

# Broker-Dealers, Institutional Investors, and Fiduciary Duty: Much Ado About Nothing?

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# BROKER-DEALERS, INSTITUTIONAL INVESTORS, AND FIDUCIARY DUTY: MUCH ADO ABOUT NOTHING?

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## ABSTRACT

*Under the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC is soliciting public opinions on whether broker-dealers should be subject to a fiduciary duty when advising retail and institutional investors. This Article focuses on the advisability of such a proposal for institutional investors. It shows that, first, a fiduciary duty could potentially enhance broker-dealers' standard of conduct for only a subset of institutional investors who are well capitalized, capable of assessing risks independently, and acknowledge in writing their non-reliance on broker-dealers' advice. Thus, the benefit of fiduciary duty is much narrower than what its proponents believe. Second, institutional investors face substantial obstacles in recovering damages from broker-dealers who violate their standard of conduct in private litigation, and yet fiduciary duty would not help in this regard. In light of fiduciary duty's negligible benefit but indeterminate cost to the financial industry, it is not a viable measure for enhancing institutional investor protection.*

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## INTRODUCTION

The role of a financial-service professional can be broadly characterized as an investment adviser, a broker, or a dealer. An investment adviser provides advice to investors on the advisability of investing in securities and the securities' values.<sup>1</sup> A broker is a "person engaged in the business of [executing trades] in securities for the account of others ...."<sup>2</sup> A dealer is a "person engaged in the business of buying and selling securities for his own account," with or without the assistance of a broker.<sup>3</sup>

Many financial-service firms offer both investment advisory and broker-dealer services. According to a recent study conducted by the Securities and Exchange Commission, approximately eighty-eight percent of investment advisers are also registered as broker-dealers.<sup>4</sup> Among more than 5,000 registered broker-dealer firms, approximately twenty percent currently or have future plans to offer investment-advisory services, with the expectation that those services will constitute at least one percent of the firm's annual revenue.<sup>5</sup> Dual registration aside, the line between the *conduct* of investment advisers and that of broker-dealers is also blurry, as the latter are often their counterparties or provide advice when executing trades for investors.<sup>6</sup>

Investment advisers and broker-dealers are subject to different sets of regulations. Investment advisers are primarily regulated under the Investment Advisers Act of 1940, but are also subject to the anti-fraud provisions of the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act).<sup>7</sup> They owe a fiduciary duty to their clients.<sup>8</sup> Broker-dealers are also regulated under both the Securities Act and the Exchange Act, as well as rules promulgated by the Financial Industry Regulatory Authority (FINRA)—a self-regulatory organization for securities firms doing business in the United States.<sup>9</sup> Broker-dealers generally do not owe a fiduciary duty to their clients under federal law, but some courts have

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<sup>1</sup> Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C.A. § 80b-2 (West 2013).

<sup>2</sup> Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C.A. § 78c (West 2013).

<sup>3</sup> *Id.* § 3(a)(5)(A).

<sup>4</sup> U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT iii (2011) [hereinafter SEC STUDY REPORT].

<sup>5</sup> *Id.* at 8.

<sup>6</sup> *Id.* at 100 (citing the results of a survey that shows thirty-four percent of retail investors that participated in the survey selected the primary function of a broker-dealer as "to offer advice").

<sup>7</sup> *Id.* at iii.

<sup>8</sup> *Id.*

<sup>9</sup> *See generally id.*

imposed a fiduciary duty under limited circumstances when there is a special trust relationship or when a broker-dealer exercises control over trading activities of the client.<sup>10</sup> This differentiated treatment has been cited as a core difference between the regulation of investment advisers and broker-dealers.<sup>11</sup>

The meltdown of the subprime mortgage and credit default swap markets in the 2008 financial crisis triggered a deluge of lawsuits brought by institutional investors (such as hedge funds, mutual funds, banks, and industrial companies) against Wall Street securities firms.<sup>12</sup> These lawsuits alleged that the securities firms lured investors into the minefield of complex credit derivatives by misrepresenting risks.<sup>13</sup> These lawsuits also highlighted concerns for investor protection, eventually triggering a legislative inquiry into whether a uniform fiduciary standard should apply to both broker-dealers and their investment-adviser counterparts when serving in an advisory capacity regarding investments for clients.<sup>14</sup>

Although the initial focus of this legislative inquiry was on providing better protections to retail investors from the misconduct of broker-dealers, the inquiry subsequently expanded into whether such a higher level of protection was also needed for institutional investors after the highly publicized SEC complaint against Goldman Sachs.<sup>15</sup> The SEC alleged that Goldman Sachs, in arranging and marketing a security, failed to disclose a known conflict of interest arising from the fact that an entity—unaffiliated with Goldman Sachs had an active role in selecting the reference securities for

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<sup>10</sup> *Id.* at iv; see also Grant E. Buerstetta, *Creating a Flexible Fiduciary Duty Rule for Banks Entering into Proprietary Derivatives Contracts*, 15 ANN. REV. BANKING L. 395, 408 (1996).

<sup>11</sup> SEC STUDY REPORT, *supra* note 4, at 106.

<sup>12</sup> Janet R. Davis & Gary L. Gassman, *Potential Insurance Coverage Implications from the Financial Crisis*, MECKLER BULGER TILSON MARICK & PEARSON LLP 1, 1–2, <http://www.mbtlaw.com/pubs/dricovinfo.pdf>.

<sup>13</sup> For example, in the dispute between the Wisconsin School District and RBC Capital Markets over \$200 million worth of CDOs, the School District claimed that RBC misrepresented the default rate of the CDOs and misled it into investing in the product. See RBC Capital Markets, LLC, Securities Act Release No. 9262, Exchange Act Release No. 65404, Investment Advisers Act Release No. 3289 (Sept. 27, 2011) (institution of proceedings). In the dispute between China Development Industrial Bank and Morgan Stanley, the Chinese Bank alleged that Morgan Stanley, upon realizing that its proprietary subprime mortgage positions were deteriorating in value, dumped the loss by arranging a credit swap deal and collaborating with a credit rating agency to misrepresent the default risk. See *China Dev. Indus. Bank v. Morgan Stanley*, 2011 N.Y. Misc. LEXIS 1808, at \*1 (N.Y. Sup. Ct. 2011).

<sup>14</sup> See Thomas J. Moloney, Paul R. St. Lawrence III & Angela F. Hamarich, *Fiduciary Duties, Broker-Dealers and Sophisticated Clients: A Mismatch that Could only Be Made in Washington*, 3 J. SEC. L., REG. & COMPLIANCE, no. 4, July 2010, at 338.

<sup>15</sup> See *id.* at 337–38; SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011).

a pool of collateralized debt obligations (CDOs)—held positions that would benefit from the decline in value of the reference securities.<sup>16</sup> In a congressional hearing over this case, the Chairman and Chief Executive Officer of Goldman Sachs, Lloyd Blankfein, openly stated that Goldman Sachs was merely acting as a market-maker in that deal and as such, it owed no fiduciary duty to disclose the information to investors.<sup>17</sup> Shortly after this hearing, Senator Boxer (D-Cal.) proposed establishing a fiduciary duty for broker-dealers in the types of relationships where the disparity in expertise between broker-dealers and investors can be substantial, including a broker-dealer's relationship with pension plans, with employee benefit plans, and with state or local governments in commodities and derivatives transactions.<sup>18</sup> Senator Spector (D-Pa.) proposed a bill to not only impose a fiduciary duty but also to criminalize willful violations of such a standard.<sup>19</sup>

Not everyone favors a uniform fiduciary standard, however: opponents have pointed to the higher sophistication level of institutional investors relative to retail investors, institutional investors' expectation of arms-length transactions with broker-dealers, and the difficulty in defining the scope of fiduciary duties in light of the multiple facets of a broker-dealer's relationship with institutional investors (for example, trade executor, counterparty, market-maker, and advisor).<sup>20</sup>

Although Senator Spector's and Senator Boxer's proposals are not included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the issue remains alive under Dodd-Frank through its provision of rule-making authority to the SEC to harmonize regulatory standards of care for brokers, dealers, and investment advisers "when providing personalized investment advice about securities to retail customers (*and such other customers as the Commission may by rule provide*)."<sup>21</sup> The SEC Study Report examined broker-dealers' standard of conduct toward retail investors, and recommended the establishment of a uniform fiduciary standard applicable to all brokers, dealers and investment advisers in providing investment advice to retail customers.<sup>22</sup> However, the SEC expressed a continuing interest in considering whether such uniformity "should also be

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<sup>16</sup> 790 F. Supp. 2d at 150–51.

<sup>17</sup> See *Factbox: Levin, Blankfein Trade Jabs at Hearing*, REUTERS (Apr. 27, 2010, 9:27 PM), <http://mobile.reuters.com/article/topNews/idUSTRE63R03320100428>.

<sup>18</sup> 156 CONG. REC. S3104, SA 3792 (daily ed. May 4, 2010).

<sup>19</sup> 156 CONG. REC. S3109, SA 3806 (daily ed. May 4, 2010).

<sup>20</sup> See, e.g., Moloney, *supra* note 14.

<sup>21</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(k)(1), 124 Stat. 1376 (2010) (emphasis added).

<sup>22</sup> See SEC STUDY REPORT, *supra* note 4, at 107–08.

extended to *persons other than retail customers* that may also benefit from the additional investor protections that would be provided by the standard.”<sup>23</sup>

This Article answers the above inquiry about Dodd-Frank and the SEC regarding the advisability of a fiduciary standard in broker-dealers’ relationships with institutional investors. It examines this issue from an angle that, until now, has been overlooked by proponents and opponents alike in this debate. Because investment advisers are recognized as fiduciaries but broker-dealers are generally not, clients *perceive* that standard of conduct for broker-dealers is different when providing advice to investors. This perception is intuitive and seemingly reasonable. However, both investment advisers and broker-dealers are subject to elaborate, albeit different, sets of regulations that have, at least on the surface, some overlap in the scope of the obligations they owe to clients. For example, both investment advisers and broker-dealers are obligated to refrain from committing fraud when advising clients, which includes making recommendations with reckless disregard to the suitability of the recommendation to the clients’ financial goals and risk tolerance.<sup>24</sup> In assessing suitability, both investment advisers and broker-dealers are required to disclose information pertinent to the investment decision of the client, such as any conflict of interest.<sup>25</sup> Could it be that the substance of the suitability requirement applicable to broker-dealers is no less stringent than that applicable to investment advisers, even though broker-dealers are not fiduciaries? In addition, what about enforcement and remedies available to investors when the prescribed standard of conduct is violated? Could it be that remedies (or the lack thereof) to investors are comparable regardless of whether the defendant is an investment adviser or a broker-dealer? If the two sets of regulations and their enforcements are comparable in every major way, the alleged regulatory disparity between investment advisers and broker-dealers exist only in the imagination, and this in turn means that explicitly recognizing broker-dealers as fiduciaries would not enhance investor protection in any visible measure.

This Article will show that in the institutional investor setting, rules regulating the conduct of investment advisers and broker-dealers, when providing investment advice, are indeed substantially similar. But there is an exception when FINRA’s exemption rule applies, which exempts broker-dealers from performing a suitability analysis for certain qualified institutional clients.<sup>26</sup> That means a uniform fiduciary standard can benefit—at most—only a small sub-group of institutional investors: those who have

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<sup>23</sup> *Id.* at 127 (emphasis added).

<sup>24</sup> See discussion *infra* Part I.

<sup>25</sup> See discussion *infra* Part I.

<sup>26</sup> See discussion *infra* Part I.C.

substantial capital (at least \$50 million in assets), who acknowledge in writing that they are not relying on the advice of the broker-dealer, and who the broker-dealer reasonably believes are capable of independently assessing the risks of their transactions. So far, proponents and opponents of a uniform fiduciary standard have argued about whether institutional investors *in general* need more protection, and proponents have pointed out that *some* institutional investors are not as sophisticated as they appear.<sup>27</sup> The conclusion of this Article suggests that, in debating this issue, we should not look at the entire institutional investor group as a whole, but rather we should focus only on the subset of institutional investors whose interactions with broker-dealers are exempt from the FINRA suitability rules. Under this fine focus, the potential benefit of a uniform fiduciary duty is far narrower than what its proponents believe.

This Article further shows that institutional investors face substantial obstacles in their private actions against broker-dealers. The obstacles arise from the limitation of investors to causes of action related to fraud, which require them to prove “reasonable reliance” on broker-dealers’ advice. By including elaborate disclaimer provisions in an investment contract and requiring institutional investors to sign before consummating a transaction, broker-dealers can prevent investors from establishing reasonable reliance and thus thwart recovery. Fiduciary duty on the part of broker-dealers will not help in this regard, as courts have been disposed to enforce such disclaimers even if a fiduciary duty were to exist. The potential benefit of a uniform fiduciary seems impalpable, and yet its potential problems abound, as will be discussed in this Article.

This Article proceeds as follows. Part I compares the standard of conduct applicable to investment advisers with that applicable to broker-dealers when they provide investment advice to institutional investors. The comparison shows a substantial similarity in the respective standards of conduct, and highlights FINRA’s suitability exemption as the main source of disparity. Part II discusses enforcement mechanisms when investment advisers and broker-dealers violate their standard of conduct, highlighting their similarity, the lack of meaningful private remedies to institutional investors, and the inability of fiduciary duty to change this outcome. Part III draws regulatory implications from the discussions in the previous parts, suggesting that a uniform fiduciary duty is not the solution to institutional investor protection in light of the limited benefit it generates and the substantial regulatory incoherence it creates. Instead, Congress and the SEC should focus their inquiry

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<sup>27</sup> See, e.g., 156 CONG. REC. S3104, SA 3792 (daily ed. May 4, 2010). *But see* discussion *infra* Part II.



on broadening the scope of investors' private rights of action abandoning the current contractarian approach to enforcing disclaimer provisions in investment contracts.

## I. THE STANDARD OF CONDUCT OF INVESTMENT ADVISERS AND BROKER-DEALERS IN ADVISING INSTITUTIONAL CLIENTS

### A. *The Standard of Conduct of Investment Advisers*

#### 1. *Investment Advisers Act Provisions*

The Investment Advisers Act broadly defines an investment adviser as:

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities....<sup>28</sup>

Broker-dealers, who otherwise would be covered in this broad definition, are explicitly exempted from the Investment Advisers Act if certain conditions are satisfied.<sup>29</sup> While the overall anti-fraud provisions of the Securities Act and the Exchange Act apply to "any person" (including investment advisers) in connection with any securities transaction, the specific duties of investment advisers in advising investors are provided in section 206 of the Investment Advisers Act.<sup>30</sup> This section has been regarded by the U.S. Supreme Court as the source of federal fiduciary standards governing the conduct of investment advisers.<sup>31</sup> Section 206 prohibits an investment adviser from:

1. employing any device or scheme to defraud any client or prospective client;
2. engaging in any conduct which operates as a fraud upon any client or prospective client;

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<sup>28</sup> Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C.A. § 80b-2 (West 2013).

<sup>29</sup> See discussion *infra* Part I.A.3.

<sup>30</sup> The Securities Act and the Exchange Act do not have specific provisions like section 206 of the Investment Advisers Act that prescribe broker-dealers standard of conduct in dealing with clients; rather broker-dealers' duties are based on the general anti-fraud provisions in those statutes. Therefore, discussions of the general anti-fraud provisions are deferred to section B in the context of broker-dealers' duties under the federal securities law.

<sup>31</sup> *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

3. selling securities for his own account without disclosing this fact and obtaining consent of his client; or
4. engaging in any conduct that is “fraudulent, deceptive, or manipulative” under the rules of the SEC.<sup>32</sup>

The key difference between the first and the second prohibition, enumerated above, is that a violation of the former requires scienter as a necessary mental state while a violation of the latter requires only proof of negligence.<sup>33</sup> Section 206 explicitly states that the disclosure requirement included in the third prohibition, above, applies only to a broker-dealer acting as an investment adviser in the transaction.<sup>34</sup> But as will be discussed in the next section, broker-dealers are subject to an obligation to disclose conflicts of interest under the anti-fraud provisions of the Securities Act, the Exchange Act, and FINRA rules.

#### *2. Interpretation of Investment Advisers’ Duties under Section 206*

The SEC has interpreted section 206 as imposing the following duties on investment advisers:

- a duty of “good faith, and full and fair disclosure of all material facts[;]”<sup>35</sup>
- a duty to recommend only securities that are suitable for the investor in light of his goals and risk tolerance;<sup>36</sup> and
- a duty of loyalty that “requires an adviser to serve the best interests of his clients, which [duty] includes an obligation not to subordinate the client’s interests” to that of the investment adviser.<sup>37</sup>

The satisfaction of these obligations requires an investment adviser to use reasonable care so as not to mislead current and prospective clients.<sup>38</sup>

##### *a. Duty of Good Faith and Full and Fair Disclosure of All Material Facts*

*Specific Disclosures in Brochures.* Section 206 is a principle-based regulation, so the extent of disclosures required under this section depends

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<sup>32</sup> Investment Advisers Act of 1940 § 206, 15 U.S.C.A. § 80b-6 (West 2013).

<sup>33</sup> See *SEC v. Seghers*, 298 F. App’x 319, 328 (5th Cir. 2008) (noting that scienter is required to show a violation of section 206(1), but negligence is sufficient to show a violation of section 206(2)).

<sup>34</sup> See Investment Advisers Act § 206.

<sup>35</sup> SEC STUDY REPORT, *supra* note 4, at 22 (citing *Capital Gains*, 375 U.S. at 194).

<sup>36</sup> *Id.* at 27–28.

<sup>37</sup> *Id.* at 22.

<sup>38</sup> *Id.*

on the facts and circumstances of each transaction.<sup>39</sup> Nonetheless, the SEC has established specific disclosure requirements when a financial-service provider files Form ADV with the SEC to register as an investment adviser.<sup>40</sup> The Form consists of two parts. Part 1 requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees.<sup>41</sup> Part 2 specifies information that must be included in an investment adviser's brochure used in marketing the adviser's service.<sup>42</sup>

A brochure is the primary disclosure document an investment adviser provides to his client before or at the time an advisory relationship is established.<sup>43</sup> An investment adviser is required to update the brochure each year when it files the annual updating amendment to its registration statements, and "promptly whenever any information in the brochure becomes materially inaccurate."<sup>44</sup>

Item 8 of Part 2 requires an investment adviser to disclose in its brochure the methods of analysis and investment strategies. Specifically, Item 8 sets forth the following requirements:

- A. Describe the methods of analysis and investment strategies you use in formulating investment advice or managing assets. Explain that investing in securities involves risk of loss that clients should be prepared to bear.
- B. For each significant investment strategy or method of analysis you use, explain the material risks involved. If the method of analysis or strategy involves significant or unusual risks, discuss these risks in detail. If your primary strategy involves frequent trading of securities, explain how frequent trading can affect investment performance, particularly through increased brokerage and other transaction costs and taxes.
- C. If you recommend primarily a particular type of security, explain the material risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail.<sup>45</sup>

Note that the intent is for the previous disclosures to be made in an investment adviser's brochure. They are not transaction specific unless the adviser uses primarily only one type of strategy. However, as discussed below,

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<sup>39</sup> *Id.* at 104.

<sup>40</sup> Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities. *See generally Form ADV*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/formadv.htm> (last visited Jan. 12, 2014).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *See* SEC, FORM ADV (2011) at pt. 2A, ¶¶ 1–2, available at <http://www.sec.gov/about/forms/formadv.pdf> [hereinafter FORM ADV].

<sup>44</sup> *See id.* at pt. 2A, ¶ 4 (emphasis omitted).

<sup>45</sup> *Id.* at pt. 2A, Item 8(A)–(C).

more detailed and transaction-specific disclosures may be required in addition to those made in the brochure in order for an adviser to satisfy its duties under the Investment Advisers Act.

The SEC has indicated that the duty of disclosure under section 206 is broad and may not be completely satisfied by the mere delivery of a brochure.<sup>46</sup> Material facts have been interpreted as information that there is a “substantial likelihood that a reasonable investor would consider important in making [investment] decision[s]....”<sup>47</sup> The SEC has explicitly recognized that any conflict of interest on the part of an adviser is a material fact and its disclosure is necessary for clients to make an informed decision as to whether or not to continue the advisory relationship.<sup>48</sup> The SEC has taken disciplinary actions against investment advisers for failure to disclose conflicts of interest.<sup>49</sup>

Although there are only a few SEC actions against investment advisers for violating section 206 in their relationship with institutional investor clients, such actions reveal the stringent standard with which the SEC is enforcing the statutory requirement of full disclosure of material facts. In *New York Life Investment Management LLC*, the investment adviser—New York Life Investment Management LLC—managed an open-end index fund that sought to replicate the movements of the S&P 500 Index before expenses. There was a guarantee provision in the investment advisory contract under which New York Life agreed to make up any shortfall through an affiliated entity for an investor, if his investment in the fund was less than his original investment on the tenth anniversary of that investment, provided that the investor remained in the fund for the entire period and reinvested all distributions (the Guarantee).<sup>50</sup> New York Life’s 2005 profitability analysis for the fund reflected a negative 103 percent profit margin due to the inclusion

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<sup>46</sup> SEC STUDY REPORT, *supra* note 4, at 23. *See also* FORM ADV at pt. 2, § 3 (“Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interests between you and your *clients* that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give you informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to *clients* information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require.”).

<sup>47</sup> SEC v. Slocum, Gordon & Co., 334 F. Supp. 2d 144, 182 (D.R.I. 2004).

<sup>48</sup> SEC STUDY REPORT, *supra* note 4, at 23 & n.92.

<sup>49</sup> *Id.* at 22 & n.89.

<sup>50</sup> N.Y. Life Inv. Mgmt. LLC, Investment Advisers Act Release No. 2883, Investment Company Act Release No. 28747, n.2 (May 27, 2009).

of a \$9.9 million expense for a reserve for the Guarantee.<sup>51</sup> However, New York Life did not provide the fund's board of trustees with "information concerning the assumptions used to calculate the reserve [n]or explain why [it] believed the full amount of the increase to the reserve should be included in the analysis of the profitability" as opposed to being amortized over a period of time.<sup>52</sup> Without considering this reserve amount, the fund would have shown a profit margin of 31 percent.<sup>53</sup> The SEC faulted New York Life under section 206(2) of the Investment Advisers Act for its failure to provide such an explanation, although there was no evidence suggesting that the omission was intentional or that the board requested an explanation and New York Life failed to respond.<sup>54</sup>

In *Charles Schwab Investment Management; Charles Schwab & Co.; and Schwab Investments*, the SEC issued a cease-and-desist order against the named entities (collectively, Charles Schwab) for misrepresenting the nature of the Yieldplus Bond Fund, an ultra-short bond fund managed by Charles Schwab, as a cash alternative.<sup>55</sup> The Yieldplus Bond Fund was Charles Schwab's best performing fund until the 2008 financial crisis when it suffered a loss of 28 percent in net asset value due to an overconcentration of its investments in mortgage-related securities.<sup>56</sup> From at least 2006 to 2008, Charles Schwab marketed the fund as a cash alternative that generated a higher yield with slightly higher risk than a money market fund.<sup>57</sup> Charles Schwab noted—*truthfully*—in marketing materials that the net asset value of the fund would fluctuate, and that it "experienced some volatility from its inception in 1999 through 2002, and then fluctuated by pennies during the next several years."<sup>58</sup> The SEC stated that describing the Yieldplus Fund as a cash alternative was misleading because "[i]nvestments

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<sup>51</sup> *Id.* at 5.

<sup>52</sup> *Id.* at 5–6.

<sup>53</sup> *Id.* at 6.

<sup>54</sup> *Id.* at 7.

<sup>55</sup> Charles Schwab Inv. Mgmt.; Charles Schwab & Co.; and Schwab Invs., Securities Act Release No. 9171, Exchange Act Release No. 63693, Investment Advisers Act Release No. 3136, Investment Company Act Release No. 29552 (Jan. 11, 2011). The SEC also faulted Charles Schwab for a misstatement about the weighted average maturity of its assets, a deviation from stated asset concentration policy without shareholder approval, and a misrepresentation with regard to investors' redemption when the fund lost in value. *See id.* at 5–8.

<sup>56</sup> This level of decline exceeded the typical loss suffered by other ultra-short bond funds. In addition to the investment loss, investors' panic withdrawals from the fund caused the amount of assets under management to fall from \$13.5 billion to \$1.8 billion. *Id.* at 4; *see also* Walter Hamilton, *Schwab Settles SEC Suit Over Fund*, L.A. TIMES, Jan. 12, 2011, at B1.

<sup>57</sup> *See Charles Schwab Inv. Mgmt.*, at 2.

<sup>58</sup> *Id.* at 4.

in the Fund are not insured, as are CDs, and the maturity and credit quality of the Fund's securities were significantly different than those of a money market fund."<sup>59</sup> The SEC claimed that such misleading statements violated section 206 of the Investment Advisers Act.<sup>60</sup> It is worth noting that marketing the fund as a cash alternative was consistent with the view held by many financial industry professionals that ultra-short bond funds were a viable alternative to putting money in cash, and indeed some ultra-short bond funds even allowed check-writing privileges on money invested in the funds.<sup>61</sup> Nonetheless, the SEC believed that the cash-alternative description was short of complete accuracy on the nature of an ultra-short bond fund.<sup>62</sup> The Charles Schwab case illustrates the high standard that the SEC applies in regulating the behaviors of investment advisers under section 206 of the Investment Advisers Act.

*b. Duty of Making Only Recommendations Suitable to Clients*

The SEC views section 206 of the Investment Advisers Act as requiring an investment adviser to refrain from recommending securities to clients that the adviser does not reasonably believe are suitable for the clients' investment goals and financial conditions.<sup>63</sup> In 1994, the SEC proposed rules to make suitability an explicit obligation under section 206 and codify its previous interpretations on suitability in disciplinary actions and no-action letters.<sup>64</sup> Although the SEC has not taken further actions on this proposal

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<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 10.

<sup>61</sup> See, e.g., Meg Richards, *Money Market Funds Are Closing the Yield Gap*, WASH. POST, Dec. 4, 2005, at F4 ("For the past several years, ultra-short bond funds have served as a higher-yielding alternative to money market mutual funds, but the gap in returns has rapidly been closing."); see also Donald Jay Korn & Robert Neubecker, *It's a Good Year for CASH: With Interest Rates Up and Other Assets Flat or Sinking, Cash is a Winning Bet As Well As a Safe One*, FINANCIAL PLANNING (Oct. 1, 2006), <http://www.financial-planning.com/news/its-good-year-cash-527823-1.html> (quoting Kathleen Grace, director of family office services at Carl Domino, Inc., an investment management firm in Palm Beach and Boca Raton: "Cash is especially important in tumultuous markets.... For the past year, I've been using Schwab YieldPlus Fund, which has worked very well for taxable accounts. The yield has been attractive and this fund has avoided erosion of principal, so it has been a good alternative to a money market fund.").

<sup>62</sup> *Charles Schwab Inv. Mgmt.*, at 2.

<sup>63</sup> SEC STUDY REPORT, *supra* note 4, at i.

<sup>64</sup> The proposal states:

Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provision of the Advisers Act, section 206, and the Commission has sanctioned advisers for violating

as of this date, the proposed release is an important document as it reflects the SEC's view on the scope of an investment adviser's suitability obligations.<sup>65</sup>

The suitability requirement applies to recommendations made to both retail and institutional investors.<sup>66</sup> Suitability must be determined in light of the client's investment portfolio.<sup>67</sup> Risky investment products can only be recommended to those clients "who can and are willing to tolerate the risks and for whom the potential benefits justify the risks."<sup>68</sup>

To satisfy the suitability requirement, an investment adviser has a duty to make "a reasonable inquiry into the client's financial situation, investment experience and investment objectives."<sup>69</sup> What constitutes a reasonable inquiry depends on the circumstances of each investor, but the SEC believes that information on the investor's "current income, investments, assets and debts, marital status, insurance policies, and financial goals" is all within the range of a reasonable inquiry.<sup>70</sup> In this regard, initial information-gathering

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this duty. The Commission now proposes to make explicit this duty in a new rule under section 206(4) of the Advisers Act. The scope of proposed rule 206(4)-5 reflects the Commission's interpretation of advisers' suitability obligations under the Advisers Act.

Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406, at 2 (Mar. 22, 1994).

<sup>65</sup> The *SEC Study Report* referred to this regulatory action as *proposed* rules. SEC STUDY REPORT, *supra* note 4, at 27 n.109. Under the proposed rule, the SEC would adopt the new rule "§ 275.206(4)-5 Suitability of Investment Advice Provided by Investment Advisers," which would "make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client, after a reasonable inquiry into the client's financial situation, investment experience, and investment objectives" and "would prohibit registered investment advisers from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly." Suitability of Investment Advice Provided by Investment Advisers, 59 Fed. Reg. 55 (proposed Mar. 22, 1994) (to be codified at 17 C.F.R. 275.206(5)-4). The current rule § 275.206(4)-5 is entitled "Political contributions by certain investment advisers." See Commodity and Securities Exchanges, 17 C.F.R. § 275.206(4)-5 (2013), available at [http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title17/17cfr275\\_main\\_02.tpl](http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title17/17cfr275_main_02.tpl).

<sup>66</sup> See Suitability of Investment Advice Provided by Investment Advisers, *supra* note 64, at 3 n.11 ("The prohibition against providing unsuitable advice would apply to advice to institutional clients as well as to individual clients. Institutional investors have experienced significant losses as a result of recommendations to invest in complex financial products that they did not fully understand.").

<sup>67</sup> *Id.* at 3.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 1. See also SEC STUDY REPORT, *supra* note 4, at 22 (citing SEC Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) at 119).

<sup>70</sup> See Suitability of Investment Advice Provided by Investment Advisers, *supra* note 64, at 2.

meetings, where clients are typically asked to complete questionnaires to provide the adviser with information necessary to develop recommendations, a financial plan, or specific investments, would generally satisfy the requirement.<sup>71</sup> In addition, the adviser is required to periodically update this information so that the initial advice for new offerings accurately takes into consideration any changed circumstances of the client.<sup>72</sup>

An adviser may rely on information provided by clients in regard to his financial condition.<sup>73</sup> In the event that a client refuses to provide information, the adviser is limited to only making reasonable assumptions about the client.<sup>74</sup> Absent information otherwise, the adviser may have to adopt a default assumption that the client's only assets or sources of income are those under the management of the adviser.<sup>75</sup> When the client refuses to provide the information needed for recommendations, "the adviser [is] ... permitted to rely upon trustworthy information about the client that it obtains from other reliable sources, such as a consultant to the client or other intermediary."<sup>76</sup> In addition, the SEC has opined that an investment adviser is not imputed with the knowledge of an affiliate for the purpose of assessing suitability if the expectation that the adviser know the information is unreasonable.<sup>77</sup> For instance, an adviser may not have information about a recommended security that an affiliated adviser may have, such as when the investment adviser has established and followed procedures as required by section 204A of the Investment Advisers Act to prevent insider trading.<sup>78</sup>

### 3. *The Broker-Dealer Exemption from the Investment Advisers Act*

Section 202(a)(11)(C) explicitly excludes a broker-dealer who provides advice to clients from the definition of *investment adviser* if:

- such advice is "solely incidental to the conduct of his business as a broker or dealer;" and
- he receives no "special compensation" for providing the advice.<sup>79</sup>

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<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 3.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C.A. § 80b-2(a)(11)(C) (West 2013).



The boundaries of both conditions were tested in recent cases in which investors sought to avail themselves of the protection of the Investment Advisers Act.

*a. The Meaning of “Solely Incidental”*

The meaning of “solely incidental” for purposes of the section 202(a)(11)(C) exemption was interpreted by the Western District of Oklahoma in *Thomas v. Metropolitan Life Insurance Company*.<sup>80</sup> The plaintiffs wished to undertake financial planning to provide for their new-born daughter’s future college education.<sup>81</sup> Toward this goal, they purchased a variable universal life policy from an acquaintance that was employed by the defendant insurance company (MetLife) to sell insurance products.<sup>82</sup> The plaintiffs wrote a check for the first \$91 monthly premium, but never paid any separate fee for any investment advice provided to them by MetLife’s sales personnel.<sup>83</sup> The product’s sales prospectus said that 2.25 percent of the premiums were dedicated to compensating the sales personnel in the form of commission.<sup>84</sup> Subsequently, the plaintiffs sued for the cancellation of the policy and restitution of the premium paid on the ground that MetLife failed to disclose a conflict of interest in violation of the Investment Advisers Act.<sup>85</sup> The alleged conflict arose from the fact MetLife compensated sales staff based on how many proprietary products they sold, and if the sales staff failed to sell enough products, they might be terminated.<sup>86</sup> The issue presented to the court was whether, for the purpose of the broker-dealer exemption under section 202(a)(11)(C) of the Investment Advisers Act, the quantum of advice given by a broker-dealer should be considered in determining whether the advice was “solely incidental” to the conduct of his business as a broker-dealer, such as, trade execution.<sup>87</sup> The court determined the meaning of “solely incidental to” as “solely attendant to” or “solely in connection with” a broker-dealer’s business of trade execution.<sup>88</sup>

Under this interpretation, the court concluded the quantum of advice provided by the broker did not render the broker ineligible for the exemption.<sup>89</sup>

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<sup>80</sup> *Thomas v. Metro. Life Ins. Co.*, No. CIV-07-0121-F, 2009 WL 2778663 (W.D. Okla. Aug. 31, 2009).

<sup>81</sup> *Id.* at \*2.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.* at \*8 n.15.

<sup>85</sup> *Id.* at \*1.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at \*3.

<sup>88</sup> *Id.* at \*7.

<sup>89</sup> *Id.* at \*5–9.

The court cited the SEC's statement that the broker-dealer exemption amounts to:

a recognition [by Congress] that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business.<sup>90</sup>

While “certain amount” can refer to both a significant amount of work and a minor amount, the court stated that the word “commonly” suggested that Congress was aware at the time of enacting the Investment Advisers Act that brokers were commonly giving advice.<sup>91</sup> According to the court, “[s]omething that is common is unlikely to be minor or insignificant or rarely occurring.”<sup>92</sup> Moreover, the court pointed out the fact that brokers are required under FINRA rules to perform an elaborate suitability analysis when recommending securities to clients, which analysis requires substantial interactions between a broker and his clients above and beyond a simple trade execution.<sup>93</sup> Therefore, the court stated that interpreting “solely incidental to” as “‘minor’ or ‘insignificant’” would result in broker-dealers losing the statutory exemption if they attempt to fulfill their duties under FINRA rules.<sup>94</sup>

The court's interpretation was affirmed on appeal by the Tenth Circuit, which pointed out that the purpose of the Investment Advisers Act was not to regulate brokers, even though Congress was aware they provided investment advice to clients in facilitating trade executions.<sup>95</sup> The SEC has held the same interpretation of the congressional intent behind the Investment Advisers Act. In the SEC release titled *Certain Broker-Dealers Not to Be Investment Advisers*,<sup>96</sup> the SEC stated there were two types of brokerage advice when the statute was first introduced:

- advice as an “auxiliary component of traditional brokerage services[,]” which could be extensive with the provision of a wide range of information such as analyses of the financial

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<sup>90</sup> *Id.* at \*5.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at \*6.

<sup>94</sup> *Id.* at \*6–7.

<sup>95</sup> *Thomas v. Metro. Life Ins. Co.*, 631 F.3d 1153, 1164 (10th Cir. 2011).

<sup>96</sup> *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, 17 C.F.R. pt. 275 (2005).

conditions of corporations, municipalities and governments, and tax schedules and consequences;<sup>97</sup> and

- advice provided by a special department within the brokerage firm for the purpose of providing advice (as opposed to facilitating brokerage services) to customers for a fee.<sup>98</sup>

The SEC pointed out that Congress knew of the above two types of advice and decided to exempt the former because it was already subject to regulation.<sup>99</sup> The SEC has acknowledged the blurry line between the conduct of broker-dealers and investment advisers, but it holds the view that subjecting broker-dealers to the Investment Advisers Act is not the solution as it is inconsistent with congressional intent.<sup>100</sup>

The *Thomas* case sent a clear signal that any advice given by a broker to his clients is deemed “solely incidental to” his brokerage service if the broker charges only a commission for executing trades.<sup>101</sup> The amount of advice given by the broker in his interactions with clients is irrelevant to the determination of whether the broker qualifies for the exemption under the Investment Advisers Act.

#### *b. The Meaning of “Special Compensation”*

To be exempt from the Investment Advisers Act, a broker-dealer must not receive special compensation for providing advice in connection with his brokerage services.<sup>102</sup> Special compensation is not defined in the Investment Advisers Act, but the Senate Banking and Currency Committee Report, issued when the statute was enacted, stated brokers qualify for the exemption “insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.”<sup>103</sup>

<sup>97</sup> *Id.* at 18.

<sup>98</sup> *Id.* at 17.

<sup>99</sup> *Id.* at 24–25, 32. Note that the D.C. Circuit disagreed with the SEC’s interpretation that Congress intended to avoid dual regulation for broker-dealers. The court stated that the sole purpose of the Investment Advisers Act was “to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.” *Fin. Planning Ass’n v. SEC*, 482 F.3d 481, 483–84 (2006) (citation omitted) (internal quotation marks omitted).

<sup>100</sup> 17 C.F.R. pt. 275, at 37.

<sup>101</sup> *Thomas v. Metro. Life Ins. Co.*, No. CIV-07-0121-F, 2009 WL 2778663, at \*7–9 (W.D. Okla. 2009), *aff’d*, 631 F.3d 1153 (10th Cir. 2011).

<sup>102</sup> 17 C.F.R. pt. 275, at 5.

<sup>103</sup> S. REP. NO. 76-1775, at 22 (1940).

Traditionally a broker is compensated in the form of a commission set as a percentage of the value of the trade he has executed on behalf of his client,<sup>104</sup> and an investment adviser is compensated in the form of an advisory fee set as a percentage of the value of the asset under his management.<sup>105</sup> However, in *Wiener v. Eaton Vance Distributors, Inc.*, the broker's compensation was partly in the form of a percentage of the assets of the fund whose shares the broker helped sell.<sup>106</sup> The plaintiff, who was a shareholder of the fund, sent a letter to the board of the fund asking the fund to change this compensation mode and to refund all past payments to the broker of such asset-based compensation.<sup>107</sup> Upon the board's refusal, the plaintiff brought a lawsuit alleging this compensation constituted special compensation that disqualified the broker for the Investment Advisers Act exemption.<sup>108</sup> Since the broker had not registered with the SEC as an investment adviser, any non-transactional asset-based compensation to the broker was argued by the plaintiff to be a violation of the statute and thus void.<sup>109</sup>

The court stated the focal point of the inquiry was whether the compensation to the broker was specifically for his rendition of advice to investors in the fund.<sup>110</sup> Since the Distribution Plan of the funds described the asset-based fee as being for "marketing support and administrative services," and at the most, such fees were for a bundle of services, including advice, the plaintiff had to unbundle the fee specifically attributable to the provision of the advice from the rest of the package in order to characterize the fee as special compensation.<sup>111</sup>

The courts in *Wiener* and *Thomas* set a high bar for investors to overcome in order to sue broker-dealers under the Investment Advisers Act.<sup>112</sup> Broker-dealers can provide their clients advice that is as extensive as that given by investment advisers, but are nonetheless exempt from the federal

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<sup>104</sup> SEC STUDY REPORT, *supra* note 4, at 10–11.

<sup>105</sup> *Id.* at 7.

<sup>106</sup> *Wiener v. Eaton Vance Distribs., Inc.*, No. 10-10515-DPW, 2011 WL 1233131, at \*2 (D. Mass. 2011).

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at \*3.

<sup>109</sup> *Id.* at \*9.

<sup>110</sup> *See id.* at \*10 ("As described above, courts rely on fact-based inquiries into the compensation paid, the services rendered, and evaluation of the connection between the two in determining whether the exemption applies.").

<sup>111</sup> *See id.* ("The most that can be said is that 12b-1 fees, even asset-based 12b-1 fees, compensate broker-dealers for a bundle of services including advice. But the advisory services are not unbundled in any fashion that could be characterized as 'special' as opposed to incidental.").

<sup>112</sup> *See supra* notes 81–95, 107–11 and accompanying text.

fiduciary standard of section 206 of the Investment Advisers Act so long as broker-dealers can attribute their compensation as commission for trade execution. Moreover, an asset-based compensation structure does not automatically hail broker-dealers into the realm of the Investment Advisers Act unless investors can pinpoint the part of the compensation that is specifically attributable to the provision of advice.

### *B. The Standard of Conduct of Broker-Dealers*

A broker-dealer's standard of conduct in providing personalized investment advice to investors is prescribed by the anti-fraud provisions of federal securities laws and by FINRA rules. The suitability requirement forms a critical component of these regulations, as will be discussed below.

#### *1. The Anti-fraud Provisions in Federal Securities Law*

Section 17(a) of the Securities Act and section 10(b) of the Exchange Act—together with SEC Rule 10b-5—provide against fraud in securities transactions. Section 17(a) prohibits anyone from “employ[ing] any device to defraud [or] engage in any [conduct] that operates as a fraud” in connection with an offer or sale of securities or any security-based swaps.<sup>113</sup> The Supreme Court has construed this section to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading.<sup>114</sup> Section 17(a) has three subsections: 17(a)(1) prohibits the use of “any device, scheme, or artifice to defraud,” while 17(a)(2) and (a)(3) prohibit omissions or misstatements of material facts and conduct that “would operate as a fraud or deceit upon the purchaser.”<sup>115</sup> Section 17(a)(1) has generally been held to require proof of scienter comparable to that necessary for a violation of section 10(b) of the Exchange Act and SEC Rule 10b-5.<sup>116</sup> Section 17(a)(2) and (a)(3), however, can be satisfied by proof of negligence.<sup>117</sup> For this reason, section 17(a)(2) and (a)(3) are often called negligence-based fraud provisions.<sup>118</sup>

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<sup>113</sup> Securities Act of 1933 § 17(a), 15 U.S.C.A. § 77q(a) (West 2013).

<sup>114</sup> *United States v. Naftalin*, 441 U.S. 768, 777–78 (1979); *see also* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171–72 (1994); *SEC v. Tambone*, 550 F.3d 106, 120 (1st Cir. 2008) (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999)).

<sup>115</sup> Securities Act of 1933 § 17(a).

<sup>116</sup> *See infra* notes 119–22 and accompanying text.

<sup>117</sup> *Aaron v. SEC*, 446 U.S. 680, 685, 701–02 (1980).

<sup>118</sup> *See, e.g.*, Thomas O. Gorman, *Trends in SEC Financial Fraud Actions: Part II*, LAW360 (May 6, 2011), [http://www.dorsey.com/files/upload/Goreman\\_TrendsInSEC\\_2](http://www.dorsey.com/files/upload/Goreman_TrendsInSEC_2)

Section 10(b) prohibits any person from using or employing any manipulative or fraudulent device in contravention of the SEC rules in connection with the purchase or sale of any security or a securities-based swap agreement.<sup>119</sup> Rule 10b-5, promulgated by the SEC under this section, prohibits any person from employing any device to defraud, or engaging in any conduct that operates as fraud, in connection with a purchase or sale of securities, or making any untrue statement of material fact, or failing to state a material fact that is necessary in order to make the statement made not misleading.<sup>120</sup> Although the text of Rule 10b-5 is nearly identical to the text of section 17(a) of the Securities Act, there are key distinctions between the respective scopes of these provisions. First, section 17(a) applies only to sellers of (or those who offer to sell) securities, whereas Rule 10b-5 applies to both sellers and purchasers of securities.<sup>121</sup> Second, Rule 10b-5 reaches only conduct leading to a consummated securities transaction—whether sale or purchase—and does not extend to an unconsummated offer to sell or purchase securities.<sup>122</sup> In the context of a broker-dealer recommending a particular security *for* his clients to purchase, section 17(a) is broader than section 10(b) in the sense that it encompasses the broker-dealer’s conduct whether or not the clients ultimately choose to follow the recommendation.

Just as the SEC has interpreted section 206 of the Investment Advisers Act as imposing a suitability obligation on investment advisers, the SEC holds the view that the above anti-fraud provisions of the Securities Act and the Exchange Act encompass an obligation on a broker-dealer to recommend only securities that are suitable to the customer’s financial conditions, investment objectives, and risk tolerance.<sup>123</sup> Moreover, just as section 206 of the Investment Advisers Act holds an investment adviser liable for intentional, reckless, as well as negligent violations of his suitability obligation, sections 17(a)(2) and (a)(3) subject a broker-dealer to liability for having intentionally, recklessly, or negligently offered or sold unsuitable securities to clients.<sup>124</sup> In contrast, liability under section 10(b) of the Exchange Act

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<sup>119</sup> 15 U.S.C. § 78j(b).

<sup>120</sup> 17 C.F.R. 240.10b-5.

<sup>121</sup> *SEC v. Tambone*, 550 F.3d 106, 122 (1st Cir. 2008).

<sup>122</sup> *Id.*

<sup>123</sup> “The concept of suitability has been interpreted as an obligation under the anti-fraud provisions of the federal securities laws.” SEC STUDY REPORT, *supra* note 4, at 59.

<sup>124</sup> See, e.g., *In re Wells Fargo Brokerage Servs.*, SEC Administrative Proceeding File No. 3-14982, Securities Act of 1933 Release No. 9349, Securities Exchange Act of 1934 Release No. 67649, Investment Company Act of 1940 Release No. 30167 (Aug. 14, 2012) (“Wells Fargo and McMurtry were, at a minimum, *negligent* in recommending the relevant asset-backed commercial paper programs without obtaining adequate information

and SEC Rule 10b-5 cannot be based on negligence, but requires intentional or reckless conduct.<sup>125</sup>

## 2. FINRA's Suitability Requirements

FINRA's suitability requirements are stated in FINRA Rule 2090 (Know Your Customer) and Rule 2111 (Suitability).<sup>126</sup> Rule 2090 is modeled after Rule 405 of the New York Stock Exchange and corresponding interpretative materials,<sup>127</sup> and Rule 2111 is modeled after Rule 2310 of FINRA's predecessor, the National Association of Securities Dealers, Inc. (NASD), and NASD's interpretative materials.<sup>128</sup> Both rules took effect in July 2012.<sup>129</sup>

### a. FINRA Rule 2090 (Know Your Customer)

Rule 2090 provides: "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."<sup>130</sup> Rule 2090.01 requires a broker know the customer's essential facts in order to "(a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations,

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about them to form a reasonable basis for recommending these products and without disclosing the material risks of these products. As a result, Wells Fargo and McMurtry violated Sections 17(a)(2) and 17(a)(3) of the Securities Act." (emphasis added)). *See also* Gorman, *supra* note 118. Note that in the SEC STUDY REPORT, *supra* note 4, at 61, the SEC stated that:

[t]o establish a violation of the antifraud provisions of Securities Act Section 17(a); Exchange Act Section 10(b) and Rule 10b-5 thereunder, the Commission must establish that the broker's unsuitable recommendation was a misrepresentation (or material omission) made with scienter (*i.e.*, with a mental state embracing intent to deceive, manipulate or defraud).

This statement appears inaccurate given the SEC's position in the disciplinary actions cited in this footnote.

<sup>125</sup> SEC STUDY REPORT, *supra* note 4, at 61.

<sup>126</sup> *See* FINRA Regulatory Notice 11-25, *Know Your Customer and Suitability* 1-2 (May 2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf>.

<sup>127</sup> *See* FINRA Regulatory Notice 11-02, *Know Your Customer and Suitability* 2 (Jan. 2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf>.

<sup>128</sup> *Id.*

<sup>129</sup> *See* FINRA Regulatory Notice 12-25, *Suitability, Additional Guidance on FINRA's New Suitability Rule 1* (May 2012), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf>.

<sup>130</sup> FINRA R. 2090 (2012).

and rules.”<sup>131</sup> FINRA rules do not specify what particular information a broker is required to obtain upon opening an account for a client, leaving to each broker’s judgment the determination of which facts are essential in the varying circumstances of each new account.<sup>132</sup>

*b. FINRA Rule 2111 (Suitability)*

Rule 2111 requires a broker-dealer or an associated person to “have a reasonable basis to believe that a recommended [security or investment] strategy ... is suitable for the customer.”<sup>133</sup> The Rule requires that the broker-dealer or an associated person exercise reasonable diligence in obtaining the requisite information about the customer’s financial conditions, investment experience, investment objectives, and risk tolerance.<sup>134</sup>

The term recommendation is not defined in the FINRA rules, but FINRA has indicated that whether a recommendation has been made is an objective inquiry of whether a communication reasonably would be viewed as a suggestion that a customer take or refrain from taking an action.<sup>135</sup> The SEC has indicated that any communication that is a “‘call to action’ and ‘reasonably could influence’ the customer to enter into a particular transaction or engage in a particular trading strategy” is deemed a recommendation for the purpose of suitability.<sup>136</sup> There is a directly proportionate relationship between the amount communications are tailored toward particular customers with regard to particular securities or strategies and the likelihood of a finding the communication constitutes a recommendation.<sup>137</sup> In contrast, impersonal, generalized statements about a security are not recommendations.<sup>138</sup> Likewise, “a broker-dealer’s general solicitation...through the use or distribution of marketing or offering materials ordinarily [does] not, by itself, constitute a recommendation....”<sup>139</sup> Moreover, suitability obligations do not apply in situations where a broker acts solely as an order-taker without solicitation and provides only a trade execution service,<sup>140</sup> or where a potential client does not act on the broker’s recommendations.<sup>141</sup>

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<sup>131</sup> *Id.*

<sup>132</sup> FINRA Regulatory Notice 11-02, *supra* note 127, at 6 n.5.

<sup>133</sup> FINRA R. 2111 (2012).

<sup>134</sup> *Id.*

<sup>135</sup> FINRA Regulatory Notice 11-02, *supra* note 127, at 3.

<sup>136</sup> SEC STUDY REPORT, *supra* note 4, at 60 (citation omitted).

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 61 n.274.

<sup>139</sup> FINRA Regulatory Notice 12-25, *supra* note 129, at 5.

<sup>140</sup> See NASD Notice to Members 01-23, *Online Suitability 2–3* (Apr. 2001), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf>.

<sup>141</sup> See, FINRA Regulatory Notice 12-55, *Suitability, Guidance on FINRA’s Suitability Rule 5* (Dec. 2012), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197435.pdf>.



Rule 2111's suitability obligations have three components: reasonable-basis suitability, quantitative suitability, and customer-specific suitability.<sup>142</sup> Reasonable-basis suitability requires a member to have a "reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least *some* investors."<sup>143</sup> What constitutes reasonable diligence varies from case-to-case, depending on, among other things, the complexity of and risks associated with the security or strategy and the broker-dealer's familiarity with the security or strategy.<sup>144</sup> Quantitative suitability requires a broker-dealer or associated person with "actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile...."<sup>145</sup>

There is no single test defining excessive activity as *excessiveness* can only be determined based on the facts of each individual case; the determination of excessiveness may be based on a number of non-exhaustive factors including "turnover rate, cost-equity ratio, and the use of in-and-out trading in a customer's account...."<sup>146</sup> A broker-dealer or associated person must "have a reasonable basis to believe that the recommendation is suitable for a particular customer based on the customer's investment profile," investment objectives, and risk tolerance, among other factors.<sup>147</sup> FINRA's suitability rule further provides explicitly that a recommendation must be consistent with the reasonable expectation "that the customer has the financial ability to meet such a commitment."<sup>148</sup> Although the FINRA suitability rule does not explicitly say brokers' recommendations must conform to the best interest of their clients, which would be synonymous with a fiduciary's standard of conduct, the FINRA Regulatory Notice 12-25 that interprets the scope of the new suitability rule spells out the best-interest standard of care for clients.<sup>149</sup> Some market professionals were surprised by this fiduciary-like standard,<sup>150</sup> but FINRA claims (rightfully) that such a standard has been applied in case law and past interpretations.<sup>151</sup>

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<sup>142</sup> FINRA R. 2111.05.

<sup>143</sup> FINRA R. 2111.05(a).

<sup>144</sup> FINRA R. 2111.05(a).

<sup>145</sup> FINRA R. 2111.05(c).

<sup>146</sup> FINRA R. 2111.05(c).

<sup>147</sup> FINRA R. 2111.05(b).

<sup>148</sup> FINRA R. 2111.06.

<sup>149</sup> FINRA Regulatory Notice 12-25, *supra* note 129, at 3.

<sup>150</sup> *See, e.g.*, Dan Jamieson, *New Finra Suitability Rules Worry Industry*, INVESTMENT NEWS (July 5, 2012, 3:45 PM), <http://www.investmentnews.com/article/20120705/FREE/120709971>.

<sup>151</sup> FINRA Regulatory Notice 12-25, *supra* note 129, at 3.

Based on FINRA Rule 2111(a), information pertinent to the investment profile for each customer includes, without limitation, the “customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose [to the broker-dealer] in connection with [the latter’s] recommendation.”<sup>152</sup> FINRA has refused to specify how the information collected should be used as the appropriateness of the usage depends again on the facts and circumstances of each case.<sup>153</sup> The flexibility built into the diligence process reflects comments raised by the financial industry when FINRA first proposed the suitability rule, that in some cases it may be unnecessary and indeed difficult to solicit each and every piece of information listed in the rule.<sup>154</sup>

FINRA and NASD disciplinary actions have delineated a more refined boundary for a broker-dealer’s duty of reasonable diligence. Brokers have been found in violation of suitability rules for neglecting to ask for the client’s financial condition or failing to review financial statements of the company whose securities were recommended, even though the client was wealthy and the investment amount was small.<sup>155</sup> Indeed, such failures have been found to constitute recklessness for the purpose of meeting the scienter requirement of securities-fraud claims.<sup>156</sup> Moreover, brokers are required to exercise reasonable care when reviewing offering documents (such as placement memoranda) of the securities recommended in order to identify material misrepresentations or omissions of facts.<sup>157</sup> The mere fact that the recommended security has raving reviews and the client’s current investment is out of favor of the market does not justify the broker in making a suggestion of switching without assessing whether the recommended security suits the investor’s own needs.<sup>158</sup> In addition, a broker must first have a good understanding of the risks associated with a security before recommending

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<sup>152</sup> FINRA R. 2111(a).

<sup>153</sup> See Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, SR-FINRA-2010-039 (proposed Jul. 30, 2010), at 37 [hereinafter FINRA Proposed Rule Consolidation (2010)], <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121835.pdf>.

<sup>154</sup> *Id.* at 34.

<sup>155</sup> FINRA v. Giarmoleo, 2008 FINRA Discip. LEXIS 15, at \*12–13 (FINRA 2008).

<sup>156</sup> *Id.* at \*17.

<sup>157</sup> See Kidder Peabody & Co., 46 S.E.C. 928, 930 (1977).

<sup>158</sup> See NASD v. Fantetti, 2005 NASD Discip. LEXIS 57, at \*28 (N.A.S.D. 2005) (showing that Broker was disciplined for violating his suitability obligations because he recommended that a client move investments from a bond fund, which was out of favor, and move it to a stock fund, which received raving reviews, but was described as for people to whom investment income was not essential).

it to his clients.<sup>159</sup> For complex financial products, this understanding “should be informed by an analysis of likely product performance in a wide range of normal and extreme market actions.”<sup>160</sup> A broker cannot rely only on the due diligence conducted by his firm or the issuer of the security in fulfilling his suitability obligations.<sup>161</sup> A broker has a heightened duty to investigate the accuracy audited financial statements if red flags have been raised about the accuracy of the statements and is required to conduct independent investigations to ascertain the truth.<sup>162</sup> These interpretations and disciplinary actions suggest the scope of a broker-dealer’s diligence is as broad as that of an investment adviser under the Investment Advisers Act.<sup>163</sup>

As is the case of investment advisers, a broker-dealer is required to disclose material facts to his clients in order to ascertain the client’s investment objectives and risk tolerance.<sup>164</sup> What constitutes a material fact varies by the nature of the recommended securities, the scope of the relationship that the broker has with the client, and the client’s individual circumstances.<sup>165</sup> FINRA and NASD disciplinary actions and case law have shown that material risks, better investment alternatives, and conflicts of interest are all material facts that must be disclosed to clients.<sup>166</sup> Note the similarity between

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<sup>159</sup> See *FINRA v. Cody*, 2010 FINRA Discip. LEXIS 8, at \*25–26 (FINRA 2010) (showing that Broker was disciplined for recommending asset-backed securities to a retail customer without having a good understanding of the product himself).

<sup>160</sup> See FINRA Regulatory Notice 12-03, *Complex Products, Heightened Supervision of Complex Products* 5–6 (Jan. 2012), <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf>.

<sup>161</sup> *NASD v. Faber*, 2002 NASD Discip. LEXIS 23, at \*41 (N.A.S.D. 2002) (noting that testimony of broker’s expert witness on the industry standard that brokers could rely on firms’ diligence was found inconsistent with years of established law).

<sup>162</sup> *NASD v. Kunz*, 1999 NASD Discip. LEXIS 20, at \*27–28 (N.A.S.D. 1999) (noting that “red flags” were raised when the most important asset of the issuer was purchased a few days before the auditor’s certification of the financial statements, and there was a wide disparity in the asset’s estimated value as recorded in different corporate documents).

<sup>163</sup> See discussion *supra* Part I.A.2.

<sup>164</sup> See FINRA, *Frequently Asked Questions: FINRA Rule 2111 (Suitability)* at 12, available at [http://www.finra.org/web/idcplg?IdcService=GET\\_FILE&dDocName=p197440&RevisionSelectionMethod=LatestReleased&Rendition=primary&allowInterrupt=1](http://www.finra.org/web/idcplg?IdcService=GET_FILE&dDocName=p197440&RevisionSelectionMethod=LatestReleased&Rendition=primary&allowInterrupt=1).

<sup>165</sup> SEC STUDY REPORT, *supra* note 4, at 55.

<sup>166</sup> See *Faber*, 2002 NASD Discip. LEXIS, at \*50 (showing that Broker was disciplined for failure to disclose the fact that the issuer of the recommended security had never been profitable since inception). See also *United States v. Laurienti*, 611 F.3d 530 (9th Cir. 2010), *cert. denied*, 131 S. Ct. 969 (2011) (noting that Brokers had a duty to disclose a conflict of interest arising from their receipt of special compensation for the securities they recommended); *Barthe v. Rizzo*, 384 F. Supp. 1063 (S.D.N.Y. 1974); *Shivangi v. Dean Witter Reynolds, Inc.*, 107 F.R.D. 313 (S.D. Miss. 1985); *FINRA v. Epstein*, 2007

the disclosure obligations of a broker-dealer and an investment adviser: the former must disclose facts so as to permit an accurate assessment of the client's investment objectives, preferences, and risk tolerance; the latter must disclose facts that are relevant to the client's investment decisions, which necessarily build on his investment objectives, preferences, and risk tolerance.<sup>167</sup> In addition, both broker-dealers and investment advisers must disclose conflicts of interest.<sup>168</sup>

Just as the SEC has applied a stringent standard in enforcing the obligations of investment advisers under the Investment Advisers Act,<sup>169</sup> FINRA and its predecessor, NASD, have vigilantly pursued broker-dealers for violating suitability obligations. Scienter is not a prerequisite for finding a violation of the rules, as a broker-dealer may be subject to disciplinary actions for having acted negligently in making any recommendation that is not suitable for the client.<sup>170</sup> In addition, a broker-dealer is not exonerated from liability for making an unsuitable recommendation even though he has explained the risks to the client.<sup>171</sup> Moreover, a broker-dealer's duty is not excused even if the client is wealthy, the investment amount is relatively small, and the client could clearly afford to lose all of the investment.<sup>172</sup> A broker has the duty to refrain from making unsuitable recommendations even if the client asks for a particular trade.<sup>173</sup> A broker may be subject to disciplinary actions for violating the suitability requirement even though the client is highly sophisticated and actively participates in making trade decisions.<sup>174</sup>

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FINRA Discip. LEXIS 18 (FINRA 2007) (showing that Broker was disciplined for failure to discuss the option of switching into a comparable mutual fund which would have been a free exchange and subject to lower expenses).

<sup>167</sup> See discussion *supra* Part I.A.2.a.

<sup>168</sup> See discussion *supra* Part I.A.2.a.

<sup>169</sup> See discussion *supra* Part I.A.2.a.

<sup>170</sup> See Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493, 1531 (2001).

<sup>171</sup> See, e.g., NASD v. Kernweis, 2000 NASD Discip. LEXIS 49 (N.A.S.D. 2000).

<sup>172</sup> See NASD v. Del Rey, 2007 NASD Discip. LEXIS 16, at \*36-37 (N.A.S.D. 2007).

<sup>173</sup> See NASD v. Howard, 2000 NASD Discip. LEXIS 16 (N.A.S.D.R. 2000) (disciplining a broker for recommending securities that were designated as "speculative" by his firm's internal report to an 85-year old client, whom broker testified as someone who constantly asked for "a piece of action").

<sup>174</sup> See NASD v. Kernweis, 2000 NASD Discip. LEXIS 49 (N.A.S.D.R. 2000) (disciplining a broker for making unsuitable recommendations despite the fact that the client spoke with the broker on a regular basis, approved each trade in his account, reviewed his trade confirmations and account statements, and signed a letter acknowledging speculation as his trade motivation, his awareness of the risk of substantial losses and high transaction costs due to frequent trading).

*c. The Institutional Account Exemption*

FINRA Rule 2111(b) exempts broker-dealers from their suitability obligations for institutional clients if certain conditions are met.<sup>175</sup> FINRA Rule 4512(c) defines an institutional account as the account of:

- (1) a bank, savings and loan association, insurance company, or registered investment company;
- (2) an investment adviser registered either with the SEC under section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or
- (3) any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.<sup>176</sup>

FINRA Rule 2111(b) provides that a broker is deemed to have fulfilled his suitability obligation if:

- (1) [he] has a *reasonable basis* to believe that an institutional customer meeting the criteria discussed above is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the [broker-dealer's] recommendations.<sup>177</sup>

The conditions attach even in the situation where an agent, such as an investment adviser or the trust department of a bank, has been delegated decision-making authority by an institutional customer.<sup>178</sup> A broker is still subject to the suitability rules in recommending securities to an institutional client if either of the two conditions are absent. Thus, suitability applies if it is apparent to the broker that the institutional investor lacks a complete understanding of the risks of the recommended securities (such as complex derivatives). The affirmative-acknowledgement condition was added to the suitability regulation when FINRA introduced Rule 2111.<sup>179</sup> By acknowledging that it is exercising independent judgment, the institutional investor raises an obstacle to bringing a private right of action against the broker-dealer for

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<sup>175</sup> FINRA R. 2111(b).

<sup>176</sup> FINRA R. 4125(c) (based on NASD Rule 3110(c)(4), which was adopted by FINRA as Rule 4512(c) in December 2011); *see also* FINRA Regulatory Notice 11-19, *Books and Records, SEC Approves Consolidated FINRA Rules Governing Books and Records 2* (Apr. 2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123548.pdf>.

<sup>177</sup> FINRA R. 2111(b) (emphasis added).

<sup>178</sup> *Id.*

<sup>179</sup> *See* FINRA Proposed Rule Consolidation (2010), *supra* note 153, at 38.

fraudulent misrepresentations about the suitability of the recommended securities, as reasonable reliance on the misrepresentation is a necessary element of the claim.<sup>180</sup>

FINRA Rule 2111 is modeled after NASD Rule 2310 and interpretative materials thereunder.<sup>181</sup> A NASD interpretative material published in 1996 lists non-exclusive guideline factors a broker can consider in assessing the sophistication of his institutional clients with regard to the recommended securities.<sup>182</sup> The factors include:

- [The customer's use of] consultants, investment advisers or bank trust departments;
- the [customer's] general level of experience ... in financial markets and specific experience with the type of instruments under consideration;
- the customer's ability to understand the economic features of the security involved;
- the customer's ability to independently evaluate how market developments would affect the security; and
- the complexity of the security ... involved.<sup>183</sup>

The presence or absence of any of the above factors is not dispositive; rather the NASD intended the factors to serve as guidelines in the determination of suitability.<sup>184</sup> Suitability determination can only be made in light of the specific context of each case, "taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction."<sup>185</sup> FINRA's disciplinary actions offer no additional guidance on when "reasonable belief" is deemed to exist as there have been few actions on the institutional account exemption altogether.

As discussed earlier, broker-dealers also have suitability obligations under the anti-fraud provisions of the Securities Act and the Exchange Act.<sup>186</sup> Even though FINRA rules exempt broker-dealers from suitability requirements when dealing with qualified institutional clients, the anti-fraud provisions of the federal securities law do not offer a similar exemption.<sup>187</sup> This raises the question of whether a broker-dealer who is exempt from performing a suitability analysis under FINRA's rules is nonetheless required to do so under the anti-fraud provisions of the securities statutes. There is no explicit answer

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<sup>180</sup> See *infra* Part II.

<sup>181</sup> See FINRA Regulatory Notice 11-02, *supra* note 127.

<sup>182</sup> Nat'l Ass'n of Sec. Dealers, NASD Rule 2310-3, NASD MANUAL (CCH) 4265 (2000).

<sup>183</sup> *Id.* at 2.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> See SEC STUDY REPORT, *supra* note 4, at 61 n.277.

<sup>187</sup> See discussion *supra* Part I.B.1.

to this question in the SEC's or FINRA's rules, explanatory guidance, or disciplinary actions, nor is the answer provided in court cases. The SEC holds the view that a broker-dealer's recommendation per se "carries the implicit representation that it was 'responsibly made on the basis of actual knowledge and careful consideration.'"<sup>188</sup> It follows, then, that a broker-dealer can be found in violation of the anti-fraud statutes by simply making a recommendation without carefully considering suitability, even if he qualifies for the FINRA suitability exemption. However, this is unlikely the result intended by the SEC given its approval of the FINRA suitability exemption rules. The SEC has not disciplined any broker-dealer for his failure to perform a suitability analysis (in absence of any affirmative misrepresentation with regard to suitability) when the FINRA exemption applies.

*C. Comparison of the Standard of Conduct of Investment Advisers and Broker-Dealers*

This section compares, based on discussions in previous sections, the standard of conduct of investment advisers with that of broker-dealers under the securities statutes. When broker-dealers are not exempt from FINRA's suitability exemption, their standard of conduct in providing advice to clients, whether retail or institutional, is comparable to that of investment advisers. First, the anti-fraud provisions in the Investment Advisers Act (applicable to investment advisers) and the Securities Act and the Exchange Act (both applicable to investment advisers as well as broker-dealers) all require disclosures of material facts and conflicts of interest.<sup>189</sup> Second, both broker-dealers and investment advisers are subject to suitability obligations.<sup>190</sup> Third, the Investment Advisers Act requires investment advisers to act in the best interest of clients in fulfilling their fiduciary duty, and FINRA has imposed a similar obligation on broker-dealers through its interpretation of the scope of the suitability requirement.<sup>191</sup> Fourth, both investment advisers and broker-dealers can be subject to liability for negligently as well as willfully violating the above obligations.<sup>192</sup> Enforcement by the SEC and FINRA against broker-dealers is no less stringent than that against investment advisers.<sup>193</sup>

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<sup>188</sup> See *In re Wells Fargo Brokerage Servs.*, SEC Administrative Proceeding File No. 3-14982, Securities Act of 1933 Release No. 9349, Securities Exchange Act of 1934 Release No. 67649, Investment Company Act of 1940 Release No. 30167 (Aug. 14, 2012), at 9–10.

<sup>189</sup> See discussion *supra* Parts I.A.2, I.B.1.

<sup>190</sup> See discussion *supra* Parts I.A.2.b, I.B.2.

<sup>191</sup> See discussion *supra* Parts I.A.2, I.B.2.b.

<sup>192</sup> See discussion *supra* Parts I.A.1, I.B.1.

<sup>193</sup> See discussion *supra* Parts I.A.2.a, I.B.2.b.

Broker-dealers may qualify for an exemption from FINRA's suitability rules in dealing with institutional clients, but they must nonetheless comply with the anti-fraud provisions of the securities statutes. Therefore, they must still make full disclosure of material facts (including conflicts of interest) and refrain from making material misrepresentations (including misrepresentations about the suitability of their recommendations). What is unclear in the current regulation is whether they must still perform a suitability analysis in order to fulfill their obligations under the securities statutes. This uncertainty arises from the statutes' failure to provide an exemption from suitability comparable to the exemption included in FINRA's rules. However, the answer is likely negative, as the SEC could not have intended a regulatory contradiction to result from its approval of FINRA's exemption rules. That means broker-dealers are relieved from the obligation to make suitability assessments for institutional clients when FINRA's exemption applies. In this narrow sense, and under the restrictive conditions set by FINRA, broker-dealers are subject to a standard of conduct lower than that of investment advisers.

## II. ENFORCEMENT OF THE STANDARD OF CONDUCT OF INVESTMENT ADVISERS AND BROKER-DEALERS

### *A. Identical Enforcement Channels and Elements of Claim*

There is no palpable difference in the enforcement of the obligations of investment advisers and broker-dealers, even though the former are labeled fiduciaries while the latter are not. There are two channels through which obligations of investment advisers and broker-dealers are enforced: disciplinary actions brought by regulatory agencies such as the SEC and (where applicable) FINRA, and private litigations by harmed investors in federal or state courts. Actions by regulatory agencies can be brought for any violation of the law or FINRA rules, irrespective of whether the violators owe any fiduciary duty to their clients. Private rights of action, on the other hand, are more restrictive.

Under section 215 of the Investment Advisers Act, an investor may bring a private action against his investment adviser to seek a cancellation of the advisory contract and/or a restitution of advisory fees paid for violations of section 206 of that act.<sup>194</sup> The statute's specific reference to "cancellation of advisory contract" and "restitution of advisory fees" has prompted the Supreme Court to conclude that Congress intended no private right of action for damages and other monetary relief unless the adviser's conduct

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<sup>194</sup> Investment Advisers Act of 1940, 15 U.S.C.A. § 80b-15 (West 2013).



constitutes fraud in violation of section 10(b) of the Exchange Act and SEC Rule 10b-5.<sup>195</sup> The investor must satisfy the pleading requirements for Rule 10b-5 fraud claims in order to survive a motion to dismiss.<sup>196</sup>

The same limitation applies to private actions against broker-dealers. For violations of the anti-fraud provisions of section 17(a) of the Securities Act, it has now been firmly established that only the SEC may bring an action for injunctive relief or criminal liabilities; that is, investors have no private right of action.<sup>197</sup> For violations of section 10(b) of the Exchange Act and SEC Rule 10b-5, investors can bring private actions for monetary damages if and only if the alleged misconduct is fraudulent as opposed to merely negligent in nature.<sup>198</sup> Courts generally hold the view that violations of rules of a self-regulatory organization such as FINRA do not give rise to a private right of action.<sup>199</sup>

In order to succeed in a federal securities fraud claim against either an investment adviser or a broker-dealer, an investor must establish that:

1. the defendant has made misrepresentations or omissions of material facts in connection with the investor's purchase or sale of securities;
2. the defendant acted with scienter;

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<sup>195</sup> See *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 18–19, 33–34 (1979). See also SEC STUDY REPORT, *supra* note 4, at 44–45 (“Advisory clients generally have no private right of action for damages and other monetary relief against an investment adviser under Advisers Act Section 206. Rather, advisory clients have only a limited private right of action under Advisers Act Section 215 to void an investment adviser’s contract and obtain restitution of fees paid. Accordingly, clients cannot sue their adviser in federal court for damages based on a violation of the Advisers Act. A client may privately enforce claims against an investment adviser under the Exchange Act.... Rule 10b-5 has been used successfully by such clients in private actions regarding scalping, failure to disclose conflicts of interest, misrepresentation and suitability violations.” (citations omitted)).

<sup>196</sup> See, e.g., *Caroll v. Bear, Stearns & Co.*, 416 F. Supp. 998, 1001 (S.D.N.Y. 1976) (quoting *Abrahamson v. Fleschner*, 392 F. Supp. 740, 750 (S.D.N.Y. 1975)) (“The wording of this provision [of Section 206 of the Investment Advisers Act], making it unlawful ‘to employ any device, scheme or artifice to defraud,’ is identical to the language employed in R. 10b-5. Consequently, the same pleading requirements with respect to particularity and scienter apply which requirements we have already found not to have been met.” (citation omitted)).

<sup>197</sup> See *SEC v. Tambone*, 550 F.3d 106, 122 (1st Cir. 2008) (“[A]lthough private plaintiffs can maintain a cause of action under Rule 10b-5, only the SEC may bring a claim to enforce the prohibitions of section 17(a).”).

<sup>198</sup> See SEC STUDY REPORT, *supra* note 4, at 45.

<sup>199</sup> See Poser, *supra* note 170, at 1531 n.150 (“The courts are divided on the question of whether an SRO violation can give rise to an implied private right of action, but the prevailing view on this question is negative.”); see also *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679 (9th Cir. 1980). *But see Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 142 (7th Cir. 1969).

3. the investor reasonably relied upon the misrepresentations or omissions;  
and
4. the investor suffered economic loss as a result of his reliance.<sup>200</sup>

Pleading standards for securities fraud claims are set forth in Rule 9(b) of the Federal Rules of Civil Procedure and the Private Securities Litigations Reform Act (PSLRA) of 1995.<sup>201</sup> Rule 9(b) provides that “[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.”<sup>202</sup> PSLRA imposes a heightened pleading standard to securities fraud claims under Rule 10b-5 such that the plaintiff must: (1) “specify each statement alleged to have been misleading and the reason or reasons why the statement is misleading”;<sup>203</sup> and (2) “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>204</sup> The same pleading standard is applied to fraud cases against both an investment adviser and a broker-dealer.<sup>205</sup>

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<sup>200</sup> See *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 666 (3d Cir. 2002); see also Investment Advisers Act of 1940, 15 U.S.C.A. § 80b-15 (West 2013). For examples of fraud cases against investment advisers under section 206 of the Investment Advisers Act, see *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *Geman v. SEC*, 334 F.3d 1183 (10th Cir. 2003); *Carroll v. Bear, Stearns & Co.*, 416 F. Supp. 998 (S.D.N.Y. 1976). For examples of fraud cases against broker-dealers, see *Michael S. Rulle Family Dynasty Trust v. AGL Life Assurance Co.*, No. 10-231, 2010 WL 2721029 (E.D. Pa. July 7, 2010); *Lapin v. Goldman Sachs Grp., Inc.*, 506 F. Supp. 2d 221 (S.D.N.Y. 2006).

<sup>201</sup> 15 U.S.C.A. § 78u-4.

<sup>202</sup> FED. R. CIV. P. 9(b).

<sup>203</sup> 15 U.S.C.A. § 78u-4(b)(1).

<sup>204</sup> *Id.* § 78u-4(b)(2).

<sup>205</sup> For cases applying the standard to claims against broker-dealers, see, e.g., *ABN AMRO, Inc. v. Capital Int’l Ltd.*, 595 F. Supp. 2d 805 (N.D. Ill. 2008) (holding that the state and common law fraud claims must meet the heightened pleading requirements of Rule 9(b), and the federal securities fraud claims must meet the even higher pleading requirements of the PSLRA); *In re Interbank Funding Corp. Sec. Litig.*, 329 F. Supp. 2d 84, 88–89 (D.D.C. 2004) (“[W]here fraud is alleged, the circumstances constituting fraud must be stated with particularity. FED. R. CIV. P. 9(b). The Private Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 (‘PSLRA’), imposes additional pleading requirements on plaintiffs in securities cases.”). For cases applying the same standard to fraud claims against investment advisers, see, e.g., *Cascade Fund, LLLP v. Absolute Capital Mgmt. Holdings Ltd.*, 707 F. Supp. 2d 1130 (D. Colo. 2010) (examining Cascade’s allegations in their entirety to determine whether they satisfy the PSLRA’s pleading requirements); *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d 845, 855 (D. Md. 2005) (noting that claims under Rule 10b-5 (a) and (c) of the Securities Exchange Act “are subject to the heightened pleading requirements of Rule 9(b) and the PSLRA”).

*B. Reasonable Reliance: An Impediment to Recovery*

In order to establish a claim of fraud against a broker-dealer, the investor must establish that he relied on the advice of the defendant and such reliance was reasonable under the particular circumstances of the case.<sup>206</sup> As discussed below, institutional investors face an almost insuperable challenge of establishing reasonable reliance because they are deemed sophisticated investors and they typically are required to sign elaborate disclaimer provisions which preclude reasonable reliance when transacting with broker-dealers.

*1. A Multi-Factored Approach to Determining Reasonable Reliance*

What constitutes reasonableness depends on the facts and circumstances of each case, but the following factors have been highlighted as important by courts in examining this issue: (1) whether the investor was sophisticated with regard to the subject security and market; (2) whether the investor had access to information necessary to evaluate the defendant's statements and detect fraud; and (3) whether the parties had a long-standing or fiduciary relationship.<sup>207</sup>

Courts have consistently found that well-capitalized business entities are sophisticated investors in assessing the reasonableness of their reliance on the alleged misrepresentations in securities fraud cases.<sup>208</sup> This is so even if the sophistication level appears marginal relative to the enormous complexity

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<sup>206</sup> See discussion *supra* Part II.A.

<sup>207</sup> For cases in which courts enumerated relevant factors for consideration of reasonable reliance, see, e.g., *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017 (4th Cir. 1997); *Jackvony v. RIHT Fin. Corp.*, 873 F.2d 411 (1st Cir. 1989).

<sup>208</sup> See, e.g., *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 27 Misc. 3d 1233(A), at \*1 (N.Y. Sup. Ct. 2010) (explaining how Merrill Lynch engaged in a CDS with LaCrosse Financial Products, LLC (LaCrosse), in which LaCrosse sold credit protection for the \$5.7 billion CDOs held by Merrill Lynch. The CDS was further insured by MBIA, a financial service firm that specialized in providing financial guarantee insurance. When the mortgage market fell out, LaCrosse and MBIA brought a lawsuit alleging that "Merrill Lynch made substantial fraudulent misrepresentations" with regard to the quality of the CDOs' collaterals, their credit ratings and default rates. *Id.* The court held that the plaintiffs failed to establish reasonable reliance and highlighted the fact that the transactions "were the product of intensive negotiations among the parties, whose sophistication and business acumen and experience cannot be overstated." *Id.* at \*4); see also *Harsco Corp. v. Segui*, 91 F.3d 337, 344 (2d Cir. 1996) (holding that the plaintiff could not establish reasonable reliance on the defendant's financial projections for purpose of its securities and common law fraud claim as the plaintiff was sophisticated in business matters and had equal bargaining power as the defendant, and transaction was a result of extensive negotiations and due diligence by the plaintiff).

of the subject security. For example, in *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*, the plaintiff was a Mexican bank that invested in collateralized mortgage obligation (CMO) securities recommended by the defendant, a US brokerage firm.<sup>209</sup> The brokerage firm's sales person initiated a cold call to the bank, sent books and other educational materials about CMOs to the bank's investment personnel, and introduced the bank to a renowned bond market expert, although no formal consulting relationship was formed with that expert.<sup>210</sup> The bank started trading CMOs two months after the brokerage firm's initial cold call; first made substantial profits; but ultimately incurred substantial loss when the CMO market collapsed in 1994.<sup>211</sup> The bank sued the brokerage firm for various causes, including the anti-fraud provisions of the federal securities law for making unsuitable recommendations and misrepresentations about the riskiness and soundness of investing in CMOs.<sup>212</sup> The bank's CMO team consisted of three key personnel, two of whom held economics degrees and one of whom had a post-graduate degree in international relations.<sup>213</sup> These individuals attended seminars, bought treatises on the subject, and developed a 14-step review-approval process for each CMO trade.<sup>214</sup> They were also provided some information about CMOs when other investment banks approached them for CMO trades.<sup>215</sup> The court rejected the bank's argument that while it was a well-capitalized institutional investor with expertise in general financial matters, it lacked specific sophistication in CMO investments.<sup>216</sup> The court concluded that the plaintiff acquired sophistication by attending seminars, purchasing treatises on the subject, obtaining information from other investment banks, and trading CMOs for a year.<sup>217</sup> CMOs are highly complicated derivative instruments with risks that often elude appreciation by even the most experienced players. Indeed, multi-million dollar hedge funds that specialized in trading CMOs and functioned as market makers were among the biggest losers in the 1994 CMO debacle.<sup>218</sup> When the brokerage firm recommended a CMO, misrepresented its riskiness, and then executed the first trades for the bank, the bank could at most be described as having obtained a peripheral understanding of

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<sup>209</sup> *Banca Cremi*, 132 F.3d at 1021.

<sup>210</sup> *Id.* at 1024–25.

<sup>211</sup> *Id.* at 1024–26.

<sup>212</sup> *Id.* at 1026–27.

<sup>213</sup> *Id.* at 1024.

<sup>214</sup> *Id.* at 1024–25.

<sup>215</sup> *Id.* at 1025.

<sup>216</sup> *Id.* at 1029.

<sup>217</sup> *Id.*

<sup>218</sup> See, e.g., Saul Hansell, *Investment Funds Are Liquidated*, N.Y. TIMES, Apr. 1, 1994, at D1.

this instrument through reading treatises and attending seminars.<sup>219</sup> Although the bank's subsequent trading in the CMO market strengthened its understanding, the trading was for a short duration and occurred mostly in a bull market; it was no basis for finding the bank was sophisticated about the risks of CMOs.<sup>220</sup> However, limited exposures in a complex security can be sufficient to portray an institutional investor as sophisticated in the eye of a court.<sup>221</sup>

An investor is precluded from relying on the alleged misrepresentations if he has access to information that, through his reasonable investigation, would have revealed the truth.<sup>222</sup> In this regard, courts have generally upheld an investor's duty to investigate when the risk disclosures contained in investment documents contradict the oral representations of the broker-dealer recommending the investment.<sup>223</sup> The duty to investigate poses a dilemma for an institutional investor in considering a broker-dealer's recommendation, especially when the recommended security is complex and novel: can the investor act upon a broker-dealer's statement that "this product is really what you need," or should it try to learn about the security first before investing? Prudence requires investigation, and hasty actions may well negate reasonable reliance. But investigation through self-education or seeking third-party opinions may result in courts finding the investor has acquired sophistication in the securities, as happened in *Banca Cremi*.<sup>224</sup> This makes it difficult for an institutional investor to establish reasonable reliance.

Courts have generally held the nature of the relationship (that is, whether it is long-standing or fiduciary) between an investor and the person who made misrepresentations is a relevant factor in determining whether the investor's reliance on the misrepresentations was reasonable for purposes

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<sup>219</sup> *Banca Cremi*, 132 F.3d at 1029.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> See, e.g., *Brown v. E.F. Hutton Grp., Inc.*, 991 F.2d 1020, 1032–33 (2d Cir. 1993) (holding that investors who purchased interests in an oil and gas limited partnership were precluded from relying on brokers' oral assurance that the investment had low risk and that the investment was suitable for investors' conservative objective because the offering prospectus had extensive and glum disclosures of risk that were in prominent print and spanned multiple pages); see also *Hirschler v. GMD Invs. Ltd.*, No. 90-1289-N, 1991 WL 115773, at \*6 (E.D. Va. 1991) (holding that the statute of limitation for a securities fraud claim began when the investor received the private placement memorandum containing risk disclosures that were inconsistent with oral representations of the broker, as the discrepancy triggered a duty of inquiry on the part of the investor), *aff'd*, 972 F.2d 340 (4th Cir. 1992). Although such an observation has been drawn mostly from cases involving individual investors, courts' stance toward institutional investors can be readily imputed from these cases as institutional investors are typically more sophisticated at detecting fraud and fending for their own interests.

<sup>223</sup> See *Brown*, 991 F.2d at 1032–33.

<sup>224</sup> See discussion *supra* Part II.B.1.

of a securities fraud claim.<sup>225</sup> It follows that imposing a fiduciary duty on broker-dealers would make it easier for institutional investors to establish reasonable reliance. However, as is evident from the case law discussed immediately below, when dealing with broker-dealers, institutional investors are typically required to sign elaborate disclaimer provisions that preclude investors from claiming reasonable reliance. Fiduciary duty would not have changed this outcome.

## 2. *The Effect of Disclaimers*

Before an institutional investor executes trades with a broker-dealer, the investor is typically asked to sign lengthy waiver provisions that are designed to insulate the broker-dealer from liability arising from potential suitability violations. For example, in *MBIA*,<sup>226</sup> the disclaimers contained in numerous documents related to the transaction stated that:

- the investor was capable of assessing risk (either internally or through independent advisers);
- the investor was capable of assessing the suitability of the transaction;
- the investor understood the terms, conditions, and risks of the transaction and chose to assume the risk;
- the investor was to conduct independent diligence;
- the investor was not relying on statements by the broker other than those specifically made in the written agreement;
- the investor acknowledged that the broker was “not acting as fiduciary or [adviser] in connection with the [t]ransaction[;]” and
- the signed document represented the entire agreement between the parties.<sup>227</sup>

The question is whether by signing such disclaimers, an institutional investor is precluded from claiming reasonable reliance on any misrepresentation with regard to the suitability of the security.

### *a. The Anti-Waiver Provisions of Securities Statutes*

The validity of this type of disclaimer should be examined in light of the restrictions of section 14 of the Securities Act<sup>228</sup> and section 29(a) of the

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<sup>225</sup> See, e.g., *Johnston v. CIGNA Corp.*, 916 P.2d 643, 646 (Colo. App. 1996); *Banca Cremi*, 132 F.3d at 1038.

<sup>226</sup> *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 27 Misc. 3d 1233(A) 3 (N.Y. Sup. Ct. 2010).

<sup>227</sup> *Id.*

<sup>228</sup> 15 U.S.C.A. § 77n (West 2013) (providing that “[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.”).

Exchange Act.<sup>229</sup> These sections invalidate any contractual provision that allows a party to waive compliance with provisions of the applicable securities statutes. This restriction reflects Congress's intent not to allow one party to a securities contract to be able to induce the other party to opt out of the securities law protection that the statute provides.<sup>230</sup>

In the context of the enforceability of a mandatory arbitration provision, the Supreme Court has interpreted the anti-waiver provision of section 29(a) as forbidding any waiver of compliance with the *substantive obligations* imposed by the Exchange Act.<sup>231</sup> The Court held, in considering the validity of an agreement under this section, the disparity of the bargaining power of the parties and the voluntariness of the agreement are irrelevant to the inquiry, as the anti-waiver provision was "concerned[] not with whether brokers 'maneuver[ed customers] into' an agreement, but with whether the agreement 'weaken[s] their ability to recover under the [Exchange] Act.'"<sup>232</sup>

The Supreme Court has yet to rule on whether disclaimers such as those stated at the beginning of this subsection are valid under the anti-waiver statutes. Lower courts' decisions are inconsistent; some courts have specifically discussed the validity of such disclaimers in light of the anti-waiver provisions, but others have not referenced those provisions in their opinions. Courts that have considered the validity of disclaimers under the anti-waiver statutes have held such disclaimers are not invalid *per se*, but rather their validity should be determined based on the facts and circumstances of each case.<sup>233</sup> In this regard, courts have paid attention to the degree of detail in broker-dealers' explicit representations and warranties, the specificity of disclaimers, the length of negotiations, and the extent of diligence done by the client-investor. Detailed contractual provisions and extended involvement by the client-investor in negotiating the contract have prompted some courts

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<sup>229</sup> 15 U.S.C.A. § 78cc(a) (providing that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

<sup>230</sup> See Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337, 351 (2003) ("Congress was particularly concerned with the plight of investors. As the Supreme Court noted in a case involving the '33 Act's savings clause: [T]he Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers." (citation omitted)).

<sup>231</sup> Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 228 (1987).

<sup>232</sup> *Id.* at 230 (citation omitted).

<sup>233</sup> See, e.g., Rogen v. Iikon Corp., 361 F.2d 260, 265-67 (1st Cir. 1966) (holding that the non-reliance provision in the parties' agreement was insufficient to find as a matter of law that the plaintiff did not rely on the defendant corporation).

to conclude the disclaimers represented the true intent of the parties and have not prevented the client-investor from protecting his substantive rights.<sup>234</sup> In some of these cases, a fiduciary relationship existed between the parties but was not the focal point of the court's examination.<sup>235</sup>

*b. The Validity of Disclaimers without Reference to Anti-waiver Provisions of the Securities Statutes*

Courts have also examined the validity of disclaimers in securities contracts without referencing the anti-waiver provisions of the securities statutes. In some cases the client-investor seeks to establish his reliance on the broker-dealer's alleged oral representations that are in addition to, but not inconsistent with, specific representations in the parties' agreement as evidence of "Additional Understanding." In other cases, the plaintiff seeks to introduce evidence of "Contradictory Understanding," comprised of oral representations that contradict specific representations in the agreement.

When the plaintiff seeks to introduce evidence of "Additional Understanding" but the parties' written agreement contains a merger clause to the effect the written agreement represents the entire understanding and representations by the parties, and/or a no-reliance clause to the effect the plaintiff is not relying on the defendant's representations, except for those made in the written agreement, courts have applied a facts-and-circumstances approach to determine whether the plaintiff could reasonably rely on the alleged oral promises. This approach takes into account factors such as the plaintiff's sophistication and the extent of his participation in negotiating the contract.<sup>236</sup> Courts have consistently found reasonable reliance lacking when the plaintiff is a business entity or an individual with solid business experience. In so finding, courts have rejected the argument that the merger clause and the no-reliance clause are boilerplate provisions in standard contracts.<sup>237</sup> It is

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<sup>234</sup> See, e.g., *Harsco Corp. v. Segui*, 91 F.3d 337, 340, 345 (2d Cir. 1996) (holding that the plaintiff could not fairly claim that disclaimers prevented it from protecting its substantive rights as the parties' agreement, which was a sixty-plus page, single-spaced written document with a fourteen-page long section on specific representations and warranties, was the result of months of negotiations and the plaintiff's extensive due diligence); *FS Photo, Inc. v. PictureVision, Inc.*, 61 F. Supp. 2d 473, 480–82 (E.D. Va. 1999) (finding that a broad and sweeping disclaimer provision to the effect that the "[a]greement 'supersedes any and all prior or contemporaneous agreements, representations and understandings between the parties,'" coupled with the lack of specific representations in the agreement which might have prompted the plaintiffs to conduct due diligence on the defendants' oral misrepresentations, constituted a violation of section 29(a) of the Exchange Act).

<sup>235</sup> See, e.g., *FS Photo*, 61 F. Supp. 2d at 484–85.

<sup>236</sup> E.g., *id.* at 480.

<sup>237</sup> See, e.g., *Jackvony v. RIHT Fin. Corp.*, 873 F.2d 411, 415–17 (1st Cir. 1989) (holding that the merger clause and the no-reliance clause in the parties' contract precluded the



worth noting that a fiduciary relationship between the parties existed in some cases but did not alter this outcome.<sup>238</sup>

When the plaintiff is a business entity and seeks to introduce evidence of an oral “Contradictory Understanding” to contradict a specific written representation, courts have consistently held the plaintiff’s reliance on the oral promise is unreasonable. A widely cited case on this point is *Citibank v. Plapinger*, in which the guarantors of a loan refused to honor their guarantee on the ground that it was induced by the creditors’ oral promise of a credit line to accompany the loan in question.<sup>239</sup> The guarantee provision in the loan agreement provided the guarantee was “absolute and unconditional irrespective of any lack of validity or enforceability of the guarantee, or any other circumstance which might otherwise constitute a defense available to guarantor in respect of the guarantee ....”<sup>240</sup> The court pointed out the loan agreement made a specific representation as opposed to a general exclusion with regard to the unqualified nature of the guarantee, and held the defendant could not realistically rely on an oral promise that directly contradicted the subject of a specific disclaimer in a written agreement signed by both parties.<sup>241</sup>

The holding in *Citibank* has been consistently followed by other courts in litigation arising from securities transactions. A written disclaimer to the effect the seller of a security makes no representation or warranty with regard to the future value of the security precludes the buyer’s reliance on any oral representations otherwise.<sup>242</sup> A written disclosure describing a security

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plaintiff’s reliance on the defendant’s oral promise that it would operate the acquiree as an independent entity either for five years or forever because the plaintiff was sophisticated in business matters, participated in drafting the contract, and the alleged promise of independence was vague); see also *Rissman v. Rissman*, 213 F.3d 381, 384–85 (7th Cir. 2000) (refusing to enforce an oral promise because the contract contained a merger clause and a no-reliance clause despite plaintiff’s reliance argument in that he sold his shares to the defendant at a lower price in light of the latter’s oral promise that he would never take the company public or sell it to another entity).

<sup>238</sup> See *Rissman*, 213 F.3d at 388–89. Although the court in *Rissman* did not discuss explicitly whether its decision would still hold if the parties had a fiduciary relationship, the defendant indeed owed a fiduciary duty to the plaintiff as the defendant was a majority shareholder and a director while the plaintiff was a minority shareholder and a salesman without an active role in the management of the company. *Id.* at 382, 388–89. For a discussion of Illinois law on this point, see generally Thomas J. Bamonte, *Expanding the Fiduciary Duties of Close Corporation Shareholders: The Dilemma Facing Illinois Corporate Law*, 15 N. ILL. U. L. REV. 257 (1995).

<sup>239</sup> *Citibank, N.A. v. Plapinger*, 485 N.E.2d 974, 975–76 (N.Y. 1985).

<sup>240</sup> *Id.* at 974.

<sup>241</sup> *Id.* at 976–77 (“[B]ut here we do not have the generalized boilerplate exclusion referred to by the commentators. Rather, following extended negotiations between sophisticated business people, what has been hammered out is a multimillion dollar personal guarantee proclaimed by defendants to be ‘absolute and unconditional.’”).

<sup>242</sup> See, e.g., *Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996).

as risky precludes an investor's reliance on a broker-dealer's oral statement that the security is not risky.<sup>243</sup> For claims alleging violations of suitability rules, written disclaimers do not have to disclaim suitability per se in order to preclude reasonable reliance by an investor on a broker's oral promise of suitability. The investor is imputed with knowledge of risks clearly disclosed in written investment documents, and if the disclosures have painted a gloomy risk profile for the security in the eyes of a reasonable investor, reasonable reliance on a broker's oral representation cannot be established.<sup>244</sup>

The disclaimers cited at the beginning of this subsection are drawn from *MBIA* and are illustrative of the breadth of their coverage.<sup>245</sup> That court pointed to the fact that the disclaimers signed by the plaintiffs were specific with regard to the plaintiffs' capability to assess the risk of the credit default swap (CDS) contracts and the underlying collateral, and to the plaintiffs' undertaking of performing independent investigation.<sup>246</sup> The court also noted the CDS contract and guarantees were the product of intensive negotiations among parties with a high level of sophistication and business acumen.<sup>247</sup> In light of these factors, the court, citing *Citibank*, held the plaintiffs should not be allowed to disavow the responsibilities they committed themselves to and "condone [their] own fraud in deliberately misrepresenting [their] true intention when putting their signatures to their absolute and unconditional guarantee."<sup>248</sup> The court's decision was affirmed on appeal, and the appellate court further concluded plaintiffs could not bring common law claims for fraud in the inducement of contract, fraud by omission, or negligent misrepresentation, all of which require reasonable reliance on representations the plaintiffs expressly stated they were not relying on.<sup>249</sup>

Would a fiduciary relationship have altered the outcome of these cases? In *Carr*, the court rejected the investor's claim that the fiduciary relationship between him and the broker warranted his reliance on the broker's oral misrepresentation about the riskiness of the investment.<sup>250</sup> According to this court, as long as the investor is a competent adult (let alone a sophisticated and well-capitalized institution), and in the absence of "such a degree of trust invited by and reasonably reposed in the fiduciary *as to dispel any duty of*

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<sup>243</sup> See *Carr v. CIGNA Sec., Inc.*, 95 F.3d 544, 548 (7th Cir. 1996).

<sup>244</sup> See *Brown v. E.F. Hutton Grp., Inc.*, 991 F.2d 1020, 1029–32 (2d Cir. 1993).

<sup>245</sup> *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 27 Misc. 3d 1233(A), at \*3–4 (N.Y. Sup. Ct. 2010).

<sup>246</sup> *Id.* at \*3–4.

<sup>247</sup> *Id.*

<sup>248</sup> *Id.* at \*5 (quoting *Citibank v. Plapinger*, 485 N.E.2d 974, 977 (1985)) (citation omitted) (internal quotations omitted).

<sup>249</sup> *MBIA Ins. Corp. v. Merrill Lynch*, 81 A.D.3d 419, 419–20 (N.Y. App. Div. 2011).

<sup>250</sup> *Carr v. CIGNA Sec., Inc.*, 95 F.3d 544, 547–48 (7th Cir. 1996).

*self-protection by the principal[.]*” the investor is bound by the clearly written disclaimers he has signed.<sup>251</sup> Is a sophisticated institutional investor entitled to trust a fiduciary who presents it with elaborate disclaimers inconsistent with oral representations to such a degree as to “dispel any duty of self-protection?” Likely not. Indeed, based on cases discussed earlier in this section, investors are required to investigate in such a situation or else are barred from claiming reasonable reliance.<sup>252</sup>

In sum, investors have only a limited recourse against a broker-dealer or investment adviser through private lawsuits. The investor must show the broker-dealer’s conduct constituted fraud in violation of section 10(b) and SEC Rule 10b-5. In order to establish a fraud claim, the investor must prove he reasonably relied on misrepresentations of the defendant. This requirement poses an almost insurmountable obstacle in lawsuits against broker-dealers because they typically seek to shield themselves from potential liability by requiring investors to sign elaborate provisions disclaiming investors’ reliance on the brokers’ oral representations. Courts have been inclined to enforce such disclaimers on the grounds that institutional investors are sophisticated investors and therefore should be bound by what they sign. Fiduciary duty is unlikely to alter this result.

### *C. Private Right of Action under Common Law*

Instead of bringing a private action under section 10(b) of the Exchange Act and SEC Rule 10b-5, an investor can sue his broker-dealer (as well as investment adviser) in a state court under the common law doctrines of fraudulent inducement of contract and negligent misrepresentation. The common law claim, however, may be subject to preemption under Securities Litigation Uniform Standards Act of 1998 (SLUSA).<sup>253</sup>

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<sup>251</sup> *Id.* at 548 (emphasis added).

<sup>252</sup> See discussion *supra* Part II.B.1.

<sup>253</sup> 15 U.S.C.A. § 78bb (West 2013). SLUSA preempts many class actions based on misrepresentations or omissions made in connection with the purchase or sale of a nationally traded security. SLUSA’s preemption provision states that:

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

*Id.* § 78bb(f). Not all fraud claims involving securities that are brought under state law are preempted by SLUSA. The preemption provision is limited to securities that are traded on a

The fraudulent inducement of contract doctrine requires the investor to establish in essence the same elements as a securities fraud claim, including reasonable reliance.<sup>254</sup> A negligent misrepresentation claim typically requires the plaintiff to establish elements as laid out in section 552 of the Restatement (Second) of Torts:

- that the provider acted either “in the course of the [provider’s] business, profession or employment, or in any other transaction in which [the provider] ha[d] a pecuniary interest” in the information supplied;
- that he “supplie[d] false information for the guidance of others in their business transactions”;
- that the recipient of the information *justifiably relied* on it;
- that the provider “fail[ed] to exercise reasonable care or competence in obtaining or communicating the information”; and
- that this failure caused pecuniary loss to the plaintiff.<sup>255</sup>

Since both fraudulent inducement of contract and negligent misrepresentation claims require reasonable reliance on the part of the plaintiff,<sup>256</sup> institutional investors who have signed disclaimer provisions are similarly unlikely to prevail on these common law claims as on a securities fraud claim.<sup>257</sup>

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national exchange, applies only to class actions, and has carved out a number of exceptions and exclusions. *Id.* § 78bb(f)(3)–(5).

<sup>254</sup> See, e.g., *Richmond Metro. Auth. v. McDevitt St. Bovis, Inc.*, 507 S.E.2d 344, 347 (Va. 1988); *Micrel, Inc. v. TRW, Inc.*, 486 F.3d 866, 874 (6th Cir. 2007); *Taylor Woodrow Homes Fla., Inc. v. 4/46-A Corp.*, 850 So. 2d 536, 542 (Fla. Dist. Ct. App. 2003); *Kaddo v. King Serv. Inc.*, 250 A.D.2d 948, 949 (N.Y. App. Div. 1998); *In re Allegheny Int’l, Inc.*, 954 F.2d 167, 178 (3d Cir. 1992).

<sup>255</sup> RESTATEMENT (SECOND) OF TORTS § 552 (1977); see, e.g., *Zurad v. Lehman Bros. Kuhn Loeb, Inc.*, 757 F.2d 129, 134 (7th Cir. 1985) (finding that an omission by an investment firm concerning the recent market price and suspension of trading of the stock held by the plaintiff, along with the provision of some faulty information, constituted a misrepresentation of fact for the purpose of a negligent misrepresentation claim); *Penrod v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 385 N.E.2d 376, 381–82 (Ill. App. Ct. 1979) (finding that broker could be subject to liability for negligent misrepresentation for giving wrong information about the window of tender offer opportunity for the stocks held by his client).

<sup>256</sup> See *Cont’l Leavitt Commc’ns, Ltd. v. PaineWebber, Inc.*, 857 F. Supp. 1266, 1272 (N.D. Ill. 1994) (stating that reasonable reliance is an element of a negligent misrepresentation claim); *Henneberry v. Sumitomo Corp. of Am.*, 532 F. Supp. 2d 523, 538 (S.D.N.Y. 2007) (“Under New York law, a claim of negligent misrepresentation lies where (1) the defendant had a duty, as a result of a special relationship, to give correct information; (2) the defendant made a false representation that he or she should have known was incorrect; (3) the information supplied in the representation was known by the defendant to be desired by the plaintiff for a serious purpose; (4) the plaintiff intended to rely and act upon it; and (5) the plaintiff reasonably relied on it to his or her detriment.” (citations omitted)).

<sup>257</sup> See *Banca Creml, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1037–39 (4th Cir. 1997) (stating that the same facts that preclude the finding of reasonable reliance for

Reasonable reliance, however, is not an element of a common law fiduciary breach claim, which requires merely showing that: reasonable reliance, however, is not an element of a common law fiduciary breach claim, which only requires showing that “there [] exist[s] a fiduciary relationship between the plaintiff and defendant, the defendant [has] breached its fiduciary duty to the plaintiff, and the defendant's breach [] result[ed] in injury to the plaintiff, or benefit to the defendant.”<sup>258</sup>

It seems that imposing fiduciary duty on broker-dealers could at least allow institutional investors to prevail on their fiduciary breach claims, irrespective of any disclaimer they have signed. However, it is unclear whether an investor can bring an action for fiduciary breach arising from violations of the securities statutes in light of the Supreme Court's decision in *Transamerica Mortgage Advisors*.<sup>259</sup> In that case, shareholders of a real estate investment trust filed derivative and class action suits against the trustees of the Mortgage Trust of America, claiming they were guilty of various frauds and breaches of fiduciary duties in the course of advising or managing the trust, causing the trust to purchase securities of inferior quality from a third entity.<sup>260</sup> The lawsuit was brought under section 206 of the Investment Advisers Act and the common law doctrine of breach of fiduciary duty.<sup>261</sup> The District Court for the Northern District of California ruled the Investment Advisers Act confers no private right of action for damages, including parallel claims under the common law, and accordingly dismissed the complaint.<sup>262</sup> The United States Court of Appeals for the Ninth Circuit reversed, holding the “implication of a private right of action for injunctive relief and damages under the [Investment] Advisers Act in favor of appropriate plaintiffs is necessary to achieve the goals of Congress in enacting the legislation.”<sup>263</sup> The Supreme Court granted certiorari and reversed the Ninth Circuit's decision on the ground that Congress did not intend for the

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an SEC Rule 10b-5 claim also preclude the same finding for purposes of common law fraud and negligent misrepresentation claims); *Cont'l Leavitt Commc'ns, Ltd.*, 857 F. Supp. at 1270–71 (exemplifying the general rule that, in a negligent misrepresentation claim, if an accurate written material is provided, the plaintiff cannot rely on contradictory oral representations unless the plaintiff lacks the information necessary to evaluate the representation and the plaintiff has placed trust in the defendant).

<sup>258</sup> *Punts v. Wilson*, 137 S.W.3d 889, 891 (Tex. App. 2004) (making no mention of reasonable reliance as an element of the cause of action). See also *Jones v. Blume*, 196 S.W.3d 440, 447 (Tex. App. 2006).

<sup>259</sup> *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

<sup>260</sup> *Id.* at 13.

<sup>261</sup> *Id.*

<sup>262</sup> *Id.* at 14.

<sup>263</sup> *Lewis v. Transamerica Corp.*, 575 F.2d 237, 239 (9th Cir. 1978).

fiduciary obligations of investment advisers under section 206 of the Investment Advisers Act to be enforced by private litigation.<sup>264</sup>

In light of *Transamerica Mortgage Advisors* and Congress's desire of achieving regulatory parity for broker-dealers and investment advisers, there is a substantial uncertainty whether investors can bring a private action against broker-dealers for breach of a fiduciary duty. However, without such a private right of action, and given institutional investors' narrow chance of winning a fraud or negligence claim under the securities statutes or the common law, extending a fiduciary duty to broker-dealers will likely have little impact on investors' ability to enforce broker-dealers' obligations through private litigations.

### III. REGULATORY POLICY IMPLICATIONS

Based on discussions in the previous parts of this Article, it appears that imposing a fiduciary duty on broker-dealers will have only a limited effect on institutional investor protection. Fiduciary duties comparable to that borne by investment advisers entails a duty to disclose material facts (including conflicts of interest), a duty not to subordinate the interests of clients to the interests of the broker-dealers, and a duty to use reasonable diligence to avoid making unsuitable recommendations. Such duties are already covered in the existing securities statutes and FINRA's suitability rules, and broker-dealers are held liable for violating them, either intentionally or negligently, just as investment advisers are. The only scenario in which broker-dealers *probably* face a reduced duty of care to an institutional client is when FINRA's suitability exemption applies, in which case broker-dealers are relieved from performing a suitability analysis for the client.<sup>265</sup> However, this exemption applies only to qualified institutional investors who have substantial capital resources, only when broker-dealers reasonably believe that the investors are capable of evaluating risks independently, and only if the investors acknowledge in writing that they are exercising independent judgment about the risks and merits of the investment rather than relying on the broker-dealers' recommendations.<sup>266</sup> The exemption requires that all three conditions be satisfied to apply. Thus, the *potential* benefit of imposing a fiduciary duty on broker-dealers extends only to a subset of institutional investors and only in limited situations. By exempting broker-dealers that have met the above conditions, FINRA has manifested its belief that these institutional investors in such situations do not need the protection of the suitability

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<sup>264</sup> *Transamerica Mortg. Advisors*, 444 U.S. at 22–25.

<sup>265</sup> See discussion of regulatory ambiguity *supra* Part I.B.2.c.

<sup>266</sup> See discussion of FINRA's exemption *supra* Part I.B.2.c.

rule; the SEC, by approving the FINRA suitability exemption, has concurred in this belief. Proponents of a fiduciary duty for broker-dealers have argued that institutional investors need this extra protection because they often are not sophisticated in dealing with complex financial products.<sup>267</sup> It should be emphasized that the FINRA suitability exemption does not apply *automatically* to transactions involving institutional investors: if broker-dealers do not have a reasonable ground to believe that the investors are indeed capable of assessing the risks of the security they recommend, the suitability obligation remains with the broker-dealers.<sup>268</sup> In addition, even when the FINRA exemption applies, broker-dealers are still subject to the anti-fraud provisions of the securities statutes, which prohibit misrepresentations of material facts pertinent to the recommended securities.<sup>269</sup> For example, in the *Goldman Sachs* case,<sup>270</sup> Goldman Sachs's failure to disclose its conflict of interest was found by the SEC to constitute a violation of the anti-fraud statutes, even though Goldman Sachs might be able to benefit from the FINRA suitability exemption given that the investors in the CDOs were institutions with substantial experience in structured finance products.

If fiduciary duty is indeed imposed on broker-dealers, Congress and the SEC must also address the question of whether institutional investors can waive broker-dealers' duties by contract. There are situations in which it is mutually beneficial for the parties to sign a waiver, such as when the institutional investor is truly sophisticated and desires to waive the broker's suitability assessment in exchange for a lower brokerage fee. Can the broker-dealer's suitability obligation, imposed as a part of his fiduciary duties, be waived in such a situation? The common law allows contractual modifications of the duties of a fiduciary,<sup>271</sup> and the SEC has opined that modification of an investment adviser's liabilities through a hedge clause is not a per se violation of section 206 of the Investment Advisers Act.<sup>272</sup> To disallow a waiver creates

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<sup>267</sup> See, e.g., 156 CONG. REC. S3104, SA 3792 (daily ed. May 4, 2010) (proposal of Sen. Barbara Boxer).

<sup>268</sup> See discussion *supra* Part I.B.2.c.

<sup>269</sup> See discussion of continued application of the anti-fraud provisions to broker-dealers who are subject to FINRA's exemption *supra* Part I.B.2.c.

<sup>270</sup> See discussion *supra* Introduction and note 15.

<sup>271</sup> See Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1213–14 (1995) (discussing conditions under which modifications of fiduciary duties have been upheld by courts).

<sup>272</sup> A "hedge clause" typically is used in an investment advisory contract to absolve the adviser from liability except for gross negligence, reckless or willful conduct and is typically followed immediately by a non-waiver clause which invalidates waiver of any rights that are non-waivable under applicable law. See Heitman Capital Mgmt., LLC, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 159, at \*25–28, \*30–31 (Feb. 12, 2007) (citing *In re* William Lee Parks, Investment Advisers Act Release No. 736 (Oct. 27, 1980) and *In re* Olympian Fin.

inconsistencies in the law and is also against the spirit of free contract, but to uphold a waiver would put the parties in exactly the same position as they are under the current regulatory regime with the FINRA exemption. Fiduciary duty has created an illusion of institutional investor protection, but it really is much ado about nothing.

A more viable approach to enhancing institutional investor protection is broadening the scope of private rights of action and abandoning a strict contractarian approach to determining the validity of disclaimer provisions signed by investors. The current limitation of private rights of action to fraud cases, the ensuing requirement of “reasonable reliance,” and elaborate boilerplate disclaimers inserted in investment contracts effectively deprive institutional investors of opportunities to recover damages through private litigation. Investors must rely on enforcement actions brought by the SEC or FINRA. SEC officials have openly acknowledged that constraints in the agency’s budget and statutory power have prevented the agency from reaching the optimal level of enforcement,<sup>273</sup> and the SEC has been an ardent advocate for a broader scope of private rights of action as a way of supplementing its enforcement efforts.<sup>274</sup> Imposing fiduciary duty without simultaneously making private rights of action more accessible to investors brings

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Servs., Inc., Investment Advisers Act Release No. 659 (Jan. 16, 1979)) (advising that a hedge clause only violates section 206(1) and 206(2) of the Investment Advisers Act if it is likely to lead an investment advisory client to believe that he or she has waived non-waivable rights of action against the investment adviser under federal or state law, and that, in this regard, the validity of the hedge clause depends on facts and circumstances of each case, including the advisory client’s sophistication).

<sup>273</sup> See Elisse B. Walter, Comm’r, U.S. Sec & Exch. Comm’n, Remarks Before the FINRA Institute at Wharton Certified Regulatory and Compliance Professional (CRCP) Program \*2–3 (Nov. 8, 2011), available at [http://www.sec.gov/news/speech/2011/spch110811ebw.htm#P8\\_192](http://www.sec.gov/news/speech/2011/spch110811ebw.htm#P8_192) (“In its amicus brief in *Borak*, for example, the Commission argued that ‘limitations of manpower present [sic] the Commission from bringing enforcement actions for all violations’ .... What I mean is that by limiting implied private rights through strict statutory interpretation, the Court has also potentially limited the express public rights of action contained in the statute.... Aside from budgetary constraints, there are also limitations on the Commission’s authority. For example, it cannot seek damages for violations of the federal securities laws, although it can require wrongdoers to disgorge their ‘ill-gotten gains.’ Thus, while the agency can require wrongdoers to give up the benefits they have received from violations, it cannot necessarily make the victims whole.”).

<sup>274</sup> See, e.g., Brief for the United States as Amicus Curiae at 3, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); Brief for the Securities and Exchange Commission as Amicus Curiae at 2, *Capital Mgmt. Select Fund Ltd. v. Bennett*, 680 F.3d 214 (2d Cir. 2012) (“Although the district court’s holding regarding standing does not affect the Commission’s ability to bring enforcement actions for the conduct alleged here, private actions are an ‘essential element’ to Commission enforcement actions.”); see also David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 6 WIS. L. REV. 1167, 1170 (1989).



little improvement upon the current state in which only a limited number of violations are sanctioned and investors are often unable to recover the full extent of their damages. However, the Supreme Court has taken an alarmingly restrictive stance toward private rights of action in a series of recent cases.<sup>275</sup> Dodd-Frank mandated that the SEC conduct a study about the cross-border scope of private rights of action under section 10(b) of the Exchange Act.<sup>276</sup> The time has also arrived for a study on broadening the domestic scope of private rights of action beyond the current restriction to fraud cases. In addition, it has long been argued in legal scholarship that courts should abandon a strict contractual approach toward disclaimer provisions in securities transactions, as institutions function through their individual investment officers who are just as prone to behavioral irrationality as are individual investors.<sup>277</sup> Courts have given scant attention to such pleas as

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<sup>275</sup> See *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 166–67 (2008) (holding that investors do not have a right of private action against third parties who only aided and abetted without having a direct fiduciary duty or making direct misrepresentations to investors because the investors’ reliance is too remote); *Janus Capital Grp.*, 131 S. Ct. at 2304 (finding that false statements in a mutual fund’s prospectus were made by the fund itself and not the fund’s investment adviser and parent company even though the parent company prepared the prospectus and marketed it on behalf of the fund; also arguing that the court must give narrow dimensions to rights of action under the anti-fraud provisions of the securities statutes); *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2881, 2888 (2010) (arguing that because the Exchange Act is silent on the extraterritorial reach of section 10b the court must presume that Congress intended to limit its application to securities transactions occurring within the United States; also holding, as a result, that purchasers of shares of a company listed on a foreign exchange do not have a right of action against the company under section 10b even though the company allegedly defrauded investors about the value of an asset acquired in the U.S.).

<sup>276</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 929Y, H.R. 4173, 110th Cong. (2010). To respond to Dodd-Frank’s mandate, the SEC produced a report of the study in April 2012 in which it advanced a few options that Congress could consider in formulating the law in this regard. See U.S. SEC. & EXCH. COMM’N, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 vi–vii (2012), available at <http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf>.

<sup>277</sup> See Prentice, *supra* note 230, at 358–77. Prentice discusses the nine reasons why, from the viewpoint of behavioral science, people do not read the contracts they sign: (1) lack of time or energy to comprehend all contractual provisions, (2) overconfidence, over-optimism and lack of skills at calculating probabilities, (3) naïvely positive perceptions of other people, (4) inability to detect deception, (5) inability to discard information even when the source of information is found to be questionable, (6) tendency to be influenced more by personal encounters than fine-print disclaimers, (7) reluctance to alter a written contract because it embodies the status quo of a bargaining result, (8) the “social proof” mentality towards boilerplate disclaimers, i.e., there are a lot of people like me investing in stock and they all signed this contract, too, and (9) a tendency to accept pre-printed contracts as the norm and any changes thereto as an abnormal situation. *Id.*

evidenced by their consistent denial of recovery by institutional investors on the basis of written disclaimers.<sup>278</sup> In this regard, FINRA's suitability-exemption rule represents a positive step toward the right direction, as it builds on not only written disclaimers of an institutional investor but also a reasonableness test that gives effect to such disclaimers only if broker-dealers reasonably believe they reflect the true capability of the institutional investor.

#### CONCLUSION

The losses suffered by investors during the 2008 financial crisis and the publicity of abusive practices by broker-dealers toward their clients prompted Congress to inquire about the feasibility of imposing a fiduciary duty on broker-dealers so as to enhance investor protection and eliminate the perceived disparity between the standard of conduct of broker-dealers and that of investment advisors. The scope of this inquiry covered broker-dealers' dealings with both retail investors and institutional investors, such as corporations, investment funds, organizations, and government entities. The institutional investor part of the inquiry turned out to be highly controversial, with both supporting and opposing voices raised from financial market professionals. Arguments have centered on whether institutional investors need a higher level of protection given the depth of their sophistication and the abundance of their capital resources.

This Article shows that the focal point of this debate should not be whether institutional investors *in general* need a higher level of protection, but rather whether *the subset* of institutional investors that are well-capitalized, capable of evaluating risks, and willing to sign a written disclaimer that they are not relying on broker-dealers' advice need a higher level of protection. This is because broker-dealers' standard of conduct under the current regulation is lower than that of investment advisors (who are fiduciary) only with regard to this subset of institutional investors. Once our inquiry focuses on this subset of investors, the potential benefit of a broker-dealer fiduciary duty appears quite limited. This paper also shows that fiduciary duty is predictably impotent in enforcing broker-dealers' standard of care through private litigations because it cannot, based on existing case law, override the effect of elaborate disclaimers that bar investors' claims of reasonable reliance on broker-dealers' advice. As for enforcement actions brought by the SEC or FINRA, fiduciary duty is not a necessary element of the cause of action under the existing regulation, and the agencies can pursue

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<sup>278</sup> See discussion *supra* Part II.B.2.

violators of law even if they are not fiduciary. The benefits of fiduciary duty are impalpable.

Financial market professionals have voiced concerns that the imprecise boundaries of fiduciary duty and the fear that its overbroad application may have a chilling effect on beneficial economic activities.<sup>279</sup> Hopefully, the results of this Article help Congress and the SEC balance the pros and cons of the fiduciary duty initiative and reach a sensible conclusion about the advisability of its implementation in the financial market.

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<sup>279</sup> See Larry E. Ribstein, *Fiduciary Duties of Investment Bankers: Senate Testimony—May 4, 2010* 6–8 (U. Ill. L. & Econ. Research Paper No. LE10-019), available at <http://ssrn.com/abstract=1661285>.