St. John's Law Review

Volume 87
Number 2 *Volume 87, Spring-Summer 2013, Numbers 2-3*

Article 3

April 2014

The Fiduciary Standard: It's Not What It Is, But How It's Made, Measured, and Decided

Mercer Bullard

THE FIDUCIARY STANDARD: IT'S NOT WHAT IT IS, BUT HOW IT'S MADE, MEASURED, AND DECIDED

MERCER BULLARD[†]

The scope and substance of an investment adviser's fiduciary duty has recently become a primary focus of U.S. legislators and regulators. A U.S. Securities and Exchange Commission ("Commission" or "SEC") study ("Section 913 Study") required by section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[1] concluded that broker-dealers should be subject to a fiduciary duty when providing personalized investment advice to retail investors.[2] In a similar vein, the Department of Labor ("DOL") proposed to expand the kind of investment advice that would trigger fiduciary obligations under the Employee Retirement Income Security Act of 1974 ("ERISA") for persons who provide investment advice to plans and plan participants.[3] Both initiatives have provoked protests from legislators and the financial services industry that have, at least temporarily, stymied regulators' plans.

This Article addresses the SEC's fiduciary rulemaking under Section 913 of the Dodd-Frank Act, but takes a step back from the debate to frame the discussion in a more holistic context. This author's previous article on the fiduciary standard discussed how the implementation of a fiduciary duty is largely contextual; a variety of factors other than the scope and substance of the fiduciary duty are proximately related to achieving the social

---

† Associate Professor of Law and Mississippi Defense Lawyers Association Distinguished Lecturer, The University of Mississippi School of Law.

1 *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 *See* U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011), *available at* http://sec.gov/news/studies/2011/913study final.pdf.

3 *See* Definition of the Term "Fiduciary", 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 86).

benefits that the fiduciary duty is intended to create.[4] Achieving these benefits may depend on, among other things: (1) the limiting of "investment advice" to advice regarding securities, as opposed to, for example, insurance and banking products; (2) the private venues that are available to enforce this right, for example, arbitration, or state or federal court; (3) the conduct standards imposed under non-securities regulatory regimes, for example, ERISA for employee benefit plans, state insurance law for insurance products; (4) the powers and jurisdiction of applicable regulators, for example, the Commission, self-regulatory organizations and states, enforcement versus rulemaking; and (5) the regulation of issuers and intermediaries, for example, mutual fund disclosure and broker sales practices. In each case, these factors turn on issues other than the scope—who should have a fiduciary duty—and substance—what should that duty require—of the fiduciary duty.

This Article considers three such factors that play an important role in framing the fiduciary debate: the rising prominence of a libertarian metric for evaluating the fiduciary duty; the development of a fiduciary duty for broker-dealers by their self-regulatory organization, rather than the Commission; and the existing fiduciary duty as applied in private claims, especially in arbitration proceedings. The first factor is one that has recently assumed a prominent role. The social utility of the fiduciary duty has generally been judged according to a utilitarian metric that evaluates social policy based on the policy's effect on net social wealth. Under this metric, the fiduciary duty is good policy if it results in an increase in net social wealth, even if accompanied by a decrease in some utilities, such as individual freedom. Recent policy debates have reflected a competing metric for evaluating the fiduciary duty, however, based on libertarian values. Under this libertarian metric, reductions in individual freedom beyond a certain point trump the utilitarian metric. The fiduciary duty is not good social policy under a libertarian metric if it reduces individual freedom beyond a certain point, even if the policy would increase net

[4] *See generally* Mercer Bullard, *The Fiduciary Study: A Triumph of Substance over Form?*, 30 REV. BANKING FIN. L. 171 (2011).

social wealth. The SEC's current paralysis with respect to Section 913 rulemaking may be largely attributable to policymakers' shift from utilitarian to libertarian values.

Next, this Article turns from the social metrics applied to evaluate the fiduciary duty to the second factor—the source of the fiduciary duty. The current debate has focused on Congress (the Dodd-Frank Act) and the Commission (Section 913 rulemaking) as the sources of an expanded fiduciary duty. However, the self-regulatory organization for broker-dealers, the Financial Industry Regulatory Authority ("FINRA"), has already taken significant steps toward imposing a *de facto* fiduciary duty on the same broker-dealers to which a Section 913 rulemaking would apply. FINRA's new suitability rule, for example, embraces a strongly fiduciary approach.[5] FINRA may be motivated to expand the fiduciary duty of broker-dealers in part because this position supports its stated goal of being designated the self-regulatory organization for investment advisers.[6] The shift of the fiduciary debate to the FINRA arena may also reflect a broader re-alignment in the administrative state in which power is shifted from government agencies that are susceptible to political influence to more politically insulated SROs and other quasi-governmental entities. However, there are signs that FINRA's insulation from political factors may be on the wane.

Finally, this Article moves from public sources of law—Congress, the SEC, and FINRA—to the third factor—private sources of law. A fiduciary duty as imposed by the Commission would not, and the existing quasi-fiduciary duty imposed by FINRA does not, create a private cause of action, but state law has long provided a private claim against broker-dealers for violating a fiduciary duty. In comparison with the SEC's and FINRA's inchoate public law fiduciary duty, the private law fiduciary duty is well-developed and frequently litigated.[7] Fiduciary duty violations are the most frequently asserted claims in broker-dealer arbitration proceedings.[8]

---

[5] FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859.

[6] *The Investment Adviser Oversight Act of 2012: Hearing on H.R. 4624 Before the Comm. on Fin. Servs.*, 112th Cong. 13–15 (2012) [hereinafter *Investment Adviser Oversight Act Hearing*] (statement of Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority).

[7] *See infra* Part III; *see generally infra* note 124.

[8] *See infra* Part III, note 123.

However, the substance and scope of this private fiduciary duty is indeterminate. The overwhelming majority of private claims are brought in arbitration, where arbitrators are not required to and do not explain their decisions, rather than in court, where public decisions allow for an empirical evaluation of claims.[9] Some commentators have evaluated the "fairness" of arbitration claims based on plaintiffs' win rates in fully litigated proceedings.[10] This Article takes issue with this methodology on the ground that plaintiffs' win rates actually reveal nothing about the substantive fairness or unfairness of arbitration as a whole. Thus, the private arena in which broker-dealers' fiduciary duties are actually being sorted out defies critical analysis, which, in turn, frustrates any attempt to evaluate the full effects of the development of a public fiduciary duty by the SEC or FINRA.

I. SOCIAL METRICS OF THE FIDUCIARY DUTY

For the most part, the current debate about a Section 913 rulemaking has assumed that the social metric that should be used to evaluate a fiduciary duty is a utilitarian one.[11] The debate has focused on whether the benefits of the fiduciary duty would outweigh its costs, with each side disagreeing about the types and amounts of costs and benefits.[12] Nonetheless, each side seems to agree about using such a cost-benefit, utilitarian analysis to decide what form of fiduciary duty, if any, would be good public policy.[13] There is evidence, however, that the utilitarian rhetoric of some opponents of a fiduciary duty serves an ulterior, non-utilitarian motive.[14] They may be motivated, in fact, by a libertarian metric that elevates individual freedom above utilitarian values. This libertarian metric is consistent with the increasing purchase in elective politics of small government values and popular mistrust of cost-benefit analysis and social engineering by administrative agencies. The fiduciary

---

[9] *See infra* Part III.

[10] *See infra* Part III.

[11] *See generally* CASS R. SUNSTEIN, THE COST-BENEFIT STATE: THE FUTURE OF REGULATORY PROTECTION (2002); Jodi L. Short, *The Paranoid Style in Regulatory Reform*, 63 HASTINGS L.J. 633, 640–42 (2012) (describing " 'familiar script' " of efficiency, rationality, and cost-benefit analysis in administrative role).

[12] *See* Short, *supra* note 11, at 641.

[13] *See id.*

[14] *See* discussion *infra* notes 32–60.

duty may not hold up well under a libertarian metric. Its future, therefore, may depend on the fiduciary debate being resolved beyond the influence of current Congressional politics.

The term "utilitarian metric" is used here to refer to the evaluation of public policy based on its effect on net social wealth. Under this metric, the fiduciary duty would be preferable to the suitability standard that currently applies to broker-dealers[15] if it caused a net increase in social wealth, regardless of the wealth effect as to any subset of society, such as investors who do not need the protection that the fiduciary duty offers. For example, the fiduciary duty may be good policy if it corrects a market inefficiency arising from asymmetric information between broker-dealers and their customers.[16] But some industry members have argued that a fiduciary duty may reduce net social wealth by raising the cost of some financial services, thereby leaving some existing broker-dealer customers unable to afford certain products or services.[17] The fiduciary duty could generate a net decrease in social wealth if the additional costs incurred by society outweighed the improvement in investors' investment outcomes.[18]

---

[15] FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859.

[16] *See* Michael Finke & Thomas P. Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice*, 25 J. FIN. PLAN., no. 7, 2012, at 28, 28–37, *available at* http://www.fpanet.org/journal/TheImpactoftheBrokerDealerFiduciaryStandard ("Imposition of a universal fiduciary standard among financial advisers may result in a net welfare gain to society, and in particular to consumers who are ill-equipped to reduce agency costs on their own by more closely monitoring an adviser with superior information, although this will likely occur at the expense of the broker-dealer industry.").

[17] *See Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals To Improve Investment Adviser Oversight: Hearing on H.R. 112-58 Before the Subcomm. on Capital Mkt. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 1–18 (2011) [hereinafter *Hearings*] (statement of John Taft, Chairman, Security Industry and Financial Market Association and testimony of Terry Headley, President, National. Association of Insurance and Financial Advisors) (fiduciary duty could make it "economically unfeasible for financial professionals to work with less affluent clients"); SIFMA & OLIVER WYMAN, STANDARD OF CARE HARMONIZATION: IMPACT ASSESSMENT FOR SEC (2010) (Section 913 fiduciary duty could make commission-based services more expensive for investors and "force the majority of these investors into fee-based managed accounts at a higher cost factor").

[18] *See Hearings*, *supra* note 17 (noting that the "universal fiduciary standard of care" would force many brokers to discontinue providing many important services to middle-market clients). *Contra* Finke & Langdon, *supra* note 16 ("Empirical results provide no evidence that the broker-dealer industry is affected significantly by the

The utilitarian metric can be illustrated in the context of variable annuity sales, which have often been cited by regulators and investor advocates as emblematic of the improper sales practices of non-fiduciaries.[19] Some argue that broker-dealers often recommend variable annuities to investors for whom they are not the best option, in part because broker-dealers receive higher compensation for selling a variable annuity than from selling another variable annuity or a mutual fund.[20] Investors'

---

imposition of a stricter legal fiduciary standard on the conduct of registered representatives.").

[19] *See generally* FIN. INDUS. REGULATORY AUTH., MEMBERS' RESPONSIBILITIES REGARDING DEFERRED VARIABLE ANNUITIES (2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=14663 (imposing heightened suitability requirements for sales of variable annuities); NAT'L ASS'N OF SEC. DEALERS, NOTICE TO MEMBERS 99-35, THE NASD REMINDS MEMBERS OF THEIR RESPONSIBILITIES REGARDING THE SALES OF VARIABLE ANNUITIES (1999); NAT'L ASS'N OF SEC. DEALERS, NOTICE TO MEMBERS 96-86, NASD REGULATION REMINDS MEMBERS AND ASSOCIATED PERSONS THAT SALES OF VARIABLE CONTRACTS ARE SUBJECT TO NASD SUITABILITY REQUIREMENTS (1996); SEC. & EXCH. COMM'N & NAT'L ASS'N OF SEC. DEALERS, JOINT SEC/NASD REPORT ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS (2004); SEC. & EXCH. COMM'N, N. AM. SEC. ADMIN. ASS'N, & FIN. INDUS. REGULATORY AUTH., PROTECTING SENIOR INVESTORS: REPORT OF EXAMINATIONS OF SECURITIES FIRMS PROVIDING "FREE LUNCH" SEMINARS 21–22 (2007), *available at* http://www.sec.gov/spotlight/seniors/freelunchreport.pdf; Letter from AARP, N. Am. Sec. Adm'rs Ass'n, Fund Democracy, & Consumer Fed'n of Am., to Christopher Dodd, Chairman and Richard Shelby, Ranking Member, Comm. on Banking, Hous. & Urban Dev., U.S. Senate (Feb. 2, 2010), *available at* http://www.nasaa.org/wp-content/uploads/2011/08/39-Fill-In-The-Blank-Sec-913-Letter-2.3.10.doc (discussing abusive sales practices in sale of variable annuities to seniors); *Advertising of Bonus Credit Variable Annuities*, FIN. INDUS. REGULATORY AUTH., http://www.finra.org/Industry/Regulation/Guidance/RCA/p015306 (last visited Dec. 31, 2013) (warning against misleading sales practices); *Should You Exchange Your Variable Annuity?*, FIN. INDUS. REGULATORY AUTH., https://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p006045 (last updated Mar. 2, 2006) (citing abusive sales practices); *Variable Annuities: Beyond the Hard Sell*, FIN. INDUS. REGULATORY AUTH., http://www.finra.org/investors/protectyourself/investoralerts/annuitiesandinsurance/p005976 (last updated Aug. 31, 2009); James W. Watkins, *Variable Annuities: Reading Between the Marketing Lines*, COMMONSENSE INVESTSENSE (2002), http://investsense.com/variable-annuities/ (variable annuities are "one of the most overhyped, most oversold, and least understood investment products"); Liz Pulliam Weston, *The Basics: The Worst Retirement Investment You Can Make*, JOHN C. GOWER, http://www.jcgower.com/media/The$20Worst$20Retirement$20Investment$20You$20Can$20Make.pdf (last visited Dec. 31, 2013).

[20] *See, e.g.*, Prime Capital Services, Inc., Release No. 398, 2010 WL 2546835, at *38–40 (ALJ June 25, 2010) (administrative law judge finding that broker-dealers committed fraud in connection with sales of variable annuities to elderly customers and received commissions of up to 8.6%); Focus Point Solutions, Inc., Release No. 3458, 2012 WL 3863221, at *1 (ALJ Sept. 6, 2012) (Undisclosed revenue sharing "agreement created incentives for [investment adviser] to favor a particular category

purchases of variable annuities therefore may result in suboptimal financial results for investors and impose negative net costs on society.[21] In theory, the fiduciary duty would require that broker-dealers recommend the best product, thereby improving investors' financial experience and increasing net social wealth.[22]

Proponents of the fiduciary duty might argue that this could be accomplished in two ways. First, the fiduciary duty could mandate enhanced disclosure of selling compensation, which, like price transparency generally, could promote competition and lower prices by heightening investors' price sensitivity.[23] Second,

---

of mutual funds over other investments."); *see also Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing on S. J-111-88 Before the Subcomm. on Crime and Drugs of the H. Comm. on the Judiciary*, 111th Cong. 6 (2010) [hereinafter *Roper Testimony*] (testimony of Barbara Roper, Director of Investor Protection, Consumer Federation of America) ("The most common problem faced by retail investors is sale of products to benefit the broker's bottom line rather than the client's financial well-being. In a fairly typical example, a broker might recommend a particular mutual fund or 529 plan or variable annuity, not because it has the lowest fees, the best management, or the best allocation of assets to match the client's investment goals, but rather because it pays the highest commission or makes revenue sharing payments to the firm."); Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 45 (2005) (discussing brokers' incentives to engage in fraud). *See generally* Edward O'Neal, *Mutual Fund Share Classes and Broker Incentives*, 55 FIN. ANALYSTS J. 76 (1999) (discussing broker-dealers' incentives to recommend class of shares paying the highest selling compensation).

[21] *See* Scott Burns, *Variable Annuity Watch, 2008*, ASSETBUILDER, http://assetbuilder.com/blogs/scott_burns/archive/2008/08/22/variable-annuity-watch-2008.aspx (estimating that variable annuities transfer approximately $25.6 billion each year "of spendable investment returns" from vulnerable investors to the insurance industry); *see also* Benjamin Cummings & Michael Finke, The Economics of Fiduciary Investment Advice 8 (Sept. 1, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1701181 ("[P]roduct-based compensation is ubiquitous within the industry and rarely leads to recommendations that are clearly in the best interest of the consumer.").

[22] This assumes that broker-dealers would change their behavior under a fiduciary duty. This assumption may be incorrect because, as discussed *infra* Parts II, III, broker-dealers already may be subject to a de facto fiduciary duty. In addition, investors may be able to bring successful claims with respect to variable annuity sales practices under antifraud principles without needing to show breach of a fiduciary duty, although proving fiduciary claims generally will be easier because of lower standards of proof as to the broker-dealer's intent and the cause of the plaintiff's loss.

[23] *See* Conformation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Release No. 33-8358, Investment Company Act Release No. 26341, 2004 WL 184973 (proposed 2004) (to be codified at 17 C.F.R. pts. 239, 240, &

it could mandate recommendations that not only were suitable, but also were in the client's best interests. This would require the broker-dealer to recommend the best product for the customer, and not necessarily the one that pays the highest compensation.

This analysis makes empirical assumptions on which some critics of the fiduciary duty disagree. They argue that enhanced disclosure or a substantive best-interest standard might not produce enough benefits to outweigh any attendant increase in social costs.[24] Two Republican Commissioners criticized the recommendations in the Section 913 Study on the ground that they lacked "a basis to reasonably conclude that a uniform standard or harmonization would enhance investor protection" and insisted upon a "stronger analytical and empirical foundation" before rulemaking could proceed.[25]

The utilitarian metric as applied in the fiduciary duty context reflects an increasing emphasis on utilitarian analysis by Congress, the courts, and the Commission. Examples include a series of recent D.C. Circuit cases in which the court vacated SEC rules for failing to conduct an adequate cost-benefit analysis.[26] Members of Congress have attacked the SEC's cost-benefit analyses, holding one hearing titled "The SEC's Aversion to Cost-Benefit Analysis,"[27] and released a flurry of bills imposing greater cost-benefit requirements on agency rulemaking.[28] The

274) (proposing a rule to require additional disclosure of revenue sharing compensation); Cummings & Finke, *supra* note 21 ("Commissions for financial products are extremely opaque, and the industry has fought to maintain those that are most difficult to detect by consumers (e.g., 12b-1 fees on mutual funds)."). *See generally* Raj Chetty et al., *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145 (2009) (showing that price salience correlates positively with price sensitivity).

[24] Kathleen Casey & Troy Paredes, Comm'rs, Sec. & Exch. Comm'n, Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers And Broker-Dealers (Jan. 21, 2011) [hereinafter Statement of Casey & Paredes], *available at* http://www.sec.gov/news/speech/2011/spch012211klctap.htm (criticizing Section 913 Study).

[25] *Id.*

[26] *See generally* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2009); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

[27] *The SEC's Aversion to Cost-Benefit Analysis: Hearing Before the Subcomm. on TARP, Fin. Servs. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112 Cong. 1–3(2012) [hereinafter *Cost-Benefit Hearing*].

[28] *See, e.g.*, Small Business Freedom of Commerce Act of 2013, H.R. 168, 113th Cong. (2013); Independent Agency Regulatory Analysis Act of 2012, S. 3468, 112th

Commission has relented under this pressure, promising to hire dozens of additional economists[29] and make evaluating the costs of regulation to the industry a top priority.[30]

The fiduciary debate as framed above suggests that both proponents and critics of the fiduciary duty agree on using a utilitarian metric to measure the social value of the fiduciary duty.[31] However, the use of a utilitarian metric by opponents of the fiduciary duty may actually reflect libertarian values. Libertarian values are implicated by the fiduciary duty because, for example, mandatory disclosure under a fiduciary duty may deny investors the freedom to contract privately for such disclosure while making them pay the costs of disclosure regardless of whether they need it.[32] Requiring that broker-dealers' recommendations be in the best interests of customers would impose additional transaction costs on those customers who would otherwise make their own best-interest determinations, possibly without providing them with any countervailing benefit. Certain legislators, judges, and regulators who are motivated by these libertarian concerns may

---

Cong. (2012); Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (2011); Regulatory Accountability Act of 2011, S. 1606, 112th Cong. (2011); SEC Regulatory Accountability Act, H.R. 2308, 112th Cong. (2011); Regulatory Flexibility Improvements Act of 2011, H.R. 527, 112th Cong. (2011). *See generally* Ben Protess, *Lawmakers Push To Increase White House Oversight of Financial Regulators*, N.Y. TIMES (Sept. 9, 2012), http://dealbook.nytimes.com/2012/09/09/lawmakers-push-to-increase-white-house-oversight-of-financial-regulators.

[29] *See Cost-Benefit Hearing*, *supra* note 27 (oral and written testimony of Mary Schapiro, Chairman, Securities and Exchange Commission).

[30] *See* Memorandum from RSFI and OGC to the Staff of the Rulewriting Divisions and Offices on Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[31] *See Investment Adviser Oversight Act Hearing*, *supra* note 6, at 3 (testimony of Chet Helck, Chairman-Elect, Securities Industry and Financial Market Association) ("SIFMA supports the establishment of a uniform fiduciary standard for broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers."); Cass R. Sunstein, *The Stunning Triumph of Cost-Benefit Analysis*, BLOOMBERG (Sept. 12, 2012, 6:30 PM), http://www.bloomberg.com/news/2012-09-12/the-stunning-triumph-of-cost-benefit-analysis.html ("[R]epublicans and Democrats have come to agree on one issue: the essential need for cost-benefit analysis in the regulatory process. In fact, cost-benefit analysis has become part of the informal constitution of the U.S. regulatory state.").

[32] Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 28–32 (1990) (comparing the cost and benefits of mandatory fiduciary duties versus freedom of contract in a corporate setting).

simply be using the more intellectually acceptable rhetoric of utilitarian cost-benefit analysis as cover. This is an admittedly unprovable claim: Any assertion that libertarian motives stand behind stated cost-benefit concerns is inherently subjective and arguably counterintuitive. Nonetheless, there is evidence that the utilitarian concerns of cost-benefit advocates are motivated more by a desire to rein in rulemaking per se than to produce more accurate utilitarian analysis.[33]

In some cases, the cost-benefit analysis demanded by critics does not square with a utilitarian metric because it appears not to be practicably achievable. In a series of decisions vacating SEC rules,[34] the D.C. Circuit has applied a seemingly impossible standard to meet, requiring that, no matter what cost-benefit findings the Commission had made, it was always required to go one step further.[35] The empirical analysis demanded by the SEC Commissioners who dissented from the Section 913 study could not practicably be accomplished by the agency in any reasonable timeframe, if at all.[36] They made it clear that any rulemaking

---

[33] *See* Short, *supra* note 11, at 668–69 (finding that the dominant critique of regulation in academic literature reflects libertarian concern that regulation is coercive).

[34] *See supra* note 26.

[35] *See* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1827–28 (2012).

[36] For example, they argued that the Commission should conduct an "[a]nalysis of the investor returns (controlling for risk and investor characteristics such as age, income, and education) generated under the two existing regulatory regimes." Statement of Casey & Paredes, *supra* note 24. It would not be possible to identify with any precision the category of accounts that fit within a particular regime—it is the overlapping nature of commission, and fee-based arrangements, that has created the very problem that a universal fiduciary is intended to address—much less to calculate with any precision the investment returns experienced under a fiduciary and a non-fiduciary regime. *See* F.C.C. v. Fox Television Stations, Inc., 556 U.S. 502, 519 (2009) ("There are some propositions for which scant empirical evidence can be marshaled."). There have been studies that address the general question of the value of brokers' services, but they are so cabined by caveats as to provide little concrete direction as to the precise contours of the fiduciary duty. *See, e.g.*, Daniel Bergstresser et al., Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry 2 (Nov. 8, 2004) (unpublished manuscript), *available at* http://business.rice.edu/uploadedFiles/Faculty_and_Research/Academic_Areas/Finance/Seminar_PDFs/bbenefits_Nov2004.pdf; Mercer Bullard et al., Investor Timing and Fund Distribution Channels 2–3 (June 1, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1070545 (load fund investors experience larger performance gaps than no-load fund investors); Mercer Bullard & Edward S. O'Neal, *The Costs of Using a Broker To Select Mutual Funds* (Inst. for Highest Educ. Law & Governance Monograph 07-03, 2006), *available at* http://www.law.uh.edu/ihelg/mono

conducted without doing this analysis "would be ill-conceived at best and harmful at worst."[37] When agencies have requested cost-benefit data that critics have demanded they consider, they have been roundly chastised, as illustrated by Congressional and industry responses to a recent DOL request for economic data.[38] A bill passed by the House in August 2012 generally prohibited agency rulemaking until the national unemployment rate declined below six percent.[39] The idea that a specific national unemployment rate could be a rational determinant of the utilitarian value of specific SEC rulemaking is inherently unreasonable, but it is consistent with the advancement of a libertarian metric, albeit clothed as a utilitarian one.

A libertarian metric provides a more coherent explanation of the position of cost-benefit advocates. Cost-benefit advocates embrace utilitarian analysis when more paternalistic policies are being considered, whereas they have eschewed utilitarian analysis when the public policies considered would increase individual freedom rather than constrain it. The current regulatory environment has provided a relatively rare opportunity to see this inconsistency in action. Under the Dodd-Frank Act and the Jumpstart Our Business Startup Act (the

---

graph/07-03.pdf (discussing higher expenses of broker-sold funds); Diane Del Guercio et al., *Broker Incentives and Mutual Fund Market Segmentation* 35–36 (Nat'l Bureau of Econ. Research, Working Paper No. 16312, 2010), *available at* https://www2.bc.edu/jonathan-reuter/research/NBER_WP16312.pdf (evaluating performance of mutual funds sold in direct and broker-sold distribution channels).

[37] Statement of Casey & Paredes, *supra* note 24.

[38] *See* Letter from Dale E. Brown, President & CEO, Fin. Servs. Inst., to John Kline & George Miller, House Educ. & Workforce Comm., U.S. House of Representatives (July 10, 2012), *available at* http://www.financialservices.org/uploadedFiles/FSI_Content/Latest_News/Miller-Kline%20Fiduciary%20Letter.pdf (responding to Borzi letter dated June 20, 2012); Letter from Congressional Democrats to Hilda Solis, Sec'y of Labor, Dep't of Labor (June 25, 2012), *available at* http://www.sparkinstitute.org/content-files/File/Dem%20Letter%20to%20DOL%20re%20Fiduciary%20Proposal%206-25-12.pdf (describing Borzi data request as "unrealistic in scope and timing"); Letter from Phyllis Borzi, Assistant Sec'y for Emp. Benefits Sec. Admin., Dep't of Labor, to John Kline & George Miller, House Educ. & Workforce Comm., U.S. House of Representatives (June 20, 2012), *available at* http://www.dol.gov/ebsa/pdf/KlineMillerfiduciaryupdateletter.pdf (discussing data request). *See generally* Darla Mercado, *FSI Unloads on Borzi*, INVESTMENT NEWS (July 10, 2012, 2:47 PM), http://www.investmentnews.com/article/20120710/FREE/120719992 (discussing Financial Services Institute response to DOL request for data).

[39] *See* H.R. Res. 4078, 112th Cong. (2012) (enacted).

"JOBS Act"),[40] enacted only sixteen months apart, Congress ordered the Commission to engage in rulemaking at opposite ends of the paternalistic-to-libertarian regulatory spectrum. The Dodd-Frank Act requires rules generally increasing regulation, while the JOBS Act requires rules generally lessening it.[41] The same members of Congress who have criticized the SEC's cost-benefit analysis in connection with Dodd-Frank rulemaking that they oppose have expressed no such concerns regarding JOBS Act rulemaking that they support.[42] They have complained that the Commission has not spent enough time considering the costs, for example, of the Dodd-Frank Act's requirement that issuers disclose information regarding certain minerals produced in the Democratic Republic of Congo ("conflict minerals"), while expressing no such concern regarding the JOBS Act exemption for crowd funding securities offerings and private offerings under Regulation D.

The seemingly contradictory positions of cost-benefit advocates have been particularly apparent in connection with the SEC's rulemaking on conflict minerals and the private offering exemption.[43] Two Republican SEC Commissioners voted against and issued critiques of the SEC's conflict minerals rule, the statutory deadline for which had passed seventeen months earlier, on the ground that the SEC staff's cost-benefit analysis was inadequate.[44] One week later, the same Commissioners supported a proposal to eliminate the ban on general solicitation

---

[40] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[41] Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Statement at Open Meeting To Adopt a Final Rule Regarding the Conflict Minerals Pursuant to Section 1502 of the Dodd-Frank Act (Aug. 22, 2012) [hereinafter Paredes Minerals Statement], *available at* http://www.sec.gov/news/speech/2012/spch082212tap-minerals.htm.

[42] *See Cost-Benefit Hearing*, *supra* note 27.

[43] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9354, 2012 WL 4356706 (proposed Sept. 5, 2012), *available at* http://sec.gov/rules/proposed/2012/33-9354.pdf; Conflict Minerals, Exchange Act Release No. 34-67716, 2012 WL 3611799 (Aug. 22, 2012), *available at* http://sec.gov/rules/final/2012/34-67716.pdf; Conflict Minerals, Exchange Act Release No. 34-63547 (proposed Dec. 15, 2010), *available at* http://sec.gov/rules/proposed/2010/34-63547.pdf.

[44] *See* Paredes Minerals Statement, *supra* note 41; Daniel Gallagher, Comm'r, Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Proposed Rule To Implement Section 1502 of the Dodd-Frank Act—the "Conflict Minerals" Provision (Aug. 22, 2012) [hereinafter Gallagher Minerals Statement], *available at* http://sec.gov/news/speech/2012/spch082212dmg-minerals.htm.

and advertising without even mentioning cost-benefit requirements, much less whether the requirements had been satisfied.[45] The conflict minerals rulemaking missed its 270-day deadline by more than seventeen months, while the general solicitation and advertising proposal was only fifty-seven days past its ninety-day deadline.[46] Nonetheless, the Republican Commissioners argued the former needed more work and should be delayed further, while the latter should not even have been subject to public notice and comment, much less any cost-benefit analysis.[47] They would have held the former rulemaking, which

[45] *See* Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Statement at Open Meeting To Propose Rule Amendments Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (Aug. 29, 2012) [hereinafter Paredes Rule 506 Statement], *available at* http://sec.gov/news/speech/2012/spch082912tap.htm (supporting amendments to Regulation D); Daniel Gallagher, Comm'r, Sec. & Exch. Comm'n, Statement at SEC Open Meeting: Proposed Rules To Eliminate the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (Aug. 29, 2012) [hereinafter Gallagher Rule 506 Statement], *available at* http://sec.gov/news/speech/2012/spch082912dgm.htm.

[46] *See* JOBS Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306 (2012) (requiring rulemaking no later than ninety days after the Act's effective date of April 5, 2012, that is, by July 4, 2012); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, § 1502(b), 124 Stat. 1376 (2010) (requiring rulemaking no later than 270 days after the Act's effective date of July 22, 2010, that is, by April 17, 2011). The JOBS Act deadline applies to the final rule, whereas only a proposal was issued on August 29, so the Commission will miss the final deadline by more than fifty-seven days. The Commission provided for a thirty-day comment period, and SEC Chairman Schapiro promised that the Commission would take action "shortly thereafter," which means adoption of a final rule around October 5, or ninety-four days past the JOBS Act deadline. The Commission had planned to issue an interim rule without notice and comment but reversed its position under pressure from investor advocates. *See Schapiro's Boss*, WALL ST. J. (Dec. 5, 2012, 7:06 PM), http://online.wsj.com/news/articles/SB10001424127887323401904578157392212779684 (describing SEC Chairman Schapiro as "fold[ing] faster than Jerry Brown in a union negotiation" after discussions with investor advocates); *SEC Announces Additional Delay on General Solicitation Rule Change*, CORE COMPLIANCE & LEGAL SERVICES, http://www.corecls.com/compliance-corner/general/sec-announces-additional-delay-on-general-solicitation-rule-change (last visited Jan. 8, 2014); Letter from Fund Democracy et al. to Mary Schapiro, Chairman, Sec. & Exch. Comm'n (Aug. 15, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-59.pdf (noting that issuing an interim rule without public notice and comment would violate the APA); *see also* Letter From Fund Democracy et al. to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Aug. 16, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf (describing issues for which costs and benefits must be evaluated pursuant to APA).

[47] *See* Paredes Minerals Statement, *supra* note 41. Congressman Patrick McHenry scheduled a hearing to examine Chairman Schapiro's "failure" to meet the JOBS Act deadline, which he attributed to her "ideological opposition" to the Act's

would increase regulatory burdens, to a high cost-benefit standard, while holding the deregulatory rulemaking, which would reduce regulatory burdens, to no cost-benefit standard at all.[48] Nor has either Republican had any objection to the SEC's continuing failure to take final action on prior Dodd-Frank Act mandate to amend the *same* private offering rules to bar bad actors from relying on the exemption. The one-year deadline for that rulemaking passed thirteen months before the Commission proposed private offering amendments under the JOBS Act.[49]

The Commissioners' intermittent advocacy for more rigorous cost-benefit analysis is far more consistent with libertarian values than utilitarian ones, which begs the question of why they do not simply argue from explicitly libertarian principles? One reason may be that libertarian principles are often associated with the kind of anti-intellectual populism that is considered simplistic and extremist in the elite regulatory community.[50]

---

mandate. *See* Letter from Patrick McHenry, Chairman, Subcomm. on TARP, Fin. Serv. & Bailouts of Pub. & Private Programs, to Mary Schapiro, Chairman, Sec. & Exch. Comm'n (Aug. 16, 2012) [hereinafter McHenry Letter], *available at* http://oversight.house.gov/wp-content/uploads/2012/08/2012-08-16-PMC-to-Schapiro-SEC-general-solicitation-due-8-30.pdf; *see also* Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Remarks at the AICPA Council Spring Meeting, Washington, D.C. (May 17, 2012), *available at* http://sec.gov/news/speech/2012/spch051712tap.htm (discussing two topics—the JOBS Act and cost-benefit analysis—without any mention of cost-benefit issues as related to the JOBS Act).

[48] *See also* McHenry Letter, *supra* note 47 ("By kicking the can down the road, you [SEC Chairman Schapiro] are abdicating your responsibility to follow the law, failing to fulfill your sworn commitment to this Subcommittee, and ignoring the will of Congress and the President of the United States."); Paredes Rule 506 Statement, *supra* note 45; Gallagher Rule 506 Statement, *supra* note 45.

[49] *See* Dodd-Frank Act § 926. The Commission proposed amendments on May 25, 2011. *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9211 (proposed May 25, 2011), *available at* http://sec.gov/rules/proposed/2011/33-9211.pdf. In addition, neither Republican objected to the SEC's failure to adopt final Dodd-Frank-mandated amendments to Regulation D's accredited investor standard until December 21, 2011—more than eighteen months after the DFA became law—there was no deadline for this rulemaking. *See* Net Worth Standard for Accredited Investors, Securities Act Release No. 9287 (Dec. 21, 2011), *available at* http://sec.gov/rules/final/2011/33-9287.pdf (adopting amendments mandated by section 413(a) of the Dodd-Frank Act although Commissioner Paredes objected that the proposal did not include a grandfathering provision); Statement of Troy Paredes, Comm'r, Sec. & Exch. Comm'n, Remarks at the Open Meeting To Propose Rules Regarding Net Worth Standard for Accredited Investors (Jan. 25, 2011), *available at* http://sec.gov/news/speech/2011/spch012511tap-2.htm.

[50] *See, e.g.*, John J. Flynn, *The Role of Rules in Antitrust Analysis*, 2006 UTAH L. REV. 605, 612 n.20.

Individual freedom as an intrinsic value has currency in electoral politics, but the appointees of politicians who espouse individual liberty principles do not carry that flag into the regulatory arena. For example, supporters of crowdfunding and permitting general solicitation and advertising in private offerings argue that any resulting economic losses to investors will be small relative to the economic benefits;[51] they generally do not argue that allowing investors greater individual freedom—even if the result is that they make bad investment decisions—has intrinsic social value.[52] The concept of freedom typically finds its voice in the form of arguments for "free" markets, which are primarily based on the utilitarian view that free markets will maximize net social wealth.[53] In other words, it is not the enhanced *freedom* of markets, and their participants, that justifies deregulatory policies, but the capacity of market-directed outcomes to create greater net social wealth than government-directed outcomes.[54]

Another reason that libertarian metrics are not openly embraced in debates about SEC rulemaking is that these metrics implicitly reject the very *raison d'etre* of a regulatory agency—to make public policy in complex fields based on expert evaluation of social costs and benefits.[55] The libertarian metric doubts the

---

[51] Jason Best & Sherwood Neiss, *SEC's Proposed Rule on General Solicitation Reads, "Sorry…Please Hold…It's Too Complicated for Us"*, TECHCRUNCH (Aug. 31, 2012), http://techcrunch.com/2012/08/31/secs-proposed-rule-on-general-solicitation-reads-sorryplease-hold-its-too-complicated-for-us ("[L]ifting the ban . . . will allow private companies to raise money from a larger pool of 'accredited investors.' ").

[52] It is not only the value of individual liberty that is difficult to quantify; the reduction in utility caused by the loss of one investment dollar may also depend on the social context. As Paul Slovic and others, have explained, the social context surrounding an event can increase the risk that the event presents. *See* Roger E. Kasperson et al., *The Social Amplification of Risk: A Conceptual Framework*, 8 RISK ANALYSIS 177, 179 (1988). For example, the effect of the Three Mile Island nuclear reactor accident far exceeded what a cost-benefit analysis would have found was the risk of such an event. *Id.* Slovic has argued that the "traditional cost-benefit and risk analyses neglect the[] higher-order impact[] [caused by social amplification of loss] . . . (and thereby underestimate the overall risk from the event)." *Id.* Incorporating the social amplification of risk into cost-benefit analysis is necessary to "bring the technical assessment of risk more in line with a fuller determination of risk." *Id.* One example of this theory in action is the social amplification of the risk of Madoff-like fraud when it results from a regulator's failure to act on credible tips, rather than from investors' own decisions or the absence of specific rules. The risk of a dollar lost to the former is far greater.

[53] *See* Ian Shapiro, *Richard Posner's Praxis*, 48 OHIO ST. L.J. 999, 1006 (1987).

[54] *See id.*

[55] *See* Michael Ray Harris, *Breaking the Grip of the Administrative Triad: Agency Policy Making Under A Necessity-Based Doctrine*, 86 TUL. L. REV. 273, 277

very capacity of administrative agencies to improve the human condition through social engineering, as opposed to allowing the free market to evolve on its own.[56] Indeed, many government officials may be naturally uncomfortable with a libertarian metric because it undermines the premise of government—that effective public policy can be derived from public processes.[57] Deregulatory SEC Commissioners may feel consciously compelled to support, or at least not openly undermine, this premise of public service, or they may unconsciously be prisoners of a kind of inverted regulatory capture.[58]

Alternatively, they may see an inconsistency in making empirical arguments about the cost of regulations while also arguing for individual liberty—a social utility that defies empirical analysis. They also may feel more comfortable and/or believe they may be more effective espousing a mainstream cost-benefit analysis. There is no reason to believe that SEC Commissioners are any less sensitive to peer norms than other professionals. Indeed, this Article's discussion of freedom for freedom's sake itself operates within the same constraints. Attempting to inject such an unquantifiable social utility as individual liberty—or, in contrast, the normative value of liberal,

(2011) ("Agencies are, and always have been, necessary because they are 'process' experts: they have the tools available to make complex, and often fluid, regulatory decisions that the constitutional branches cannot.").

[56] *See generally* Jodi L. Short, *The Political Turn in American Administrative Law: Power, Rationality, and Reasons*, 61 DUKE L.J. 1811, 1815–16 (2012) (discussing dynamics of political-reason giving in administrative decisions).

[57] *See generally* Gary Lawson, *The Rise and Rise of the Administrative State*, 107 HARV. L. REV. 1231, 1231 (1995) (characterizing post-New Deal administrative state as unconstitutional and inconsistent with separation of powers); Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 446–48 (1987) (discussing failure to incorporate constitutional commitment to checks and balances into regulatory administration).

[58] *See* Carl Landauer, *Deliberating Speed: Totalitarian Anxieties and Postwar Legal Thought*, 12 YALE J.L. & HUMAN. 171, 174 (2000) (describing legal scholars' "internalized attachment to government" and views of "government as efficacious rather than susceptible to the mood swings of a pathological society" as reflecting a "confident identification with government").

redistributional policies[59]—into a regulatory debate may be more likely to be met with polite disdain than afforded serious consideration.

The foregoing discussion raises the question of whether the debate about the costs and benefits of the fiduciary duty is beside the point. The debate may actually be less about the balancing of quantifiable social utilities than about not only the role, but also the primacy of libertarian values. Individual liberty could be viewed as having independent value, as opposed to incorporating it into the netting of utilities that a more communitarian ethic assumes. In other words, individual freedom may be viewed as an incommensurate value that must be considered independently when making public policy. Under this metric, a public policy would not be adopted if it reduced individual freedom below some minimum value, regardless of whether the policy would result in an increase in net social wealth. Whatever form it takes, the libertarian metric must be explicitly considered in order to explore fully the pros and cons of the fiduciary duty.

It is unlikely, however, that we will soon see an SEC study on the cost of a fiduciary duty as reflected in a reduction in individual liberty, or a reduction in investor confidence. Libertarian principles impose implicit constraints on, if not pose a direct threat to, administrative authority.[60] Administrative agencies will respond to this challenge. One response may be to shift their regulatory functions to entities that are currently further from Congress's reach yet still subject to agency authority. As discussed below, the result may be that it is not the Commission that guides the ultimate development of the fiduciary duty but an agency that it oversees.

---

59 Although this discussion is focused on the relationship between utilitarian analysis and libertarian values, the straightjacket of utilitarian cost-benefit analyses may similarly weaken the position of more communitarian values such as those reflected in investor protection policies. *See Cost-Benefit Hearing*, *supra* note 27, at 70–71, 74–75, 81–82 (statements of Mercer Bullard, Fund Democracy, and University of Mississippi School of Law, all three discussing derogation in cost-benefit analysis of benefits of deterring fraud and misleading sales practices).

60 *See* Robert P. Murphy, *Do Libertarians Have a Problem with Authority?*, THE AM. CONSERVATIVE (Dec. 12, 2012), http://www.theamericanconservative.com/articles/should-libertarians-have-a-problem-with-authority/ (stating that "many people are attracted to libertarianism because they simply *don't like rules*").

II. THE FINRA FIDUCIARY DUTY

If, as discussed immediately above, agency rulemaking has been paralyzed by political forces in the form of heightened cost-benefit requirements,[61] one might look to the development of the fiduciary duty under sources of law that are not so susceptible to direct Congressional oversight and judicial power. One such source of law could be the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory organization ("SRO") for broker-dealers. FINRA rulemaking and enforcement actions are not subject to nearly the same degree of accountability to which the SEC and other agencies are held.[62] SEC enforcement actions and rulemakings are more likely to be challenged than are FINRA actions. FINRA is not subject to either the Administrative Procedures Act or the Freedom of Information Act and is not subject to any statutory cost-benefit standard.[63]

---

[61] *See* Steven Sloan, *Cost-Benefit Analysis Puts the Brakes on Dodd-Frank*, BLOOMBERG NEWS (May 7, 2012), http://www.businessweek.com/news/2012-05-07/cost-benefit-analysis-puts-the-brakes-on-dodd-frank ("Business lobbyists and Republican lawmakers who failed to stop the Dodd-Frank Act from becoming law have managed to put the brakes on many of its provisions a second way: cost-benefit analysis.").

[62] *See* Desiderio v. Nat'l Ass'n of Sec. Dealers, 191 F.3d 198, 206–07 (2d Cir. 1999) (The National Assocation of Securities Dealers ("NASD"), predecessor to FINRA, is generally not subject to constitutional requirements).

[63] However, there are rumblings that suggest that critics of regulation may be taking aim at FINRA's independence and/or authority. *See* Investment Adviser Oversight Act of 2012, H.R. 4624, 112th Cong. § 203(C)(b)(1) (2012) (proposing amendments to Investment Advisers Act to create self-regulatory organization for investment advisers, the rulemaking of which would be subject to APA notice and comment requirements); Fiero v. FINRA, 660 F.3d 569, 571 (2d Cir. 2011) (holding that FINRA does not have the power to obtain judicial enforcement of fines imposed on members); CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA (2011) (arguing that FINRA should be subject to additional administrative, due process and/or transparency requirements); Joseph McLaughlin, *Is FINRA Constitutional?*, 11 ENGAGE: J. FEDERALIST SOC'Y PRAC. GROUPS 111 (2011); Roberta S. Karmel, *Is the Financial Industry Regulatory Authority a Government Agency?* (Brooklyn Law Sch. Legal Studies Research Papers, Paper No. 86, 2007), *available at* http://ssrn.com/abstract=1018396; *see also* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3147 (2010) (finding unconstitutional the limitation on President's power to terminate Public Company Accounting Oversight Board ("PCAOB") board member). FINRA has occasionally referred to itself as an "independent" regulator in arguing its ability be oversee investment advisers who compete with FINRA's broker-dealer membership, a claim that may backfire if Congress decides to treat it like any other administrative agency. *See Investment Adviser Oversight Act Hearing*, *supra* note 6, at 11–13 (statement of Chet Helck, Chairman-Elect, Securities Industry & Financial Markets Assocation); SEC. INDUS. & FIN. MKTS. ASS'N, TESTIMONY OF CHET HELCK,

Its self-funding frees it from the kind of short-term political pressure that Congress exerts through its control of the SEC's budget. FINRA's governance structure is less cumbersome than the SEC's two-party system, which has evolved to echo the ideological culture wars more than the disinterested deliberations of an expert agency.[64] These factors give FINRA

available at http://financialservices.house.gov/uploadedfiles/hhrg-112-ba-wstate-chelck-20120606.pdf ("'[S]elf-regulatory organization . . . is truly a misnomer. . . . After many decades of legislation, oversight, and regulation, regulatory organizations like FINRA are not controlled, or unduly influenced, by the industry they regulate."). FINRA and other SROs appear to be enhancing their cost-benefit analyses, in part to forestall congressional action. *See* Nick Paraskeva, *U.S. Self-Regulatory Bodies Move Toward Cost-Benefit Analysis*, REUTERS (Oct. 9 2012), http://blogs.reuters.com/financial-regulatory-forum/2012/10/09/u-s-self-regulatory-bodies-move-toward-cost-benefit-analysis/; Suzanne Barlyn, *FINRA To Ramp Up Scrutiny of Costs, Benefits of Rules*, REUTERS (Sept. 25, 2012), http://www.reuters.com/article/2012/09/25/us-finra-costs-idUSBRE88O1AH20120925; Mark Schoeff, *FINRA's 'Independent Regulator' Label Gets Closer Scrutiny During SRO Debate*, INVESTMENT NEWS (Aug. 15, 2012, 3:08 PM), http://www.investmentnews.com/article/20120815/BLOG07/120819943#.

[64] For example, it has become standard practice for minority Republican Commissioners to file public dissents from rulemakings based on, inter alia, concerns regarding the adequacy of the SEC's cost-benefit analysis that, to a large extent, reflect fundamentally differing views regarding the specific role of the Commission and the broader utility of administrative law and agencies. *See, e.g.*, Gallagher Rule 506 Statement, *supra* note 44 (opposing conflict minerals rule); Paredes Minerals Statement, *supra* note 41 (opposing conflict minerals rule); Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Statement at Open Meeting To Adopt Final Rule Regarding Conflict Minerals Pursuant to Section 1502 of the Dodd-Frank Act (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510tap.htm (opposing proxy access rule); Kathleen Casey, Comm'r, Sec. & Exch. Comm'n, Statement at Open Meeting To Adopt Amendments Regarding Facilitating Shareholder Director Nominations (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510klc.htm (opposing proxy access rule); Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Opening Remarks and Dissent Regarding Final Rule 151A Indexed Annuities and Certain Other Insurance Contracts (Dec. 17, 2008), *available at* http://www.sec.gov/news/speech/2008/spch121708tap.htm (opposing equity-indexed annuities rule); Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Statement by SEC Commissioner Regarding Investment Company Governance Proposal (June 23, 2004), *available at* http://www.sec.gov/news/speech/spch062304psa.htm (opposing investment company governance rules); Cynthia A. Glassman, Comm'r, Sec. & Exch. Comm'n, Statement by SEC Commissioner Regarding Investment Company Governance Proposal (June 23, 2004), *available at* http://www.sec.gov/news/speech/spch062304cag.htm (opposing investment company governance rules); *see also* Statement of Casey & Paredes, *supra* note 24 (criticizing Section 913 Study). Intra-Commission conflict recently reached a boiling point when SEC Chairman Mary Schapiro, an independent, felt compelled to issue a public statement taking her fellow Republican and Democratic Commissioners to task for not supporting her position on money market fund regulation and calling for another regulatory agency to intercede, *see* Press Release, Sec. & Exch. Comm'n, Statement

much greater freedom than the Commission to impose a fiduciary duty on broker-dealers when providing personalized, retail investment advice, and advice in other situations. Thus, resolving the debate about broker-dealer conduct standards may have more to do with choosing the source of law—government agency or SRO—than establishing the particular scope or substance of the fiduciary duty.[65]

In fact, while the debate regarding the fiduciary duty has been focused on the SEC's and DOL's efforts, FINRA has been steadily establishing a foundation for imposing a fiduciary duty on the same broker–dealers to which a fiduciary rule under Dodd-Frank Section 913 would apply. FINRA regulations have long included a strong fiduciary element. The Commission described FINRA rules as "embod[ying] basic fiduciary responsibilities" almost twenty-five years ago,[66] a characterization that has gained purchase ever since.

As a general matter, FINRA members are subject to broad fairness standards that are structurally akin to the principles-based fiduciary duty.[67] For example, FINRA Rule 2010 requires

---

of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), *available at* http://www.sec.gov/news/press/2012/2012-166.htm, which was followed by counter-statements released by the Democratic Commissioner and two Republican Commissioners with whom she disagreed, *see* Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Statement Regarding Money Market Funds (Aug. 23, 2012), http://sec.gov/news/speech/2012/spch082312laa.htm; Troy A. Paredes & Daniel M. Gallagher, Comm'rs, Sec. & Exch. Comm'n, Statement on the Regulation of Money Market Funds (Aug. 28, 2012), http://sec.gov/news/speech/2012/spch082812dmgtap.htm.

[65] Even under a section 913 rulemaking, FINRA could still become the primary source of law as to broker-dealers' fiduciary duties. *See* MERCER BULLARD, AARP PUB. POLICY INST., PROTECTING INVESTORS—ESTABLISHING THE SEC FIDUCIARY DUTY STANDARD 17 (2011), *available at* http://assets.aarp.org/rgcenter/ppi/cons-prot/rr2011-02.pdf.

[66] E.F. Hutton & Co., Inc., Securities Act Release No. 34-25887, 1988 WL 901859, at *4 (July 6, 1988).

[67] *See, e.g.*, N.Y. Stock Exch. Rule 2020 (2009) ("No member . . . shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."); FINRA Rule 2210(d)(1)(A), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10648 (requiring that communications with the public be "based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service"); FINRA Rule 5121, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9456 (requiring participants in public offerings to disclose prominently conflicts of interest); FINRA Rule 5110(b)(4)(C), *available at* http://finra.complinet.com/en/

that members "observe high standards of commercial honor and just and equitable principles of trade."[68] In some circumstances, broker-dealers' duties are explicitly fiduciary, such as when executing customer transactions.[69] Other rules impose a broad principles-based standard *and* specific conduct requirements, which effectively couples a non-fiduciary conduct rule with a fiduciary-like overlay. For example, principal transactions with customers must be effected at prices that are "fair, taking into consideration all relevant circumstances"[70]—a facts-and-circumstances, fiduciary-like standard—*and* not exceed a five percent mark-up or -down limit—a bright-line, rule-based, nonfiduciary standard.[71] Adding a further fiduciary gloss, a mark-up or -down of five percent or less still "may be considered unfair or unreasonable," depending on the particular facts and circumstances.[72]

The closest cousin in broker-dealer regulation to a Section 913 fiduciary standard is FINRA's suitability rule. The suitability rule requires that members have a "reasonable basis to believe that a recommended transaction or investment strategy" is suitable for the retail customer "based on the information obtained through the [member's] reasonable

display/display_main.html?rbid=2403&element_id=6831 (prohibiting participation in underwriting in which arrangements are "unfair or unreasonable").

68 FINRA Rule 2010, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

69 *See* Order Execution Obligations, Exchange Act Release No. 37619A, 1996 WL 506154 (Sept. 6, 1996) ("A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated both in SRO rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws."); FINRA Rule 5310(a)(1), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455 (requiring members to "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions").

70 NASD Rule 2440, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3660.

71 NASD Rule IM–2440–1, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3661.

72 *Id.* FINRA has frequently found markups of less than five percent to be excessive. *See* Dan Jamieson, *FINRA Backtracks on Plan To End 5% Markup Rule*, INVESTMENT NEWS (Feb. 10, 2013), http://www.investmentnews.com/article/20130204/FREE/130209979 (commentator noting FINRA settlements involving three percent markups).

diligence . . . to ascertain the customer's investment profile."[73] A "customer's investment profile" includes the customer's age, other investments, financial situation and needs, other enumerated factors, and "any other information the customer may [choose] to disclose."[74]

The suitability rule has been criticized by fiduciary advocates for not requiring that a recommendation be in the customer's best interests, but only that it be suitable.[75] Thus, for a customer for whom a variable annuity was "suitable" a broker-dealer could recommend the variable annuity that paid him the highest compensation as opposed to the one that would be in the customer's best interests, as discussed above. Yet suitability goes some distance down the fiduciary road by establishing a qualitative test for investment advice that mandates that it be consistent with clients' best interests, if not necessarily that it be the best option.[76] It is, again, the kind of principles-based, fact-dependent conduct standard that reflects the structure of a fiduciary standard more than that of a specific conduct rule.

FINRA recently adopted a new suitability rule[77] that, in two primary respects, moves the suitability standard closer to a fiduciary standard.[78] First, in a number of ways, the new rule contemplates evaluating broker-dealer conduct in the context of

---

[73] FINRA Rule 2111, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (formerly NASD Rule 2310). There is a parallel NYSE rule—the "know your customer" rule—that became a FINRA rule in 2011 following the merger of the two regulators in 2007. *See* FINRA Rule 2090, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858 (formerly NYSE Rule 405) ("Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.").

[74] FINRA Rule 2111.

[75] *See* BULLARD, *supra* note 65, at 6.

[76] *See id.* at 6–7.

[77] Order Approving Proposed Rule Change, Exchange Act Release No. 34-63325, 75 Fed. Reg. 71,479 (Nov. 23, 2010) (SEC release approving FINRA Rule 2111, effective July 9, 2012).

[78] *See* Seth Lipner, *The New FINRA Suitability Rules*, 1969 PLI/CORP 173, 192 (Aug. 2, 2012) (on file with author) (FINRA's new suitability rule does not impose a fiduciary duty but "brings FINRA closer to imposing such a standard on brokers"); Duane Thompson, *FINRA's Quasi–Fiduciary Rule*, FI360 BLOG (July 11, 2012), http://www.fi360.com/blog; Christina N. Davilas et al., *FINRA Issues Additional Guidance on Its New Suitability Rule*, 4 FIN. FRAUD L. REP. 795, 799–800 (2012) (FINRA "[a]nnounces a New, 'Best Interests of the Client' Standard" that "may be viewed as akin to a fiduciary duty.").

the kind of comprehensive, ongoing advisory relationship with customers that is more akin to a fiduciary relationship.[79] For example, FINRA expanded the rule to cover not only recommendations, but also "investment strategies," which include situations in which a security or strategy is recommended, regardless of whether a transaction takes place.[80] Along with the rule's expansion to cover "hold" recommendations, the inclusion of investment strategies expands the kind of recommendations covered by the rule well beyond the transactional advice that has been the core of the suitability rule.[81]

FINRA's assertion of authority over transactions that may involve non-securities, such as equity-indexed annuities, home-equity loans, and viatical settlements,[82] has further extended the suitability rule beyond transactions in securities to encompass, at least indirectly, virtually every form of financial advice.[83] FINRA has stated that broker-dealers must design their supervisory procedures to detect, investigate, and follow–up on " 'red flags' indicating that a broker may have recommended an unsuitable

---

[79] *See* Melanie Waddell, *FINRA's New Suitability Rule Edges Closer to 'Fiduciary': NAPFA Chairman*, ADVISORONE (July 16, 2012), http://www.advisorone.com/2012/07/16/finras-new-suitability-rule-edges-closer-to-fiduci.

[80] *See* FINRA, Regulatory Notice 12-25, Suitability: Additional Guidance on FINRA's New Suitability Rule (2012); FINRA, Regulatory Notice 12-55, Suitability: Guidance on FINRA's Suitabilty Rule (2012) (modifying FINRA Regulatory Notice 12-25).

[81] *See* Kenneth Corbin, *FSI Wary of Investment Strategy, Hold Provisions in FINRA Suitability Rule*, FINANCIAL PLANNING (July 9, 2012), http://www.financial-planning.com/news/fsi-wary-of-investment-strategy-hold-provisions-in-finra-suitability-rule-2679753-1.html (Comments of David Bellaire, General Counsel and Director of Government Affairs, Financial Services Institute, regarding suitability rule's coverage of hold recommendations: " 'It's very easy for firms to monitor a transaction . . . . Things happen—products are purchased or sold.' But 'the recommendation to hold is a situation where suitability rules now apply in which there is no clear moment, no resulting transaction.' ").

[82] *See* FINRA, Regulatory Notice 12-25; FINRA, Regulatory Notice 12-55. The term "viatical settlement" refers to the sale of a life insurance policy to a third party.

[83] *See generally* Mercer Bullard, *The Future of Financial Planning Regulation*, MORNINGSTAR.COM (July 7, 2011), http://ibd.morningstar.com/article/article.asp?id=386262&CN=brf295,http://ibd.morningstar.com/archive/archive.asp?inputs=days=14;frmtId=12,%20brf295.

investment strategy with both a security and non-security component,"[84] which further extends the reach of investment strategies category discussed above.

FINRA's interpretation of the new rule seems to portend a broker-dealer duty to monitor customer accounts on an ongoing basis.[85] An ongoing duty to monitor an account makes brokers' services more closely resemble the kind of ongoing relationship of trust and confidence that is characteristic of a fiduciary relationship, in contrast with the services of a salesperson who only makes a one-time recommendation.[86] FINRA's January 2011 guidance on the new suitability rule states that the broker-dealer must "know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts."[87] It refers further to the need to verify essential facts about customers "at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances" and reminds broker-dealers of their obligation under Exchange Act Rule 17a–3 to "attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations."[88] These pointed assertions of an ongoing duty to update information imply a developing affirmative duty to

---

[84] FINRA, Regulatory Notice 12-25, at 8; *see, e.g.*, NFP Securities, Inc., FINRA Letter of Acceptance, Waiver and Consent, FINRA Case No. 2007011393902 (Mar. 28, 2011) (settling for failing to supervise of equity-indexed annuities).

[85] *See* De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002) (broker-dealer ordinarily has no duty to monitor a non-discretionary account).

[86] *See* Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999) (broker-client fiduciary duty is limited "to the narrow task of consummating the transaction requested"). Conversely, the Department has proposed to expand the definition of "fiduciary" under ERISA to include not only persons who provide investment advice on a "regular basis" but also to those who provide advice regarding a single transaction. *See* Definition of the Term "Fiduciary", *supra* note 3.

[87] FINRA, Regulatory Notice 11-02, Know Your Customer and Suitability: SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (2011). Interestingly, Dodd-Frank's rulemaking authorization expressly prohibited a rule that required a broker-dealer to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities, *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, § 913(g)(1), 124 Stat. 1376 (2010), yet FINRA's interpretation of the new suitability rule seems to apply to certain customer relationships and entails precisely such a relationship.

[88] FINRA, Regulatory Notice 11-02.

update prior recommendations periodically and make new recommendations based on changed circumstances as appropriate. Although other FINRA guidance creates some doubt as to FINRA's direction in this respect,[89] it appears that, at a minimum, FINRA has put the suitability rule on a path of requiring that broker-dealers assume greater responsibility for the longer-term effects of their transaction and investment strategy recommendations.

Thus, FINRA's comments about ongoing monitoring and its authority over non-securities transactions, combined with the expansion of the suitability rule to cover both hold recommendations and investment strategies, reflect a rule that is decidedly moving toward a fiduciary duty. The foregoing changes, like FINRA's addition of "age, investment experience, time horizon, liquidity needs and risk tolerance" to the list of factors that broker-dealers must consider in developing a customer's investment profile, envision something more akin to a full-blown financial planning relationship than an intermittent transactional relationship.[90] At the same time that financial

[89] FINRA states that recommendations normally do "not create an ongoing duty to monitor and make subsequent recommendations." FINRA, Regulatory Notice 12-25*,* at 7; FINRA, Regulatory Notice 11-25, Know Your Customer and Suitability: New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer Suitability Obligations (2011). Further obscuring its January 2011 guidance, FINRA stated that a broker who meets with a customer for a quarterly or annual review and "remains silent regarding, or refrains from recommending the sale of, securities" would *not* be subject to the rule, even if the broker had "previously recommended the purchase of the securities." *Id.* The rule would apply if the broker made an express recommendation to hold the securities, which seems to create an incentive to avoid potential suitability liability by saying nothing, even when the customer should sell—although private liability risk arising from silence might counsel otherwise. FINRA explains that explicit hold recommendations should be covered because they "constitute the type of advice upon which a customer can be expected to rely." *Id.* However, the same reliance is likely to arise when a broker is silent during a customer account review meeting when there are securities that should be sold. It is unclear how FINRA will resolve these incongruities.

[90] *See* Corbin, *supra* note 81 (Comments of David Bellaire, General Counsel and Director of Government Affairs, Financial Services Institute, regarding suitability rule's coverage of non-securities and investment strategies: " '[I]t's questionable whether that's a fair requirement for firms to be experts on things outside of their business'. . . . 'That goes far afield from the business that our members are engaged in of selling securities and monitoring the suitability of those securities,' . . . warning that the rule sets 'no outside limit' on what constitutes a covered investment strategy."). Ironically, in 2005 the Commission adopted a rule, later vacated by the D.C. Circuit, under which such financial planning services could have required a

planning organizations have pressed for separate regulation of financial planning as such,[91] FINRA has moved aggressively to create and occupy that field on its own and its efforts have not gone unnoticed by the financial planning community.[92] Through rulemaking—by text and interpretation—FINRA has expanded: (1) the idea of "suitability" to reflect the broader context in which broker-dealers advertise and deliver retail financial services, and (2) the suitability rule to impose a standard approaching the fiduciary standard that traditionally has applied to such advisory services.

The second way in which the suitability rule has moved toward a fiduciary standard is by FINRA's position that the new rule entails a de facto requirement that broker-dealers reasonably believe not only that their recommendations are suitable, but also that they are in the best interests of their customers.[93] There is no question that the fiduciary duty applicable to advisers continues to be a higher standard, in part because it requires that recommendations be suitable *and* that

---

broker-dealer to register under the Advisers Act. *See generally* Black, *supra* note 20, at 48–49.

[91] *See* Press Release, Certified Fin. Planner Bd., Financial Planning Coalition Announces Support for Professional Regulation of Financial Planners (Apr. 27, 2009), *available at* http://www.cfp.net/news-events/news-release-archive/article/2009/04/27 (The financial planning community has asked Congress to enact legislation specifically regulating the financial planning industry.). This effort was unsuccessful, but section 919C of the Dodd-Frank Act did require the U.S. Government Accountability Office to study the oversight and regulation of financial planers. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-235, REGULATORY COVERAGE GENERALLY EXISTS FOR FINANCIAL PLANNERS, BUT CONSUMER PROTECTION ISSUES REMAIN 1 (2011), *available at* http://www.gao.gov/new.items/d11235.pdf; *see also* Bullard, *supra* note 4 (critiquing GAO study).

[92] In 2009, the Financial Planning Association complained to the Commission that FINRA had exceeded its jurisdiction by bringing an enforcement action against a broker-dealer for offering misleading financial plans. *See* Letter from Richard Salmen, President, Fin. Planning Ass'n, to Mary Schapiro, Chairman, Sec. & Exch. Comm'n (Aug. 17, 2009) (citing Press Release, Fin. Indus. Regulatory Auth., Ameritas Fined $100,000 for Use of Misleading College Funding Plans To Sell Variable Life Products (Aug. 6, 2009), *available at* http://www.finra.org/Newsroom/NewsReleases/2009/P119744), *available at* http://www.fpanet.org/docs/assets/29F7D0C5-1D09-67A1-AC1B0DBAFF454BCE/SchapiroLetterFINRAEnforcement081709final.pdf; *see also* Letter from David Becker, Gen. Counsel, Sec. & Exch. Comm'n, to Richard Salmen, President, Fin. Planning Ass'n (Aug. 27, 2009), *available at* http://www.fpanet.org/docs/assets/85DA73EB-1D09-67A1-7A4156FADA6BF5D2/82909SECresponse.pdf (responding to FPA letter).

[93] *See* Davilas et al., *supra* note 78, at 800 ("[FINRA's] reading a fiduciary duty requirement into the suitability rule marks another attempted significant expansion of FINRA's regulatory authority over broker-dealers.").

conflicts of interest be fully disclosed, whereas broker-dealers generally have not been required to disclose conflicts of interest.[94] However, FINRA has applied a strong fiduciary gloss to the "consistent with the best interests of [investors]" formulation in its most recent interpretive guidance on the suitability rule.[95] In some respects, the suitability standard reaches the same result as the "act in the best interests of the [customer]" standard that appears in Dodd-Frank Section 913 and in cases applying the fiduciary duty under the Investment Advisers Act.[96]

---

[94] *See* Suitability of Investment Advice Provided by Investment Advisers, Custodial Account Statements for Certain Advisory Clients, Advisers Act Release No. 1406, 1994 WL 84902, at *2 (Mar. 22, 1994) ("Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice."); ANGELA A. HUNG ET AL., RAND INST. FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 13 (2008) ("[T]he kernel of the fiduciary obligations that investment advisers owe to clients is to refrain from any undisclosed conflicts of interest, a requirement that constrains only some broker-dealers. In addition, even for those requirements that appear similar to those for broker-dealers, violation may be viewed as much more significant."); MICHAEL KOFFLER, THE BRAVE NEW WORLD OF FIDUCIARY DUTY FOR BROKER-DEALERS AND INVESTMENT ADVISERS 13, 24 (2010) (subjecting broker-dealers to a fiduciary duty would require that they disclose the revenue sharing payments). *Contra* Barbara Black, *How To Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 86 (2010) ("There is little support, either in the law or regulatory guidance, for this distinction" between suitability and fiduciary obligations). *Cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196–97 (1963) (fiduciary duty under section 206 of Advisers Act requires full disclosure of material conflicts of interest). *Compare* Focus Point Solutions, Inc., Release No. 3458, 2012 WL 3863221, at *1–2 (ALJ Sept. 6, 2012) (settling charges that investment adviser violated section 206(2) of Advisers Act by failing to disclose revenue sharing payments to client), *with* Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 612 (6th Cir. 2005) (broker-dealer has no duty to disclose that Class B shares of mutual fund are never the best option for shareholders or that it received greater compensation for selling Class B shares), *and* Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000) (broker-dealer not required to disclose mutual fund 12b-1 fees), *and* Morgan Stanley & Van Kampen Mut. Fund Sec. Litig., 2006 WL 108183, at *7 (S.D.N.Y. Apr. 18, 2006) ("Form N-1A requires the disclosure of the total fees paid by the investor in connection with a securities purchase, as well as total commissions paid by the fund, but it does not require disclosure of how differential compensation is allocated. Nor does it require disclosure of the sales contests or management bonuses."). The foregoing decisions in *Benzon, Press* and *Morgan Stanley* have not deterred the SEC's enforcement division from bringing antifraud charges against and obtaining settlements with broker-dealers for failing to disclose revenue sharing payments. *See* Bullard, *supra* note 4, at 183 n.40.

[95] *See* FINRA, Regulatory Notice 12-25, Suitability: Additional Guidance on FINRA's New Suitability Rule 3–4 (2012).

[96] In some cases, FINRA panels have interpreted the suitability rule to require that broker-dealers "act in the best interests of the client," rather than merely

FINRA's interpretation of the rule has made the "consistent with the best interests" standard essentially fiduciary in nature with respect to situations where a broker-dealer may be motivated to recommend one suitable investment over another in order to increase the broker-dealer's compensation. This is the same sale-motivated-by-compensation fact pattern found in the sale of variable annuities, which the fiduciary standard reaches but the suitability standard may fail to cover, according to fiduciary advocates.[97] FINRA's interpretation of the "consistent with the best interests" standard implies a duty of care, rather than a duty of loyalty, that may achieve the practical effect of a disclosure-based fiduciary duty.

In its recent reinterpretation of the suitability rule, FINRA interpreted the "consistent with" formulation to "prohibit[] a broker from placing his or her interests ahead of the customer's interests."[98] As examples, FINRA listed a series of suitability cases in which a broker-dealer's recommendation was allegedly motivated by the prospect of higher compensation.[99] It treated the suitability of the recommendation as separate from the question of whether "the broker [was] placing his or her interests ahead of the customer's interests," reflecting the view that an improperly motivated recommendation could violate the suitability rule even if the recommended investment was suitable.[100]

The cases cited by FINRA reflect a mix of rules and allegations that make it difficult to pinpoint the legal standard being applied. For example, a case in which a broker recommended transactions that triggered unnecessary additional fees, both suitability violations and violations of the more general

"consistent with" the client's best interests. *See, e.g.*, Willard, Disciplinary Proceeding No. 2006006046401, at 16 (FINRA Dec. 18, 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p120850.pdf (relying on Dunbar, Disciplinary Proceeding No. C07050050, at 11 (FINRA, May 20, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p018501.pdf (using the "consistent with the customer's best interests" formulation).

[97] *See, e.g.*, *Roper Testimony*, *supra* note 20, at 7.

[98] *See* FINRA, Regulatory Notice 12-25, at 3–4.

[99] *Id.*

[100] *Id.* at 4 (A broker is not obligated to recommend the least expensive security, "as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests.").

"fair dealing" and "commercial honor" rules were involved.[101] Indeed, FINRA's discussion of the "consistent with" standard includes a long citation to general misconduct rules and other rules that "provide broad and significant protections to investors"—that is, broad enforcement authority—as if to remind FINRA members of the breadth of FINRA's authority to bring principles-based enforcement actions that might be considered outside of the scope of a strict reading of the suitability rule.[102] Regardless of whether transactions that are suitable, but compensation-motivated, violate the suitability rule, the fiduciary-like flexibility of other FINRA rules, in combination with FINRA's interpretive discretion as an SRO, make such transactions actionable. This standard continues to lack the failure-to-disclose claim that a fiduciary duty would provide, and it is still an open question as to how well FINRA's duty of care will weather challenges in courts—or before a more libertarian Commission—that may be less inclined than a FINRA panel to defer to a regulator's rate-setting views regarding when expenses are so high as to make a recommendation unsuitable.[103]

[101] *See* Epstein, Exchange Act Release No. 34-59328, 2009 WL 223611, at *21 (Jan. 30, 2009) (upholding FINRA disciplinary decision finding suitability violation based on improper mutual fund switching and violations of fair dealing and commercial honor rules); *see also* Sathianathan, Exchange Act Release No. 34-54722, 2006 WL 3228694, at *15 (Nov. 8, 2006), *aff'd*, 304 F. App'x 883 (D.C. Cir. 2008) (finding suitability and fair dealing violations in part based on a recommendation to invest in a higher cost class of mutual fund shares); Faber, Exchange Act Release No. 34-49216, 2004 WL 239507, at *7 (Feb. 10, 2004) (upholding the FINRA disciplinary decision finding unsuitable recommendations and violations of antifraud and commercial honor rules); Belden, Exchange Act Release No. 34-47859, 2003 WL 21088079, at *5 (May 14, 2003) (upholding FINRA disciplinary decision finding suitability violation based on sales of higher-cost classes of mutual fund shares and violations of commercial honor rules); Evans, Complaint No. 2006005977901 9–11 (FINRA Oct. 3, 2011), *available at* http://www.finra.org/web/groups/industry/documents/nacdecisions/p124603.pdf (finding that excessive and inappropriate trading violated suitability, excessive trading and commercial honor rules). *Cf.* 1st Global Capital Corp., Exchange Act Release No. 34-54754, 2006 WL 3313842, at *7 (Nov. 15, 2006) (settling the proceeding based on MSRB fair dealing (G-17) and suitability (G-19) rules and taking the position that recommending highest cost class of 529 shares violated fair dealing and suitability rules).

[102] *See generally* FINRA, Regulatory Notice 12-25, at n.23 (citing FINRA Rules 1014, 1021, 1031, 2010, 2090, 2210, 2330, 2360, 2370, 3010 and 5310) (stating "[t]hese (and many other) FINRA rules provide broad and significant protections to investors").

[103] For example, no court has ever ruled in favor of plaintiffs who alleged that fees charged by a mutual fund were excessive in violation of the fiduciary duty in section 36(b) of the Investment Company Act. *See* Mercer E. Bullard, Dura*, Loss*

However, FINRA is already deeply engaged in forms of rate-setting in other contexts[104] and openly refers to part of its suitability rule as including a "quantitative" suitability standard.[105] FINRA's under the radar status as a regulator may permit it to expand a "quantitative" suitability duty of care to make up much of the ground that a Section 913 fiduciary duty would cover.[106]

The incorporation of compensation-motivated claims in suitability cases places broker-dealers in a difficult position. Any situation in which a broker-dealer may receive different compensation amounts for implementing different recommendations, which is the norm in the context of recommendations involving mutual funds and variable annuities,[107] automatically begins to build the foundation for a suitability claim based on the recommendation having been compensation-motivated. A broker-dealer might defend on the ground that the transaction was suitable, the differential compensation was disclosed and/or the customer consented, but none of these arguments is a defense to a FINRA claim that the recommendation was, in fact, motivated by higher compensation.[108] Alternatively, the broker-dealer could revise compensation arrangements so that its compensation—and any nonmonetary benefits or burdens—did not vary based on the particular security recommended. This "level fee" model mirrors

---

Causation, and Mutual Funds: A Requiem for Private Claims?, 76 U. CIN. L. REV. 559, 559–60, n.5 (2008).

[104] *See, e.g.*, FINRA Rule IM-2440-2, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3662 (limiting markups and markdowns to five percent); FINRA Rule 2830(d)(1), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3691 (limiting mutual fund commissions to 8.5%); FINRA, Regulatory Notice 12-25, at 14 & nn.66–67 (citing specific turnover rates and cost-to-equity ratios in evaluating churning claims).

[105] FINRA Rule 2111 cmt. .05, Components of Suitability Obligations, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

[106] *See* Davilas et al., *supra* note 78 (FINRA interpretation "[p]rovides that the suitability obligation includes a requirement to act in the 'best interests of the client,' seemingly pre-empting any rulemaking by the SEC pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank') that broker-dealers are subject to a generalized fiduciary duty.").

[107] *See, e.g.*, *Revenue Sharing from Mutual Fund Families*, PRIMERICA, http://shareholder.primerica.com/public/shareholder/rev_share_disc.html (last visited Jan. 10, 2014).

[108] *See* discussion *supra* notes 98–100.

the approach taken under ERISA in permitted plan fiduciaries to provide beneficiaries with conflicted advice.[109] Another defense would be for broker-dealers to document the reasons that a particular higher-compensation recommendation was the best option for the customer, that is, to adopt a de facto fiduciary "best interests" standard.

FINRA supports imposing a fiduciary duty on broker-dealers with respect to personalized, retail investment advice[110] and appears to intend to continue moving the suitability standard further in that direction. FINRA's Vice Chairman has stated that FINRA intends, before any SEC rulemaking under Section 913, to "begin implementing changes to move the standard forward" toward a fiduciary duty, including a proposal to require a disclosure document similar to the Form ADV required under the Advisers Act.[111] FINRA views this disclosure document as a

> stepping stone toward a fiduciary standard. [FINRA] supports the three principles FINRA believes are fundamental to a fiduciary relationship: avoiding conflicts where possible; fully disclosing conflicts that do exist; and taking actions that are in the best interests of customers.[112]

This requirement to take actions that "are in" a customer's best interests, rather than merely "consistent with" those interests, echoes Section 913's formulation of the fiduciary standard. FINRA has an incentive to further embrace the

---

[109] *See* Investment Advice—Participants and Beneficiaries, 76 Fed. Reg. 66,135, 66,139 (Oct. 25, 2011) (adopting rule permitting investment advice otherwise prohibited by ERISA where adviser's fees do not vary based on the investment option selected).

[110] *See Investment Adviser Oversight Act Hearing*, *supra* note 6, at 13 (statement of Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority).

[111] Stephen Luparello, Vice Chairman, Fin. Indus. Regulatory Auth., Remarks at the FSI Advocacy Summit (Oct. 5, 2011), *available at* http://www.finra.org/Newsroom/Speeches/Luparello/P124599; *see* FINRA, Regulatory Notice 10-54, Disclosure of Services, Conflicts and Duties (2010).

[112] Luparello, *supra* note 111.

fiduciary standard in order to strengthen its case to become the self-regulatory organization for investment advisers,[113] a goal toward which it made significant strides in 2011.[114]

The possibility that the fiduciary debate will be played out based not on SEC rulemaking but on FINRA's evolving standards may reflect a broader dynamic in the evolution of administrative law. Financial services, like other heavily regulated industries, have become more complex at an accelerating rate.[115] The agencies that oversee these industries may no longer have the knowledge or flexibility to adapt adequately to the speed of innovation. At the same time, agencies have increasingly been burdened with procedural requirements and political interference that further limit their ability to keep pace with the markets that they regulate, as discussed above. Government agencies have increasingly found their rulemaking initiatives paralyzed by internal and external political gridlock. This characterization aptly describes the current state of both the SEC's position on the fiduciary duty, where it cannot even achieve sufficient internal consensus to release a request for information on the costs and benefits of a fiduciary rulemaking[116]—after already failing to achieve consensus on the release of the staff's Section 913 Study—and the Department of Labor's fiduciary duty proposal, where a cost-benefit information request was released only to trigger an angry response from members of the President's own party.[117]

---

[113] *See* Dan Jamieson, *New FINRA Suitability Rule Worries B-Ds*, INVESTMENT NEWS (July 8, 2012, 9:58 AM), http://www.investmentnews.com/article/20120708/REG/307089984 ("Mr. [Hardy] Callcott [partner at Bingham McCutchen, LLP] thinks that Finra is trying to get a jump on overseeing a fiduciary duty in an attempt to bolster its case for getting oversight of advisers.").

[114] *See generally* Investment Adviser Oversight Act of 2012, H.R. 4624, 112th Cong. (2012).

[115] Noreen Clancy et al., *Complexity of Financial Services Industry Makes It Difficult for Individual Investors To Distinguish Broker-Dealers and Investment Advisers*, RAND CORP. (Jan. 3, 2008), http://www.rand.org/news/press/2008/01/03.html; Felix Salmon, *Why Finance Can't Be Fixed with Better Regulation*, REUTERS BLOG (July 23, 2010, 12:24), http://blogs.reuters.com/felix-salmon/2012/07/23/why-finance-cant-be-fixed-with-better-regulation.

[116] *See* Letter from Mary Schapiro, Chairman, Sec. & Exch. Comm'n, to Scott Garrett, Chairman, Subcomm. on Capital Mkts. & Gov't-Sponsored Entities, House of Representatives (Jan. 10, 2012), *available at* http://www.bdamerica.org/wp-content/uploads/2012/01/SEC-response-to-GARRETT-Section-913-follow-up-2.pdf (stating that SEC staff was drafting a request for data "specific to the provision of retail financial [investment] advice").

[117] *See Cost-Benefit Hearing*, *supra* note 27, at 2.

Independent agencies such as the Commission may have no choice but to surrender a broader range of policymaking to quasi-governmental, or quasi-private, entities that operate one degree further from the zone of political conflicts. This could be a short-term shift that only responds to the current climate of heightened political polarization.[118] Or it may reflect a longer-term, natural evolution of the modern administrative state to policymaking arenas that are further removed from political processes and closer to quasi-private structures.[119] One could crudely posit four epochs in this evolution: (1) From the pre-1900 absence of governmental regulatory mechanisms during the birth of free market economies, (2) to the rise of legislative regulatory initiatives from 1900–1932, (3) to the delegation by legislatures to agencies from 1933–2000, (4) to the delegation by legislatures and agencies to quasi-private, self-regulatory forms from 2000 onward. Perhaps we are living in the age of the Fifth Branch.[120]

III. THE PRIVATE FIDUCIARY DUTY

The foregoing analysis discusses the fiduciary debate in the context of a public duty, yet fiduciary claims, and their close cousin suitability claims, are addressed far more often in private litigation than in public enforcement actions.[121] FINRA brought

---

[118] *See* Nolan McCarty et al., *Polarized America: The Dance of Ideology and Unequal Riches* 3 (Ctr. on Insts. & Governance, Working Paper No. 5, 2005), *available at* http://igovberkeley.com/sites/default/files/No5_McCarty.pdf (voting patterns show increase in relative divergence of Republicans' and Democrats' voting patterns). *See generally* A.E. Dick Howard, *The Constitution and the Role of Government*, 6 CHARLESTON L. REV. 449, 489–94 (2012) (comparing consensus at the inception of the administrative state with current political polarization).

[119] *See* Mercer Bullard, Caremark*'s Irrelevance*, 10 BERKELEY BUS. L. J. 15, 22 (2013) (discussing role of corporate form as a kind of self-regulatory structure).

[120] Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L REV. 573, 579 (1984). This evolution could just as well be characterized as the dismantling of the Fourth Branch, with the advent of self-regulation representing a return to a tripartite, limited federal government. *See* Short, *supra* note 11, at 674–75 (finding positive correlation between expressions of concern that regulation is coercive and support for self-regulatory structures). *Cf.* Sunstein, *supra* note 57. *See generally* FTC v. Ruberoid Co., 343 U.S. 470, 487 (1952) (Jackson, J., dissenting) (administrative agencies "have become a veritable fourth branch of the Government, which has deranged our three-branch legal theories much as the concept of a fourth dimension unsettles our three-dimensional thinking"); Lawson, *supra* note 57.

[121] *Compare* Clifford Kirsch et al., *Understanding FINRA's Suitability Rules: Possible Enforcement Actions*, FINANCIAL PLANNING BLOGS (Mar. 17, 2013), http://www.financial-planning.com/blogs/understanding-finra-new-suitability-rules-

only fifty-three suitability cases in 2010. Although it doubled that total in 2011,[122] the total still pales in comparison with the tens of thousands of fiduciary duty and suitability claims brought in court and arbitration.[123] The primary source of law as to the scope and substance of the fiduciary duty for broker-dealers is private claims.

Broker-dealers can be found to be fiduciaries under state common law when plaintiffs establish, for example, that they had a relationship of trust and confidence with their broker or where some inequality of bargaining position exists,[124] although a broker-dealer's state law fiduciary duty is not a model of

---

knowing-your-customer-2679758-1.html, *with Dispute Resolution Statistics*, FIN. INDUS. REGULATORY AUTH., http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last updated Dec. 16, 2013).

[122] *See* Kirsch et al., *supra* note 121.

[123] From 2002 through 2011, 61,304 arbitration claims were filed. *See Dispute Resolution Statistics*, *supra* note 121; *see, e.g.*, Billings v. Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA Arbitration No. 11-01948 (Oct. 12, 2012), *available at* http://finraawardsonline.finra.org/viewDocument.aspx?DocNb=59344 (finding respondent violated fiduciary duty to claimants and awarding monetary relief).

[124] *See, e.g.*, Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1038 (4th Cir. 1997) (under Texas law, " '[f]iduciary relationships arise when a party occupies a position of confidence toward another' "); MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1259 (10th Cir. 1989) (under Oklahoma law, "a fiduciary duty exists when the party in the weaker position reasonably places its confidence and responsibility in the party in the stronger position"); Amendolia v. Rothman, No. Civ.A 02-8065, 2003 WL 23162389, at *4 (E.D. Pa. Dec. 8, 2003) (under Pennsylvania law, the relationship between a securities broker and his customer is a fiduciary one as a matter of law); Courtland v. Walston & Co., 340 F. Supp. 1076, 1080 (S.D.N.Y. 1972) ("When a registered representative is giving more than the normal amount of incidental investment advice, and has instilled in customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels, and the registered representative knows that the customer feels, that the registered representative is acting in customer's interest, a fiduciary relationship may arise."); Dinsmore v. Piper Jaffray, Inc., 593 N.W.2d 41, 46 (S.D. 1999) (applying South Dakota law, "[s]ecurities [b]rokers owe . . . fiduciary obligations to their clients . . . 'a duty of utmost good faith, integrity and loyalty' "). Broker-dealers also may be found to be fiduciaries when they exercise discretion over a client's account, but these cases are not of interest here because broker-dealers who exercise discretion are already subject to the fiduciary duty under the Advisers Act. *See* Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 34-51523, 2005 WL 849053, at *1 (Apr. 15, 2005) (exercise of investment discretion is not solely incidental investment advice and therefore not eligible for broker-dealer exemption from the Advisers Act), *vacated by* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007). They therefore are not the focus of section 913 rulemaking, which would primarily affect broker-dealers who are not subject to the Advisers Act.

clarity.[125] Broker-dealer customers may also be able to bring contract or negligence claims under state common law that are indirectly based on a suitability standard, which is somewhat akin to a fiduciary claim.[126] Thus, state law has recognized a variety of circumstances in which a broker-dealer may be found to have a fiduciary relationship with a client.

Federal law is not nearly as hospitable to private fiduciary claims.[127] There is no federal common law fiduciary duty outside the fiduciary duty under the Advisers Act, and there is no private right of action under the Act for a breach of the fiduciary duty. Nor is there is a private right action for a violation of FINRA's suitability rule.[128] Courts have recognized private claims for unsuitable recommendations under the general anti-fraud provisions of the federal securities laws, but these claims are unlikely to succeed. Plaintiffs generally must show, along with other elements of a fraud claim, "that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs," and "that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities."[129] This is a difficult, if not insurmountable, burden of proof for plaintiffs.

---

[125] *See* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 706 (2010) (calling broker's fiduciary duty "a perplexing fusion of state and federal law"); Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 550 (2002) ("Whether described as 'considerable confusion' or as 'judicial smoke,' it is clear that courts have not always consistently articulated the fiduciary obligations of broker-dealers under state law. Even a cursory review of authorities shows deep division within the courts regarding the fiduciary duties of broker-dealers.").

[126] *See, e.g.*, Keenan v. D.H. Blair & Co., 838 F. Supp. 82, 86–87 (S.D.N.Y. 1993) (discussing elements of "warranty of suitability" claim); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 697 F. Supp. 1224, 1227 (D.D.C. 1988) (A violation of the suitability rule in a common law claim "will not automatically result in [the broker-dealer] being held liable for negligence; it would simply be a factor consideration by the jury as to whether he acted as a 'reasonable' person in his conduct toward the [customer] and their account with Merrill Lynch."); Piper, Jaffray & Hopwood Inc. v. Ladin, 399 F. Supp. 292, 297 (S.D. Iowa 1975) ("[T]he Know Your Customer Rule and the Suitability Rule may form part of the negligence concept in common law.").

[127] *See* Black, *supra* note 94, at 67.

[128] *See* HUNG ET AL., *supra* note 94, at 10.

[129] Brown v. E.F. Hutton Grp., 991 F.2d 1020, 1031 (2d Cir. 1993); *see also* Coleman & Co. Sec., Inc. v. Giaquinto Family Trust, 236 F. Supp. 2d 288, 302 n.10

This scienter-proof problem could be remedied by legislation requiring that a broker-dealer show, as it must do in a FINRA proceeding, that it had a reasonable basis for believing that a recommendation was suitable. To comport with the scope of Section 913, this burden could be limited to particularized investment advice provided to retail investors. For example, Section 21D of the Exchange Act could be amended to provide as follows:

> In any private action arising under this title in which a plaintiff who is a retail investor proves that the defendant provided particularized investment advice that was unsuitable, the defendant shall have the burden of proving that the defendant had a reasonable belief that the advice was suitable based on the exercise of reasonable diligence.[130]

This provision would leave the burden of proof on investors to show that a recommendation was actually unsuitable, but then shift the burden to the broker-dealer—where it already resides under the FINRA suitability rule—to show that the broker-dealer had a reasonable basis, based on the exercise of reasonable diligence, to believe that the recommendation was suitable. However, plaintiffs would still be left to deal with the hurdles created by the steady erosion of private rights of action under the federal securities law over the last two decades.[131]

A more significant problem for both state and federal private claimants may be that most broker-dealer customers do not have the right to bring claims in court. Since the Supreme Court's *McMahon* decision in 1987 upholding a mandatory arbitration

---

(S.D.N.Y. 2002) ("Unsuitability cannot be shown by negligence alone."); Cremi v. Brown, 955 F. Supp. 499, 517–18 (D. Md. 1997). *But cf.* Stein, Exchange Act Release No. 34-47335, 2003 WL 431870, at *4 n.31 (Feb. 10, 2003) ("Scienter is not an element for finding a violation of the NASD suitability rule.").

[130] Section 21D sets forth various requirements for private actions under the Exchange Act, such as those relating to pleading standards, lead plaintiffs, loss causation and limitations on damages. *See* 15 U.S.C. § 78u-4 (2012).

[131] Private rights of action have been eroded by the Private Litigation Securities Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), and the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, and a series of Supreme Court decisions, *see, e.g.*, Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296, 2303 (2011); Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2883–84 (2010); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 152–53 (2008); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313–14 (2007); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345–46 (2005); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191–92 (1994).

clause in a broker-dealer's customer agreement,[132] these clauses have become *de rigueur* in the industry.[133] From 2002 through 2011, more than 60,000 arbitration claims were filed.[134] No similar data is available for comparable state and federal court claims, but it is reasonable to assume, in light of the prevalence of mandatory arbitration clauses, that they are greatly outnumbered by arbitration claims. Thus, it is arbitration panels, not courts, that are the primary source of law for private claims based on fiduciary and suitability duties.

There is reason to believe that suitability and fiduciary claims have some success in arbitration proceedings.[135] Breach of fiduciary duty was the most frequently asserted claim from 2008 through mid-2012; suitability claims consistently made the top six.[136] Arbitration counsel presumably would not bring so many of these claims if they were not somewhat successful, but how successful they are is unknown.[137] Arbitrators are not required to follow any particular source of substantive law, such as public law standards established by the Commission or FINRA, or to provide an explanation of their decisions unless both parties request one,[138] and the requirement that those appealing an

[132] Shearson/Am. Express v. McMahon, 482 U.S. 220, 242 (1987); *see also* Rodrigues de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 481 (1989) (upholding mandatory arbitration agreement as to claim arising under Securities Act of 1933).

[133] *See* Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 622 (2010) ("Virtually every customer agreement contains an explicit clause requiring that disputes be heard in arbitration."); Black, *supra* note 94, at 68.

[134] *See Dispute Resolution Statistics*, *supra* note 121.

[135] *See* Black, *supra* note 94, at 68 ("[I]t is generally believed that investors frequently do recover damages from broker-dealers and investment advisers for careless or incompetent advice.").

[136] For example, of the 4,729 arbitration claims filed in 2011, 1,619 (thirty-four percent) and 2,589 (fifty-five percent) included, respectively, unsuitability and breach of fiduciary duty claims. *See Dispute Resolution Statistics*, *supra* note 121.

[137] *See* Stephen J. Choi et al., *The Influence of Arbitrator Background and Representation on Arbitration Outcomes* 2 (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 12-17, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109712 ("The absence of detailed case-specific information creates challenges for empirical research, making evaluation of arbitration's effectiveness in protecting investors' rights exceedingly difficult.").

[138] *See* FINRA Rule 12904, *available at*, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4192. *But cf.* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 105, 116 Stat. 745 (permitting PCAOB proceedings to be public only if the PCAOB finds good cause and both sides consent); H.R. 3503,

arbitration decision show a manifest disregard for the law is almost impossible to satisfy.[139] These factors frustrate any attempt to determine the legal standard under which fiduciary and suitability claims are resolved. There is good reason to be concerned about how arbitration panels decide cases. The number of arbitration panels that have no industry representative has increased since FINRA allowed plaintiffs to opt for an all-public panel,[140] which may have resulted in less expertise on panels and, accordingly, less predictability as to the law applied.[141]

Some commentators have dealt with the dearth of information on the basis of arbitration decisions by extrapolating from data on litigated outcomes. A common approach has been to analyze investors' win rates to determine whether arbitration is "fair"—the theory being that the percentage of litigated outcomes in which the investor prevails indicates whether arbitration has a pro-industry or pro-investor bias. FINRA data shows that, from 2007 through July 2012, the percentage of decided cases in which claimants recovered monetary damages or obtained non-monetary relief ranged from thirty-seven to forty-seven percent.[142] On the one hand, one might conclude that,

---

112th Cong. (1st Sess. 2011) (requiring public PCAOB proceedings except by determination of Board); *see* Black, *supra* note 94, at 68; Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 995–98 (2002) (discussing whether and to what extent FINRA arbitrators apply substantive law).

[139] *See, e.g.*, Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Comm. of Bayou Grp., 491 F. App'x 201, 203–04 (2d Cir. 2012).

[140] Dan Jamieson, *All-Public Panels Are a Hit with Investors, FINRA Says*, INVESTMENT NEWS (Jan. 29, 2012, 7:16 PM), http://www.investmentnews.com/article/20120129/REG/301299988 (percentage of investor claimants choosing an all-public panel rose from fifty-four during twenty-seven-month pilot program to seventy-six during first full year after full implementation).

[141] *See* Choi et al., *supra* note 137, at 8 ("[M]ore knowledgeable arbitrators are likely to produce more accurate awards. Broker-customer disputes frequently involve technical issues in which familiarity with industry practices is valuable. Securities expertise enables an arbitrator to understand the nature of the claims better."); SIFMA, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 36–37 (2007) [hereinafter SIFMA White Paper], *available at* http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf (industry arbitrators' expertise improves arbitration); Jamieson, *supra* note 140 (quoting industry arbitrators: "[e]liminating industry panelists 'is a mistake' . . . 'Finra doesn't do a good job of educating [public] arbitrators about investments' . . . 'the public arbitrators are generally unprepared' ").

[142] *See Dispute Resolution Statistics*, *supra* note 121 (2007: 37%; 2008: 42%; 2009: 45%; 2010: 47%; 2011: 44%; 2012: 45%).

because in each year investors recovered nothing in more than half of these cases, arbitration was biased against them. On the other hand, based on other data showing a higher percentage of outcomes favorable to investors, some have concluded that arbitration is not biased against investors.[143] For example, an oft-cited 1992 GAO report found no industry bias based in part on its finding that fifty-nine percent of litigated arbitrations were decided in favor of investors, and that monetary awards to investors averaged sixty-one percent of the amount of their claims.[144] In his 2002 report, Professor Michael Perino similarly concluded that arbitration was not biased because of the balance of litigated outcomes.[145]

This empirical approach is fraught with problems. For example, what qualifies as a "win" is inherently subjective. FINRA counts investors as prevailing when they recover monetary damages or other non-monetary relief, regardless of how small. In some of these cases, defendants would undoubtedly consider themselves to have prevailed. Even when investors recover monetary damages, most awards go uncollected.[146] These analytical weaknesses have been recognized previously and are not necessarily fatal. However, evaluating arbitration based on outcomes and relief awarded actually may miss the point altogether. The issue is whether arbitration reaches the "right" result, not whether one side or the other prevails in a certain percentage of cases. Investors could

---

[143] *See* SIFMA White Paper, *supra* note 141 (citing outcomes percentages as evidence of no industry bias in arbitration); U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 35–39 (1992) [hereinafter GAO, HOW INVESTORS FARE], *available at* http://www.gao.gov/assets/160/151835.pdf; U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 23 (2000) [hereinafter GAO, ACTIONS NEEDED], *available at* http://www.gao.gov/assets/160/156962.pdf (concluding that "investors have not fared as well" because investor win rate declined from fifty-nine percent to fifty-one percent from 1992 to 1996 and to fifty-six percent and fifty-seven percent in 1997 and 1998, respectively).

[144] *See* GAO, HOW INVESTORS FARE, *supra* note 143, at 35. The GAO reached the same conclusions in an updated report. *See* GAO, ACTIONS NEEDED, *supra* note 143, at 4–5, 7.

[145] *See* MICHAEL PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS 30–34 (2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf.

[146] *See* GAO, ACTIONS NEEDED, *supra* note 143, at 5 (estimating that $129 million (eighty percent) of $161 million awarded to investors in FINRA arbitration was unpaid).

win fifty percent of all arbitrations, which some would interpret to mean that arbitration was fair, but if cases in which plaintiffs prevailed consistently involved situations in which there was no legal basis for finding that the defendant owed a legal duty or that the duty was violated, then, in fact, arbitration would be unfairly biased in favor of plaintiffs.

Extrapolating "fairness" from litigated outcome data seems inherently flawed because the determinant of litigation outcome rates is not "fairness," but prior litigation outcome rates. If the parties to arbitrations act efficiently, they will litigate to a final outcome rather than settle only when there is enough uncertainty regarding the outcome that they are unable to reach agreement on the expected value of the claim. If arbitrators consistently reach unfair outcomes, the parties will adjust their analysis of the expected value of their claims, which will in turn shift the set of facts under which there is sufficient outcome uncertainty to litigate. The cases in which outcomes may be uncertain and the parties therefore choose to litigate may comprise exclusively cases that plaintiffs, or defendants, should always win. In other words, every outcome might be unfair, no matter how outcomes are split.

An efficient arbitration "market" should produce litigation outcomes each year that reflect a normal distribution curve, with the midpoint reverting to a long-term mean as parties adjust their litigation decisions to incorporate the most recent set of outcome data.[147] In other words, litigation outcomes necessarily represent an equilibrium point that moves in relation to prior outcomes based on participants' past experience, regardless of the fairness of any particular set of prior outcomes.[148] The equilibrium point should be the set of facts under which the odds

[147] The GAO indirectly acknowledged this point in positing as one reason for a declining win rate for investors that "broker-dealers [were] more likely to try to settle cases that they think they might lose." *Id.* at 24.

[148] This equilibrium theory is consistent with findings that investors fare better when represented by an attorney because one would expect an attorney to have more experience evaluating when a case's expected litigation value exceeds the value of any settlement terms. *See id.* at 26 (Investors were twenty-seven percent more likely to receive an award when represented by an attorney). Investors who are not represented by attorneys presumably generally overestimate their chances of success, leading to a lower percentage of favorable litigated outcomes.

of either party prevailing are about equal, regardless of whether, under that set of facts, the odds of either party prevailing *should* be equal.

It is beyond the scope of this Article to fully develop a theory regarding the irrelevance of investor win rates. For purposes of this Article, the point is that we cannot evaluate the efficacy of existing fiduciary or fiduciary-like private claims because the arbitration system prevents us from knowing how these claims fare in arbitration. In other contexts, legal standards can be debated largely because judges' explanations of their decisions can be analyzed, categorized, and regurgitated in forms that identify and reinforce consistent principles of law as applied to generally similar fact patterns. When adjudicative forums do not afford such transparency, the rights and obligations of individuals become unknowable.

This might not be a concern where only a small percentage of disputes are heard by the nontransparent forum. When nontransparent forums operate on the periphery of a dominant core of transparent forums, they are likely to follow the law as applied in explained decisions in the latter forums. When adjudicators in these forums are retired judges who have spent decades creating, applying, and following this legal core, they may be likely to continue to do so even when their decisions are no longer subject to public scrutiny. Even if non-transparent forums do not follow this legal core, the social costs are small because these peripheral decisions make up only a small minority of disputes. However, when the overwhelming majority of cases involving a set of legal principles are decided in a non-transparent forum by non-judge decision-makers who have no industry expertise, achieving correct legal outcomes may be as likely as a roll of the dice.[149] Yet this is how the majority of private claims against broker-dealers based on fiduciary or fiduciary-like legal principles are decided.

[149] *But cf.* DEL. CODE ANN. tit. 10, § 349 (West 2013) (authorizing confidential arbitration of business disputes with both parties' consent before state judge); Del. Coal. for Open Gov't v. Strine, No. 1:11–1015, 2012 WL 3744718, at *10 (D. Del. Aug. 30, 2012) (Delaware proceedings under 10 Del. C. § 349 violate First Amendment public right of access to civil trials); *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 105, 116 Stat. 745; H.R. 3503, 112th Cong. (1st Sess. 2011).

The mandatory, non-transparent nature of arbitration frustrates any attempt to develop a public, Section 913 fiduciary duty for broker-dealers that works in harmony with broker-dealers' preexisting private legal obligations. How the fiduciary duty is applied in arbitration is a necessary component of any reasonable attempt to develop a uniform fiduciary duty with respect to retail investment advice,[150] but the SEC's Section 913 Study had virtually nothing to say about this primary source of fiduciary law. The Commission should give greater consideration to Section 921 of the Dodd-Frank Act, which granted the Commission broad authority to regulate the terms of mandatory arbitration clauses.[151] A good use for that authority would be to adopt rules requiring arbitrators to explain their decisions.

IV. CONCLUSION

The SEC's Section 913 rulemaking has run aground on the shoals of heightened cost-benefit requirements and expectations that cannot practicably be satisfied. Their impracticability may be by design, as they may simply be cover for libertarian values quite different from the utilitarian values that cost-benefit analysis presupposes. The Obama Administration, once a principal instigator of the push for a fiduciary duty,[152] has now become an advocate for deregulatory initiatives under the JOBS Act, which was passed with bipartisan Congressional support. The courts have repeatedly demonstrated their hostility toward SEC rulemaking, and Republican SEC Commissioners have set the stage for a legal challenge on cost-benefit grounds to any Section 913 rulemaking. The near-term prospects for Section 913 rulemaking by the Commission are slim.

---

[150] *See generally Strine*, 2012 WL 3744718, at *5 (discussing benefits of public proceedings).

[151] Section 919B of the Dodd-Frank Act also required the Commission to study ways to improve investor access to registration information relating to broker-dealers, including arbitration proceedings. *See* SEC. & EXCH. COMM'N, STUDY AND RECOMMENDATIONS ON IMPROVED INVESTOR ACCESS TO REGISTRATION INFORMATION ABOUT INVESTMENT ADVISERS AND BROKER-DEALERS 1 (2011), *available at* http://sec.gov/news/studies/2011/919bstudy.pdf. The study did not consider the mandatory publication of explanations of arbitration decisions.

[152] *See* DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 71 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ("Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers.").

However, the appropriate context in which to consider the fiduciary duty is far broader than merely SEC rulemaking. The goals of the fiduciary duty can be achieved through other sources of law that are not as susceptible to political influence. Indeed, while the SEC's rulemaking stalls, FINRA has been applying a form of fiduciary duty to broker-dealers. FINRA's rules have had a strong fiduciary element for quite some time, and its recent interpretation of its suitability rule represents a significant shift closer to a Section 913 fiduciary standard. FINRA has an incentive to continue this process because enhancing its credibility as a promulgator and enforcer of a fiduciary duty should help its bid to become the self-regulatory organization for investment advisers. Fiduciary duty advocates might do well to redirect their efforts away from the SEC arena and toward FINRA as a more reliable ally.

One difficulty with this approach is that FINRA is not even the primary source of fiduciary law for broker-dealers. Fiduciary claims are litigated most often in private lawsuits. Most private claims are brought in arbitration proceedings, where fiduciary claims are more frequently asserted than any other. Thus, there is a well-established body of private law under which broker-dealers are already subject to a fiduciary duty when providing particularized investment advice to retail customers, but the Section 913 Study had nothing to say about the substance or scope of this source of law, in part because arbitrators are not required to explain their decisions. The first step in the coherent development of a fiduciary standard for broker-dealers would be to evaluate whether the benefits of requiring arbitrators to reveal how that standard is already being applied would outweigh the potential costs.