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How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Abstract

The Dodd-Frank Wall Street Reform and Consumer Protection Act gives the Securities and Exchange Commission the authority to deal with 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 brokers and dealers. Second, section 921 grants the SEC the 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 competence and care for broker-dealers and investment advisers.

Third, I argue that SEC adoption of standards of care will not create any additional federal remedies for investors because it is unlikely that the U.S. Supreme Court will create a private damages remedy for their breach. If the SEC prohibits 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.

INTRODUCTION

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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 2008-09 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 investor’s business. Both advertise on the basis of the quality of their investment advice and hold themselves out as providing ongoing investment advice tailored to meet the changing needs of the individual investor. Although the nature of their services can appear identical to retail investors, broker-dealers and investment advisers are subject to different regulatory schemes and standards of conduct, which has led to investor confusion and concern about the adequacy of retail investor protection.\(^3\) Section 913 requires the SEC to conduct a six-month study and report to Congress on the effectiveness of existing standards of care for broker-dealers and investment advisers and whether there are “legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers” relating to

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\(^2\) 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.§ 913(a). In general, retail investors’ portfolios are smaller, and their investment knowledge less extensive, than “sophisticated investors” such as institutional investors or individuals like Warren Buffet.
the standards of care.4 The statute provides that the SEC may commence a rulemaking to address these issues5 and specifically authorizes the SEC to establish a fiduciary duty for brokers and 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)7 arbitration forum; 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 customers9 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, what has been largely overlooked is that the issues are closely related. Investors who suffer losses caused by poor investment advice will seek to recover damages from their

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4 Dodd-Frank § 913(b). The statute also sets forth a number of factors for the SEC to take into consideration. § 913(c).
5 § 913(f).
6 § 913(g). There are significant limitations on the scope of the fiduciary duty the SEC is authorized to adopt, as discussed infra notes 75-77, 186 and accompanying text.
7 FINRA operates the largest dispute resolution forum in the securities industry, http://www.finra.org/ArbitrationMediation/index.htm.
9 Unlike § 913, § 921 is not limited to retail customers.
10 § 921. Self-Regulatory Organization is defined in Exchange Act § 3(a)(26), 15 U.S.C. § 78c(a)(26). FINRA is the SRO for all U.S. broker-dealers, http://www.finra.org/AboutFINRA/ . There is no SRO for investment advisers. By its terms the statute 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; see FINRA Dispute Resolution Statistics, Arbitration Cases Served by Controversy at http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm. This issue is discussed infra at note 245 and accompanying text.
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 I, I make three arguments:

First, in Part II, 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, both investment advisers and broker-dealers. Fiduciary duty is too amorphous to establish a standard of conduct, the breach of which will cause serious consequences, and is inapposite in the context of individuals and firms that reasonably expect to profit from their services. Rather, retail investor protection will be 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 III, I propose, for adoption by the SEC, federal professional standards of competence and care for broker-dealers and investment advisers. These include a core set of principles setting forth minimum standards that the parties cannot disclaim. Additional standards are applicable whenever the investment advice provider
invites the investor's reliance, and the investor actually relies on the investment advice provider for financial advice.

Finally, in Part IV, 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 U.S. Supreme Court’s 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 the retail investor’s perspective, is that she 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.

I. 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.\textsuperscript{12} It is also a highly regulated industry. Broker-dealers and their salespersons (known technically as “associated persons” or “registered representatives”\textsuperscript{13}) are regulated under the Securities Exchange Act of 1934 (the Exchange Act),\textsuperscript{14} which provides for regulation over virtually every aspect of the business.\textsuperscript{15} While the SEC has authority to adopt federal standards of competence\textsuperscript{16} and has direct authority over broker-dealers and their associated persons,\textsuperscript{17} FINRA, as the SRO for broker-dealers, is the principal regulator,\textsuperscript{18} over which the SEC exercises oversight authority.\textsuperscript{19} Salespersons of broker-dealers are subject to licensing requirements, including examinations administered by FINRA.\textsuperscript{20} State securities commissioners also regulate broker-dealers and associated persons.\textsuperscript{21}

\textsuperscript{16} 15 U.S.C. §§ 78o(b)(7), (c)(2)(D).
\textsuperscript{17} The SEC's Office of Compliance Inspections and Examinations conducts examinations, see The Office of Compliance Inspections and Examinations at http://www.sec.gov/about/offices/ocie.shtml; the SEC's Division of Enforcement investigates possible violations and brings enforcement proceedings; see Office of Enforcement at http://www.sec.gov/divisions/enforce.shtml.
\textsuperscript{18} See About Financial Industry Regulatory Authority at http://www.finra.org/AboutFINRA/. “It is doubtful whether any regulated industry has been allowed to regulate itself to the degree that the securities industry has.” Poser & Fanto, BROKER-DEALER LAW, supra note 12, § 4.01.
\textsuperscript{21} See The Role of State Securities Regulators at http://www.nasaa.org/About_NASAA/Role_of_State_Securities_Regulators/.
In contrast, the investment advisory industry is less complex, with its principal function providing investment advice,\textsuperscript{22} and is less regulated. Investment advisers (but not investment adviser representatives) are regulated under the Investment Advisers Act of 1940 (the Advisers Act),\textsuperscript{23} which places few substantive burdens on investment advisers.\textsuperscript{24} The Advisers Act does not provide for industry self-regulation. Instead, the SEC is the principal regulator of larger investment advisers, while states regulate the smaller investment advisers as well as investment adviser representatives.\textsuperscript{25} The Advisers Act does not establish qualifications for investment advisers and does not require that investment advisers or their representatives pass any examinations,\textsuperscript{26} although many states have examination requirements.\textsuperscript{27}

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

Neither federal statute explicitly sets forth a standard of conduct to which broker-dealers or investment advisers, as the case may be, 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

\textsuperscript{22} 1 Tamar Frankel & Ann T. Schwing, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS §1.01(B (2nd ed. 2000) (hereinafter REGULATION OF MONEY MANAGERS).
\textsuperscript{25} 15 U.S.C. § 80b-3(a).
\textsuperscript{26} In 1975, the SEC sought amendments to address what has been described as "the most serious defect" in the Advisers Act, see 7 Louis Loss & Joel Seligman, SECURITIES REGULATION 3397 (3d ed. 1991), but they failed to pass. See Frankel & Schwing, supra note 22, REGULATION OF MONEY MANAGERS §1.02(A)(1)(a).
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, when the broker-dealer had the power to affect trades in the account without the customer's authorization.\footnote{See SEC v. Zandford, 535 U.S. 813 (2002) (referring to a broker's fiduciary duty in the context of a discretionary account).} 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.\footnote{See, e.g., Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 536 (2d Cir. 1999).} The Exchange Act requires a "national securities association" (i.e., FINRA) to adopt membership rules "to promote just and equitable principles of trade;"\footnote{15 U.S.C. §78o-3(b)(6) (2010).} 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.\footnote{FINRA Regulation, Inc., FINRA Rule 2010 (2010), available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905.} The most important conduct rule is the “suitability” rule. NASD Rule 2310\footnote{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. FINRA Regulation, Inc., NASD Conduct Rule 2310 (2010), available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315.} imposes on broker-dealers obligations, when making recommendations, to conduct due diligence both to know their customer\footnote{The broker-dealer must make reasonable efforts to obtain relevant information about the customer, including financial status, tax status, and investment objectives. FINRA Regulation, Inc., NASD Conduct Rule 2310(b) (2010), available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315.} 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.\footnote{The rule makes clear that suitability determinations must be made on a portfolio basis. FINRA Regulation, Inc., NASD Conduct Rule 2310(a) (2010), available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315.}
In contrast, federal law establishes 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., 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. v. Lewis, 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, 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 its standards of business conduct "that must reflect [its] fiduciary obligations," but the agency itself has never adopted conduct rules that explicate the fiduciary duty concept.

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.
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.
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.\textsuperscript{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;\textsuperscript{42} investment advisers, in turn, refer to the higher fiduciary standard.\textsuperscript{43}

C. \textit{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)\textsuperscript{44} is the only express private damages remedy for negligent advice; in \textit{Gustafson v. Alloyd Co., Inc.},\textsuperscript{45} the Supreme Court held that this provision did not apply to trading transactions. The Court also, in \textit{Ernst & Ernst v. Hochfelder},\textsuperscript{46} limited the implied remedy under Exchange Act Section

\begin{itemize}
\item[\textsuperscript{41}] Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, SEC Rel. No. IA-1406 (Mar. 16, 1994). The SEC asserted that the proposed rule was a codification of existing SEC interpretations.
\item[\textsuperscript{44}] 15 U.S.C. § 77l(a)(2) (2010).
\item[\textsuperscript{45}] 513 U.S. 561 (1995).
\item[\textsuperscript{46}] 425 U.S. 185 (1976).
\end{itemize}
10(b)\textsuperscript{47} and Rule 10b-5\textsuperscript{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\textsuperscript{49} apply to negligent advice in trading transactions,\textsuperscript{50} the federal appeals courts currently assume that the Court would not recognize an implied cause of action under these sections.\textsuperscript{51} Finally, 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.\textsuperscript{52} Similarly, 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\textsuperscript{53} and refuse to imply private causes of action for breach of SRO rules.\textsuperscript{54} State courts may allow investors to recover under 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.

\textsuperscript{47} 15 U.S.C. § 78j(b) (2010).
\textsuperscript{48} 17 C.F.R. 240.10b-5 (2010).
\textsuperscript{50} In Aaron v. SEC, 446 U.S. 680 (1980), the Supreme Court held that Securities Act §§ 17(a)(2) and 17(a)(3) do not require scienter In U.S. v. Naftalin, 441 U.S. 768 (1979), the Supreme Court held that Securities Act §17(a) applies to trading transactions.
\textsuperscript{52} Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).
For example, retail investors who purchase mutual funds recommended by their broker may have claims for inaccurate oral communications related to the prospectus.\footnote{The difficulties with a § 12(a)(2) claim are discussed infra notes 200-206 and accompanying text.}

Ever since the Supreme Court held, in\textit{ Shearson/American Express v. McMahon},\footnote{482 U.S. 220 (1987).} that PDAAs were enforceable under the federal securities laws,\footnote{Id. at 238.} virtually all customers’ disputes with their brokers are resolved through arbitration in the FINRA forum. Because there is no SRO for investment advisers, there is less information available about arbitration of disputes involving investment advisers, but it appears that arbitration before one of the commercial forums is the customary method of resolving disputes between investors and investment advisers as well.\footnote{Courts routinely enforce PDAAs in light of the Court’s post-\textit{McMahon}, pro-arbitration policy; see, e.g., Bakas v. Ameriprise Fin. Servs., Inc., 651 F. Supp.2d 997 (D. Minn. 2009). The SEC, however, has never withdrawn the Opinion Letter relied on in Bakas, which states that investment advisers could not require PDAAs. McEldowney Financial Services, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2825 (Oct. 17, 1986).} 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.\footnote{See generally Barbara Black & Jill Gross, \textit{Making It Up As They Go Along: The Role of Law in Securities Arbitration}, 23 CARDOZO L. REV. 991 (2002) [hereinafter \textit{Making It Up}].}

D. \textit{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.\footnote{It identified the problem of investor confusion because “investment advisers and broker-dealers are regulated under different}
statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective." Its initiatives "to increase fairness for investors" included measures to "establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers." 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.

Although the white paper's use of the phrase "harmonizing the regulation of broker-dealers and investment advisers" 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, early on in the debate, a consensus emerged 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

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61 Id.
62 Id.
63 Id.
64 Id. at 72. This paper addresses only the proposal for the same fiduciary obligation 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, 424-428 (2010) (hereinafter Reforming the Regulation).
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,"\(^{65}\) while the broker-dealer industry supported legislation that would delegate authority to the SEC to study the matter further and develop appropriate conduct rules consistent with a fiduciary duty principle.

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 required 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]"\(^{66}\) and the "standard of conduct shall be no less stringent than the standard applicable to investment advisers…."\(^{67}\)

The original Senate version, in contrast, would have eliminated the broker-dealer exclusion from the definition of "investment adviser" in the Advisers Act,\(^ {68}\) 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

\(^{65}\) 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). See Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 33 (2005).

\(^{66}\) H.R. 4173, 111\(^{st}\) Cong. §7103(a) (2009).

\(^{67}\) Id.
called for the SEC to conduct a one-year study. 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. The brokerage industry essentially won this debate. Section 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…;”

(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.”

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

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68 Restoring American Financial Stability Act, S. 3217, 111th Cong. § 913(a) (discussion draft, as introduced to the Senate Banking Committee on Nov. 10, 2009).
70 See Mark Schoeff Jr., Congress passes fiduciary ball to SEC (June 27, 2010) at http://www.investmentnews.com/article/20100627/FREE/100629911 (identifying some of the groups involved in the debate).
71 § 913(b)(1)
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.\footnote{\textsection 913(b)(2)} 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.\footnote{\textsection 913(g)(1)} 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;\footnote{Id.} (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 investment advice about securities;”\footnote{Id.} and (3) broker-dealers that sell only proprietary or other limited range of products do not, for that reason alone, violate the standard of care.\footnote{Id.} 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 \footnote{Id. As I discuss infra note 186 and accompanying text, this limits substantially the imposition of a meaningful standard of care for broker-dealers. 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.}
acknowledgement of the customer.\textsuperscript{78} 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.”\textsuperscript{79} 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”\textsuperscript{80} and the standard of conduct “shall be no less stringent than the standard of conduct applicable to investment advisers.”\textsuperscript{81}

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 broker-dealers 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 adviser….\textsuperscript{82}

\textsuperscript{78} Id.
\textsuperscript{79} 913(g)(2).
\textsuperscript{80} Id.
\textsuperscript{81} Id. The statute refers to Advisers Act § 206(1) and (2), 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.”
\textsuperscript{82} § 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, \textit{In Brief: FY 2011 Congressional...}
2. Mandatory Securities Arbitration

Ever since *McMahon*, many investors perceive the FINRA arbitration forum as unfair, although academics who have studied the forum award it high marks for meeting most generally recognized standards of fairness. 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. The Treasury white paper recommended amendment of the federal securities laws to give the SEC authority to prohibit PDAAs in brokerage and investment advisory contracts with retail investors and an SEC study of the issue. Section 921 of Dodd-Frank (which is essentially the same provision contained in the House and Senate versions) 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

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*Justification* at 2. 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. (Numbers are taken from Select SEC and Market Data for fiscal years 2005-2009, table 2; all documents cited in this note are available at http://www.sec.gov/about.shtml.
83 482 U.S. 220.
88 U.S. DEP’T. TREASURY, *supra* note 60 at 72
limitations are in the public interest and for the protection of investors.\textsuperscript{90} In contrast with section 913 and its required study on 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.\textsuperscript{91}

Finally, it should be noted what is \textit{not} included in Dodd-Frank. Although the Obama administration identified “increas[ing] fairness for investors” as a goal,\textsuperscript{92} 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\textsuperscript{93} are still without a federal damages remedy unless they can establish fraud.\textsuperscript{94}

\textbf{Part II: 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

\textsuperscript{89} H.R. 4173 § 7201; Senate § 921.
\textsuperscript{90} 921 (emphasis added)
\textsuperscript{91} See infra notes 256-257 and accompanying text.
\textsuperscript{92} See supra note 60 and accompanying text.
\textsuperscript{93} Retail investors who purchase mutual funds recommended by their brokers can bring a negligence claim under Securities Act § 12(a)(2), 15 U.S.C. § 77l(a)(2), but courts have not been receptive to these claims; see, e.g., In re Morgan Stanley Information Fund Sec. Litig., 592 F.3d 347 (2d Cir. 2010) (dismissing claims based on failure to disclose conflicts of interest), DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209 (3d Cir. 2007) (dismissing claims based on failures to disclose involving Class B shares), Benzen v. Morgan Stanley Distributors, Inc., 420 F.3d 598 (6th Cir. 2005) (dismissing claims based on failures to disclose involving Class B shares).
they provide essentially the same service--personalized advice to retail investors—and solicit business by encouraging trust and reliance on their diligence and expertise.\footnote{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.} As discussed above,\footnote{For the importance of trust in the securities markets, see Lynn A. Stout, \textit{Trust Behavior: The Essential Foundation of Securities Markets}, UCLA School of Law, Law-Econ Research Paper No. 09-15 (Aug. 3, 2009, http://ssrn.com/abstract=1442023.} 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 II, 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 competence and care for all investment advice providers when they provide advice to retail investors.

A. \textit{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:

\begin{quote}
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.\footnote{Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).} \end{quote}

\footnote{See supra notes 71-73 and accompanying text.}
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.\textsuperscript{98} 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 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."\textsuperscript{99} 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:

\textsuperscript{98} See Deborah A. DeMott, \textit{Beyond Metaphor: An Analysis of Fiduciary Obligation}, 1988 DUKE L.J. 879, 879 (stating that "recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis") (hereinafter \textit{Beyond Metaphor}). See also Frank H. Easterbrook & Daniel R. Fischel, \textit{Contract and Fiduciary Duty}, 36 J.L & ECON. 425, 425 (1993) (stating that "[t]he many agency relationships that fall under the 'fiduciary' banner are so diverse than a single rule could not cover all without wreaking havoc").

\textsuperscript{99} DeMott, \textit{Beyond Metaphor, supra} note 98, 1988 Duke at 915.
“to say that a man is a fiduciary only begins the 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?”

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. The central features of a fiduciary relationship are that "the fiduciary serves as a substitute for the entrustor" and "the fiduciary obtains power for the purpose of enabling the fiduciary to act effectively." 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."

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.

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102 Id. at 808.
103 Id. at 809.
104 Id. at 807-08. See also Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 ORE. L. REV. 1209, 1212 (1995) (stating that "[i]n 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") (hereinafter Default Rules).
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 position that fiduciary obligations are limited to duties of loyalty and not competence. Accordingly, extending the fiduciary duty principle to all investment advice providers does little to advance the analysis of the appropriate level of competence and care 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, to emphasize the altruistic nature of fiduciary relationships, and in recognition of the vulnerability of the entrustor. 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. While I do not agree that fiduciary obligations have no place in the law, the

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105 See § 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 agency'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 Id. (stating that "once an individual undertakes to act as a fiduciary, he should act to further the interests of another in preference to his own").
108 Id. at 832. Professor Langevoort emphasizes the "pervasiveness of trust" in broker-customer relationships; brokers seek to win the customers' trust, and customers wish to bestow it. 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).
109 See, e.g., Easterbrook & Fischel, Contract and Fiduciary Duty, supra note 98, 36 J.L. & Econ. at 427 (1993). For criticism of the contractarians' approach, see generally DeMott, Beyond Metaphor, supra note 98, 1988 Duke at 891 and Frankel, Default Rules, supra note 104, 74 Or. L. Rev. at 1211 (1995). 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. Id. at 1212.
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 services.\footnote{Arthur B. Laby, Reforming the Regulation, supra note 64, 65 BUS. LAW. at 426.} 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 so 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.\footnote{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} While this is a value, 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.* 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. *Gartenberg v. Merrill Lynch Asset Management, Inc.*, a Second Circuit § 36(b) opinion whose approach is endorsed in *Harris Associates*, tracked the legislative history on this section, which it described as "tortuous" and the Supreme Court, more diplomatically, described as representing "a delicate compromise" that resulted in the statutory reference to fiduciary duty that is "hardly pellucid." Thus, *Harris Associates* presents a cautionary tale about uncertainties created by the political decision to use the felicitous phrase rather than

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*Continuing Success, 2009 U. ILL. L. REV. 1* (pointing out the dangers of the indeterminate fiduciary duty approach).

112 130 S. Ct. 1418 (2010).
114 694 F.2d 923 (2d Cir. 1982).
115 Id. at 928.
116 *Harris Associates*, 130 S. Ct. at 1423.
117 Id. at 1426.
develop a workable standard. The end result is an approach that the Court concedes "lacks sharp analytical clarity."\textsuperscript{118}

Moreover, the history of § 36(b), culminating in \textit{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,\textsuperscript{119} whereas in a classic conflict-of-interest relationship the fiduciary has the burden of establishing fairness. Second, the outcome of \textit{Harris Associates} makes clear that plaintiffs will rarely prevail.\textsuperscript{120} 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"\textsuperscript{121} -- 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"\textsuperscript{122} -- under which plaintiffs rarely prevail and that Congress expressly rejected. Under \textit{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

\textsuperscript{118} \textit{Id.} at 1430.
\textsuperscript{120} Indeed, plaintiffs have never prevailed in court under § 36(b). Mercer E. Bullard, \textit{Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?}, 76 U.CIN. L. REV. 559, 560 note 5 (2008).
\textsuperscript{121} \textit{Harris Associates}, 130 S. Ct. at 1426
\textsuperscript{122} \textit{Brehm v. Eisner}, 746 A.2d 244, 263 (Del. 2000).
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 ethics in the securities industry," and failure to act professionally is recognized as unethical conduct. 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. In subsequent amendments Congress frequently sought to elevate the level of professionalism. Thus, 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. 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


124 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”).

125 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 and Joel J. Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 LAW & CONTEMP. PROBS. 691, 694 (1964).

126 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 Bureau of National Affairs, 2 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 1761 (1983).
markets;” as part of that reform, the SROs were required to adopt and enforce rules that promoted “just and equitable principles of trade.” In 1990, Congress added provisions to raise the standard of brokers' practices in the sale of penny stocks that are frequently sold to unsophisticated retail investors.

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. 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, the Advisers Act has been amended 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. 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. Indeed, whatever fiduciary means, Capital Gains makes clear it encompasses an obligation to act professionally.

127 H. R. REP. 94-123 at 44, reprinted in 3 LEGISLATIVE HISTORY, supra note 126, at 2514.
128 Specifically, the rules of national securities exchanges, the SEC (with respect to SECO broker-dealers) and national securities associations were required to promote “just and equitable principles of trade,” 15 U.S.C. §§ 78f(b)(5), 78o(b)(9), 78o-3 (b)(6), and standards with respect to “training, experience and competence,” 15 U.S.C. §§ 78f (c)(3)(A), 78o(b)(7), 78o-3(g)(A),(B). FINRA Rule 2010 emphasizes “high standards of commercial honor” and “just and equitable principles of trade” for the protection of investors. FINRA Rule 2010, supra note 31.
130 See supra notes 23-27 and accompanying text.
131 LOSS & SELIGMAN, SECURITIES REGULATION, supra note 26, at 3314.
132 See, e.g., SEC, supra note 41 (stating that the investment adviser's suitability obligation is enforceable under the antifraud provisions of the Advisers Act).
133 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187 (“investment advisers … basic function [is] furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments...”)
The SEC early on identified competence and care as important components of professional conduct and frequently brings disciplinary proceedings against broker-dealers and investment advisers for unprofessional conduct, such as soliciting customers to purchase securities at excessive mark-ups\(^{134}\) and making unsuitable or uninformed recommendations.\(^{135}\) SROs bring disciplinary actions against broker-dealers and associated persons for unprofessional and unethical conduct; a showing of 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.”\(^{136}\) State securities commissioners discipline securities professionals for unprofessional and unethical practices.\(^{137}\)

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 advice to retail investors. In Part III, I set forth these proposed federal standards of competence and care.

**Part III: Federal Professional Standards for Investment Advice Providers**

After the SEC completes the six-month study required by Section 913 of Dodd-Frank,\(^{138}\) 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

\(^{134}\) See, e.g., Charles Hughes & Co. v. SEC, 139 F.2d 434, 436 (2d Cir. 1961) (stating that broker-dealer “holds itself out as competent to advise”).


\(^{136}\) See, e.g., 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).
standard, I propose adoption by the SEC of federal standards of competence and care for investment advice providers.\textsuperscript{139}

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) \textit{Prohibition against Unauthorized Trading}. The investment advice provider must obey the investor’s instructions and cannot make decisions pertaining to the account unless authorized by the investor to do so.\textsuperscript{140} Unauthorized trading has long been recognized as an egregious example of unprofessional conduct.\textsuperscript{141}

(2) \textit{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.\textsuperscript{142} The duty of best execution is a well-established professional responsibility that the SEC and other regulators enforce in disciplinary proceedings.\textsuperscript{143}

\textsuperscript{137} See, e.g., Knowles v. State of 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").

\textsuperscript{138} \textit{See supra} notes 71-73 and accompanying text.

\textsuperscript{139} The proposal set forth herein is a refinement of my earlier proposal contained in \textit{Transforming Rhetoric}, \textit{supra} note 11, 8 TRANSACTIONS: THE TENN. J. BUS. L. 101 (2006).

\textsuperscript{140} Agents must obey their principal’s lawful instructions. \textit{See RESTATEMENT (SECOND) OF AGENCY} § 385, \textit{RESTATEMENT (THIRD) OF AGENCY} § 8.09.


\textsuperscript{143} \textit{In re} Michael L. Smirlock, 51 SEC 849, Rel. No. IA-1393 (Nov. 29, 1993) (investment adviser); Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971) (broker-dealer).
(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.\textsuperscript{144} Since the foundation of the federal securities regulatory system is 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.\textsuperscript{145}

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 2008-09 the SEC and other regulators entered 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.\textsuperscript{146} 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

\textsuperscript{144} 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," \textit{Restatement (Second) of Agency} § 381 (1958). This duty is an aspect of FINRA's requirement of "fair dealing with customers," see FINRA Conduct Rule 2010, supra note 31; FINRA Regulations, Inc., NASD Conduct Rule IM-2310-2 (2010) available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3640. With respect to disclosing material conflicts of interest, see NASAA Model Rule 102(a)(4)-1(k), supra note 114.


\textsuperscript{146} The SEC posted the settlements and other documents on its website, \textit{Auction Rate Securities}, http://www.sec.gov/investor/ars.htm (last visited July 3, 2010).
access those funds when the credit markets froze.\textsuperscript{147} If these actions had been litigated, it is not clear whether the SEC could have established fraud. While the SEC alleged knowledge on the part of the firms that the ARS market was deteriorating, a fraud claim,\textsuperscript{148} it also alleged that the firm did not adequately train its salespersons to ensure that they understood the products they were selling; in other words, the salespersons made negligent misrepresentations. 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.

\textbf{(4) Suitability Obligation.} When making recommendations about products and strategies,\textsuperscript{149} 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.\textsuperscript{150} FINRA has been the regulator that has principally explicated the suitability obligation through its interpretations of NASD Conduct Rule

\begin{footnotesize}
\textsuperscript{147} See Linda Chatman Thomas, Director, Division of Enforcement, SEC, \textsc{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.

\textsuperscript{148} In their complaints, the SEC alleged broker-dealer fraud under § 15(c) of the Exchange Act. \textsl{See, e.g.}, \textsc{Auction Rate Securities}, supra note \textsuperscript{31} (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.

\textsuperscript{149} Or purchases if it is a discretionary account

\textsuperscript{150} NASD Conduct Rule 2310, \textsc{supra} note 31; \textsl{In re Arleen W. Hughes, Exchange Act Release No. 4048, 27 S.E.C.} 629 (Feb. 18, 1948).
\end{footnotesize}
2310 in disciplinary proceedings against broker-dealers, but the SEC has made clear that the suitability obligation applies as well to investment advisers through its interpretation of § 206(4) of the Advisers Act. 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 the recommendation be consistent with the investor's financial situation and investment objectives and 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. 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 and draw a distinction between the investment adviser's fiduciary obligation

152 See SEC, supra note 41 (stating that the proposed suitability obligation for investment advisers was a codification of existing principles).
154 See, Wall Street and Fiduciary Duties: Can Jail Time serve as an adequate Deterrent for Willful Violations?: Hearing Before the S. Comm. on the Judiciary Subcommittee on Crime and Drugs, 111th Cong. (2010) (Testimony of Barbara Roper, Director of Investor Protection, Consumer Federation of America); Financial Planning Coalition, 75,000-Member Financial Planning Coalition to Senate: Reduce Elder Financial Abuse and Protect All Consumers by Approving Fiduciary Standard Amendment, (May 12,
that its recommendation is in the investor's best interests and the broker-dealer's suitability obligation that requires that its recommendation is suitable for the investor.\textsuperscript{155}

There is little support, either in the law or regulatory guidance, for this distinction. Beginning with \textit{Capital Gains},\textsuperscript{156} courts viewed the "best interests of the client" standard as an aspect of the investment adviser's duty of loyalty to address conflicts of interests,\textsuperscript{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.\textsuperscript{158} While the agency's references to the "best interests of the client" standard have blurred distinctions between the duties of loyalty and care,\textsuperscript{159} the SEC's position that the suitability obligation applies to investment advisers\textsuperscript{160} 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. Consistent with this, FINRA has frequently

\textsuperscript{155} \textit{Id.} at 11.
\textsuperscript{159} \textit{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).
\textsuperscript{160} \textit{Supra} note 41 and accompanying text.
equated the suitability standard with acting in the best interests of the investor. Finally, this supposed distinction between "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 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. To date, the importance of considering costs in determining suitability has principally arisen in three situations: recommending 529 plans with complex fee structures, recommending Class B mutual fund shares in situations where Class A shares were less expensive, and recommending switching of mutual funds. In these situations, regulators have established the principle that broker-

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163 In re First Global Capital Corp., Exchange Act Release No. 54754, 2006 SEC Lexis 2632 (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 they sold, they lacked reasonable grounds to believe that their recommendations were suitable, based upon 529 Plan fee structures and customer needs and objectives).
165 Krull v. SEC, 248 F.3d 907 (9th Cir. 2001) (holding that broker-dealer's recommendations to switch mutual funds were unsuitable because of the high costs associated with short-term trading in mutual funds); NTM 95-80, supra note 164.
dealers do not meet their suitability obligations when recommendations are made to maximize their own profits. While extending this principle to broker-dealer's 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;\footnote{Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Securities Act Release No. 8358, Exchange Act Release No. 49148, Investment Company Act Release No. 26341, 2004 SEC LEXIS 222 (proposed Jan. 29, 2004). The SEC later reproposed the rule. 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, Securities Act Rel. No. 8544, Exchange Act Release No. 51274, Investment Company Act Release No. 26778, 2005 SEC LEXIS 465 (proposed Feb. 28, 2005).} 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 purchaser 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,\footnote{I have previously criticized the SEC's performance in Are Retail Investors Better Off Today?, 2 BROOK. J. CORP. FIN. & COM. L. 303 (2008).} ultimately, it 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.\textsuperscript{168} If the broker-dealer believes that the higher-cost proprietary investment has benefits for the customer to warrant the additional costs, he 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.\textsuperscript{169}

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) \textit{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.

\textit{Leib v. Merrill Lynch, Pierce, Fenner, & Smith, Inc},\textsuperscript{170} one of the most frequently cited opinions on broker-dealers' duties to its customers, explicitly states that their

\begin{footnotesize}
\begin{enumerate}
\item[168] 913(l)
\item[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 that broker'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 broker recommended, because it focused solely on cost savings).
\end{enumerate}
\end{footnotesize}
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.\footnote{See Barbara Black and Jill I. Gross, \textit{Economic Suicide: The Collision of Ethics and Risk in Securities Law}, 64 U. \textit{PITT. L. REV.} 483, 501-02 (2003) (hereinafter \textit{Economic Suicide}).} 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.\footnote{FINRA Regulation, Inc., \textit{FINRA Rule 2264} (2010) \textit{available at} http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11901} Indeed, with respect to certain high-risk trading strategies, such as penny stocks,\footnote{Sales Practice Requirements for Certain Low-priced Securities, 17 C.F.R. 240.§ 15g-9 (2010).} day trading\footnote{FINRA Regulation, Inc., \textit{FINRA Rule 2130} (2010) \textit{available at} http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8831.} and options trading,\footnote{FINRA Regulation, Inc., \textit{FINRA Rule 2360(b)(16)} (2010) \textit{available at} http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306.} 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) \textit{Duty to Monitor.} All investment advice providers that represent that they are providing advice on an ongoing basis should have a duty to 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 investors' 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*\(^{176}\) described the investment adviser's function as providing "continuous" advice,\(^{177}\) 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.\(^{178}\) In addition, the Restatement (Second) 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.\(^{179}\) 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.\(^{180}\) 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.\(^{181}\) 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-dealers by severing the link between


\(^{177}\) 375 U.S. at 187. See also 505 A.2d at 234-235.

\(^{178}\) SEC, supra note 41.

\(^{179}\) § 425(c) (1958).

\(^{180}\) 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). RESTATMENT (THIRD) AGENCY § 8.08, comment d., states this distinction. See Black & Gross, Economic Suicide, supra note 171, 64 U. Pitt. L. Rev. at 488.

compensation and individual brokerage transactions. 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," and many securities firms at least periodically inquire if there has been a change in their customers’ personal circumstances and update their customers’ profiles.

Finally, both investment advisers and broker-dealers compete head on for business on the basis of the quality of their advice. Both advertise on the basis of the quality of their investment advice and 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 hold themselves out as financial advisers or consultants; many investment advisers call themselves financial planners. Because many retail investors do not perceive a difference between the services provided by broker-dealers and investment advisers, they rely on their investment advice providers’ representations that they are looking out for them. An SEC rule that would impose a monitoring duty on both broker-dealers and investment advisers would be a significant improvement in investor protection and consistent with the modern reality.


184 SEC Rule 17a-3(a)(17)(ii)(B)(3) has 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.

185 RAND report, supra note 3, at 117-118.
Unfortunately, however, Congress restricted the SEC’s authority to adopt standards of care in one significant respect. Section 913(g) 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.” Accordingly, the SEC cannot impose a duty to monitor on broker-dealers and cannot eliminate the most significant distinction between the broker-dealer and the investment adviser under the current law and the source of great confusion for retail investors. This is a serious shortcoming that can only be cured by Congressional amendment. Unless that happens, the SEC should adopt a duty to monitor standard for investment advisers and adopt 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, however, 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 the investors' reliance on oral representations unreasonable when they were inconsistent with the written disclaimer. Because it is important that the investor understands that he cannot expect such services,
the disclaimer should be written in plain English, in bold-face type and require a separate acknowledgement, as by initializing, 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.¹⁸⁸

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 advisers the importance of these professional standards.¹⁸⁹

In addition, as I discuss in Part IV, 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

¹⁸⁸ See Geman v. SEC, 334 F.3d 1183 (10th Cir. 2003) (firm offering wrap-fee program that in its promotional brochure held itself out as independent fiduciary will be held to a fiduciary standard).
¹⁸⁹ This is consistent with the legislative intent expressed in § 913(b)(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
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 IV.

**Part IV: 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.” This Part first explains the limited unavailability of investors' remedies for careless and incompetence 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 III. 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 competence and care established under federal securities laws and SRO rules and acknowledge their importance for 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._

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investor protection in disciplinary or enforcement actions, they resist investors’ efforts to 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. Even in instances where securities professionals hold themselves out as possessing special skills and knowledge, courts are reluctant to hold them to that standard, even though the Restatement (Third) of Agency states it is appropriate to do so. 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, although state courts generally allow investors to bring unauthorized trading claims as a breach of the agency relationship.

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190 See, e.g. Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Geman, 334 F.3d 1183 (10th Cir. 2003).
191 RESTATEMENT (THIRD) OF AGENCY §§ 8.08, 8.11; RESTATEMENT (SECOND) OF TORTS § 299A.
192 RESTATEMENT (THIRD) AGENCY § 8.08; see also Hooker, Professional Ethics, supra note 123, 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 done this, see Geman v. SEC, 334 F.3d 1183 (10th Cir. 2003) (firm offering wrap-fee program that in its promotional brochure held itself out as independent fiduciary will be held to a fiduciary standard).
(2) **Duty of Best Execution.** Investors cannot recover damages for a violation under federal law unless they can establish Rule 10b-5 fraud, although state courts may allow a claim based on negligence.

(3) **Duty to Convey Accurate Information.** As a result of *Gustafson v. Alloyd Co., Inc.*, *Ernst & Ernst v. Hochfelder*, and *Transamerica Mortgage Advisors, Inc. v. Lewis*, 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 a mutual fund. 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 § 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. (2) It can prove that the investor’s losses were caused

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196 *See* Zannini v. Ameritrade Holding Corp., 667 N.W.2d 222 (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).


200 *See supra* note 55 and accompanying text.

201 Section 12(a)(2) does not require a due diligence investigation.
by something other than depreciation in value resulting from the misstatement. This “loss causation” defense may effectively preclude any damages recovery, particularly since courts have not recognized consequential damages based on illiquidity. In the second scenario, assume that the investor can prove that the registered 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 § 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.” (2) Because the prospectus contained accurate information, courts may hold that the investor “knew” that the oral communication was untrue.

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.

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202 Section 12(b).
206 While § 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).
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,\textsuperscript{208} many state courts have been reluctant to impose liability.\textsuperscript{209}

(4) **Suitability Obligation.** Investors have no claim for unsuitable recommendations under federal securities laws in the absence of fraud,\textsuperscript{210} because federal courts do not imply a private cause of action for breach of an SRO rule.\textsuperscript{211} Although some state courts have allowed unsuitability claims based on negligent misrepresentation,\textsuperscript{212} breach of an SRO rule\textsuperscript{213} or breach of fiduciary duty,\textsuperscript{214} others have not.\textsuperscript{215}

(5) **Duty to Warn.** Federal courts do not recognize a duty to warn in the absence of fraud.\textsuperscript{216} Because the broker-dealer's duty to warn is a well-established,\textsuperscript{217} it is hard to explain why state courts are reluctant to enforce it in investors' actions for damages.\textsuperscript{218}


\textsuperscript{215} E.g., Szego v. Craigie, Inc., 1 Va. Cir. 210 (Va. Cir. 1980)(holding there is no private cause of action for NASD violations).

\textsuperscript{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, 1991 U.S. App. LEXIS 5472 (9th Cir. 1991)(unpublished).

\textsuperscript{217} See supra note 170 and accompanying text.

\textsuperscript{218} For rare exceptions, see Beckstrom v. Parnell, 730 So.2d 942 (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); Gochnauer v. A.G. Edwards & Co., 810 F.2d 1042 (11th Cir. 1987) (affirming trial court's holding that broker should have warned customer about changing from a conservative to a speculative investment strategy when he recommended an options expert). These opinions are discussed in Black & Gross, *Economic Suicide,*
Courts do not provide extensive analysis; they frequently state that the internal rules are for the protection of the firm and express a concern that firms with higher standards would be exposed to greater liability.

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

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 application 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. Courts worry about “hindsight bias,” that fact finders will

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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., Newman v. Rothschild, 651 F. Supp. 160 (S.D.N.Y. 1986); Bogart v. Shearson Lehman Bros., Fed. Sec. L. Rep. (CCH) ¶ 98,733 (S.D.N.Y. 1995).


find investment advice faulty because it turned out to be unsuccessful. They apparently fear that 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 competence and care in private damages actions will protect securities professionals that have acted carefully and competently from liability from 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 careful and competent broker-dealers and investment advisers will be protected. 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 in fraud. The broker-dealer and investment advisory industries are large and complex, and there has never been an era where government and SRO resources were sufficient to police it adequately. In an era where governments are running at a deficit and state governments, in particular, are

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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 Competence and Care Create Additional Remedies for Investors? Since the Obama administration early on identified “increas[ing] fairness for investors” as a goal, 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. We next consider the possibility that federal or state courts would recognize investors’ negligence claims based on breach of these professional standards.

Federal Law. It is unlikely that the Supreme Court would, under its current approach, 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, and the Court’s current approach is to require affirmative evidence showing Congressional intent. 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

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227 See supra note 60.
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 §12(a)(2). S. 3976, CONGR. REC. S3566 (May 11, 2010).
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.
private cause of action when it wants to.\textsuperscript{232} The Supreme Court’s search for Congressional intent begins with an examination of the statute’s text and structure.\textsuperscript{233} In \textit{Transamerica}, the Court found that Congress intended a limited rescissionary remedy in a statement that a contract “shall be void;”\textsuperscript{234} by contrast, in \textit{Alexander v. Sandoval},\textsuperscript{235} the Court found that the express provision of one method of enforcement suggested that Congress intended to preclude others.\textsuperscript{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.\textsuperscript{237} In \textit{Touche Ross v. Redington},\textsuperscript{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 § 17(a) was designed to provide protection for brokers’ customers does not require the implication of a private damages action on their behalf.”\textsuperscript{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 assumed that investors could enforce the standards in damages actions is (1) Congress, in Section 913, gave the SEC the authority to adopt these

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\item Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1979) (holding that Advisers Act § 215(b) stating that contracts that violate any provision of the Act “shall be void” implied a limited rescissionary remedy, but not a damages remedy)
\item Id. at 18.
\item Merrill Lynch v. Curran, 456 U.S. 353 (1982) (holding that there was a private damages remedy under CFTC Act because Congress assumed one existed when it amended statute)
\item Id. at 560 (1979).
\item Id. at 578.
\item Id. at 290.
\end{enumerate}
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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 § 913 contains a reference to private enforcement. 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 § 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.

*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 SRO standards, such as the NASD suitability rule, in setting forth duties of care owed to investors. State courts may place more weight on professional standards adopted by the SEC, the federal agency charged with the responsibility of protecting

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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.
investors, in establishing the appropriate duty of care for investment advice providers. 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.

C. Mandatory Securities Arbitration. As the Supreme Court advanced its pro-arbitration policy in recent years, Congress has expressed concerns about the fairness of mandatory arbitration provisions in contracts where employees and consumers realistically have little choice. 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.” 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 charged with responsibility for enforcing federal securities laws, authority with respect to state law claims. 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 comprise, because of the difficulties in proving federal claims, most investors’ claims.

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243 RESTATEMENT (THIRD) AGENCY § 8.08, comment b, stating that “[i]f 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.”

244 Gross, *The End?*, supra note 87, 30 PACE L. REV. at .

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

246 See supra notes 44-54 and accompanying text.
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)\(^\text{248}\) 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.\(^\text{249}\) While the system is not perfect, FINRA, under SEC oversight, has enacted major reforms in recent years to improve the fairness of the forum.\(^\text{250}\) It is also true, however, that many investors who have filed claims with the FINRA forum have negative perceptions about its fairness.\(^\text{251}\) Accordingly, it is incumbent upon FINRA to continue to improve the quality of the arbitration forum, and to its credit it continues to do so. Most recently, it has, for example, permitted parties, in a pilot program, to select

\(^{247}\) 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.

\(^{248}\) See supra note 86.


arbitration panels without an industry arbitrator, and it has adopted a rule that requires arbitration panels to give reasons for its decision if both parties request it.

Whatever its imperfections, from the investors' perspective, the great advantage of FINRA arbitration forum, with its emphasis on equity, is that arbitrators can fashion a remedy for investors that may not be supported by the law. 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. Moreover, eliminating the broker-dealer’s right to require arbitration in a PDAA may have a serious negative impact on most retail investors that is not fully appreciated.

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 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. A sensible agency choice might be to defer any action

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254 Black & Gross, Making It Up, supra note 59, 23 CARDOZO L. REV. at 995.
255 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, Is Securities Arbitration Fair?, supra note 86, 25 PACE L. REV. at 4.
256 See Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (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).
until such time as Congress took 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 evaluate their choices differently, but at least some firms may decide simply to eliminate any PDAA from their customers’ agreement. 257

Here we must introduce another uncertainty. What makes securities arbitration different from other consumer and employment arbitration is that, under FINRA Rule 12200, 258 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 Rule 12200 if Congress and the SEC decide to limit or prohibit mandatory arbitration. 259 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 (for example, a claim based on violation of a 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. If that proved successful,

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


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 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.260 Similarly, brokerage firms have cost advantages attributable to mandatory arbitration that may be lost in a voluntary system.261 Once a dispute has arisen, each side will have a view about its claim will fare better in court or in arbitration. As a result, they are unlikely to agree, post-dispute, on a choice of forum.

Suppose, for example, a $25,000 claim for 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 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


261 Estreicher, Saturns for Rickshaws, supra note 260, 16 Ohio St. J. on Disp. Resol. at 563-565.
and consumer) that post-dispute arbitration agreements are rare.\textsuperscript{262} 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 a 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 congressional goal of improving protection for retail investors.

\textbf{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!