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Investment Recommendations and the Essence of Duty

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ARTICLES

INVESTMENT RECOMMENDATIONS AND
THE ESSENCE OF DUTY

ONNIG H. DOMBALAGIAN∗

“[Did you consider] yourself to have a duty to
act in the best interests of your clients?”
“I believe we have a duty to serve our clients well.”
—Exchange between Sen. Susan Collins (R-ME) and Daniel
Sparks, Head of Goldman Sachs’ Mortgage Department

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1. Wall Street and the Financial Crisis: The Role of Investment Banks, Hearing Before
   the Permanent Subcomm. on Investigations of the Sen. Comm. On Homeland Security and Go-

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INTRODUCTION

The political theater surrounding the recently settled enforcement action against Goldman Sachs & Co.\(^2\) has punctuated the ongoing debate about the legal and professional obligations of financial intermediaries when recommending transactions in financial products—specifically, investment products that shift the risks and split the return of an underlying asset across the marketplace.\(^3\) Recent crises involving investors in auction-rate municipal securities\(^4\) and

\(^2\) On July 15, 2010, Goldman, Sachs & Co. agreed to pay the Securities and Exchange Commission (SEC) a $550 million penalty, the largest ever paid by a Wall Street firm, to settle charges that it misled investors as to the process by which a reference portfolio of subprime residential mortgage backed securities was selected in marketing a synthetic collateralized debt obligation. Notably, Goldman Sachs acknowledged in its settlement papers that “the marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information” and agreed to undertake remedial action to prevent future violations, including a “comprehensive, firm-wide review of its business standards.” Litigation Release No. 21592, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), available at http://www.sec.gov/litigation/litreleases/2010/lr21592.htm [hereinafter Goldman Litigation Release].


\(^4\) On May 31, 2006, fifteen broker-dealer firms consented to the entry of a cease-and-desist order and agreed to pay more than $13 million in penalties in connection with alleged violations of federal securities law resulting from the marketing of “auction-rate securities” (i.e., municipal bonds, corporate bonds, and preferred stocks with variable interest rates or dividends periodically set by auction). The SEC alleged that the firms had failed to adequately disclose certain practices to investors in connection with the conduct of the required auctions, the effect of which was to conceal the liquidity and credit risks of such securities and to favor certain customers...
mortgage-backed securities have further demonstrated the destabilizing effects that poorly designed or unsuitable investment transactions can have on the financial markets as a whole. Congress has recently taken a number of steps to address this crisis of confidence in investment recommendations and the quality of regulation in the financial services sector generally in the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act.

Unlike other areas of financial regulation, such as financial responsibility, where Congress sought more aggressively to harmonize regulatory treatment across financial services providers, the legislative reforms respecting investment recommendations continue to cling to the historic distinctions among “securities,” “derivatives,” “consumer finance,” and “banking” products. For example, Congress has granted the SEC authority to promulgate rules imposing a uniform, fiduciary standard of conduct on broker-dealers and investment advisers when “providing personalized investment advice and recommendations about securities to retail customers.” In the realm of over-the-counter derivatives, by contrast, the SEC and the Commodity Futures Trading Commission (“CFTC”) may only require swap deal-
ers to provide certain material disclosures to their institutional “counterparties” and to “communicate in a fair and balanced manner based on principles of fair dealing and good faith.”

Consider further the regime governing investment recommendations with respect to traditional banking products. In the realm of consumer finance, the Act consolidates rulemaking authority over consumer financial products and services, including mortgages, in a new Bureau of Consumer Financial Protection. While the scope of the Bureau’s supervisory activities is broad, the Bureau’s authority is subject to oversight by other financial regulators and largely circumscribed to compelling disclosure of the risks and benefits of consum-

11. Id. § 731, at 1708 (to be codified at 7 U.S.C. § 6s) (authorizing CFTC to adopt rules for swap dealers to ensure counterparties comply with eligibility standards, to disclose material risks and material conflicts of interests, and to provide daily marks on request); Id. § 764, at 1790 (to be codified at 15 U.S.C. § 78o-8) (establishing the same authority for the SEC).

12. The Act defines a covered “financial product or service” to include, among other financial activities: extending credit and servicing loans; extending or brokering leases functionally equivalent to purchase finance arrangements; engaging in deposit-taking activities; and providing financial advisory services to consumers on individual financial matters or in relation to proprietary financial products or services. Id. § 1002(15)(A)(i)–(ii), (iv), (viii), at 1957–59 (to be codified at 12 U.S.C. § 5481).

13. See id. tit. X, at 1955 (to be codified in scattered sections of 12 U.S.C.); id. § 1101(a), at 1964 (to be codified at 12 U.S.C. 5491) (establishing “in the Federal Reserve System[] an independent bureau” to “regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws”).

14. Id. § 1022, at 1980 (to be codified at 12 U.S.C. § 5512) (authority to promulgate regulations and issue orders and interpretive guidance). The Act provides for the transfer of the consumer financial protection functions of the Federal Reserve Board, the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Department of Housing and Urban Development to the new Bureau, as well as certain functions of the Federal Trade Commission under “enumerated consumer laws.” Id. § 1061, at 2037 (to be codified at 12 U.S.C. § 5581). The Bureau also has the authority to impose registration requirements on persons not otherwise subject to prudential regulation, and to supervise nondepository institutions that originate, broker, or service certain consumer loans. Id. § 1024(b)(1), at 1987 (to be codified at 12 U.S.C. § 5514) (authorizing the Bureau to require reports and conduct examinations on enumerated nondepository covered persons defined by the Bureau to assess compliance, obtain information about activities and compliance systems and procedures, and to detect and assess risks to consumers and markets).

15. The autonomy of the Bureau was hotly contested in the negotiations over the final bill: although the Dodd-Frank Act does not create the Bureau as a separate agency, as set forth in H.R. 4173, which passed in the House of Representatives, the ability of the Board of Governors of the Federal Reserve System to review or intervene in any matters before the Bureau is limited. Id. § 1012(c), at 1965 (to be codified at 12 U.S.C. § 5492) (describing autonomy of the Bureau). However, the Financial Stability Oversight Council (FSOC), on which the Federal Reserve Board has one seat, has the power to review and set aside final regulations of the Bureau if they would put “the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.” Id. § 1023(a), at 1985 (to be codified at 12 U.S.C § 5513).
er financial products and services and taking enforcement action to prevent “unfair, deceptive or abusive acts or practices,” as narrowly defined in the statute. At the same time, in light of abuses in the origination of residential mortgages, the Act imposes a nebulous “duty of care” on loan originators requiring them, subject to certain safe harbors, to make a reasonable and good faith determination that the consumer is reasonably able to repay the loan.

As these open-ended and disjointed initiatives suggest, delimiting the legal and professional duty of the various categories of financial intermediaries in providing advice with respect to investment transactions is a topic that policymakers have both exhaustively debated and yet unsatisfactorily addressed. On the one hand, financial intermediaries cannot perform the essential risk-spreading function of markets if investors can effectively exercise an option to “put” back the

16. Id. § 1032, at 2006–07 (to be codified at 12 U.S.C. § 5532). (authorizing the Bureau to prescribe rules and model disclosures to ensure that the features of any consumer financial product or service are “fully, accurately and effectively disclosed . . . in a manner that permits consumers to understand the costs, benefits, and risks”).

17. Id. § 1031(a), at 2005 (to be codified at 12 U.S.C. § 5531). The Act also authorizes the Bureau to prescribe rules that identify “unfair, deceptive, or abusive acts or practices” in connection with transactions for or the offering of consumer financial products or services as unlawful, as well as to adopt prophylactic rules to prevent such acts or practices. Id. § 1031(b), at 2005–06 (to be codified at 12 U.S.C. § 5531).


19. Id. § 1411, at 2142 (to be codified at 15 U.S.C. § 1639c) (requiring creditors, prior to making a residential mortgage loan, to make a reasonable and good faith determination based on verified and documented information about income and assets that a consumer is reasonably able to repay the loan and all applicable taxes, insurance, and assessments). The Act also creates a safe harbor for “qualified mortgages,” see id. § 1412 (codified at 15 U.S.C. § 1639c); infra text accompanying notes 206–208, and prohibits mortgage originators from steering customers away from “qualified mortgages,” or steering customers to mortgage loans that cannot reasonably be paid or that have predatory characteristics or effects. Id. § 1403 (codified at 15 U.S.C. § 1639b); see also 12 C.F.R. § 226.36(e).

risk of investment products through the threat of litigation. On the other hand, as financial innovation increases in complexity and investors take on greater responsibility for their financial security, the profession, if not the law, must intervene to ensure that the end-users of such products are not disadvantaged by the imbalance in information and sophistication between financial services providers and their customers.

Commentators have long catalogued the traditional templates within which the obligations of financial services providers may be judged. As discussed in much greater detail below, fiduciary relationships between financial services providers and clients who repose their trust and confidence in them create sweeping duties of loyalty and care enforceable in law and equity. Professional obligations defined and enforced by industry representatives, such as the obligation to ensure that products and transactions are “suitable” or “appropriate” for a client based on its individual needs, may provide collateral benefits for such clients through public enforcement and in some cases private litigation or arbitration. Likewise, tailored disclosures and prohibitions against fraudulent, unfair, or deceptive practices may provide investors with additional grounds for relief beyond those available in the common law of contract or tort. As adaptable as these concepts are, courts continue to grapple with their application to discrete disputes, while regulators take conflicting positions as to which template best fits certain products or categories of financial intermediary.

What is remarkable about the Act’s various mandates, however, is the subtle attempt to conform the standards that traditional securities brokers and dealers, security and non-security based swap dealers, mortgage originators, and other financial services providers must observe when recommending or structuring transactions for retail customers. Whether such a convergence will actually occur depends in large part on how such standards are characterized. For example,


while the SEC staff has echoed the recommendation of those commentators who have argued that a fiduciary duty should govern investment advice given by brokers and dealers (as it governs investment advisers today), the staff has provided little guidance as to what concrete steps may be taken to harmonize sales practices without requiring broker-dealers to make significant changes to their operations. Moreover, the CFTC and bank regulators would likely object to any such fiduciary standard that applied to over-the-counter derivatives, mortgages, and other financial products that have traditionally been viewed as arm’s-length agreements.

Because a uniform standard of sales practices across all financial services would improve investor understanding and facilitate investor decision-making, this Article advocates that securities regulators eschew attempts to establish a chimerical fiduciary duty that would apply only to broker-dealers and investment advisers, and instead opt to work with the CFTC, bank regulators, and other federal and state financial regulators to adopt a uniform approach to defining the obligations of financial services providers when making investment recommendations. The CFTC and bank regulators, in response, should heed the admonitions of the Dodd-Frank Act and work with the SEC to develop standards that capture the essence of the fiduciary obligation, even as they might rightly continue to object to the liability of banks and other credit market participants as fiduciaries.

What form would such a standard take? This Article presumes that the essence of a financial services provider’s duty—regardless of how

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26. SEC REPORT, supra note 24, at 111.

it is constituted or regulated—is to have an ongoing, honest discussion with the customer about each investment decision. More specifically, a discussion focused on a specific measure of risk—for example, the financial services provider’s own estimate of the cost of hedging the transaction at certain intervals—will focus the customer’s attention to the risk of the proposed transaction and comparable transaction with a view to prompting a broader discussion of the customer’s financial goals and needs. Customers must be allowed to take (and financial services providers must be allowed to recommend) financial risks, but only if the customer receives complete, adequate, and comprehensible information from the financial services provider about its assessment of the risks and rewards of a transaction. If financial intermediaries are to be permitted (or required) to act as principals in investment transactions, of course, full disclosure of their proprietary holdings, trading, and valuation models is not realistic; financial intermediaries can nevertheless structure a dialogue about investment decisions with their clients in a manner that promotes the communication of relevant information to the customer and thereby enables the intermediary to discharge its obligations.

Part I of this Article considers the basic policy rationales that underlie the development of sales practice or business conduct rules for recommending investment transactions. Part II considers existing legal approaches to regulating such recommendations under securities, commodities, banking, and insurance law. Part III summarizes the difficulties in extending a fiduciary standard to the various kinds of financial products marketed today. Part IV surveys various proposals to improve the process by which financial intermediaries make investment recommendations, and Part V offers a proposal for a uniform sales practice rule for financial services providers when recommending such transactions.

I. WHY WE REGULATE INVESTMENT RECOMMENDATIONS

Policymakers tend to treat investment transactions differently from commercial transactions (where communications with counterparties are governed by principles of common law contract and tort) and consumer transactions (where communications with consumers are subject to prohibitions against “unfair and deceptive acts or practices”). Commentators both for and against greater regulation in this

area have struggled to identify whether the solicitation of investment transactions is affected with such imbalances in information, sophistication, and ability to absorb risk, or is rife with conflicts of interest so prevalent and pervasive, that they should be governed by a unique set of rules and standards instead of the morals of the marketplace.29

For purposes of this discussion, the scope of the term “investment transactions” or “investment recommendations” is intended to include not only transactions involving traditional investment products, such as stocks, bonds, shares in mutual and exchange-traded funds, and structured notes, but also transactions involving mortgaged property, derivatives, and other products that entail capital at risk and an expectation of profit, whether marketed by banks, insurance companies, or other financial services providers.30 It is also important to stress the difference between investment products and investment transactions: An otherwise suitable product may be sold in an unsuitable transaction (for example, if the markup or commission is excessive or the terms of financing are unconscionable).31 The manner in which a transaction is designed, moreover, may significantly affect a customer’s decision to invest in a given product.32

29. But see Adam J. Levitin, Hydraulic Regulation: Regulating Credit Markets Upstream, 26 YALE J. ON REG. 143, 193 (2009) (suggesting that market pressure resulting from the rescission of or default on mortgages held by special purpose vehicles may improve underwriting standards for mortgages and hence improve customer protection).

30. Some commentators correctly note that hedging transactions should not be deemed investments per se, as they are predominantly used to eliminate or reduce the risk of fluctuation in interest rates, currency exchange rates, or market prices in connection with routine operating transactions. George J. Sotos & Kevin F. Bowen, Commodity Regulation—The Proposed Suitability Standards for the Commodity Industry: Right Church, Wrong Pew, 53 CHI.-KENT L. REV. 289, 303 (1976) (arguing that hedging is not investing). To the extent that derivatives trading is dominated by contracts on individual securities or financial indices, which are combined with securities and other instruments to adjusted portfolios or to create synthetic investment (such as in various exchange traded funds, collateralized debt obligations, and structured financial products), there is a strong case for subjecting them to the same regulatory regime as other investment products. See U.S. DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 106–109 (2008), available at http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf (describing the rise of financial futures and the corresponding need for convergence between securities and futures regulation) [hereinafter “TREASURY BLUEPRINT”].


32. See, e.g., Goldman Litigation Release, supra note 2 (suggesting that the failure to disclose the passive nature of the collateral manager’s role in selecting securities for a synthetic CDO was a material misstatement).
A. Limiting Assumption of Risk

To the extent that investment transactions are about shifting risk to the investor, whether from the intermediary, an issuer, or a third party, the mere risk that a customer may lose all or part of its investment cannot, in and of itself, be sufficient justification for imposing liability on a financial intermediary. Sales practice rules, for example, should not generally be thought of as an “insurance policy” against unfulfilled customer expectations, absent some additional policy justification for imposing liability on the firm. Nevertheless, some commentators have postulated that there should be substantive limits on the amount of risk firms should allow their customers to bear even in unsolicited transactions, on the theory that firms have a duty to prevent customers from “gambling” or committing “economic suicide.” The suggestion appears to be that some level of risk is substantively so untenable, based on the type of investment or the size of the transaction, that firms have a duty to intervene.

Certainly, in transactions where the investor is required to make a stream of payments over a period of time, there is a strong legal and reputational interest in limiting the customer’s exposure to risk. Firms that extend credit to customers as principals, whether in the context of financing transactions or derivative transactions, have an interest in ensuring that the customer is able to satisfy any obligations it undertakes. For example, the NYSE’s “know-your-customer” rule, the precursor to the suitability doctrine, reflected the exchange’s concern about protecting firms against customers’ fraudulent conduct or inability to perform. Likewise, the Office of the Comptroller of

38. Such payments could take a variety of forms: mortgage payments, interest payments on margin loans, net payments under swap agreements, variation margin for options, futures, and other derivatives cleared through a clearinghouse.
39. Sotos & Bowen, supra note 30, at 301.
the Currency’s (OCC) “appropriateness” doctrine for national banks entering into derivatives reflected the OCC’s concern that firms might suffer credit or reputational risk if counterparties were unable to make the required payments.40

On a macroeconomic level, an argument could be made that the law should impose some limits on the assumption of risk in investment transactions because the financial system is unable to bear the shock of mass defaults and ensuing litigation.41 Commentators have noted the externalities wrought by the recent financial boom and bust: blight from foreclosures resulting from predatory lending,42 distortions in market demand for credit,43 and a disproportionate impact on poor minorities without history of access to credit markets.44 To the extent, moreover, that there are proposals to replace public funding of retirement and health care programs with self-directed private accounts, such proposals must take into account the strain placed on welfare programs by widespread declines in the value of retirees’ investments.45 On the other hand, sales practice rules may not be the most appropriate vehicle for deterring such losses, to the extent that that financial services providers are likely to be under equal stress during such periods and may not be able to absorb the shock of such events without government assistance.

B. Least Cost Avoidance

A second set of policy justifications for imposing sales practice rules on financial intermediaries is based on the proposition that financial

43. Bar-Gill & Warren, supra note 33, at 63-64.
44. Id. at 64-69; Raymond H. Brescia, Tainted Loans: The Value of a Mass Torts Approach in Subprime Mortgage Litigation, 78 U. CIN. L. REV. 1, 29-36 & n.105 (2009) (suggesting a “growing awareness that a disproportionate share of subprime loans, particularly those in the latter years of the subprime mortgage market’s heyday, were marketed and sold to African-American and Latino borrowers” and summarizing cases alleging that lenders violated civil rights laws by steering minorities into subprime and predatory loans).
45. Fanto, supra note 22, at 112 (understanding retirement planning); Karmel, supra note 31, at 909; Markham, supra note 22, at 365.
services providers have better information, or at least better access to information, necessary to make informed investment decisions and, thus, are better able to avoid the foreseeable losses resulting from investment transactions. For example, commentators have argued that securities and other financial products are “credence” goods, the value of which often turns largely on information available to issuers or sponsors—such as the quality of management, estimates of future earnings, or the value of underlying assets. To the extent that investors are unable to discount for such asymmetry, firms should, at a minimum, be obligated to provide information in the first instance. Moreover, to the extent that all financial innovation carries latent risks, it may be reasonable to hold firms responsible for such risks as an incentive for them to perform ongoing diligence.

Asymmetries in access to information between intermediaries and their clients, of course, vary from transaction to transaction. For some transactions, such as derivatives or stock funds indexed to currencies, spot prices in commodity markets, or broad-based indices, it is arguable that firms possess no privileged access to information. Moreover, government agencies, financial firms and sophisticated investors devote extensive resources to basic research on property pric-


47. Arthur R. Pinto, The Nature of the Capital Markets Allows a Greater Role for the Government, 55 BROOK. L. REV. 77, 82–88 & n.22 (1989) (summarizing the view of economists that a “security’s value depends upon information, much of which is about the business and comes directly from the business” and therefore that “the value of securities is substantially dependent upon the ability of the business issuing the securities to supply the firm-specific information to the buyers”).


50. See, e.g., LAWRENCE HARRIS, TRADING AND EXCHANGES 314–315 (2003) (observing that, to the extent informational asymmetries contribute to wider spreads, “[s]preads in contracts that represent economywide risks” will be “quite small” because “[t]raders rarely have significant material information” about such conditions and “information about local supply and demand conditions” generally does not have a “material effect” on the whole market; making similar observations about “diversified portfolios” to the extent that “information about individual assets” “rarely is material” to all assets in the portfolio); see also Robinson v. Merrill Lynch, Pierce, Fenner & Smith, 337 F. Supp. 107, 112 (D.C. Ala. 1971) (noting that a “broker has no duty to relay news of political, economic, weather or price changes to his principal”)
es, default and prepayment rates on mortgages, economic forecasting, agricultural cycles, and so forth with a view to divining how such transactions will perform.\textsuperscript{51} In other cases, markets operate without an adequate opportunity for investors to perform diligence, and in effect, force reliance on the firm’s integrity in finding or structuring the investment transaction.

When the variables contributing to the value of an investment transaction are within the intermediary’s control or at least subject to its influence, the case for holding intermediaries liable may be stronger. For example, in some transactions, the firm retains the right to amend the terms of the transaction unilaterally (e.g., the right to call or increase the interest rate on margin loans), or assumes responsibility for the determination of critical obligations under the transaction (e.g., collateral payments based on the fair value of the transaction).\textsuperscript{53} In others, the transaction may be effected in reliance on continued willingness of the firm, the issuer, or the sponsor to maintain a secondary market in the investment product\textsuperscript{54} or, in the absence of a secondary market, to provide an opportunity to unwind the transaction on reasonable terms.\textsuperscript{55} While sales practice rules typically look to the firm’s conduct at the time of the transaction,\textsuperscript{56} one can question whether heightened duties at the outset are an appropriate way to encourage both full disclosure and faithful conduct throughout the life of the investment.

\begin{footnotes}
\item[51] Harris, supra note 50, at 314 (noting that “many governments have agencies that collect and publish information on market conditions” in order “[t]o reduce information asymmetries”); David P. Stowell, An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm 119–122 (2010) (noting that the research provided by large investment banks “usually covers equity, fixed income, currency, and commodity markets”).
\item[52] Engel & McCoy, supra note 49, at 2060, 2068 (noting that institutional investors often lack the opportunity to perform adequate due diligence with subprime mortgage pools and instead rely on credit entities whose interests are not aligned).
\item[53] See, e.g., Bar-Gill & Warren, supra note 33, at 9 (discussing credit card interest-rate adjustments).
\item[55] Bethel & Ferrel, supra note 49, at 22.
\end{footnotes}
C. Imbalances in Actual or Perceived Sophistication

Another common policy justification for enhanced sales practice rules for investment transactions is the imbalance in sophistication between financial firms and their customers, whether real or perceived. The expansion of homeownership, defined contribution plans, and individual retirement planning means that more households engage in investment transactions, but basic financial literacy, in the view of some commentators, has not kept up with these trends. Similarly, even relatively sophisticated institutional investors or corporations may not rationally be able to devote sufficient resources to mastering the terms of financial transactions designed by specialized teams within major commercial or investment banks. As a result, policymakers debate whether regulation should paternalistically correct for such imbalances by shifting some of the responsibility for decision-making to financial intermediaries, or whether regulators should focus on warning investors of risks and prompting them to educate themselves.

57. See, e.g., Allison De Tal, Knowledge Is Power: Consumer Education and the Subprime Mortgage Market, 11 CHAP. L. REV. 633, 651 (2008) (noting the lack of financial literacy leading to the subprime mortgage problems and arguing for a financial counseling requirement for purchases of mortgages with certain characteristics); Fanto, supra note 22, at 107–08 (“Saving and investing are critical for survival in our society . . . . Because investing has assumed a significance in their lives that it did not generally have for their parents, they must be educated in how to invest.”); Henry T. C. Hu, The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model, 60 BUS. LAW. 1303, 1307–08 (2005) (“The inevitable long-run cutbacks in Social Security and Medicare benefits further emphasize the need for all Americans to have some at least minimally acceptable framework for evaluating investment risks and returns.”); see also Lauren E. Willis, Against Financial-Literacy Education, 94 IOWA L. REV. 197, 200 (2008) (arguing that widespread investor education is not plausible).

58. Professor Choi, among others, has advocated a certification regime, in which investors would hold themselves out as possessing (or be evaluated to determine whether they possess) the sophistication necessary to participate in investment transactions; concomitantly, firms would be relieved of ethical obligations (but presumably not liability for affirmative misstatements) to such customers. Stephen J. Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 CALIF. L. REV. 279, 280 (2000). This philosophy is recognized, to a certain degree, in the CFTC’s disclosure-based approach to suitability and the NASD’s interpretive memorandum regarding suitability obligations to institutional investors. See infra note 156.

59. Hu, supra note 23, at 2356; Poser, supra note 51, at 1517–19; Rosenthal, supra note 30, at 1255 (firms may have pricing models superior to those of the corporate end-users). Moreover, to the extent that institutional investors necessarily act through human agents, commentators have also noted that such human agents are often prone to the same cognitive biases as investors acting for their own account. See, e.g., Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future, 51 DUKE L.J. 1397, 1511 (2002) (collecting evidence that contends market professionals are subject to the same biases as other investors).

60. Black & Gross, supra note 37, at 483–85; Fanto, supra note 22, at 118–26 (arguing that “[c]onstraints in American culture,” such as the “preference for individual responsibility and decision-making” and the “longstanding ‘Main Street’ hos-
In recent years, scholars following the field of behavioral economics have argued that sales practice regulation should also take into account the cognitive biases that impair rational decision making.\footnote{Donald C. Langevoort, Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers, 84 CALIF. L. REV. 627, 635 (1996); Robert Prentice, Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis, 2003 U. ILL. L. REV. 337, 358–78 (analyzing behavioral factors such as rational ignorance, optimism, biases, and probabilities).} Even investors with a working knowledge of financial concepts expected of the “reasonable investor”—such as the time value of money, the relationship between risk and return,\footnote{Fanto, supra note 22, at 132 (“A consumer must comprehend elementary finance to be able to think about investing from a financial perspective. An investor should understand the time value of money, investment return and risks, liquidity, and the relationship of risk to return”); Barbara Black & Jill I. Gross, Making It Up as They Go Along: The Role of Law in Securities Arbitration, 23 CARDOZO L. REV. 991, 1037 (2002) (observing that courts expect reasonable investors appreciate to the time value of money, the relationship of return to risk, how brokers are compensated, and the importance of diversification).} or simple financial fraud—may be susceptible to sales pitches that exploit basic cognitive limitations or psychological vulnerabilities.\footnote{Matter to, suspicion of, and yet irresistible attraction to the dominant market capitalism typified by Wall Street, compel an approach in which individuals take responsibility for their own savings and investment decisions but demand education to help “correct the ‘educational’ asymmetry between ordinary investors and Wall Street”); Frederick Mark Gedicks, Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability, 37 ARIZ. ST. L.J. 535, 586 (2005); David Reiss, Subprime Standardization: How Rating Agencies Allow Predatory Lending To Flourish in the Secondary Mortgage Market, 33 FLA. ST. U. L. REV. 985, 1004 (2006).} Some scholars have suggested that firms use detailed information about how consumers’ expected use of financial products deviates from their actual use...
(e.g., credit cards) and design products that take advantage of such deviations.\(^65\) Likewise, to the extent that firms are able to tailor financial products to the needs of an investor (whether at the time of the transaction or while the transaction is outstanding), firms may be able to discriminate between those investors who actively negotiate the standard terms in their transactions and those who seek to free-ride off the monitoring costs of others but are unaware of the better deals available to those who ask.\(^66\)

Naturally, regulation might be particularly appropriate when firms create a perceived asymmetry of sophistication in order to market their financial services. At the time the Securities Exchange Act of 1934 was enacted, for example, securities and insurance brokers were commonly perceived to be professionals subject to professional duties of care.\(^67\) In a complementary vein, bankers have traditionally been viewed as conservative lenders who have designed financial products with a view to ensuring, at a minimum, that extensions of credit are adequately secured and that the borrower has the means to make timely payments of interest and principal.\(^68\) Minimum standards of professional competence certainly may be set through examination and qualification requirements for sales representatives and other associated persons of a financial services provider. But when firms hold themselves out as providing “investment advice,”\(^69\) advertising “superior skill,”\(^70\) encouraging “trust,”\(^71\) or otherwise engage customers in

\(^{65}\) Bar-Gill & Warren, supra note 33, at 70 (describing patterns of credit card use).

\(^{66}\) Id. at 9.


\(^{68}\) Engel & McCoy, supra note 42, at 1272 (describing the Stiglitz-Weiss model of monopoly on credit historically used to restrict mortgage loans to all but most creditworthy borrowers).

\(^{69}\) Laby, supra note 67, at 413–17 (arguing that the broker-dealer exclusion from the definition of “investment adviser” in 15 U.S.C. § 80b-2(a)(11)(C) should be lost if a broker-dealer markets itself or otherwise holds itself out as an “adviser” in light of the connotation of the word).

one-on-one discussions about their financial needs and goals, it is debatable whether the risk of reputational harm is sufficient to encourage financial services providers to deal honestly with customers.  

D. Conflicts of Interest

Investors also are not necessarily able to appreciate, or adequately discount for, the many conflicts of interest to which financial services providers and their associated persons are subject. The simplest of these is compensation: To the extent that firms or sales representatives are compensated on the basis of the number, size, or profitability of the individual transactions they consummate, they have an incentive to push customers to execute more, larger, and more lucrative transactions. By contrast, when service firms or sales representatives are compensated based on the size of the portfolio they oversee, there is a risk that they will adopt management strategies that allow them to devote increasingly less attention to individual transactions or customers. To the extent that these compensation

73. Henry T.C. Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 YALE L.J. 1457, 1492–94 (1993) (contemplating problems with the principal/agent relationship when swap traders are compensated by bonuses); Laby, supra note 67, at 406–07 (discussing the Tully-Levitt report on brokers’ transaction based compensation); Langevoort, supra note 61, at 662 (positing that brokers’ quotas might spur selling that they would otherwise have reservations about); Poser, supra note 31, at 1524; see 15 U.S.C. § 78c(a)(4)(B)(i)(VI) (excluding “banks” from the definition of “broker” in connection with certain third party arrangements as long as “bank employees do not receive incentive compensation for any brokerage transaction other than nominal compensation “unless such employees are associated persons of a broker or dealer”); id. § 78c(a)(4)(B)(ii) (excluding “banks” from the definition of “broker” in connection with certain trust activities provided, inter alia, that the bank “is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee . . . a percentage of assets under management, or a flat or capped per order processing fee”). Similar practices occur in the mortgage finance market. See, e.g., Engel & McCoy, supra note 42, at 1263 (bonus for loan flipping encourages flipping); Bar-Gill & Warren, supra note 33, at 31 (pushing subprime mortgages to customers who qualify for prime mortgages). The Dodd-Frank Act prohibits the payment to or receipt by a mortgage originator of any “compensation that varies based on the terms of the loan (other than the amount of the principal).” Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1403, 124 Stat. 1376, 2139 (2010) (to be codified at 15 U.S.C. § 1639b).
structures mimic compensation structures in other consumer markets, the question becomes whether customers can make informed decisions about the frequency, size, or type of transactions best suited to their needs despite those conflicts.

The nature of financial services, however, entails a much more complex and opaque web of relationships among service providers. Since the enactment of the Gramm-Leach-Bliley Act (and even before), commercial banks have offered a variety of banking, securities, derivatives, and insurance services under a single umbrella. Investment banks and other securities firms, likewise, provide a range of underwriting, market making, derivatives, research, and advisory business under one roof. Even independent insurance companies, mutual fund companies, mortgage brokers, and other financial services firms enter into a variety of arrangements with other financial firms for the marketing and distribution of their products. As a result, commentators focus the debate on the extent to which sales practice regulation is necessary to prevent firms from charging excessive fees or steering customers to inferior products offered by their affiliates or business partners.

At a minimum, the transparency of such fees and relationships is important to ensuring that the market is able to discount for potential conflicts of interest; some commentators have argued that competition may be sufficient, for example in the mutual fund industry, to ensure that fees are fairly set. Others argue that mere disclosure and competition are insufficient to protect investors, particularly if

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76. LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 140 (2003) (defining “investment banks” as “[b]rokerage firms that engage in large capital transactions,” such as block trading, underwritings, and mergers and acquisitions).

77. Wilmarth, supra note 75, at 428–34.


79. See, e.g., Johnsen, supra note 74, at 584 (arguing that mutual fund management fees are set competitively).
customers are reliant on their brokers or financial advisers to guide them in the process of selecting particular transactions from a range of potential options. 80 More extreme approaches to addressing these concerns might include a heightened duty to sanitize certain conflicts, such as through regulatory exemptions, 81 or outright segregation of proprietary trading and public customer business.

II. THE REGULATORY TAXONOMY TODAY

The extension of heightened sales practice standards to a broader range of financial transactions is simultaneously enticing and unnerving. Even if recent events have proven the existing paradigms for regulating investment transactions ineffectual, the difficulty lies not only in adapting the depth and scope of the fiduciary standard to the specific transactions that recur in customer disputes, but also in tailoring remedies that appropriately balance the multiple roles that commercial and investment banks, brokerage firms, insurance companies, and other financial intermediaries play.

Take, for example, the concept of the financial intermediary as “fiduciary.” Borrowed from the law of trust and agency, the term refers to the highest obligation of the agent to act loyally for the principal’s benefit. 83 The concept of fiduciary duty is sufficiently elastic in its depth and scope that it has been invoked in the context of simple securities transactions with individual investors as well as complex derivatives transactions between investment banks and institutional investors. 84 And yet, the concept of a fiduciary, if extended to financial

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80. See, e.g., Steven J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 STAN. L. REV. 1, 22 (2003) (“For behavioralists, the single-minded focus of the SEC on disclosure presents a puzzle. We doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases.”); Usha Rodrigues & Mike Stegemoller, Placebo Ethics: A Study in Securities Disclosure Arbitrage, 96 VA. L. REV. 1, 10 (2010) (criticizing the “soft” disclosure mandated by Section 406 of the Sarbanes-Oxley Act of 2002).


82. See infra text accompanying notes 204–10 (discussing the pros and cons of segregation).

83. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006). The formulation “best interest” was introduced into fiduciary law to supplant the notion that a fiduciary acts in the “sole interest” of the party to whom the duty is owed, in part to reflect that conflicts of interest may exist. See TAMAR FRANKEL, FIDUCIARY LAW 150 (2011).

services providers with respect to all investment recommendations, would force a dramatic, and not necessarily salutary, reconfiguration of the multiple roles that securities brokers and dealers play in the financial marketplace.

Other commentators have focused on extending the “suitability” requirement, long a staple of the law governing broker-dealers, to apply to ethically problematic conduct by purveyors of mortgage products and other financial services providers. One of the difficulties, for example, in proscribing predatory practices in the mortgage lending market is the uniqueness of each borrower, the property to be mortgaged, and the expected duration of the loan. Some scholars have often advocated that “suitability” obligations for financial services providers that originate or underwrite mortgages—particularly when such mortgages are bundled and fed to securities markets through the process of securitization—are more appropriate than the required “truth-in-lending” disclosures or prohibitions against narrowly defined “unfair and deceptive” lending practices. And yet federal bank regulators and credit rating agencies have resisted such initiatives, even after the collapse of the subprime lending market, in part out of the fear (however ironic) that stringent consumer financial protection laws might jeopardize the safety and soundness of the originating banks and the integrity of the market for mortgage-backed securities.

The continued effectiveness of disclosure and antifraud rules in the context of both securities transactions and other consumer finance transactions is also routinely questioned. Commentators have noted the mixed record of courts in granting equitable relief in disputes over inadequate disclosures in mortgage finance and the marketing of other banking products. In the context of securities transactions, courts presiding over private litigation of broker-customer disputes have likewise undertaken a steady campaign over


85. See Macey et al., supra note 20, at 790–91, 837–38 (arguing that the application of the suitability requirement might have stopped homeowners from obtaining subprime mortgages); Wirth, supra note 67, at 47–48, 81–85 (analyzing the application of suitability requirement to insurance contracts).

86. See, e.g., Engel & McCoy, supra note 42, at 1317–65 (2002) (arguing for the application of the duty of suitability to the subprime mortgage market).

87. See supra note 27 (making the case against applying the suitability doctrine).

88. See infra text accompanying note 146–149.
the past several decades to shift the burden onto aggrieved investors to establish defendants’ consciousness of wrongdoing and a right to rely on the defendants’ representations as a predicate to recovery.\footnote{See infra text accompanying notes 155–156.} However justifiable it may be, the rigorous burden-shifting with respect to scienter and reliance in suits between financial services providers and their customers weakens incentives for securities brokers to engage customers in a forthright discussion of the risks and rewards of particular investments, particularly when compulsory arbitration of securities disputes eliminates any transparency in how this body of law is applied.\footnote{See infra text accompanying notes 150–154, and 176–181.}

The following three sections examine the fiduciary standard as currently applied to investment advisers and in other contexts, with a view to contrasting it with the suitability doctrine and the use of affirmative disclosures.

\textit{A. The Fiduciary Standard}

The scope and depth of fiduciary duties holds the greatest promise for ensuring that providers of financial services act in the best interests of their clients, even as the imposition of duties of loyalty and care on all investment transactions poses a variety of theoretical and practical problems. The duty of loyalty in general “requires that the agent subordinate the agent’s interests to those of the principal and place the principal’s interests first as to matters connected with the agency relationship,” although such arrangements may be modified by mutual agreement.\footnote{RESTATEMENT (THIRD) OF AGENCY § 8.01 cmt. b (2006).} The duty of loyalty thus subjects arrangements such as dual agency or self-dealing to heightened scrutiny to ensure that the principal’s interests are not subordinated to that of the agent or another.\footnote{WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP §§ 67–68, at 140–144 (3\textsuperscript{rd} ed. 2001) (describing the duties of an agent when transacting with the principal or as a dual agent).} The duty of care has traditionally required fiduciaries to manage the affairs of the principal with the “care, competence, and diligence normally exercised by agents in similar circumstances,” taking into account any “[s]pecial skills or knowledge possessed by [the] agent.”\footnote{RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).}

In the context of financial services, clear examples of relationships consistent with fiduciary obligations include custodial services or asset management: When the custodian or manager has discretionary authority over investment, duties of loyalty and care are necessary to
protect the interests of beneficial owners who may otherwise have limited legal power to direct the manner in which funds are invested or that fees are set for such services. Both the Investment Advisers Act and state law generally recognize that a person who manages the funds of others is a fiduciary. The SEC staff’s report notes that 91.2% of accounts managed by investment advisers registered with the SEC confer some discretionary authority on the investment adviser.

Courts have also found that securities or insurance brokers may have fiduciary duties when they recommend transactions to customers, for example, when customers have reposed such “trust and confidence” in the broker that the broker exercises de facto discretionary authority over the management of the customer’s account. By and large, however, brokers and other transactional agents are subject to fiduciary duties under common law only to the extent that they execute specific tasks as agents for the account of and subject to the direction of the principal, such as placing orders, executing, clearing, and settling transactions, and holding customer funds or securities.

Fiduciary duties appeal to those commentators who doubt the efficacy of ex ante regulation through rules or principles-based ongoing...
supervision. Ex ante rulemaking in the financial industry, as scholars routinely note, may be efficient when regulators are able readily to accumulate information about the types of abuses frequently perpetrated by issuers, sellers, and sponsors of financial products and to develop succinct disclosures or procedures that can check their recurrence; ex ante rules perform less well when malefactors easily circumvent each new iteration of rules or when the burdens of disclosure deter new entrants or the provision of new services. While ongoing supervision under a principles-based regime may be appropriate for safety and soundness regulation, it would be extraordinarily complicated to extend that model to ongoing supervision of clients’ investment accounts for the purpose of identifying exposure to excessive investment risk.

98. SEC REPORT, supra note 24, at 102–04 (contrasting “principles-based” investment adviser regulation with “rules-based” broker-dealer regulation); John C. Coffee, Jr. & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea?, 95 VA. L. REV. 707, 757–58 (2009) (criticizing the “rules/principles continuum”). But see Lawrence A. Cunningham, A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting, 60 VAND. L. REV. 1411, 1492 (2007) (speculating that the phenomenon of “global rhetoric championing principles-based systems” is “due to a combination of a regulatory desire to provide a counterweight to demand for rules, a quest to rejuvenate ethics, and a desire to distinguish a jurisdiction’s legal-financial products” and arguing that if it is “infeasible to establish a principles-based system of corporate law, securities regulation, or accounting, then it is misleading to promote the possibility”).

99. Bar-Gill & Warren, supra note 33, at 74 (noting the greater ability of regulatory agencies, as opposed to courts, to distinguish fees in credit contracts that represent “liquidated damages” and punitive fees that are unenforceable).

100. See Langevoort, supra note 61, at 673–74 (describing the costs of regulatory intervention). As discussed below, regulators have prescribed voluminous disclosures in connection with individual securities, financing transactions, and other financial products, and yet the cumulative effect of these disclosures is not only to overload the capability of the investor to make a rational decision but also to shield the offering firm from liability if sufficient meaningful cautionary disclosures have been made. See infra text accompanying note 129.


102. Of course, regulators may conduct periodic inspections of firms to target specific risks, such as scams targeting the elderly or particularly vulnerable segments of the population. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989A, 124 Stat. 1376, 1941 (2010) (to be codified at 12 U.S.C. § 5537) (requiring the CFPB’s Office of Financial Literacy to establish a program to make grants available to states or state securities commissions, insurance commissions, and consumer protection agencies to protect senior citizens from certain misleading designations or misleading or fraudulent marketing with respect to advising or servicing individuals over the age of sixty-two); David Adam Friedman, Reinventing Consumer Protection, 57 DePAUL L. REV. 45, 73–74 (2007) (examining the practice of random hyper-protection for certain groups).
The power of fiduciary duties has also traditionally lain in the sweeping equitable relief that courts may employ not only to compensate principals for harm suffered as a breach of duty, but also to deter misconduct even in the absence of harm to the principal.\textsuperscript{103} Thus, for example, a breach of the duty of loyalty might require not only that the agent compensate the principal for any harm suffered as a result of self-dealing, but also require the agent to disgorge to the principal any “secret profits” or other financial benefit obtained as a result of the breach.\textsuperscript{104} The severity of these remedies traditionally has been explained as a tool for punishing or deterring disloyalty by the agent, or more recently, as a means of placing the onus on the agent to obtain the principal’s informed consent prior to affecting mutually beneficial transactions.\textsuperscript{105} In this respect, the fiduciary duty performs a suppletive role—filling in terms most friendly to the principal in the absence of specifically negotiated terms between the agent and the principal.

Fiduciary duties are also notable for the willingness of courts to disregard contractual arrangements when they have reason to suspect that the fiduciary is not acting with the principal at arm’s length. Congress has imposed a fiduciary duty on advisers to mutual funds, pension funds, or other collective investment funds, even when they purport to contract at arm’s length with fund representatives, to the extent that such funds that lend themselves to exploitation by the financial services provider.\textsuperscript{106} Similarly, financial services providers require conversations and customer complaints to be preserved as evidence in subsequent investigations. See, e.g., NASD Rule 3110(d), FINRA Manual (CCH) 17,360, at 17,361 (2009), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3754 (requiring record of customer “complaints”).

\textsuperscript{103} See, e.g., Deborah A. DeMott, Disloyal Agents, 58 Ala. L. Rev. 1049, 1056–61 (2007) (describing “[t]he ‘substantial factor’ standard for loss causation . . . as a ‘prophylactic rule intended to remove all incentive to breach’”); D. Gordon Smith, The Critical Resource Theory of Fiduciary Duty, 55 Vand. L. Rev. 1399, 1493–97 (2002) (arguing that the availability of restitution, and specifically disgorgement, is necessary for a beneficiary to be able to control a fiduciary). But see discussion infra Part III.A (noting that clients of an investment adviser have no private right of action against the investment adviser for breach of the fiduciary duty created by section 206 of the Investment Advisers Act).

\textsuperscript{104} FRANKEL, supra note 83, at 254–56; see, e.g., Coburn v. Warner, 110 F. Supp. 850, 851 (S.D.N.Y. 1953) (concerning secret commission); O’Malley v. Boris, 742 A.2d 845, 847 (Del. 1999) (requiring disclosure of broker’s receipt of ownership interest in exchange for transfer of customer accounts under Delaware law).

\textsuperscript{105} See, e.g., FRANKEL, supra note 83, at 101–02 (identifying morality, punishment, and self-protection by entrusting parties as mechanisms that limit misconduct by fiduciaries).

\textsuperscript{106} See, e.g., 29 U.S.C. § 1002(21)(A) (defining who is a “fiduciary” under ERISA); 15 U.S.C. § 80a-35(a) (authorizing the SEC to bring an action for “breach of
contracting with corporate representatives may be held responsible
for transactions effected by corporate employees who exceed their
authority or violate internal controls. In some cases, clearing bro-
kers have been held responsible for breaches of fiduciary duty by in-
troducing brokers on whose behalf the clearing brokers carry securi-
ties accounts, on the theory that the clearing broker had a duty to
monitor such accounts.

Whether the concept of the fiduciary can be extended to other
areas of financial sales practice regulation is debatable, as discussed
in Parts III and IV below. Many investment transactions offered by
financial services providers possess the characteristics of arm’s-length
transactions: Dealer sales from inventory, extensions of credit under
a mortgage or margin loan, and tailored derivatives contracts all in-
volve an arm’s-length relationship. Moreover, fiduciary standards,
particularly to the extent they encompass a duty of care, have never-
theless typically been associated with investment professionals with de
jure or de facto discretion to trade on behalf of client accounts.

1995) (holding that whether Morgan had knowingly aided and abetted a violation by
state employees of a state statute barring the use of state funds for “speculation” was a
question for the jury); see also Langevoort, supra note 61, at 697–99 (intimating that
such a doctrine could become “something of a loose cannon” imposing a duty on
brokers to refrain from a transaction anytime an institutional buyer seems to be act-
ing inconsistently with an objective standard of the institution’s needs); Markham,
supra note 22, at 365 (describing Drexel’s liability in CFTC proceeding); Rosenthal,
supra note 40, at 1264 (“[I]t was not the absence of regulation that led to . . . large
derivatives losses, but rather the continuing absence of internal corporate controls . . .”);


109. See, e.g., Grant E. Buerstetta, Creating a Flexible Fiduciary Duty Rule for Banks En-
(distinguishing the bank-to-depositor relationship, where traditionally there is no
fiduciary duty, from the bank-to-customer relationship in which investment products
are sold).

110. Jill E. Fisch, Fiduciary Duties and the Analyst Scandals, 58 ALA. L. REV. 1083, 1090–96 (2007) (arguing that a fiduciary duty should not be imposed on analysts, in
part because “analysts do not exercise discretionary authority over the property
of their institutional and issuer clients”); Karmel, supra note 31, at 1273 (asserting that a
firm that “exercises actual or de facto control over a customer’s account because of a
customer’s trust and confidence . . . may owe a fiduciary obligation to the custom-
For example, it is difficult to hold a fiduciary liable for the failure to take care in making investment recommendations, unless it has the authority to manage the client’s entire portfolio—and thus assume overall responsibility for appropriate allocation of investments and diversification.\footnote{See, e.g., 29 C.F.R. § 2550.404a-1(b)(1) (2010) (describing the duty of a fiduciary to an employee benefit plan); Jerry W. Markham, Privatizing Social Security, 38 San Diego L. Rev. 747, 796–98 (2001) (discussing evolution of prudent man rule and DOL standards for portfolio management); Wirth, supra note 67, at 78–79 (discussing insurance producers).}

B. Disclosure-Based Approaches

A second approach to characterizing the relationship between a financial services provider and its client is an arm’s-length transaction, subject to an implied covenant of good faith and fair dealing as augmented by enumerated affirmative disclosures (or implied representations) about the quality of the investment and the terms governing the transaction. At a minimum, this approach would prohibit firms from making material misstatements about the character of a transaction.\footnote{See, e.g., Hu, supra note 23, at 2326–28 (explaining the “no-lying” category).} Thus, for products such as swap transactions among sophisticated parties, which have not historically been subject to federal securities law or other product-specific disclosure obligations, litigants have relied upon common law concepts of contract or fraud to establish a right to relief.\footnote{See S. Lawrence Polk & Bryan M. Ward, A Guide to the “Regulatory No Man’s Land” of Over-The-Counter Interest Rate Swaps, 124 Banking L.J. 397, 402–04 (2007) (discussing the legal regime governing swap transactions).} For many products, however, federal or state law requires the disclosure of extensive additional information to customers prior to or at the time the transaction is consummated.\footnote{See, e.g., Joseph U. Schorer, The Credit Card Act of 2009: Credit Card Reform and the Uneasy Case for Disclosure, 127 Banking L.J. 924, 937–38 (2010) (describing, among other things, the new federal law’s mandate of more explicit disclosure to credit card users about the long-term cost of making only minimum payments).}

Such disclosures can serve multiple purposes.\footnote{See, e.g., Hu, supra note 23, at 2321–22 (noting that disclosure “facilitate[s] information gathering and reduce[s] errors stemming from rational or irrational decisions to forego information”).} In addition to addressing the imbalance of information between the financial services provider and the customer, disclosures necessarily disrupt the selling
process and give the customer an opportunity to consider more carefully the terms of the transaction.\textsuperscript{116} In an era where signing on the dotted line has been replaced by electronic records of oral consent, the delay between sales pitch and confirmation has all but disappeared. The effectiveness of disclosure at upending the sales pitch depends upon timing; in some contexts, law and regulation require significant ex ante disclosure of the terms, or require firms to offer clients a “cooling off” period during which a transaction may be rescinded.\textsuperscript{117} Similarly, for some products, disclosure must be made concurrently with each individual transaction consummated, whereas for others, a “blanket” disclosure governing all subsequent transactions is sufficient to relieve the service provider of any continuing obligation.\textsuperscript{118}

Disclosure regimes are much more common in financial services, in part because of the relative ease with which regulators can standardize what information needs to be disclosed and the relative certainty they provide the financial services industry (not to mention bank supervisors who view liability as a risk to safety and soundness) as to what their statutory or regulatory obligations are. To illustrate, the issuance of mortgages or home equity lines of credit is governed by elaborate disclosures under rules promulgated by the Federal Reserve Board for banking institutions and by the Federal Trade Commission (“FTC”) for non-bank originators pursuant to statutes such as the Truth in Lending Act (“TILA”),\textsuperscript{119} the Real Estate Settlement Procedures Act (“RESPA”), and the Home Ownership and Equity Pro-

\begin{footnotes}
\footnotetext[116]{Langevoort, \textit{supra} note 61, at 693.}
\footnotetext[118]{See Credit Suisse First Boston LLC, SEC No-Action Letter, [2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,051, at 76,978, 76,988 n.13, 76,989 (Aug. 31, 2005) (granting no-action relief permitting the use of blanket global consents for certain principal transactions but noting the Commission’s position that “[b]lanket disclosure and consent, rather than transaction-by-transaction consent, generally will not suffice because of the potential for self-dealing that can be associated with each principal transaction”); \textit{see also} Black, \textit{supra} note 74, at 38–39 (“The disclosure must include the facts necessary to alert the client to the adviser’s potential conflict of interest; it is not sufficient for the investment adviser merely to provide a blanket disclosure and general consent.”).}
\footnotetext[119]{15 U.S.C. §§ 1601–67f.}
\footnotetext[120]{12 U.S.C. §§ 2601–17 (2006).}
\end{footnotes}
tection Act ("HOEPA"). Special disclosure rules exist for the marketing of contracts sold on futures exchanges and options exchanges, and for transactions in penny stock, variable annuities, and other specialty products. And of course, federal securities law imposes extensive affirmative disclosures governing both primary offerings of and secondary markets in individual securities and mutual funds, in addition to catch-all liability for securities fraud under section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act.

One pervasive critique of disclosure regimes is that they tend over time to inundate investors with information. Several commentators have echoed concerns that securities and other regulatory disclosures have reached the cognitive limits of the individual investor. Inves-

121. 15 U.S.C. § 1639; see also Engel & McCoy, supra note 42, at 1305–09 (describing disclosure requirements under TILA, RESPA, and HOEPA).
122. 17 C.F.R. § 1.55 (2010) (requiring the distribution of “Risk Disclosure Statement” by futures commission merchants and introducing brokers); see also Protection of Commodity Customers; Risk Disclosure by Futures Commission Merchants to Customers, 47 Fed. Reg. 52,723, 52,723–25 (Nov. 23, 1982) (codified at 17 C.F.R. pt. 1) (proposing an amendment to section 1.55 of the 17 C.F.R. to clarify that risk disclosure statement is not exhaustive of a futures commission merchant’s duty to disclose all material information to customers under applicable state law); Sotos & Bowen, supra note 30, at 306 (explaining the recommendation of the Advisory Committee on Commodity Futures Trading Professionals that new commodity futures customers should be given a risk disclosure statement).
124. Sales Practice Requirements for Certain Low-Priced Securities, 17 C.F.R. § 240.15g-9(a) (2010); see also Langevoort, supra note 61, at 687 (outlining the substance and timing of required disclosure for penny stock transactions).
tors who do not perceive that the benefits of digesting required disclosures exceed the potential costs may simply ignore such materials out of rational apathy, or assume that they can free-ride off of the diligence of other investors receiving such information. Regulators may regularly attempt to redefine what is material to permit a greater degree of abstraction, or to simplify disclosures so that persons of a specific reading level and sophistication can comprehend the material terms. Such simplification comes at a cost, however, since reliance on abstract categories or classifications (for example, in the naming of products) can create incentives for financial services providers to game the system.

Disclosure requirements also do not necessarily provide information to the consumer that is of practical use. To the extent that we sure can be insufficient to remedy the information asymmetry between the originator and its investors”).


131. Fanto, supra note 22, at 171–78 (discussing the SEC’s initiatives to modify mutual fund disclosure formats to improve comparability of firm disclosures).


134. See, e.g., Hu, supra note 25, at 2373–74 (critiquing the usefulness of certain historical data on investment returns); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2559, 2577 (1998) (“Researchers found no stock price effect when firms disclosed the newly mandated replacement cost information, suggesting that investors did not find the SEC’s mandated disclosure useful for valuing firms.”); see also Paula J. Dalley, The Use and Misuse of Disclosure as a Regulatory System, 34 FLA. ST. U. L. REV. 1089, 1129 (2007) (concluding that a suc-
might expect investors to rely on the firm’s own representations as to the risk of a particular transaction, qualitative disclosures about possible risk factors, expressed through the copious use of modal verbs, are not helpful in making an informed judgment.\textsuperscript{135} For example, a disclosure that market makers may not support a product in the future, or that interest rates may rise in connection with an adjustable-rate mortgage, convey no information about the firm’s assessment of those risks. As such, it may be difficult for the ordinary investor to discount for such risks when making an investment decision. On the other hand, commentators rightly note that sophisticated customers can negotiate for such information\textsuperscript{136} and the disclosure of the firm’s own analysis of the merits of a transaction might inappropriately lead investors to believe that they are entitled to certain returns.\textsuperscript{137}

Moreover, as several commentators have suggested, disclosures about the merits of an individual product or transaction may not be helpful absent references to comparable products.\textsuperscript{138} To demonstrate, the need for disclosure of comparable products is frequently invoked in the context of marketing subprime mortgage products to borrowers qualifyng for prime mortgages,\textsuperscript{139} or in the context of excessive fees charged by actively managed funds versus passively managed index funds.\textsuperscript{140} Disclosures about comparable products, however, could conceivably raise issues of freedom of speech\textsuperscript{141} if firms are compelled to make disclosures that contravene their own judgment.

\textsuperscript{135} See, e.g., Langevoort, supra note 61, at 692 (advocating disclosure of the “probability”—not just the “possibility”—of particular risks).

\textsuperscript{136} Howell E. Jackson & Eric J. Pan, Regulatory Competition in International Securities Markets: Evidence From Europe In 1999—Part I, 56 BUS. LAW. 653, 685–86 (2001) (observing the quality of disclosure documents that accompany “International-style Offerings” to institutional investors in Europe and the due diligence work that underlies this documentation are “of a much higher quality than the formal disclosure requirements of most, if not all, European countries” because “the market requires” the higher level of disclosure institutions are accustomed to receiving in offerings under U.S. law).

\textsuperscript{137} Hu, supra note 28, at 2375.


\textsuperscript{139} Engel & McCoy, supra note 42, at 1264, 1264 n.20 (discussing “naïve borrowers” who are tricked into borrowing costlier loans).

\textsuperscript{140} See, e.g., Hu, supra note 23, at 2359–60 (proposing greater disclosure of quantitative information about performance relative to other instruments).

(or their own financial interests) when regulators’ determination of what constitutes comparable products is subject to dispute.  

Furthermore, applying disclosure requirements at the time of a transaction appears to foreclose the possibility that a firm has any continuing duty to advise the customer as to material information that may trigger a decision to liquidate the position or to modify the terms of the transaction. Courts have generally rejected the argument that a pattern of providing ongoing investment advice with respect to customer trading may create a duty to provide complete or updated advice.  

It would be even more difficult to conceive of a requirement that mortgage brokers or bank representatives review the accounts of mortgagors to determine whether refinancing is appropriate, or for insurance brokers to recommend that customers scale back coverage as their personal circumstances change.  

While enforcement actions based on disclosure violations may generate fines and injunctions to deter future violations, they do not necessarily compensate aggrieved investors for the entirety of their loss. Unlike regulations governing pure credit products in which courts may be willing to protect customers from paying excessive rate hikes or charges under theories of unconscionability or lack of good faith, or pursuant to statutes prohibiting unfair and deceptive acts or practices, the typical investor claim involves an asset that may have declined in value through no fault of the financial intermediary.  

When disclosure violations committed by a financial intermediary are discovered after the transaction has been consummated, a court must

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142. See, e.g., SEC v. Wall Street Publ’g Inst., Inc., 851 F.2d 365, 373 (D.C. Cir. 1988) (“[D]isclosure requirements have been upheld in regulation of commercial speech even when the government has not shown that ‘absent the required disclosure, [the speech would be false or deceptive] or that the disclosure requirement serves some substantial government interest other than preventing deception.’” (alteration in original)).  

143. See, e.g., De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002) (“The giving of advice triggers no ongoing duty to do so.”).  

144. See Wirth, supra note 67, at 59 n.42 (noting the New York Insurance Department’s opposition to a proposed duty to suggest amendments to life insurance policies).  

145. The Dodd-Frank Act amended the “fair funds” provisions of the Sarbanes-Oxley Act to permit the SEC to direct that civil monetary penalties collected from parties found in violation of the securities laws be added to a disgorgement fund or other fund for the benefit of the victims of a violation. See 15 U.S.C. § 7246(a) (as amended by Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929B, 124 Stat. 1376, 1852 (2010)).  

146. See Bar-Gill & Warren, supra note 83, at 71–72 (discussing unconscionability and penalty defenses).  

147. Langevoort, supra note 61, at 628 (characterizing the “mutual finger-pointing that often occurs in disputes between stockbrokers and their customers” as a “predictable drama in the field of investments”).
decide not only whether the intermediary should disgorge its revenue from the transaction, but also whether the intermediary should absorb the full amount of the loss to the customer attributable to the violation.\textsuperscript{148} Courts may be unwilling to impose equitable remedies such as rescission or restitution, even when expressly authorized by federal or state law,\textsuperscript{149} absent egregious circumstances.

To the extent that investment transactions can be expected to fail routinely, courts may impose a gauntlet of obstacles to avoid undoing the risk-shifting objectives of the investment transaction based on inaccurate or incomplete disclosure.\textsuperscript{150} For instance, courts may be reluctant to brand novel conduct as deceptive or fraudulent.\textsuperscript{151} In the context of securities fraud claims under Rule 10b-5 of the Exchange Act, courts have required plaintiffs to prove the defendant’s consciousness of the disclosure violation (scienter) and have permitted defendants to use disclosure documents containing cautionary language to defeat plaintiff’s reliance on oral representations.\textsuperscript{152} Courts also focus on the sophistication of the investor in determining the reasonableness of his right to rely on statements of the broker that conflict with written disclosures,\textsuperscript{153} thus ironically shifting the

\textsuperscript{148} See, e.g., In re Mutual Funds Investment Litig., 566 F.3d 111 (4th Cir. 2009) (permitting mutual fund shareholders to bring Rule 10b-5 class action against investment adviser for misrepresentations made in prospectus with respect to “market timing”), cert. granted sub nom. Janus Capital Group Inc. v. First Derivative Traders, 130 S. Ct. 3499 (June 28, 2010).

\textsuperscript{149} For example, courts have imposed obstacles in the face of customers seeking rescissionary relief under TILA and other mortgage lending disclosure laws. See Robert Murken, Comment, Can’t Get No Satisfaction? Revising How Courts Rescind Home Equity Loans Under the Truth in Lending Act, 77 TEMP. L. REV. 457, 465 (2004) (describing many courts’ underlying “concern that the statutory scheme would impose inequitably harsh forfeitures on creditors”).

\textsuperscript{150} See, e.g., Jonathan Eisenberg, Beyond the Basics: Seventy-Five Defenses Securities Litigators Need To Know, 62 BUS. LAW. 1281, 1285–87 (2007) (discussing “75 defense doctrines that courts have used in recent years to dismiss securities claims” at preliminary stages of securities class action litigation, based, inter alia, on the defendant’s alleged role, the nature and materiality of the disclosure violation, the defendant’s state of mind, the reasonableness of plaintiff’s reliance, and the relationship between the violation and loss).


\textsuperscript{152} Langevoort, supra note 61, at 677, 681 (discussing the right-to-rely and duty to read).

\textsuperscript{153} See, e.g., Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997) (weighing eight factors to determine institutional investor’s justifiable reliance; the “sophistication and expertise of the plaintiff in financial and securities matters”; “existence of long standing business or personal relationships”; “access to relevant information”; “existence of a fiduciary relationship”; “concealment of the fraud”; “opportunity to detect the fraud”; “whether the plaintiff initiated the stock transaction or sought to expedite the transaction”; and “generality or specificity of
C. Ethical or Professional Obligations

A third approach attempts to stake a middle ground between the undue paternalism associated with fiduciary duties and the assumption of sophistication and rational decision making associated with disclosure-based approaches. This approach finds its best expression in the National Association of Securities Dealers’ (“NASD”) suitability rule. Under the rule, firms are generally required to “make reasonable efforts to obtain information” regarding a customer’s financial status, tax status, investment objectives, and other information used or considered to be reasonable in making recommendations. The rule then generally requires member securities firms making recommendations to a customer to “have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.”

As a rule of a self-regulatory organization (“SRO”), the suitability requirement is cast as a professional obligation grounded in “just and equitable principles of trade.” Analogous rules appear in the rulebooks of other securities SROs, such as the New York Stock Ex-
change and the Municipal Securities Rulemaking Board. In the insurance industry, suitability requirements appear in various state insurance codes as well as in the recommended suitability guidelines of industry bodies such as the National Association of Insurance Commissioners ("NAIC"). Suitability requirements may also reflect a desire to protect firms from the reputational or credit risk of customer defaults or misconduct, as does the OCC’s appropriateness requirement for derivative transactions effected by national banks.

Other regulators have historically disavowed any suitability rule, although courts may imply such duties as part of a financial services provider’s fiduciary duty.

The clear benefit of an industry standard of care is that it focuses on the firm’s conduct, rather than its motivations or conflicts of interest, in an objectively verifiable way. Firms are thus invited to develop internal guidelines for the risk characteristics of particular investment transactions and to identify the classes of customers to which they will be offered based on information gathered through questionnaires and other documents submitted by the customer.

In both banking and securities firms, these internal controls can then be evaluated by examiners—this can be done on an ongoing basis.


162. Wirth, supra note 68, at 56-57 (noting the range of “suitability” tests).


166. See e.g., Root, supra note 70, at 321–27 (discussing the judicial imposition of fiduciary duties, including the obligation to make suitable recommendations, in commodities cases notwithstanding lack of CFTC guidance).

through the traditional bank supervisory process for outstanding loans, derivative contracts on a firm’s balance sheet, or in inspection sweeps focusing on particular account classifications. For this reason, a number of commentators have suggested that suitability requirements should be imposed, often through a self-regulatory process, in the context of other financial markets, such as mortgage finance.168

Suitability obligations pose a number of problems. First, the obligation of due diligence in assessing a customer’s status and objectives assumes that customers are entirely forthcoming about their financial situation. Firms that act as financial planners or advisers to individual customers might have such holistic information about a client’s objectives, but for customers whose finances are spread out over various financial professionals, financial services providers can easily argue that they should not be held responsible for the performance of the entire portfolio.169 If one accepts the premise that any nonfraudulent investment transaction can, in proper proportions to the rest of an investor’s portfolio, represent a proper balance of risk and return,170 it is difficult to hold firms liable for aggressive recommendations that go sour under a theory of suitability.

This poses particular problems in the case of institutional investors, which are naturally reluctant to disclose their financial dealings with other firms. For example, NASD member firms are exonerated from their suitability obligations to an institutional customer if the firm assures itself of a “customer’s capability to evaluate investment risk independently” and determines that the customer will “exercis[e] independent judgment in evaluating a member’s recommendation.”171 Nevertheless, some of the most prominent suitability cases under federal and state law have involved institutional investors seeking to rescind or modify transactions in various derivatives or asset-backed

168. For example, Engel and McCoy suggest suitability as a tool for deterring predatory lending, supra note 42, at 1319, while Macey and his co-authors make an argument that mortgage brokers who originate securities with a view to securitization are subject to 10b-5, supra note 20, at 807.

169. Lewis D. Lowenfels & Alan R. Bromberg, Beyond Precedent: Arbitral Extensions of Securities Law, 57 Bus. Law. 999, 1008–13 (2002) (suggesting that an arbitration panel may “have stretched or reached beyond existing legal authorities” in finding a brokerage firm liable to a customer who was “an experienced and knowledgeable businessman and stock and options investor [who] devoted a substantial amount of his time to investments in the securities markets and maintained brokerage accounts with several brokerage houses.” (citations omitted) (internal quotation marks omitted)).

170. But see Stephen B. Cohen, Suitability Rule and Economic Theory, 80 Yale L.J. 1604, 1634 (1971) (suggesting that no investment is unsuitable if a portfolio is properly balanced).

171. NASD Rule IM-2310-3, FINRA Manual (CCH) at 17,158.
securities on the ground that they did not possess the information or sophistication necessary to understand the risks they had assumed.\textsuperscript{172}

Second, as an industry standard of care, it is difficult to develop objective standards of conduct for the amount of risk a customer can undertake for purposes of determining liability or comparative fault. Certainly, if a customer cannot take advantage of the unique features of an investment transaction (e.g., tax benefits) because of his status, an argument can be made that a more generic transaction might have been appropriate. Presumably, statutes and rules that govern deceptive practices can police transactions that are designed to fail or generate excessive fees. But in cases where the product is arguably suitable for some investors, objectively scaling the transaction to a particular investor’s income, net worth, or investment portfolio is inherently arbitrary.\textsuperscript{173}

Private litigation over violations of an industry code of conduct may also create significant uncertainty for both financial services providers and their clients. Because SRO rules or regulatory requirements are generally not actionable in themselves, private rights of action are typically rooted either in breach of a common law duty of care or, in the context of securities law, breach of an implied representation that brokers will conduct themselves in accordance with industry norms.\textsuperscript{174}

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173. \textit{See, e.g.}, Commonwealth v. Fremont Inv. & Loan Co., NO. 07-4373-BLS1, 2008 WL 517279 (Mass. Super. Ct. Feb. 26, 2008). In \textit{Fremont}, the court held that any mortgage loan (including loans that were not “high cost mortgage loans” under the Predatory Home Loan Practices Act) secured by the borrower’s principal dwelling should be presumed to be structurally unfair “within the penumbra of [the Act’s] concept of unfairness” if it possessed four characteristics: The loan is an ARM with an introductory period of three years or less; the loan has an introductory or “teaser” rate for the initial period that is at least 3 percent lower than the fully indexed rate; the borrower has a debt-to-income ratio that would have exceeded 50 percent if the lender’s underwriters had measured the debt, not by the debt due under the teaser rate, but by the debt due under the fully indexed rate; and the loan-to-value ratio is 100 percent or the loan carries a substantial prepayment penalty or a prepayment penalty that extends beyond the introductory period. \textit{Id.} at 9. In response to the argument that such conduct was not generally recognized to be unfair at the time the loans were made, the Court observed that the meaning of unfairness “is forever evolving, not only to adapt to changing social, economic, and technological circumstances, but also to reflect what we have learned to be unfair from our experience as a commonwealth” and that Fremont had more than fair warning of the dangers posed by the loans bearing the four characteristics identified above. \textit{Id.} at 12–13.

174. \textit{See, e.g.}, GMS Group, LLC v. Benderson, 326 F.3d 75, 81–82 (2d Cir. 2003) (“Although arguably there is no right of action simply for a violation of NASD rules, .
Reliance on the antifraud provisions of securities law thus gives rise to the same burdens of proof (e.g., state of mind) and affirmative defenses (e.g., duty to read, sophistication) that frustrate private litigants in the context of affirmative misstatements or misleading omissions.\footnote{175}

In the securities context, the availability of mandatory arbitration of disputes under the auspices of self-regulatory bodies creates further uncertainty, for good or for ill.\footnote{176} While commentary on the effectiveness of arbitral fora in securities disputes has been mixed,\footnote{177} it is arguable that arbitral fora comprised of industry and public representatives might be better suited to resolving customer disputes in an equitable manner than judicial or administrative fora. Arbitrators are not required to issue opinions and there is limited opportunity for judicial review;\footnote{178} in contrast, judicial procedures, which are bound by precedent, are subject to appeal, and may entail comparatively more expense.\footnote{179} Both policymakers and academic commentators have advocated the creation of self-regulatory bodies to promulgate business conduct rules and, in some cases, arbitral fora for sellers of investment advisory, mortgage,\footnote{180} and insurance\footnote{181} services.

\section*{III. Theoretical Challenges to a Fiduciary Standard}

Crises of confidence in the financial system instinctively translate into a desire to ratchet up the duties of financial services providers.\footnote{182} . . violations may be considered relevant for purposes of § 10(b) unsuitability claims.” (citation omitted)); Jablon v. Dean Witter & Co., 614 F.2d 677, 681 (9th Cir. 1980) (concluding that “there is no implied right of action for an NASD rule violation”); see also \textit{9 Louis Loss & Joel Seligman, Securities Regulation} 4440-4443 (3d ed. 2004).
\footnote{175} Langevoort, \textit{supra} note 61, at 677 (explaining the concept of a customer’s right to rely); \textit{id.} at 681 (noting judicial imposition of a duty to read).
\footnote{177} \textit{See generally} Jill I. Gross, \textit{The End of Mandatory Securities Arbitration?}, 30 PACE L. REV. 1174 (2010) (examining the history and criticism of arbitration in arguing that pre-dispute arbitration agreements should not be banned by Congress).
\footnote{178} Lowenfels & Bromberg, \textit{supra} note 156, at 1584, 1594 (noting that ninety-five percent of “errors and omissions” claims under brokerage firms’ insurance policies are suitability claims).
\footnote{179} Black & Gross, \textit{supra} note 62, at 1013.
\footnote{180} Engel & McCoy, \textit{supra} note 42, at 1337.
To the extent that financial intermediaries are sometimes required to observe fiduciary duties (e.g., when holding funds or engaging in discretionary trading), it is only natural to assume that such duties may be extended more broadly to all financial intermediaries at marginal additional cost. Further, to the extent that conflicts of interest can result in harm to the client, it is a natural impulse to invoke traditional fiduciary duties of a trustee or agent in an effort to discipline financial intermediaries.

Yet, as Justice Frankfurter aptly remarked, imposing the doctrine “only begins the analysis; it gives direction to further inquiry.” The business model that broker-dealers and other financial services providers employ is not well equipped to deal with the full range of obligations a true fiduciary duty would entail. For example, investment advisers are subject to significant statutory restrictions when acting as a principal or dual agent in transactions effected for clients and have a duty to avoid other conflicts of interest when managing discretionary accounts. Because broker-dealers may often participate as principals in transactions with customers, their fiduciary duty to nondiscretionary accounts has traditionally been limited to the faithful execution of customer transactions and the “handling” of customer accounts. Likewise, because broker-dealers have traditionally been compensated for transactions rather than accounts, broker-dealer regulation has evolved to address abuses of such “transaction-based compensation,” such as churning of accounts and excessive markups.

FIN. 1, 1 (2002) (describing the evolution of securities law as “punctuated” by capital market events spurring regulation).

184. See, e.g., 15 U.S.C. § 80b-6(3) (prohibiting certain transactions between an investment adviser as principal and its customer “without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction”); 17 C.F.R. § 275.206(3)-2 (requiring written consent “prospectively authorizing” agency-cross transactions and a “written confirmation at or before the completion of each such transaction” describing the nature of the transaction); Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 40, 11 Fed. Reg. 10997 (Feb. 5, 1945) (“In my opinion the requirements of written disclosure and of consent contained in [section 206(3) of the Advisers Act] must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice.”).
Applying the label “fiduciary” more broadly may thus be an exercise in appearances rather than substance.  

To the extent that financial intermediaries not otherwise responsible for discretionary decision-making have a duty of care, those obligations typically have been limited to, and are difficult to extend beyond, the traditional diligence into the character of the transaction and the financial situation and needs of the client. To the extent that it is consistent with the duty of loyalty to establish procedures to sanitize conflicts, the question arises whether courts or regulators are better suited to dictating what procedures are sufficient and what remedies are appropriate for the failure to observe. Establishing more permanent information barriers or an ongoing duty to advise could significantly ratchet up the costs of financial services. Each of these arguments is considered in turn.

A. Professionalism and Care

A duty of care pervades many aspects of a financial services provider’s relationship with the customer, such as the execution of transactions, the custody of customer funds and securities, recordkeeping and reporting, and forwarding proxy materials and other important notices affecting the customer’s portfolio. In addition, regulators prescribe examinations and qualifications as a condition of registration of such professionals and impose recordkeeping and reporting requirements to ensure that duties are fulfilled; malfeasance or nonfeasance with respect to any of the foregoing often results in some sanction.  

The concept of a duty of care when making investment recommendations is not only implied (if not explicitly stated) in the fiduciary duty investment advisers owe to their clients under the Investment Advisers Act, but is also implicit in various mandates for broker-dealers under the Securities Act and the corresponding requirements for secondary transactions developed through SEC en-

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186. Cunningham, supra note 98, at 1492 (arguing that if it is “infeasible to establish a principles-based system of corporate law, securities regulation, or accounting, then it is misleading to promote the possibility”).
187. Even here, one may argue that such standards are designed for the protection of the financial and reputational interests of the financial services industry, rather than customers. Unlike malpractice liability for legal and medical professionals, the failure to comply with industry custom rarely gives rise to liability by financial services providers to retail clients or counterparties.
forcement actions, \textsuperscript{190} the FINRA suitability rule, \textsuperscript{191} and the OCC appropriateness policy. \textsuperscript{192}

However, beyond the mere performance of due diligence into a security and into the customer’s financial condition and needs, it is unclear how regulators should articulate any additional obligation that a “fiduciary” duty of care requires. \textsuperscript{193} As one commentator has noted, the fundamental concern with brokerage sales practices is the prospect of unduly risky or unnecessarily costly transactions. \textsuperscript{194} If courts or regulators are permitted to make hindsight judgments as to relative risk and available alternatives, the cost of providing investment advice could increase dramatically, \textsuperscript{195} with a particular impact on smaller firms that may not be able to pass on such costs to clients. \textsuperscript{196} If, on the other hand, investment recommendations are simply “professional judgments” to which courts must defer, the duty of care would appear to be satisfied as long as a documentary record of diligence can be produced. \textsuperscript{197} Although regulators have developed express quantitative guidelines in certain narrow contexts—e.g., the 5% guide for “excessive” markups under the NASD’s markup policy \textsuperscript{198} or

\textsuperscript{190} See, e.g., Hanly v. SEC, 415 F.2d 589, 595 (2d Cir. 1969).


\textsuperscript{192} See supra note 164.


\textsuperscript{194} Langevoort, supra note 20, at 444–45.

\textsuperscript{195} In a study sponsored by the Securities Industry and Financial Markets Association (SIFMA), the Oliver Wyman Group estimated that fee-based accounts under the Investment Advisers Act are twenty-three to thirty-seven basis points more expensive than retail commission-based accounts and further determined that shifting brokerage customers to a fee-based advisory model would increase costs across the range of investors. OLIVER WYMAN GROUP, STANDARD OF CARE: HARMONIZATION IMPACT ASSESSMENT FOR SEC 4, 23–31 (2010), available at www.sifma.org/WorkArea/DownloadAsset.aspx?id=21999 [hereinafter OLIVER WYMAN STUDY].

\textsuperscript{196} In its Staff Report, the SEC staff noted that, as of December 2010, fifty-three percent of FINRA broker-dealers employed less than ten registered representatives, twenty-nine percent employed ten to fifty employees, nine percent employed fifty-one to 150 employees, and nine percent employed over 150 employees. SEC REPORT, supra note 24, at 11–12.

\textsuperscript{197} Ramirez, supra note 67, at 550.

\textsuperscript{198} NASD IM-2440-1 (adopting a “5% Policy” on markups while stressing that the policy is a “guide, not a rule” and that lesser markups may be “considered unfair or unreasonable”); NASD IM-2440-2 (stating that markups must be determined based on “prevailing market price” as determined by the dealer’s “contemporaneous cost” or “contemporaneous proceeds”).
statutory standards for “high-cost” mortgages 199 — courts applying qualitative standards of suitability must struggle with the decision whether to ground their rulings in empirical evidence demonstrating abnormalities from industry practice. 200

Developing quantitative standards for suitability, while not infeasible, 201 poses its own challenges. Any attempt by regulators to require firms to classify or otherwise grade investment transactions on an objective spectrum of risk, and thereafter to sanction firms that mischaracterize such risk, runs the risk of being counterproductive or, at worst, treading upon the financial services provider’s ability or willingness to speak candidly about its perceptions of risk. Congress and the SEC, for example, have generally sought to shield projections, opinions, or other forward-looking statements about securities from sanction for fear that such liability could chill the flow of information to potential investors. 202 In the context of securities litigation, credit rating agencies have invoked the First Amendment with mixed success to defend their right to publish negative ratings about corporate issuers. 203

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200. See, e.g., Press v. Chemical Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999) (criticizing the district court’s finding that a markup on a Treasury security was not “excessive” because it was “indisputably at the extreme low end of what the SEC considers to be acceptable” and because there was “no authority for his contention that ‘the standard industry spread’ for such a markup is five times less than what the defendants charged” for not engaging in a “more extensive examination”); Merrill Lynch, Pierce, Fenner & Smoot v. Arceneaux, 767 F.2d 1498, 1502 (11th Cir. 1985) (noting judicial rule of thumb that an annual turnover rate in excess of six reflects excessive trading”).


203. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 175 (S.D.N.Y. 2009) (“It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an ‘actual malice’ exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern.” (citation omitted)); In re Enron Corp. Sec., Derivative & “ERISA” Litig., 511 F. Supp. 2d 742, 817 (S.D. Tex. 2005) (“[W]hile there is no automatic, blanket, absolute First Amendment protection for reports from the credit rating agencies based on their status as credit rating agencies, the courts generally have shielded them from liability for allegedly negligent ratings for various reasons.”); see also Compuware Corp. v. Moody’s Investors Servs., Inc., 499 F.3d 520, 531, 534 (6th Cir. 2007) (affirming the dismissal of claims against rating agencies brought on the basis of credit ratings by invoking the protections of the First Amendment).
B. Inherent Conflicts in Principal Trading

Perhaps the most controversial of the conflicts of interest to which financial services providers are subject is proprietary trading. The underwriting and market-making activities of securities and commodity broker-dealers by their nature entail a conflict of interest, to the extent that many securities or derivatives contracts are sold out of or purchased for inventory, whether by the firm itself, an affiliate, or a third party pursuant to a contractual or other arrangement. Retail investors who subscribe for IPO securities or who purchase municipal securities and corporate debt from dealer inventory almost invariably deal directly with a dealer acting as principal. In the context of investment advisory activity, however, Congress and the SEC have subjected such conflicts to fairly extensive disclosure and consent requirements to mitigate the “dumping” of securities into the accounts of managed funds or discretionary accounts.

Another approach would be to segregate marketing or advisory activities from other functions, such as underwriting, dealing, market making, structuring new products, and proprietary trading. By eliminating conflicts, regulation would preclude misalignment of the incentives of sales representatives with their clients’ financial interests; as a result, firms would be encouraged to compete based on customer service, rather than the ability to push transactions to customers that benefit the firm financially. Prohibiting affiliations between public customer business and other financial services might further improve the diligence of employees of financial services firms. The use of independent agents, such as insurance agents, mortgage brokers, accountants, and occasionally lawyers, is common in many financial transactions; such agents in theory possess the freedom to build relationships with several financial services providers with a view to steering their clients to the products that offer them the best value.

204. The Oliver Wyman Study notes, for example, that municipal and corporate debt securities are largely sold out of dealer inventory and that a ban on principal trading would cut customers off from a range of products. OLIVER WYMAN STUDY, supra note 195, at 15–21.
205. Laby, supra note 20, at 408.
206. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 621, 124 Stat. 1376, 1631–32 (2010) (to be codified at 15 U.S.C. § 77a) (prohibiting underwriters, placement agents, initial purchasers, or sponsors of an asset-backed security from engaging “in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity” for a period of one year, except in connection with risk-mitigation activities or market-making or liquidity commitments).
207. Wilkerson, supra note 163, at 526.
Such strategies have not been successful for a number of reasons. Segregating the brokerage function (acting as an agent for customers) from the dealing function (buying and selling for one’s account) would require customers to pay two intermediaries for the simple execution of a stock transaction; independent research and financial advice would add costs that could be prohibitive for individual investors. More generally, financial services providers might argue (however strenuous the opposition) that they can reduce the cost of searching for and effecting transactions in investment products for their clients if they offer substantially equivalent products in house. Firms may also possess privileged information and access with respect to offerings of securities in connection with their underwriting activities that (to the extent legally permissible) may be used to benefit their clients.

Moreover, an absolute prohibition against such affiliations is rare because they may be beneficial to customers. Financial services firms have developed a dense web of quid-pro-quo arrangements, such as marketing fees or payments for order flow, that create similar opportunities to internalize costs and similar conflicts of interest. Market makers, dealers, and event-registered stock and options exchanges maintain payment-for-order-flow relationships with execut


209. See Black, supra note 78, at 87–88 (summarizing criticisms of and litigation against brokers recommending proprietary mutual funds that carry high costs without disclosing the availability of comparable mutual funds at significantly lower costs).

210. John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 YALE L.J. 929, 973–76 (2005) (describing the success of the financial services industry in persuading the Department of Labor and state legislatures to permit fiduciaries to invest beneficiaries’ assets in affiliated mutual funds despite the evident conflict of interest).


212. H.R. REP. NO. 106-434 (1999) (Conf. Rep.) (stating that the purpose of the Gramm-Leach-Bliley Act is “to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes”).

ing brokers, even though the SEC has suggested that they may compromise the quality of trade executions.\footnote{Payment for Order Flow, Exchange Act Release No. 34902, 59 Fed. Reg. 55006 (Nov. 2, 1994) (codified at 17 C.F.R. pt. 240) (approving final rules for payment for order flow practices).} Mutual funds pay marketing fees to broker-dealers and other financial services purveyors, in addition to fees for execution, custodial, and other services, which may create conflicts of interest.\footnote{See, e.g., Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591, 69 Fed. Reg. 54728, 54730 (Sept. 9, 2004) (codified at 17 C.F.R. pt. 270) (amending Rule 12b-1 under the Investment Company Act, 17 C.F.R. § 270.12b-1, to prohibit evasion of the rules governing 12b-1 marketing fees through directed brokerage).} Sponsors of securitization vehicles necessarily pay mortgage brokers and mortgage originators for providing them with a stream of underlying assets.\footnote{12 C.F.R. § 226.36(d), (e); Truth in Lending, 75 Fed. Reg. 58509, 58512 (Sept. 24, 2010) (describing purpose of rule as “protecting consumers in the mortgage market from unfair practices involving compensation paid to loan originators” by “prohibit[ing] a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction’s terms or conditions, except the amount of credit extended”); see also David Streitfeld, Fed Adopts Rules Meant to Help Protect Home Buyer, N.Y. TIMES, Aug. 17, 2010, at B3 (describing the Federal Reserve’s proposal to adopt new rules “banning yield spread premiums, which allowed mortgage brokers and lenders to gain additional profit from loans by charging borrowers higher-than-market interest rates”).} While regulators may adopt rules banning or regulating the fees provided in such relationships (e.g., when they encourage placement of customers into transactions with burdensome terms),\footnote{See supra note 19 (describing Dodd-Frank Act § 1405).} or requiring greater transparency of such fees,\footnote{See Truth in Lending, 75 Fed. Reg. 58509, 58512 (Aug. 16, 2010) (codified at 12 C.F.R. pt. 226) (amending Regulation Z to restrict compensation to loan originators that encouraged them to steer borrowers to loans that carried higher-than-market interest rates); supra note 218 (payment for order flow); supra note 215 (Rule 12b-1 fees).} firms can constantly create innovative new ways to funnel money to business partners.

Assuming that such relationships cannot (or should not) be undone, what meaningful results could additional regulation of conflicts of interest under a fiduciary standard produce? As discussed below, the law of agency typically requires the fiduciary to obtain the consent of the client in good faith after disclosure of all material facts about the transaction and the conflict of interest. For investment advisers with discretionary trading authority, there is a requirement to provide disclosure and obtain consent transaction by transaction;\footnote{15 U.S.C. § 80b-6(3) (2006) (requiring disclosure of principal trades “to such client in writing before the completion of such transaction . . . and obtaining the consent of the client”); Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 8, 11 Fed. Reg. 10997 (Feb. 5, 1945) (“In my opi-}
whereas, for the typical nondiscretionary account, the financial services provider lacks the authority to consummate the transaction without consent, but all conflicts are not currently disclosed. Accordingly, in both cases, the benefit of imposing a fiduciary duty on brokers, advisers, bankers, or other financial services provider will rest primarily on the ability to improve the manner in which disclosure is provided and the manner in which the client’s consent is secured.

The fact that the securities industry has expressed little discomfort with the application of a fiduciary duty that can be satisfied through good-faith disclosure and consent\textsuperscript{220} suggests that any disclosures required by SEC rulemaking under Section 913 are likely to impose little burden on their business model.\textsuperscript{221} The SEC has already tipped their reluctance to require transaction-by-transaction consent for financial services provides broadly, in light of its position against extending the rules governing principal and agency cross trades under the Investment Advisers Act to broker-dealers.\textsuperscript{222} Disclosure of how the various components of the financial services industry operate and interrelate would be too “voluminous” to be of help in any specific transaction.\textsuperscript{223} Such disclosures are unlikely to provide the investor, phrased as they are with descriptions of a range of possible conflicts,\textsuperscript{224} with either a quantitative indication of probability or the likelihood that a financial services provider’s incentives to profit from
one line of business (dealing) at the expense of another (client services) will be altered by the volume of transactions or the opportunity for profit. In addition, any such granularly detailed disclosures would not necessarily provide any guidance as to whether a specific recommendation is, or is not, made in good faith.

C. Ongoing Obligations to Advise

The asymmetry in the perceived duration of investment transactions may also account for some of the tension in applying fiduciary duties to firms that arrange or execute investment transactions. From the perspective of the financial services provider, its obligations should end the moment the transaction is completed. If a firm is compensated on the basis of completing individual transactions, and yet is responsible for such transactions for their expected duration (which in the case of stocks or mutual funds, could be indefinite), the exponentially increasing burden of monitoring prior transactions (both with respect to the performance of the asset and the continuing suitability for the investor) is unaffordable. From the firm’s perspective, an ongoing duty would be implied only if there was an opportunity to collect ongoing compensation (e.g., a wrap fee or mortgage service fee).

On the other hand, from the customer’s perspective, the financial services provider’s performance is often judged based on the long-term performance of the transaction, particularly if the customer incurs ongoing costs to maintain the investment. Because of the significant interval between the time that the transaction is consummated and the gains or losses of the transaction are realized, customers may view the transaction as involving a relational contract with ongoing obligations on the part of the financial services provider. To the extent that financial services providers create the impression of such a relationship, whether through the mandatory provision of financial statements and other disclosures or through the recommendation or execution of additional transactions, it is understandably difficult for the customer to appreciate the unwillingness of financial services providers to accept responsibility for continued performance.

The boundary between recommending securities transactions at a given point in time and providing investment advice over a period of time has grown hazy as a result of the transformation of compensa-
tion models in the securities industry over the past several decades. Compensation for investment advice has traditionally been structured as a fixed fee or percentage of assets under management as an incentive to maximize the value of the investors’ portfolios. Brokers, on the other hand, have traditionally received compensation in the form of a per-transaction commission, while dealers have received compensation in the form of a “mark-up” on the price of securities sold to a customer from (or a “mark-down” on the price of securities bought from a customer for) their inventory.

As fee competition among broker-dealers and other discount brokers intensified, brokerage firms experimented with “wrap fees” for a full complement of brokerage, research, and advisory services based on assets under management rather than transaction volume and “discount brokerage” fees for self-directed customer accounts. This collision in business models contributed in no small part to the SEC rulemaking vacated in Financial Planning Ass’n v. SEC. In that case, financial planners and investor advocacy groups successfully challenged a Commission rule permitting brokerage firms to offer asset-based fee structures to non-discretionary brokerage accounts.

225. As a result, in enacting the Advisers Act, Congress sought to distinguish brokerage activity from investment advisory activity based on compensation structure: section 202(a)(11) of the Act provides that the term “investment adviser” includes “any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities,” but subsequently excludes in clause (C) “any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.” 15 U.S.C. § 80b-2(a)(11)(C). As traditionally interpreted by the Commission, broker-dealers were not deemed to receive “special compensation” for incidental investment advice if their compensation consisted solely of the traditional commission received for the execution of securities transactions. See Opinion of the General Counsel relating to section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2, 11 Fed. Reg. 10996 (Sept. 27, 1946).

226. Integrated firms that offer both brokerage and dealer services may act as both broker and dealer with respect to a customer transaction and accordingly receive both forms of compensation.


228. 482 F.3d 481 (D.C. Cir. 2007) (vacating the exclusion from the definition of investment adviser for “[c]ertain broker-dealers” in 17 C.F.R. § 275.202(a)(11)-1); Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20424 (Apr. 19, 2005) (codified at 17 C.F.R. pt. 275). In vacating the Commission’s rule, the majority opinion focused largely on the question whether the Commission could use its authority under subsection (F) to exclude any “additional” class of broker-dealer not excluded under subsection (C). Fin. Planning Ass’n, 482 F.3d at 487. The majority observed, inter alia, that the Commission had reversed “six decades of consistent SEC understanding” in interpreting subsection (F) in this manner, id. at 490, and that the Commission’s power to “prescribe different requirements for different classes of persons or matters” did not give it the power to defy the will of Congress, id. at 490.

229. Fin. Planning Ass’n, 482 F.3d at 483. Exclusions were subject, inter alia, to greater disclosure about the differences between brokerage and investment advisory
from the Commission’s perspective the development of wrap fees was salutary to the extent that it eliminated incentives for brokers to engage in aggressive sales practices, the convergence in compensation models continues to create confusion about what “full service” brokerage customers are paying for.

One can question the utility of a fiduciary duty to the extent that it confuses, rather than clarifies, this asymmetry of expectations. The Dodd-Frank Act, for example purports not to impose on broker-dealers “a continuing duty of care or loyalty to the customer after providing personalized investment advice.” If ongoing asset-based wrap fees in “full-service” nondiscretionary brokerage accounts significantly exceed the discount commissions paid by “self-directed” accounts on individual transactions, however, “full-service” customers may believe they are paying premium compensation for some ongoing advisory service, even if account documentation suggests otherwise. Such a system of rules would appear to entrench, rather than address, the disconnect between the expected and actual benefits of a fiduciary duty.

D. Availability of Private Relief

Finally, extending the proposed “fiduciary” label to broker-dealers or other financial services providers may well ring hollow to the extent that no private right of action exists for clients injured by “personalized investment advice.” Advisory clients currently cannot sue their investment advisers for damages resulting from breach of the duties enumerated in Section 206 of the Investment Advisers Act, absent the showing of reliance on a material misstatement or misleading omission made with scienter as required by Rule 10b-5. Moreover, nothing in the Dodd-Frank Act suggests that private remedies for breaches of any fiduciary duty created under section 913 are available, and commentators have speculated that the SEC is unlikely to endorse such a range of remedies.
The purpose of a broad fiduciary duty appears to be to give public authorities significant flexibility to develop causes of action based on novel legal theories, particularly in cases where an intent to deceive may be difficult to establish because no affirmative misstatement is made to investors about the role being played by the putative fiduciary in the same or comparable transactions. But public enforcement officials can assert greater flexibility in applying securities law to the sales practices of financial intermediaries without necessarily labeling such duties as “fiduciary.” For example, courts have applied the more liberal standard of securities fraud in New York’s Martin Act and section 17(a) of the Securities Act—neither of which creates a private right of action—to reach conduct that would otherwise not be actionable under Rule 10b-5, based on a liberal reading of the common law distinctions between fraud and deceit.

IV. PRACTICAL CHALLENGES TO A FIDUCIARY STANDARD

In addition to the theoretical problem of extending fiduciary duties beyond traditional relationships of trust and investment, adopting a fiduciary standard any subset of financial services providers could pose a number of practical challenges. Any attempt to extend fiduciary duties beyond the realm of securities business—e.g., to mortgage transactions—would be anathema to banks and bank regulators alike and would compromise efforts to harmonize sales practice standards for all investment transactions. Regulators would invariably come under pressure to adopt safe harbors to give financial services providers greater certainty with respect to routine transactions. There is also a risk that courts and regulators might simply apply increasingly commercialized versions of a fiduciary duty to reflect the realities of modern financial services, and thus undermine the appli-

233. See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963) (holding that scienter is not required to establish that a practice “operates as a fraud or deceit upon any client or prospective client” within the meaning of section 206 of the Investment Advisers Act).

234. N.Y. GEN. BUS. LAW § 352 (McKinney 1996) (granting the Attorney General exclusive authority to bring actions under Martin Act).

235. Aaron v. SEC, 446 U.S. 680, 697 (1980) (holding that the SEC need not show scienter to establish that a person was engaged “in a transaction, practice, or course of business which operates or would operate as a fraud or deceit” under section 17(a)(3) of the Securities Act); In re Wash. Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1355 (9th Cir. 1987) (finding no private right of action under section 17(a) of the Securities Act of 1933). The Martin Act has generally been interpreted to preclude actions under state common law for misrepresentation and breach of fiduciary duty in connection with transactions “within or from” New York in the absence of a showing of scienter. Lehman Bros. Commercial Corp. v. Minimetals Int’l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 162–65 (S.D.N.Y. 2001).
cation of fiduciary duties in those areas (e.g., investment advisory services and discretionary trading) where they are needed most.

A. Regulatory Competition and Inconsistent Enforcement

The most significant complication in calibrating the obligations of financial services providers to their clients is the opportunity for regulatory arbitrage create by our fragmented system of financial services regulation. The differences in sales practice regulation across regulated entities constitute some of the significant remaining obstacles to harmonizing financial services regulation within the United States.236

As commercial and investment banks and other financial services providers have increasingly branched into overlapping lines of business, Congress and federal regulators have only made modest efforts to standardize business conduct rules—primarily, ministerial “back-office” practices, such as notifications of privacy policies, money laundering, telemarketing, sharing of information among affiliates, and identity theft.237

While the financial crisis has prompted Congress to consider uniform measures of capital adequacy and to harmonize resolution protocols for financial services firms,238 sales practice regulation for U.S. financial services providers has thus far escaped efforts at harmonization.239

Such disharmony has traditionally been explained by the historical differences in core products offered by regulated entities; for example, as discussed above, there may be less need to regulate the con-
duct of purveyors of traditional banking products, such as deposits and mortgages, through sales practice regulation when bank examiners’ focus on safety and soundness precludes the creation of highly dangerous products. Conversely, the high risks undertaken by underwriters, market makers, and other securities dealers may have historically counseled in favor of more rigorous business conduct regulation of securities representatives. As financial services providers may now provide a multitude of services in the name of affiliated companies, such distinctions are anachronistic.

Indeed, the greater threat presently seems to be confusion as to the level of service that clients receive from their financial services providers. Recent studies have suggested that customers do not appreciate the difference between an investment adviser and a broker-dealer sales representative that provides incidental investment advice, that certain products sold by bank employees carry FDIC insurance while others do not, and that variable annuities marketed by insurance agents are largely interchangeable with traditional mutual funds. Other differences are more subtle: Derivatives embedded in mortgages or non-financial services—such as the differences between floating and fixed energy bills or other commodities—are not regulated as separate financial products, even though customers

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240. See supra notes 68 (discussing credit rationing as a tool for protecting lenders against imperfect information about default risk under the Stiglitz-Weiss model) and 164 (discussing the OCC’s appropriateness policy for derivatives transactions by national banks).

241. Karmel, supra note 31, at 1275 (discussing the difficulty of finding broker-dealers to be fiduciaries in light of their role as agents or principals).


244. Markham, supra note 111, at 798.

245. Macey et al., supra note 20, at 810 (arguing that mortgages are equivalent to an annuity written by the borrower to the lender while reserving an option to prepay or put the property to the lender).
face the same asymmetries of information, sophistication, and ability to bear risk when selecting from among such products.

Commentators have developed a variety of theories to explain the obstacles to harmonizing differences in sales practice regulation. Those sympathetic to the SEC’s efforts to bolster sales practice regulation frequently invoke regulatory capture to explain the tension between the SEC and the banking agencies. Others cast the tension in terms of institutional competence, preservation of regulatory turf, or simply differences in culture. While Congress has expanded the activities in which regulated financial services providers may engage, it largely has abdicated any role in determining the regulatory jurisdiction of the regulated.

The courts, meanwhile, have expressed over time a preference for technical construction of obsolescent statutory text in lieu of developing principles to match regulatory jurisdiction to the merits of particular financial products. In *American Bankers Ass’n v. SEC*, the D.C. Circuit blocked an attempt by the SEC to address the boundaries between brokerage activity subject to Commission regulation and the authority of banking regulators over entities chartered as federal or state banks. The Commission’s Rule 3b-9 would have subjected to Commission regulation any bank that earned “transaction-related compensation” from brokerage services, whether as an accommodation for existing banking customers or resulting from public solicitation.


248. See infra text accompanying notes 261–264.


250. 804 F.2d 739 (D.C. Cir. 1986).

251. The Office of the Comptroller of the Currency is charged with the regulation of “nationally chartered banks,” which are chartered under 12 U.S.C. § 21. The Board of Governors of the Federal Reserve System supervises bank holding companies and state-chartered banks that are members of the Federal Reserve System; the Federal Deposit Insurance Corporation supervises state-chartered banks not subject to the Board’s supervision.

252. Notwithstanding the exclusion of banks from the statutory definitions of “broker” and “dealer” in the Exchange Act, 15 U.S.C. § 78c(a)(4)–(5), the Commission predicated its authority to exclude banks engaged in for-profit brokerage servic-
Noting that Congress was aware of the various securities-related activities in which banks had traditionally engaged, the court noted that the term “bank” was “defin[ed] . . . in terms of the government agencies that regulated them,” rather than the specific functions they performed (i.e., deposit-taking) and that the exclusion of banks from registration as brokers and dealers was thus “but one part of a consistent congressional policy of keeping oversight of the banking system separate from the SEC’s oversight of the securities trading and investment industries.” The Court notably refused to consider whether Congress would have granted the SEC the power to regulate the brokerage activities of banks had it anticipated that bank regulators might interpret Glass-Steagall to permit banks to engage in retail bank brokerage activity.

In the Gramm-Leach-Bliley Act of 1999, Congress clarified that banks may engage in securities-related activities, subject to the requirement to “push out” activities other than certain enumerated activities that constituted traditional banking activity into a subsidiary subject to Commission regulation. The trouble is that Congress has left it to the federal agencies to squabble among themselves as to the appropriate allocation of regulation through a variety of legislative gimmicks. Joint rulemaking exercises, consultation require-

253. See Am. Bankers Ass’n v. SEC, 804 F.2d 739, 746 (D.C. Cir. 1986) (quoting the testimony of William Potter, Chairman, Guaranty Trust Co.). Many of these services may continue to be offered by banks without registration as a broker or dealer. See 15 U.S.C. § 78c(a)(4)-(5) (listing exclusions from the definition of “broker” and “dealer” for certain bank activities).

254. Id.

255. Id.


257. For example, while Congress initially granted the Commission the authority to determine the scope of activities that would trigger broker-dealer registration under the Gramm-Leach-Bliley Act, it subsequently mandated joint rulemaking between the SEC and bank regulators after the SEC published a proposing release containing rules to which the banking community objected. Compare Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §§ 201-02, 113 Stat. 1358, 1385–91 (1999) (amending the definitions of “broker” and “dealer” in sections 3(a)(4)-(5) of the Exchange Act), with Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966, 1968 (amending section 3(a)(4) of the Exchange Act by adding a joint rulemaking requirement for implementing exceptions to the definition of “broker” under subparagraph (B)).
ments, dual registration of financial intermediaries and “jump ball” provisions giving regulators the right to challenge one another’s turf in federal court have become troublingly commonplace in the regulation of business practices in the financial community. To the extent that Congress is unable to articulate a coherent vision of how regulatory authority should be functionally allocated, it is up to the SEC, the CFTC, federal and state banks, and insurance and consumer protection regulators to find ways to harmonize their respective regulatory frameworks.

B. Safe Harbors for Compliance

Another challenge to extending fiduciary or professional obligations to financial services providers is the need to define categories of products or transactions that fulfill the provider’s fiduciary duty without further action. Safe harbors are routinely developed to guide fiduciaries in structuring transactions or making decisions on behalf of a principal in a manner that minimizes the risk of challenge and subsequent judicial review. Unlike regulations that prohibit unfair or

258. See 15 U.S.C. § 78c(a)(55)(D) (requiring joint SEC-CFTC rulemaking to establish rules for classifying foreign indices as “narrow-based securities indices” for purposes of allocating jurisdiction over related index futures and index options); § 78g(c)(2)(B) (providing for joint SEC-CFTC rulemaking pursuant to delegated authority from the Federal Reserve Board regarding margin requirements for security futures products).


261. See 7 U.S.C. § 27d (granting the Federal Reserve Board a similar right of consultation and challenge with respect to any CFTC rule regulating a hybrid instrument that the CFTC has determined not to be predominantly a banking product); 15 U.S.C. § 78o(i) (granting the Federal Reserve Board a right of consultation and a right to challenge before the D.C. Circuit any SEC rule imposing broker or dealer registration requirements with respect to any new hybrid product, based on whether imposing such a requirement “is appropriate in light of the history, purpose, and extent of regulation under the Federal securities laws and under the Federal banking laws, giving deference neither to the views of the Commission nor the Board”); Dodd-Frank Act § 712(c), 124 Stat. at 1643–44 (to be codified 15 U.S.C. § 8302) (permitting either Commission to petition for judicial review of the other’s rulemaking).
deceptive practices or limit investment to certain approved products, the purpose of the exercise is to put investors on notice that certain products may pose greater risk or greater complexity than more “plain vanilla” products.

In specific contexts, the financial intermediary’s duty of loyalty is exhaustively defined by statute and regulation. ERISA, for example, prohibits transactions between a private plan and a fiduciary or transactions between a private plan and any “party in interest” caused by a fiduciary unless effected pursuant to a specific exemption, with the understanding that the associated regulators (the Secretaries of Labor and the Treasury) would exercise exemptive authority to provide guidance to persons providing brokerage or management services. In some cases, such statutes are expressly designed to displace open-ended fiduciary duties or duties of disclosure, whereas in others, courts may be inclined to infer displacement to provide definitive guidance to financial services providers.

An example of such a regulatory safe harbor in the Dodd-Frank Act is the classification and treatment of certain “qualified mortgages.” To the extent that mortgage originators are subject to a professional

262. Root, supra note 70, at 353 (describing evolution from “legal lists” to modern portfolio theory). The Dodd-Frank Act creates a process by which any person that proposes to list or trade a “novel derivative product” may seek a determination from the SEC and the CFTC (subject to judicial review) as to whether such product is a "security" or "contract for future delivery," "commodity option" or "option on a contract for future delivery," but gives the agencies no special authority to regulate such products. Dodd-Frank Act § 718, 124 Stat. at 1652–54 (to be codified at 15 U.S.C. § 8306).

263. 29 U.S.C. § 1106 (prohibiting a fiduciary with respect to an ERISA plan from entering into certain transactions with the plan or causing the plan to enter into certain transactions with a “party in interest”); HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION, § 2.04[b][1], at 64–65 (2d ed. 2004) (stating the “general principle” that “unless expressly exempted, any transaction (1) with an employee benefit plan by a fiduciary for its own account, or (2) between a plan and a party in interest . . . or a disqualified person . . . caused by a fiduciary is prohibited”).

264. 29 U.S.C. § 1108(a) (providing the Secretary of Labor with the authority to grant exemptions “if administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of such plan”); H.R. Rep 1280, 93d Cong. 309–310 (1974); see also BINES & THEL, supra note 270, § 11.02[B][1], at 740. For example, the Department of Labor has promulgated a “prohibited transaction exemption” for “qualified plan asset managers” that are deemed “independent of the parties in interest and which meet specified financial standards.” Class Exemption for Plan Asset Transaction Determined by Independent Qualified Professional Asset Managers 84-14, 49 Fed. Reg. 9494 (March 15, 1984), as amended in 70 Fed. Reg. 43905 (Aug. 23, 2005).

265. Cf. Press v. Quick & Reilly, Inc., 218 F.3d 121, 132 (2d Cir. 2000) (determining compliance with Rule 10b-10 requirement regarding disclosure of third party remuneration was sufficient to avoid liability for securities fraud under Rule 10b-5).
or fiduciary “duty of care” in originating mortgages, the Act creates a presumption that a consumer has the “ability to pay” a mortgage that meets certain statutory criteria and standards implemented by regulation related to the loan’s duration and amortization schedule, the ratio of monthly debt to monthly income resulting from the loan, the ratio of total points and fees to the size of the loan, and the spread between the loan’s interest rate and the average prime offer rate. Such rules create an incentive for mortgage originators to conform to the terms dictated by the statute and implement regulations to avoid subsequent challenge under the statute’s duty of care and the attendant penalties.

Such approaches are not without their flaws. First, to the extent that sales practice rules should provide some protection to institutional or sophisticated investors, regulatory guidelines are not easily extensible to such transactions; some residual fiduciary or professional duty would therefore be necessary to address complex transactions. Second, such approaches presuppose that regulators are able to establish and maintain guidelines on an ongoing basis for suitable and unsuitable investment transactions. For example, only in 2008, did Congress and the Department of Labor permit managers of defined contribution plans to invest unallocated employee contributions to a default option other than money market mutual funds, on the theory that the Department did not want to create a safe harbor protecting fiduciaries from litigation in the event of a decline in value.

266. See supra text accompanying notes 6–19 (describing the Dodd-Frank Act’s imposition of such duties).
268. Id. § 1404, at 2141 (to be codified at 15 U.S.C. § 1639b) (extending liability under section 130 of the Truth in Lending Act to mortgage originators in breach of such duties for the greater of actual damages or an amount equal to three times the total amount of compensation or gain accruing to the mortgage originator, plus costs and attorneys’ fees); id. § 1413, at 2148–49 (to be codified at 15 U.S.C. § 1640(k)) (providing that a consumer may assert a violation of such duties as a matter of defense by recoupment or set off in the face of a judicial foreclosure at any time notwithstanding the statute of limitations under section 130 of the Truth in Lending Act).
269. 29 C.F.R. § 2550.404c-5 (protecting such a fiduciary from liability “for any loss... that is the direct and necessary result of... investing all or part of a participant’s or beneficiary’s account in any qualified default investment alternative,” as defined in the rule); 29 U.S.C. § 1104(c)(3), as amended by section 624 of the Pension Protection Act of 2006, Pub. L. 109-280, 120 Stat. 780.
270. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 131 (2008) (noting the Department of Labor’s “reluctance... to issue guidelines officially blessing (by granting a “safe harbor” status) any fund that could ever decline in value”).
Third, they create a perception that certain investments are government-sanctioned, which creates political pressure for protecting such investments through fiscal or monetary policy, particularly when there are significant inducements for the certifying body to grant more favorable treatment. For example, the favorable treatment assigned to certain mortgage-backed securities under capital adequacy rules encouraged financial services providers, pension funds, and sovereign wealth funds to concentrate holdings. This overconcentration, and subsequent collapse of the market when defaults started mounting, triggered unprecedented intervention by the Federal Reserve to stabilize prices indefinitely.  

From the perspective of firms, such approaches pose a risk of stifling innovation to the extent that deviations from favored products can give rise to significant liability. Professor Jill Fisch has addressed this problem by proposing a rule that would provide financial innovators with a safe harbor from the imposition of fiduciary remedies if, among other things, such innovators either offer transactions that “conform” to regulatory guidelines or “explain” material deviations therefrom. The protective effect of such disclosures, however, is unclear for either investors or financial services providers. To the extent that such safe harbors, by implication, deal with novel terms, reviewing courts may well focus on the subjective intent of the offeror rather than the objective materiality of the deviations—this, in turn, would impair investors’ ability to challenge the suitability of novel products.

C. The Trend to Commercialize Fiduciary Duties

A third complication with imposing fiduciary duties on all investment recommendations is that it would invariably lead legislatures and courts to “commercialize” fiduciary obligations, either through codification of fiduciary obligations or by developing legal presumptions or defenses that neutralize prima facie claims. Fiduciary duties of loyalty and care, like all standards applied ex post facto in administrative or judicial proceedings, in theory would shift the burden onto financial services providers, individually and collectively, to develop norms of conduct to be tested in enforcement proceedings and pri-

271. Expressing concern over the possibility of such “moral hazard,” Congress commissioned a study of the feasibility of creating an SRO or similar public or private entity to assign NRSROs to determine credit ratings. Id. § 939F(b)(2)(C), at 1889 (to be codified at 15 U.S.C. § 78o-9).

272. Fisch, supra note 213, at 103, 117, 118 (explaining that a safe harbor from fiduciary duties or antifraud rules exists only if there is adequate disclosure of non-conforming features of a particular product).
vate litigation, and to make adequate provision for the legal risks resulting from any foray into novel services. Fiduciary standards, however, may be so open-ended, particularly if sanctions or remedies are sought well after the offending conduct has occurred, that their application by courts or arbitrators might well appear highly arbitrary from the perspective of both firms and their clients.

To the extent that fiduciary duties may be limited or eliminated by agreement, judicial forbearance is all that is required to blunt their impact. SIFMA’s endorsement of fiduciary duties, as long as the impact of such duties can be rendered “business-model neutral” through disclosure and waiver of conflicts, reflects this trend. In private placements and over-the-counter offerings, firms have long sought to negotiate “no reliance” clauses, “big boy letters,” and similar clauses disaffirming any duty of care or reliance on the firm’s advice for purposes of federal securities law and state agency law. Of course, commentators argue that fiduciary duties should continue to play an “extracontractual” role to prevent abusive contracting, or at


274. Lowenfelds & Bromberg, supra note 155, at 1584 (noting that the securities industry’s concern with respect to unsuitability claims “has been exacerbated within the last decade,” among other factors, by the shift of private actions from the courts to arbitration tribunals and “a concomitant shift in the legal basis for unsuitability claims from an interpretation and application of rules promulgated by the SEC under the federal securities laws to an interpretation and application of the suitability rules promulgated by the SROs”); Karmel, supra note 31, at 1295–97 (noting that “arbitration is a business forum, not a court of law, and arbitrators need not follow legal precedent”); Black, supra note 79, at 103 (“Whatever its imperfections, the FINRA arbitration forum presents a great advantage from the investors’ perspective: its emphasis on equity allows arbitrators to fashion a remedy for investors that may not be supported by the law.”).


278. The SEC’s general counsel has taken the position that attempts to disclaim liability for ordinary negligence may be void and may further be fraudulent, to the extent that such liability cannot be waived under federal securities law. See, e.g., Interpretive Releases Relating to Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, 16 Fed. Reg. 3387 (Apr. 18, 1951) (opining that such clauses may be void under section 215(a) and violative of sections 206(1) and 206(2) of the Investment Advisers Act).

279. Ramirez, supra note 68, at 563.
least a suppletive role when conflicts of interest cannot be adequately defined or addressed by contract.\textsuperscript{280} In other contexts, courts have taken the initiative in fashioning doctrines that relieve fiduciaries of the more onerous aspects of the duty of loyalty and care when it might otherwise impair the efficiency of the fiduciary’s performance. Whereas the law of asset management once imposed very detailed prescriptions for investment decision making under the prudent man rule, courts and legislators have significantly liberalized the parameters within which asset managers exercise their duty of care.\textsuperscript{281} In the context of corporate law, the duty of care has been rendered largely a procedural rule, rather than a substantive rule, in order to free directors to take calculated risks.\textsuperscript{282} At the same time, courts have carved out safe harbors from prohibitions against self-dealing, dual agency, or other conflicts of interest to accommodate financial services providers operating in multiple capacities as long as they act in an objectively “fair” manner.\textsuperscript{283}

This term’s decision in \textit{Jones v. Harris Associates}\textsuperscript{284} is perhaps the most recent illustration of judicial attitudes with respect to fiduciary duties in the context of financial services. The fiduciary duty at issue in \textit{Harris Associates} was created by Congress in Section 36(b) of the Investment Company Act of 1940, which creates a private right of action against the investment adviser of a registered company for breach of “fiduciary” duty in connection with the adviser’s compensation.\textsuperscript{285}

The statutory language was meant to serve as a compromise


\textsuperscript{281} See, e.g., \textit{Bines & Thel}, supra note 270. § 8.02, at 365–98 (tracing the evolution of prudent-investor jurisprudence in both case law and statutory law from the Second Restatement of Trusts to the Third Restatement).

\textsuperscript{282} See, e.g., Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (en banc) (“As for the plaintiffs’ contention that the directors failed to exercise ‘substantive due care,’ we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is process due care only. Irrationality is the outer limit of the business judgment rule.”).

\textsuperscript{283} Leslie, supra note 283, at 2713. For example, legislators in most states have permitted trustees to purchase proprietary mutual funds for trusts. \textit{Id.} at 2733 & n.68. Trustees can avoid “further inquiry” of beneficial owners by engaging in “fair” transactions with principal. \textit{Id.} at 2721. \textit{But see} John H. Langbein, \textit{Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?}, 114 YALE L.J. 929, 931 (2005) (defending “no further inquiry” rule).

\textsuperscript{284} 130 S. Ct. 1418 (2010).

\textsuperscript{285} More specifically, section 36(b) of the Investment Company Act of 1940 deems investment advisers of mutual funds registered as an investment company “to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.” 15 U.S.C. § 80a-35(b) (2006). Section 36(b) further allows
between traditional corporate law remedies for excessive compensation—which requires shareholders of a mutual fund to show that the directors had committed waste in agreeing to an excessive compensation arrangement with the investment adviser—and granting the SEC the authority to set “reasonable” compensation for mutual fund advisers through some sort of ratemaking process.\textsuperscript{286}

The prevailing test for reviewing investment adviser compensation under Section 36(b) was articulated by the Second Circuit in \textit{Gartenberg v. Merrill Lynch Asset Management, Inc}.\textsuperscript{287} In that case, the Second Circuit concluded that the test for excessive compensation is “essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances,” and more specifically, whether the fee charged is “so disproportionately large that it bears no reasonable relationship to the services rendered.”\textsuperscript{288} Among the “pertinent facts” a reviewing court was required to weigh in making this determination were “the adviser-manager’s cost in providing the service,” the adviser’s ability to realize “economies of scale as the fund grows larger,” and “the volume of orders which must be processed by the manager.”\textsuperscript{289}

Prior to the Supreme Court’s decision in \textit{Jones v. Harris Associates}, the petitioner challenged, in the Court of Appeals below, the differential fee structure \textit{Harris Associates} applied to its “captive” retail and institutional mutual funds and other independently managed funds. The Seventh Circuit, departing from the reasoning in \textit{Gartenberg}, viewed the fiduciary requirement in section 36(b) as little more than a requirement to disclose conflicts of interest. In its view, competition among mutual funds, based on full disclosure of compensation arrangements, was sufficient incentive for fund managers and investment advisers to avoid “excessive” fees; fund advisers, under the Seventh Circuit’s logic, should be permitted to negotiate at “arm’s length” for differential compensation for different levels of research. shareholders in such funds to bring a suit against the investment adviser in the right of the mutual fund “for breach of fiduciary duty in respect of such compensation or payments.” \textit{Id.}

\textsuperscript{286. S. REP. NO. 91-184, at 16 (1969) (noting the Senate Committee’s belief that a private action for breach of fiduciary duty “provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund” and favoring “industry self-regulation” over “recommendation that the Congress set a maximum statutory commission rate for mutual fund sales loads”).}

\textsuperscript{287. 694 F.2d 923 (2d Cir. 1982).}

\textsuperscript{288. \textit{Id.} at 928.}

\textsuperscript{289. \textit{Id.} at 930.}
In the wake of the Seventh Circuit’s decision, some commentators made even more aggressive assertions about adviser compensation—for example, suggesting that an investment adviser who consistently generates abnormally high returns should be entitled to keep a significant percentage of those returns in the form of higher advisory fees to the same extent as private equity and hedge fund managers share in the returns they generate for their clients.\(^{290}\)

In interpreting section 36(b), the Supreme Court reaffirmed the reasoning in *Gartenberg* with a view to upholding the fiduciary concept without engaging in ratemaking or reflexively relying on market competition. In particular, the Court focused on the need to “take into account both procedure and substance” when assessing whether the fee comported with the investment adviser’s fiduciary duty.\(^{291}\)

Noting that Congress had already stiffened the requirements for the independence of mutual fund directors vis-à-vis the advisory fund, it rejected judicial “second-guessing” of “informed board decisions.”\(^{292}\) Thus, “[w]here a board’s process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process.”\(^{293}\) Conversely, “where the board’s process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome.”\(^{294}\)

The Supreme Court thus recognized that the law can, in relevant ways, shift the burden to financial services providers to develop substantive and procedural safeguards when setting the terms of their relationship with their clients. But its decision reinforces the perception that fiduciary duties, in the context of financial services, are fundamentally duties of process and candor, with substantive scrutiny of particular transactions only in rare cases when those requirements are not met. Extending an open-ended fiduciary duty to financial services providers who make investment recommendations may ultimately accomplish little more than backstop existing internal controls and mandatory disclosures required by financial regulators or self-regulatory bodies. Even forceful advocates of raising sales prac-

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290. Johnsen, supra note 75, at 590 (arguing that if a fund generates abnormal returns, it is not inappropriate for manager to charge higher fees).
291. *Harris Assocs.*, 130 S. Ct. at 1429.
292. Id. at 1430.
293. Id.
294. Coffee Testimony, supra note 56, at 19–20; RESTATEMENT (SECOND) OF TORTS § 551(2)(a); Langevoort, supra note 62, at 688.
tice standards have conceded that such standards must be articulated in a manner that avoids imposing quantitative guidelines.\textsuperscript{295}

V. CAPTURING THE ESSENCE OF FIDUCIARY DUTY

This article argues that there is a case for applying certain disclosures of a fiduciary nature consistently across all financial services providers, as long as compliance can clearly be defined ex ante and customers clearly understand the contours, if not the precise limits, of their financial services provider’s duties. The essence of fiduciary duty when making investment recommendations, as described above, should be good faith disclosure of both qualitative and quantitative information about the financial services provider’s basis for making a recommendation, as well as any conflicts of interest affecting the financial services provider’s judgment, coupled with a requirement to make the customer whole if the customer suffers a loss proximately caused by the breach of such duties.

Accordingly, this article speculates that such a fiduciary duty would be manageable if financial services providers could qualify for a safe harbor by providing their clients with certain quantitative information in good faith about their proprietary assessment of the risk of the transaction. Specifically, the mandatory offer of a put option “married” to investment transactions, or offer of a comparable hedging transaction, can function more effectively than a fiduciary “put” at communicating risks, sanitizing conflicts, and shaping client expectations. Several scholars have explored the use of “revealing options” or “self-assessment” as a means to encourage or compel parties to communicate information about their valuation of entitlements or tort damages,\textsuperscript{296} or as a means of valuing the right to sue, for example, for claims of expropriation.\textsuperscript{297}

\textsuperscript{295} See, e.g., Engel & McCoy, supra note 42, at 1342 (advocating a suitability standard for mortgage products, but conceding that could devolve into price regulation if not adequately articulated). See also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376, 1890–96 (to be codified at 15 U.S.C. § 78o-9) (requiring federal banking agencies, the SEC, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency to jointly define the term “qualified residential mortgage,” for purposes of the Act’s credit risk retention requirement, by reference to “underwriting and product features that historical loan performance data indicate result in a lower risk of default,” including the mortgagor’s residual income after the payment of all monthly obligations and the ratio of both monthly mortgage payments and total monthly installment payments to the mortgagor’s monthly income).

\textsuperscript{296} Lee Anne Fennell, Revealing Options, 118 Harv. L. Rev. 1399, 1434 (2005) (arguing that the use of “entitlements subject to self-made options” in lieu of liability rules as a means of allowing entitlement holders in “name-your-own liability” regime will enhance “entitlement holder’s autonomy”); Ian Ayres, Protecting Property With

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This approach would also complement regulatory efforts to supplement, or in some cases substitute, qualitative guidance with quantitative or empirical information about market risk. Recent scholarship has explored the possibility of that institutional investors might find it useful to rely on credit default swap spreads, in lieu of or in addition to investment grade ratings, for regulatory and risk-management purposes; these initiatives follow on the coattails of the SEC’s own efforts to eliminate regulatory reliance on investment grade ratings. Similarly, the Dodd-Frank Act has championed greater disclosure about the specific assets underlying asset-backed securities. This proposal takes these initiatives one step further by requiring firms to disclose, in discrete quantities, their proprietary assessment of the markets they offer customers.

A. The Proposal

Consider the following requirement: When recommending an investment transaction, a financial services provider enjoys a safe harb-

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297. Jeremy A. Blumenthal, *Legal Claims as Private Property: Implications for Eminent Domain*, 36 Hastings Const. L.Q. 373, 416–21 (2009) (arguing that the right to bring a lawsuit can be valued using real options theory for purposes of determining “just compensation” when the government seeks to condemn a prospective plaintiff’s right to bring a lawsuit against a third party); *see also* Bradford Cornell, *The Incentive to Sue: An Option-pricing Approach*, 19 J. Legal Stud. 173, 174 (1990) (“Filing a suit is analogous to purchasing an option, because it gives the plaintiff the right to proceed toward trial without having the obligation to try the case.”). 298. *See, e.g.*, Booth, supra note 205, at 1626.

299. *See, e.g.*, Mark J. Flannery et al., *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. Pa. L. Rev. 2085, 2113–14 (finding support for the conclusion that “CDS spreads reflect information more quickly and accurately than credit ratings”) (2010). 300. *See also* Dodd-Frank Act § 939(a)–(c), 124 Stat. at 1885–86 (to be codified at 12 U.S.C. § 1817) (replacing references to ratings and related terms, such as “investment grade,” in various statutes governing financial institutions with delegation of authority to individual agencies to develop “standards of credit-worthiness”); *id.* § 939A, at 1887 (to be codified at 12 U.S.C. § 78o-7) (requiring federal agencies to review and, as necessary, modify any regulations that require assessments of credit-worthiness or refer to or require reliance on credit ratings).

301. I propose to define “recommendation” to refer to communications by a financial services provider reasonably intended to solicit a specific transaction, as used in FINRA’s suitability rule. *See* NASD Rule 2310, FINRA Manual (CCH) 17,155 (2009). This definition would exclude, for example, general advice about financial
bor from liability based on a breach of the duty of care or a conflict of interest if it offers its customers in good faith a “put” or “collar” giving the customer the ability to rescind the transaction at an arbitrary percentage of the initial investment amount (e.g., eighty percent) within an arbitrary period (e.g., one year) after each debit of customer funds (e.g., payment of the purchase price, payment of interest and principal on a loan, or posting of additional margin in a securities or commodities account). Analogous rules could be extended to annuities and other insurance products, as well as mortgages—for example, lenders could be required to offer and price the right to “put” an underlying property to the lender via a non-recourse mortgage.

On the one hand, customers who elect to purchase the additional protection would forgo the “fiduciary put” they would enjoy under law—i.e., the ability to rescind a transaction within the statutory limitations period for all or part of the purchase price if they can demonstrate a breach of fiduciary duty in a judicial or arbitral proceeding—with an option that has clearly defined price and time parameters. From both the perspective of the financial services provider and the customer, the good faith offer and purchase of such an option eliminates the indeterminacy of fiduciary duty. On the other hand, if the customer chooses not to purchase the option, the mere fact of making such an offer in good faith would reveal significant information planning, allocation of assets, and other transactions not involving specific financial products. Id. It would also not apply to situations in which a member acts “solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member.” NASD Notice to Members 96–60, Clarification of Members’ Suitability Responsibilities Under NASD Rules on Member Activities in Speculative and Low-Priced Securities (Sept. 1996), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noties/p016905.pdf. As the NASD has noted, a “broad range of circumstances may cause a transaction to be considered recommended,” including, for example, dissemination of forecasts, research reports, or other communications by a financial service provider designed to draw a customer’s attention to a financial product. Id.; see Sales Practice Requirements for Certain Low-Priced Securities, 54 Fed. Reg. 35468, 35476–77 (Aug. 28, 1989); Lowenfels & Bromberg, supra note 156, at 1560–61 (describing industry concerns about NASD’s suitability rule and definition of “recommendation”); NASD Notice to Members 96–60, supra (maintaining that it is facts-and-circumstances that determine whether a transaction is “recommended”); see also Frederick Mark Gedicks, Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability, 37 Ariz. St. L.J. 533, 542 n.17 (2005) (discussing Internet broker-dealers and recommendations).

302. In the case of a “married put,” the required disclosures would consist of, at a minimum, the premium required to purchase the option; in the case of a “collar,” the required disclosure would consist, at a minimum, of the cap on the upside gains of the transaction as a condition of receiving the downside protection.
about the financial services provider’s estimation of the risk entailed in entering into the transaction.

An accurately priced “put” premium would convey to even the least financially literate customer some relative sense of the risk of an investment transaction—particularly when viewed in comparison to the premiums associated with other products. Keeping disclosure down to simple numbers will facilitate efforts at improving numeracy of investors across product classes. Moreover, requiring that such options and associated price information be offered as part of the solicitation of the transaction would force the kind of disruption in the selling process that is desirable to overcome the aggressive sales pitch touting the virtues of a particular investment.

B. Defining Good-Faith Information

The key to implementing such a proposal is to ensure that the option is accurately priced, which is where the law of fiduciary duty can play a critical role. Targeting the financial services provider’s fiduciary duty on the narrow question of providing an accurate price for the option would eliminate much of the qualitative second-guessing of an investment recommendation. Instead, it would focus any ex post facto inquiry on the accuracy of the price-setting process and the adequacy of internal controls designed to capture all relevant information within the firm’s possession that should influence that process. In particular, requiring firms to use a consistent price across all customer transactions that is derived from a consistent proprietary methodology creates a record that regulatory or self-regulatory authorities can easily audit to ensure that customers are treated fairly.

For products that have an externally derived reference price (e.g., publicly traded options on securities, commodity futures, interest rate futures), quoting an option at the public price—or even offering to purchase a corresponding option on such a market—would suffice. For many financial services providers, this would create an incentive to offer customers highly standardized products that can easily be hedged rather than to tack on additional features that may generate additional fees but increase rescission risk.

To the extent that there are no perfect hedges, self-regulatory bodies might be charged, in the first instance, with identifying which listed contracts are suitable for hedging particular investment transactions in accordance with the procedures currently used, such as set-

303. See Fanto, supra note 22, at 111 (arguing that agencies should require customer disclosure to match educational initiatives).
ting margin requirements for options and futures strategies. For nonfungible underlying assets, such as real property, self-regulatory bodies might permit regional indices, if available, to substitute for loan-level information. Regulators might also exclude certain products whose risk of default is minimal, or at least ascertainable using commonly available information—such as certain government securities and FDIC-insured certificates of deposit. Likewise, where the financial services provider itself guarantees performance of a product—such as a covered bond, fixed income annuity, guaranteed investment contract, or principal-protected security issued by the financial services provider—the firm itself should not generally be required to quote an option on its own solvency.\footnote{304. Michael Durrer et al., The Proposed United States Covered Bond Act of 2010, 127 BANKING L.J. 632 (2010) (describing the operation of covered bond programs); Johnsen, supra note 75, at 565 (describing FLAs).}

For other products and transactions—particularly those involving nonfungible underlying assets, such as real property—there is a risk that firms will either overprice or underprice the option. A firm may have an incentive to overprice in order to discourage customers from purchasing such protection or to bilk unsophisticated customers by tacking on additional fees. A firm may have an incentive to underprice the option in order to downplay the risk of the transaction, if it can otherwise effectively discourage the customer from purchasing the option. In these cases, compliance with the fiduciary duty to individual customers becomes a question of whether the firm has implemented internal controls that meet regulatory standards (as affirmed by a regulatory or self-regulatory body) and whether the price generated was determined in accordance with those procedures.

To qualify for a safe harbor from fiduciary analysis, such controls would likely have to ensure that option premiums either (i) reflect contemporaneous cost, if the firm does not engage in market making or proprietary trading with respect to the transaction, or (ii) reflect the firm’s own internal projection(s) of the expected value of the option if it does. To say that the option must reflect contemporaneous cost is not to say that firms are not entitled to turn a profit: the proposal does not prohibit them from charging a commission, fee, markup, markdown, or other costs in connection with the transaction itself. Such fees may take into account the administrative or other costs associated with the offering of such options as well. But to the extent that the purpose of communicating the value of the option is to shield the transaction from a claim for breach of fiduciary duty,
the precision of price cannot be clouded by spreads, markups, mark-downs, or other distortive influences.

Even more controversial, perhaps, would be the requirement that firms incorporate price information from their own underwriting, market making, and proprietary trading activities in determining the value of the proposed option. From a technical standpoint, this proposal presents the obvious question whether a “single” price would even be possible to derive, to the extent that each trader or unit within a firm may employ different models. From the investing public’s point of view, the choice of internal model is not necessarily as important as consistency in the use of the model by a particular financial services provider, insofar as the exercise is a comparative one. Moreover, to the extent that risk management in financial services firms of any significant size is required to use a single model, the appropriate universe of models can be confined to those employed in that department.

More substantively, financial services providers may argue that fiduciary duties should not require disclosure of confidential information regarding their proprietary trading strategies gathered in the course of their representation of particular issuers or clients. Of course, every securities, derivative, or other financing transaction reveals certain information about each counterparty’s trading positions, and the proposal does not contemplate requiring public customers to keep any such information confidential, for to do so would frustrate the purpose of facilitating comparison shopping. To the extent that the proposal is designed with the goal of providing information as concisely as possible—i.e., a snapshot of the firm’s view as to the expected performance of the transaction expressed as a single number—reverse engineering proprietary trading strategies is likely to be very difficult. Moreover, a firm would always be free to forgo offering the option, and thus face the risk of an ex post adjudication of breach of fiduciary duty.

C. Customer Interaction

The proposal substantially relies on the average customer’s ability to appreciate the importance, and limitations, of a married put or

305. In this respect, the proposal is much more conservative than proposals advanced to require public disclosure of proprietary trading models for purposes of containing systemic risk. Cf. Erik F. Gerding, Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis, 84 WASH. L. REV. 127, 189 (2009) (proposing an “open-source” approach to prudential regulation in which “that banks seeking to use internal risk models for setting their capital requirements publicly disclose the details of those risk models”).
similar contract. Practically speaking, it will rarely be possible or desirable to claim a safe harbor from fiduciary duties when the financial services provider had “dominated or controlled” the customer, or otherwise managed the customer’s account on a de facto discretionary basis. And of course, the financial services provider will lose the safe harbor if it has not acted in good faith—for example, by offering a product that technically complies with the provisions of the safe harbor but is intentionally designed to evade the purposes of applicable law.

But the proposal remains subject to a behaviorist critique that providing quantitative information without context can exacerbate the perceived weaknesses in decisions about investment transactions. Moreover, the exercise may prove largely futile in enabling customers to make long-term investment decisions if contracts can be structured to shift risk into the future. It may be possible, however, to use the tools identified in the behaviorist literature to make the “optionality” conversation as informative as the disclosed price information itself.

First, the safe harbor should require that information about the married put or similar option be communicated and updated during each material communication (oral or written) with the customer about the transaction. A self-regulatory organization, for example, could formulate the proposed communication in a number of ways, depending on the nature of the transaction and the need to keep the particular statement as concise as possible (e.g., for a simple stock purchase, something like “based on the revised terms, we can offer you the option to unwind this transaction within a year for 90% of your investment at a price of $X”). Questions about the option could then trigger additional disclosures and references to regulatory discussions of the meaning and limitations of the information being communicated, in much the same way that sales representatives or customer service representatives used automated scripts today.

306. See Choi & Pritchard, supra note 81, at 22; Donald C. Langevoort, Ego, Human Behavior, and Law, 81 Va. L. Rev. 853, 880 (1995) (“Similarly, a salesperson selling something tempting but risky, such as options or commodities, will bring a marginally plausible set of reasons why the product is a smart, responsible choice, knowing that investors wish to construct an explanation for the desired investment consistent with their positive self-concept. . . . Investors and consumers want to think the warnings are meant for someone else, not them.” (internal citations omitted)).

307. For these purposes, a “material communication” would be any communication in which the terms of the proposed transaction are amended or modified in a material way.

Regulators would also need to launch a concerted investor education effort around the importance of understanding how such information could be used. At a minimum, regulators might caution investors to refrain from investing in a particular transaction, or “nudge” them toward particular “plain vanilla” transactions, if they do not understand the numbers.\textsuperscript{309} For the average investor, regulators could develop guidelines, similar to other consumer protection guidelines, that discuss a spectrum of risk and illustrate how products along such a risk spectrum may perform under different circumstances, similar to the format in which many brokerage websites provide key financial statistics and compare the performance of different asset classes.\textsuperscript{310} In particular, such rules of thumb can complement credit ratings to provide both quantitative and qualitative information about the relative risk of securities.

\section*{D. Risk Management}

Such a proposal is likely (as with any proposal that imposes fiduciary duties on financial services providers) to increase legal or operational risk. Firms may respond to the prospect of increased risk in a number of ways, such as by making more conservative recommendations or limiting their recommendations to easily hedged products, adopting enhanced hedging practices as part of managing their proprietary risk, or simply treating such increased risk as unhedgeable and thus increasing the likelihood of a firm default in the event of a heightened incidence of rescission (whether through the exercise of

\begin{footnotesize}
\begin{enumerate}
\item One could argue that if the option is not comprehensible, the transaction is unsuitable. \textit{See, e.g.}, Macey et al., supra note 20, at 815 (distinguishing transaction suitability from product suitability). Alternatively, the safe harbor might not be available for certain retail accounts. \textit{Cf.} 15 U.S.C. § 78u-4(f)(4)(A)(i) (exception from proportionate liability provisions governing federal securities law class actions for individuals “whose recoverable damages . . . are equal to more than 10 percent of [his] net worth” or whose “net worth . . . is equal to less than $200,000”).
\item \textit{See, e.g.}, E*Trade Financial, Mutual Fund Screener, \textit{available at} https://www.etrade.wallst.com/v1/fundresearch/etfscreener/etf_screener.asp; Fidelity.com, Mutual Fund Evaluator, \textit{http://screener.fidelity.com/ftgw/evaluator/mf/goto/landing?ref_ro=0005}; \textit{see also} Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Release No. 33-8998, 74 Fed. Reg. 4545, 4548 (Jan. 26, 2009) (adopting rules responding to “address the length and complexity of mutual fund prospectuses by streamlining the key information that is provided to investors, ensuring that access to the full wealth of information about a fund is immediately and easily accessible, and providing the means to present all information about a fund online in an interactive format that facilitates comparisons of key information, such as expenses, across different funds and different share classes of the same fund”).
\end{enumerate}
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puts or lawsuits for breach of fiduciary duty). Each of these options would naturally impose serious costs on investors, whether in the form of diminished investment opportunities or additional transaction costs; nevertheless, the proposal reduces the costs of compliance and enforcement by establishing clear and auditable standards for compliance.

To assess the impact of the proposal on firms, it is useful to consider first how the marketplace is likely to respond to a mandate that individual firms making investment recommendations offer downside protection. The proposal enables financial services providers to more accurately determine their legal risk when providing recommendations that otherwise would be subject to a fiduciary standard. It also implicitly assumes that risks can be transferred to larger financial institutions that are better able to diversify them. For actively traded products, the cost of protection can be determined ex ante from current market prices and passed on to the customer at the point of sale. For products that trade in less liquid markets, in theory, firms unable to bear the risk of rescission could purchase wholesale portfolio insurance from larger firms that engage in proprietary trading (whether account by account or on an omnibus basis).

As a practical matter, for most investment transactions, mechanisms would develop to manage the risk on a wholesale level. Clearing firms that hold public customer accounts might offer portfolio protection to clients of introducing firms for securities transactions, since they already manage credit risk. If any class of firms would be unable to meaningfully offset the risks of the proposal, it would likely be underwriters of equity offerings, to the extent that they would likely be required to assume any additional risk of rescission if their selling group members breached a fiduciary standard when offering underwritten products; even here, however, the risk of liability for breach of fiduciary duty could be limited to section 11 of the Securities Act.

To the extent that the proposal does impose a significant compliance cost—i.e., how do wholesale firms manage their exposure to introducing or originating firms—the cost will therefore likely be shifted to wholesalers. Regulators would seek to ensure that wholesalers have adequate internal controls in place to anticipate the extent

311. See generally Henry F. Minnerop, Clearing Arrangements, 58 BUS. LAW. 917, 929–931 (2003) (describing clearing arrangements between introducing and clearing brokers and the role of the clearing firm in managing credit risk). I do not intend, of course, to suggest that clearing firms would, as a result of providing such services, owe any fiduciary duty or otherwise be liable to customers of the introducing broker.

of the risk to which their retail counterparties will expose them. Wholesalers in turn will negotiate with specificity what products retailers will offer, the terms on which they will be offered, and so forth. In sum, if efficient transfer of risk is permitted, the supervisory responsibilities that regulators have long sought to impose on clearing firms and sponsors of special purpose vehicles will become enshrined in arm’s-length contracts.

What then would the impact of the proposal be on the range of investment recommendations financial services providers are likely to make? To the extent that wholesalers are responsible for managing much of the risk of rescission, the short answer is likely to be “not much.” Whereas independent investment advisers may well proceed with greater caution in offering products (consistent with their existing fiduciary obligations), wholesalers will continue to rely on retail broker-dealers and mortgage originators to push inventory, and as discussed above, will likely need to provide some risk-management capacity to their correspondents to keep the pipelines open.

E. Extensibility to Institutional Transactions

While the Dodd-Frank Act focuses on the fiduciary obligations owed to retail investors, the principles that underlie the proposal could be used to address the thorny question of suitability and institutional investors. One preliminary question that has vexed commentators is whether financial services providers owe any duty, derivative or otherwise, to investors in a professionally managed fund, such as a mutual fund, hedge fund or private equity fund, on the theory that the directors, general partners, or managing members of such funds do not themselves have such advisory duties and may be dominated and controlled, or otherwise have a conflict of interest with the financial services provider. The proposal in this article could handily address that issue by simply passing through the same information and exercise rights pro rata to individual fund investors. Because many complex securities or derivative transactions already detail discussions over the pricing of downside protection, extending the proposed option requirement would largely be superfluous.


As discussed above, one of the principal difficulties that institutional investors face is that financial services providers successfully stave off liability in private actions under Rule 10b-5 and in suits alleging breach of state law fiduciary duty by challenging the justifiability of reliance by sophisticated investors.\textsuperscript{315} Courts, moreover, engage in a qualitative, multifactor analysis to determine whether such liability is warranted in light of the investor’s sophistication\textsuperscript{316} and yet treat the absence of a right to rely as a complete defense to liability.\textsuperscript{317} In this respect, an affirmative obligation to disclose a single rescission price for a transaction or group of transactions, and allowing institutions to litigate the accuracy of that price, might pierce through the morass of considerations that have clouded liability in such suits without necessarily dramatically increasing the likelihood of liability.

If a financial services provider’s fiduciary duty required it to reveal the price of providing downside protection for a particular transaction (or group of transactions), any subsequent judicial proceedings would focus their inquiry on the accuracy of the information at the time of the transaction. In such a system, courts could easily adopt a presumption that investors are entitled to rely on the quoted price, and that any material misstatement of the price would be deemed to be the proximate cause of an investor’s decision not to modify the terms of the transaction or seek a contemporaneous hedge against downside risk. As discussed above, however, if a financial services provider is able to establish, based on contemporaneous internal records, that the price quoted did not materially deviate from the price that would have been assigned to a particular transaction by its own internal risk management systems, it would be entitled to summary judgment as a matter of law on any claim alleging breach of fiduciary duty.

To the extent that institutional and other sophisticated investors do not engage in isolated transactions, the fiduciary could be permitted to fulfill its duty by offering periodic quotations on a portfolio-wide basis, rather than quotations in connection with individual transactions. The result would be a continuous stream of information from the financial services provider to its clients about the risks inherent in their portfolio, based on the firm’s own internal valuation

\textsuperscript{315} See supra notes 152–154.
\textsuperscript{316} See supra note 153.
\textsuperscript{317} See, e.g., Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997) (“A plaintiff’s failure to prove that it justifiably relied on a broker’s alleged omission or misstatement is necessarily fatal to a securities fraud claim.”).
models. Firms, of course, might object that this framework would empower clients to “reverse engineer” their proprietary valuation models and thus expose firms to the risk of adverse selection when entering into transactions with clients; however, any system of fiduciary duties for institutional investors could be designed to curtail this risk by periodically tweaking internal controls and negotiating with regulators for individualized relief.

CONCLUSION

Extending fiduciary duties to retail investment transactions is a laudable sentiment that is likely to encounter significant obstacles to implementation. But regulators and industry representatives should strive to identify the essence of the goals that proponents of such duties seek to achieve and to find ways to implement the resulting principles in a manner that improves not only the quality of recommendations that are made but also the nature of investment conversations between firms and their clients across the entire spectrum of financial services.