Summer July 27, 2013

“UNDER PRESSURE”: BASEL III’S CAPITAL ADEQUACY REQUIREMENTS SQUEEZE BROKER-DEALER RETURNS ON EQUITY, INCREASE NEED FOR THE IMPOSITION OF UNIFORM FIDCUIARY DUTIES

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Abstract

The most recent round of international banking regulations promulgated by the Basel
Committee on Banking Supervision, called Basel III, is an attempt to prevent future global
recessions by implementing tougher capital requirements on financial institutions. However,
these regulations have also been made applicable to broker-dealer operations, and new methods
of calculating capital reserves will choke available liquidity, both in-house and on the repo
market, which in turn will reduce broker-dealer profitability, as measured by returns on equity
(ROE). While this is troublesome for broker-dealer shareholders and bank managers, it is even
more troubling for the SEC, FINRA, and the clients of broker-dealers, who will likely have to
deal with increased instances of fraud as broker-dealers try intently to achieve pre-Basel III
profitability.
I. INTRODUCTION

The most recent global financial crisis brought about a number of regulatory reforms, both in the United States and abroad. However, none of these reforms have impacted broker-dealers as much as the new global regulatory standards that the Basel Committee on Banking Supervision has adopted, colloquially termed “Basel III”. While Basel III regulations primarily cover capital adequacy, stress testing, and market liquidity rates, the new capital and margin requirements have put increased pressure on broker-dealer’s profitability, particularly their returns on equity (ROE). New capital requirements, including the mandate for financial institutions to maintain “loss-absorbing” capital equal to at least seven percent of the risk-weighted assets they hold, have been met with criticism from industry leaders specifically because of concerns surrounding profitability. Although these new capital standard requirements intend to strengthen the international financial community and prevent another global collapse, bankers and financial industry experts are concerned that they may place too much pressure on broker-dealers. While meeting new capital requirements may be a problem for financial institutions that engage in broker-dealer activities, the real problem comes from the increased incentive for fraud and unethical behavior by broker-dealers in order to meet profit expectations while complying with a stricter regulatory environment.

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4 Brooke Masters & Justin Baer, U.S. Banks Face $100 Billion Capital Shortfall, FIN. TIMES (Nov. 22, 2010), http://www.cnbc.com/id/40309961 (noting that the top 35 U.S. banks would be between $100 and $150 billion short in equity capital after Basel III was implemented, with the shortfall primarily coming from the top 6 banks).
Part II of this article will briefly explain the current apparatuses for regulating broker-dealers and categorize, historically, how they have committed fraud. Part III will explore Basel III and focus on explaining how the new capital adequacy requirements are calculated and what that means for financial institution’s bottom lines. Part IV will be dedicated to demonstrating how these new capital standards requirements impact broker-dealers, specifically why they could lead to an increase in fraud. Part V will explain the current fiduciary standard applied to broker-dealers at the state level, paying particular attention to the three different categories of common law fiduciary relationships. Part VI will discuss what a uniform fiduciary standard is, current attempts at implementing it, and how full-scale implementation would help fight the rise in risky and fraudulent behavior that Basel III is expected to cause.

II. REGULATION OF BROKER-DEALERS

Academics and policy makers seem to have broken down the definition of a broker-dealer into two distinct, yet interrelated parts: (1) the institutional broker-dealer and (2) the individual broker-dealer. It is important that these two types of broker-dealers be differentiated, as Basel III will only directly pressure one, the institutional broker-dealer, yet have a significant indirect effect on the other, the individual broker-dealer. As this article will identify, new capital calculation methods and reserve requirements will strain the liquidity that has become a staple of institutional broker-dealers funding methodology, which will in turn directly affect the ability of individual broker-dealers to continue the level of pre-Basel III purchasing, leading them (and even the institutional broker-dealer) to risk-prone investment decisions and an increase in the level of fraud.

Institutional Broker-dealers are a type of financial institution, which includes some of the nation’s largest investment banks, that that finance their asset purchases via security repurchase
agreements and other types of short-term credit sources, usually from other large financial institutions. Currently these types of institutions are “not subject to the same risk-based capital ratios as commercial banks”\(^\text{5}\), although the most recent standards promulgated by the Basel Committee on Banking Supervision will change this exempt status.

However, an individual broker-dealer is “someone who effects securities transactions for customers either on a commission or mark-up/mark-down basis”\(^\text{7}\). This term encompasses the two distinct words that compose the term “broker-dealers”, as a broker is “one who effects the securities transaction on behalf of another”\(^\text{8}\), while a dealer is “one who buys and sells particular securities”\(^\text{9}\). However, dissecting the term still permits for ambiguity, as it can include a number of customary and non-customary candidates for classification as broker-dealers.\(^\text{10}\) Broker-dealers have traditionally served as salesman, arranging the purchasing and sale of securities for clients, instead of investment advisers, who have historically counseled customers.\(^\text{11}\)

A. Current Regulatory and Enforcement Regimes

Broker-Dealers are currently regulated by the Securities Exchange Act of 1934 (the “1934 Act”) and are sometimes subject to common law fiduciary requirements by state courts.


\(^{6}\) John Holman, Note, A Flawed Solution: The Difficulties of Mandating a Leverage Ratio in the United States, 84 S. CAL. L. REV. 713, 728 (2011) (noting one the major differences between broker-dealers and traditional financial institutions lies in their respective capital requirements).

\(^{7}\) David A. Lipton, A Primer on Broker-Dealer Registration, 36 CATH. U.L. REV. 899, 899 (1987).


\(^{9}\) Id.

\(^{10}\) Id. at 900 (noting that the designation broker-dealer can apply to traditional investment personnel as well as non-traditional persons, such as vice-presidents of energy exchange and trading companies).

although those standards vary widely. The 1934 Act is the central apparatus for regulatory control over broker-dealers and gives the Securities and Exchange Commission (“SEC”) broad rulemaking authority regarding broker-dealers, including the ability to discipline them for breaking federal law. However, what is unique about the current state of broker-dealer regulation is that the SEC delegates most of its rulemaking authority to self-regulatory organizations (“SROs”), with the Financial Industry Regulatory Authority, or FNRA, being primarily responsible for establishing rules and standards by which broker-dealers are required to abide. This kind of industry self-regulating regime is made possible by Sections 15(b)(1) and 15(b)(8) of the 1934 Act, which requires broker-dealers to both register with the SEC and become a member of a qualifying self-regulatory organization, which may be either a registered securities association or a national exchange.

B. Traditional Types of Broker-Dealer Fraud

Broker-Dealer fraud is not a recent phenomenon, as Congress has been seriously concerned with fraud committed specifically by broker-dealers since 1934. However, over the years several distinct trends have emerged in broker-dealer fraud and misconduct, allowing academics and policy makers to create imperfect, but easily identified categories of broker-dealer fraud.

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15 Alan Lawhead, Useful Limits to the Fifth Amendment: Examining the Benefits that Flow from a Private Regulator’s Ability to Demand Answers to its Questions During an Investigation, 2009 COLUM. BUS. L. REV. 210, 252 (2009)(noting that this rulemaking delegation is done primarily because the SEC lacks the resources to oversee broker-dealer regulation by itself).
fraud. The most common allegation of broker-dealer misconduct is a claim of unsuitability.\textsuperscript{19} These suits, brought under §10(b)(5) of the 1934 Act, allege that the broker violated the SRO’s regulations in that he or she did not have “reasonable grounds for believing that the recommendation of a particular security was suitable for the customer”\textsuperscript{20}. While claims such as churning\textsuperscript{21} are also common against individual broker-dealers, institutional brokers are subject to claims of fraud as well. Since the SEC began policing capital requirements, broker-dealers at the institutional level have failed on a number of occasions\textsuperscript{22} to comply with the Net Capital Rule\textsuperscript{23}, which requires broker-dealers to maintain a minimum capital cushion to ensure it can repay customers in the case of an institutional collapse\textsuperscript{24}. All of these common types of fraud are major concerns in the new Basel III-era of reduced liquidity and only by imposing a tougher uniform fiduciary standard on broker-dealers can the SEC and other financial regulatory agencies ensure that fraud does not become an epidemic.

\textbf{III. WHAT IS BASEL III?}

\textsuperscript{19} Lewis D. Lowenfels & Alan R. Bromberg, \textit{Suitability in Securities Transactions}, 54 BUS. LAW. 1557, 1557 (1999) (noting that “unsuitability claims account for 95% of filing under NASD members’ errors and omission insurance policies).


\textsuperscript{21} Robert T. Greene, Comment, \textit{Differential Commissions as Material Fact}, 34 EMORY L.J. 507, 525 (1985) (noting that churning occurs when a “broker-dealer, to obtain commissions, engages in trading activity in a customer’s account beyond the customer’s invest objectives”).

\textsuperscript{22} Bruce Kelly, \textit{Questions Raised about Broker-Dealer’s Financial Health}, INVESTMENT NEWS (May 30, 2013), http://www.investmentnews.com/article/20130530/FREE/130539991 (noting that broker-dealers, such as Allied Beacon Partners, Inc., have in the past failed to comply with the Net Capital Rule). \textit{See also} Thomas W. Joo, \textit{Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure}, 72 S. CAL. L. REV. 1071, 1086 (1999)(explaining that historically, compliance with minimum capital requirements has been a problem area for institutional broker-dealers).

\textsuperscript{23} 17 C.F.R. § 240.15c3-1 (1983); Jorge E. Vinuales, \textit{The International Regulation of Financial Conglomerates: A Case-Study of Equivalence as an Approach to Financial Integration}, 37 CAL. W. INT’L L.J. 1, 39 (2006)(explaining that the Net Capital Rule requires a broker-dealers to maintain minimum capital levels, as calculated by use of the accompanying appendices to the rule).

\textsuperscript{24} Stepehn Zak, \textit{Market Regulation Isn’t as Broken as We Think It Is}, TABB FORUM (Mar. 12, 2013), http://tabbforum.com/opinions/market-regulation-isn't-as-broken-as-we-think-it-is.
Banking regulations are not set by individual nations working alone, as the resulting financial landscape would be a steep race to the bottom to attract large financial institutions.\(^\text{25}\) Instead, the Basel Committee on Banking Supervision, an international regulatory body based in Switzerland, will promulgate standard minimum regulations for the central bank and financial regulators in individual countries to adopt.\(^\text{26}\) Like the previous Basel Accords, Basel III is “a series of global financial regulations” that were issued by the Basel Committee on Banking Supervision in response to the perceived failings of the international financial community during the Great Recession.\(^\text{27}\) Non-binding in nature, the Basel Accords can and have been widely adopted by a number of nations, although they are a contentious issue in many states, including the United States, where banking professionals and bank regulators often have differing views of the necessity of such requirements.\(^\text{28}\) Although most of the international community has previously adopted Basel III, the United States did not formally approve the final rules for the new capital standard implementation under Basel III until July 2, 2013.\(^\text{29}\)

Ultimately, the primary goal of Basel III is “to strengthen the global capital framework” by “raising the quality, consistency and transparency of the capital base” \cite{basel-iii} of financial institutions.\(^\text{30}\) Under previous Basel Accords, bank’s capital requirements have been determined using a risk-weighted calculation of the bank’s assets, known as the risk-weighted

\(^{25}\) Ed Dolan, \emph{What is the Liquidity Coverage Ratio for Banks and why Should we Care that it Has Been Watered Down?}, ECONOMONITOR (Jan. 11, 2013), \url{http://www.economonitor.com/dolanecon/2013/01/11/what-is-the-liquidity-coverage-ratio-for-banks-and-why-should-we-care-that-it-has-been-watered-down/}.

\(^{26}\) Tom Brainthwaite, \emph{Banks Await Orders as Fed Acts on Basel III}, FINANCIAL TIMES (July 2, 2013), \url{http://www.ft.com/cms/s/0/94abb696-e337-11e2-9bb2-00144feabdc0.html%23axzz2ZtvNtf8n} (noting that the Basel Committee promulgates standards for the central banks of individual nations to adopt).


\(^{28}\) See id. at 520.

\(^{29}\) David Reilly, \emph{Banks Need Tougher Love from the Fed}, WALL STREET J. (July 2, 2013), \url{http://online.wsj.com/article/SB10001424127887324251504578581703410210648.html} (reporting that on July 2, 2013, the Fed adopted the final rules required to implement new Basel III regulations).

asset (RWA) framework. While Basel III will continue to use the RWA framework, it will also adopt a “universal leverage ratio as an additional measure of capital adequacy”, which will involve a direct comparison of capital to assets without risk weighting and, in fact, will require financial institutions to perform these calculations independently from those used to determine their risk-weighted capital requirement. In addition to increasing the capital requirement for financial institutions, the Basel III framework would impose a minimum Liquidity Coverage Ratio and a Net Stable Funding Ratio on all financial institutions, including institutional broker-dealers, who will have to adjust their current asset holdings and funding methodologies to meet these new regulations.

IV. HOW DOES BASEL III PRESSURE BROKER-DEALERS?

A. A Brief Explanation of Broker-Dealer Funding and How Basel III Would Affect Traditional Funding Sources

Basel III attempts to insure that banks have enough cash capital to meet a larger portion of its liabilities than it did under the old capital requirement regime, which is difficult to implement for broker-dealers as their activities are financed by an unusual method. Called the repurchase, or repo, market, broker-dealers rely on short-term loans, made available to them by other financial institutions and usually lent overnight, in return for collateral that is equal to


100% of the value of the loan. Dealers will then repurchase the collateral, usually securities, at a later date, and the cash is sent back to lenders. This market, while comparatively under regulated given the sheer volume and financial worth of the assets traded, was a major target of Basel III regulators and is set to become the subject of tighter restrictions in an attempt to avoid the liquidity crisis that triggered the Great Recession.

Basel III establishes two separate liquidity standards in an attempt to ensure that banks have adequate capital reserves to preserve liquidity in the face of financial distress. The first, the “Liquidity Coverage Ratio” (LCR), would require banks to “hold sufficient high quality liquid assets to cover total net outflows…allowing them to weather a stressed period” without relying on a central bank for liquidity support. The LCR, which is scheduled to be implemented sometime in 2015, was originally intended to be comprised of government bonds, but the recent sovereign debt crisis in Europe has led to a more relaxed definition of what was an acceptable high-quality liquid asset (HQLA). Two distinct categories of assets comprise

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40 Edward F. Greene & Joshua L. Boehm, The Limits of “Name-and-Shame” in International Financial Regulation, 97 CORNELL L. REV. 1083, 1114 (July 2012)(noting that in the original vision of Basel III, government bonds formed a majority of the HQLA that banks could use when calculating the LCR).
41 Noam Noked, Basel Committee Revises Basel III Liquidity Coverage Ratio, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Feb. 3, 2013), http://blogs.law.harvard.edu/corpgov/2013/02/03/basel-committee-revises-basel-iii-liquidity-coverage-ratio/ (explaining that the Basel Committee relaxed the LCR requirement in Basel III to permit other, non-government backed securities to form a significant portion of the bank’s HQLA for purposes of LCR calculations).
HQLA for the purpose of LCR determination. However, securities held by consumers, which compromise a significant amount of institutional broker-dealers asset holdings, will not be eligible for HQLA status, either as Level One or Level Two assets. As a result, financial institutions that engage in broker-dealer operations will likely look to divest a significant amount of its’ security holdings in favor of more stable Level One and Two assets in order to meet the Liquidity Coverage Ratio requirements. Even the watered down LCR requirements proposed this year will still force banks, albeit to a smaller extent, to favor the holding of easy-to-sell assets in favor of the traditionally less stable consumer securities in order to gather enough HQLAs to meet the 60% LCR mark by Jan. 1, 2015.

The second requirement, the “Net Stable Funding Ratio” will require banks to match short-term corporate loans and other assets (including securities) with long-term funding in an attempt to wean banks from their reliance on short-term funding sources in favor of long-term funding of assets. The NSFR is determined by measuring the short-run capital sufficient of a financial institution, not its cash flows. Therefore, the only types of capital that will count towards the bank’s fulfillment of the NSFR minimum requirement are those that have maturities greater than or equal to one year (in addition to demand deposits not likely to be withdrawn in

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42 Andrew W. Hartlage, Note, The Basel III Liquidity Coverage Ratio and Financial Stability, 111 Mich. L. Rev. 453, 463 (2012)(noting that the full market value of Level 1 assets will be applied to the LCR, while only 40% of the market value of Level 2 assets, which includes corporate bonds, covered bonds, and sovereign securities will be applied. No other assets will count towards a bank’s LCR).


the event of a bank run). This means that “banks that rely too heavily on short-term wholesale funding or do not hold sufficient high quality liquid assets” will struggle to adjust to the new ratio requirements as they seek medium- and long-term funding options as opposed to short-term options. Institutional broker-dealers, who typically rely on funding through the repo market will struggle to find additional sources of funding for their security purchase and sale operations, opting to find more expensive funding that lacks the liquidity that makes the repo market an attractive option for broker-dealers. As a result, individual broker-dealers will be pressured to engage in riskier trades and engage in fraud to lure customers into securities purchases to cover increased lending over-head.

B. Impact of Basel III on Broker-Dealers

So how do these new capital reserve requirements impact broker-dealers? Quite simply, any reduction in the amount of capital that broker-dealers are required to maintain threatens to reduce dealer’s profitability, as evidence by decreasing returns on investments. When financial institutions have to increase capital reserves to meet Basel III regulatory guidelines, the scarcity of capital will call into question broker-dealer’s capacity to meet the demand for long-run leverage as investor’s appetite for risk returns. In addition to a scarcity of capital for intraday trading loans, the regulatory formulas that financial institutions will have to abide by will also impact the manner and volume of broker-dealers’ operations. There are a number of reasons

why the new capital calculation requirements will adversely affect available traditional funding for broker-dealer operations, including: (1) the inclusion of securities financing in the calculation of risk weighted assets (RWAs) and (2) the extension of the liquidity coverage ratio (LCR) to broker-dealer asset stockpiles.\textsuperscript{52}

By subjecting securities financing to risk weighted asset calculation, brokers will have to account for a capital charge in proportion to the size of their financing activities\textsuperscript{53}, thus increasing their need to borrow more intra-day funds just to maintain their current trading volume. Additionally, new minimums for liquidity coverage ratios will prevent broker-dealers from being able to adequately fund long-term transactions through fund acquisition on the repo market, as the amount of capital that will be required to be set aside will make that traditional funding structure prohibitively expensive.\textsuperscript{54} Therefore, broker-dealers will have substantially less access to traditional capital sources, namely because other large financial institutions will be required to dedicate more assets to capital reserve requirements, and their inclusion in their own institutions capital reserve calculations will reduce in-house funding. Additionally, broker-dealers could look to curtail the number of long-term liabilities that it commits itself to in an attempt to reduce their RWA calculation, thus further stretching broker-dealer’s potential profitability.

C. Why is Fraud a Concern in the Post-Basel III Financial Regulatory Environment?

Although fraud is always a concern for courts and lawmakers in the financial sector, the increased capital requirements imposed by Basel III and the Federal Reserve have the potential to create an environment where fraud is the only way for broker-dealers to survive. A number of

\textsuperscript{52} Id. (noting the two ways in which capital reserve requirements imposed by Basel III will affect broker-dealer funding).

\textsuperscript{53} Devasabai, supra note 51.

\textsuperscript{54} Id.
banking executives, broker-dealers, and financial industry professionals have expressed concern that increased minimum capital level requirements will put unnecessary strain on financial institutions that engage in broker-dealer regulation and in fact, threaten their ability to turn a profit. The paramount concern for finance industry professionals and broker-dealers in particular are the negative effects that Basel III will have on industry profitability, particularly as measured by return on equity (ROE).\(^55\) Because the firms that engage in fraud typically can increase their profits compared to firms that do not engage in fraud\(^56\), in an era where broker-dealer profitability is threatened, fraud could be the only way for financial institutions to achieve pre-Basel III levels of profitability from trading activity. The increased incentive to commit fraud, from trading in increasingly ‘unsuitable’ securities to engaging in fraudulent sales practices, has put broker-dealer fraud at the top of the SEC’s priority list for at least the next year.\(^57\)

It is a fairly well accepted principle that poor economic conditions, either at the macro- or microeconomic level, are linked to an increase in fraud.\(^58\) This concurrent trend, with macro-level concerns causing managers and directors to increase pressure on broker-dealers to keep up profitability in the Basel III era and micro-level concerns plaguing broker-dealers (namely concern about personal finances)\(^59\), threaten to create a perfect storm for increased broker-dealer fraud. Since the bleak economic climate will always make concern for individual finances a risk

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\(^{59}\) Tracy Coenen, *Essentials of Corporate Fraud* (2008) (noting that questions and concerns about individual financial stability is a contributing factor to corporate and investment fraud).
factor, it is the pressure that Basel III puts on institutional broker-dealers that threatens to increase fraud levels. Strict capital regulation and the inclusion of risk-weighted assets in capital reserve calculation threaten to reduce available liquidity for broker-dealers and greatly diminish the return on equity that serves as a benchmark for broker-dealer profitability. This increased pressure will permeate broker-dealer institutions, from the director level to investment advisors, and threatens customers through the risk of increasingly risk-prone broker-dealers and threatens the American economy, by inducing artful accounting of risk-weighted assets to skirt Basel III capital requirements.

V. CURRENT STATE OF BROKER-DEALER’ LEGAL RESPONSIBILITIES TO CLIENTS

Although there is currently no standardized duty extending from broker-dealers to all clients, Section 913 the Dodd-Frank Act mandated the Securities and Exchange Commission (SEC) to study the need for implementing a uniform fiduciary standard of care for those that provide personalized investment advice. Currently, the SEC is in the preliminary stage of their rule-making phase, as the public comment period began March 1, 2013 and the agency is currently seeking data from interested parties concerning the costs and benefits of adopting such a rule. Although the SEC was granted the direct authority to pass new regulations over three years ago, whether they will adopt formal regulations in the future is still a mystery.

A. Current State of Broker-Dealer’s Fiduciary Duties

Academics have identified three distinct categories of state regulation of broker-dealers: (1) those that unambiguously apply a fiduciary standard; (2) states that unambiguously apply no

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60 GRANT-THORTON, supra note 2 (noting that Dodd-Frank required the SEC to study the feasibility and need to create a uniform fiduciary standard of care).
fiduciary responsibilities; and (3) states that have adopted a limited fiduciary standard to regulate
the broker-dealer-client relationship.62 There is currently a rather substantial body of common
law that holds that a “broker who recommends an unsuitable security breaks his fiduciary duty to
the customer”.63 However, this law is not consistent from state to state, as places such as New
York have found a fiduciary duty to exist only in respect to matters that the client entrusts to the
broker-dealer64, while states such as Massachusetts have held that the broker-dealer-client
relationship is merely a business arrangement, not a fiduciary relationship65. To add even more
confusion to idea of fiduciary relationships, some states have found that fiduciary obligations
extend to broker-dealer-client relationships in specific, narrow situations, while it does not in
others.66 Some state courts have imposed almost equity based liability on broker-dealers who
recommend unsuitable securities, finding that they are liable for breaches of fiduciary duties
even in situations where educated clients have authorized the transaction.67

1. First Category: Complete Fiduciary Relationship between Broker-Dealer and Client

Ohio courts have been exceedingly clear that a broker-dealer is a fiduciary who owes
their customer a high degree of care throughout the transaction.68 In fact, the Ohio approach has
explicitly elucidated affirmative requirements for broker-dealers, including mandatory disclosure

that a broker who makes a recommendation to a client, but ignores the unsuitability of the investment, may be in
breach of their fiduciary duty to the client).
65 See Brine v. Paine, Webber, Jackson & Curtis, Inc., 745 F.2d 100 (1st Cir. 1984).
66 Poser, supra note 63, at 1555.
faulty security and the executive in charge of a company’s profit-sharing plan not only approved the transaction,
but had expressed an affirmative desire to enter into the transaction).
of all material information which he learns concerning the subject matter of the fiduciary relationship and the imposition of a duty for a broker-dealer to give the client information in a manner timely enough to permit the client to protect his interests.\textsuperscript{69}

However, a number of states have enacted statutory schemes whose duties, while universal within the state, are not as specific as those exposed by the Ohio courts. Nebraska, for example, has codified broker-dealers fiduciary duties in Neb. Rev. Stat. § 8-1102(1), which merely prevents broker-dealers from: (1) employing a fraudulent device, scheme, or artifice, (2) making untrue statements, (3) or engaging in any act, practice, or course of business which would operate as a fraud or deceit.\textsuperscript{70} Most of the duties codified as fiduciary duties appear to be mere reiterations of the Nebraska Unfair and Deceptive Trade Practices Act\textsuperscript{71} and do not precede or follow any discussions of the role of fiduciary duties in the broker-dealer relationship. Instead, the Nebraska Supreme Court is quick to begin its discussion of the federal rules that govern broker-dealer activities\textsuperscript{72}, which could point to a judicial reluctance to strictly interpret a state-wide uniform standard of fiduciary duty.

\textbf{2. Second Category: Limited Fiduciary Relationship}

Even with states that have imposed broad based fiduciary duties on broker-dealers, the duty is normally limited to those investors that are customers.\textsuperscript{73} However, in addition to this general limitation, courts in a number of jurisdictions have held that although a fiduciary relationship does not arise as a matter of law, pleading additional facts can suffice to create a

\textsuperscript{69} \textit{In re Estate of Sedgwick}, 74 Ohio App. 444, 460 (Ohio Ct. App. 7th Cir. 1944).


\textsuperscript{71} Myers, \textit{supra} note 70 (discussing federal unsuitability claims after laying out the Nebraska state statute and failing to include any extended discussion or interpretation of the Neb. State law).

fiduciary relationship. While there are a variety of different factual allegations that could lead to the imposition of fiduciary liability, chief among those considerations is whether the firm or the broker-dealer specifically, gained the trust and confidence of its client.

For instance, the appellate courts in Colorado have been presented with the issue of fiduciary relationships between broker-dealers and customers a number of times and although they don’t impose fiduciary responsibilities as a matter of law, they often find sufficient factual information to justify the imposition of one. In Johnston v. CIGNA Corp., the Colorado Court of Appeals flatly rejected the notion that a broker-dealer never owes a fiduciary duty to a customer, exploring instances where the state supreme court had found such a duty to exist. What is notable about the dicta in this case is that the appellate court notes that an issue of material fact exists as to whether or not a fiduciary duty exists, as the court is not able to decide as a matter of law. This is illustrative of the second way that state courts have limited broker-dealer fiduciary relationships; instead of creating a state-wide universal fiduciary standard, the courts will base their decision to find a fiduciary relationship on a factual finding that in a particular situation, the clients reposed trust and confidence in the broker-dealer. This follows the general approach adopted by a number of states, who, although they will not find a fiduciary duty as a matter of law, will find that fiduciary obligations extend to broker-dealers.

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74 Fredrick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 Ariz. St. L.J. 535, 556 fn 69 (2005) (citing Fey v. Walston & Co., 493 F.2d 1036, 1049 (7th Cir. 1974))(noting that a majority of cases applying state common law in the Circuit do not find fiduciary duties to arise as a matter of law, but are open to imposing them if a party can plead additional facts to sustain a claim that a fiduciary relationship exists).


77 Id. at 648 (“Defendant’s characterization of themselves as “broker-dealers” rests on their assumption that a broker-dealer does not owe a fiduciary duty to a customer. However, that is not necessarily the case).


79 Paine, Webber, Jackson & Curtis, Inc. v. Adams, 7`8 P.2d 508, 522-524 (Col. Sup. Ct. 1986)(noting that there are four factors to determine whether the broker-dealers has “functional control” over the customer’s account).
when they have prior authorization to trade for the client on a discretionary basis, or control of
the account.80

3. Third Category: No Fiduciary Relationship

Although a number of states have imposed some varying level of fiduciary responsibility
on broker-dealers, some state courts have resisted judicial imposition of such a relationship.81
Believing that the broker-dealer client relationship is a “business relationship” rather than a
fiduciary one, courts have found that broker-dealers often do not act as agents, especially when
working with large, institutional clients, therefore making fiduciary duties not applicable.82 In
Banca Cremi, S.A. v. Alex. Brown & Sons83, the Fourth Circuit, applying Texas state law, found
that no such fiduciary relationship applied to broker-dealers who “conducted their business at
arm’s length in a principal-to-principal relationship.”84 Federal Courts applying New York law
have also come to the conclusion that parties, when they contract at arms’ length, do not carry
fiduciary duties with them.85 However, these holdings have limited their finding of no fiduciary
relationships between broker-dealers and clients when the customer is another business-savvy
party, finding that one is unlikely to take advantage of the other.86 Whether it be for moral
hazard purposes, or simple calculations based on the findings of facts, if there is no concern for

80 See United States v. Szur, 289 F.3d 200, 211 (2d Cir. 2002) ([A] relationship of trust and confidence does exist
between a broker and a customer with respect to those matters that have been entrusted to the broker.); Tapia v.
Chase Manhattan Bank, N.A., 149 F.3d 404, 412 (5th Cir. 1998) (Where the investor controls a nondiscretionary
account and retains the ability to make investment decisions, the scope of any duties owed by the broker will
generally be confined to executing the investor's order.).
81 Hazen, supra note 17, at 742 (noting that a majority of states applying common law hold that there is no blanket
fiduciary relationship between a broker-dealer and their client as a matter of law).
82 Liability of Broker- Dealers for Unsuitable Recommendations to Institutional Investors, 2001 B.Y.U.L. REV. 1493,
83 132 F.3d 1017 (4th Cir. 1997).
84 Id. at 1038.
85 Beneficial Commercial Corp. v. Murray Glick Datsun, Inc., 601 F. Supp. 770, 772 (S.D.N.Y. 1985); Gruman Allied
Indus., Inc. v. Rohr Indus., Inc., 748 F.2d 729 (2nd Cir. 1984).
York State law, found that where the parties are “counterparts”, or on equal business footing, neither party needs
to be protected by the imposition of fiduciary duties).
consumer protection, courts have historically not been willing to imbue broker-dealers with fiduciary responsibilities.

VI. UNIVERSAL LEGALLY COGNIZABLE FIDUCIARY DUTIES WOULD PREVENT FUTURE FRAUD

A. The Uniform Standard of Fiduciary Duty for Broker-Dealers

Instituting a uniform standard of fiduciary responsibilities for broker-dealers would, at the very least, “end the era of regulating brokers under a commercial standard that treats advice as a byproduct without fiduciary accountability”.\textsuperscript{87} Currently, only a narrow segment of broker-dealers are subjected to full-blown fiduciary responsibilities, but those that are typically have reported higher asset growth, stronger revenue growth, and obtain a greater share of client assets that those that operate with limited or no fiduciary responsibilities.\textsuperscript{88} However, the goal of implementing a uniform fiduciary standard is not monetary, but is instead designed to reduce fraud perpetrated by broker-dealers. So what would a universal fiduciary standard look like?

A universal fiduciary standard for broker-dealers would look similar to that adopted by many states today and would likely mirror that currently applied to Registered Investment Advisers (RIAs).\textsuperscript{89} Imposed by the Investment Advisers Act of 1940 (“Advisers Act”), the fiduciary standard for RIAs creates an “affirmative duty of utmost good faith, and full and fair disclosure of material facts as well as an affirmative obligation to employ reasonable care to


\textsuperscript{88}See Michael Cohn, Study Argues in Favor of Uniform Fiduciary Standard, ACCOUNTING TODAY (July 8, 2013), http://www.accountingtoday.com/news/Study-Argues-Favor-Uniform-Fiduciary-Standard-67355-1.html (noting that monetary benefits that have followed the imposition of fiduciary standards on broker-dealers).

\textsuperscript{89}Warren S. Hersch, Don’t Extend RIA Fiduciary Standard to Broker-Dealers, LIFEHEALTHPRO (June 7, 2013), http://www.lifehealthpro.com/2013/06/07/dont-extend-ria-fiduciary-standard-to-broker-dealers (noting that the uniform fiduciary standard applied to broker dealers would be similar to the one currently applied to RIAs.
avoid misleading their clients”\textsuperscript{90}. An SEC study completed in 2011 suggested that broker-dealers and brokerage firms should be required to adhere to the uniform fiduciary standard that is currently applied to RIAs.\textsuperscript{91} This is a heightened requirement from the current suitability standard that broker-dealers operate under and would mandate broker-dealers to “act in the best interest of the customer”\textsuperscript{92} instead of simply recommending “suitable” securities.

B. The Role of the Uniform Fiduciary Standard

Implementing a uniform fiduciary standard is primarily about client protection, whether it be protection for individuals or institutional investors.\textsuperscript{93} One of the most common justifications made by those who wish to harmonize broker-dealer regulation is that there is tremendous customer confusion regarding the roles and responsibilities of broker-dealers\textsuperscript{94}, who often take titles such as “financial advisor” or “financial consultant”\textsuperscript{95}. This is a particularly troublesome phenomena, as 49 \% of the customers who were surveyed by the Rand Report believed that an adviser must act in a customer’s best interest, while 42\% believed that a broker must act in a customer’s best interest.\textsuperscript{96} Currently, customers are unable to make an informed decision when


\textsuperscript{94} RAND REPORT, supra note 13, at 87.

\textsuperscript{95} Arthur B. Laby, Selling Advise and Creating Expectations: Why Brokers Should be Fiduciaries, 87 WASH. L. REV. 707, 737 (noting that customer confusion often results from the confusing titles that broker-dealers adopt).

\textsuperscript{96} See Sec. & Exch. Comm’n Staff, Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act 87 (2011) [hereinafter Section 913 Study].
selecting a financial intermediary and many policy makers and industry professionals believe that investor education or required disclosures would not be enough to reduce the trend of consumer confusion. Given the wide percentage of even educated investors who are unsure of the legal and functional differences between the broker-dealers and investment advisers, a uniform standard would be one of the few ways to ensure that customers, even if they select incorrectly, will still be protected.

One of the key benefits of a uniform fiduciary standard for broker-dealers is not just that it would protect investors, but that it would do so better than the current suitability standard. Not only would the fiduciary responsibility extend to investment advice, but it would also stop churning, which is a self-dealing practice that allows the broker-dealer to “effectively misappropriate funds from the client’s account for the broker’s benefit”. Given the perfect storm of personal and institutional economic pressures on broker-dealers, any type of permissible self-dealing should be a red flag for potential fraud and the uniform fiduciary standard would at least attempt to end self-interested transactions to prevent systemic abuse of consumers by broker-dealers pressured to increase their personal and institutional profit margins.

But the disincentives to commit fraud do not just apply to individual broker-dealers, as they extend to institutional broker-dealers as well. Given that Basel III will drastically reduce available liquidity for institutional broker-dealers to fund their short-term asset purchases, fraudulent reporting to satisfy the Net Capital Rule is a serious concern. Large broker-dealers

97 Laby, supra note 95, at 738.
will attempt to pull available capital from any liquid source they have, including in-house capital reserves that are intended as cushions to meet immediate claims. This is a serious threat to investors who rely on capital reserves and the Net Capital Rule to protect them from losing everything in a Lehman-style collapse.\(^{101}\) Imposing a “best interest of the customers”-type universal fiduciary standard may force large broker-dealers to reconsider depleting capital reserves in favor of short-term liquidity for trading if they could be faced with a large number of individual or class-action lawsuits for breach of fiduciary duty, even in the absence of significant customer monetary loss from an institutional collapse.

**VII. CONCLUSION**

Although the new capital reserve requirements and new capital calculation formulas in the Basel III standards are a significant advancement in financial institution security, they also pose a serious threat to broker-dealers. Decreased profitability of broker-dealers as a result of a dramatic shortage of the liquidity that has predominately fueled broker-dealer transactions threatens to force broker-dealers at the institutional and individual level to make riskier investment decisions and commit fraud to achieve pre-Basel III profitability levels. This effect is compounded by the negative economic environment in which broker-dealers operate and the historic lack of institutional control by corporate directors and executives in the financial sector. In order to protect the public, both as purchasers of securities and as economic participants who rely on stability in the financial sector, the Securities and Exchange Commission should adopt a stringent universal fiduciary standard for broker-dealers. The many benefits of a uniform fiduciary standard over the traditional unsuitability standard are significant and promise to be

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one of the few safeguards to counter a potential systemic risks created by pressure on broker-dealers.