# HOW TO IMPROVE RETAIL INVESTOR PROTECTION AFTER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Barbara Black*

*The Dodd-Frank Wall Street Reform and Consumer Protection Act gives the Securities and Exchange Commission authority to address two issues especially important to retail investors. First, section 913 requires the SEC to conduct a six-month study on the effectiveness of existing standards of care for broker-dealers and investment advisers and specifically authorizes the SEC to establish a fiduciary duty for broker-dealers. Second, section 921 grants the SEC authority to prohibit the use of predispute arbitration agreements that would require investors to arbitrate future disputes arising under the federal securities laws and regulations or the rules of a self-regulatory organization. What has been overlooked in the debate over retail investor protection is the interconnectedness of these two provisions. Debate over retail investor protection after Dodd-Frank must consider these two issues together in order to achieve the goal of better retail investor protection. I make three principal arguments. First, I argue that broker-dealers and investment advisers should be held to standards of care and competence based on professionalism, rather than fiduciary duty. Second, I propose, for adoption by the SEC, federal professional standards of care and competence for broker-dealers and investment advisers. Third, I argue that the SEC's adoption of standards of care and competence will not create any additional federal remedies for investors because it is unlikely that the United States Supreme Court will imply a private damages remedy for their breach. If the SEC prohibits mandatory securities arbitration of*

* Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law. Michael Keefe, Corporate Law Fellow and UC College of Law '10, and Michael Richardson, Corporate Law Fellow and UC Law '12, provided valuable research assistance. Tamar Frankel, Arthur Laby, John F.X. Peloso, and Paul Rose provided helpful comments on earlier drafts. I presented this paper at the Law and Society Annual Meeting and the Midwest Corporate Scholars Conference in the summer of 2010 and received many useful comments from the participants.

*claims based on federal securities law and SEC and SRO rules, the ability of retail investors, particularly those with small claims, to recover damages for careless and incompetent investment advice may be substantially reduced.*

## I. INTRODUCTION

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[1] comprehensive financial reform legislation enacted in response to the 2008-2009 financial crisis. Dodd-Frank gives the Securities and Exchange Commission (SEC) the authority to deal with two issues especially important to retail investors.[2]

First, section 913 addresses what is generally described as harmonizing the standard of conduct between broker-dealers and investment advisers (collectively, investment advice providers) or holding broker-dealers to the federal fiduciary duty standard applicable to investment advisers. Today broker-dealers and investment advisers compete head-on for the retail investors' business. Both solicit investors' business on the basis of the quality of their investment advice and advertise that they provide ongoing advice tailored to meet their customers' changing needs. Although retail investors may perceive the nature of their services as identical, broker-dealers and investment advisers are subject to different regulatory schemes and standards of conduct, which cause investor confusion and concern about the adequacy of retail investor protection.[3] Section 913 requires the SEC to conduct a six-month study and to report to Congress on the effectiveness of existing standards of care for broker-dealers and investment advisers and on "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care."[4] The statute provides that the SEC may commence a rulemaking to address these issues[5] and specifically authorizes the SEC to establish a fiduciary duty for

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

2. Dodd-Frank defines a "retail customer" as a "natural person . . . who [] receives personalized investment advice . . . from a broker or dealer or investment adviser; and [] uses such advice primarily for personal, family, or household purposes." *Id.* § 913(a). In general, retail investors have smaller portfolios, and their investment knowledge is less extensive, than sophisticated investors such as institutional investors.

3. ANGELA HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 117-18 (2008) [hereinafter THE RAND STUDY].

4. Dodd-Frank, § 913(b)(2); *see also* Dodd-Frank, § 913(c) (setting forth a number of factors for the SEC to take into consideration when conducting its study).

5. *Id.* § 913(f).

broker-dealers.[6]

Second, section 921 addresses the issue of mandatory securities arbitration. Currently, virtually all broker-dealers include in their customers' agreements a predispute arbitration agreement (PDAA) that requires customers to arbitrate their disputes before the Financial Industry Regulatory Authority (FINRA) arbitration forum.[7] Many investment advisers also include PDAAs that require arbitration before a commercial forum.[8] Section 921 grants the SEC the authority to limit or prohibit the use of PDAAs that would require customers[9] of investment advice providers to arbitrate future disputes arising under the federal securities laws and regulations or the rules of a self-regulatory organization (SRO).[10]

Although each issue is controversial and has been the subject of extensive debate, the close relationship between the two has been largely overlooked. Investors who suffer losses caused by poor investment advice will seek to recover damages from their investment advice providers under any standard of care adopted by the SEC. If the SEC bans PDAAs for claims based on federal securities laws and SEC and SRO rules, many parties will likely litigate these claims in court, contrary to current practice. Migration of these claims away from the FINRA arbitration forum could, in turn, significantly impact the securities arbitration process in ways that may be disadvantageous to retail investors. Accordingly, debate over retail investor protection after Dodd-Frank must consider these two issues together in order to achieve the goal of better retail investor protection.

This article seeks to shed some light on, and remove some heat from, these often contentious debates. After providing background in Part II, I make three arguments:

6. *Id.* § 913(g). There are significant limitations on the scope of the fiduciary duty the SEC is authorized to adopt, as discussed *infra* notes 76-78, 185 and accompanying text.

7. *See Arbitration & Mediation*, FIN. INDUS. REGULATORY AUTH. (FINRA), http://www.finra.org/ArbitrationMediation/index.htm (last visited Oct. 2, 2010) ("FINRA operates the largest dispute resolution forum in the securities industry . . . .").

8. *See, e.g.*, Bakas v. Ameriprise Fin. Servs., Inc., 651 F. Supp. 2d 997 (D. Minn. 2009) (enforcing arbitration clauses in the parties' investment services agreements which called for arbitration before a commercial forum).

9. Unlike section 913 of Dodd-Frank, section 921 is not limited to retail customers.

10. Dodd-Frank, § 921. Self-Regulatory Organization (SRO) is defined in the Securities Exchange Act of 1934 (Exchange Act) § 3(a)(26), 15 U.S.C. § 78c(a)(26) (2006). FINRA is the SRO for all United States broker-dealers. *About the Financial Industry Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Oct. 2, 2010). There is no SRO for investment advisers. By its terms, Dodd-Frank does not give the SEC the authority to limit or prohibit PDAAs with respect to state law claims, which account for the largest number of FINRA claims. *Arbitration and Mediation: Dispute Resolution Statistics*, FINRA, http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm (last visited Oct. 2, 2010). See *infra* notes 245-248 and accompanying text for discussion of this issue.

First, in Part III, I argue that the fiduciary duty principle is not helpful in establishing standards of care and competence to judge the performance of investment advice providers, whether investment advisers or broker-dealers. Fiduciary duty is too amorphous to establish a standard of conduct, the breach of which can cause serious consequences, and is inapposite in the context of individuals and firms that reasonably expect to profit from their services. Retail investor protection will be better advanced if the applicable standards of conduct focus on professionalism. Accordingly, broker-dealers and investment advisers should be held to professional standards of care and competence.

Second, in Part IV, I propose, for adoption by the SEC, federal professional standards of care and competence for broker-dealers and investment advisers. These include a core set of principles setting forth minimum standards that the parties cannot disclaim. Additional standards would be applicable whenever the investment advice provider invites the investor's reliance on its advice and the investor does in fact so rely.

Finally, in Part V, I address investors' remedies and the debate over mandatory securities arbitration. Currently, under federal law, most investors can recover damages for harm caused by poor investment advice only if they can establish fraud, which requires proof of scienter.[11] Despite the frequent expression of the need to improve retail investor protection, at no time did Congress give serious consideration to amending federal securities legislation to provide an explicit damages remedy for careless and incompetent investment advice. It is unlikely, under the United States Supreme Court's current approach to implying causes of action, that the Court will create a private damages remedy for breach of any SEC standards. Unless it does, SEC adoption of standards of conduct (whether based on fiduciary duty or professionalism) would not create any additional federal remedies for investors. The advantage of securities arbitration from retail investors' perspective is that they may be able to recover damages despite the unavailability of a legal remedy. If the SEC determines to prohibit mandatory securities arbitration of claims based on federal securities law and SEC and SRO rules, the ability of retail investors—particularly those with small claims—to recover damages for careless and incompetent investment advice may be substantially reduced.

11. See my earlier work, Barbara Black, *Transforming Rhetoric into Reality: A Federal Remedy for Negligent Brokerage Advice*, 8 TRANSACTIONS: TENN. J. BUS. L. 101 (2006), for a discussion of the need for a federal negligence remedy.

## II. THE STATUS QUO AND LEGISLATIVE SOLUTIONS (AND LACK THEREOF)

### *A. Regulation of Broker-Dealers and Investment Advisers*

The broker-dealer industry is large and complex and encompasses a wide variety of activities beyond the brokerage activities of executing trades and providing investment advice.[12] It is also a highly regulated industry. Broker-dealers and their salespersons (known technically as "associated persons" or "registered representatives"[13]) are regulated under the Securities Exchange Act of 1934 (the Exchange Act),[14] which provides for regulation over virtually every aspect of the business.[15] While the SEC has authority to adopt federal standards of competence[16] and has direct authority over broker-dealers and their associated persons,[17] FINRA, as the SRO for broker-dealers, is the principal regulator,[18] over which the SEC exercises oversight authority.[19] Salespersons of broker-dealers are subject to licensing requirements, including examinations administered by FINRA.[20] State securities commissioners also regulate broker-dealers and associated persons.[21]

In contrast, the investment advisory industry is less complex, since its

12. NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 4.01 (4th ed. 2010).

13. *See* 15 U.S.C. § 78c(a)(18) (2006) (using the term "associated person[s]"); *see also Registered Representatives Brochure: Registration, Testing, and Qualifications*, FINRA, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Brochure/P009865 (last visited Oct. 2, 2010) (using the term "registered representatives").

14. 15 U.S.C. §§ 78a-78pp (2006), *amended by* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

15. *Id.* § 78o-3.

16. *Id.* § 78o(b)(7), (c)(2)(D).

17. The SEC's Office of Compliance Inspections and Examinations conducts nationwide examinations and inspections, *Office of Compliance Inspections and Examinations*, U.S. SEC. & EXCH. COMM'N (SEC), http://www.sec.gov/about/offices/ocie.shtml (last modified Mar. 19, 2010), and the SEC's Division of Enforcement investigates possible violations and brings enforcement proceedings, *Division of Enforcement*, SEC, http://www.sec.gov/divisions/enforce.shtml (last modified Jul. 22, 2010).

18. *See generally About the Financial Industry Regulatory Authority*, *supra* note 10 (describing FINRA's regulatory activities); s*ee also* POSER & FANTO, *supra* note 12, § 4.01 ("It is doubtful whether any regulated industry has been allowed to regulate itself to the degree that the securities industry has.").

19. 15 U.S.C. § 78o-3.

20. *See FINRA Registration and Examination Requirements*, FINRA, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/p011051 (last updated July 16, 2010) (outlining the categories of registered principals and their corresponding examination requirements).

21. *See Role of State Securities Regulators*, N. AM. SEC. ADM'RS ASS'N (NASAA), http://www.nasaa.org/About_NASAA/Role_of_State_Securities_Regulators/ (last visited Oct. 2, 2010) (describing the various duties of state securities regulators).

principal function is providing investment advice,[22] and less regulated. Investment advisers (but not investment adviser representatives) are regulated under the Investment Advisers Act of 1940 (the Advisers Act),[23] which places few substantive burdens on investment advisers.[24] The Advisers Act does not provide for industry self-regulation. Instead, the SEC is the principal regulator of larger investment advisers, and states regulate the smaller investment advisers as well as investment adviser representatives.[25] The Advisers Act does not establish qualifications for investment advisers and does not require that investment advisers or their representatives pass any examinations,[26] although many states have examination requirements.[27]

### *B. Standards of Conduct for Broker-Dealers and Investment Advisers*

Neither the Exchange Act nor the Advisers Act explicitly sets forth a standard of conduct to which broker-dealers or investment advisers, respectively, must adhere. Federal and state case law have filled in the gaps and have subjected broker-dealers and investment advisers to different standards.

Federal courts have not derived from the Exchange Act or its legislative history a federal standard of conduct for broker-dealers and associated persons in their dealings with investors. Although the Supreme Court has never directly addressed the issue, it has recognized the broker-dealer relationship as giving rise to a fiduciary relationship in one situation:

22. *See generally* 1 TAMAR FRANKEL & ANN T. SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 1.01(B) (2d ed. 2001) (describing the services provided by investment advisers).

23. 15 U.S.C. §§ 80b-1 to -21 (2006), *amended by* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

24. The Act is viewed largely as a disclosure, record-keeping and anti-fraud statute. Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion,* 39 RUTGERS L.J. 627, 627-28 (2008); *see also* Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (describing the Advisers Act as mainly a registration and anti-fraud statute).

25. 15 U.S.C. § 80b-3(a).

26. In 1975, the SEC sought amendments to address what has been described as "the most serious defect" in the Advisers Act, 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3397 (3d ed. 1991), but they failed to pass. FRANKEL & SCHWING *supra* note 22, §1.02(A)(1)(a).

27. *See Exams: Frequently Asked Questions*, NASAA, http://www.nasaa.org/Industry___Regulatory_Resources/Exams/926.cfm#14 (last visited Oct. 2, 2010) (noting that most states have examination requirements to become an investment adviser); *see also Investment Advisers: Frequently Asked Questions*, NASAA, http://www.nasaa.org/Industry___Regulatory_Resources/Investment_Advisers/445.cfm#1 (noting the state examination requirements to become an investment adviser) (last visited Oct. 2, 2010).

when the broker-dealer has the power to affect trades in the account without the customer's authorization.[28] Lower federal courts apply agency principles and generally treat broker-dealers as salespersons who owe a fiduciary duty to investors (referred to as "customers") with nondiscretionary accounts only with respect to their responsibilities to execute trades.[29] The Exchange Act requires a "national securities association" (i.e., FINRA) to adopt membership rules "to promote just and equitable principles of trade,"[30] and FINRA rules require members to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business.[31] The most important conduct rule is the "suitability" rule, National Association of Securities Dealers (NASD) Rule 2310.[32] Rule 2310 imposes on broker-dealers obligations, when making recommendations, to conduct due diligence both to know their customer[33] and to know the security, so that any recommended security is suitable for the customer, based on the investor's other securities holdings and her financial situation, objectives and needs.[34]

In contrast, federal law recognizes that investment advisers owe a fiduciary duty to those investors with whom they have an advisory relationship, who are referred to as clients. Although the Advisers Act does not call investment advisers "fiduciaries" or refer to a "fiduciary duty," the Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.*,[35] relied on the statute's legislative history to find "congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship.'"[36] In a later opinion, *Transamerica Mortgage Advisors, Inc.*

28. *See* SEC v. Zandford, 535 U.S. 813 (2002) (referring to a broker's fiduciary duty in the context of a discretionary account).

29. *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999) (stating that the fiduciary obligation between broker and customer is limited to the narrow task of consummating the transaction requested).

30. 15 U.S.C. § 78o-3(b)(6) (2006).

31. FINRA R. 2010 (FINRA 2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905.

32. Because FINRA has not yet completed the consolidation of the New York Stock Exchange and National Association of Securities Dealers (NASD) rules necessitated by the 2007 merger, NASD Rule 2310 remains the operative provision. NASD R. 2310 (NASD 1996), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315.

33. The broker-dealer must make reasonable efforts to obtain relevant information about the customer, including financial status, tax status, and investment objectives. NASD R. 2310(b).

34. The rule makes clear that suitability determinations must be made on a portfolio basis. NASD R. 2310(a).

35. 375 U.S. 180 (1963).

36. *Id.* at 191-92. In another part of the opinion, the Court acknowledged that Congress recognized the investment adviser to be a fiduciary. *Id.* at 194.

*v. Lewis,*[37] the Court reaffirmed that the Advisers Act established "federal fiduciary standards" for investment advisers. *Capital Gains* also identified the "basic function" of investment advisers—"furnishing to clients on a personal basis *competent, unbiased, and continuous* advice regarding the sound management of their investments."[38] Neither *Capital Gains* nor *Transamerica Mortgage Advisors*, however, presented the Court with the opportunity to explore concretely the nature of fiduciary duties owed by an investment adviser providing individualized investment advice,[39] and there is limited case law or regulatory guidance on the issue. The SEC requires investment advisers to adopt a code of ethics setting forth their standards of business conduct that "must reflect their fiduciary obligations,"[40] but the agency itself has never adopted conduct rules that explicate the fiduciary duty concept. In 1994 the SEC proposed a suitability rule for investment advisers that was substantially the same as the broker-dealer's suitability rule but derived from the fiduciary duty standard; it was never adopted.[41]

Because broker-dealers and investment advisers compete for investors' business, each industry frequently takes the opportunity to explain how its regulatory scheme better protects investors. Thus, broker-dealers point to the self-regulatory structure as affording greater investor protection;[42] investment advisers, in turn, refer to the higher fiduciary standard.[43]

37. 444 U.S. 11, 17-18 (1979) (citing earlier Supreme Court opinions and legislative history).

38. 375 U.S. at 187 (emphasis added).

39. *Capital Gains* involved a financial publication; *Transamerica* held that investors had no private cause of action for damages under the Advisers Act.

40. 17 C.F.R. § 275.204A-1 (2010).

41. Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, 59 Fed. Reg. 13,464 (proposed Mar. 16, 1994) [hereinafter Suitability of Investment Advice]. The SEC asserted that the proposed rule was a codification of existing SEC interpretations.

42. *See, e.g., Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs,* 111th Cong. 165 (2009) (prepared statement of Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Association), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg144/pdf/CHRG-111shrg144.pdf (asserting that an independent regulatory organization for investment advisers would prevent future harm to investors).

43. *See, e.g.*, *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 246 (2009) (statement of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:55810.pdf (asserting that not holding brokers to a fiduciary standard creates confusion in client expectations).

*C. Investors' Remedies for Harm Caused by Poor Investment Advice*

Investors have no federal remedy to compensate them for losses caused by investment advice provided by incompetent and careless investment advice providers, whether a broker-dealer or an investment adviser, in trading transactions. Section 12(a)(2) of the Securities Act of 1933 (the Securities Act)[44] is the only express private damages remedy for negligent advice; in *Gustafson v. Alloyd Co.*,[45] the Supreme Court held that this provision did not apply to trading transactions. The Court also, in *Ernst & Ernst v. Hochfelder*,[46] limited the implied remedy under Exchange Act Section 10(b)[47] and Rule 10b-5[48] to require scienter and exclude negligence actions. While the Supreme Court held that sections 17(a)(2) and 17(a)(3) of the Securities Act[49] apply to negligent advice in trading transactions,[50] the federal appeals courts currently assume that the Court would not recognize an implied cause of action under these sections.[51] The only investors' remedy in the Advisers Act is a limited rescissionary remedy; there is no provision for compensating losses caused by negligent investment advisers.[52] Finally, the lower federal courts do not recognize the SEC's shingle theory—that broker-dealers make an implied representation to their customers that they will deal with them fairly and in accordance with the standards of the profession—outside of SEC enforcement actions[53] and refuse to imply private causes of action for breach of SRO rules.[54] State courts may allow investors to recover under

44. 15 U.S.C. § 77l(a)(2) (2006).

45. 513 U.S. 561 (1995).

46. 425 U.S. 185 (1976).

47. 15 U.S.C. § 78j(b) (2006).

48. 17 C.F.R. § 240.10b-5 (2010).

49. 15 U.S.C. § 77q(a)(2)-(3) (2006).

50. In *Aaron v. SEC*, the Supreme Court held that sections 17(a)(2) and 17(a)(3) of the Securities Act do not require scienter. 446 U.S. 680, 700 (1980). In *U.S. v. Naftalin*, the Supreme Court held that section 17(a) of the Securities Act applies to trading transactions. 441 U.S. 768, 777 (1979).

51. *See, e.g.,* Maldonado v. Dominguez, 137 F.3d 1, 6 (1st Cir. 1998) (holding that section 17 of the Securities Act did not create an implied private right of action). *But see* AFA Private Equity Fund 1 v. Miresco Inv. Servs., No. 02-74650, 2005 WL 2417116, at *5 (E.D. Mich. Sept. 30, 2005) (following 6th Circuit precedent to the contrary).

52. Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

53. *See* Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) (distinguishing private damages suits from enforcement actions); Roebuck v. Guttman, 678 F. Supp. 68, 69 (S.D.N.Y. 1988) (same); Vernon J. Rockler & Co. v. Graphic Enters., Inc., 52 F.R.D. 335, 342 n.12 (D. Minn. 1971) (same); *see also* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1295-97 (1995) (concluding that private plaintiffs cannot recover damages under the shingle theory).

54. *See, e.g.,* Gurfein v. Ameritrade, Inc., 312 F. App'x 410, 414 (2d Cir. 2009) (holding that a customer could not sue for breach of SRO best execution rule).

various state law theories in some circumstances.

Retail investors who purchase securities in a registered public offering from a statutory seller do have a negligence claim under Section 12(a)(2) of the Securities Act.[55] For example, retail investors who purchase shares in mutual funds recommended by their broker may have claims for inaccurate oral communications related to the prospectus.[56]

Ever since the Supreme Court held, in *Shearson/American Express, Inc. v. McMahon*, that PDAAs were enforceable under the federal securities laws,[57] virtually all customers' disputes with their broker-dealers and registered representatives are resolved through arbitration in the FINRA (or its predecessors NASD and New York Stock Exchange (NYSE)) forum. Because there is no SRO for investment advisers, there is less information available about arbitration of disputes involving investment advisers. However, it appears that arbitration before one of the commercial forums is the customary method of resolving disputes between investors and investment advisers as well.[58] Arbitration is an equitable forum; investors are not required to state a legal cause of action, and arbitrators are not required to apply the law. Although few arbitration panels provide reasons for their awards, it is generally believed that investors frequently do recover damages from broker-dealers and investment advisers for careless or incompetent advice.[59]

### *D. Financial Reform Legislation*

#### 1. Harmonizing Standards of Conduct

The genesis of Dodd-Frank was the June 2009 U.S. Department of Treasury's white paper on financial regulatory reform.[60] It identified the problem of investor confusion because "investment advisers and broker-

---

55. 15 U.S.C. § 77l(a)(2) (2006) (setting forth affirmative defense of "reasonable care").

56. See *infra* notes 200-206 and accompanying text for a discussion of the difficulties associated with a section 12(a)(2) claim.

57. 482 U.S. 220, 238 (1987).

58. Courts routinely enforce PDAAs in light of the Court's post-*McMahon* pro-arbitration policy. *See, e.g.*, Bakas v. Ameriprise Fin. Servs., Inc., 651 F. Supp. 2d 997 (D. Minn. 2009) (holding that the investor's claims against an investment adviser were subject to arbitration). The SEC, however, has never withdrawn its Opinion Letter referred to in *Bakas* that states that investment advisers could not require PDAAs. McEldowney Fin. Servs., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

59. *See generally* Barbara Black & Jill Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration,* 23 CARDOZO L. REV. 991 (2002) (examining the role of law in arbitration of investors' disputes with their broker-dealers).

60. U.S. DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

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."[61] Its initiatives "to increase fairness for investors"[62] included measures to "[e]stablish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers."[63] The white paper contained three proposals:

> [1.] requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;
> [2.] providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and
> [3.] prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.[64]

Although the white paper's use of the phrase "harmonizing the regulation of investment advisers and broker-dealers"[65] at least invites a comprehensive review of the regulatory provisions of the Exchange Act and the Advisers Act in order to determine the optimal regulatory scheme for all investment advice providers, in fact Congress had little energy for this. Instead, a consensus emerged early on in the debate for harmonizing the standards of conduct applicable to those who provide personal investment advice to retail investors, which became synonymous with extending the federal fiduciary duty standard applicable to investment advisers to broker-dealers that offered investment advice. The major industry groups supported at least the concept, although they hotly debated implementation. The investment adviser industry and consumer groups supported amending the Advisers Act to eliminate the broker-dealer exclusion from the statutory definition of "investment adviser,"[66] while the broker-dealer industry supported legislation that would delegate authority to the SEC to study the matter further and develop appropriate conduct

61. *Id.* at 71.

62. *Id.*

63. *Id.*

64. *Id.* at 72. This paper addresses only the proposal for creating the same fiduciary obligations for broker-dealers and investment advisers. For analysis of the conflicts of interest issue, see Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers,* 65 BUS. LAW. 395, 424-28 (2010).

65. U.S. DEP'T OF TREASURY, *supra* note 60, at 15.

66. Broker-dealers are explicitly excluded from the IAA's broad definition of "investment adviser" so long as (1) their performance of advisory services is "solely incidental" to the broker-dealer business and (2) they receive "no special compensation" for their services. 15 U.S.C. § 80b-2(a)(11)(C) (2006); *see also* Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 33 (2005) (outlining the different legal obligations that brokers and investment advisors owe their customers).

rules consistent with a fiduciary duty principle.[67]

The versions of the House and Senate financial reform legislation, in turn, reflected those different approaches. In December 2009 the House passed a bill that would require the SEC to promulgate rules to provide that the standard of conduct for all brokers, dealers and investment advisers, "when providing personalized investment advice about securities to retail customers[,] . . . shall be to act in the best interest of the customer without regard to the financial or other interest of the [advice provider]"[68] and the "standard of conduct shall be no less stringent than the standard applicable to investment advisers."[69]

The original Senate version, in contrast, would have eliminated the broker-dealer exclusion from the definition of "investment adviser" in the Advisers Act,[70] thus subjecting all broker-dealers that offered investment advice to regulation under the Advisers Act. The Senate Banking Committee, however, never voted on that version, and in March 2010, the committee instead approved a revised legislative proposal that was included in the version passed by the Senate on May 19, 2010. The Senate version called for the SEC to conduct a one-year study.[71] Thereafter, if the study identified any gaps or overlap in the standards in the protection of retail investors relating to standards of care, the SEC was required to commence a rulemaking to address the deficiencies within two years after enactment of the statute.

Throughout the reconciliation process that produced the final legislation, industry groups engaged in intense lobbying for their positions.[72] The brokerage industry essentially won this debate. Section

67. For a comparison of these views, see, e.g., *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 227 (2009) (Testimony of David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association) (strongly supporting extending an investment adviser's fiduciary duty to brokers who provide investment advice); *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 227 (2009) (Testimony of John Taft, Head of U.S. Wealth Management, RBC Wealth Management, Chairman of the Private Client Group Steering Committee, Securities Industry and Financial Markets Association) (agreeing with proposal to delegate to the SEC broad authority to create the rules that would govern the federal fiduciary standard).

68. Wall Street Reform & Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103(a) (as passed by House of Representatives, Dec. 2, 2009).

69. *Id.*

70. Restoring American Financial Stability Act, S. 3217, 111th Cong. § 913(a) (discussion draft, as introduced to S. Banking Comm., Nov. 10, 2009).

71. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 913(b) (Senate Amendment No. 3739, April 29, 2010).

72. *See* Mark Schoeff Jr., *Congress Passes Fiduciary Ball to SEC*, INVESTMENTNEWS

913 of Dodd-Frank requires the SEC to conduct a six-month study to evaluate:

> (1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers . . . ; [and]
> (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute . . . .[73]

The statute also sets forth a long list of considerations that the SEC should take into account in conducting its study, including investor confusion, resources devoted to regulatory enforcement, the potential impact on retail investors of imposing a fiduciary duty on broker-dealers, the potential impact of eliminating the broker-dealer exclusion from the definition of investment adviser under the Advisers Act, and potential costs from any additional regulation.[74] After completion of the study, the SEC may commence a rulemaking to address the standards of care and to improve regulation of broker-dealers and investment advisers.

The statute amends the Exchange Act to give the SEC the authority to establish a standard of care for broker-dealers and their associated persons when providing personalized investment advice about securities to retail customers that is the same as the standard of conduct applicable to investment advisers.[75] The statute imposes three limits on the SEC's authority: (1) the receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of the standard;[76] (2) "nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities;"[77] and (3) broker-dealers that sell only proprietary or other limited range of products do not, for that reason alone,

(June 27, 2010), http://www.investmentnews.com/article/20100627/FREE/100629911 (identifying several of the groups involved in the debate).

73. Dodd-Frank Act, Pub. L. No. 111-203, § 913(b), 124 Stat. 1376, 1824 (2010).

74. *Id.* § 913(c).

75. *Id.* § 913(g)(1).

76. *Id.*

77. *Id.* As I discuss *infra* note 185 and accompanying text, this limits substantially the imposition of a meaningful standard of care for broker-dealers.

violate the standard of care.[78] With respect to the latter type of broker-dealers, the SEC may require them to provide notice to each retail customer and obtain the consent or acknowledgement of the customer.[79] The statute, in turn, amends the Advisers Act to give the SEC the authority to establish a standard of conduct for all broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[80] It bears emphasis that section 913(g) does not require the SEC to promulgate any conduct rules, but it does set forth two requirements for any standards of conduct it may adopt: (1) "any material conflicts of interest shall be disclosed and may be consented to by the customer"[81] and (2) the standard of conduct "shall be no less stringent than the standard applicable to investment advisers."[82]

Finally, the statute addresses harmonization of enforcement and amends the Exchange Act and the Advisers Act to mandate a "parity of enforcement" for violations of the standards of conduct applicable to investment advice providers providing personalized investment advice to retail investors. Both the Exchange Act and the Advisers Act are amended to state that the SEC "shall seek to prosecute and sanction violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer . . . to same extent as the [SEC] prosecutes and sanctions violators of the standard of conduct applicable to an investment advisor[sic]."[83]

---

78. *Id.*

79. *Id.*

80. *Id.* § 913(g)(2).

81. *Id.* The statute also requires the SEC to "facilitate the provision of simple and clear disclosures" to investors about the terms of their relationships with their investment advice providers, including conflicts of interest and to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes . . . that the [SEC] deems contrary to the public interest and the protection of investors." *Id.*

82. *Id.* The statute refers to Advisers Act sections 206(1) and (2), as well as 15 U.S.C. § 80b-6, which makes it illegal for investment advisers to engage in fraudulent activities or to engage in any practice "which operates as a fraud or deceit . . . ."

83. Dodd-Frank, § 913(h). It is not clear what Congressional concern motivated this provision. The SEC currently oversees about 11,500 investment advisers and 5,400 broker-dealers; the number of investment advisers registered with the SEC has grown by 32% since 2005. SEC, IN BRIEF: FY 2011 CONGRESSIONAL JUSTIFICATION 2 (Feb. 2010), *available at* http://www.sec.gov/about/secfy11congbudgjust.pdf. In the past five years the SEC has brought a total of 3,195 actions (both civil and administrative), of which 427 (13.4%) were brought against broker-dealers and 409 (12.8%) against investment advisers. *See* SEC, SELECT SEC AND MARKET DATA 3 (2005–2009), *available at* http://www.sec.gov/about.shtml (providing this data in table 2 for all five fiscal years).

2. Mandatory Securities Arbitration

Ever since *Shearson/American Express, Inc. v. McMahon*,[84] there has been ongoing debate over the fairness of SRO securities arbitration.[85] Many investors perceive the FINRA arbitration forum as unfair,[86] although academics who have studied the forum award it high marks for meeting most generally recognized standards of fairness.[87] In 2009 Congress considered, but did not pass, legislation to invalidate PDAAs in employment and consumer arbitration and expressly included securities arbitration within the definition.[88] The Treasury white paper recommended an SEC study of the issue as well as an amendment of the federal securities laws to give the SEC authority to prohibit PDAAs in brokerage and investment advisory contracts with retail investors.[89] Section 921 of Dodd-Frank (which is essentially the same provision contained in the House and Senate versions)[90] gives the SEC the authority to prohibit, or to impose conditions or limitations on the use of, "agreements that require customers or clients . . . to arbitrate *any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rule of a self-regulatory organization* if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."[91] In contrast with section 913 and its required study on

84. 482 U.S. 220 (1987).

85. *See* Black & Gross, *supra* note 59, at 994 (describing current perceptions).

86. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration,* 2 J. DISP. RESOL. 349, 389-91 (2008).

87. *See* MICHAEL PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATION (2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf (finding that the current SRO conflict disclosure requirements generally appear adequate); *see also* Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1, 3-12 (2004) (discussing the author's view that securities arbitration is a fairer process than many consumer/employee arbitration processes); Jill Gross, McMahon *Turns Twenty: The Regulation of Fairness in Securities Arbitration,* 76 U. CIN. L. REV. 493, 518 (2008) (expressing the author's belief that current regulation of securities arbitration does ensure that it is fair to investors and concluding that SEC oversight sufficiently regulates the fairness of securities arbitration).

88. *See* Jill Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174, 1177-1178 (2010) (noting that 2009 legislation to invalidate PDAAs expressly extended coverage to securities industry disputes through its definition of "consumer dispute," but also noting that this legislation did not pass).

89. U.S. DEP'T OF TREASURY, *supra* note 60, at 72.

90. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 913(b) (Senate Amendment No. 3739, April 29, 2010); Wall Street Reform & Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103(a) (as passed by House of Representatives, Dec. 2, 2009).

91. Dodd-Frank Act, Pub. L. No. 111-203, § 921(a), 124 Stat. 1376, 1841 (2010)

standards of conduct, section 921 is solely enabling and does not require the SEC to take any action.

By its terms, the statutory language imposes a significant limitation on the SEC's authority to prohibit the use of PDAAs; its authority does not extend to future disputes arising under state law. The limitation, and the complications it introduces into future considerations of the policy question, are discussed later in this article.[92]

Finally, it should be noted what is *not* included in Dodd-Frank. Although the Obama administration identified "increas[ing] fairness for investors" as a goal,[93] at no point did the administration or Congress consider amending federal securities legislation to provide investors with a damages remedy for careless and incompetent investment advice. To the contrary, Dodd-Frank provides no explicit remedy for an investor harmed by an investment advice provider's negligence or breach of fiduciary duty. Thus, after the enactment of Dodd-Frank, investors who purchased securities in trading transactions[94] are still without a federal damages remedy unless they can establish fraud.[95]

## III. FIDUCIARY DUTIES OR PROFESSIONAL STANDARDS?

Section 913 of Dodd-Frank reflects a well-placed skepticism about whether different standards of care for broker-dealers and investment advisers make sense when they provide essentially the same service—personalized advice to retail investors—and solicit business by encouraging trust and reliance on their diligence and expertise.[96] As discussed above,[97]

---

(emphasis added).

92. *See infra* notes 258-59 and accompanying text (discussing the potential complications that may arise from the statutory language's limitation on the SEC's authority to prohibit the use of PDAAs).

93. U.S. DEP'T OF TREASURY, *supra* note 60, at 15.

94. Retail investors who purchase mutual funds recommended by their brokers can bring a negligence claim under the Securities Act § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006), but courts have not been receptive to these claims. *See, e.g.*, *In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 358 (2d Cir. 2010) (dismissing claims based on failure to disclose conflicts of interest); DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209, 216 (3d Cir. 2007) (dismissing claims based on failures to disclose involving Class B shares); Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 608 (6th Cir. 2005) (dismissing claims based on failures to disclose involving Class B shares).

95. The possibility that federal courts might imply a private cause of action under a standard of care rule adopted by the SEC is discussed *infra* notes 229-241 and accompanying text.

96. *See* Lynn A. Stout, *Trust Behavior: The Essential Foundation of Securities Markets* (UCLA Sch. of Law, Law & Econ. Research Paper No. 09-15, 2009), *available at* http://ssrn.com/abstract=1442023 (detailing the importance of trust in the securities markets).

97. Dodd-Frank Act, Pub. L. No. 111-203, § 913(b), 124 Stat. 1376, 1824 (2010); *see*

section 913 directs the SEC to conduct a study on the current regulation of broker-dealers and investment advisers and gives the SEC the authority to adopt a fiduciary duty standard for broker-dealers. In Part III, I first examine the underpinnings of the fiduciary duty concept and conclude that it does not provide a workable standard to assess the performance of investment advice providers. I then argue that professionalism should be the foundation for establishing appropriate standards of care and competence for all investment advice providers when they provide advice to retail investors.

### *A. The Enduring Mystery of Fiduciary Duty*

Lawyers, judges, and academics invoke the fiduciary duty concept in order to convey a strong ethical duty to be protective of another's interest. The phrase connotes a tone of high mindedness, an altruistic regard for another. Recall Judge Cardozo's often-quoted language:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[98]

Fiduciaries appear in many forms and in many areas of the law; in the business setting alone, controlling shareholders, directors, partners, investment advisers to mutual funds, and trustees of ERISA pension plans are common examples. Thus, determining the principles underpinning fiduciary relationships has proved elusive.[99] The difficulty is exacerbated because judges frequently use the term as a conclusionary label whenever they find injury to a vulnerable party without much analysis of the factors deemed relevant in arriving at that conclusion. Many scholars have explored the concept of the fiduciary relationship in an effort to ascertain its defining characteristics. In the corporate and securities fields, the scholarship of Tamar Frankel and Deborah DeMott has been especially influential.

In the view of Professor DeMott, there is no one core principle in identifying fiduciary obligations, beyond the descriptive statement that "the

*also supra* text accompanying note 73 (discussing section 913 of Dodd-Frank).

98. Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

99. *See* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879 (1988) ("Recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 425 (1993) ("The many agency relations that fall under the 'fiduciary' banner are so diverse that a single rule could not cover all without wreaking havoc.").

fiduciary obligation is a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of the characteristics of that person's relationship with another."[100] Accordingly, careful analysis requires asking two related, but distinct, questions: (1) is there a fiduciary relationship, and (2) what duties are created by that fiduciary relationship. Thoughtful judges have recognized this; as Justice Frankfurter famously stated:

> [T]o say that a man is a fiduciary only begins analysis . . . To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?[101]

Professor Frankel, in her analysis of fiduciary law, finds as a unifying theme the creation of a relationship for the benefit of one party because of that party's dependence on another for a particular service.[102] The central features of a fiduciary relationship are that "the fiduciary serves as a substitute for the entrustor"[103] and "the fiduciary obtains power . . . for the sole purpose of enabling the fiduciary to act effectively."[104] Consistent with this approach, she asserts that "all fiduciary relations give rise to the problem of abuse of power, that the purpose of fiduciary law should be to solve this problem, and that the differences in the rules applicable to various fiduciary relations stem from differences in the extent of the problem."[105]

Both approaches require an analysis of the nature of the relationship to assess the degree of vulnerability of one party to another. Professor DeMott focuses on imposing duties to limit one party's discretion for the protection of the other, while Professor Frankel focuses specifically on the danger of abuse of power. Neither approach, however, provides useful guidance in determining the appropriate standard of care in providing investment advice. It makes sense to talk of a need to limit discretion or find an abuse of power in instances of obvious forms of misconduct (such as misappropriation of funds) or in self-dealing transactions. It is problematic to describe deficiencies in advice-giving services as resulting from unchecked discretion or an abuse of power. Indeed, the Restatement (Third) of Agency (for which Professor DeMott is the Reporter) takes the

100. DeMott, *supra* note 99, at 915.

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

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

103. *Id.* at 808.

104. *Id.* at 809.

105. *Id.* at 807-08; *see also* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1212 (1995) [hereinafter *Default Rules*] ("In sum, fiduciary rules reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for entrustors and receive substantial power to effectuate the performance of the services, while entrustors cannot efficiently monitor the fiduciaries' performance.").

position that fiduciary obligations are limited to duties of loyalty and not competence.[106] Accordingly, extending the fiduciary duty principle to all investment advice providers does little to advance the analysis of the appropriate level of care and competence that an investor can reasonably expect from her investment adviser or broker-dealer. The debate over fiduciary duty is largely off-point.

Finally, Professors DeMott and Frankel also identify the importance of the moral theme in fiduciary regulation. Thus, judicial opinions use language of moral obligation to distinguish fiduciary from contractual obligations,[107] to emphasize the altruistic nature of fiduciary relationships,[108] and in recognition of the vulnerability of the entrustor.[109] In contrast, law and economics scholars argue that there is nothing special about fiduciary relationships; they are nothing more than contractual arrangements with high transaction costs.[110] While I do not agree that fiduciary obligations have no place in the law, the objections of the law and economics scholars have relevance in the context of investment advice providers' relationships with their investors. These relationships are always contractual, entered into by both parties for the purpose of making a profit. While investment advice providers cultivate and encourage retail investors' reliance on their services, there are degrees of vulnerability, and not all retail investors are the equivalent of the "widows and orphans" that the law traditionally recognizes as vulnerable. In this context, language of altruism is inapposite. Indeed, as Professor Laby points out, the core fiduciary principle of putting another's interest ahead of the fiduciary's cannot literally be applied in this context, since it would mean that the investment advice provider would have to renounce its compensation for its

106. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. E (2006) ("It is open to question whether an agent's unconflicted exercise of discretion as to how to best carry out the agent's undertaking implicates fiduciary doctrines."); *see also* Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1409 (2002) (arguing that the duty of care is not a fiduciary duty).

107. DeMott, *supra* note 99, at 891. Frankel, *supra* note 102, at 830.

108. *See* Frankel, *supra* note 102, at 830 ("[O]nce an individual undertakes to act as a fiduciary, he should act to further the interests of another in preference to his own.").

109. *Id.* at 832. *See also* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 671 (1996) (emphasizing the "pervasiveness of trust" in broker-customer relationships and that brokers seek to win the customers' trust, and customers wish to bestow it).

110. *See, e.g.*, Easterbrook & Fischel, *supra* note 99, at 427 (discussing the nature of a fiduciary relation). For criticism of the contractarians' approach, see generally DeMott, *supra* note 99, at 902 and *Default Rules*, *supra* note 105, at 1211. As Professor Frankel notes, the difference in approach largely comes down to whether the fiduciary obligation created by the relationship can be waived; she argues that beneficiaries of the fiduciary relationship can waive some (but not all) duties owed to them only with informed consent. *Default Rules*, *supra* note 105, at 1212.

services.[111] All investment advice providers face conflicts from the profit motive in advising investors; these conflicts can be mitigated but not eliminated. Accordingly, the altruistic language that is an integral aspect of the fiduciary duty concept is a poor fit in this context and provides at least a partial explanation for why judicial analysis of these relationships under the fiduciary duty framework is intellectually unsatisfying. The courts must resort to the rhetorical flourish because any extended legal analysis would expose the weakness of the analogy.

This is not to say that rhetoric does not serve a purpose. It can set an aspirational tone, as Professor Edward Rock has explored in the "sermons" of the Delaware Supreme Court on directors' fiduciary duties.[112] While this is valuable, the cost of fiduciary language is high. Because of its vague and amorphous quality, the fiduciary duty concept does not promote the development of clear and workable standards that investment advice providers can incorporate into their business practices, regulators can consistently enforce, and courts and arbitration panels can apply in resolving investors' claims against their broker-dealers.

The Supreme Court's recent opinion in *Jones v. Harris Associates L.P.*[113] nicely illustrates the difficulties created by the use of a fiduciary duty standard in federal securities legislation, in this case the Investment Company Act of 1940 (the Company Act). In 1970 Congress amended the Company Act to improve investor protection and addressed the issue of excessive fees paid by the mutual fund board to its investment adviser, a classic conflict of interest situation since the investment adviser and mutual fund are affiliated companies. Section 36(b) of the Company Act provides that the investment adviser to a mutual fund "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services," and fund shareholders can sue the investment adviser for breach of that duty.[114] *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[115] a Second Circuit section 36(b) opinion whose approach is endorsed in *Harris Associates,* tracked the legislative history on this section, which it described as "tortuous"[116] and the Supreme Court, more diplomatically, described as representing "a delicate compromise"[117] that resulted in the

111. Laby, *supra* note 64, at 426.

112. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997). *But see* William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1 (2009) (pointing out the dangers of the indeterminate fiduciary duty approach).

113. 130 S. Ct. 1418 (2010).

114. 15 U.S.C. § 80a-35(b) (2006).

115. 694 F.2d 923 (2d Cir. 1982).

116. *Id.* at 928.

117. *Harris Associates*, 130 S. Ct. at 1423.

statutory reference to fiduciary duty that is "hardly pellucid."[118] Thus, *Harris Associates* presents a cautionary tale about uncertainties created by the political decision to use the felicitous phrase rather than develop a workable standard. The end result is an approach that the Court concedes "may lack sharp analytical clarity."[119]

Moreover, the history of section 36(b), culminating in *Harris Associates*, supports the argument that the legislative use of "fiduciary duty" results in a rhetorical flourish rather than a meaningful investors' remedy. The statutory fiduciary duty is really an ersatz fiduciary duty. First, the statute provides that the shareholder has the burden of proof to establish a breach of fiduciary duty,[120] whereas in a classic conflict-of-interest relationship the fiduciary has the burden of establishing fairness. Second, the outcome of *Harris Associates* makes clear that plaintiffs will rarely prevail.[121] The holding—that an investment adviser is liable if the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining"[122]—sets forth a standard that is close to, if not identical with, a "corporate waste" standard—generally expressed as "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[123] Plaintiffs rarely prevail under a corporate waste standard that Congress expressly rejected. After *Harris Associates* the investment adviser has only to meet the standards of the marketplace and meets a "fiduciary standard" through arms-length bargaining, in marked contrast to Judge Cardozo's approach.

In conclusion, adoption of a fiduciary standard is unlikely to improve the quality of investment advice and advance retail investor protection. I argue that instead the standard of conduct for investment advice providers should be based on professionalism. In the next section, I develop the rationale for professionalism.

### *B. The Importance of Professionalism in the Securities Industry*

As the Court has frequently stated, a fundamental purpose, common to the federal securities statutes, is to achieve "a high standard of business

118. *Id.* at 1426.
119. *Id.* at 1430.
120. 15 U.S.C. § 80a-35(b)(1).
121. Indeed, plaintiffs have never prevailed in court under section 36(b). Mercer E. Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. CIN. L. REV. 559, 560 n.5 (2008).
122. *Harris Associates*, 130 S. Ct. at 1426.
123. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

ethics in the securities industry."[124] Failure to act professionally is recognized as unethical conduct.[125] The need for professionalism in the selling of securities is a consistent theme in the Exchange Act, dating from its initial enactment as reform legislation intended to restore public confidence in the U.S. capital markets.[126] In subsequent amendments, Congress frequently sought to elevate the level of professionalism. For example, in 1964, Congress strengthened qualification standards for broker-dealers, in recognition of the fact that greater participation in the securities markets by retail investors called for more professionalism on the part of broker-dealers.[127] In 1975, Congress adopted major reforms to the self-regulatory system to better "police the conduct and strengthen the professional standards of professional participants in [the United States] securities markets."[128] As part of that reform, the SROs were required to adopt and enforce rules that promoted "just and equitable principles of trade."[129] In 1990, Congress added provisions to raise the standard of brokers' practices in sales of penny stocks that are frequently sold to

124. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); SEC v. Zandford, 535 U.S. 813, 819 (2002); United States v. Naftalin, 441 U.S. 768, 775 (1979); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972). For a discussion of professional ethics more generally, see John Hooker, *Professional Ethics: Does It Matter Which Hat We Wear?* 2 (Carnegie Mellon Univ. Tepper Sch. of Bus., Working Paper, 2006), *available at* http://tepper.cmu.edu/alumni/lifelong-learning/speaker-presentations/john-hooker-keynote-talk-on-professional-ethics-does-it-matter-which-hat-we-wear/index.aspx.

125. *See, e.g.*, Heath v. SEC, 586 F.3d 122, 134 (2d Cir. 2009) (stating that SRO rule's concern with unethical conduct is consistent with focus on the "professionalism of the securities industry").

126. As expressed by an SEC Commissioner who was, for many years, a staff attorney in its Enforcement Division, "it is clear that, in enacting the securities laws, Congress intended to raise the standard of conduct of those playing important roles in the securities market." Manuel F. Cohen & Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROBS. 691, 694 (1964).

127. The House of Representatives observed "a [dramatic] increase" in "public participation in the securities markets[,]" particularly among persons having but slight acquaintance with the intricacies of corporate finance and stock market operations. This development demands that the selling of securities be conducted in a more professional manner . . . . H.R. REP. NO. 87-882, at 3 (1961), *reprinted in* 2 BUREAU OF NAT'L AFFAIRS (BNA), FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 1750, 1752 (1983).

128. H. R. REP. NO. 94-123, at 44 (1974), *reprinted in* 3 BNA, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 2471, 2514.

129. Specifically, the rules of national securities exchanges and national securities associations were required to promote "just and equitable principles of trade," 15 U.S.C. §§ 78f(b)(5), 78o-3(b)(6) (2006) and standards with respect to "training, experience and competence." *Id.* §§ 78f(c)(3)(A), 78o-3(g)(3)(A)-(B). FINRA Rule 2010 emphasizes "high standards of commercial honor" and "just and equitable principles of trade" for the protection of investors. FINRA R. 2010 (FINRA 2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905.

unsophisticated retail investors.[130]

As noted previously, the Advisers Act places few substantive burdens on investment advisers, does not provide for industry self-regulation, and does not set qualifications or educational requirements for investment advisers.[131] Thus it is fair to say that the statute does not evidence the same degree of concern for professionalism found in the Exchange Act. Nevertheless, Congress has amended the Advisers Act several times to tighten regulation, most pertinently in 1975, when the registration and disciplinary procedures were revised to conform more closely to those for broker-dealers.[132] The SEC, moreover, uses its authority under the antifraud provisions to hold investment advisers to professional standards, although it typically expresses them as fiduciary obligations.[133] Indeed, whatever "fiduciary" means, *Capital Gains* makes clear it encompasses an obligation to act professionally.[134]

The SEC consistently identifies care and competence as important components of professional conduct. The agency frequently brings disciplinary proceedings against broker-dealers and investment advisers for unprofessional conduct, such as soliciting customers to purchase securities at excessive mark-ups[135] and making unsuitable or uninformed recommendations.[136] FINRA (and its predecessors, NASD and the New York Stock Exchange) bring disciplinary actions against broker-dealers and associated persons for unprofessional and unethical conduct; a showing of

---

130. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

131. *See supra* notes 23-27 and accompanying text (describing the relatively fewer substantive burdens on investment advisers).

132. 7 LOSS & SELIGMAN, *supra* note 26, at 3314.

133. *See, e.g.*, Suitability of Investment Advice, *supra* note 41 (stating that the investment adviser's suitability obligation is enforceable under the antifraud provisions of the Advisers Act).

134. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187 (1963) ("[An] investment adviser[']s . . . basic function [is to] furnish[] to clients[,] on a personal basis[,] competent, unbiased, and continuous advice regarding the sound management of their investments . . . . ").

135. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434, 436 (2d Cir. 1961) (stating that a broker-dealer "holds itself out as competent to advise.").

136. *See, e.g.*, Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969) (affirming SEC's sanctions against four broker-dealer defendants for fraud in failing to disclose material adverse information about stocks to customers); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961) (remanding to SEC to clarify findings that broker-dealer's statements to customer on projected stocks were misleading); *In re* David A. King & King Capital, Exchange Act Release No. 33167, 55 SEC Docket 1107 (Nov. 9, 1993) (barring unregistered investment adviser from such a position after he made material misrepresentations to clients to induce investments); *In re* Shearson, Hammill & Co., Exchange Act Release No. 7743, 42 SEC Docket 811, 840 (Nov. 12, 1965) (noting that executive committee of investment advisers made no effort to investigate "methods used and representations made to induce customers to purchase the stock").

bad faith is not required, because customers are entitled to believe that they will be "dealt with fairly and in accordance with the standards of the profession."[137] State securities commissioners discipline securities professionals for unprofessional and unethical practices.[138]

In conclusion, professionalism provides a well-established and clear principle on which to base standards of conduct for both broker-dealers and investment advisers when they provide investment advice to retail investors. In Part IV, I set forth these proposed federal standards of competence and care.

## IV. FEDERAL PROFESSIONAL STANDARDS FOR INVESTMENT ADVICE PROVIDERS

After the SEC completes the six-month study required by Section 913 of Dodd-Frank,[139] it may commence a rulemaking to address standards of care and to improve regulation of broker-dealers and investment advisers. Because establishing well-defined and enforceable professional standards is a better approach than adopting a fiduciary duty standard, I set forth, for adoption by the SEC, federal standards of care and competence for investment advice providers.[140]

These proposed federal standards include four minimum standards that investment advice providers owe to all retail investors, based on SEC interpretations, SRO rules, industry standards and common law fiduciary duty, tort and agency principles. Because these are minimum standards, the investment advice provider cannot contract out of adherence to these standards. They may be stated as follows:

(1) *Prohibition against Unauthorized Trading*. The investment advice provider must obey the investor's instructions and cannot make decisions pertaining to the account unless the investor has authorized the investment advice provider to do so.[141] Courts and regulators have long recognized unauthorized trading as an egregious example of unprofessional

137. Heath v. SEC, 586 F.3d 122, 130 (2d Cir. 2009) (affirming SEC order that affirmed NYSE's finding that associated person engaged in unethical conduct when he disclosed confidential client information and violated the "just and equitable principles of trade" rule; no finding of bad faith required).

138. *See, e.g.*, Knowles v. Montana *ex rel.* Lindeen, 222 P.3d 595 (Mont. 2009) (affirming securities commissioner's findings that failure to conduct suitability analysis before customers signed sales documents was an "unethical practice").

139. *See supra* note 73 and accompanying text.

140. The proposal set forth herein is a refinement of my earlier proposal contained in *Black*, *supra* note 11.

141. Agents must obey their principal's lawful instructions. RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006); RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

conduct.[142]

(2) *Duty of Best Execution*. When executing transactions on behalf of an investor, the investment advice provider must use reasonable diligence to obtain the best available price.[143] The duty of best execution is a well-established standard of professional responsibility that the SEC and other regulators enforce in disciplinary proceedings.[144]

(3) *Duty to Convey Accurate Information*. When communicating information about an investment product or strategy to an investor, the investment advice provider must exercise reasonable care to ensure that he conveys the necessary information to make an informed decision (including costs and conflicts of interest), that the information is correct and that he conveys it accurately.[145] Since the foundation of the federal securities

142. *See* Merrill Lynch Pierce Fenner & Smith v. Cheng, 901 F.2d 1124, 1128 (D.C. Cir. 1990) (explaining broker's duty to act only as authorized); Pross v. Baird, Patrick & Co., 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) (describing unauthorized trading as "reprehensible"); In re Rooney A. Sahai, Exch. Act Rel. 51549, 2005 WL 883705, at *6 (Apr. 15, 2005) (stating that unauthorized trading violates NASD Conduct Rule 2110 that requires observance of "high standards of commercial honor and just and equitable principles of trade"); NASAA UNETHICAL BUS. PRACTICES OF INV. ADVISERS, INV. ADVISER REPRESENTATIVES, AND FED. COVERED ADVISERS MODEL R. 102(a)(4)-1(d) (2005), *available at* http://www.nasaa.org/content/Files/IAUnethical091105.pdf (stating that "[p]lacing an order to purchase or sell a security for the account of a client without authority to do so" is an unethical business practice).

143. *See* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998) (setting forth the history of the duty of best execution); *see also* NASD R. 2320 (NASD 2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3643 ("In any transaction for or with a customer[,] . . . a member . . . shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible . . . .").

144. Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971) (affirming SEC's order barring broker-dealer's order clerk because he breached duty of best execution); *In re* Michael L. Smirlock, Investment Advisers Act Release No. 1393, 55 SEC Docket 1529 (Nov. 29, 1993) (finding that the Chief Investment Officer of investment adviser failed to take adequate steps to obtain best execution for clients).

145. An agent has a duty "to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have . . . ." RESTATEMENT (SECOND) OF AGENCY § 381 (1958). This duty is an aspect of FINRA's requirement of "fair dealing with customers." *See* FINRA R. 2010 (FINRA 2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."); NASD R. IM-2310-2 (NASD 2010) *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3640 ("Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing."). With respect to an investment adviser's duty to disclose material conflicts of interest, see NASAA UNETHICAL BUS. PRACTICES OF INV. ADVISERS, INV. ADVISER REPRESENTATIVES, AND FED. COVERED ADVISERS MODEL R. 102(a)(4)-1(k).

regulatory system is based on complete and accurate disclosure, it is incumbent upon the professional to live up to this standard so that the investor has the requisite information to make an informed decision about the investment or strategy.[146]

The litigation resulting from the collapse of the auction rate securities (ARS) markets is a good illustration of the harm that can be caused by the careless dissemination of inaccurate information. In 2008-2009, the SEC and other regulators entered into settlements with a number of securities firms involving charges that the firms' salespersons misrepresented that ARS were safe, liquid investments that were the equivalent of cash or money market funds.[147] As a result of these misrepresentations, many retail investors invested funds they needed to have available on a short-term basis and lost the ability to access those funds when the credit markets froze.[148] If these actions had been litigated, it is not clear that the SEC could have established fraud. While the SEC alleged knowledge on the part of the firms that the ARS market was deteriorating, which, if established, would support a fraud claim,[149] it also alleged that the firm did not adequately train its salespersons to ensure that they understood the products they were selling, which, if established, is a negligence claim. Even if the agency could not establish that the misrepresentations constituted securities fraud, it is likely that the agency could have established that the firms and their salespersons made negligent misrepresentations about the nature and risks of ARS that misled customers and caused them serious injury. This constitutes unprofessional conduct; securities professionals owe a duty to understand the products they are selling and to explain them accurately to investors. Moreover, the settlements reflect the regulators' conviction that the firms should pay investors for the harm caused by their negligence.

146. *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (holding that a broker-dealer must disclose to a customer that it is a market maker with respect to a given security); SEC v. Hasho, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992) (finding that a broker-dealer made misstatements and unjustified predictions); *In re* Flanagan, Securities Act Release No. 8437, Exchange Act Release No. 49979, 2004 SEC LEXIS 1447 (July 7, 2004) (broker-dealer must disclose differences between mutual fund classes); *In re* Alfred C. Rizzo, 1984 SEC LEXIS 2429 (Jan. 11, 1984) (stating that investment adviser must base recommendations on accurate research).

147. The SEC posted the settlements and other documents on its website. *Auction Rate Securities*, SEC, http://www.sec.gov/investor/ars.htm (last modified July 21, 2009).

148. *See* Linda Chatman Thomsen, Director, Div. of Enforcement, SEC, Testimony Concerning the SEC's Recent Actions with Respect to Auction Rate Securities (Sept. 18, 2008), *available at* http://www.sec.gov/news/testimony/2008/ts091808lct.htm (noting that investors "could not access their funds for important short term needs" after brokers had led them to believe their investments were "safe and liquid").

149. In their complaints, the SEC alleged broker-dealer fraud under section 15(c) of the Exchange Act. *See, e.g.*, *Auction Rate Securities*, *supra* note 147 (listing complaints against Bank of America, RBC Capital Markets Corp., and Deutsche Bank). Because these actions were settled, the firms did not admit or deny the findings.

(4) *Suitability Obligation*. When making recommendations about products and strategies (or effecting purchases if it is a discretionary account), the investment advice provider must have sufficient information about (1) the investor's financial situation, including current holdings and investment objectives, and (2) the investment product or strategy he recommends, so that his recommendations are suitable for the customer.[150] FINRA has been the regulator that has principally explicated the suitability obligation through its interpretations of NASD Conduct Rule 2310 in disciplinary proceedings against broker-dealers,[151] but the SEC has made clear that the suitability obligation applies as well to investment advisers through its interpretation of section 206(4) of the Advisers Act.[152] The suitability obligation requires the investment advice provider to undertake due diligence both as to the investor and the security. Thus, the first prong, referred to as "customer-specific" suitability, requires that the recommendation be consistent with the investor's financial situation and investment objectives and also requires due diligence on the part of the investment adviser provider to ascertain the investor's needs. The second prong, referred to as "reasonable basis" suitability, requires that the investment advice provider understand the characteristics of the investment, including its risks and rewards.[153] While the SEC views the suitability obligation as an aspect of the investment adviser's fiduciary duty, the suitability obligation is better grounded in the concept of professionalism: a professional does not make a recommendation about a matter that is important to the investor's welfare unless he has done his due diligence.

Much of the contentious debate over the fiduciary duty standard has focused on the suitability standard. Investment adviser groups argue that the investment adviser's obligation to act in the best interests of the client is a higher standard than the suitability standard.[154] They draw a distinction

150. NASD R. 2310 (NASD 1996), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315; *In re* Arleen W. Hughes, Exchange Act Release No. 4048, 27 S.E.C. Docket 629 (Feb. 18, 1948).

151. *See, e.g.*, *In re* Willard, Disciplinary Proceeding No. 2006006046401, 2009 FINRA Discip. LEXIS 47, at *28 (Dec. 18, 2009) (suspending and fining registered representative for unsuitable recommendations); *In re* Evans, Disciplinary Proceeding No. 2006005977901, 2009 FINRA Discip. LEXIS 40, at *2 (Oct. 16, 2009) (barring registered representative from association with any FINRA firm after recommending and effecting unsuitable transactions); *In re* Siegel, Complaint No. C05020055, 2007 NASD Discip. LEXIS 20, at *36-37 (Nat'l Adjudicatory Council May 11, 2007) (fining and suspending registered representative for making unsuitable recommendations).

152. *See* Suitability of Investment Advice, *supra* note 41 (stating that the proposed suitability obligation for investment advisers was a codification of existing principles).

153. *In re* Siegel, 2007 NASD Discip. LEXIS 20, at *36-37.

154. *See Wall Street and Fiduciary Duties, Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing Before the Subcomm. On Crime & Drugs of the*

between the investment adviser's fiduciary obligation—that its recommendation is in the investor's best interests—and the broker-dealer's suitability obligation, which requires that its recommendation is suitable for the investor.[155] There is little support, either in the law or regulatory guidance, for this distinction. Beginning with *Capital Gains*,[156] courts have viewed the "best interests of the client" standard as an aspect of the investment adviser's duty of loyalty to address conflicts of interests,[157] rather than as an aspect of the adviser's duty of care addressing the quality of investment advice. Over time, the SEC came to express the investment adviser's fiduciary obligation more generally as a duty of loyalty that requires advisers to manage their clients' portfolios in the best interest of clients; specific aspects of that duty include disclosing conflicts and having a reasonable basis for client recommendations.[158] While the agency's references to the "best interests of the client" standard have blurred distinctions between the duties of loyalty and care,[159] the SEC's position that the suitability obligation applies to investment advisers reinforces the position that the "best interests" standard does not establish a higher standard related to the quality of advice, since it would not make sense to have a redundant lower standard of care if the best interests standard is applicable to the advice giving function.[160] Consistent with this, FINRA has frequently equated the suitability standard with acting in the best

*S. Comm. on the Judiciary*, 111th Cong. 7 (2010) (Testimony of Barbara Roper, Director of Investor Protection, Consumer Federation of America) (urging the expansion of fiduciary duty to brokers and their dealings with their clients); *see also* Release, Financial Planning Coalition, *75,000-Member Fin. Planning Coal. to Senate: Reduce Elder Fin. Abuse and Protect All Consumers by Approving Fiduciary Standard Amendment* (May 12, 2010), *available at* http://www.financialplanningcoalition.com/docs/assets/9223C96D-1D09-67A1-AC4D1C6E1984939D/RLSmediacallonAkaka-Menendez-Durbinamendmentv3final.pdf (supporting an amendment requiring broker-dealers to act in the best interests of their clients). The SEC's Investor as Purchaser Subcommittee stated that it was "relatively uncontroversial" that "the federal fiduciary duty standard is a higher standard than the suitability standard that applies to brokers." Memorandum from the SEC Investor as Purchaser Subcomm. to the SEC Investor Advisory Comm. 10-11 (Feb. 15, 2010), *available at* http://www.sec.gov/spotlight/invadvcomm/iacmemofiduciaryduty.pdf.

155. *See* Memorandum from the SEC Investor as Purchaser Subcomm., *supra* note 154, at 11.

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

157. *See, e.g.,* SEC v. Blavin, 760 F.2d 706, 712 (6th Cir. 1985) (holding that fiduciary duty requires disclosure of conflicts of interest); SEC v. Moran, 922 F. Supp. 867, 901 (S.D.N.Y. 1996) (finding that IAA § 206 applied to adviser's allocation of shares to personal and family account to the detriment of clients).

158. *See* Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006) (quoting SEC's Hedge Fund Rule, Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004)).

159. *See, e.g.,* Agency Cross Transactions for Advisory Clients, 17 C.F.R. § 275.206(3)-2(c) (2010) (stating that nothing in the rule relieves investment advisers from acting in the best interests of the client, including the duty of best price and best execution).

160. *See supra* note 41 and accompanying text.

interests of the investor.[161] Finally, this supposed distinction between the "best interests" and "suitability" standards is based on a faulty premise—that there is only one "best" investment instead of a number of suitable investments that would fulfill the investment advice provider's professional responsibility. Given the multiplicity of investment opportunities, it is far-fetched that one would be "best."

Investment advisory groups are correct to criticize the common practice of some broker-dealers in recommending proprietary mutual funds that carry high costs without disclosing the availability of comparable mutual funds at significantly lower costs. The investment adviser groups suggest that this would satisfy a suitability obligation standard, but not a "best interests" standard.[162] To date, the importance of considering costs in determining suitability has principally arisen in three situations: recommending 529 plans with complex fee structures,[163] recommending Class B mutual fund shares in situations where Class A shares were less expensive,[164] and recommending switching of mutual funds.[165] In these

161. *See In re* John Richard Willard III, Disciplinary Proceeding No. 2006006046401, 2009 FINRA Discip. LEXIS 47, at *28-29 (Dec. 18, 2009) (noting that the suitability obligation flows from the requirement that a broker acts in the best interests of the client).

162. *See, e.g.,* David Serchuk, *Suitability: Where Brokers Fail*, FORBES, June 24, 2009, http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html (commenting that brokers will push what is suitable, but not necessarily what is best for customers); *Where Do We Go From Here*, INVESTMENT NEWS, February 14, 2010, http://www.investmentnews.com/article/20100214/REG/100219956 (discussing industry understanding and application of the standards).

163. 1st Global Capital Corp., Exchange Act Release No. 54754, 2006 SEC Lexis 2632, at 5 (Nov. 15, 2006) (settled disposition) (finding that because broker-dealer did not adequately understand and evaluate the comparative costs of the various classes of 529 Plan units it sold, it lacked reasonable grounds to believe that its recommendations were suitable, based upon 529 Plan fee structures and customer needs and objectives).

164. *See* Raghavan Sathianathan, Exchange Act Release No. 54722, 2006 WL 3228694 (Nov. 8, 2006), *aff'd* 304 F. App'x 883 (D.C. Cir. 2008) (holding that registered representative's recommendations to purchase Class B shares in seventeen mutual funds were unsuitable because they were designed to maximize his own commissions rather than to establish suitable portfolios); *see also* FINRA R. 2342 (FINRA 2009), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8414 (prohibiting "breakpoint" sales for the purpose of earning the FINRA member a higher sales charge); FINRA, NOTICE TO MEMBERS 95-80 (NASD Sept. 26, 1995), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1876 (explaining FINRA member obligations with respect to mutual fund sales practices because of proliferation of new funds and varied fee structures); FINRA, NOTICE TO MEMBERS 94-16 (NASD Mar. 1994), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1518 (reminding FINRA members of mutual fund sales obligations, including disclosure of fees and breakpoints).

165. *See* Krull v. SEC, 248 F.3d 907, 912-13 (9th Cir. 2001) (holding that registered representative's recommendations to switch mutual funds were unsuitable because of the high costs associated with short-term trading in mutual funds); *see also* NOTICE TO

situations, regulators have established the principle that broker-dealers do not meet their suitability obligations when recommendations are made to maximize their own profits. While extending this principle to broker-dealers' recommendations of proprietary funds instead of lower-cost alternatives is supportable as a matter of logic, it conflicts with recognition of the fact that, in a world with a multitude of investments, broker-dealers may select which investments they choose to offer their customers. Indeed, the broker-dealer's duty to know the investment necessarily places a limit on the number of investments it can recommend. A broker-dealer can reasonably argue that its obligations when recommending a product cannot extend to comparing that investment with every other comparable product. Thus far, the regulators have principally dealt with costs and conflicts of interest as a disclosure issue. In 2004, the SEC proposed a rule requiring more specific customer-tailored disclosure at the time of sale.[166] The broker-dealer industry has resisted the rule, and to date it has not been adopted.

Thus, the investment adviser community makes a good point that the suitability obligation, as currently interpreted, provides inadequate protection to retail investors, the principal purchasers of load funds. Comparison of costs is an important aspect of suitability. If two investments are identical in every way but one is more expensive, it is difficult to find the higher cost investment suitable. Although, to date, the SEC has done a poor job in improving mutual fund disclosure to retail investors,[167] ultimately, that may be the best solution. Dodd-Frank directs the SEC to improve disclosures regarding the terms of the relationship and to prohibit abusive sales practices, conflicts of interest, and compensation schemes.[168] If the broker-dealer believes that the higher-cost proprietary investment has benefits for the customer that warrant the additional costs, it should be able to justify them. Accordingly, the SEC's suitability rule should make explicit that with respect to comparable investment products that are available at different prices, the suitability obligation also requires a comparison of costs.[169]

MEMBERS 95-80, *supra* note 164.

166. Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, 69 Fed. Reg. 6438 (proposed Feb. 10, 2004). The SEC later re-proposed the rule in Point of Sale Disclosure Requirements and Confirmation requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, 70 Fed. Reg. 10,521 (proposed Mar. 4, 2005).

167. I have previously criticized the SEC's performance in Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303 (2008).

168. Dodd-Frank Act, Pub. L. No. 111-203, § 913(l), 124 Stat. 1376, 2005-06 (2010).

169. Cost comparisons are important, but not decisive, in suitability analysis. *See In re* Doherty, 2005 NASD Discip. Lexis 17 (Mar. 15, 2005) (rejecting enforcement's argument

I also propose two additional standards applicable whenever the investment advice provider holds itself out as looking out for the interests of its investors or providing ongoing advice and the retail investor relies on the investment advice provider to do so. These duties are:

(5) *Duty to Warn.* Investment advice providers owe a duty to warn the retail investor when they become aware that securities or strategies the investor decides to pursue on her own entail greater risks than she should assume based on her financial situation. It is the responsibility of a professional to explain the risks of an important decision to his customer or client if, based on his expertise, he has reason to believe that the individual does not fully appreciate them. This duty is most applicable when unsophisticated retail investors express an interest in investing in low-cost and speculative securities or engaging in high-risk trading strategies.

*Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,*[170] one of the most frequently cited opinions on broker-dealers' duties to their customers, explicitly states that their professional responsibilities include a duty to warn. Moreover, the duty is well-recognized within the securities industry; brokerage firms' compliance manuals frequently state that warning customers of risks they may not adequately understand is part of brokers' responsibilities to their customers.[171] Margin trading is regarded as such a risky trading strategy that the broker-dealer must furnish the customer a specific statement of the risks involved.[172] Indeed, with respect to certain high-risk trading strategies, such as penny stocks,[173] day trading,[174] and options trading,[175] the SEC and the FINRA go further than a duty to warn and require the broker-dealer to make a determination of suitability before effecting the transaction or opening the account, irrespective of whether the broker-dealer has made a recommendation.

(6) *Duty to Monitor.* All investment advice providers that represent that they are providing advice on an ongoing basis should have a duty to

---

that registered representative's recommendations were unsuitable because the investor's costs would have been lower if he had invested in Class A shares of a single fund family rather than the Class B shares in several fund families that the registered representative recommended, because it focused solely on cost savings).

170. 461 F. Supp. 951, 953-54 (E.D. Mich. 1978).

171. *See* Barbara Black and Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law,* 64 U. PITT. L. REV. 483, 501-02 (2003) (describing a study guide and compliance manuals that set forth broker's duty to warn).

172. FINRA R. 2264 (FINRA 2009), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11901.

173. Sales Practice Requirements for Certain Low-priced Securities, 17 C.F.R. § 240.15g-9 (2010).

174. FINRA R. 2130 (FINRA 2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8831.

175. FINRA R. 2360(b)(16) (2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306.

monitor the investor's account, reassess periodically the investor's investment objectives and strategy, and, when appropriate, recommend modifications to the investor's portfolio. Adjustments to the investment strategy may be warranted because of changes in investor's personal circumstances (e.g., retirement), changes in specific investments (e.g., downgrading of credit rating) and changes in market conditions (e.g., extreme volatility). Although current law has not been precise in distinguishing between these three components of monitoring, the law is clear in treating the monitoring obligations of investment advisers and broker-dealers very differently. *Capital Gains* described the investment adviser's function as providing "continuous" advice,[176] which is a vague description but must encompass some duty to update. The SEC previously proposed a suitability rule for investment advisers that would have at least required investment advisers to update customer information so that they could adjust their advice.[177] In addition, the Restatement (Second) of Agency includes, for those whose duties include management of the portfolio, a duty to change investments if warranted by changes in the security or changes in the client's condition.[178] In contrast, courts consistently state that the broker-dealer's duty is transaction-specific and do not recognize that broker-dealers have any duty to provide ongoing advice to their customers or to monitor their customers' accounts and update previous advice, except in limited situations where the broker-dealer exercises "control" over the account.[179] The SEC, however, has recognized that broker-dealers have a duty to update recommendations in at least one situation: where a broker-dealer recommended an unseasoned company on the basis of management projections, it had a duty to communicate subsequent adverse information to its customers.[180] Moreover, a principal reason for the SEC's adoption of a rule that would have allowed broker-dealers to offer fee-based accounts without registering as investment advisers was that it could improve the advice-giving function of broker-

176. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187 (1963); *see also* Erlich v. First Nat'l Bank of Princeton, 505 A.2d 220, 234-35 (N.J. Super. Ct. Law Div. 1984) (holding that the standard of care for a professional investment adviser is higher than the broker-dealer's suitability obligation).

177. Suitability of Investment Advice, *supra* note 41, at 13,464.

178. RESTATEMENT (SECOND) OF AGENCY § 425(c) (1958).

179. *See, e.g.,* De Kwiatowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002) (stating that it is "uncontested" that a broker ordinarily has no duty to monitor the account or provide advice on an ongoing basis); RESTATEMENT (THIRD) OF AGENCY § 8.08, cmt. d (2006) (stating that a securities broker's duty of diligence is limited to executing a client's orders and does not extend to advising the client or issuing risk warnings on an ongoing basis); *see also* Black & Gross, *supra* note 171, at 487-488 (explaining the differences in the broker's obligations based on the type of account).

180. *In re* Merrill Lynch, Pierce, Fenner & Smith, Exchange Act Release No. 14149, [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,723 (Nov. 9, 1977).

dealers by severing the link between compensation and individual brokerage transactions.[181] Finally, the brokerage industry identifies monitoring the customers and making ongoing recommendations as the mark of a professional. The qualification examination for general securities registered representatives identifies monitoring the customer's account and making ongoing recommendations as one of the broker's "critical functions and tasks,"[182] and many securities firms at least periodically inquire if there has been a change in their customers' personal circumstances and update their customers' profiles.[183]

Finally, both investment advisers and broker-dealers compete head-on for business and advertise on the basis of the quality of their investment advice. Both hold themselves out as providing ongoing investment advice tailored to meet the changing needs of the individual investor. This is reflected in their titles: many broker-dealers call themselves financial advisers or consultants, and many investment advisers consider themselves financial planners. Because many retail investors do not perceive a difference between the services provided by broker-dealers and investment advisers,[184] they rely on their investment advice providers' representations that they are looking out for them. An SEC rule that imposed a monitoring duty on both broker-dealers and investment advisers would be a significant improvement in investor protection and consistent with the modern reality.

Unfortunately, however, Congress restricted the SEC's authority to adopt standards of care in one significant respect. Section 913(g)(1) of Dodd-Frank states that "nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."[185] Accordingly, the SEC cannot impose on broker-dealers a duty to monitor and cannot eliminate the most significant distinction between the broker-dealer and the investment adviser under the current law and a source of great confusion for retail investors. This is a serious shortcoming that can only be cured by congressional amendment.

---

181. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, 17 C.F.R. § 275.202(a)(11)-1 (2005) (exempting certain broker-dealers providing advice that is solely incidental to brokerage services from the Advisers Act. The D.C. Circuit later struck down the rule as contrary to the language of the Advisers Act. Fin. Planning Ass'n. v. SEC, 482 F.3d 481, 492 (D.C. Cir. 2007).

182. N.Y. STOCK EXCH., CONTENT OUTLINE FOR THE GENERAL SECURITIES REGISTERED REPRESENTATIVE EXAMINATION (TEST SERIES 7) 3 (1995), *available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p038201.pdf.

183. *See, e.g.*, 17 C.F.R. § 240.17a-3(a)(17)(i)(B)(3) (2010) (containing a limited requirement to update investment objectives but only with respect to accounts for which the broker-dealer is required to make a suitability determination).

184. THE RAND STUDY, *supra* note 3, at 117-18.

185. Dodd-Frank Act, Pub. L. No. 111-203, § 913(g)(1), 124 Stat. 1376, 1828 (2010).

Unless that happens, the SEC should adopt a duty to monitor for investment advisers and a rule prohibiting broker-dealers from advertising or otherwise holding themselves out as providing ongoing advice.

Because many investors make their own investment decisions and select their investment advice providers for reasons unrelated to the quality of the investment advice, the investor and investment advice provider should have the freedom to agree that the duty to warn and the duty to monitor (with respect to investment advisers) do not apply to their relationship. Accordingly, their contract can explicitly state that the investment advice provider does not undertake these responsibilities. Unfortunately, written disclaimers do not provide adequate disclosure to investors if the broker-dealer or investment adviser, as the case may be, makes oral representations to the contrary on which the investor relies. Courts have consistently found investors' reliance on oral representations unreasonable when they were inconsistent with the written disclaimer.[186] Because the investor needs to understand that he cannot expect such services, the disclaimer should be written in plain English with bold-face type and require a separate acknowledgement, such as initialing, from the investor. The investment advice provider should be required to document that the provision was specifically called to the attention of the investor. Finally, the investor should not be barred from presenting evidence that the investment advice provider made other written or oral representations on which the investor relied that contradict the written disclaimer.[187]

Adoption by SEC rulemaking of professional standards of care and competence for all investment providers should advance investor protection by providing clear and workable standards for all investment advice providers. First and foremost, the performance of investment advice providers should improve, because of their greater awareness of the importance of their professional responsibilities. In addition, although the SEC, because of resource constraints, usually limits its enforcement actions against securities professionals to instances of egregious fraud, it should place a high priority on disciplinary and enforcement actions for violations of these rules in order to impress upon broker-dealers and investment

186. *See, e.g.*, Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031-32 (2d Cir. 1993) (upholding grant of summary judgment to investment fund because the unsophisticated investors' reliance on oral communications was not reasonable when the prospectus contained adequate disclosures about the risk); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518-19 (10th Cir. 1983) (stating that "[I]t is evident that [the investor] acted recklessly by intentionally closing his eyes to and failing to investigate the contradiction between the misrepresentations and the information in the memorandum.").

187. *See* Geman v. SEC, 334 F.3d 1183, 1189 (10th Cir. 2003) (stating that a firm offering wrap-fee program and holding itself out as a fiduciary in its promotional brochure should be held to a fiduciary standard).

advisers the importance of these professional standards.[188] In addition, as I discuss in Part V, investors should have greater success in establishing negligence claims against investment advice providers based on failure to live up to the standards established by the SEC rules adopted for their protection. Accordingly, as the SEC proceeds with its study mandated under section 913 of Dodd-Frank and considers subsequent rulemaking, I urge that it carefully consider adoption of these professional standards of care and competence.

I next explore the issue of investors' remedies in Part V.

## V. INVESTORS' REMEDIES AND MANDATORY SECURITIES ARBITRATION

Section 921 of Dodd-Frank gives the SEC the authority to prohibit or restrict the use of agreements that require investors to arbitrate future disputes "arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization."[189] In this Part, I first explain the limited availability of investors' remedies for careless and incompetent investment advice under current law. I then explore whether federal or state courts would recognize additional remedies if the SEC adopted the standards of care and competence proposed in Part IV. Unless adoption of SEC standards creates additional private remedies for investors, securities arbitration provides investors with a significant advantage: arbitration panels allow investors to recover damages for harm caused by negligent investment advice even in the absence of a legal cause of action. If the SEC exercised its authority to prohibit the use of PDAAs with respect to federal and SRO rule-based claims, the paradoxical result may be to reduce the remedies available to retail investors, the very group that Congress was concerned about protecting.

### *A. The Unavailability of Investors' Remedies*

Although courts hold broker-dealers and investment advisers to the standards of care and competence established under federal securities laws and SRO rules and acknowledge their importance for investor protection in disciplinary or enforcement actions,[190] they resist investors' efforts to

188. This is consistent with the legislative intent expressed in Dodd-Frank section 913(h)(1) that the SEC "[should] seek to prosecute and sanction violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under this Act to the same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to an investment advisor under the Investment Advisers Act of 1940." In fact, the SEC has not previously placed a high priority on conduct implicating the duty of care owed by investment advisers.

189. Dodd-Frank Act, Pub. L. No. 111-203 § 921(a), 124 Stat. 1376, 1841 (2010).

190. *See, e.g.*, *Geman*, 334 F.3d at 1191 (affirming SEC's finding that the breach of the

recover damages for losses caused by failure to adhere to those standards, unless the investor can establish fraud. Similarly, many courts are reluctant to impose liability for damages based on industry standards, even though general agency and tort principles support the use of an industry professional standard to establish a standard of care for a negligence claim.[191] Even in instances where securities professionals hold themselves out as possessing special skills and knowledge, courts are reluctant to hold them to that standard, despite the fact that the Restatement (Third) of Agency states it is appropriate to do so.[192] Thus:

(1) *Prohibition against Unauthorized Trading.* Federal courts do not recognize unauthorized trading as a Rule 10b-5 violation for which investors can recover damages,[193] although state courts generally allow investors to bring unauthorized trading claims as a breach of the agency relationship.[194]

(2) *Duty of Best Execution.* Investors cannot recover damages for a

duty of best execution by order clerk was in furtherance of fraud on the broker-dealer's customers); Sinclair v. SEC, 444 F.2d 399, 400-02 (2d Cir. 1971) (affirming SEC's conclusion that investment adviser's failure to disclose fully how it handled principal trades harmed customers).

191. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) (stating that an agent's duty to his principal is to act with the same "care, competence, and diligence" as a similarly situated agent); *Id.* § 8.11 (stating that an agent has a duty to notify his principal of facts that he knows or should know his principal would want to know); RESTATEMENT (SECOND) OF TORTS § 299A (1965) (stating that one who works in a profession is "required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities," unless he makes known that he is of a different skill or knowledge).

192. RESTATEMENT (THIRD) OF AGENCY § 8.08 cmt. c (stating that "[t]he agent's professed level of skill or knowledge becomes the standard against which the agent's performance should be assessed"); *see also* Hooker, *supra* note 124, at 3 (stating that the specific duties that bind a professional are defined by the expectations that the profession has created in the public mind). For a rare instance where the court has held the professional to his promotional pitch, see *Geman*, 334 F.3d at 1189 (holding firm to a fiduciary standard after it identified itself as an independent fiduciary in its promotional brochure).

193. *See* Messer v. E.F. Hutton & Co., 833 F.2d 909, 917 (11th Cir. 1987) (holding that investor could not succeed on his claim because broker did not act with the requisite scienter for a Rule 10b-5 violation).

194. *See* RESTATEMENT (SECOND) OF AGENCY § 383 (1958) (stating that agent has a duty not to act in principal's affairs, except with personal privilege or with the principal's consent); *see also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128-29 (D.C. Cir. 1990) (analyzing an unauthorized trading claim under an agency law framework); Wildermuth v. Becker, No. 87-5368, 1989 WL 46840, at *5 (E.D. Pa. April 28, 1989) (holding that unauthorized trading constituted breach of defendants' duties as an agent); Sec. Investor Prot. Corp. v. R.D. Kushnir & Co., 267 B.R. 819, 824 (Bankr. N.D. Ill. 2001) (holding that unauthorized trading constituted a breach of defendant's duties as an agent).

violation under federal law unless they can establish Rule 10b-5 fraud,[195] although some state courts may allow a claim based on negligence.[196]

(3) *Duty to Convey Accurate Information.* As a result of *Gustafson v. Alloyd Co., Inc.*,[197] *Ernst & Ernst v. Hochfelder*,[198] and *Transamerica Mortgage Advisors, Inc. v. Lewis,*[199] investors do not have a federal damages remedy for losses caused by careless and incompetent investment advice, with one exception: when the investment advice provider sold the investor shares in a mutual fund.[200] Even in that instance, the investor's remedy is generally illusory. Consider, for example, two scenarios in which an investor, who told her registered representative of her plans to use her funds to buy a house within a year, purchased ARS after her broker tells her that ARS are liquid investments. In the first, assume that the investor can prove that the mutual fund prospectus contained a misstatement about the investment's liquidity of which she was unaware. The investor can establish a prima facie section 12(a)(2) claim, but the broker-dealer is not liable if it can establish one of the affirmative defenses: (1) It did not know, and in the exercise of reasonable care could not have known, of the misstatement. So long as the broker-dealer did not participate in the preparation of the mutual fund prospectus, it can likely establish this "reasonable care" defense.[201] (2) It can prove that the investor's losses were caused by something other than depreciation in value resulting from the misstatement.[202] This "loss causation" defense may effectively preclude any damages recovery,[203] particularly since courts have not recognized consequential damages based on illiquidity.[204] In the second scenario, assume that the investor can prove that the registered

195. *See* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70 (3d Cir. 1998) (holding that for plaintiffs to recover damages under a Rule 10b-5 claim based on failure of best execution, they must establish scienter).

196. *See* Zannini v. Ameritrade Holding Corp., 667 N.W.2d 222, 234 (Neb. 2003) (holding that investors' negligence claim based on discount securities broker's misrepresentations concerning its ability to place and execute trade orders during period of expansion was not preempted). *But see* Gurfein v. Ameritrade, Inc., 312 F. App'x 410, 412 (2d Cir. 2009) (holding that brokerage agreement with customer did not create a breach of contract claim for violations of SRO regulations, including duty of best execution).

197. 513 U.S. 561 (1995).

198. 425 U.S. 185 (1976).

199. 444 U.S. 11 (1979).

200. *See supra* note 55 and accompanying text.

201. *See* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006) (containing no requirement for due diligence investigations).

202. 15 U.S.C. § 77l(b).

203. *See* Bullard, *supra* note 121, at 575 (advocating that courts adopt a more flexible loss causation standard, replacing the current strict or strong standard).

204. *See* Aimis Art Corp. v. Northern Trust Sec., Inc., 641 F. Supp. 2d 314, 320-21 (S.D.N.Y. 2009) (holding that investor could not recover damages for inability to purchase art because of illiquid investment).

representative made the oral misstatement about liquidity but cannot prove that the mutual fund prospectus contains a misstatement about liquidity. In this instance, the investor likely cannot establish a section 12(a)(2) claim for two reasons. (1) Courts do not hold the broker's oral misstatement actionable because they construe the statutory reference to "oral communication" narrowly to include only statements "related to a prospectus."[205] (2) Because the prospectus contained accurate information, courts may hold that the investor "knew" that the oral communication was untrue.[206]

Moreover, ARS purchasers have been consistently unsuccessful in securities fraud class actions. While these actions have failed for a variety of reasons, one consistent theme is that the courts have not been persuaded that any misrepresentations were the product of fraud, as opposed to negligence.[207]

As to state law claims: while leading torts commentators state that common law liability for negligent misrepresentations exists in commercial relationships where the injury is pecuniary,[208] many state courts have been reluctant to impose liability.[209]

(4) *Suitability Obligation.* Investors have no claim for unsuitable

205. *See* Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 688-89 (3d Cir. 1991) (holding that, because the terms "prospectus or oral communication" appear together, the latter must conform to the more restrictive former term); *In re* Morgan Stanley Tech. Fund Sec. Litig., 643 F. Supp .2d 366, 381 (S.D.N.Y. 2009) (upholding the Ballay observation that only oral communications related to a prospectus are subject to Section 12 liability).

206. While section 12(a)(2) does not require plaintiff to prove due diligence, plaintiff bears the burden of showing excusable ignorance. *See* Woodward v. Wright, 266 F.2d 108, 116 (10th Cir. 1959) (noting the buyer's burden of proving he could not have known the falsity of statements through the exercise of reasonable care). *But see* MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/American Express Inc., 886 F.2d 1249 (10th Cir. 1989) (interpreting section 12(a)(2) to bar recovery only when the investor has actual knowledge of the misstatement).

207. *See, e.g.*, Zisholtz v. Suntrust Banks, Inc., No. 1:08-CV-1287-TWT, 2009 WL 3132907, at *12 (N.D. Ga. Sept. 24, 2009); Openwave Systems Inc. v. Fuld, No. C 08-5683 SI, 2009 WL 1622164, at *12 (N.D. Cal. June 6, 2009) (dismissing fraud claims, but allowing state law claim based on breach of duty of care).

208. RESTATEMENT (SECOND) OF TORTS, §552(1) (1977). *See* Baker v. Goldman Sachs & Co., 656 F. Supp.2d 226, 237 (D. Mass. 2009) (stating that Massachusetts has adopted the liability standard for negligence set forth in section 552); Maliner v. Wachovia Bank, N.A., No. 04-60237-CIV-ALTONAGA/Bandstra, 2005 U.S. Dist. LEXIS 5985, at *26 (S.D. Fla. Mar. 1, 2005) (allowing plaintiff's negligent misrepresentation claim against a portfolio manager).

209. Under New York law, for example, courts do not allow non-fraud based claims because they interpret the Martin Act as precluding a private right of action for common law claims the subject matter of which is covered by the Act. *See* Stephenson v. Citco Group Ltd., 700 F.Supp.2d 599 (S.D.N.Y. 2010) (holding that the Martin Act preempted negligence and breach of fiduciary duty claims).

recommendations under federal securities laws in the absence of fraud,[210] because federal courts do not imply a private cause of action for breach of an SRO rule.[211] Although some state courts have allowed unsuitability claims based on negligent misrepresentation,[212] breach of a duty of care[213] or breach of fiduciary duty,[214] others have not.[215]

(5) *Duty to Warn.* Federal courts do not recognize a duty to warn in the absence of fraud.[216] Because the broker-dealer's duty to warn is well-established,[217] it is hard to explain why state courts are reluctant to enforce it in investors' actions for damages.[218] Courts do not provide extensive analysis; they frequently state that the internal rules are for the protection

210. *See, e.g.*, Cohen v. Prudential-Bache Secs., Inc., 713 F. Supp. 653, 660 (S.D.N.Y. 1989) (holding that customer must allege scienter to state a Rule 10b-5 claim based on unsuitable recommendations).

211. *See, e.g.*, Appert v. Morgan Stanley Dean Witter, Inc., No. 08-CV-7130, 2009 U.S. Dist. LEXIS 104594, at *4 (N.D. Ill. Nov. 6, 2009) (holding that there is no private cause of action for violation of NASD rules); SSH Co. v. Shearson Lehman Bros., Inc., 678 F. Supp. 1055, 1058 (S.D.N.Y. 1987) (holding that there is no private cause of action for violation of NASD and NYSE rules).

212. *E.g.*, Byrum v. Brand, 268 Cal. Rptr. 609, 938 (Cal. Ct. App. 1990) (holding that negligent misrepresentation claim can be stated in any type of relationship between a investor and a financial consultant); Marram v. Kobrick Offshore Fund, Ltd., Nos. 01-2815-BLS1, 05-0672-BLS2, 2009 WL 1015557, at *6 (Mass. Super. Ct. Jan. 30, 2009) (holding that investors can bring negligent misrepresentation claims against investment adviser).

213. *E.g.*, Ives v. Ramsden, 174 P.3d 1231 (Wash. Ct. App. 2008) (holding that although no private cause of action existed for breach of state securities suitability rule, broker could be liable under common law for breach of duty of care).

214. *E.g.*, Twomney v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 726 (Cal. Ct. App. 1968) (holding that an injured investor does not have to claim fraud when a fiduciary relationship exists).

215. *E.g.*, Minn. Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 183 (Minn. 1994) (holding that investor's unsuitability claim requires fraudulent conduct); Szego v. Craigie, Inc., 1 Va. Cir. 210 (Va. Cir. Ct. 1980) (holding that under Virginia law, no private cause of action for violation of NASD rules exists).

216. If the failure to warn reaches the level of recklessness, it may be regarded as equivalent to fraud. *See* Quick & Reilly, Inc. v. Walker, Nos. 89-55085, 89-55116, 1991 U.S. App. LEXIS 5472 (9th Cir. Mar. 28, 1991) (recognizing distinction between reckless conduct that is the equivalent of fraud and negligence).

217. The duty to warn is a well-established concept in law and within the securities industry. *See supra* notes 170-175 and accompanying text.

218. For examples of rare exceptions, see Gochnauer v. A.G. Edwards & Co., 810 F.2d 1042, 1046 (11th Cir. 1987) (affirming trial court's holding that broker should have warned customer about changing from a conservative to a speculative investment strategy because he recommended an options expert) and Beckstrom v. Parnell, 730 So.2d 942, 952 (La. Ct. App. 1998) (upholding trial court's decision imposing liability on broker for failure to warn his elderly customer about the high costs of switching mutual funds, when he was aware of the investor's diminished capacities). These opinions are discussed in Black & Gross, *supra* note 171, at 500-01. *See also* Erlich v. First Nat'l Bank, 505 A.2d 220, 243 (N.J. Super. 1984) (granting summary judgment against a bank and investment manager for failure to warn plaintiff about lack of diversity in investments).

of the firm[219] and express a concern that firms with higher standards would be exposed to greater liability.[220]

(6) *Duty to Monitor.* Federal courts do not recognize a duty to monitor, because it is not a fraud claim.[221] State courts recognize that an investment adviser has a duty to monitor,[222] but generally do not impose the duty on a broker-dealer unless the registered representative controls the account.[223]

What are the overarching policy considerations that account for this general disinclination on the part of both federal and state courts to allow investors to recover for the injuries caused by investment advice providers' carelessness and incompetence? Courts have not engaged in extensive discussion of these issues beyond technical applications of the law. It is likely that courts are unwilling to allow investors to recover damages in the absence of fraud because of the suspicion that dissatisfied investors seek to hold their investment advice providers responsible whenever they lose money. A frequent refrain is that the securities laws are not supposed to be an insurance policy against investors' losses.[224] Courts worry about "hindsight bias," that factfinders will find investment advice faulty simply because it turned out to be unsuccessful.[225] They apparently fear that

219. *See, e.g.*, J.E. Hoetzger & Co. v. Ascencio, 572 F. Supp. 814, 822 (E.D. Mich. 1983) (stating that purpose of internal rules on trading limits were to protect the firm from customers' losses).

220. *See, e.g.*, DeKwiatowski v. Bear, Stearns & Co., 306 F.3d 1293, 1311 (2d Cir. 2002) (stating that as a policy matter, it makes no sense to discourage adoption of higher standards by treating them as predicates for liability).

221. Even if the investment advice provider stated that it was monitoring the account, the court would likely dismiss that representation as puffery. *See, e.g.*, Bogart v. Shearson Lehman Bros., Fed. Sec. L. Rep. (CCH) ¶ 98,733 (S.D.N.Y. 1995) (stating that certain statements made by brokers are commonly understood by investors as hyperbole rather than statements of misrepresentations); Newman v. Rothschild, 651 F. Supp. 160, 163 (S.D.N.Y. 1986) (holding that some misrepresentations are not material).

222. *See* Lillard v. Stockton, 267 F. Supp.2d 1081, 1117 (N.D. Okla. 2003) (Magistrate's Report and Recommendation), *aff'd*, 267 F. Supp. 2d 1081 (N.D. Okla. 2003) (holding that plaintiff stated claim against investment adviser for poor investment advice based on their ongoing relationship); *Erlich*, 505 A.2d at 234-235 (holding that bank offering professional investment advisory services should be held to the standard of care for professional investment advisers).

223. *See De Kwiatowski*, 306 F.3d at 1302 (stating that it is "uncontested" that a broker ordinarily has no duty to monitor the account or provide advice on an ongoing basis); McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 767 (3d Cir. 1990) (stating that the clear weight of authority is that broker is in a fiduciary relationship when the customer gives the broker discretion over the account).

224. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005); Minn. Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 182 (Minn. 1994) ("[A] broker is not a guarantor or insurer against losses sustained by her customer.").

225. Mitu Gulati, Jeffrey J. Rachlinski, & Donald C. Langevoort, *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 780 (2004) (examining judges' difficulties in distinguishing between fraud and mistake).

applying professional standards of competence and care will encourage meritless lawsuits and subject investment advice providers to excessive risk of liability. However, it is more plausible that judicial recognition of standards of care and competence in private damages actions will protect securities professionals that have acted carefully and competently from liability because of unprofitable investments. Investors, after all, will have the burden to establish that their broker acted carelessly and incompetently. Just as the business judgment rule protects corporate directors from liability for disastrous business decisions so long as they live up to their duties of care and loyalty, so too adherence to recognized professional standards will protect careful and competent broker-dealers and investment advisers. Moreover, securities and advisory firms will have additional incentives to train and supervise their associated persons and investment adviser representatives.

Courts may also believe that regulatory supervision over the industries provides sufficient investor protection and hesitate to impose additional costs. Thus, for example, New York courts have been aggressive in asserting that the state securities law, the Martin Act, "preempts" investors' claims unless based on fraud.[226] The broker-dealer and investment advisory industries are large and complex, and there has never been an era when government and SRO resources were sufficient to police it adequately. At a time when governments are running at a deficit and state governments, in particular, are forced to operate with fewer resources, it is hard to say with a straight face that the prosecutors and regulators can adequately protect investors.

### *B. Would Adoption of SEC Standards of Care and Competence Create Additional Remedies for Investors?*

Since the Obama administration early on identified "increas[ing] fairness for investors" as a goal,[227] it is perplexing that at no point did the administration or Congress put forth a proposal to cure the most serious deficiency in both the Exchange Act and the Advisers Act—the lack of an explicit negligence remedy for damages in trading transactions.[228] We next consider the possibility that federal or state courts would recognize investors' negligence claims based on the breach of any professional standards adopted by the SEC.

226. CPC Int'l v. McKesson Corp., 70 N.Y.2d 268, 277 (N.Y. 1987); Stephenson v. Citco Group Ltd., 700 F. Supp. 2d 599 (S.D.N.Y. 2010).

227. U.S. DEP'T OF TREASURY, *supra* note 60, at 15.

228. Senator Levin proposed an amendment known as the "Gustafson fix," but his concern dealt with the exclusion of private placements from the coverage of section 12(a)(2). 156 CONGR. REC. S3562, S3566 (May 11, 2010).

*Federal Law.* It is unlikely that the Supreme Court would, under its current approach,[229] imply a cause of action for damages to allow investors to sue for harm caused by the investment advice provider's failure to adhere to any standards of care and competence promulgated by the SEC pursuant to Section 913 of Dodd-Frank. The determinative factor is whether Congress intended to create a private cause of action,[230] and the Court requires affirmative evidence of Congressional intent.[231] Thus, whoever is arguing for an implied remedy in the face of a statute that does not explicitly provide one must rebut a strong presumption against implication, because, as the Court is fond of saying, Congress knows how to create a private cause of action when it wants to.[232] The Supreme Court's search for Congressional intent begins with an examination of the statute's text and structure.[233] In *Transamerica,* the Court found that Congress intended a limited rescissionary remedy in a statement that a contract "shall be void;"[234] by contrast, in *Alexander v. Sandoval,*[235] the Court found that the express provision of one method of enforcement suggested that Congress intended to preclude others.[236] Apart from the statutory language, the Court has considered extrinsic evidence that Congress at the time of the statute's enactment assumed the availability of a private remedy, as when it amended a statute at a time when courts had consistently found an implied remedy.[237] In *Touche Ross v. Redington,*[238] however, the Court found no implied cause of action under the "books and records" provision, section 17(a) of the Exchange Act, and stated that "the mere fact that [section] 17(a) was designed to provide protection for brokers' customers does not require the implication of a private damages action on their behalf."[239]

Under the Court's approach, the evidence in support of a Congressional intent to create a private remedy is weak. Since the statute does not explicitly provide one, there must be evidence that Congress must have assumed its existence. The best evidence that Congress must have

229. *See* ERWIN CHEMERINSKY, FEDERAL JURISDICTION §6.3.3 (5th ed. 2007) (describing the Court's development of more restrictive approaches in creating private causes of action since *Borak*).

230. *Id.*

231. *Id.*

232. Touche Ross v. Redington, 442 U.S. 560, 572 (1979).

233. Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1979).

234. *Id.* at 18.

235. 532 U.S. 275 (2001).

236. *Id.* at 290.

237. Merrill Lynch v. Curran, 456 U.S. 353, 384 (1982) (holding that there was a private damages remedy under CFTC Act because Congress assumed one existed when it amended statute).

238. 442 U.S. 560 (1979).

239. *Id.* at 578.

assumed that investors could enforce the standards in damages actions is (1) Congress, in Section 913, gave the SEC the authority to adopt these standards for the express purpose of improving retail investor protection and (2) Congress, in Section 921, gave the SEC the authority to provide investors with an opportunity to bring their claims arising under federal securities laws and regulations in court. Accordingly, Congress must have assumed that investors had legal claims arising under any such standards adopted by the SEC.

The evidence against implying Congressional intent, however, is stronger. First, nothing in section 913 contains a reference to private enforcement.[240] The placement of the new provision in the existing legislation does not support an inference that Congress intended to create a new private remedy. Section 913(g) of Dodd-Frank is an amendment to provisions in the Exchange and Advisers Acts that deal with SEC authority to adopt regulations and orders. As such, it is more like the books and records statute in *Touche Ross* than the "rights creating" language in *Transamerica.* Dodd-Frank section 913(h) provides a method for enforcing the standards through SEC enforcement. Finally, it is hard to argue that Congress could have assumed that there would be an implied remedy, given the Court's current disinclination to imply remedies, because the Supreme Court assumes that Congress knows the law.[241]

*State Law.* Adoption of SEC standards of care and competence may encourage greater recognition of negligence claims under state law. Currently, a few states have relied on state or SRO standards, such as the NASD suitability rule, in setting forth duties of care owed to investors.[242] State courts may place more weight on professional standards adopted by the SEC, the federal agency charged with the responsibility of protecting investors, in establishing the appropriate duty of care for investment advice providers.[243] Unless that happens, however, development of standards of care and competence (whether based on professionalism or fiduciary duty) will not adequately protect investors, because of the absence of legal remedies available to them.

*Mandatory Securities Arbitration.* As the Supreme Court advanced its pro-arbitration policy in recent years, Congress expressed concerns about the fairness of mandatory arbitration provisions in contracts where

240. Moreover, if it is relevant under the Supreme Court's approach, none of the Congressional leaders ever stated that the statute contained a private remedy for the standards of conduct.

241. *Curran*, 456 U.S. at 379.

242. *See supra* note 213 and accompanying text.

243. *See* RESTATEMENT (THIRD) OF AGENCY § 8.08, cmt. B ("If the statute or rule is designed to protect persons in the principal's position, the trier of fact may consider the agent's violation of the statute in defining and applying the standard stated in this section.").

employees and consumers realistically have little choice.[244] Section 921 of Dodd-Frank reflects this concern in the specific context of securities arbitration. It gives the SEC the authority to prohibit or restrict the use of agreements that require investors to arbitrate future disputes "arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization."[245] By its terms, the statutory language imposes a significant limitation on the SEC's authority to prohibit the use of PDAAs; its authority does not extend to future disputes arising under state law. There is no publicly available explanation for this limitation; perhaps Congress believed it was inadvisable to give the SEC, the agency responsible for enforcing federal securities laws, authority with respect to state law claims.[246] If the SEC chose to exercise its authority to ban PDAAs, it could not prevent brokerage firms and investment advisers from continuing to use them to require arbitration of state law claims which, because of the difficulties in proving federal claims,[247] comprise most investors' claims.[248]

Most disputes between brokerage firms and their customers are arbitrated in the FINRA forum. The FINRA arbitration forum has been closely studied, so we know a great deal about its operation. Because investment advisers do not have a central arbitration forum, we have much less information about arbitration involving investment advisers and their clients. Accordingly, the following discussion focuses primarily on broker-dealer arbitration in the FINRA forum.

People who have studied the FINRA arbitration forum closely (including myself)[249] give it high marks on most of the recognized fairness standards for dispute resolution; the outstanding fairness concerns relate to the presence of an industry arbitrator on every three-person arbitration panel and lack of reasons for the arbitration panel's award.[250] While the system is not perfect, FINRA, under SEC oversight, has enacted major reforms in recent years to improve the fairness of the forum.[251] It is also

244. Gross, *supra* note 88, at 1175.

245. Dodd-Frank Act, Pub. L. No. 111-203, § 921, 124 Stat. 1376, 1841 (2010).

246. I am grateful to Jill Gross for this possible explanation. Congress could prohibit PDAAs with respect to all claims under the Federal Arbitration Act.

247. *See supra* notes 44-56 and accompanying text (supporting author's assertion that apart from purchasers of mutual funds investors have no federal remedy to compensate for losses caused by investment advice from incompetent and careless investment advice providers).

248. FINRA arbitration claims do not require a statement of the legal basis for claims, so under current practice there frequently is no need to classify claims as based on federal or state law.

249. Black, *supra* note 87, at 3-12.

250. *Id.* at 7-9.

251. *See, e.g.*, SEC Order Approving Proposed Rule Change, Securities Act Release No. 56039, 72 Fed. Reg. 39,110 (July 17, 2007) (tightening the definition of public arbitrator);

true, however, that many investors who have filed claims with the FINRA forum have negative perceptions about its fairness.[252] Accordingly, it is incumbent upon FINRA to continue to improve the quality of the arbitration forum. To its credit, it continues to do so. Most recently, for example, FINRA permits parties in a pilot program to select arbitration panels without an industry arbitrator,[253] and it filed with the SEC a proposed rule change that would give all investors the option of a panel consisting entirely of all public arbitrators.[254] FINRA also adopted a rule that requires an arbitration panel to give reasons for its decision if both parties request the panel to do so.[255]

Whatever its imperfections, the FINRA arbitration forum presents a great advantage from the investors' perspective: its emphasis on equity allows arbitrators to fashion a remedy for investors that may not be supported by the law.[256] An SEC rule prohibiting PDAAs to the full extent of its authority would mean that investors with federal claims (principally Rule 10b-5 fraud claims) could litigate their claims, but it would provide no advantage to investors with claims based on violations of any SEC standards of care or SRO rules, since courts would dismiss those claims for failure to state a claim. Consequently, eliminating the broker-dealer's right to require arbitration in a PDAA may have a serious negative impact on many retail investors that is not fully appreciated.[257]

Initially, there is reason to doubt that the SEC will exercise its discretionary authority to limit the use of PDAAs. The SEC's lack of full authority to prohibit the use of PDAAs may act as a powerful disincentive. Prior to *McMahon,* brokerage firms could enforce PDAAs with respect to

SEC Order Approving Proposed Rule Change, Securities Act Release No. 55158, 72 Fed. Reg. 4574 (Jan. 31, 2007) (adopting new Code of Arbitration Procedure); SEC Order Approving Proposed Rule Change, Securities Act Release No. 40555, 63 Fed. Reg. 56,670 (Oct. 22, 1998) (adopting a Neutral List Selection System for selecting arbitrators).

252. Gross & Black*, supra* note 86, at 379.

253. News Release, FINRA, FINRA to Launch Pilot Program to Evaluate All-Public Arbitration Panels (July 24, 2008), http://www.finra.org/Newsroom/NewsReleases/2008/P038958.

254. Proposed Rule Change to Amend the Panel Composition Rule, and Related Rules, of the Code Of Arbitration Procedure for Customer Disputes ("Customer Code"), to Provide Customers With the Option to Choose an All Public Arbitration Panel In All Cases, SR-FINRA-2010-053 (Oct. 26, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p122354.pdf.

255. *See* SEC Order Approving Proposed Rule Change To Require Arbitrators To Provide an Explained Decision, Securities Act Release No. 59358, 74 Fed. Reg. 6928 (Feb. 11, 2009).

256. Black & Gross, *supra* note 59, at 995.

257. There are other advantages stemming from the traditional model of arbitration as an informal, confidential proceeding that may result in a speedier, less expensive process. Black, *supra* note 87, at 4.

state claims only; this distinction led to complicated and inefficient litigation over the nature of claims and the bifurcation of claims that the SEC may not wish to reintroduce.[258] A sensible agency choice might be to defer any action until such time as Congress takes up the general issue of the use of PDAAs in all employment and consumer arbitrations.

Assuming the SEC chose to prohibit PDAAs to the full extent of its authority, brokerage firms (and investment advisers) would have to decide whether to require PDAAs for state claims or whether to drop a PDAA altogether. Assuming that some firms chose to require a PDAA, investors would make strategic choices about the characterization of their claims depending on whether they preferred litigation or arbitration. Firms may well evaluate their choices differently, but at least some firms could decide simply to eliminate any PDAAs from their customers' agreements.[259]

Here we must introduce another uncertainty. What makes securities arbitration different from other consumer and employment arbitration is that, under FINRA Rule 12200,[260] a customer can always require the firm to arbitrate her claim. FINRA takes the position that "it is essential for investor protection that FINRA maintain Code Rule 12200 if Congress or the SEC decides to limit or prohibit mandatory arbitration."[261] Accordingly, the investor always has the option of requiring the firm to arbitrate her dispute, even if it is a claim that the firm would prefer to litigate, as for example, a claim based on the violation of an SRO rule. If brokerage firms are no longer permitted to require arbitration of all disputes, however, we can expect that the brokerage industry would campaign to eliminate Rule 12200 as one-sided and unfair to the industry.[262] If the industry successfully eliminated Rule 12200, then claims based on securities laws and SEC and SRO rules would be litigated unless, after the dispute arose, both parties agreed to arbitrate.

The obvious question then becomes: if arbitration is better for most investors, and the industry wants arbitration, then will not most parties

258. *See* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 217 (1985) (holding that broker-dealer could require arbitration of state law claims even if the result would be inefficient maintenance of separate proceedings in different forums).

259. If firms make different choices, this may introduce an element of competition that investors have not previously observed. Investors may select their brokerage firm on the basis of the presence or absence of a PDAA.

260. FINRA R. 12200 (FINRA 2008), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106.

261. FINRA, Statement on Key Issues at the Securities and Exchange Commission Investor Advisory Committee Panel on Securities Arbitration 2 (May 17, 2010), http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-finra.pdf.

262. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA), WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 3 (Oct. 2007), *available at* http://www.sifma.org/issues/item.aspx?id=21334 (eliminating PDAAs would give investors "an unfair strategic advantage").

agree to it post-dispute? The answer is: not necessarily. Scholars who have studied consumer and employment arbitration note that the incentives to support arbitration change when the system becomes voluntary.[263] Similarly, brokerage firms have cost advantages attributable to mandatory arbitration that may be lost in a voluntary system.[264] Once a dispute has arisen, each side will have a view about whether its claim will fare better in court or in arbitration. As a result, the parties are unlikely to agree, post-dispute, on a choice of forum. Consider, for example, a $25,000 claim for a breach of the suitability rule. The investor is likely to want arbitration, while the firm has strategic advantages to insist on court. It will not be cost-efficient for the investor to litigate this claim, and there is no private cause of action for breach of an SRO rule. Conversely, if a disabled investor has a $5 million claim against his broker-dealer for fraudulent misrepresentations that caused him to lose his money in a Ponzi scheme, the investor's attorney will likely want to take the case to a jury, with all the attendant publicity, while the firm would prefer arbitration of the claim.

As a result, we can expect that the number of claims going to arbitration will decrease. There is some empirical evidence in other types of arbitration (employment and consumer) that post-dispute arbitration agreements are rare.[265] Moreover, even if Rule 12200 remains operative so that small investors can always arbitrate their disputes, the nature of the FINRA arbitration would likely change if it became predominately a small investors' dispute resolution forum. The incentives on the part of the firm to support arbitration decrease if they cannot require arbitration of those claims for which arbitration is strategically advantageous for them—the big-ticket claims that may appeal to a jury's sense of outrage. In addition, the resources devoted to maintain a fair and efficient arbitration forum—which, on the part of FINRA, are considerable—would likely decrease if the FINRA forum becomes a small claims dispute resolution forum. In short, eliminating mandatory securities arbitration would likely have unintended consequences that would not be advantageous to the

263. *See* Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predispute Employment Arbitration Agreements*, 16 OHIO ST. J. ON DISP. RESOL. 559, 568 (2001) (discussing the difference in regard for arbitration when employers and employees voluntarily agree to arbitrate at time of initial hiring); Peter B. Rutledge, *Who Can Be Against Fairness? The Case Against the Arbitration Fairness Act*, 9 CARDOZO J. CONFLICT RESOL. 267, 279 (2008) (stating that each party has an incentive to enter into arbitration in the predispute phase); Stephen J. Ware, *Employment Arbitration and Voluntary Consent*, 25 HOFSTRA L. REV. 83, 139 (1996) (comparing cases in which employee's consent to arbitration is voluntary to those in which consent is coerced).

264. Estreicher, *supra* note 263, at 563-65.

265. *See* Lewis L. Maltby, *Out of the Frying Pan, into the Fire: The Feasibility of Post-Dispute Employment Arbitration Agreements*, 30 WM. MITCHELL L. REV. 313, 314 (2003); Amy J. Schmitz, *Legislating in the Light: Considering Empirical Data in Crafting Arbitration Reforms*, 15 HARV. NEGOT. L. REV. 115, 194 (2010).

congressional goal of improving protection for retail investors.

## VI. CONCLUSION

This article addresses two provisions in the Dodd-Frank Act that are especially important for retail investor protection. Section 913 requires the SEC to conduct a six-month study on the effectiveness of existing standards of care for broker-dealers and investment advisers and authorizes the SEC to establish a fiduciary duty for brokers and dealers. Section 921 grants the SEC the authority to limit or prohibit the use of PDAAs that would require customers of investment advice providers to arbitrate future disputes arising under the federal securities laws and regulations or SRO rules.

Because current legal remedies provide inadequate protection for retail investors, I applaud increased recognition of the inadequacies of the current system. Unfortunately, much of the debate on both these provisions has not focused on the right issues. As I argue in this paper, the SEC should adopt professional standards of care and competence applicable to both broker-dealers and investment advisers that provide advice to retail investors. Further, unless and until Congress adopts an explicit remedy for investors harmed by careless and incompetent investment advice, the elimination of mandatory securities arbitration of federal securities and SRO claims may have the undesirable effect of making it harder for retail investors to recover damages for negligent investment advice. Surely, after the worst financial crisis since the Crash of 1929 and its aftermath, Congress cannot intend to decrease retail investor protection!