC, U.S. INVESTORS & THE FIDUCIARY STANDARD 18 (2010)). This survey response, however, is not really about investor expectations; this question asks individuals about what the law *should be*. Investors' normative views of the law are not the same as cataloguing their expectations of what the law actually is.

247. *See supra* Part II.A.2.

law, one needs an account for why investors have such expectations and whether they are worth vindicating. As explained above, there may be good reasons to permit brokers to operate under a non-fiduciary standard, even if that standard does not comport with investors' expectations.[248]

An analogy might be helpful. Take the case of airline passengers whose flight is canceled and the next departing fight is the following day. Those passengers likely expect a voucher for one night's lodging or some other form of compensation. The fact that passengers expect to receive a voucher under these circumstances is not necessarily a reason to require it. (Similarly, the fact that passengers do *not* expect a voucher is not a reason not to provide one.) One can look to other considerations, such as the airline's cost of providing vouchers and passengers' cost of not receiving them. Many relevant considerations apart from customers' empirical expectations would enter into a decision to impose a voucher requirement.

It may be more profitable to view the argument about expectations as an argument about reasonable expectations. Perhaps those advocating a fiduciary standard based on expectations are really making an argument about reasonable expectations and invoking survey results and other empirical data to support a reasonable expectations claim. In other words, the fact that investors actually expect a broker to operate under a fiduciary standard gives a reasonable expectations claim empirical support. Something more than empirical expectations, however, is required to give rise to reasonable expectations.

Look again at the analogy: If a particular airline has a practice of dispensing vouchers when canceling evening flights, and if a passenger has received such vouchers in the past, the passenger might have a strong expectation that he will receive a voucher when his evening flight is canceled. The passenger's expectation, however, would not give rise to an entitlement. However, if this airline held itself out as the airline that assures on-time departures, then one could craft an argument about reasonable expectations based on the airline's own claim, which has little to do with empirical expectations. The question is whether the airline has done something to strengthen the justificatory force of the passenger's expectation.[249] In the new analogy, the airline has arguably induced the passenger to choose it over competing airlines by assuring on-time departures.

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248. *See supra* Part II.C.2.

249. Catherine Mitchell, *Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law*, 23 O.J.L.S. 639, 656 (2003).

A comparable distinction between empirical and reasonable expectations is important to the doctrine of apparent authority in agency law. Apparent authority is the power held by an agent to affect a principal's legal relations with third parties when a third party "reasonably believes" the agent has authority to act on the principal's behalf, and the belief is traceable to the principal's manifestations.[250] It is not enough for apparent authority that a third person empirically believes that an actor was authorized by a principal; the belief must be reasonable.

Supporters of a fiduciary standard appear to rely on empirical expectations, not reasonable expectations. Although the *Section 913 Study* stated that investors have a "reasonable expectation" that advice they are receiving is in their best interest,[251] it provided little or no foundation for reasonable expectations other than empirical expectations.[252] As discussed more fully in Part III, empirical expectations alone do not justify a change in the law; reasonable expectations may provide a better argument.

This Part has shown that the conventional arguments for placing a fiduciary duty on brokers that provide advice are incomplete and do not alone justify a new fiduciary obligation. Investor confusion, inconsistent standards, ineffective standards, and economic benefits appear to be plausible arguments, but after careful consideration, each fails to fully support a fiduciary duty. The last argument, investor expectations, is most persuasive, but a stronger argument turns on reasonable expectations, not empirical expectations.

III. REASONABLE EXPECTATIONS JUSTIFY A FIDUCIARY OBLIGATION FOR BROKER-DEALERS

This Part puts forth a justification for placing a fiduciary duty on brokers that give personalized advice to retail customers. While the conventional justifications for a fiduciary obligation are not compelling, this Part argues that a broker-dealer's use of advertisements and titles replete with advice language gives rise to a reasonable expectation that the broker will operate under a fiduciary standard. Reasonable expectations have consequences for regulation as well as under the common law. As a regulatory matter, use of advertisements and titles justifies a new administrative rule imposing a fiduciary standard. Under

250. RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006).

251. SECTION 913 STUDY, *supra* note 1, at 101.

252. *Id.*; *see also* Financial Planning Coalition, *supra* note 170, at 3.

the common law, reasonable expectations can ground a fiduciary obligation for broker-dealers that give personalized investment advice to retail customers. Reasonable expectations of the parties provide a more complete justification for a fiduciary standard than those reasons already put forth.[253]

A. Broker-Dealers Employ Advertisements and Titles Promoting the Advisory Function

This section begins by reviewing advertisements by broker-dealers over the past decades and shows how they have evolved by increasingly emphasizing advice. This section is not a comprehensive survey of brokers' advertisements. It shows anecdotally that brokers advertise independent, objective advice. This section will also discuss studies that have examined broker-dealer advertising and support the conclusions drawn from the anecdotes.

Historically, brokerage firms resisted advertising. Advertising was viewed as unrefined and inconsistent with the patrician image the firms sought to promote.[254] Historian Edwin J. Perkins has suggested that brokerage firms initially resisted advertising to maintain a de facto cartel and avoid destructive competition amongst themselves.[255] This resistance changed to some degree with Merrill Lynch's decision to break ranks and advertise in the 1940s.[256] After Merrill Lynch began to advertise, the NYSE encouraged the practice through its "Own Your Share of American Business" campaign, which ran from 1954 to

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253. The argument from reasonable expectations does not depend on the outcome of a traditional cost-benefit analysis. A robust cost-benefit analysis regarding imposing a fiduciary duty on brokers that give advice is difficult to complete because the benefits are diffuse and hard to measure, and good estimates of the costs are difficult to obtain. The analysis, therefore, does not turn on a traditional cost-benefit analysis. The argument relies instead on reasonable expectations that broker-dealers have created over the years through marketing and advertising. One determines reasonable expectations based on a variety of factors. This is not to say that costs and benefits of imposing a fiduciary duty are irrelevant. In fact, the reasonableness of an expectation is determined in part by the social consequences of imposing liability based on the expectation. For example, if an electronics mart advertises televisions for $199, it cannot claim that the actual price is $250. However, the store is not required to have an unlimited quantity available at the advertised price. A reasonable person would know that quantity is limited. One's analysis of reasonableness is based in part on the social costs of requiring the store to stock an unlimited quantity. Thus, costs and benefits are relevant to but not determinative of reasonableness.

254. EDWIN J. PERKINS, WALL STREET TO MAIN STREET: CHARLES MERRILL AND MIDDLE-CLASS INVESTORS 56–57, 201 (1999); Traflet & Coyne, *supra* note 97, at 136.

255. PERKINS, *supra* note 254, at 57.

256. *Id.* at 201. Charles Merrill drew from his deep involvement with Safeway Stores and initiated an informational advertising campaign at Merrill Lynch. *Id.* at 12, 204–05.

1968.[257] In the late 1960s and early 1970s, advertising by the larger firms began to target individual investors. One advertisement offered "service to every investor, including the 'little guy.'"[258] Another focused on "investment insight" applied to the "individual needs" of clients.[259] By the early 1970s, several brokerage firms were enhancing their advertising to appeal to the investment needs of small investors.

The elimination of fixed commissions in 1975 was a turning point in brokerage advertising. First, as commission rates began to drop, brokerage firms needed to advertise their new fee structures to win over new customers and retain existing ones.[260] Second, in 1976 and 1977, the U.S. Supreme Court held that prohibitions on professional advertising constituted a violation of the right of free speech under the First Amendment.[261] These developments led to widespread advertising by many professionals, including brokers.[262]

As brokerage advertising developed, firms began to shift from use of the terms "brokerage firm" or "stockbroker." In the early 1980s, firms often advertised in print media using the phrase "brokerage services."[263] Although a few firms started using the term "Account Executive" to describe their registered representatives in the 1960s and early 1970s,[264] other firms continued to use the term "stockbroker" through the early 1980s.[265] Moreover, in the early 1980s, firms did not yet advertise advice as their primary function, stating instead that accounts were "serviced" by account executives, rather than "managed" or "advised."[266]

In the 1960s and 1970s a slow trend began whereby some firms' advertisements began to use language suggestive of advice.[267] In the

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257. Janice Traflet, *Spreading the Ideal of Mass Ownership: Public Relations and the NYSE*, 22 ESSAYS ECON. & BUS. HIST. 257, 266–67 (2004).

258. *See* FORBES, Aug. 1, 1971, at 14 (Paine Webber Jackson & Curtis, Inc., advertisement).

259. *See* TIME, July 22, 1966, at 82 (Prudential Bache & Co., advertisement); *see also* TIME, Aug. 5, 1966, at 91 (Merrill Lynch, Pierce, Fenner & Smith, advertisement).

260. Traflet & Coyne, *supra* note 97, at 136.

261. *See* Bates v. State Bar of Ariz., 433 U.S. 350, 384 (1977) (lawyers); Va. Pharmacy Bd. v. Va. Consumer Council, 425 U.S. 748, 770 (1976) (pharmacists).

262. Traflet & Coyne, *supra* note 97, at 137.

263. *See* FORBES, Jan. 21, 1980, at 93 (Fidelity Brokerage Services, Inc., advertisement).

264. FORBES, Jan. 15, 1973, at 35 (Reynolds Securities, Inc., advertisement); TIME, July 1, 1966, at 73 (Merrill Lynch, advertisement).

265. *See* FORBES, Apr. 25, 1983, at 45 (Kidder Peabody & Co., advertisement); FORBES, Jan. 21, 1980, at 93 (Fidelity Brokerage Services, Inc. advertisement).

266. FORBES, Apr. 11, 1983, at 189 (Merrill Lynch advertisement).

267. FORBES, Jan. 15, 1973, at 35 (Reynolds Securities, Inc. advertisement); FORBES, Aug. 1,

early to mid 1980s, brokerage firms explicitly advertised advice and financial planning. One firm referred to the "quality of investment advice" it provided.[268] "Total Financial Planning," another firm advertised, "requires a careful assessment of your entire financial situation, and the assembling of a financial profile that forms the basis of an approach to meet all your financial objectives."[269] By the mid-1980s, firms used the title "Financial Consultant" to refer to broker-dealer registered representatives.[270] The term "consultant" suggested that the firm was acting in an advisory capacity.[271] In the 1990s, some firms started using the title "Financial Advisor," more explicitly suggesting an advisory relationship.[272]

By the late 1980s, brokerage firms not only referred to their registered representatives as Financial Consultants, they also encouraged investors to talk to the Financial Consultant for "straight answers" and advertised the Financial Consultant as a "valuable source of information," suggesting that the customer could turn to the representative for advice.[273] One advertisement from this period noted that the Financial Consultant began the customer relationship by asking about long-term goals and levels of risk, and setting priorities.[274] Another stated that individuals were seeking "answers, not sales talk."[275] Still another exclaimed in large lettering: "Ask for investment help and we'll answer. In person."[276] By 1995, advertising advice by brokers was more ubiquitous, with some firms advertising a close personal relationship between the broker and the customer, including text and images

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1971, at 14 (Paine Webber Jackson & Curtis, Inc., advertisement); TIME, July 22, 1966, at 76 (Merrill Lynch, Pierce, Fenner & Smith Inc., advertisement).

268. BUS. WEEK, Apr. 18, 1986, at 3 (Drexel Burnham advertisement).

269. FORBES, Apr. 25, 1983, at 89 (Prudential Bache Securities advertisement).

270. FORBES, Oct. 2, 1989, at 97 (Merrill Lynch, Pierce, Fenner & Smith, Inc., advertisement); BUS. WEEK, July 21, 1986, at 109 (Merrill Lynch, Pierce, Fenner & Smith advertisement); FORBES, July 14, 1986, at 1 (Merrill Lynch, Pierce, Fenner & Smith advertisement); FORBES, Apr. 8, 1985, at 145 (Shearson Lehman Brothers Inc., advertisement).

271. A definition of consultant is "[a] person qualified to give professional advice or services . . . an adviser." OXFORD ENGLISH DICTIONARY (Online ed. March 2012), *available at* http://oed.com/view/Entry/39956?redirectedFrom=consultant#eid. Consultant is also defined as "a person who gives professional or expert advice." *Id.*

272. FORBES, Apr. 20, 1998, at 75 (Prudential Securities advertisement); FORBES, Apr. 6, 1998, at 55 (Prudential Securities advertisement).

273. FORBES, Apr. 30, 1990, at 132 (Merrill Lynch advertisement); FORBES, July 14, 1986, at 1 (Merrill Lynch advertisement).

274. FORBES, July 14, 1986, at 1 (Merrill Lynch advertisement).

275. MONEY MAGAZINE, Apr. 1989, at S5 (Fidelity advertisement).

276. MONEY MAGAZINE, Mar. 1989, at 148 (First Investors advertisement).

demonstrating the broker's concern and involvement with the customer's family members.[277] One advertisement from that period referred explicitly to the provision of "financial advice" and declared that more clients "trusted" the firm with their assets than any other firm.[278] A 2012 advertisement highlights, and has registered, the phrase: "So what do I do with my money?"[279]

This evidence of broker advertising is not merely anecdotal. According to the *Rand Report*, advertising campaigns by larger brokerage firms often promoted experience in managing money.[280] Investment advisers interviewed by Rand observed that brokers' advertisements sounded as if they were selling advice. Brokers' advertisements, the advisers said, portrayed a close relationship between the firm and the customer by using imagery such as a broker attending a customer's family function or a broker and customer walking down the beach together.[281] Although advisers' views about brokers may be colored by competition, these reports corroborate the emphasis on personalized advice in the examples above.[282]

According to the *Rand Report*, use of titles also connotes an advisory relationship. The most commonly reported title for a registered representative was "financial advisor."[283] Other typical titles included "financial consultant," "financial representative," "investment specialist," "investment representative," and "registered representative."[284] According to the *Section 913 Study*, these titles—particularly financial advisor and financial consultant—strongly suggest

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277. BUS. WEEK, May 3, 1993, at 123 (Paine Webber advertisement); BUS. WEEK, Apr. 5, 1993, at 36 (Paine Webber advertisement); *see also* BUS. WEEK, Apr. 12, 1993, at 15 (Putman Inv. Advertisement).

278. HARV. BUS. REV., Mar.-Apr. 1995, at 25 (Merrill Lynch advertisement); *see also* FORBES, Apr. 20, 1998, at 105 (Dean Witter Reynolds Inc. advertisement).

279. WALL ST. J., June 5, 2012, at A13 (BlackRock, Inc. advertisement).

280. RAND REPORT, *supra* note 84, at 70.

281. *Id.* at 71.

282. Mercedes M. Cardona & Hillary Chura, *Morgan Stanley Pursues Younger, Well-Heeled Investors: Brokerage Expands Its Target, Aims for the Internet-Savvy*, 71 ADVERTISING AGE 3 (2000) (quoting ads emphasizing level of knowledge brokers bring to the relationship); Mercedes M. Cardona, *Paul Polito*, 72 ADVERTISING AGE 29 (2001) (quoting Merrill Lynch executive stating that the firm is trying to make people understand "there is no better time to get advice"); Christopher Hosford, *Financial Services Advertising Roars Back*, B TO B, Aug. 16, 2010, http://www.btobonline.com/apps/pbcs.dll/article?AID=/20100816/FREE/308169986/0/SEARCH (quoting Fidelity executive stating a recent ad campaign to emphasize the advisory role increased brand preference by 66%).

283. RAND REPORT, *supra* note 84, at 91.

284. *Id.* at 74.

that the individual will provide investment advice and counseling. Moreover, use of these titles actually affected customers.[285] Respondents equated the titles financial advisor and financial consultant to an investment adviser rather than a broker-dealer.[286]

The use of advertising and titles with advice language evokes a personal connection that was historically the cornerstone of the advisory relationship. Recall that the Advisers Act was intended to promote the personal confidential relationship that existed between the adviser and the client.[287] In addition, the personal relationship promoted by advertising triggers the authority in Section 913 of the Dodd-Frank Act, which is limited to the context of providing "personalized" investment advice to retail customers.[288] Although a cynic might view the terms "adviser" or "consultant" as phatic discourse meant to create goodwill, disregarding this language ignores the potential it has to induce customers to act in response. Because the use of this language is intentional, one should examine how it might bear on expectations.

B. Broker Advertising Creates Reasonable Expectations to Receive Advice

1. Reasonable Expectations Can Ground a Right

A reasonable expectation is one element in the argument for a legal right.[289] A reasonable expectation implies in the first instance that a person believes he has an entitlement to be treated in a certain way, and that the belief is based on objective criteria.[290] The expectation alone does not demonstrate that the person has a legal right.[291] The right is based on a legal system's recognition of *reasonable* expectations.[292]

Reasonable expectations are particularly important in the law of agency. As discussed above, an agency relationship is formed under the doctrine of apparent authority when a third party reasonably believes an agent has authority to act on the principal's behalf, and the belief is

285. *Id.* at 92.

286. *Id.*

287. *See supra* Part I.B.2.

288. Dodd-Frank Act, *supra* note 14, § 913(f).

289. Mitchell, *supra* note 249, at 642.

290. *Id.*

291. *Id.*

292. *Id.* at 644. Mitchell inserts an intermediate step of *legitimate expectation*, which is situated between *reasonable expectation* and *legal entitlement*. A legitimate expectation requires an argument for recognizing one's expectation as legitimate. *Id.*

traceable to the principal's manifestations.[293] The purpose of the apparent agency doctrine is to hold a principal accountable for the results of a third party's belief about an actor's authority to act as an agent, but only when the belief is reasonable and traceable to the principal's conduct. According to the *Restatement (Third) of Agency*, reasonability can turn on, among other things, an industry and its customs, a transaction that is conventionally done in a particular way, or reasonable expectations based on analogous situations.[294]

Reasonable expectations are also important in the law of contract. The primary purpose of contract law is the realization of reasonable expectations induced by making a promise.[295] Promises can be either implied or express. If a person has reason to know that his words may cause another to believe a promise is intended, and the promisee alters her beliefs accordingly, a promise is legally made.[296] A promise is "an expression of commitment to act in a specified way communicated in such a way that the addressee of the expression may justly expect performance and may reasonably rely thereon."[297] The key question is whether the addressee may *justly* expect performance. To determine when an expectation is just, courts look to whether an expectation is reasonable under the circumstances; contract law protects reasonable expectations.[298]

2. Several Criteria Can Determine Reasonable Expectations

Before examining whether advertisements and titles with advice language create a reasonable expectation that brokers will provide advice, one must first decide what serves as a basis for a reasonable expectation. There are at least three possibilities: the contract itself, the

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293. RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006).

294. *Id*. § 2.03 cmt. d.

295. 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.1, at 2 (Joseph M. Perillo ed., rev. ed. 1993).

296. *Id.* § 1.13, at 37.

297. *Id.* § 1.13, at 35.

298. *Id.* § 1.1, at 2–5. The same principle is captured by the definition of "offer." According to the *Restatement (Second) of Contracts*, an offer is defined as "the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it." RESTATEMENT (SECOND) OF CONTRACTS § 24 (1981). Again, the key question is whether the manifestation *justifies* another in assuming that his assent will conclude a bargain. This answer turns on when a reasonable person would understand or expect that a merchant manifests an intention to create a binding relationship. Jay M. Feinman & Stephen R. Brill, *Is an Advertisement an Offer? Why It Is, and Why It Matters*, 58 HASTINGS L.J. 61, 77 (2006).

parties' empirical beliefs, and the parties' normative expectations.

a. The Contract Is One Basis for Determining Reasonable Expectations

The first candidate to ground the parties' reasonable expectations is the contract itself. The best guide to the parties' expectations is often their own contractual language.[299] Thus, a court's primary concern is often to determine the parties' intentions as they are expressed in the written contract.[300] There are many contracts, however, that at least one party neither reads nor understands. And even if the parties read and understand the document, the parties may have numerous expectations not embodied in the contract itself, particularly for standardized agreements. Under conventional contract doctrine, a standardized agreement is not necessarily given effect if its terms are at odds with the reasonable expectations of the party who did not prepare it.[301] As a result, the contract alone can be insufficient as a source of reasonable expectations.

b. Empirical Expectations Form Another Basis for Determining Reasonable Expectations

Empirical expectations are relevant, but they are not determinative of reasonable expectations. The phrase "reasonable expectation" has two parts, each of which is important. The word "expectation" refers to a mental state, and is defined as the "forecasting [of] something to happen, or anticipating something to be received; anticipation; a preconceived idea or opinion with regard to what will take place."[302] One characterization of expectation is "looking for something as one's due."[303] Expectation, therefore, connotes subjectivity.[304] The other part of reasonable expectations, "reasonable," implies the presence of just or

299. *See, e.g.*, Law Debenture Trust Co. of N.Y. v. Maverick Tube Corp., 595 F.3d 458, 467 (2d Cir. 2010); Gibney v. Pillifant, 32 So.3d 784, 785 (Fla. Dist. Ct. App. 2010).

300. Albemarle Corp. v. MEMC Elec. Materials, Inc., 685 F. Supp. 2d 652, 659 (S.D. Tex. 2010).

301. CORBIN, *supra* note 295, § 1.1, at 5; *see* A/S Apothekernes Laboratorium for Specialpraeparater v. I.M.C. Chem. Grp., Inc., 873 F.2d 155, 157 (7th Cir. 1989) ("Courts look to all of the circumstances surrounding the negotiations, including the actions of the principles both during and after, to determine what the parties intended.").

302. OXFORD ENGLISH DICTIONARY, *supra* note 271, *available at* http://oed.com/view/Entry/66455?redirectedFrom=expectation#eid.

303. *Id*.

304. Bailey H. Kuklin, *The Plausibility of Legally Protecting Reasonable Expectations*, 32 VAL. U. L. REV. 19, 23–24 (1997).

legitimate grounds for doing or believing something, as in "reasonable cause" or "reasonable doubt."[305] Reasonable, therefore, connotes objectivity or normativity.

While subjective expectations are relevant to reasonable expectations, they are not conclusive. Whether an expectation is reasonable does not turn on survey data of actual expectations.[306] Expectations held by the average investor, or even the majority of investors, are not necessarily reasonable and, therefore, are insufficient to ground liability.[307] A person might expect an event to occur in the future simply because a similar event has occurred in the past. As demonstrated with the airline example, empirical expectations are both an insufficient basis to support a claim of entitlement[308] and a weak basis for liability.[309]

The importance of objectivity with regard to expectations was established in the historical debate in contract law between the subjectivists and objectivists. Subjectivists looked to the parties' actual assent to an agreement to determine whether a contract was in force.[310] Objectivists looked to external or objective appearances of the parties' intentions.[311] As Learned Hand famously wrote, "[a] contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties."[312] Actual assent is not necessary for a court to find reasonable expectations, or to find that a contract has been concluded. Instead, the law protects reasonable expectations.[313] Courts are not indifferent to parties' actual expectations but, as Arthur Corbin explained in his classic treatise, justice is not served by enforcing every result that either party may expect, or by not enforcing a result unless both parties expect and intend the result.[314]

Similar principles apply when courts imply terms into a contract.

305. *Id.* at 24.

306. Feinman & Brill, *supra* note 298, at 77.

307. CORBIN, *supra* note 295, § 1.9, at 25 ("Agreement consists of mutual expressions; it does not consist of harmonious intentions or states of mind."); Feinman & Brill, *supra* note 298, at 77; Mitchell, *supra* note 249, at 656.

308. *See supra* Part II.E.2.

309. Mitchell, *supra* note 249, at 656.

310. 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 3.6, at 208–10 (3d ed. 2004).

311. *Id.* § 3.6, at 209.

312. Hotchkiss v. Nat'l City Bank, 200 F. 287, 293 (S.D.N.Y. 1911).

313. FARNSWORTH, *supra* note 310, § 3.6, at 209–10.

314. CORBIN, *supra* note 295, § 1.9, at 26; *see also* P.D. Finn, *The Fiduciary Principle*, *in* T.G. YOUDAN, EQUITY, FIDUCIARIES AND TRUSTS 6 (1989) (explaining that reasonable expectations are a combination of actual expectations and "judicial prescription").

Parties rarely specify their entire agreement in advance.[315] Courts often are called upon to fill in missing terms, typically called "implied terms."[316] In deciding which terms to imply, courts might look to actual expectations of the parties even if not reduced to writing.[317] But if the parties' expectations were different, or nonexistent, a court will substitute an objective test, asking whether one party should have reasonably understood the other's expectation. According to the *Restatement (Second) of Contracts*, when contracting parties omit an essential term, a court will supply a term that is "reasonable in the circumstances."[318]

Determining reasonable expectations requires looking at basic principles to guide a court when moving from situations the parties anticipated to situations they did not. The *Restatement (Second) of Contracts* instructs a court to supply a term that "comports with community standards of fairness and policy."[319] The difficult question is determining which principles to use in making the determination of what is fair or reasonable. If justice is served by enforcing a result where both parties did not expect or intend the result, then something more than empirical expectations is required to give force to reasonable expectations.

c. Normative Expectations Are a Further Basis for Determining Reasonable Expectations

Normative rules or principles are necessary to give substance to the otherwise vague notion of reasonableness where neither the contract nor actual expectations can sufficiently ground reasonable expectations. Let us explore what is meant by a normative rule or principle that might ground expectations. One can distinguish between expectations that a person has a *good reason* to have on the one hand, and expectations that a person has a *right* to have on the other, because of a rule or principle grounding that right.[320] Consider expectations regarding traffic laws, for example. People do not have an empirical expectation that all motorists will follow traffic laws; it would be unreasonable to have such a starry-

315. Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 30 (1990).

316. E. ALLAN FARNSWORTH, CONTRACTS § 7.16, at 483 (4th ed. 2004).

317. *Id.* § 7.16, at 485.

318. RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981).

319. *Id.* § 204 cmt. d.

320. JULES COLEMAN, RISKS AND WRONGS 280 (1992).

eyed view of one's fellow drivers. Yet traffic laws give people normative grounds to expect motorists to follow the rules of the road. People have a normative expectation for compliance and act accordingly.[321]

To strengthen the force of one's expectation, one must rely on a rule or principle. Because broker-dealers have been advertising themselves as advisers, this inducement gives justificatory force to reasonable expectations by virtue of an express or implied promise.[322] This Article does not argue that inducement through advertising or use of titles provides proof that a legal contract has formed between an investor and any particular brokerage firm. Rather, inducement provides normative support for reasonable expectations.[323] Consider the agency law analogy in the doctrine of apparent authority discussed above.[324] For apparent authority to exist, the third party must reasonably believe the agent has authority to act on behalf of the principal *and* the belief must be traceable to the principal's manifestations, analogous to an inducement.[325] Moreover, one should view brokers' inducement in the context of changes in the financial services industry discussed above,[326] whereby advice has advanced and execution has receded in importance. In that respect, advertisements are part of a broader picture that has given rise to expectations that were not present in previous decades. The next section explores inducement in more detail.

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321. *Id.*

322. Mitchell, *supra* note 249, at 656.

323. Once one articulates a normative basis to support reasonable expectations, the original notion of expectations recedes in importance. Articulating an independent principle to ground expectations moves one away from the idea of expectations. A normative basis to support reasonable expectations points to the fact that individuals *should have* such expectations because there are *good reasons* for having them. If expectations depend on good reasons, and if the reasons articulated count as good reasons, then one can largely ignore the notion of reasonable expectations and ground an obligation on the reasons identified. COLEMAN, *supra* note 320, at 281; Mitchell, *supra* note 249, at 657. This shift is a common theme when articulating hypothetical constructs, such as hypothetical consent. The good reasons for grounding hypothetical consent are doing the real work for requiring action or inaction, and reference to consent is hardly necessary. SHELLY KAGAN, NORMATIVE ETHICS 90 (1998).

324. *See supra* note 293–94 and accompanying text.

325. *See supra* note 293 and accompanying text; *see also* RESTATEMENT (THIRD) OF AGENCY § 3.03 (explaining that the principal's manifestation is the lynchpin of apparent agency).

326. *See supra* Part I.D.3.

3. *Advertisements Induce Customers to Engage Broker-Dealer Firms*

a. *Advertisements Are Important to Customers*

Advertising advice and adviser titles induce individuals to contract with broker-dealers and ground a reasonable expectation that a broker-dealer will provide advice. Advertising is the paid promotion of an idea, cause, product, or service by an identified sponsor attempting to inform and ultimately persuade a target audience into taking action.[327] The advertising by many brokerage firms is sometimes referred to as institutional advertising because it takes a broad approach, emphasizing the philosophy of a particular industry, and is often meant to engender goodwill toward a product, service, or firm. Institutional advertising is similar to public relations because both attempt to promote a positive image.[328] Advertising by broker-dealers can also take the form of persuasive advertising typically used after a product or service has been introduced to a customer. Persuasive advertising builds selective demand for a product or service by promoting its special feature.[329]

Advertising is meant to reach specific customers at a particular time and induce them to change their behavior.[330] The SEC has stated that regulating advertising is important because of the impact advertising has on retail investors.[331] FINRA regulates brokerage firm advertising, which must be approved by a registered principal at the firm and, in some cases, filed with FINRA.[332] Regulating advertising comprises an important aspect of FINRA's program, which has a Department of Advertising Regulation dedicated to the task.[333]

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327. Allen D. Truell & Michael Milbier, *Advertising*, *in* ENCYCLOPEDIA OF BUSINESS AND FINANCE 15 (Burton S. Kaliski ed., 2d ed. 2007); ENCYCLOPEDIA OF AMERICAN BUSINESS 6–7 (W. Davis Folsom ed., 2004).

328. Truell & Milbier, *supra* note 327, at 17; ENCYCLOPEDIA OF AMERICAN BUSINESS, *supra* note 327, at 6.

329. Truell & Milbier, *supra* note 327, at 17.

330. *Id.* Companies that advertise generally try to achieve one of several objectives, all of which are meant to encourage or induce the customer to make a purchase. The *trial* objective encourages customers to make an initial purchase of a product or service. The *continuity* objective is intended to retain current customers and build loyalty. *Brand switching* seeks to have a customer change from a competitor's brand; non-dominant companies in a field often have this objective. The *switchback* objective seeks to regain lost customers by emphasizing new features or other important information. *Id.*; *see also* ENCYCLOPEDIA OF AMERICAN BUSINESS, *supra* note 327, at 6.

331. SECTION 913 STUDY, *supra* note 1, at 130.

332. John R. Hewitt, *Advertising and Communications*, *in* BROKER-DEALER REGULATION § 7:2.1, 76 (Clifford E. Kirsch ed., 2011).

333. Advertising regulation covers content standards, disclosure requirements, filing requirements, and review methods. *See generally id.* §§ 7.1–7.2, at 7-1 to 7-44.

Advertising works. According to research in the field of emotional advertising, one can develop positive beliefs about a subject's attributes merely by having a positive emotional reaction to an advertisement.[334] Emotions such as "warmth" can relax the viewer and put him in a positive state of mind. Warmth can be stimulated by pictures or by narratives of friendship, caring, and tenderness.[335] These feelings may be engendered through brokerage advertisements discussed above, particularly those suggesting that brokerage employees will provide trust, guidance, advice, answers, and help.[336] Researchers have found that advertisements that evoke feelings of warmth are correlated with the likelihood of purchase.[337] As discussed above, use of titles such as "financial advisor" and "financial consultant" appears to affect investors, with investors viewing financial advisors and financial consultants as more similar to investment advisers than to brokers in terms of the services offered and duties imposed.[338]

b. Advertisements Are Intended to Be Believed

One response to the argument that advertising and titles induce customers to engage a particular brokerage firm is that advertising language is not meant to be taken literally; the language is mere puffery.[339] Under the puffery doctrine, words such as "trust," "advice," and "trusted advice" are not meant to be believed as actually true. For example, no one would think that the phrase "best cheesesteaks in Philadelphia" is the result of a proprietor's survey. Instead, the phrase is mere puffery.

Puffery is a spurious objection here. First, it is unlikely that the brokerage industry would argue that use of advertisements proposing advice, and titles such as "financial advisor" or "financial consultant,"

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334. Julie A. Edell, *Emotion in Advertising: A Timely Union*, *in* EMOTION IN ADVERTISING: THEORETICAL AND PRACTICAL EXPLORATIONS xiv (Stuart J. Agres et al. eds., 1990).

335. GERARD J. TELLIS, EFFECTIVE ADVERTISING: UNDERSTANDING WHEN, HOW, AND WHY ADVERTISING WORKS 171 (2004).

336. Some financial services firms employ language of trust in their advertisements to create a particular mood, image, or emotion. Similarly, by differentiating "answers" from "sales talk," which was done in one of the advertisements mentioned above, see *supra* Part III.A., brokers shed their historical role as securities salesmen and promoted an image that they provide impartial advice. *See supra* Part III.A.; *see also supra* note 273 and accompanying text.

337. *See* David A. Aaker et al., *Warmth in Advertising: Measurement, Impact, and Sequence Effects*, 12 J. OF CONSUMER RES. 365, 378 (1986).

338. *See supra* Part III.A.

339. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 606–09 (6th ed. 2009); WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 723 (4th ed. 1971).

are acceptable expressly because no one would actually believe them at face value. Moreover, there is evidence that consumers consistently view puffery statements as important when making decisions.[340] This evidence is consistent with the *Rand Report*, which suggests that people believe their brokers are acting in their best interest.[341]

A second response is that even if the words in an advertisement are taken as true, the general rule is that an advertisement is not an offer.[342] There are two reasons for this rule. First, an advertisement is general; it is not clear to whom it is directed and there is no limitation on the number of persons who could accept it. Second, an advertisement is merely a notice of available goods or services and acts as an invitation to examine, negotiate, and buy.[343]

Recent scholarship debunks the shibboleth that an advertisement is not an offer. Legal scholars Jay Feinman and Steven Brill point to three reasons why the rule is wrong: (i) the cases that cite this rule do not apply it, (ii) other legal rules, such as statutes and regulations, prevent application of the rule, and (iii) the rule is inconsistent with fundamental tenets of contract law.[344] In light of this analysis, there are strong reasons to believe that advertisements in some cases might be considered offers. Regardless of whether or not an advertisement can be considered an offer, an advertisement under agency law could be considered a manifestation by a principal to a third party (a customer) that a broker-dealer registered representative is acting in a fiduciary capacity, giving rise to reasonable expectations regarding the conduct of a broker-dealer firm. Again, the point is not that any one broker-dealer should be liable because of a particular advertisement or use of a title, but rather that broker-dealers that give advice should be subject to a general fiduciary duty because of the reasonable expectations they have created.

C. Brokers' Claim to Provide Advice Results in a Fiduciary Promise

The argument to this point has been that use of advertisements and titles with advice language creates a reasonable expectation that broker-

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340. *See* David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1434–39 (2006).

341. RAND REPORT, *supra* note 84, at 109.

342. *See* RESTATEMENT (SECOND) OF CONTRACTS § 26 cmt. b (1981) ("Advertisements of goods . . . are not ordinarily intended or understood as offers to sell."); *see also* CORBIN, *supra* note 295, § 2.4, at 116 (stating that it is not "customary" that an advertisement is an offer and the presumption is the other way).

343. Feinman & Brill, *supra* note 298, at 63–64.

344. *Id.* at 65–80.

dealer firms provide advice to retail customers. The provision of advice alone, however, may not give rise to a fiduciary duty. This section explains why a broker-dealer's promise to advise another results in a promise to do so in an impartial manner, consistent with the other's best interest—a fiduciary standard.

1. Advising Another Implies Advising Impartially

One might begin by asking what it means to "advise" another. To advise is to give guidance or suggestions, to state one's opinion as to the best course of action, to counsel or make recommendations, typically as a basis for another to make a decision.[345] A key element of this definition is to give guidance on the best course of action. Implicit in the term "advise" is that the guidance given will be the best guidance for the recipient of the advice, tantamount to a best interest standard.

To clarify what is meant by "advise," one might contrast it with the term "persuade," which is to urge someone successfully to do something: to attract, induce, or entice in a particular direction.[346] Both advising and persuading entail giving another reasons to undertake a particular course of action. An important difference, however, is that advising does not necessarily entail trying to convince another to change her conduct and follow a recommended course of action. To advise is to set forth a course of action for another. Even if the speaker believes the recipient should follow the course of action, the decision is left to the recipient and the speaker remains neutral.[347] By contrast, persuasion connotes a speaker's desire for a particular outcome.

An adviser's impartiality is implicit in the profession and the hallmark of adviser regulation. As discussed above, before the investment advisory profession developed, investors sought advice from their

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345. OXFORD ENGLISH DICTIONARY, *supra* note 271, *available at* http://www.oed.com/view/Entry/3001?redirectedFrom=advise#eid.

346. *Id.*, *available at* http://www.oed.com/view/Entry/141561?rskey=clv4LK&result=2&isAdvanced=false#eid.

347. The etymology of *advice* sheds light on the distinction. *Advice* can be traced to the French *avis*. The old French expression *il m'est a vis* meant "it is to me at sight" or "it is my view or opinion." F. Max Müller, *How to Work*, 65 ECLECTIC MAG. OF FOREIGN LIT., SCI., & ART 433, 434 (1897) (containing detailed etymology of *advice*). The French phrase *ce m'est à vis* became *ce m'est avis* meaning "it seems to me." OXFORD ENGLISH DICTIONARY, *supra* note 271, *available at* http://www.oed.com/view/Entry/2987?redirectedFrom=advice#eid. Similarly, the phrase *mon à vis*, meaning "my at sight or my view," became *mon avis*, and then, in the Latin of that time, *advisum*, derived from *ad* (to) and *visum* (seen), or the way in which a matter is seen or looked upon. Müller, *supra*, at 434.

lawyers and other professionals, not from specialists.[348] In engaging with their lawyer, investors believed they were dealing with someone in whom they could confide their personal circumstances.[349] The genesis of the profession was what Rudolf Berle, General Counsel of the Investment Counsel Association of America, called a "personal professional relationship."[350] Individuals turned to their investment adviser, like their lawyer, as someone they could trust to help them arrive at a solution to their problems.

As described in Part I, a key concern underlying the Advisers Act was the presence of tipsters who were disguising themselves as legitimate advisers.[351] There was antipathy by advisers who provided unbiased advice toward those with a vested interest in recommending a particular security.[352] Leading up to passage of the Advisers Act, Berle lamented the fact that congressional bills that regulated investment companies and investment advisers appeared together. As he put it, "Investment counsel have only services to sell. Investment companies have securities to sell."[353] Implicit in this distinction was that investment counsel would advise in a client's best interest whereas other securities professionals were trying to make a sale.[354]

2. *A Claim of Impartiality Results in a Fiduciary Duty*

When one advises another, he is purporting to provide independent, impartial information in the best interest of the recipient. This is common sense. When a student seeks enrollment advice from an academic counselor, the student has a reasonable expectation that the counselor will advise based on the student's best interest and not on other considerations, such as which classes the school must fill or which

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348. *See supra* Part I.A.

349. *Hearings on S. 3580*, *supra* note 64, Part 2 at 750 (statement of Rudolf P. Berle, General Counsel, Investment Counsel Association of America).

350. *Id.*

351. *See supra* Part I.B.3.

352. *See supra* note 60 and accompanying text.

353. Berle, *supra* note 349, at 743.

354. Developments in the European Union reflect this trend. The current draft of the Markets in Financial Instruments Directive II (MiFID II) states that investment firms should explain to clients the reasons for their advice. The draft also states that when providing investment advice on an independent basis, it is appropriate "to further restrict the possibility for firms to accept or receive inducements from third parties." *Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments Repealing Directive 2004.39.ec of the European Parliament and of the Council*, at 27, COM (2011) 656 final (Oct. 20, 2011), *available at* http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=200940.

professors the counselor likes best. According to William Prosser's *Handbook of The Law of Torts*, it is reasonable to rely on an opinion that is given by one who purports to be disinterested.[355] The propensity to rely on a disinterested adviser is illustrated by a venerable common law doctrine that distinguishes between advice given by a seller and advice given by one who holds himself out as disinterested.

The rule of the disinterested adviser dates to the 1800s. In *Medbury v. Watson*,[356] the Supreme Judicial Court of Massachusetts held that false statements by a seller of property might not be actionable because a buyer should be aware of a seller's motive. A reasonable buyer would understand that a seller would be inclined towards hyperbole with regard to the property sold. By contrast, the same false statement made by a person purporting to be independent would result in liability:

> [T]he distinction between the two cases is marked and obvious. In the one, the buyer is aware of his position; he is dealing with the owner of the property, whose aim is to secure a good price, and whose interest it is to put a high estimate upon his estate, and whose great object is to induce the purchaser to make the purchase; while in the other, the man who makes the false assertions has apparently no object to gain; he stands in the situation of a disinterested person, in the light of a friend, who has no motive nor intention to depart from the truth, and who thus throws the vendee off his guard, and exposes him to be misled by the deceitful representations.[357]

The Court distinguished a seller, whose role is transparent to the buyer and whose advice should be taken with a grain of salt, from another person who appears to be disinterested, which causes the buyer to let his guard down, exposing him to misrepresentations.

Modern courts express a similar principle: an adviser that holds itself out as an expert assumes fiduciary obligations. In *Burdett v. Miller*,[358] an unsophisticated investor, Burdett, formed a relationship with a stockbroker, Miller, who was also a certified public accountant, a professor of accounting, and the owner of his own accounting firm.[359] The two became friendly, occasionally having lunch and discussing business and personal matters. Burdett hired Miller to prepare her tax

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355. PROSSER, *supra* note 339, at 727.

356. 47 Mass. (6 Met.) 246 (1843).

357. *Id.* at 260; *see also* Batchfelder v. Stephenson, 184 N.W. 852, 852–53 (Minn. 1921); Samp v. Long, 210 N.W. 733, 734–35 (S.D. 1926).

358. 957 F.2d 1375 (7th Cir. 1992).

359. *Id.* at 1378–79.

return and several years later sought his advice on how to invest to minimize her tax liability. Miller recommended that she invest in a number of tax shelters, but he failed to disclose conflicts of interest in making the recommendation and other relevant facts—such as the lack of an investment track record and the lack of liquidity. Burdett invested based on Miller's advice and lost $200,000.[360] Burdett sued, alleging that Miller, among other things, breached his fiduciary duty.[361]

In *Miller*, Judge Richard Posner wrote that if a person solicits another to trust him in matters for which he holds himself out as expert and trustworthy, and if the other, who is not an expert, accepts the offer and reposes her trust in the first, a fiduciary relationship is established.[362] Thus, by holding oneself out as a disinterested adviser, a broker-dealer must act in the customer's best interest, disclosing conflicts of interest and recommending the best investment among alternatives.[363]

The claim of impartiality for advisers played an essential role in Supreme Court jurisprudence governing investment advisers, discussed above.[364] In *SEC v. Capital Gains Research Bureau, Inc.*, the Court held that a practice known as scalping—buying shares for the adviser's own account and then recommending the same shares to clients—operated as a fraud and deceit on clients.[365] The Court explained that when an adviser trades on the market effect of his own recommendation, he might be motivated to recommend the security to take advantage of a short-term increase in price, and an investor should be permitted to evaluate an adviser's "overlapping motivations."[366] The dissent in the Second Circuit

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360. *Id.* at 1379.

361. *Id.*

362. *Id.* at 1381; *see also* EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31 (N.Y. 2005) (holding that when an arm's length relationship becomes advisory and one person was induced to and did repose confidence in another, the relationship becomes fiduciary).

363. The holding-out argument is not the same as the shingle theory. *See supra* Part II.C.2. The shingle theory refers to the implicit statement by a broker, which hangs a shingle, that it will conduct business in an equitable and professional manner. *See supra* note 82 and accompanying text. The shingle theory holds that when a broker sells a security, it warrants that statements regarding the security are correct. The broker, therefore, has an obligation of due diligence to ensure its statements are correct. If the broker conceals information that is inconsistent with its statements, the concealment may be considered fraudulent. *See* HAZEN, *supra* note 30, at 608; Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, *supra* note 19, at 751–52. The claim of reasonable expectations applies more expansively to the relationship between the broker and the customer than the shingle theory, establishing a reasonable expectation not only that the broker's statements regarding a particular security are correct, but also that the broker will more generally act in the customer's best interest.

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

365. *Id.* at 181.

366. *Id.* at 196.

Court of Appeals, which presaged the majority decision in the Supreme Court, focused on the appearance of objectivity and the importance such appearance would have to an investor:

> Here Capital Gains held itself out as an investment adviser and stated that the service was exclusively designed to help clients protect investment capital, realize income, and accumulate capital gains. It thus naturally instilled in its clients the belief that it would render impartial and unbiased expert advice. Having taken this fiduciary stance, it then secretly engaged in profitable trading operations often inconsistent with its own advice . . . . Failure to disclose the existence of such a motive in the light of the implicit and explicit guaranty of impartiality was a scheme to defraud and operated as a fraud upon the clients.[367]

The Supreme Court majority adopted this theme, noting that affiliations by advisory firms with banks or corporations might preclude a "disinterested, objective, or critical" perspective regarding an investment.[368]

Recalling that the Advisers Act was meant to address "tipster" firms masquerading as bona fide investment advisers illustrates that Congress and the SEC have returned to where they started in 1940. The Advisers Act was passed out of concern that certain individuals or firms were masquerading as advisers without providing impartial advice. Today, the same tension animates the debate over whether to impose a fiduciary duty on brokers that give advice. Absent a fiduciary duty for brokers that give advice, the concern remains that brokers that are paid to sell securities, or that have other conflicts of interest, are masquerading as objective investment advisers, even though they are not regulated as such.[369] As one expert stated when testifying in support of a fiduciary standard, "the key characteristic that distinguishes advice from a sales pitch is that it is designed with the recipient's interest in mind."[370]

D. Regulatory and Common Law Consequences Follow from Investors' Reasonable Expectations of a Fiduciary Obligation

The use of advertising and titles laden with the language of advice has

367. SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 617 (2d Cir. 1962) (Clark, J., dissenting).

368. *Capital Gains*, 375 U.S. at 187–88 (quoting H.R. DOC. NO. 76-477, 29 (1939)).

369. *See* Susanne Craig & Jessica Silver-Greenberg, *Conflict Seen In Sales Tactic at JPMorgan*, N.Y. TIMES, July 3, 2012, at A1.

370. Roper, *supra* note 177, at 6.

consequences in both regulatory law and common law. The regulatory consequence is that customers' reasonable expectations that brokers act in a fiduciary capacity can form the basis for a new fiduciary rule for broker-dealers under Section 913 of the Dodd-Frank Act. The common law consequence is that courts can look to the reasonable expectations of investors in determining whether broker-dealers that give personalized advice to retail customers should be held to a fiduciary standard.

1. Reasonable Expectations Support a New Fiduciary Duty Under the Dodd-Frank Act

In the *Section 913 Study*, the SEC staff's primary recommendation is that the Commission "should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers."[371] According to the Study, a uniform standard should require that all brokers, dealers, and advisers, when providing personalized advice, "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[372] Insofar as brokers advertise themselves as advisers, thereby inducing customers to use their services, brokers are raising reasonable expectations that they will act in a fiduciary capacity. Moreover, brokers' advertisements focus on giving personalized advice, which was Congress' precise concern in Section 913 of the Dodd-Frank Act. As a result, regulators have a basis for imposing a fiduciary duty on brokers that give advice.

Under this analysis, brokers would still be excluded from the Advisers Act if their advice was solely incidental to brokerage and they did not charge special compensation for advice. Broker-dealers that give personalized advice to retail customers will not be subject to the Advisers Act in its entirety. The SEC would maintain discretion to determine when advice is so significant that it cannot be considered solely incidental to brokerage.

One example of where advice would probably not be solely incidental to brokerage is when a broker has discretion over an account. When the SEC adopted the exemptive rule in 2005, it determined that discretionary advice could no longer be considered "solely incidental" to brokerage. Broker-dealers would not be excluded from the Advisers Act for discretionary accounts, regardless of the form of compensation received.

371. SECTION 913 STUDY, *supra* note 1, at 109.

372. *Id.* at 109–10.

According to the SEC, authority to effect a trade without consulting a client is "qualitatively distinct" from providing advice that is "solely incidental" to brokerage. The SEC explained that when a broker has discretion, the broker is both the source of the advice and the person with the authority to carry it out. This type of activity is "quintessentially supervisory or managerial" and warrants protections provided by the Advisers Act.[373] Decisions such as these would be left to the SEC to resolve through rulemaking, interpretation, and enforcement cases. Under a new rule, however, an overarching fiduciary obligation would apply across the board to broker-dealers that provide personalized advice to retail customers.

2. Reasonable Expectations Support a Common Law Fiduciary Duty for Broker-Dealers That Provide Advice

This Article argues that brokers' use of advertisements and titles, which induces customers to obtain advice from brokerage firms, along with changes in the brokerage industry, creates a reasonable expectation that brokers providing advice are fiduciaries and must act in customers' best interest. This in itself creates a legal basis for holding broker-dealers to a fiduciary standard when those brokers provide advice. As a result, if an action were brought by a brokerage customer against a firm for breach of fiduciary duty in the context of a broker providing advice, a court could hold that the brokerage firm has breached its fiduciary duty resulting in a tort. According to the *Restatement (Second) of Torts*, a person in a fiduciary relationship with another is subject to liability for harm resulting from a breach of duty imposed by the relation.[374] In the context of a broker providing advice, a fiduciary relationship exists and the duty is imposed *by the relation*. That is, the duty arises because of the inducement from the broker's use of advertising and titles. If harm has occurred as a result of a breach, the broker would be subject to liability in tort.

This rule should apply to the category of brokers that provide personalized advice to retail customers. This category of brokers would join the group of paradigmatic relationships, such as trustee and beneficiary, guardian and ward, and attorney and client, all of which are already subject to a fiduciary obligation.[375] Courts would no longer have

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373. Adopting Release, *supra* note 10, at 20,440.

374. RESTATEMENT (SECOND) OF TORTS § 874 (1979).

375. *See* Finn, *supra* note 314, at 32; Ethan J. Leib, *Friends as Fiduciaries*, 86 WASH. U. L. REV. 665, 671–72 (2009).

to engage in a case-by case determination regarding whether a broker-dealer that provides advice is a fiduciary.

To say that a court should hold that a fiduciary duty exists and that a breach of the duty would constitute a tort does not settle what the scope or contours of the broker's fiduciary obligation would be. As noted above, fiduciary duties are ambiguous and the details of the broker's fiduciary duty are open to question.[376] The duties imposed in a particular case would likely vary depending on the contract between the brokerage firm and the customer and other circumstances surrounding the relationship. A fiduciary's obligations typically depend on the scope of the fiduciary's authority.[377] The scope of this authority can vary, even within a particular brokerage firm. For example, some accounts are discretionary; others are not.[378] Regardless of the particular contours of the fiduciary obligation, the standard obligations attendant to a fiduciary relationship would follow: the broker, for example, could not use the customer's property, the broker's position, or any non-public information acquired as a result of the relationship for the broker's own purposes.[379] The broker would owe a fiduciary duty to the customer and breach would constitute a tort.

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Whether a fiduciary relationship is imposed by administrative rule or common law, one feature of the fiduciary relationship that cannot be ignored is the ability of the parties in the relationship to change their rights and responsibilities by contract.[380] Although the parties can alter many obligations attendant to a fiduciary relationship, certain obligations—such as a core duty of loyalty—cannot be negotiated.[381] A strict duty of loyalty to place the customer's interest before the firm's

376. *See supra* Part II.A.2.

377. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006).

378. *See supra* Part III.D.1.

379. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e.

380. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 90–91 (1989).

381. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(2) (2007) ("Even an express authorization [to engage in prohibited transactions], however, would not completely dispense with the trustee's underlying fiduciary obligations to act in the interest of the beneficiaries and to exercise prudence in administering the trust."); *see also* BT-I v. Equitable Life Assurance Soc'y of the U.S., 75 Cal. App. 4th 1406, 1412 (Cal. Ct. App. 1999) ("[A] limited partnership agreement cannot relieve the general partner of its fiduciary duties in matters fundamentally related to the partnership business.").

interest would be etched in the law, whether by rule or case law. Perhaps more importantly, in the large number of instances when the parties do not revise terms by contract, default rules governing fiduciary relationships, developed through centuries of precedent in the common law, would be applicable to the brokerage relationship.[382]

CONCLUSION

As the SEC edges closer to imposing a fiduciary duty on brokers that give advice, it can look to investors' reasonable expectations as a justification for doing so. The debate over whether and when to impose a fiduciary duty on brokers is not new. It has existed in the courts for decades and took on new dimensions once brokers began to market themselves as advisers, particularly after the abolition of fixed commissions. Charging asset-based fees and the development of two tiers of pricing for brokerage services raised questions over whether brokers could continue to rely on the broker exclusion from the Advisers Act. Although the SEC attempted to address this conundrum through rulemaking, the SEC's rule was vacated. And although Congress took up the issue in the Dodd-Frank Act, Congress made no final decisions, opting to delegate resolution of this thorny problem to the SEC. The SEC staff has recommended imposing a fiduciary duty on brokers that give advice, but the SEC has yet to act.

To date, the justifications relied on by those proposing a fiduciary duty for brokers are not completely convincing. Arguments such as investor confusion or inconsistent or weak standards are insufficient to ground a change in the law. Confusion could be addressed by mechanisms short of a rule change, and the presence of inconsistent or even weak standards alone does not justify changing them. A better reason stems from investors' expectations, though a fiduciary standard is not supportable based on the empirical expectations of some or even most investors.

To support a fiduciary duty for brokers, regulators and courts should look instead to the reasonable expectations of brokerage customers, formed over years of advertising and use of titles, which project an image of a broker as a trusted adviser and provide a promise of rendering advisory services. Inherent in a promise to provide advice is a promise that the advice will be objective and shorn of conflicts of interest—the hallmarks of advice given by investment advisers in

382. *Cf.* Andrew Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478, 503 (2005).

accordance with a fiduciary standard as articulated by the SEC and the courts. The reasonable expectations of the parties, resulting from brokers' use of advertising and titles reflecting an advisory role, provide a sound justification to change the law to impose on broker-dealers a fiduciary duty when providing personalized investment advice to retail customers. The SEC should exercise its authority and impose a fiduciary duty in this circumstance.