# ARE EXISTING STOCK BROKER STANDARDS SUFFICIENT? PRINCIPLES, RULES, AND FIDUCIARY DUTIES

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*In recent years there has been concern as to the adequacy of broker-dealer regulation. SEC and self-regulatory organization rulemaking address specific types of broker-dealer conduct, but by and large the regulation has been based on principles and standards rather than voluminous detailed rules specifying prohibited conduct. In particular, a good deal of broker-dealer conduct is addressed under the umbrella of regulating according to fair and just principles of trade. Similarly, much of the SEC's rulemaking authority is*

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*based on the ability to prohibit fraudulent, manipulative, and deceptive devices. It also has been suggested that broker-dealers should be subject to fiduciary duties, but to a large degree, they already are. This Article examines the extent to which principles-based regulation or the setting of general standards should be further supplemented by rulemaking addressing specific types of conduct.*

## I. INTRODUCTION—THE PROBLEM AT HAND

Broker-dealer regulation under the federal securities laws is administered by the Securities and Exchange Commission ("SEC") as well as the self-regulatory organizations, including the securities exchanges. The SEC and the relevant self-regulatory organizations have developed their regulation in piecemeal fashion. In recent years there has been concern as to the adequacy of current regulation. A considerable amount of rulemaking addresses specific types of broker-dealer conduct, but, by and large, the regulation has been based on principles and standards rather than voluminous detailed rules addressing specific conduct under regulation. In particular, a good deal of broker-dealer conduct is addressed under the umbrella of regulating according to fair and just principles of trade.[1] Also, much of the SEC's rulemaking authority is based on the ability to prohibit fraudulent, manipulative, and deceptive devices.[2] One issue that has developed over the last decade is the

[1] *See, e.g.*, FINRA Manual Rule 2010, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905&element_id=5504&highlight=2010#r6905 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.").

[2] Section 10(b) of the Securities Exchange Act of 1934 empowers the SEC to promulgate rules to prohibit manipulative and deceptive devices in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b) (2010), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 15(c) of the Securities Exchange Act gives the SEC similar rulemaking authority with respect to broker-dealer activities. 15 U.S.C. § 78o(c) (2010), *amended by* 124 Stat. 1376 (2010).

extent to which principles-based regulation or the setting of general standards should be further supplemented by rulemaking addressing specific types of conduct. The extent to which broker-dealers are or should be subject to fiduciary duties is another issue that has been at the forefront due to recent financial events. This Article analyzes those issues first as a general proposition and then by examining the current state of broker-dealer regulation.

Following the financial crisis and frauds such as those perpetrated by Bernard Madoff,[3] there was considerable discussion of creating explicit stock broker fiduciary duties. Although this inspired fear within the industry,[4] it is far from clear that such a mandate would significantly change the current law. These calls for heightened duties also arose in the context of the Goldman Sachs ("Goldman") investigation. Both the SEC and Congress investigated Goldman for its role in the over-the-counter derivatives markets. Specifically, there was concern over Goldman's role as fabricator of the derivative instruments and the ways in which Goldman marketed them to its customers.[5] Goldman maintained that it was merely acting as a market maker and, as such, had no disclosure duties to its customers regarding Goldman's allegedly betting against the investments that it was marketing.

This led many to suggest that it be clarified that brokers are in fact fiduciaries. The SEC brought charges against

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[3] *Cf.* Anwar v. Fairfield Greenwich Ltd., No. 09 Civ. 0118(VM), 2010 WL 3022848, at *17 (S.D.N.Y. July 29, 2010) (upholding state law claims against defendants who steered investors to Madoff controlled investments).

[4] *See, e.g.*, Joe Rauch, *Retail Brokers Fear New Law Could Bring Sea Change*, REUTERS, Oct. 30, 2009, http://www.reuters.com/article/idUSTRE59T4C120091030 (noting also that the proposed fiduciary duty language was suggested by SEC Chair Mary Schapiro).

[5] *See, e.g.*, Andrew Ross Sorkin, *Goldman Acknowledges Conflicts with Clients*, N.Y. TIMES DEALBOOK, Jan. 12, 2010, http://dealbook.blogs.nytimes.com/2010/01/12/goldman-executive-discloses-conflicts-policy/.

Goldman[6] claiming that Goldman breached its obligations as a broker of these privately placed derivatives. Congressional or SEC recognition of broker-dealer fiduciary duties addressed Goldman's market maker defense as well as the obligations of those brokers who brought their clients to Bernard Madoff.

Nevertheless, it is far from clear that these obligations do not exist under current law. The Goldman Sachs settlement[7] means, among other things, that the extent of Goldman's obligations to its clients was not clarified by the courts. As discussed below, there is plenty of authority under the existing law that recognizes heightened obligations of securities broker-dealers, at least when they are acting in a capacity beyond that of mere order taker.

Many observers identified a perceived need for more explicit recognition of broker-dealer fiduciary duties. It would have been more accurate to describe this as enhancing fiduciary duties since, as pointed out in Part IV of this Article, it has long been the case that stock brokers owe fiduciary duties when acting in certain capacities. As the financial reform legislation developed, controversy arose as to whether to statutorily impose new fiduciary duties. Investor-protection advocates supported such a move. Not surprisingly, the industry and others opposed the suggestion. To the extent that these duties already exist, the suggestion may have been less meaningful than thought by its advocates.[8] In any event, the final legislation eschewed a

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[6] *See* Complaint, SEC v. Goldman Sachs & Co., No. 1:10-CV-03229, 2010 WL 1508202 (S.D.N.Y. 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf.

[7] *See* SEC v. Goldman Sachs & Co., SEC Litigation Release No. 21592, No. 10 Civ. 3229 (July 15, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21592.htm; Patricia Hurtado & Christine Harper, *SEC Settlement with Goldman Sachs for $550 Million Approved by U.S. Judge*, BLOOMBERG, (July 21, 2010), http://www.bloomberg.com/news/2010-07-20/goldman-sachs-settlement-with-sec-for-550-million-approved-by-u-s-judge.html.

[8] Even as a tactical matter, this proposal was fraught with danger. Congressional rejection of a fiduciary duty requirement could have a narrowing impact on current case law and rulemaking.

statutorily mandated fiduciary duty.[9] Instead, Congress directed the SEC to conduct a study to identify any gaps, shortcomings, or overlapping regulation regarding standards of conduct and supervision requirements applicable to broker-dealers and investment advisers.[10] The upshot of the new legislation is that broker-dealer standards of conduct will continue to develop piecemeal through rulemaking and case law developments.

The Article concludes that although some additional rulemaking may be warranted as a conceptual matter, the current approach to broker-dealer obligations is appropriate and provides an adequate basis for vigorous enforcement of broker-dealer obligations notwithstanding some apparent enforcement lapses in a few celebrated cases.[11] The law, regulations, and regulatory interpretations to date make clear that broker-dealers have fiduciary or fiduciary-like obligations when they provide services beyond executing customer orders.[12] A legislative or regulatory declaration that brokers can be scrutinized under a fiduciary analysis is not necessary but could provide a cautionary reminder to this effect.

## II. THE NEW CONGRESSIONAL MANDATE

In the wake of the recent credit and financial crisis, questions were raised as to whether Congress should strengthen broker-dealer regulation. While clearly

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[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010).

[10] § 913(b)(2), 124 Stat. at 1824–25.

[11] There was considerable controversy concerning the SEC's failure to make a timelier discovery of the frauds perpetrated by Bernard Madoff and Alan Stanford. *See, e.g.*, Clifford Krauss, Philip L. Zweig & Julie Cresswell, *Texas Firm Accused of $8 Billion Fraud*, N.Y. TIMES, Feb. 17, 2009, *available at* http://www.nytimes.com/2009/02/18/business/18stanford.html (describing the Stanford allegations); Diana Henriques, *Madoff Fraud Rippled Around the World*, N.Y. TIMES, Nov. 21, 2008, *available at* http://www.nytimes.com/2008/12/21/business/worldbusiness/21iht-madoff.4.18852346.htm (describing the magnitude of the Madoff fraud).

[12] *See infra* Part V.C.

indicating that regulation should be strengthened, Congress declined to impose a statutory mandate of heightened obligations. Instead, Congress left it to the SEC to decide the appropriate level of regulation. Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the SEC to complete a study and report within six months of the bill's passage an assessment on "the effectiveness of existing legal or regulatory standards of care" for broker-dealers.[13] The Act directs the SEC to look at issues such as whether there exist any "gaps, shortcomings, or overlaps" in law or regulations in this area.[14] As required by the Act, the SEC solicited public comment[15] following the study and report, such that the SEC may now proceed with rulemaking proceedings to deal with the issue of standard of care owed by brokers and dealers to retail customers.[16] An explicit declaration of a fiduciary duty, without more, would add little other than confusion to the existing law.[17]

Section 913(g) of the Dodd-Frank Act expressly provides the SEC with rulemaking authority to impose a fiduciary duty on broker-dealers.[18] For instance, the Commission may choose to issue a rule which places on broker-dealers who give investment advice to retail clients the same fiduciary duty as that currently placed on investment advisers under the Investment Advisers Act of 1940 ("the Investment Advisers Act").[19] It is not clear that this would impose

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[13] § 913(b)(1), 124 Stat. at 1824–27.

[14] § 913(c), 124 Stat. at 1825.

[15] *See* SEC Publishes Public Request for Comment to Inform Study of Obligations of Broker-Dealers and Investment Advisers, Dodd-Frank Act Release No. 2010-134 (July 27, 2010), http://www.sec.gov/news/press/2010/2010-134.htm (July 27, 2010); § 913(e), 124 Stat. at 1827.

[16] § 913(f), 124 Stat. at 1827–28.

[17] *See, e.g.*, Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 456 (2010) ("[A]n open-ended broker fiduciary obligation is so loaded with unanswered questions that baseline predictability would come slowly, if at all.").

[18] § 913(g), 124 Stat. at 1827–28.

[19] § 913(g)(1), 124 Stat. at 1828 (amending § 15 of the Securities Exchange Act of 1934, 15 U.S.C. § 78o).

significantly greater duties on stock brokers.[20] Fiduciary duties existed under the Investment Advisers Act without having been expressly incorporated into the statute. In 1963, the Supreme Court held that, under the Investment Advisers Act, investment advisers are *fiduciaries* to their clients, and as such, must comply with the fiduciary duties of care and loyalty even though the word fiduciary did not appear in the Investment Advisers Act.[21] As applied, this fiduciary duty meant that investment advisers must fully disclose material facts about prospective investments, learn about the client's needs and goals, describe all fees that could be associated with an investment, and fully to disclose all conflicts of interest when giving advice. As discussed in Part IV below, these duties have traditionally been applied to broker-dealers as well.

[20] If the SEC opts for such an approach, it would be interesting to create a taxonomy of the ways in which this would enhance existing broker-dealer obligations. *See, e.g.*, Joshua E. Broaded, *A Survey of Regulations Applicable to Investment Advisers*, 12 DUQ. BUS. L.J. 27 (2009). One possibility would be to ban proprietary trading for broker-dealers giving investment advice to the same extent as investment advisors. *See* Investment Advisers Act § 206(3), 15 U.S.C. § 80b-6(3) (2010); *see also, e.g.*, Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395 (2010) (discussing existing obligations and analyzing some suggested reforms).

[21] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963):

> The Investment Advisers Act of 1940 . . . reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or to at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.

The authority cited for the proposition that Congress recognized a "delicate fiduciary nature" was a securities law treatise. 2 LOUIS LOSS, SECURITIES REGULATION 1412 (2d ed. 1961). *See* 375 U.S. at 191 n.38. There was no reference either to the statute or to legislative history. Nonetheless, there and then, the principles of fiduciary law by judicial fiat were imported into the Advisers Act.

The Dodd-Frank Act does not impose fiduciary duties on broker-dealers explicitly by the new legislation, but rather leaves that decision to the SEC. The Act thus did not mandate that broker-dealers have a continuing duty of care or loyalty to the retail customers receiving such investment advice.[22] In addition to the possibility of imposing fiduciary duties, the SEC may also choose to promulgate rules that would require broker-dealers to make certain disclosures to retail customers, such as if the broker-dealer only sells a limited range of products.[23] The Act also provides that the SEC may choose to create a rule requiring broker-dealers offering personalized investment advice to retail customers to act in the best interest of the customer, as well as requiring broker-dealers to disclose certain conflicts of interest.[24]

The statutory mandate leaves the SEC with many choices in terms of the appropriate regulatory response. For example, the SEC could retain the status quo, which is unlikely in light of the pressure that led to the massive reform legislation. Alternatively, the SEC could expressly adopt a fiduciary duty standard. As discussed below, there is plenty of support in existing interpretations recognizing fiduciary obligations. The new Act gives the SEC the opportunity to clarify these interpretations and codify the existing duties that are recognized by the SEC and the self-regulatory organizations. The SEC could elect to adopt rules with guiding principles or it could opt in favor of more detailed rulemaking. This Article examines the alternative avenues the SEC could take and evaluates the current state of broker-dealer regulation. This analysis leads to the conclusion that while some fine-tuning may be in order, the SEC and self-regulatory organization rules strike a good balance between principles-based regulation and rule-based regulation. The Act should not be taken as a message to move away from a principles-based approach.

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[22] § 913(g)(1), 124 Stat. at 1828.

[23] *Id.*

[24] § 913(g)(2), 124 Stat. at 1828.

## III. RULES, PRINCIPLES, AND STANDARDS

It is a relatively uncontroversial statement that the securities laws enhance disclosure and prohibit fraud. Broker-dealer regulation occupies a special place in the securities laws insofar as the regulations go beyond merely outlawing fraud.[25] In considering the appropriate scope of broker-dealer regulation and the nature of the stock broker/customer relationship, it is worth considering some aspects of lawmaking generally and, in particular, the distinctions that can be made between rules, standards, and principles. As explained below, rules tend to give more concrete guidance as to prohibited conduct. In contrast, laws based on principles and standards give flexibility to adapt the law to situations not covered by explicit rules.

Even a fraud-based regime raises the rules versus standards dichotomy. Since the nineteenth century, both courts[26] and commentators[27] have suggested that defining

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[25] *See infra* Part V.

[26] *See, e.g.*, McAleer v. Horsey, 35 Md. 439, 452 (1872):

> The common law not only gives no definition of fraud, but perhaps wisely asserts as a principle that there shall be no definition of it, for, as it is the very nature and essence of fraud to elude all laws in fact, without appearing to break them in form, a technical definition of fraud, making everything come within the scope of its words before the law could deal with it as such, would be in effect telling to the crafty precisely how to avoid the grasp of the law.

*See also, e.g.*, Syracuse Knitting Co. v. Blanchard, 43 A. 637, 639 (N.H. 1899):

> It is difficult to define fraud, except in a very general way. It is variable, depending upon the circumstances of the case. Those who make use of it adopt ways that have the appearance of good faith. Great skill is often shown in the attempt to make that which is false and corrupt appear true and honest. Hard and fast rules of law would be a hindrance to the discovery of fraud.

*Accord* Arkansas Valley Compress & Warehouse Co. v. Morgan, 229 S.W.2d 133, 136 (Ark. 1950) ("[Trial c]ourts have always been reluctant to define 'fraud' (either actual or constructive) lest man's fertile mind invent fraud provides unscrupulous actors with an invitation to find a way around the law. The law thus recognized that it is sufficient to identify a principle as opposed to focusing on specific detailed definitions of the types of conduct to be prohibited.[28]

The jurisprudential debate as to the relative effectiveness of specific rule-based lawmaking versus lawmaking through a system of principles and standards is a longstanding, well-established one. Thus, for example, the common law, although perhaps inefficient in its evaluation, presents an environment for flexible rules that can adapt to change.[29]

Likewise, administrative law has for a long time recognized a similar dichotomy with respect to alternative approaches to administrative rulemaking.[30] Standards- (or principles-) based rulemaking focuses on "the goal toward

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a new scheme outside the definition but just as nefarious as previously denounced schemes.").

[27] *See* Dan M. Kahan, *Lenity and Federal Common Law Crimes*, 1994 SUP. CT. REV. 345, 410 (1994) ("[L]a[y] down as a general proposition, what shall constitute fraud, or any general rule, beyond which they will not go upon the ground of fraud, lest other means of avoiding the equity of the courts should be found out." (quoting JOSEPH STORY, EQUITY JURISPRUDENCE 190 (10th ed. 1870))); *see also, id.* at 410 n.316 ("Some lawyers talk as though they thought maximum clarity always desirable even though they wouldn't have to probe very deeply to find that fraud, and fiduciary obligation, and undue influence, have been carefully isolated from exact definition, because such exact definition would simply point out safe ways of immunity, and, to the birds of prey, make the law 'their perch and not their terror.'" (quoting CHARLES L. BLACK, JR., THE HUMANE IMAGINATION 33 (1986)).

[28] U.S. v. Bishop, 825 F.2d 1278, 1280 (8th Cir. 1987) ("[The] law does not define fraud; it needs no definition. It is as old as falsehood and as versatile as human ingenuity."); Weiss v. U.S., 122 F.2d 675, 681 (5th Cir. 1941) ("The law does not define fraud; it needs no definition. It is as old as falsehood and as versable as human ingenuity."); Greco v. State, 499 A.2d 209, 214 (Md. App. 1985), *aff'd* 515 A.2d 220 (Md. 1986) ("Courts have been reluctant to define fraud with any degree of preciseness.").

[29] *See, e.g.*, OLIVER WENDELL HOLMES, JR., THE COMMON LAW (1909).

[30] *See, e.g.*, Edward L. Rubin, *Law and Legislation in the Administrative State*, 89 COLUM. L. REV. 369 (1989).

which conduct should be oriented."[31] Specific rules respond more directly to the concern that people deserve to have some reasonable idea of what conduct is prohibited.[32] There are a number of advantages traditionally associated with a rules-based system. It can be assumed that rules may ensure even-handed enforcement—a specific rule leaves no room for discretionary application because it clearly denotes prohibited or proscribed conduct.[33] Clear rules are efficient because they eliminate the need for interpretive or adjuratory supplementation.[34] They also make it easier for Congress to evaluate the agency.[35] On the other hand, specific and detailed rules can hinder an agency in applying its goals because of their inherent inflexibility. It is

[31] ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, ADMINISTRATIVE LAW 37 n.1 (2d ed. 2001). *Cf.* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 (2007) (suggesting that drawing a distinct dichotomy between rules and principles oversimplifies complexity).

[32] AMAN & MAYTON, *supra* note 31, at 65; *see also, e.g.*, Gellhorn & Robinson, *Perspectives on Administrative Law*, 75 COLUM. L. REV. 771, 792–93 (1975) (discussing due process and vagueness issues).

[33] AMAN & MAYTON, *supra* note 31, at 66–67. Regulatory agencies may prefer rules to standards because agency officials do not have to apply the specific facts of a situation to a general standard and make a personal judgment. It has thus been suggested that a clear rule makes the judgment for agency officials, thereby "enhanc[ing] routine and neutrality." *Id.* at 67. It has further been suggested that "[t]he private sector tends to conform to the substance of agency regulations: once this substance is settled and then revealed. As the private sector by its own motion conforms to rules, regulation according to rules reduces agency enforcement costs." *Id.*

[34] *See* RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 497–498 (5th ed. 2010) ("Rulemaking eliminates the need to engage in expensive and time-consuming adjudicatory hearings to address issues of legislative fact; rulemaking eliminates the need to relitigate recurring issues; and rules created through rulemaking are easier and less expensive to enforce and to implement than are 'rules' announced in the course of adjudicating specific disputes.").

[35] *Id.* (observing that because an agency must issue a public notice of a proposed rule before enacting the rule, the public has a chance to alert Congress and the President of the proposed rule).

problematic to apply strict rules to a situation that does not neatly fit into the rules. Standards, on the other hand, permit agencies to apply principles to the unique facts of each case in furtherance of the overall goal of the agency.[36] Of course, it is necessary to state the standards in such a way as to make it clear what the guiding principles are.

Thus, there is no one-size-fits-all answer to the appropriate balance between specific rules and more generalized standards and principles. There is no easy solution since some areas of regulation are more suited to specific rules while others lend themselves to a more principles-based approach. An optimal balance of rules and standards will "channel the discretion of public officials" without stripping regulators of their ability to use judgment where appropriate.[37] The Supreme Court in *SEC v. Chenery* stated that an agency cannot foresee every situation that may occur and thus cannot account for every situation with a rule for that situation, aptly identifying the advantages of standards and agency flexibility in achieving goals.[38]

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[36] AMAN & MAYTON, *supra* note 31, at 67; *see also, e.g.*, Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L. J. 1, 2 (2008) (suggesting principles-based securities regulation as a New Governance regime—one that uses innovative, pragmatic, information-based, iterative, and dialogic mechanisms to gather, distill, and leverage industry learning in the service of a still-robust but better designed, that is, more effective and less burdensome, public regulatory mandate).

[37] AMAN & MAYTON, *supra* note 31, at 67 n.9 (citing Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983)).

[38] 332 U.S. 194, 202–03 (1947) ("[P]roblems may arise in a case which the administrative agency could not reasonably foresee . . . [or] the problems might be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule."); *see also, e.g.*, AMAN & MAYTON, *supra* note 31, at 104 ("For instance, the Securities Exchange Commission developed its standard restricting the use of inside information by stockbrokers by adjudication rather than by rulemaking. As described by Professor William Cary, a past Chairman of the Commission, that body chose adjudication because it not [sic] wish to deal with inputs and objections from the stock exchanges and brokerage firms as would have been the case with rulemaking.") (*citing* WILLIAM CARY, POLITICS AND THE REGULATORY AGENCIES 82–85 (1967)).

Professor Diver makes the point that there are three dimensions to regulation by administrative agencies. First, there is transparency: a rule is transparent if it uses well-defined words that are unambiguous to the audience.[39] Second is accessibility: "[t]he rulemaker will want his rule to be 'accessible' to its intended audience—that is, applicable to concrete situations without excessive difficulty or effort."[40] The third dimension is congruency: a rule is congruent if it achieves the regulatory scheme's desired objective. The analysis then turns to examination of whether the rules are effective in affecting behavior so that the law's policy objective is realized.

A legislative or regulatory declaration of broker-dealer fiduciary duties would constitute a broadly-stated principle. The guidance that would be provided by such a statement depends in large part on what it means to say that a fiduciary duty exists. The discussion that follows provides an overview of general fiduciary principles, a description of factors that the law has used to identify fiduciary relationships, and the significance of labeling a relationship as fiduciary.

## IV. OVERVIEW OF FIDUCIARY DUTY

Although there is no clear definition of fiduciary relationship,[41] some important generalizations can provide good guidance. A fiduciary relationship consists of two parties, the fiduciary and the beneficiary. It is generally understood that in such a relationship, the fiduciary has the

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[39] Diver, *supra* note 37, at 67.

[40] *Id.*

[41] *See, e.g.*, Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1972) ("A 'fiduciary relation' is an elusive status to define."); Keenan v. D.H. Blair & Co., 838 F. Supp. 82, 89 (S.D.N.Y. 1993) ("The precise contours of a fiduciary relationship are incapable of expression."); Farragut Mortgage Co. v. Arthur Andersen, LLP, No. 95-6231-B, 1999 WL 823656, at *1, *13 (Mass. Super. Ct. Aug. 5, 1999) (explaining that there is no all-inclusive definition of a fiduciary relationship; the existence of such a relationship is a question of fact).

duty to be loyal and act in the interest of the beneficiary.[42] The beneficiary has entrusted the fiduciary with the power to oversee his well-being.[43] The beneficiary is dependent upon the fiduciary due to his reliance upon a specific service the fiduciary provides under the arrangement in question.[44] The beneficiary ordinarily has very little or no control over the relationship or its subject matter, and thus the beneficiary is forced to rely on the fiduciary's expertise in the specific area.[45] In other words, a fiduciary relationship often exists when one person places his trust and confidence in another. There is reliance upon the fiduciary that the fiduciary will not abuse this trust.[46] Described another way, a fiduciary relationship is said to exist when any person instills a power of some type within another, the fiduciary, with the intention that the fiduciary will act to further the beneficiary's best interests.[47] The Restatement of Torts is particularly helpful to understanding the nature of the stock broker relationship to his or her customer: "[A] fiduciary relation exists between two persons when one of them is under a duty to act or to give advice for the benefit of another upon matters within the scope of the relation."[48]

Under common law, fiduciary duties were imposed in situations where one party's knowledge or expertise was far vaster than that of another party who may rely upon this

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[42] *See, e.g.*, Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation,* 1988 DUKE L.J. 879 (1988); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 624 (1997).

[43] *See, e.g.*, Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 IOWA J. CORP. L. 239, 240 (2009).

[44] *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

[45] *See* Alces, *supra* note 43, at 240–41; *see also, e.g.*, Frankel, *supra* note 44.

[46] *See* Alces, *supra* note 43, at 259–60; *see also, e.g.*, DeMott, *supra* note 43; Smith, *supra* note 42, at 1402–03.

[47] *See* Alces, *supra* note 43, at 260.

[48] RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979).

expertise.[49] However, not all relationships of this nature are defined as fiduciary. Instead, some are nothing more than contractual.[50] Thus, the existence of special knowledge or expertise of one party is a factor but is not determinative. However, when a party holds oneself out as having special knowledge, a fiduciary duty is even more likely to exist.[51]

A summary of the cases and the literature leads to the conclusion that fiduciary relationships can be placed within one of four categories:

> (1) [W]here one person has control of property which . . . in the view of the court of equity is the property of another;
> (2) Where one person 'has undertaken or is under an obligation . . . to act on another's behalf or for another's benefit';
> (3) Where one person with limited or partial interests in property obtains renewed or additional rights in the property; and
> (4) Where 'undue influence' exists.[52]

However, while there are a number of relationships that are generally considered fiduciary in nature,[53] it is difficult to generalize from one relationship to another. Overall, the nature of the relationship depends on the type of fiduciary relationship. In other words, the "fiduciary obligation is inevitably tied to the particular context in which it arises."[54] Standards within fiduciary relationships are flexible, and courts can apply them as they see fit in individual

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[49] Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 322 (1999).

[50] *See* Frankel, *supra* note 44, at 808.

[51] *See* discussion of the "shingle theory" in Part V.D. *infra*.

[52] Smith, *supra* note 42, at 1427.

[53] The following are generally considered to be fiduciary relationships: trustee/trust, guardian/ward, agent/principal, priest/devotee, attorney/client, accountant/client. *See* DeMott, *supra* note 42, at 883, 904, 907–08; Smith, *supra* note 42, at 1427, 1460; FitzGibbon, *supra* note 49, at 307.

[54] *See* DeMott, *supra* note 42, at 909.

circumstances.[55] As a result, it is difficult to make meaningful generalizations describing fiduciary relationships, considering the diversity of contexts in which they can arise.[56] Broadly speaking, the scope of the fiduciary duty depends upon a standard of the duty defined by the type of relationship.[57]

While fiduciary relationships across the board possess some similarities, they are also different—thus generalities are insufficient to explain fiduciary relationships.[58] These differences include: (1) the purpose and nature of the relationship; (2) the amount of power granted to the fiduciary by the beneficiary; and (3) protective mechanisms put into place to aid in reducing the abuse of this power.[59] Notwithstanding these differences, all fiduciary relationships share the feature that the fiduciary is the substitute for the beneficiary. The beneficiary is looking to the fiduciary for a benefit.[60] It has been suggested that one way to view a fiduciary relationship based upon trust and confidence is to see it from the perspective of morality—that there is a moral premise for a fiduciary relationship.[61] The various descriptions of a fiduciary relationship have one thing in common—fiduciary relationships are more expansive than those established through a contract.[62] For example, as discussed more fully below, fiduciary obligations not present in arm's length contract dealings include heightened disclosure duties as well as duties of loyalty.

The foregoing shows that generalizations can be made, but they are not always very helpful. The same can be said

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[55] *See* Smith, *supra* note 42, at 1415; *see also* Frankel, *supra* note 44, at 810.

[56] *See* Smith, *supra* note 42, at 1415.

[57] *See* DeMott, *supra* note 42, at 915.

[58] *See* Frankel, *supra* note 44, at 807–08; *see also* Alces, *supra* note 43, at 259–60.

[59] *See* Frankel, *supra* note 44, at 810; *see also* Smith, *supra* note 42, at 259–60.

[60] *See* Frankel, *supra* note 44, at 808.

[61] Alces, *supra* note 43, at 259–60.

[62] Smith, *supra* note 42, at 1488.

of defining the consequences that follow once a fiduciary duty is established. Identifying a fiduciary relationship is simply the first step in the inquiry. It is then necessary to determine the obligations that flow from the recognition of a relationship as fiduciary. Fiduciary law states some general principles and, in some instances, specific rules of conduct. Most often the duty is expressed in terms of principles rather than rules. A fiduciary duty is something more than would exist simply as a result of dealing with a party at arm's length. This duty extends beyond just honesty and fairness. As stated in an oft-quoted passage penned by Justice Cardozo: "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[63] The fiduciary possesses the obligation to act in a way that furthers the beneficiary's interests.[64] In a fiduciary relationship, the beneficiary is vulnerable to the power of the fiduciary. If the fiduciary were to abuse his power, the beneficiary's interest is at stake.[65] For this reason, the needs and interests of the beneficiary are the utmost priority.[66] Thus, the most ideal relationships are those in which the beneficiary's interests do not conflict with those of the fiduciary. Ultimately, the most basic definition of a fiduciary relationship is a relationship in which the fiduciary is held to a "higher standard of trust and an obligation to work in a trustworthy manner for the benefit of another, with the beneficiary's best interests as its goal in the performance of the task."[67]

As stated in a famous passage by the United States Supreme Court:

> [T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To

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[63] Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

[64] *See* DeMott, *supra* note 42, at 882; *see also, e.g.*, Frankel, *supra* note 44, at 801.

[65] *See* DeMott, *supra* note 42, at 902.

[66] *See* Frankel, *supra* note 44, at 801.

[67] *See* Alces, *supra* note 43, at 244.

> whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[68]

It has been said that fiduciary relationships are relationships which are entered into voluntarily in which the fiduciary possesses a zealous duty of good faith.[69] Fiduciary relationships established by law often are mirrored by relationships established by custom reflecting positive social attributes including "loyalty, civility, self-sacrifice, vocational excellence, and high standards of honesty."[70] The law thus recognizes that a fiduciary relationship entails a strong duty of the utmost loyalty. This loyalty means that the fiduciary must act solely in the beneficiary's best interests rather than acting in the fiduciary's own interests.[71]

Although they cannot be defined in bright-line terms, the various descriptions of fiduciary relationships share a common thread—the existence of heightened obligations to be contrasted to contractual obligations resulting in non-fiduciary arm's length transactions. Before discussing the extent to which fiduciary principles apply to broker-dealer obligations, the next section explores the background and scope of broker-dealer regulation under the federal securities laws.

## V. BROKER-DEALER REGULATION UNDER THE CURRENT REGIME

Federal securities regulation is based on disclosure rather than merits scrutiny of transactions. This means that rather than focus on the merits of particular investments, the basic thrust of the law is "truth in securities" so that after full disclosure of material facts investors can make their own

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[68] SEC v. Chenery Co., 318 U.S. 80, 85–86 (1943).

[69] FitzGibbon, *supra* note 49, at 304, 308–09; *see also* DeMott, *supra* note 42, at 902.

[70] FitzGibbon, *supra* note 49, at 340.

[71] *See* Smith, *supra* note 42, at 1488.

decisions.[72] A notable exception to this disclosure approach, even before the enactment of the first federal securities law in 1933,[73] was broker-dealer regulation which dates back to the thirteenth century.[74] This early regulation authorized licensing securities brokers in London.[75] Stock exchange dealings, with speculation subject to alternate booms and panics, became a part of the English markets in the latter part of the seventeenth century. Trading in shares of stock led to periods of speculation and wild fluctuations in the market.[76] This was followed by English legislation by the end of the seventeenth century, which was enacted to protect investors against unscrupulous manipulation by stock jobbers[77] and stock brokers.[78] Investment schemes

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[72] As I have explained elsewhere, "[t]he reasoning is that full disclosure provides investors with sufficient opportunity to evaluate the merits of an investment and fend for themselves." 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2[3][A] (7th ed. 2009).

[73] The Securities Act of 1933 was the first comprehensive federal securities law. Act of May 27, 1933, c. 38, Title I, § 1, 48 Stat. 74, codified in 15 U.S.C. §§ 77a *et seq.* (2010). The 1933 Act focuses on public offerings of securities.

[74] Statute of Edward I, in 1285. *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 1–A (3d ed. 1989).

[75] *Id.*

[76] Promoters of both incorporated and unincorporated companies foisted doubtful schemes on the investing public. *See* 1 JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 2.2 (3d ed. 2010).

[77] As explained by a report that led up to the legislation:

> The pernicious Art of Stock-jobbing hath, of late, so wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on, of Manufactures, to the private Profit of the first Projectors, that the Privileges granted to them have, commonly, been made no other Use of, by the First Procurers and Subscribers, but to sell again, with Advantage, to ignorant Men, drawn in by the Reputation, falsely raised, and artfully spread concerning the thriving State of their Stock.

11 H.C.J. 595 (1696), reprinted in 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3–4 (3d ed. 1989).

throughout Europe led to many frauds, including the infamous South Sea Bubble.[79] Thus there thus is a long history of viewing the stock broker industry as one in need of special regulation. No doubt this was at least partly due to the recognition that stock brokers often nourish their customers' trust and that such a position of trust should be governed by heightened conduct rules. As shown in the discussion below, broker-dealer regulation as it developed in the United States embraced heightened standards of conduct for participants in this regulated industry.

## A. Overview of Broker-Dealer Regulation in the United States

Section 15(b)(1) of the Securities Exchange Act of 1934 requires that broker-dealers register with the SEC.[80] In addition, section 15(b)(8) requires that all broker-dealers be members of a qualifying self-regulatory organization (either a national exchange or registered securities association).[81]

[78] LOSS & SELIGMAN, supra note 74 ("An act to restrain the number and ill practice of brokers and stock jobbers."); *see also* Lane, *The Years Before the Stock Exchange*, 7 HIST. TODAY 760, 761 (1957).

[79] *See generally* LOSS & SELIGMAN, *supra* note 74.

[80] 15 U.S.C. § 78o(b)(1) (2010).

[81] 1 U.S.C. §15(b)(8) (1934) (current version at 15 U.S.C. § 78o(b)(8) (2010)). Up until 1983, broker-dealers could submit themselves to direct SEC control, but the Act was amended to abolish SECO ("SEC Only") regulation. Over the years, there has been considerable discussion elsewhere concerning self-regulation under SEC oversight. *See generally*, William L. Cary, *Self Regulation in the Securities Industry*, 49 A.B.A. J. 244 (1963); Hugh I. Crossland & Robert J. Sehr, Jr., *The Gods of the Marketplace: An Examination of the Regulation of the Securities Business*, 48 B.U. L. REV. 515 (1968); Alexander H. Frey, *Federal Regulation of the Over-the-Counter Securities Markets*, 106 U. PA. L. REV. 1 (1957); Richard W. Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663 (1964); Sam S. Miller, *Self-Regulatory Organizations and the Securities Industry: Does Membership Have its Privileges?*, 19 SEC. REG. L.J. 3 (1991); John E. Pinto, Jr., *The NASD's Enforcement Agenda*, 85 NW. U. L. REV. 739 (1991); Howard C. Westwood & Edward G. Howard, *Self -Government in the Securities Business*, 17 LAW & CONTEMP. PROBS. 518 (1952); Marc A.

The broker-dealer registration requirements apply only to persons who, as a firm or as individuals, engage in broker-dealer activities.[82] Associated persons who work for the registered broker-dealer firm are subject to SEC regulation but do not have to register as a broker-dealer.[83] The exemption from the broker-dealer registration requirements does not insulate registered representatives and other associated persons from SEC regulation. Thus, for example, employees of brokerage firms who have regular contact with the public as order takers have to qualify as registered representatives.[84] Furthermore, associated persons who do not have to register in any capacity are subject nevertheless to SEC and FINRA (formerly NASD) disciplinary authority.[85]

The three principal capacities in which firms act in the securities business are as broker, dealer, and investment adviser. The 1934 Act defines a "broker" as a "person engaged in the business of effecting transactions in securities for the account of others,"[86] while a "dealer" is a "person engaged in the business of buying and selling securities for such person's own account."[87] An "investment adviser" is defined in section 202(a)(11) of the Investment Advisers Act of 1940 as a "person who, for compensation, engages in the business of advising others . . . as to the advisability of

White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959).

[82] *See, e.g.*, Roth v. SEC, 22 F.3d 1108, 1109 (D.C. Cir. 1994) (holding that an associated person had to register as a broker-dealer where she was engaged in the securities business on her own and not through a registered broker-dealer).

[83] *Id.* (holding that the exemption from broker-dealer registration extends only to those individuals subject to the supervisory relationship which normally accompanies association with a member firm).

[84] *See, e.g.*, Exch. Servs., Inc. v. SEC, 797 F.2d 188, 191 (4th Cir. 1986) (holding that order takers for discount brokers must register as general securities representatives).

[85] Haberman v. SEC, No. 99-1014, 2000 WL 84494, at *1 (8th Cir. 2000) (upholding disqualification of associated person).

[86] 15 U.S.C. § 78c(a)(4)(A) (2010).

[87] *Id.* § 78c(a)(5).

investing in, purchasing or selling securities,"[88] but broker-dealers who render such advice as part of their brokerage activities are exempt from the 1940 Act definition because of the assumption that broker-dealer regulation is sufficient to adequately protect investors' interests.[89]

As noted above, under section 15(a) of the 1934 Act,[90] no person may engage in business as a broker or dealer in securities unless he or she conducts exclusively intrastate business, deals only in exempted securities, or is registered with the Commission. Under section 15(b),[91] the SEC may revoke or suspend a broker-dealer's registration, or impose a censure, if the broker-dealer is found to have violated any of the federal securities laws or committed other specified misdeeds.[92]

In spelling out the substantive obligations of these securities "professionals" in dealing with public investors, the SEC proceeded with rulemaking largely under the general anti-fraud provisions of sections 10(b)[93] and 15(c)[94] of the 1934 Act, section 17(a) of the Securities Act of 1933,[95] and section 206 of the Investment Advisers Act.[96] The SEC's attention has been focused on two broad areas: (a) conflicts between the firm's obligations to its customers and its own

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[88] *Id.* § 80b–2(a)(11).

[89] *Id.* § 80b–2(a)(11)(C). *Accord* Applicability of the Investment Advisers Act to Certain Brokers and Dealers, Exchange Act Release No. 15215, 1978 WL 14788 (1978) (extending temporary exemption from Investment Advisers Act for broker-dealers exercising discretionary authority over accounts).

[90] *Id.* § 78o(a)(1).

[91] *Id.* § 78o(b)(4); *see also* Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b–3(e) (2010) (containing comparable provisions with respect to investment advisers).

[92] *See, e.g.*, Studer v. SEC, 148 Fed. Appx. 58, 59 (2d Cir. 2005) (upholding revocation of broker-dealer registration).

[93] 15 U.S.C. § 78j(b); *see also* 5 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.1 (6th ed. 2009).

[94] 15 U.S.C. § 78o(c).

[95] *Id.* at § 77q(a).

[96] *Id.* at § 80b–6.

financial interests,[97] and (b) trading in or recommending securities in the absence of adequate information about the issuer.[98] Violation of the anti-fraud provisions in these two areas has given rise to lawsuits by aggrieved customers[99] as well as disciplinary actions by the SEC.[100]

There is a wide range of approaches taken by the SEC, FINRA, and the courts in regulating broker-dealers, including (1) excessive prices for NASDAQ and over-the-counter securities,[101] (2) activities of market-makers who deal directly with individual customers in a retail capacity,[102] (3) excessive trading in customers' accounts designed to generate brokerage commissions,[103] and (4) undisclosed interests of brokers and investment advisers in the stocks they recommend.[104]

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[97] *See* 5 HAZEN, *supra* note 93, §§ 14.3, 14.10 (discussing applicable regulations).

[98] *See generally id.* §§ 14.15–14.18.

[99] *See id.* § 14.26(3)–(5); *see also generally id.* ch.15.

[100] *See id.* § 14.3(3)–(4) and ch.16 (discussing the SEC's enforcement authority generally).

[101] *See, e.g.*, Lehl v. SEC, 90 F.3d 1483, 1488 n.4 (10th Cir. 1996) ("To guide its members in determining when a price is 'reasonably related to the current market price,' the NASD surveyed industry pricing practices, concluding that the vast majority of transactions occurred at markups of 5% or less. It then issued guidelines setting 5% as a benchmark of reasonableness, to be considered with other relevant factors. The NASD cautioned, however, that the 5% policy 'is a guide—not a rule'; that a 'mark-up pattern of 5% or even less may be considered unfair or unreasonable'; and that '[i]n the case of certain low-priced securities, such as those selling below $10.00, a somewhat higher percentage may sometimes be justified.'" ); 5 HAZEN, *supra* note 93, § 14.14(3).

[102] *See, e.g.*, Eichler v. SEC, 757 F.2d 1066 (9th Cir. 1985) (market maker's duty to execute customer orders meant that it could not base pricing and order execution on an orderly market without making full disclosure to its customers); 5 HAZEN, *supra* note 93, § 14.10(5). Market makers operate in the over the counter and Nasdaq markets and in essence operate as wholesalers of securities.

[103] This is often referred to as churning. *See* 5 HAZEN, *supra* note 93, § 14.20.

[104] This is sometimes referred to as scalping. Scalping consists of material omissions from the recommendation—namely that the person making the recommendation has a position in the security being

Market regulation includes the establishment of fair market practices and minimum capital requirements for broker-dealers in order to minimize the risk of insolvency.[105] A major goal of this regulation is to assure orderly markets.[106] It also contains several prohibitions against fraudulent and manipulative broker-dealer conduct.[107] Additionally, the SEC and the Federal Reserve Board work together in regulating the extension of credit for securities transactions.[108]

The SEC thus has broad regulatory authority over securities broker-dealers and their conduct.

## B. Broker-Dealers' Obligations—SEC and FINRA Regulation and Common Law[109]

Various SEC and FINRA (formerly NASD) rules address misconduct by broker-dealers. As a general standard, SEC Rule 15c1-2[110] generally prohibits fraudulent, manipulative, and deceptive practices in connection with securities brokerage transactions. The types of specific conduct that are addressed in other rules include market manipulation,[111]

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recommended. A variation on scalping occurs when the person making the recommendation affirmatively misrepresents that he or she does not own any of the securities recommended. *See, e.g.*, In re Snyder, Exchange Act Release No. 46108, 2002 WL 1364075 (June 25, 2002) (finding violations of Rule 10b-5 where respondent stated he did not have an ownership position in Internet communications about a particular company); 5 HAZEN, *supra* note 93, § 14.17.

[105] *See, e.g.*, 17 C.F.R. § 240.15c3-1 (2010) (establishing the net capital requirements); 5 HAZEN, *supra* note 93, § 14.8(1).

[106] *See* 5 HAZEN, *supra* note 93, §§ 14.3(4)(D), 14.10–14.11.

[107] *See id.* §§ 14.3(6), 14.15–14.23.

[108] *See id.* § 14.9.

[109] Much of this discussion is adapted from portions of 5 HAZEN, *supra* note 93, §14.15.

[110] 17 C.F.R. § 240.15c1–2 (2010).

[111] *See* 2 HAZEN, *supra* note 93, §§ 6.2–6.3 (covering manipulation in connection with public offerings), 3 HAZEN, *supra* note 93, § 12.1 (covering manipulation generally), and 5 HAZEN, *supra* note 93, § 14.10[5] (covering manipulation by market makers).

high pressure sales tactics,[112] deceptive recommendations,[113] generation of excessive commissions,[114] unauthorized trading,[115] improper order executions,[116] improper extension of credit for securities transactions,[117] and misuse of customer funds or securities.[118] In addition, broker-dealers and their employees are subject to a more standards-based approach under Rule 10b-5's general antifraud proscriptions relating to deceptive conduct in connection with a purchase or sale of a security.[119] Beyond these specific activities and the general anti-manipulation and deception rules, the SEC makes it clear that violation of its rules is not limited to violation of any specified SEC or self-regulatory organization rules, but rather covers all conduct that operates as a deceptive or manipulative device.[120] That is, the SEC has taken the position elsewhere that it can regulate conduct that would be manipulative even if the concern is not based on any specified violation of existing rules.[121] Beyond SEC

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[112] *See* 5 HAZEN, *supra* note 93, § 14.18; *see also, e.g.*, *NASD Hearing Panel Expels Yankee Financial for Fraud, Orders Payment of More Than $3.8 Million in Restitution*, FINRA (Jan. 13, 2005), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName =NASDW_012997&ssSourceNodeId=9 (discussing boiler room operator expelled from NASD membership and ordered to pay more than $38 million in restitution).

[113] *See* 5 HAZEN, *supra* note 93, §§ 14.15–14.18.

[114] *See* 5 HAZEN, *supra* note 93, § 14.20.

[115] *See* 5 HAZEN, *supra* note 93, § 14.21.

[116] *See* 5 HAZEN, *supra* note 93, § 14.13.

[117] *See* 5 HAZEN, *supra* note 93, § 14.9.

[118] *See* 5 HAZEN, *supra* note 93, § 14.8(2).

[119] *See* 17 C.F.R. § 240.10b-5 (2010).

[120] *See* 17 C.F.R. § 240.15c1-2(c) (2010) ("The scope of this section shall not be limited by any specific definitions of the term 'manipulative, deceptive, or other fraudulent device or contrivance' contained in other rules adopted pursuant to section 15(c)(1) of the Act.").

[121] *See, e.g.*, Trautman, Exchange Act Release No. 9088A, Exchange Act Release No. 61167A, 2009 WL 6761741, at *19 n.75 (Dec. 15, 2009) (noting that late trading of mutual funds violated the Exchange Act even in the absence of an SEC rule specifically addressing that activity); Hazel Bishop, Inc., 40 SEC 718 (1961) (issuing a stop order on a registration statement because of the potential for manipulation in connection with an

rules, the rules of the self-regulatory organizations, such as FINRA, impose standards of conduct on broker-dealers. For example, following the statutory mandate, FINRA imposes principles based regulation through the requirement that broker-dealers adhere to "just and equitable principles of trade."[122]

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at-market secondary offering); *see generally* 2 HAZEN, *supra* note 93, §§ 4.28, 6.1–4.

[122] FINRA Manual Rule 2010, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905&element_id=5504&highlight=2010#r6905 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."). FINRA also has rules and interpretations targeting specific practices. *See also, e.g.*, 5 HAZEN, *supra* note 93, § 14.14 (discussing the FINRA rules governing mark-ups from market price); FINRA Manual Rule 3220, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=7067&element_id=5665&highlight=3220#r7067 (prohibiting members from engaging in conduct designed to influence decisions of other entities). As explained in a recent FINRA opinion:

> The "special focus" of FINRA's rules is upon "the professionalization of the securities industry." Gustafson v. Strangis, 572 F. Supp. 1154, 1158 (D. Minn. 1983). Section 15A(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") requires FINRA, as a registered securities association, to have and enforce rules that "promote just and equitable principles of trade." When Congress enacted the Exchange Act, it recognized that the law "must be supplemented by regulation on an ethical plane in order 'to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry' and 'to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market.'" *See* Heath v. SEC, 586 F.3d 122, 132 (2d Cir. 2009), *cert. denied,* No. 09-959, 2010 U.S. LEXIS 3029 (Apr. 5, 2010) (quoting 6 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2796 (3d ed. 2002)).
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> NASD Rule 2110 provides that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." The rule

In addition to SEC rules and requirements of the applicable self-regulatory organizations,[123] broker-dealers are, of course, subject to common law duties and, in some contexts, fiduciary obligations.[124] Further, on appropriate facts, federal courts have recognized the existence of a fiduciary relationship in federal securities cases.[125] The cases make it clear that although there is no across-the-board fiduciary duty that applies to every transaction involving a broker-dealer, some heightened level of obligation will exist depending on the activities that the broker is carrying out on the customer's behalf. In contrast to the narrow view of securities brokers' fiduciary duties, as noted above, there have been a number of decisions that have taken a broader

> underscores a "broad ethical principle that implements the requirements of [Exchange Act] Section 15A." Timothy L. Burkes, 51 S.E.C. 356, 360 n.21 (1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994). Disciplinary actions brought to enforce compliance with standards of commercial honor and just and equitable principles of trade are "ethical proceedings" and are concerned with the "ethical implications" of the respondent's conduct. *Id.* at 360.

In the Matter of Conway, 2010 WL 4254606, at *8 (FINRA Oct. 26, 2010) (footnote omitted).

[123] *See* 5 HAZEN, *supra* note 93, § 14.3.

[124] *See, e.g.*, Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker–Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65 (1997) (reviewing history of broker-dealer fiduciary duties); *see also*, Francis J. Facciolo, *A Broker's Duty of Best Execution in the Nineteenth and Early Twentieth Centuries*, 26 PACE L. REV. 155 (2005) (tracing the best execution obligation back to state law); Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527 (2002) (arguing that the federal courts should recognize professional malpractice claims based on the self-regulatory regime for broker-dealers).

[125] *See, e.g.*, U.S. v. Santoro, 302 F.3d 76, 82 (2d Cir. 2002) (holding that broker's recommendation created "position of trust" pursuant to federal sentencing guidelines); Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977) (citing Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975)); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968).

view.[126] For example, since a brokerage relationship is a principal/agent relationship, some courts have recognized fiduciary duties that accompany agency relationships generally.[127]

## C. Broker-Dealers' Fiduciary Duties Under Current Securities Law

Many times a broker-dealer does more than merely take an order, and in such cases there are heightened obligations.

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[126] *See* Goodrich v. E. F. Hutton Grp., 542 A.2d 1200, 1204 (Del. Ch. 1988) (noting that stock broker owes a fiduciary duty to customers); McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989) (finding that a broker owed a fiduciary duty to the customer because of the customer's inexperience); Byrley v. Nationwide Life Ins. Co., 640 N.E.2d 187, 198 (Ohio Ct. App. 1994) ("A broker and client are in a fiduciary relationship and, therefore, the broker owes the client a duty to disclose material information concerning investments."); *see also* Paine, Webber, Jackson, and Curtis, Inc. v. Adams 718 P.2d 508, 515–17 (Colo. 1986) (discussing different courts' tests to discern whether a fiduciary relationship existed between stockbrokers and customers).

[127] *See, e.g.*, Glisson v. Freeman, 532 S.E.2d 442, 449 (Ga. Ct. App. 2000) ("A stockbroker's duty to account to its customer is fiduciary in nature, so that the broker is obligated to exercise the utmost good faith. . . . [I]t is the agent's duty to make known to the principal all material facts which concern the transactions and subject matter of his agency." (quoting Minor v. E.F. Hutton & Co., 409 S.E.2d 262, 264 (Ga. Ct. App. 1991))). As the Delaware Supreme Court observed,

> The relationship between a customer and stock-broker is that of principal and agent. The broker, as agent, has a duty to carry out the customer's instructions promptly and accurately. In addition, the broker must act in the customer's best interests and must refrain from self-dealing unless the customer consents, after full disclosure. These obligations at times are described as fiduciary duties of good faith, fair dealing, and loyalty. They are comparable to the fiduciary duties of corporate directors, and are limited only by the scope of the agency.

O'Malley v. Boris, 742 A.2d 845, 849 (Del. 1999); *see also, e.g.*, Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124 (D.C. Cir. 1990); Huppman v. Tighe, 642 A.2d 309 (Md. App. 1994); Stavaridis v. Dynamic Mach. Works, Inc., 1994 WL 879484, 2 Mass. L. Rptr. 446 (Mass. Super. 1994).

When a broker acts as a mere order taker, most courts say that the only duty is to find the best and most prompt execution for that order.[128] Where the broker performs additional functions, fiduciary obligations may exist.[129] For example, when a broker has discretion with respect to executing transactions, the broker is a fiduciary.[130] Similarly, when a broker recommends securities or transactions, heightened duties apply.[131] This parallels the development of fiduciary duties under the Investment Advisers Act that arose from judicial interpretation rather than the language of the Act.[132]

What is the practical consequence of applying fiduciary obligations to broker-dealer conduct? When a fiduciary duty exists, a broker will be subject to heightened disclosure requirements.[133] Fiduciary duties can also result in implied

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[128] For a description of the "duty of best execution," see Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998).

[129] *See, e.g.*, Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439 (2010) (discussing distinctions between fiduciary obligations of brokers and investment advisors); Steven D. Irwin, *Wasn't My Broker Always Looking Out for My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41 (2009) (discussing broker investment advisors' fiduciary duties versus brokers' suitability standards).

[130] *See, e.g.*, SEC v. Pasternak, 561 F. Supp.2d 459, 499 (D.N.J. 2007) (acknowledging "the weight of the authority to hold that a broker is in a fiduciary relationship with a client, where that client maintains an account with the broker in which the broker, not the client, retains discretion," relying on McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 767 (3d Cir. 1990)).

[131] Consider for example, the suitability requirement contained within FINRA Manual Rule 2310, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469; *see also, e.g.*, United States v. Laurienti, 611 F.3d 530, 540–41 (9th Cir. 2010) (broker making recommendations in a "pump and dump scheme" had fiduciary duties requiring disclosure of bonus commissions).

[132] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963) (imposing fiduciary duties on investment advisers), as quoted *supra*, note 21.

[133] *See, e.g.*, *Pasternak*, 561 F. Supp.2d at 506 (noting that when broker is acting as a fiduciary, there may be a duty to disclose a mark-up or other profit which would not ordinarily have to be disclosed as a result

representations,[134] including implied representations of expertise, which may also be referred to as the "shingle theory."[135] The SEC has referred to the "basic principle" that by holding itself out as a broker-dealer, a firm is

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of a stock brokerage relationship). Note that accountability for the implied representations that may arise out of a fiduciary duty will not violate the securities laws' antifraud provisions in the absence of a showing that the defendant acted with the requisite scienter. *See* Flanagan, Administrative Proceeding File No. 3-9784, 71 S.E.C. Docket 1415, 2000 WL 98210, at *24 (ALJ Jan. 31, 2000) (Initial Decision) ("[A]fter *Hochfelder* and *Aaron*, it is not enough for the Division to show that a fiduciary breached an implied representation. It must also show a specific intent to deceive the customer to prevail under those antifraud provisions requiring proof of scienter."); *see generally* Aaron v. SEC, 446 U.S. 680 (1980) (considering scienter requirements for violations of securities regulations); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that scienter is required to recoup damages for private actions under section 10(b) and rule 10b-5); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476–80 (1977) (holding that rule 10b-5 prohibits only deceptive conduct and thus does not apply simply because a transaction is unfair or violates a fiduciary duty).

[134] *See* SEC v. Zandford, 535 U.S. 813, 823 (2002) ("[A]ny distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients."); *cf.*, Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 200 n.19 (3d Cir. 1990) ("'Silence, absent a duty to disclose, is not misleading under Rule 10b-5.'") (quoting Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988)).

[135] *See, e.g.*, Confirmation of Transactions, Exchange Act Release No. 33743, 56 SEC Docket 558, 1994 WL 73633, at *8 n.48 (Mar. 9, 1994):

> Two theories, the fiduciary and shingle theory, establish an obligation on the part of a broker-dealer to deal with customers fairly. In cases where a broker-dealer has established a customer relationship based upon trust and confidence, and the customer depends upon and follows the broker-dealer's advice, a fiduciary relationship is established between the broker-dealer and customer. As a fiduciary, the broker-dealer is also obligated to disclose all the material facts of a customer's transaction . . . . Closely related to the fiduciary theory is a duty to the customer established by the "shingle theory." According to the shingle theory, a broker-dealer impliedly represents at the outset of a securities transaction that it will deal with its customers fairly and in accordance with the standards of the industry.

The Shingle theory is discussed in Bissell, *infra* note 174, at 246.

representing that it will act in the customer's best interests.[136] Additionally, when the broker claims to have special skills in handling a customer's account, fiduciary duties will attach.[137] Even in the context of federal claims against a broker-dealer, the federal court may look to state law to determine whether a fiduciary duty existed.[138]

In contrast, a few courts have spoken in terms of an "inherent" fiduciary duty running from the stock broker to the customer.[139] The reasoning behind the inherent fiduciary duty approach is that the brokerage relationship is an

[136] *See* In the Matter of D.E. Wine Investments, Inc., Administrative Proceeding File No. 3-8543 Release No. ID-134, 1999 WL 373279 (SEC Initial Decision June 9, 1999), *relying on* Charles Hughes & Co. v. SEC, 139 F.2d 434, 436–37 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 978 (S.D.N.Y. 1973); In the Matter of Duker & Duker, Exchange Act Release No. 34-2350, 6 S.E.C. 386, 388–89, 1939 WL 36426 (Dec. 19, 1939); *see also, e.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215 (8th Cir. 1990).

[137] *See* Patsos v. First Albany Corp., 741 N.E.2d 841 (Mass. 2001), *affirming* 719 N.E.2d 882 (Mass. App. Ct. 1999) (a fiduciary relationship existed when the broker approached plaintiff, offered services, and claimed to be experienced in the field and uniquely capable of handling the purchase of certain stocks); *see also, e.g.*, Stokes v. Henson, 265 Cal. Rptr. 836, 839 (Cal. Ct. App. 1990). The experience and sophistication of the customer will be a factor in judging the extent of the broker's fiduciary duty. *Compare, e.g.*, McCracken v. Edward D. Jones & Co., 445 N.W.2d 375 (Iowa Ct. App. 1989) (broker owed a fiduciary duty to the customer, relying in large part on the customer's inexperience) *with* Williams v. Edward D. Jones & Co., 556 So. 2d 914 (La. Ct. App. 1990) (finding no breach of duty to a sophisticated customer).

[138] *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999) (in connection with 10b-5 claims relating to mark-ups, finding no fiduciary duty under New York law); SEC v. Pasternak, 561 F. Supp. 2d 459, 499 (D.N.J. 2008) ("To determine the existence of a fiduciary relationship in federal securities fraud actions, district courts generally look to state law.").

[139] *See, e.g.*, French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 825 (M.D. Tenn. 2002) (noting that "the investor-stockbroker relationship is an inherently fiduciary relationship") (applying Tennessee law), *relying on* Street v. J.C. Bradford & Co., 886 F.2d 1472, 1481 (6th Cir. 1989); Youngblood v. Wall, 815 S.W.2d 512, 516 (Tenn. Ct. App. 1991) (dispute involving real estate broker).

agency relationship, which by itself is fiduciary in nature.[140] However, that the relationship is fiduciary in nature only takes one so far. The key question is what actual duties arise out of the relationship. The answer depends on the particular broker-customer relationship and the functions performed by the broker. Thus, for example, a clearing broker that does not perform the retail functions normally associated with introducing brokers and full-service brokers has been said not to owe fiduciary duties to the customer.[141] Where a clearing broker has reason to know of wrongdoing by the introducing broker, both brokers can be held accountable.[142] For similar reasons, a prime brokerage operation[143] servicing an investment fund does not ordinarily owe duties directly to the fund's participants.[144]

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[140] *French*, 209 F. Supp. 2d. at 825. When applicable, state law fiduciary obligations also heighten the disclosure obligations relating to agreements to arbitrate broker-dealer/customer disputes. It has thus been held that a failure to adequately explain the arbitration clause can result in non-enforcement of the pre-dispute arbitration agreement. Willems v. U.S. Bancorp Piper Jaffray, Inc., 107 P.3d 465, 470 (Mont. 2005). Broker-dealer arbitration is discussed in 5 HAZEN, *supra* note 93, ch.15.

[141] *See, e.g.,* Lesavoy v. Lane, 304 F. Supp. 2d 520, 526 (S.D.N.Y. 2004) (applying New York law); Rozsa v. May Davis Grp., Inc., 187 F. Supp. 2d 123, 129 (S.D.N.Y. 2002); In re Adler Coleman Clearing Corp., 198 B.R. 70, 73 (Bankr. S.D.N.Y. 1996) ("As a general rule, a clearing firm is not liable for losses occasioned by an introducing broker because the clearing firm does not have a fiduciary relationship with the customers of that broker.").

[142] *See, e.g.*, Fezzani v. Bear, Stearns & Co., 384 F. Supp. 2d. 618 (S.D.N.Y. 2004).

[143] Prime brokerage refers to the services offered by broker-dealer firms to institutional investors, including hedge funds. Prime brokerage services include lending securities and extending credit to facilitate the fund's ability to invest on a leveraged basis. A prime broker typically also provides a clearing facility for its customers.

[144] *See* Eurycleia Partners LP v. UBS Sec., LLC, 600874/2007 (N.Y. Sup. Ct. July 1, 2008), as reported in *Case Against UBS Securities Dismissed, N.Y. Court Finds No Fiduciary Obligation*, SEC. L. DAILY (BNA) (Aug. 1, 2008), *available at* http://pubs.bna.com/ip/bna/sld.nsf/eh/A0B6W9G6H0; *see also Investor Suit Against UBS Over Hedge Fund Dismissed by Judge*, Bloomberg.com (July 29, 2008), http://www.bloomberg.com/apps/news?pid=20601127&sid=aWkFyvFRXlHo&refer=law.

Although there is authority to the contrary,[145] the apparent majority view of the cases applying state common law is that there is no blanket fiduciary relationship[146] between a broker-dealer and a client as a matter of law,[147]

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[145] There are a number of cases stating that a securities broker is a fiduciary and is subject to fiduciary duties. *See* Conway v. Icahn & Co., 16 F.3d 504 (2d Cir. 1994) (applying New York law); Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042 (11th Cir. 1987) (applying Florida law); Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 396 S.W.2d 570 (Mo. 1965) (broker is functionally a trustee). Seeking a doctrinal basis for such a holding, some courts have relied on the traditional duties of an agent to a principal. *See* Farmland Indus. v. Frazier-Parrott Commodities, 871 F.2d 1402 (8th Cir. 1989) (applying Missouri law); Thropp v. Bache Halsey Stuart Shields, Inc., 650 F.2d 817 (6th Cir. 1981) (applying Ohio law); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Perelle, 514 A.2d 552, 560–61 (Pa. Super. Ct. 1986) (citing RESTATEMENT (SECOND) OF AGENCY); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cole, 457 A.2d 656 (Conn. 1983); Reinhart v. Rauscher Pierce Sec. Corp., 490 P.2d 240 (N.M. Ct. App. 1971); *see also* Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties—Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DEPAUL L. REV. 709 (1990); Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61 (1990).

[146] *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999), *affirming* 988 F. Supp. 375, 386–87 (S.D.N.Y. 1997) ("naked allegation" that broker was a fiduciary of customer was insufficient).

[147] *See* Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208 (7th Cir. 1993) (applying Wisconsin law); Burdett v. Miller, 957 F.2d 1375, 1381–82 (7th Cir. 1992) (investment adviser not *per se* fiduciary, but could be shown to be by clear and convincing evidence) (applying Illinois law); Greenwood v. Dittmer, 776 F.2d 785 (8th Cir. 1985) (commodities broker) (applying Arkansas law); Ray E. Friedman & Co. v. Jenkins, 738 F.2d 251 (8th Cir. 1984) (commodities broker) (applying North Dakota law); Lesavoy v. Lane, 304 F. Supp. 2d 520, 526 (S.D.N.Y. 2004) (clearing broker's obligations related only to execution of orders and did not create fiduciary duties) (applying New York law); Stephenson v. Deutsche Bank AG, 282 F. Supp. 2d 1032, 1061 (D. Minn. 2003) (broker did not owe duty of care to sophisticated investor so as to trigger liability for negligent misrepresentation); Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87 (D. Mass. 1989); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986); Rude v. Larson, 207 N.W.2d 709 (Minn. 1973); DeSciose v. Chiles, Heider & Co., 476 N.W.2d 200 (Neb. 1991); In re Dean Witter Managed Futures Ltd.

but that the surrounding circumstances can suffice to create a fiduciary duty.[148] Chief among these factors that may create a fiduciary relationship is "a reposing of faith, confidence and trust,"[149] often evidenced by a broker-dealer having either prior authorization to trade for the client's account on a discretionary basis, or de facto control of the account.[150] Representing oneself to have investment and

P'ship Litig., 282 A.D.2d 271, 724 N.Y.S.2d 149, (N.Y. App. Div. 2001); Berki v. Reynolds Sec., Inc., 560 P.2d 282 (Or. 1977).

[148] *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999) (New York law); Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc., 157 F.3d 933, 940 (2d Cir. 1998) (New York law); Kwiatkowski v. Bear, Stearns & Co., No. 96 Civ. 4798, 1999 WL 1277245, at *7–8 (S.D.N.Y. Nov. 29, 1999); Perl v. Smith Barney, Inc., 230 A.D.2d 664, 666, 646 N.Y.S.2d 678, 680 (N.Y. App. Div. 1996); *cf.* Ongstad v. Piper Jaffray & Co., 407 F. Supp. 2d 1085 (D.N.D. 2006) (state law claim for breach of fiduciary duty, including unauthorized trading, was not removable to federal court under the Class Action Fairness Act of 2005 (28 U.S.C.A. § 1332)). *But cf.* Cordova v. Lehman Bros., 413 F. Supp. 2d 1309 (S.D. Fla. 2006) (SLUSA preempted state law claims against financial institutions, which provided custodial and trustee services with respect to their retirement trusts, for aiding and abetting common law fraud, aiding and abetting breach of fiduciary duty and breach of fiduciary duty).

[149] McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989) (quoting Kurth v. Van Horn, 380 N.W.2d 693, 695–96 (Iowa 1986)).

[150] United States v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (while there is no inherent fiduciary duty arising out of the brokerage relationship, fiduciary duties do arise out of a discretionary account), *relying on* United States v. Szur, 289 F.3d 200, 211 (2d Cir. 2002) ("[A] relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker."); Tapia v. Chase Manhattan Bank, N.A., 149 F.3d 404, 412 (5th Cir. 1998) ("[W]here the investor controls a nondiscretionary account and retains the ability to make investment decisions, the scope of any duties owed by the broker will generally be confined to executing the investor's order."); Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc., 157 F.3d 933, 940 (2d Cir. 1998). *Cf.* Trumball Invs. Ltd. v. Wachovia Bank, N.A., 436 F.3d 443, 447 (4th Cir. 2006) ("[T]he plain meaning of the phrase 'shall in its discretion' allows First Union to use its expert judgment. (applying Virginia law)). *See also* The Random House Dictionary of the English Language 563 (2d ed. 1987) (defining discretion as "the power or right to decide or act according to one's own judgment; freedom of judgment or choice").

advisory expertise will give rise to fiduciary obligations.[151] When a broker makes investment recommendations to a customer, the broker is acting in a position of trust vis-a-vis the customer, and as such is acting as a fiduciary.[152] A broker who misrepresents his or her expertise is guilty of a material misrepresentation.[153]

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Some courts treat the question of whether the account was discretionary or nondiscretionary as dispositive on the issue of fiduciary duty. *See, e.g.*, McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766–67 (3d Cir. 1990) (applying New Jersey law); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567–68 (9th Cir. 1985) (applying California law); Chor v. Piper, Jaffray & Hopwood, Inc., 862 P.2d 26, 32 (Mont. 1993). *Cf.* Allen D. Madison, *Derivatives Regulation in the Context of the Shingle Theory*, 1999 COLUM. BUS. L. REV. 271 (1999).

However, courts have rejected the notion that the "discretionary-nondiscretionary dichotomy [is a] shibboleth . . . ." Baker v. Wheat First Sec., 643 F. Supp. 1420, 1428 (S.D.W. Va. 1986) (applying West Virginia law). The latter view is more common. *See, e.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1217 (8th Cir. 1990) (applying South Dakota law); MidAmerica Fed. S & L Ass'n. v. Shearson/American Express, Inc., 886 F.2d 1249, 1258 (10th Cir. 1989) (fiduciary duty arises from doctrine of "holding out") (applying Oklahoma law); Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F.2d 605, 607 (9th Cir. 1983) (applying California law); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 697 F. Supp. 1224, 1226–27 (D.D.C. 1988); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 952 (E.D. Mich. 1978) (churning case); Duffy v. Cavalier, 259 Cal. Rptr. 162, 172–73 (Cal. Ct. App. 1989), *review granted and cause transferred*, 262 Cal. Rptr. 195 (1989).

[151] *See, e.g.*, Burdett v. Miller, 957 F.2d 1375, 1381–82 (7th Cir. 1992).

[152] *See* United States v. Laurienti, 611 F.3d 530, 540 (9th Cir. 2010) (holding that a broker making recommendations in a pump and dump scheme had a fiduciary duty which required disclosure of bonus commissions); United States v. Hart, 273 F.3d 363, 376 (3d Cir. 2001) (citing with approval United States v. Hussey, 254 F.3d 428 (2d Cir. 2001)); Louros v. Kreicas, 367 F. Supp. 2d 572, 595–96 (S.D.N.Y. 2005) (holding that allegations of fraud involving recommendation of option strategies were not preempted by New York's blue sky law ("the Martin Act")).

[153] *See* Misleading Communications About Expertise, FINRA Notice 08-27, 2008 WL 2583019 (May 20, 2008); NASD Manual Rule 2210 (prohibiting false, misleading, or exaggerated communications with the public and the omission of material facts or qualifications that would cause a communication to be misleading). This can apply to an omission

In reviewing the relevant state law decisions, some generalizations can be made about the treatment of securities broker-dealers. A broker-dealer is more likely to have a duty to make a full disclosure when recommending a security,[154] but is less likely to have an unqualified duty to provide the client with useful market information concerning the client's present portfolio even when the broker-dealer is aware of such information.[155] Some courts have been less vigilant in finding a fiduciary duty in the brokerage relationship. Those courts have questioned whether the common law imposes a special obligation on a broker-dealer.[156] There is considerable authority, however, to the effect that honesty and good faith are basic obligations of

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as well as a misrepresentation. For example, a broker giving advice without disclosing that he or she is unknowledgeable in that area would be a violation.

[154] *See* McCracken v. Edward D. Jones & Co., 445 N.W.2d 375, 381 (Iowa Ct. App. 1989) (holding that a broker should disclose the liquidity of investments and sales commission paid by the issuer to the broker); *see also* Ritch v. Robinson–Humphrey Co., 142 F.3d 1391, 1394 (11th Cir. 1998) (holding that an unsuitable recommendation gives a private right of action under Alabama Securities Act); Johnston v. CIGNA Corp., 916 P.2d 643, 649 (Colo. App. 1996) (holding that issues of fact as to whether investment recommendations were suitable precluded summary judgment).

[155] *See* Arst v. Stifel Nicolaus & Co., 871 F. Supp. 1370, 1384 (D. Kan. 1994), *aff'd in part, rev'd in part*, 86 F.3d 973 (10th Cir. 1996) (holding broker did not have a fiduciary duty to investigate or disclose information about securities customer wanted to sell); Walston & Co. v. Miller, 410 P.2d 658, 661 (Ariz. 1966) (holding that no fiduciary duty existed between broker-dealer and client with a commodities margin account); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck, 377 N.W.2d 605, 610 (Wis. 1985) (holding that a broker handling a soybean futures account was not strictly liable to accurately report crop sizes).

[156] *See, e.g.*, Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87, 92 (D. Mass. 1989) (holding that a brokerage relationship does not in itself create a fiduciary obligation) (citing with approval Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986), and Vogelaar v. H.L. Robbins & Co., 204 N.E.2d 461 (Mass. 1965)); DeSciose v. Chiles, Heider & Co., 476 N.W.2d 200, 206 (Neb. 1991).

broker-dealers.[157] Other courts are more willing to recognize that a broker has a fiduciary relationship with his or her customer.[158] Furthermore, it is clear that when a broker exercises discretion over an account, he or she will be subject to fiduciary obligations.[159] In such a case the broker is acting as trustee with regard to the customer's investments. With respect to a nondiscretionary account, the broker's duty may be limited to the proper execution of individual transactions, and that duty ends when the transaction is complete.[160] This

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[157] *See, e.g.*, Messer v. E.F. Hutton & Co., 833 F.2d 909, 920 (11th Cir. 1987), *amended*, 847 F.2d 673 (11th Cir. 1988) (applying Florida common law).

[158] *See, e.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215 (8th Cir. 1990) (holding that brokers are fiduciaries who owe their customers a duty of the utmost good faith, integrity, and loyalty under South Dakota law); MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249, 1259 (10th Cir. 1989) (upholding damage award based on broker's breach of fiduciary duty); First Union Brokerage v. Milos, 717 F. Supp. 1519, 1526 (S.D. Fla. 1989) (confirming existence of fiduciary relationship between broker and securities investor); Duffy v. Cavalier, 264 Cal. Rptr. 740, 751-52 (Cal. Ct. App. 1989) (holding that broker owes fiduciary duty to both sophisticated and unsophisticated investors alike). *Cf.* Laird v. Integrated Res., Inc., 897 F.2d 826, 835 (5th Cir. 1990) (ruling that an investment adviser is a fiduciary for purposes of judging the scope of Rule 10b-5 obligations).

[159] *E.g.*, Thropp v. Bache Halsey Stuart Shields, Inc., 650 F.2d 817, 819-20 (6th Cir. 1981); Rupert v. Clayton Brokerage Co. of St. Louis, 737 P.2d 1106, 1109 (Colo. 1987); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 517-18 (Colo. 1986) (en banc); *Merrill Lynch*, 377 N.W.2d at 609. This is true even if the broker does not have written authority but nevertheless exercises de facto control over the account. *E.g.*, Petersen v. Sec. Settlement Corp., 277 Cal. Rptr. 468, 471-473 (Cal. Ct. App. 1991); Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 235 (Cal. Ct. App. 1968). In such situations, some courts describe the broker as having assumed broad fiduciary duties. *See, e.g.*, Patsos v. First Albany Corp., 741 N.E.2d 841, 850 (Mass. 2001).

[160] *DeSciose*, 476 N.W.2d at 206 ("The mere existence of a broker-client relationship, without more, does not imply a confidential relationship." (citing with approval Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974))); Russo v. Bache Halsey Stuart Shields, Inc., 554 F. Supp. 613 (N.D. Ill. 1982)); *cf.* Mars v. Wedbush Morgan Sec., Inc., 283 Cal. Rptr. 238, 242 (Cal. Ct. App. 1991) (holding that the clearing broker did not owe a duty to the customer); *see also, e.g.*, Martinez Tapia v. Chase Manhattan

is almost certain to be the case with respect to unsolicited transactions.[161] Under New York law, for example, the broker in a non-discretionary account has the duty to notify the customer before trades are made and also to execute trades[162] requested by the customer.[163] Upon completion of the trade, a securities broker who acted upon a customer's order does not have any further duty to call upon his or her own professional skill and prudence concerning the wisdom of any of the customer's trades.[164]

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Bank, N.A., 149 F.3d 404, 412 (5th Cir. 1998) ("[W]here the investor controls a nondiscretionary account and retains the ability to make investment decisions, the scope of any duties owed by the broker will generally be confined to executing the investor's order."); Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc., 157 F.3d 933, 940 (2d Cir. 1998) ("Under New York law, as generally, there is no general fiduciary duty inherent in an ordinary broker-customer relationship . . . . [A general fiduciary] duty can arise only where the customer has delegated discretionary trading authority to the broker."); Hill v. Bache Halsey Stuart Shields, Inc., 790 F.2d 817, 824 (10th Cir. 1986) (the fiduciary duty owed by a broker operating a nondiscretionary account is "very narrow—primarily not to make unauthorized trades."); *cf.* Kwiatkowski v. Bear, Stearns & Co., No. 96 Civ. 4798, 1999 WL 1277245, at *9 (S.D.N.Y. Nov. 29, 1999) (holding that a broker's fiduciary duties are broader than merely those related to the execution of a transaction).

[161] However, when the transaction is the result of a broker-initiated recommendation, there are duties that attach to the making of the recommendation. *See* 5 HAZEN, *supra* note 93, § 14.16.

[162] *See, e.g.*, Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996) (holding that the duty is limited to the completion of the transaction).

[163] *Foresters*, 157 F.3d at 940; *Kwiatkowski*, 1999 WL 1277245, at *9; *Perl*, 646 N.Y.S.2d at 680.

[164] *See* Rude v. Larson, 207 N.W.2d 709, 711 (Minn. 1973) (holding that absent a special agreement, a stock broker or brokerage house owes a customer only the duty to exercise due care in executing the customer's instructions); Davis v. Midwest Disc. Sec., Inc., 439 N.W.2d 383, 388 (Minn. Ct. App. 1989); Puckett v. Rufenacht, Bromagen & Hertz, Inc., 587 So.2d 273, 279 (Miss. 1991) ("A commodities broker in a non-discretionary account only owes his customer the duty to properly execute trades as directed by him, and has no further duty to call upon his own professional skill and prudence as to the wisdom of any of his customer's trades."); Vogel v. A.G. Edwards & Sons, Inc., 801 S.W.2d 746, 751-52 (Mo. Ct. App. 1990); Merrill Lynch, Pierce, Fenner & Smith v. Perelle, 514 A.2d 552, 561

However, the absence of a discretionary account is not conclusive in all cases; what also matters is the degree of trust and confidence that the broker cultivates in the customer.[165] A securities broker has a duty to the customer with respect to the functions that have been entrusted to the broker.[166] For example, duties associated with a non-discretionary account include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer.[167]

(Pa. Super. Ct. 1986); Edward D. Jones & Co. v. Fletcher, 975 S.W.2d 539, 544 (Tex. 1998) ("[A] stockbroker's only duty to a client with a non-discretionary account is to faithfully carry out the client's instructions."); Hand v. Dean Witter Reynolds Inc., 889 S.W.2d 483, 493-94 (Tex. App. 1994) (holding that in a non-discretionary account the duty of a broker is limited to carrying out the customer's instructions); *see also, e.g.*, Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 952-53 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

[165] *See, e.g.*, Wallace v. Hinkle Nw., Inc., 717 P.2d 1280, 1282 (Or. Ct. App. 1986); *see also, e.g.*, Starkweather v. Shaffer, 497 P.2d 358, 361 (Or. 1972) ("A fiduciary relationship exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing the confidence.").

[166] *See, e.g.*, *Foresters*, 157 F.3d at 940; *Kwiatkowski*, 1999 WL 1277245, at *7–8; Rush v. Oppenheimer & Co., 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988).

[167] *Leib*, 461 F. Supp. at 953 (citations omitted); Beckstrom v. Parnell, 730 So.2d 942, 948-49 (La. Ct. App. 1998).

Some courts have indicated that a stock broker is a fiduciary to the extent that he or she owes the customer the utmost good faith.[168]

## D. The Shingle Theory

As discussed below, courts and regulators have often referred to the "shingle theory" in talking about securities broker-dealers when they make recommendations or otherwise hold themselves out as having a degree of expertise. Sometimes discussion of the shingle theory is combined with references to fiduciary obligations. Regardless of whether it is discussed explicitly in fiduciary terms, the shingle theory addresses the same issue: instances in which broker-dealers are held to higher standards of conduct than might otherwise apply in a market or arm's-length situation.

Simply put, the "shingle theory" holds that by hanging up a shingle, the broker implicitly represents that he or she will conduct business in an equitable and professional manner.[169]

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[168] *E.g.*, Minor v. E.F. Hutton & Co., 409 S.E.2d 262, 264 (Ga. Ct. App. 1991). Many courts will look to all of the factual circumstances surrounding the broker-customer relationship at issue. *See, e.g.*, Williams v. Edward D. Jones & Co., 556 So.2d 914, 916 (La. Ct. App. 1990) ("In determining the liability of a broker in a bond transaction, we must look to the nature of the transaction and the relationship between the broker and the customer."); Roberson v. PaineWebber, Inc., 998 P.2d 193, 198-99 (Okla. Civ. App. 1999) (finding that there is a fiduciary duty running from the broker to the customer but the scope of that duty depends upon the nature of the relationship between the broker and customer, and is to be determined on the facts of each case).

[169] *See, e.g.*, Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), ("It is now well established that a securities dealer who does business with the public, even at arm's length, impliedly represents that he will deal fairly with the public."), *aff'd* 417 F.2d 147 (7th Cir. 1969); *accord, e.g.*, Charles Hughes & Co. v. Sec. and Exch. Comm'n, 139 F.2d 434, 436-37 (2d Cir. 1943); *see also, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cole, 457 A.2d 656, 664 (Conn. 1983) ("The 'shingle' theory . . . has become a well established doctrine in the securities field.") (citation omitted); Mennillo v. Tucker, Anthony & R. L. Day, Inc., No. CV86-0227043S, 1991 WL 83981, at *8 (Conn. Super. Ct. May 3, 1991).

As noted elsewhere in this article, SEC and self-regulatory rules require broker-dealers to adhere to standards of fair and equitable principles of trade.[170] A breach of the implied representation that a broker will deal fairly with the customer will be actionable in a private action under the securities laws only if the plaintiff can show a causal relationship between the alleged breach and an injury to the plaintiff.[171] A breach of fiduciary duty will not by itself support a claim under the federal securities laws.[172] Thus, the shingle theory will support a private right of action only to the extent that it amounts to a fraudulent implied misrepresentation in connection with the purchase or sale of a security.[173]

Additionally, it has been explained that the shingle theory is but an extension of the common law doctrine of "holding out."[174] It has long been recognized that a securities

[170] *See supra* notes 1, 123, 128, 136, and accompanying text.

[171] *See, e.g.*, *In re* Credit Suisse First Boston Corp., No. Civ.A.02-12056-GAO, 2005 WL 852455, at *9 (D. Mass. Mar. 31, 2005) (failure to adequately allege causal connection between analyst's "buy" recommendations and impact on price of securities); Gruntal & Co. v. San Diego Bancorp, 901 F. Supp. 607, 619 (S.D.N.Y. 1995).

[172] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (SEC Rule 10b-5 is a fraud-based rule).

[173] *See* Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 246 n.7 (S.D.N.Y. 1996) ("The 'shingle theory' denotes the proposition that a broker-dealer, by holding itself out as competent to conduct a brokerage business, owes its customer certain duties, including the duty not to sell securities at prices far in excess of market prices. . . . Recent cases have harmonized the older 'shingle theory' cases with the Supreme Court's Rule 10b-5 fraud jurisprudence by identifying both a duty to disclose and a material omission. . . . To the extent plaintiff's 'shingle theory' claim relies on a violation of section 10(b) and Rule 10b-5, the claim must fail because . . . a breach of fiduciary duty does not give rise to a securities fraud claim merely because it involves a securities transaction . . . .") (citations omitted).

[174] *See, e.g.*, Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992) (holding that representing oneself as an expert in investment advice creates fiduciary duties); *see also* WILLIAM L. PROSSER, LAW OF TORTS 697 (4th ed. 1971). *But see, e.g.*, Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986) (holding that stockbroker and client

broker occupies a special position of trust and confidence with regard to his or her customer when making a recommendation and that any recommendation of a security carries with it an implicit representation that the broker has an adequate basis for the recommendation.[175]

Originally the shingle theory was first applied under the securities laws in the context of a broker's charging excessive mark-ups,[176] but now it is not so limited.[177] As previously

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had no fiduciary relationship where client had minimal investment knowledge and relied on the expertise of his broker).

[175] *See, e.g.*, Hanly v. SEC 415 F.2d 589, 596 (2d Cir. 1969) ("A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has an adequate basis for the opinions he renders."); *see also, e.g.*, Merrill Lynch, Pierce Fenner & Smith, Inc., Exchange Act Release No. 14149, 1977 WL 187397, at *6 (Nov. 9, 1977). Failure to have such a reasonable basis for a recommendation can result in a violation of the securities laws' antifraud proscriptions. As observed many years ago,

> The Commission is relying on the so-called "shingle" theory to establish statutory fraud. The essence of this theory is that in certain circumstances one who sells securities to the public—who hangs out his shingle—implicitly warrants the soundness of statements of stock value, estimates of a firm's earnings potential, and the like. When such a person conceals known information inconsistent with this "implicit warranty of soundness" he has omitted a material fact without which the statements made would be misleading. . . . One element of this warranty . . . is that all such statements, or at least highly optimistic ones, have an "adequate basis." If the salesman makes statements, knowing they had no adequate basis, or if he is "grossly careless or indifferent to the existence of an adequate basis" for his statements, then he has violated the antifraud provisions of the securities laws, principally § 17(a)(2) of the Securities Act of 1933.

Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring). *Cf. In re* Thomson McKinnon Sec., Inc., 143 B.R. 612, 619 (Bankr. S.D.N.Y. 1992) (holding that a mortgage broker did not have the heightened duty with respect to recommendations that applies to securities brokers).

[176] Charles Hughes & Co. v. SEC, 139 F.2d 434, 437–38 (2d Cir. 1943).

[177] *See, e.g.*, 8 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 9-C-1, at 3816–18 (3d ed., rev. 2004) ("By now—one may add 'happily'—the shingle theory not only is unchallenged but has been considerably refined.

noted, applying this aspect of shingle theory, a broker who makes a recommendation is viewed as making an implied representation that he or she has adequate information on the security in question for forming the basis of the broker's opinion.[178] This concept of implied representation has also been expressed in terms of a broker-dealer "implicitly warrant[ing] the soundness of the statements of stock value,"[179] but this clearly is too broad a statement of the rule. To date, the concept of implied warranty has not been extended to brokers' recommendations, and the appropriate standard of care, whether under the shingle theory or otherwise, is necessarily based upon the broker-dealer's factual basis and reasonable belief in the opinions that form the basis of the recommendation.

Furthermore, the shingle theory is sometimes applied to bring within the ambit of the SEC antifraud rules those

. . . Moreover the potentialities of the 'shingle' theory are not exhausted by markup cases.").

[178] *See, e.g.*, Filloramo v. Johnston, Lemon & Co., 697 F. Supp. 517, 521 (D.D.C. 1988) (upholding complaint against broker-dealer for alleged misrepresentations regarding future events; absence of evidence supporting his predictions could lead jury to conclude that broker acted recklessly); V.F. Minton Sec., Inc., Exchange Act Release No. 32074, Fed. Sec. L. Rep. (CCH) ¶ 85,128 (Mar. 31, 1993) (sanctioning brokerage firm and its president for making recommendations without an adequate basis). The shingle theory has a long history with the SEC. *See generally* NICHOLAS WOLFSON, RICHARD M. PHILLIPS & THOMAS A. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS 2–14–2–16 (1977) (discussing the shingle theory and brokers' obligations generally); Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407 (1989) (surveying securities brokers' duties); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627 (1996) (discussing brokers' obligations in the context of sophisticated customers); Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247 (1983) (discussing securities brokers' fraud); Robert N. Leavell, *Investment Advice and The Fraud Rules*, 65 MICH. L. REV. 1569 (1967) (discussing duties associated with the giving of investment advice). *But see* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995).

[179] Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (Clark J., concurring).

activities of the broker which otherwise might not fall within the literal application of those rules. In many of these cases, brokers have held themselves out as having complied with SEC regulations. Those activities that have been used as a basis for accountability, and in some cases liability, include undisclosed insolvency,[180] egregious failures to comply with SEC bookkeeping requirements,[181] and noncompliance with net capital requirements.[182] Also, the SEC has referred to the shingle theory as governing the broker's obligations with regards to execution of customer orders.[183]

Therefore, the SEC has clearly demonstrated that prohibited conduct is not limited to violation of any specified, enumerated SEC rules, but instead covers all behavior that amounts to a deceptive or manipulative device.[184] The

[180] SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 979 (S.D.N.Y. 1973); *see also* Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd* 417 F.2d 147 (7th Cir. 1969).

[181] Joseph v. Shields, Jr., Exchange Act Release No. 8484, [1967–1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,643 (Jan. 3, 1969).

[182] SEC v. Charles Plohn & Co., 433 F.2d 376 (2d Cir. 1970); *see also* Joseph, *supra* note 181. For other decisions employing the shingle theory, see, for example, *Hanly v. SEC,* 415 F.2d 589 (2d Cir. 1969); Hamilton Waters & Co., Exchange Act Release No. 7725, 1965 WL 87585 (Oct. 18, 1965); In the Matter of B. Fennekohl & Co., Exchange Act Release No. 6898, 1962 WL 68130 (Sept. 18, 1962); Alexander Reid & Co., Exchange Act Release No. 6727, 1962 WL 68704 (Feb. 8, 1962); Duker & Duker, Exchange Act Release No. 2350, 1939 WL 36426 (Dec. 19, 1939).

[183] *See, e.g.*, Richardt-Alyn & Co., Exchange Act Release No. 151, 1999 WL 777449, at *13 (Sept. 30, 1999) ("The Commission has variously articulated this duty [the best execution obligation] in terms of the 'shingle' theory, a relationship of trust and confidence, and agency") (citing Order Execution Obligations, 62 SEC Docket at 2242–44); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998); E.F. Hutton & Co., Exchange Act Release No. 34-25887, 41 SEC Docket 413, 1988 WL 901859 (July 6, 1988); Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61 (1990).

[184] SEC Rule 15cl-2 generally prohibits fraud and misrepresentation by broker-dealers. Subsection (c) of that rule expressly provides that the scope of the rule prohibiting fraudulent conduct "shall not be limited by any specific definitions of the term 'manipulative, deceptive, or other fraudulent device or contrivance' contained in other rules adopted

shingle theory as a basis for violation of the antifraud rules is based on an implied representation that the broker will deal with the customer fairly and in a professional manner.[185] This same obligation to conduct one's business in a fair manner is found in FINRA (formerly the NASD) rules.[186]

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pursuant to section 15(c)(1) of the Act." 17 C.F.R. § 240.15c1-2(c) (2010); *see also* the general antifraud proscriptions of SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010).

[185] Gartz, Exchange Act Release No. 113, 1997 WL 441913, at *19 n.33 (Aug. 6, 1997) ("Under the shingle theory, investors are entitled to rely on the implied representation that they will be dealt with fairly, honestly and in accord with industry standards." (*citing* Trost & Co., 12 S.E.C. 531, 535 (1942))); *see also, e.g.*, In the Matter of Johansen, Complaint No. C8A940073, 1997 WL 1121295, at *8 n.12 (N.A.S.D.R Sept. 18, 1997) ("This obligation has been referred to as one derived from the 'shingle theory,' on the basis that brokers who hang out a 'shingle' implicitly represent to their customers that the prices they are charging in securities transactions are reasonably related to the prices charged in an open and competitive market." (*citing* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1469 (2d Cir. 1996))); Mac Robbins & Co., Exchange Act Release No. 6846, 1962 WL 67931, at *2 (July 11, 1962) (discussing the shingle theory in the context of boiler room operations); Nat'l Ass'n Sec. Dealers, Inc., Exchange Act Release No. 3700, 1945 WL 26103, at *11 (June 11, 1945) ("[A] member's failure to live up to obligations owed to a customer . . . constitutes a breach of 'just and equitable principles of trade' . . . ."); Duker & Duker, Exchange Act Release No. 2350, 1939 WL 36426, at *2 (Dec. 19, 1939) ("Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession."); Market Surveillance Comm. v. R. B. Marich, Inc. et al., Complaint No. MS–849, n.27 (NBCC Decision Dec. 23, 1991) ("[A] broker/dealer's professional 'shingle' impliedly represents that he will engage in fair and honest dealings with customers, according to industry standards."); *see also, e.g.*, In the Matter of Shvarts, Complaint No. CAF980029, 2000 WL 768524, at *7 (N.A.S.D.R. June 2, 2000); Payment for Order Flow, Exchange Act Release No. 34902, 57 SEC Docket 2315, 1994 WL 587790 (Oct. 27, 1994); Suitability of Investment Advice Provided by Investment Advisers, Exchange Act Release No. 1406, 56 SEC Docket 724, 1994 WL 84902 (Mar. 14, 1994).

[186] FINRA Manual Rule 2010, *available at* http://finra.complinet.com/en/display_main.html?rbid=2403&element_id=5504 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."); *see also* NASD Rule IM-2310-2(a)(1), *available at* http://finra.complinet.com/en/display/display_main.

The foregoing discussion demonstrates how general principles, including general fiduciary obligations, have played a significant role in broker-dealer regulation. Without defining each and every potential prohibited practice, this approach to regulation has proven satisfactory in addressing improper practices. Regulation will not entirely prevent unscrupulous conduct. The best that can be hoped for is that regulation will provide a sound basis for determining when the line between proper and improper conduct has been crossed.

Although broker-dealer regulation is premised on general principles and standards, there are instances in which regulators have engaged in more specific rulemaking. Striking examples are the rules that developed in the wake of various public offering abuses that occurred in the 1990s. The section that follows discusses the regulatory responses to these events.

html?rbid=2403&element_id=3640 ("Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public."); NASD Rule IM–2310–2(b)(5)(d), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3640:

> The Commission has also recognized that brokers and dealers have an obligation of fair dealing in actions under the general anti-fraud provisions of the federal securities laws. The Commission bases this obligation on the principle that when a securities dealer opens his business he is, in effect, representing that he will deal fairly with the public. Certain of the Commission's cases on fair dealing involve practices not covered in the foregoing illustrations. Usually, any breach of the obligation of fair dealing as determined by the Commission under the anti-fraud provisions of the securities laws could be considered a violation of the Association's Rules.

## E. Public Offering Sales Practices

An example of broker-dealer rulemaking with specific, detailed rules occurred in the aftermath of problems in the late 1990s regarding certain practices in connection with public offerings. During that era there was an upsurge in a number of questionable practices.[187] For example, there were instances of allocating "hot issues"—those that were anticipated to trade above the offering price. There were preexisting principles regarding improper allocation practices;[188] nevertheless, the NASD saw fit to propose more detailed rules regarding allocation of public offerings.[189]

The pernicious practice of laddering, or pre-selling the aftermarket, grew during the 1990s. Laddering consists of requiring purchasers of registered offerings to commit to purchase shares in the aftermarket in order to get part of the public offering allocation. This practice not only provides improper consideration for the allocation of IPO shares, but also creates additional demand in the aftermarket, designed to ensure an increase in prices once the shares are publicly traded.[190]

Laddering generates buying interest in offered securities that would not exist otherwise. This practice violates a number of existing rules and principles. For instance, a

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[187] *See generally* HAZEN, *supra* note 93.

[188] *See* FINRA Manual Rule 5110, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6831 and FINRA Manual Rule 5190, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6833 (addressing filing requirements for underwriters associated with IPOs).

[189] *See* FINRA Proposed Rule 5131, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p120939.pdf; NASD Proposed Rule 2712, *available at* http://www.complinet.com/file_store/pdf/rulebooks/nasd_0255.pdf (proposing a rule to end abusive IPO allocation processes); *see also* NYSE/NASD IPO Advisory Committee Report (May 2003), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf.

[190] *See, e.g.*, Jenny Anderson, *2 Firms to Pay $40 Million Each in I.P.O. Case*, N.Y. TIMES, Jan. 26, 2005, *available at* http://www.nytimes.com/2005/01/26/business/26wall.html.

distribution plan requiring purchasers to commit to aftermarket purchases would have to be disclosed in the offering registration statement filed with the SEC.[191] Regardless of disclosure, pre-selling the aftermarket implicates the antifraud and anti-manipulation rules, as those sales are designed to produce artificial demand. Solicitation of commitments to purchase in the aftermarket violates the Securities Act's anti-gun jumping provisions.[192]

Also, in the 1990s, many IPOs were marketed by "spinning"[193] IPO shares to favored customers in exchange for a *quid pro quo*. Some shares were given to parties who planned to "flip"[194] the shares by reselling them immediately into the public market. Although not explicitly fraudulent or otherwise *per se* manipulative, these practices proved problematic and have been attacked as manipulative and deceptive. Even without explicit rules, severe sanctions may be imposed against brokerage firms that engage in these and other improper IPO practices.[195]

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[191] The 1933 Act disclosure requirements are discussed in HAZEN, *supra* note 93, ch. 3.

[192] Securities Act of 1933, Section 5(a), 15 U.S.C. § 77e(a) (2010), prohibits sales of securities covered by a 1933 Act registration prior to the registration statement's effective date, which is the date that the public offering begins. In securing commitments of securities sales prior to the offering date, section 5(a) is violated.

[193] Spinning is when the underwriter diverts hot issues to venture capitalists and/or executives of companies, who in turn have the potential to direct their company's future offerings to the underwriters. *See, e.g.*, Spitzer v. McLeod, 2006 WL 1374014 (N.Y. Sup. Ct. 2006) (upholding civil fraud suit for undisclosed spinning in connection with IPO). *Cf.* In re eBay, Inc S'holders' Litig., 2004 Del. Ch. LEXIS 4 (Del. Ch. Jan. 23, 2004) (excusing demand requirement for derivative suit challenging alleged spinning in connection with IPO).

[194] "'Flipping' is the practice of buying a 'hot issue' and then selling it within a short period of time into a rising market, earning a quick profit on the transactions." In the Matter of Account Management Corp., Exchange Act Release No. 36314, 60 SEC Docket 962, 1995 WL 579449, at *3 (Sept. 29, 1995).

[195] For example, severe penalties have been imposed against firms charged with improper IPO practices. *See, e.g.*, SEC v. Morgan Stanley & Co., Civ. Action No. 1:05 CV00166 (D.D.C.), Litigation Release No. 19050,

There are several other offering practices that were addressed by proposed NASD and FINRA rulemaking.[196] The risk in adopting such a detailed taxonomy of prohibited practices is that they will be interpreted as providing an exhaustive list of prohibited practices. However, these rules were not drafted with such intent, and consequently, should not be viewed as providing a complete list of impermissible behaviors. Thus these rules should not be used to provide safe harbors for unenumerated deceptive practices. Instead, it is imperative that such rules be viewed as supplementing, rather than replacing, general principles, standards, and the antifraud rules that apply to broker-dealers.

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2005 WL 156766 (Jan. 25, 2005); SEC v. Goldman Sachs & Co., 05 CV853 (S.D.N.Y. 2005), Litigation Release No. 19051, 2005 WL 156767 (Jan. 25, 2005). These were two instances in which the firm agreed to $40 million fines without admitting guilt. The SEC charged the firms with various improper practices, including (1) pre-selling the aftermarket by telling certain customers that they could obtain good allocations of "hot" IPOs if they expressed an interest in buying shares in the immediate aftermarket and (2) encouraging flipping by soliciting aftermarket interest from customers that the firm knew had no interest in owning the shares for the long term, resulting in the customers flipping both their IPO allocations and aftermarket purchases. A number of other manipulative practices were also alleged: suggesting to certain customers the aftermarket price limits they should provide in order to obtain a good IPO allocation; in certain cases, encouraging customers to increase the aftermarket prices they originally said they would be willing to pay; accepting customers' indications that they would purchase shares in the aftermarket interest equal to or greater than their IPO allocations (such as "1 for 1" or some other ratio); and in one case, soliciting an aftermarket order from a customer before all of the IPO shares had been distributed, which the firm executed once trading began (this customer sold both its IPO and aftermarket shares on the same day); *see also, e.g.*, *Broker-Dealers: Goldman Sachs Sub, Formerly Spear Leeds, Settles Charges of Hiding IPO Sales*, 37 Sec. Reg. & L. Rep. (BNA) 563 (March 28, 2005). *Cf.* Cordes & Co. Fin. Servs., Inc. v. A.G. Edwards & Sons, Inc., 502 F.3d 91 (2d Cir. 2007) (reversing denial of class certification and remanding for further proceedings claims of illegal pricing in IPOs).

[196] *See* FINRA Proposed Rule 5131, *supra* note 189 (proposing rules regarding issues such as reports of indications of interests, lock-up agreements, underwriter agreements, and market orders).

In 2003, the SEC approved the NASD's revamped approach to regulating certain public offering practices.[197] The older rules related to "hot issues." In contrast, the new rules clearly address the offering process for *all* IPOs. The NASD's IPO requirements were approved by the SEC in October 2003.[198] NASD Rule 2790 (now FINRA Rule 5130)[199] replaced the former hot issue interpretations,[200] making it clear that the new requirements apply to and addressed all IPOs, not just those that involve hot issues.[201] The new IPO rule expands and clarifies many of the NASD policies already in place. Subject to some specific exceptions,[202] IPO shares may not be allocated to "restricted persons"—the label given to those individuals or entities having an interest in the issuer or in the offering.[203] Under the former hot issue interpretation, brokers could sell IPO shares to a restricted person, provided that, after determining the issue was hot, the broker (1) cancelled the trade before the end of the first business day after secondary market trading began for that issue, and (2) reallocated the security at the public offering price to a nonrestricted person or account.[204] The NASD's

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[197] *See* In re NASD, Inc., Exchange Act Release No. 48701, 2003 WL 22438827 (Oct. 24, 2003).

[198] *See id.*

[199] FINRA Manual Rule 5130, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4894.

[200] *See* NASD's Free Riding and Withholding Interpretation, IM–2110–1. Hot issues are discussed in 2 HAZEN, *supra* note 93, at § 6.3.

[201] *See* NASD's Free Riding and Withholding Interpretation, formerly NASD Rule IM-2110-1. "Hot issues" are discussed in 2 HAZEN, *supra* note 93, at § 6.3.

[202] For example, the rule does not apply to sales to underwriters under a stand-by underwriting agreement.

[203] The former hot issue interpretation treated certain people, such as hedge fund managers and other investment managers, as "conditionally restricted." The IPO Rule eliminates the conditionally restricted status, treating all persons as either restricted or nonrestricted.

[204] Under the FINRA (formerly the NASD) IPO rule, "restricted persons" include broker-dealers involved with the offering and their associates, finders, and fiduciaries of the managing underwriter of a public offering. Lawyers, accountants, and consultants working on an offering

IPO rule is designed to prohibit distribution of IPO shares to restricted persons entirely. Accordingly, before selling IPO shares, the broker must verify that the customer is not a restricted person under the rule.[205]

## VI. ASSESSMENT OF BROKER-DEALER REGULATION

The foregoing discussion provides a sense of the ways in which SEC and FINRA regulation of securities broker-dealers combines rules addressing specifically defined conduct and broader principles of fair dealing. This approach is also supplemented by an antifraud regime.

Standards and principles are sometimes criticized because they do not provide a bright-line test. Clearly, broker-dealers need firm guidelines for determining appropriate conduct. To this end, the existing rules supplemented by regulatory interpretations are sufficient. The current rules make it clear that certain types of conduct are impermissible. Fraud and manipulation are outlawed.[206] A number of specific practices are also addressed by rulemaking. For example, churning (entering into

will generally be classified as restricted persons for purposes of the offering on which they work. The IPO rule not only covers people occupying the aforementioned positions, but also applies to their immediate family.

[205] Within twelve months prior to any allocation of a new issue, brokers must receive from each person or account, a representation that the person or account is eligible as a nonrestricted person to receive new issue securities. As an alternative to a representation directly from the customer, a broker may rely on a representation from a domestic bank, foreign bank, broker-dealer, investment adviser, or other conduit, that all purchases of new issues for its accounts are in compliance with the IPO Rule. The broker must update this information annually, but may rely on the customer for news of any changes. Thus, for example, if within a year of receiving verification from a person that the customer qualifies as a nonrestricted person, the customer's status changes to restricted, the NASD member will not be considered to be in violation of the IPO Rule unless the broker has been notified of this change or otherwise has reason to believe that such a change has occurred.

[206] *See supra* Part V.B.

transactions to generate commissions) is expressly prohibited.[207] Similarly, it is illegal to recommend transactions without a sufficient knowledge of the security[208] or to make recommendations that are unsuitable in light of the customer's knowledge, experience, and risk-bearing tolerance.[209] These are just a few examples of improper broker-dealer activity expressly addressed by SEC or FINRA rules.

Concerns about the current approach of supplementing existing specific rules with a "just and equitable principles of trade" requirement are misplaced. The current approach—perhaps combined with a more explicit recognition of broker-dealer fiduciary obligations through SEC rulemaking or a direct legislative declaration—provides a good approach to regulation. There can be problems with a regulatory scheme that does not give sufficient notice to the regulated industry regarding the proper standards of conduct. Such issues arise concerning conduct at the margins, which does not clearly violate or comply with specific administrative rules. Granted, a standard based on just and equitable principles of trade does not translate into a detailed list of do's and don'ts with respect to such conduct at the margins. However, under the present regime, the message to broker-dealers is clear: the broker-dealer should be comfortable in its belief that it can establish, without any doubt, that the conduct is consistent with just and equitable principles of trade. A broker who decides to engage in conduct it recognizes is marginal, but with the belief that it can marshal arguments to support its conduct, consciously assumes the risk that it will be unable to justify its actions. In such a case, the actor is on notice that there is a reasonable likelihood that the conduct violates applicable principles of just and equitable conduct. Given the fact that stock brokers occupy a position of trust, and thus are often placed in fiduciary or fiduciary-

[207] *See* 5 HAZEN, *supra* note 93 at § 14.20 and Part V.B for further discussion.

[208] *See supra* Part V.C.

[209] *See supra* Part V.C.

like positions, it is not unreasonable to have a legal and regulatory regime that puts a high burden on the broker to establish that its conduct is within the realm of what is permissible.

## VII. CONCLUSION

Broker-dealer conduct is under increased scrutiny because of recent events. The problems that led to recent scandals reveal that there has been enforcement failure but do not show that there has been a substantial gap in regulation. Congress has mandated that the SEC study whether there are gaps in broker-dealer regulation and whether there should be more explicit regulatory statements regarding broker-dealer fiduciary obligations. As discussed throughout this article, there are many examples of particular broker-dealer fiduciary obligations in the existing law. In fact, any time a securities broker acts as something more than a mere order taker, heightened obligations attach. There is no doubt that expressly stating that broker-dealers are fiduciaries will provide further emphasis on their obligations. However, even in the absence of a legislative or regulatory declaration to that effect, heightened standards for broker-dealers are already well established.