Caveat Consiliator - Let the Adviser Beware Imposing Fiduciary Duties on Fee-Based Financial Professionals

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I. Introduction

The last five years have been a very tumultuous time for individual investors. Since 2000, the following events have impacted the financial markets: (1) an economic slowdown in early 2000; (2) increased inflation and decreased consumer confidence;[2] (3) the tragic events of 9/11; (4) the fraudulent activities at Enron, Tyco, Worldcom, Global Crossing and other high-flying publicly traded companies;[3] (5) the numerous investigations into the trading abuses at many of the large mutual fund companies;[4] and, (6) a significant decline in home buying and home sales prices. Each of these events has caused individual investors to lose confidence in the securities markets.[5] In response to some of these events, Congress passed the Sarbanes-Oxley Act of 2002[6] and the Securities and Exchange Commission ("SEC") proposed or issued rules related to mutual fund disclosures.[7]

Despite the recognition of critical problems with the corporations and investment companies whose securities are offered to the public, and the subsequent regulations to enhance investor protection, regulators have done very little to change the requirements for financial professionals.[8] As a result, individual investors are also losing faith in financial

[1] Some revisions have been made from the article's original form, including discussion of the March 30, 2007 decision by the United States Court of Appeals for the District of Columbia Circuit in.

[2] *See Fed: Slowdown Not Over*, CNNMONEY, Feb. 28, 2001, *at http://money.cnn.com/2001/02/28/economy/greenspan/index.htm* (last visited Sept. 15, 2004).

[3] *See* Jake Ulich, *Year of the Scandal*, CNNMONEY, Dec. 17, 2002, *at* http: //money.cnn.com/ 2002/12/17/news/review_scandals/index.htm (last visited Sept. 15, 2004); Rebecca Thomas, *Crisis of Confidence*, SMARTMONEY, Feb. 6, 2002, *at http://www.smartmoney.com/theeconomy /index.cfm?Story=20020206* (last visited Sept. 15, 2004).

[4] *See* Christine Dugas & Elliot Blair Smith, *SEC Rule Viewed As Both 'Right Step' and Restrictive*, USA TODAY, June 24, 2004 (includes a listing of settlements reached with various mutual fund companies between Sept. 3, 2003 and June 21, 2004); *60 Minutes: Mutual Fraud; Uncovering a Late-trading Scheme of Mutual Funds* (CBS television broadcast, July 7, 2004); *Day to Day: SEC Votes On Several Proposals To Crack Down On Abuses In the Mutual Fund Industry* (National Public Radio broadcast, June 23, 2004).

[5] *See, e.g.*, *Business Center: Tom Lauricella of The Wall Street Journal and Stephen Schurr of TheStreet.com Discuss the Problems Facing Mutual Funds* (CNBC News television broadcast, Oct. 21, 2003).

[6] Sarbanes-Oxley Act of 2002, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28 U.S.C. (2002)).

[7] *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418, 17 C.F.R. 239, 274 (Apr. 16, 2004); Investment Company Governance, Investment Company Act Release No. 26,520, 17 C.F.R. 270 (Sept. 7, 2004).

[8] Sarbanes-Oxley does have some provisions for "analyst conflicts of interest," relating to analysts or employees employed by a broker-dealer. *See* 15 U.S.C. § 78o-6 (2004).

professionals.[9]

Financial professionals have resorted to a variety of fraudulent practices in recent years to make up for the decline in the value of the assets they manage,[10] such as "unlicensed individuals, selling securities[,]" unauthorized transactions, unexplained fees,[11] "senior investment fraud,"[12] "mutual fund business practices,"[13] selling promissory notes,[14] and sales of high-commissioned, non-regulated products, such as equity-indexed annuities. To provide individual investors with adequate protection, additional standards must be imposed on those who most often disseminate the information to the investor—their financial professional. *A superior method to accomplish this task would be to broaden the fiduciary duties financial professionals owe their clients*. In particular, federal and state securities laws should impose fiduciary duties on financial professionals who are compensated by charging a "management fee," rather than individual commissions, and who, in conjunction with their business of serving as a broker[15] on individual transactions, provide investment advice, and other related services to their customer.

There have been a few problems in determining whether a financial professional should (or would) be held to fiduciary duties. In general, a fiduciary is:

> A person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor; one who must exercise a high standard of care in managing another's money or property.[16]

Although this definition seems to be exactly what the average person would expect from their financial professional, the issue of whether fiduciary duties exists, and, if so, to what extent the financial professional is bound by such duties, is unclear.[17] Some ambiguity comes from the numerous designations these professionals use and the

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[9] *See, e.g.*, Jeff Benjamin, *Do-it-yourself Investors? Seems They're Doing It Again; Discount Brokers See Volume Spike*, INVESTMENT NEWS, Mar. 22, 2004, at 3.

[10] *See* Helen Huntley, *Stockbroker Fraud In Investment Scam Top 10*, ST. PETERSBURG TIMES, Aug. 27, 2002, at 1E.

[11] *Securities regulators' 'Most Wanted List': the top 10 investment scams of 2002*, CONSUMER RES. MAG., Oct. 1, 2002, at 26.

[12] Press Release, North American Securities Administrators Association, State Securities Regulators Release Top 10 Scams, Schemes & Scandals: Mutual Fund Practices, Senior Investment Fraud, Variable Annuities Join 2004 List (Jan. 14, 2004), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=244 (last visited Sept. 15, 2004) ("Volatile stock markets, record low interest rates, rising health care costs, and increasing life expectancy, have combined to create a perfect storm for investment fraud against senior investors… [who] are being targeted with increasingly complex investment scams involving unregistered securities, promissory notes, charitable gift annuities, viatical settlements, and Ponzi schemes all promising inflated returns.") *Id*.

[13] *Id.*

[14] *Id.*

[15] "[A]ny person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(4)(A) (2004)

[16] BLACK'S LAW DICTIONARY (8th ed. 2004), *at http://www.westlaw.com* (last visited August 27, 2004).

[17] *See generally* Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407 (1989) (discussing the issue of fiduciary duty as it applies to stockbrokers).

remainder of this vagueness has come from the courts.[18]

A significant problem in determining whether a fiduciary duty exists has been related to the development of the practice of financial professionals. These professionals use a variety of terms to describe the services they provide; lack of regulation regarding generic descriptions of financial professionals has left individual investors to assume that the services offered by each are identical. The SEC, however, has created a loophole[19] in determining whether a financial professional should be held to the standard of a stock "broker", as that term is defined by the Securities Act of 1934,[20] or an "investment adviser", as defined under the Investment Advisers Act of 1940.[21] This loophole now appears to have closed.

Another significant problem in determining the application of fiduciary duties to financial professionals is that since 1987, the development of jurisprudence in securities law has stagnated because customer claims have primarily been adjudicated by arbitration panels.[22] Because these arbitration panels do not issue written opinions, there has not been much case law on the subject of the fiduciary duties of financial professionals over the past 20 years.[23] As a result, the issue of whether a financial professional has a fiduciary duty to his client has remained, for the most part, suspended.[24]

The focus of this paper is on fee-based financial professionals, hereinafter referred to as "fee-based advisers" (to distinguish their activity from the activities of "Investment Advisers", as defined in the Investment Advisers Act of 1940[25]). These financial professionals charge their customer/client a fee, generally paid quarterly or annually, based on some measurable factor.[26] Those factors include: an hourly rate; "a percentage of assets" the professional manages; a fixed rate for a package of advice; or, a percentage

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[18] *See id. Compare* Farmland Indus. v. Frazier-Parrott Commodities, Inc., 871 F.2d 1402, 1411 (8th Cir. 1989) (In Missouri, fiduciary duties may arise out of a financial professional-customer relationship); *with* Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986) (stating that "a simple [financial professional]-customer relationship does not constitute a fiduciary relationship in Massachusetts."); *and with* Brown v. California Pension Administrators & Consultants, Inc., 52 Cal. Rptr. 2d 788, 796-97 (Cal. App. 1996) (stating that where a financial professional provided investment advice to his customer, the relationship was one of principal-agent, and therefore, fiduciary duties applied).

[19] *See* Amy Borrus, *Brokers Aren't Advisers; To Protect Investors, the SEC Must Draw a Clear Line*, BUSINESSWEEK, Aug. 30, 2004, at 55 (referring to Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 1845, 64 Fed. Reg. 61,226 (proposed Nov. 10, 1999). *See also* Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275) (Final Rule).

[20] *See* 15 U.S.C. § 78c(4)(A) (2004).

[21] *See* 15 U.S.C. § 80b-2(a)(11) (2004). *See also* discussion in Section II, *infra*.

[22] *See* William A. Gregory & William J. Schneider, *Securities Arbitration: A Need For Continued Reform*, 17 NOVA L. REV. 1223, 1233-35 (1993).

[23] *See* Leslie William Moore, Rodriguez de Quijas v. Shearson/American Express, Inc.*: Is Securities Arbitration Finally Above Suspicion?*, 78 KY. L.J. 839, 860 (1990) (suggesting that following the Supreme Court Decision in *Rodriguez*, some critics felt "securities case law may stagnate as more disputes are sealed through arbitration).

[24] *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 14.15[1], at 248 (4th ed. 2002).

[25] *See* definition of "investment adviser," *infra* Part II.A.2.

of the customer/client's income.[27] The term "wrap account" has been used industry-wide to describe an account that

> significantly expands the traditional client/broker stock-picking relationship to include all a client's investment accounts under one roof. It bundles, or "wraps", all service charges for advice, execution, custody and clearing under one contract. For a set fee, a broker simply steers a client to money managers of the client's choice while continuing to service the client's other trading needs, if desired.[28]

Assets managed in wrap accounts have experienced the greatest amount of growth in the financial services industry.[29]

This paper serves three main purposes: (1) Provide a brief explanation of the current application of fiduciary duties as they pertain to financial professionals; (2) Discuss problems with the current legal framework as it applies to fee-based financial professionals; and, (3) Discuss the effects and the aftermath of the unifying and heightening the fiduciary duty imposed on fee-based financial professionals. In doing so, Section II will discuss current law as it relates to the fiduciary duty of financial professionals, including different jurisdictions' positions on what differentiates the level of fiduciary duties to which the financial professional should be held. Section III will offer an analysis of why, in many respects, the current standard falls short of offering the public the protection securities laws and SROs are designed to provide with respect to fee-based financial professionals. Section IV includes discussion of *Fin'l. Planning Assoc. v. SEC*,[30] which was recently decided by the United States Court of Appeals for the District of Columbia. Section V provides a summary of this Paper and a discussion related to the impact that the outcome that the Court of Appeals' decision in *FPA v. SEC* could have on claims in securities arbitration and litigation.

II. When Does a Fiduciary Duty Exist?

The concept of fiduciary duty originated in trust law.[31] Fiduciary duty is "an equitable concept that has been applied by courts across separate and discrete areas of the law,"[32] generally in which there is some form of principal-agent relationship.[33] Typically, for a fiduciary relationship to exist, specific factors need to be present that cause the subservient party to rely on the dominant

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[26] *See* National Ass'n of Personal Financial Advisors, *Why Select a Fee-Only Financial Advisor?*, *at http://www.napfa.org/ConsumerServices/whyfee.htm* (last visited September 3, 2004).

[27] *See id.*

[28] Jessica Sommar, *Wrap Accounts: Is the Fox In With the Hens?*, INVESTMENT DEALERS DIG., Mar. 2, 1992, at 18.

[29] *See* Gregg Wirth, *It's the Advice, Stupid*, REGISTERED REPRESENTATIVE, July 1, 2004, at 7; *Wraps Boom: A Product or Process?*, ON WALL STREET, May 1, 2002, *available at http://www.onwallstreet.com/detail.cfm?page=/pubs/ows/20020501007.html* (last visited Sept. 3, 2004); John Churchill, *Huge Growth in Fee-Based Brokerage*, REGISTERED REPRESENTATIVE, Mar. 12, 2004, *available at http://registeredrep.com/news/finance_huge_growth_feebased/index.html* (last visited Sept. 3, 2004).

[30] No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356 (D.C. Cir. 2007) (hereinafter "*FPA v. SEC*").

[31] Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997).

[32] Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 Iowa J. Corp. L. 65, 67 (1997).

[33] Brudney, *supra* note 55, at 595.

party – the fiduciary.[34] Those elements have been defined as:

> (1) as between the parties, one must be subservient to the dominant mind and will of the other as a result of age, state of health, illiteracy, mental disability, or ignorance; (2) things of value such as land, monies, a business, or other things of value which are the property of the subservient person must be possessed or managed by the dominant party; (3) there must be a surrender of independence by the subservient party to the dominant party; (4) there must be an automatic or habitual manipulation of the actions of the subservient party by the dominant party; and (5) there must be a showing that the subservient party places a trust and confidence in the dominant party.[35]

Courts have also found fiduciary relationships in situations where one or more of the elements are lacking.[36] For example, "[a] fiduciary relationship may arise as a matter of law by virtue of the parties' relationship, e.g., attorney-client, or it may arise as a result of the special circumstances of the parties' relationship where one places trust in another so that the latter gains superiority and influence over the former."[37] Accordingly, a fiduciary relationship has been found to exist for physicians,[38] attorneys,[39] insurance brokers,[40] and in other agency-principal relationships.[41] The foundation for fiduciary duty as it applies to "stockbrokers"[42] has been discussed at length by numerous authors.[43] Whether a financial professional is held to a fiduciary duty often varies by jurisdiction, as well as other factors.[44] A financial professional may be liable to his customer under a theory of breach of fiduciary duty;[45] however, whereas securities laws are written, enforceable legislation, the theory of fiduciary duty is largely a matter of judicial construction and interpretation.[46]

Since the enactment of the various securities regulations, a variety of terms has evolved to describe financial professionals.[47] Whether a financial professional is called a "broker", a

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[34] *See* Chmieleski v. City Prods. Corp., 660 S.W.2d 275, 294 (Mo. Ct. App. 1983)

[35] *Id*.

[36] A.G. Edwards & Sons, Inc. v. Drew, 978 S.W.2d 386, 394 (Mo. Ct. App. 1998).

[37] State Sec. Ins. Co. v. Frank B. Hall & Co., 630 N.E.2d 940, 945 (Ill. Ct. App. 1994) (citations omitted).

[38] *E.g.*, Brandt v. Med. Def. Assocs., 856 S.W.2d 667 (Mo. 1993) ("The legislature has implicitly recognized the existence of a physician's fiduciary duty of confidentiality."). *Id*. (citations omitted).

[39] *E.g.*, Shaffer v. Terrydale Mgmt. Corp., 648 S.W.2d 595, 605 (Mo. Ct. App. 1983).

[40] *E.g.*, *A.G. Edwards*, 978 S.W.2d at 395; Faulkner v. Gilmore, 621 N.E.2d 908, 911 (Ill. Ct. App. 1993) (citations omitted).

[41] *E.g.*, Preferred Physicians Mut. Mgmt. Group v. Preferred Physicians Mut. Risk Retention, 918 S.W.2d 805 (Mo. Ct. App. 1996).

[42] Distinguishing "stockbrokers" from "investment advisers." *See* discussion *infra* Parts II.A.1, II.A.2.

[43] For a thorough discussion of the development of the duty owed by a stockbroker to his client, see, for example, Weiss, *supra* note 56. *See also* Goforth, *supra* note 16; Ramirez, *supra* note 29.

[44] *See* Ramirez, *supra* note 29, at 550-51.

[45] Goforth, *supra* note 16, at 409, 412.

[46] *See id.* at 409-10.

[47] *See Generally* Lewis Braham, *Which Adviser Knows the Way?*, BUSINESSWEEK, Nov. 25, 2002, at 146 ("Almost anyone can claim to be a financial planner or investment adviser. There are a myriad of credentials an adviser can appropriate, some familiar and others obscure.").

"stockbroker", a "financial advisor", a "financial planner", or any of the other often-used titles, many of these professionals often perform the same tasks for their clients.[48] In fact, the designation one of these professionals uses is often a matter of personal preference.[49] While there are numerous designations that are restricted based on certification or licensing,[50] a financial professional can often provide financial planning services by successfully completing only two securities licensing examinations offered by the National Association of Securities Dealers ("NASD").[51]

A. Types of Financial Professionals

1. "Stockbrokers"

The Securities and Exchange Act of 1934 uses the term "broker" or "stockbroker" to define financial professionals who engage "in the business of effecting transactions in securities for the account of others."[52]

However, the financial services industry has evolved since 1934, and now, in addition to stockbrokers, financial professionals are designated with various titles and perform different services.[53] While financial professionals provide varied services depending on the specific securities licenses they possess, the majority provide some form of *investment related advice*.[54] This advice can come in the form of specific investment recommendations, asset allocation proposals, investment related tax advice, or comprehensive financial plans.[55] This advice is often used as a marketing tool, designed to promote the financial professional's services and/or knowledge of related issues.[56] In other situations, it is provided as a component of an over-arching agreement between the financial professional (and his or her broker/dealer) and the customer, as part of the implementation of a comprehensive plan.[57]

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[48] *See Lawsuit Seeks To Define Who Is 'Financial Adviser,'* ROANOKE TIMES, July 24, 2004, *available at http://www.roanoke.com/roatimes/news/story169990.html* (last visited Sept. 3, 2004).

[49] *See id.*

[50] For example, in order to call themselves a Certified Financial Planner ("CFP"), a financial professional must satisfy "education, examination, experience and ethics requirements" of the Certified Financial Planner Board of Standards, Inc. *See* Certified Financial Planner Board of Standards, Inc., *Financial Services Credentials*, *at http://www.cfp.net/learn/knowledge base.asp?id=15* (last visited Aug. 27, 2004). There are additional numerous other financial services credentials, such as a Chartered Financial Analyst ("CFA"), Chartered Financial Consultant ("ChFC"), or Personal Financial Specialist ("PFS"). *See id.*

[51] For example, in most states, a financial professional may serve as a registered representative after successfully completing the NASD Series 63 Examination and the NASD Series 6 Examination. *See* NASD, Inc., *NASD Registration and Examination Requirements*, *at http://www.nasdr.com/5200_explan.asp* (last visited Aug. 27, 2004).

[52] 15 U.S.C. § 78c(4)(A) (2004).

[53] *See* Christine Dugas, *What to Look for When Picking a Financial Planner*, NEWSDAY, Nov. 21, 1993, at 113.

[54] *See, e.g.*, Mitch Zacks, *Likelihood of Recovery Should Spur Stock Buying*, CHICAGO SUN-TIMES, July 27, 2003, at 48.

[55] *See* SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011-12 (Mar. 16, 1988)

[56] *See* Anuradha Raghunathan, *Money Advisers Await Wave of Empty-Nesters*, CHATTANOOGA TIMES FREE PRESS, Nov. 5, 2003, at C1.

[57] *See* Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,228.

As stated above, a "broker" is a financial professional who engages "in the business of effecting transactions in securities for the account of others."[58] Stockbrokers (and presumptively, financial professionals in general) have a fiduciary, confidential relationship with their customers,[59] which is "as exacting as those imposed upon a trustee, and include the duty of keeping the customer fully informed of all facts pertinent to the transaction."[60] The financial professional's duty "includes at least these obligations: to manage the account as dictated by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies."[61] In addition, at the time the Securities and Exchange Act of 1934 was enacted, Congress "assumed that an ordinary stockbroker owed fiduciary duties to clients with respect to the giving of investment advice. This concept of fiduciary duty was general and wide-ranging."[62] Unfortunately, the obligation to manage the account as dictated by the customer's needs and objectives often conflicts with the obligation to follow order instructions.[63] It is this conflict that will be discussed throughout this article, and will serve as a primary point of tension in the discussion of the relationship between a financial professional and his or her customer. In many states, for example, it has not yet been determined "whether fiduciary duties between a broker and a customer can exist independent of any principal-agent relationship . . . [and the] cases that have discussed the subject have in general . . . suggest[ed] that a stockbroker-customer relationship is ordinarily that of principal and agent and that fiduciary duties may arise out of it."[64]

2. "Investment Advisers"

The Investment Advisers Act of 1940 introduced the term "investment adviser" to define "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[65] Investment advisers, however, "do not buy or sell securities or execute trades as a part of that business,"[66] and the definition does not include "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[67] In addition, financial professionals "who may render generalized advice as to how people should manage their money, including their investment activities but do not render advice on individual securities" are excluded from the definition of "investment adviser."[68] As a

[58] 15 U.S.C. § 78c(4)(A) (2004).

[59] Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 396 S.W.2d 570, 575 (Mo. 1965).

[60] *Id.* at 575-76 (citing Feltz v. Pavlik, 257 S.W.2d 214 (Mo. Ct. App. 1953)).

[61] *See, e.g.*, Missouri *ex rel.* PaineWebber, Inc. v. Voorhees, 891 S.W.2d 126, 130 (Mo. 1995).

[62] Ramirez, *supra* note 29, at 551 (citations omitted).

[63] *See* NORMAN S. POSER, BROKER-DEALER LAW & REGULATION § 16.01 (2d ed. 2001).

[64] Farmland Indus. v. Frazier-Parrott Commodities, Inc., 871 F.2d 1402, 1410-11 (8th Cir. 1988).

[65] 15 U.S.C. § 80b-2(a)(11) (2004).

[66] JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1173 (3rd ed. 2001).

[67] 15 U.S.C. § 80b-2(a)(11)(C) (2004).

[68] THOMAS LEE HAZEN & DAVID L. RATNER, BROKER DEALER REGULATION: CASES AND MATERIALS 584 (2003).

result, a broker can often provide advice related to securities transactions as long as he is not paid specifically for the advice, thereby escaping registration as an investment adviser under the 1940 Act.[69]

For a financial professional to qualify as an investment adviser, he must generally satisfy two conditions: (1) he must be "in the business of advising others;" and (2) he must be compensated for his advice.[70] The question of whether a professional is "in the business" has generated some interesting case law;[71] however, this article is only focusing on those professionals who are assumed to meet the "in the business" test – by the fact that they are affiliated with a brokerage-type service and that is the only business they conduct. The question of compensation is equally complex. To qualify as an "investment adviser" under the 1940 Act, the individual must be paid for the action of offering advice. In addition, an investment adviser does not engage in placing the transactions; rather, his sole purpose is to provide financial advice. For example, a person who meets with an individual, then gathers relevant personal and financial information, creates a report that illustrates a proposed financial plan, presents the plan to the individual, and is paid by the individual for the plan and does nothing more obviously meets the statutory definition of "investment adviser". The issue of compensation is often blurred, however, when a financial professional engages in providing his client with advice *and* directly manages the assets involved. The varied ways in which financial professionals are compensated also cloud this issue.

Investment advisers are fiduciaries[72] who are required to adopt a code of ethics.[73] The legislative history behind the Investment Advisers Act and the general nature of the investment adviser-client relationship support such a fiduciary duty.[74] An investment adviser "should continuously occupy an impartial and disinterested position, as free as humanly possible from the *subtle* influence of prejudice, *conscious or unconscious*."[75] Therefore, "he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect."[76] The SEC has stated "that although the investment adviser's fiduciary duty is not specifically delineated in the Act, the concept of fiduciary duty is indirectly incorporated into the Act through the various prohibitions and disclosure requirements."[77] For example, the SEC requires investment advisers to disclose detailed information regarding the individual

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[69] *See* Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION, at §8-C-2(b)(iv) (3d ed. 2004).

[70] *See* 15 U.S.C. § 80b-2(a)(11) (2004).

[71] *Compare* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977) (general partner in a limited partnership that was formed to invest in securities and whose compensation was based on the performance of the securities is an investment adviser), *with* Zinn v. Parrish, 644 F.2d 360 (7th Cir. 1981) (sports agent who occasionally passed securities recommendations from others to his client not an investment adviser).

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

[73] *See* Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,696 (July 9, 2004).

[74] Lowe v. SEC, 472 U.S. 181, 210 (1985).

[75] *Capital Gains*, 375 U.S. at 188 (emphasis in original).

[76] *Capital Gains*, 375 U.S. at 188 (emphasis in original).

[77] Susan K. Foster, Note, *Financial Planning: Is It Time For a Self-Regulatory Organization?*, 53 BROOK. L. REV. 143, 168 (1987).

investment adviser, and his practice by completing and amending Form ADV,[78] and requires investment advisers to provide similar disclosures to their clients in the form of a brochure.[79] This brochure discloses "information about [the adviser's] business practices, fees and any conflicts of interest [(s)he] may have with [his or her] *clients*."[80]

Additionally, if the adviser offers a fee-based (wrap) account, he or she must provide a separate brochure that discloses information about the wrap program,[81] such as the adviser's name, business address, telephone number, date of the brochure,[82] a table of contents,[83] a description of the "services, including the types of portfolio management services, provided under each program,"[84] disclosure of any additional fees the customer might have to pay,[85] and a disclosure that "the *person* recommending the *wrap fee program* to the *client* receives compensation as a result of the *client's* participation in the program."[86] In addition, the brochure must disclose client-related information that will be relayed to the portfolio managers,[87] as well as the process by which the adviser selects the portfolio managers.[88] The NASD also mandates that the determination of whether a financial professional may use a fee-based arrangement with its customer must be appropriate and adequately supervised,[89] under its "Standards of Commercial Honor and Principles of Trade."[90] All of these requirements focus on the issue of full disclosure to the client, and illustrate the fiduciary nature of the relationship.

3. "Financial Planners"

Over the past 20 years, the term "financial planner" has become main stream in the financial services industry. Many financial professionals complete a rigorous training and certification process to be designated as a Certified Financial Planner.[91] The SEC has

[78] *See* Form ADV, Uniform Application for Investment Adviser Registration, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004) (hereinafter Form ADV).

[79] *See* Written Disclosure Statements, 17 C.F.R. § 275.204-3 (2004).

[80] Form ADV: General Instructions, at 2, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[81] Written Disclosure Statements, 17 C.F.R. §275.204-3(f) (2004).

[82] Form ADV, Part 2A Appendix 1, at Item 1, p. 82, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[83] *Id*. at Item 3, p. 82.

[84] *Id.* at Item 4(A), p. 82.

[85] *Id.* at Item 4(C), p. 82.

[86] *Id.* at Item 4(D), p. 83 (emphasis in original).

[87] Form ADV, Part 2A Appendix 1,at Item 7, p. 83, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[88] *Id.* at Item 6, p. 83.

[89] *See* National Association of Securities Dealers, Action Required: Fee-Based Compensation; NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate, NASD Notice to Members 03-68, at 2-3 (Nov. 2003), *available at* http: //www.nasdr.com/pdf-text/0368ntm.pdf (last visited Sept. 15, 2004).

[90] NAT'L ASS'N OF SECS. DEALERS R. 2110.

[91] *See* Certified Financial Planner Board of Standards, Inc., *Guide to CFP Certification*, *at http://www.cfp.net/become/certification.asp* (last visited September 1, 2004).

referred to a "financial planner" as a professional who typically provides "a variety of services, principally advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of individual client needs."[92] The SEC has stated that the typical "financial planner" is not involved in the direct management of his client's money; rather, he is a consultant whose "primary service is to prepare a financial plan for the client, and to offer advice as to the purchase or sale of specific financial products appropriate to the implementation of the plan."[93] If a financial planner offers advice related to any type of security, he must register with the SEC under the Investment Advisers Act of 1940.[94] A variety of financial professionals who perform a variety of services use the label "financial planner."[95] The SEC distinguished financial planners from other financial professionals as those who "usually do[] not manage client assets;"[96] however, they acknowledge that the term "financial planner" is not always applied to individuals performing the same services.[97]

B. Conditions in Determining the Existence of Fiduciary Duties

1. Types of Services Provided

Financial professionals "may be divided roughly into three groups depending on the principal type of service they provide to clients."[98] They include "discretionary money managers, non-discretionary money managers and financial planners;" some may provide overlapping services.[99] Most courts have found that "[i]n general, the relationship between a stockbroker and a customer is a fiduciary one."[100] Nevertheless, "the mere existence of a broker-customer or investment adviser-customer relationship may not be proof of the fiduciary character of the relationship."[101] While most courts find a broker/financial professional has a general fiduciary duty in each individual transaction – to make sure that the transaction is executed in the customer's best interest[102] - the legal basis for imposing a fiduciary duty on a financial professional has often turned on whether the professional has discretion to trade in the account.[103]

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[92] Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION 885 (5th ed. 2004) (citing Investment Adviser Act Release No. 1092, 39 SEC Dock. 494, 495-98 (1987)).

[93] *See* SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[94] 15 U.S.C. §§ 80b-2(a)(11), 80b-3 (2004).

[95] Carolyn Mora, *Avoid Errors That Could Smash Your Financial Plan*, EL PASO TIMES, May 17, 2004, at 1F.

[96] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[97] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,012 (Mar. 16, 1988).

[98] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[99] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[100] 12 AM. JUR. 2D *Brokers* § 149 (2004) (citations omitted).

[101] *Id.*

[102] *See, e.g.*, De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302-03 (2d Cir. 2002).

[103] *See* French v. First Union Secs., Inc., 209 F. Supp. 2d 818, 825 (M.D. Tenn. 2002).

a. Discretionary Accounts

Discretionary accounts are those "in which the broker determines which investments to make and carries out such transactions without prior authorization" from his customer.[104] A financial professional has actual authority to handle the affairs of the client in relation to the discretionary account. Discretionary authority over an account is usually established by checking a box on the customer's account agreement; such authority can be created through other forms of agreement[105] or modified by contract.[106] It has generally been held that financial professionals are subject to fiduciary duties when they oversee a discretionary account.[107] As a result of the fiduciary duty owed by the financial professional in a discretionary account, he (or she):

> must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests; (3) keep his customer informed as to each completed transaction; and (5) [sic] explain forthrightly the practical impact and potential risks of the course of dealing in which the [financial professional] is engaged.[108]

Courts have generally imposed a fiduciary duty with respect to discretionary accounts based on the level of influence the financial professional has over the customer, and the fact that the customer has deposited money or securities with the broker.[109]

b. Nondiscretionary Accounts

A nondiscretionary account is just the opposite of a discretionary account – the financial professional must get permission from the customer before he or she can conduct any activity whatsoever within the account.[110] In most cases, a nondiscretionary account is created by leaving a box unchecked on an account agreement.

The courts have been inconsistent in determining whether a fiduciary duty exists within non-discretionary accounts. Generally, courts *do not* impose a fiduciary duty on a financial professional who oversees a nondiscretionary account because he lacks control over the investment decisions.[111] Furthermore, a broker has no ongoing duty to keep a nondiscretionary customer updated as to "financial information which may affect his customer's portfolio or to inform his customer of developments which could influence his investments."[112] It has also been stated that the relationship between a financial professional and his customer in a non-

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[104] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128 (D.C. Cir. 1990).

[105] *See*12 AM. JUR. 2D *Brokers* § 43 (2004)

[106] *See* 12 AM. JUR. 2D *Brokers* § 47 (2004); Chipser v. Kohlmeyer & Co., 600 F.2d 1061, 1066 (5th Cir. 1979).

[107] Vogel v. A.G. Edwards & Sons, Inc., 801 S.W.2d 746, 752 (Mo. Ct. App. 1990).

[108] *Leib*, 461 F. Supp. at 953 (citations omitted).

[109] "A broker . . . is bound to keep accurate records and to account to his or her principal for all funds belonging to the latter." 12 AM. JUR. 2D *Brokers* § 113 (2004).

[110] Merrill Lynch, Pierce, Fenner & Smith v. Perelle, 514 A.2d 552, 561 (Pa. Super. Ct. 1986).

[111] *See* Int'l Order of Foresters v. Donaldson, Lufkin & Jenrette, 157 F.3d 933, 940-41 (2d Cir. 1998).

[112] Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 112 (N.D. Ala. 1971).

discretionary account is "that of a limited agent",[113] in which "a far more limited range of duties" are owed by the financial professional to his customer.[114] Even if a nondiscretionary customer pays an ongoing management fee to the broker, the broker may not necessarily owe a fiduciary duty to the client.

Courts have held that a financial professional owes fiduciary duties to his customer when the account is technically a non-discretionary account, if they take 'control" of the customer's account.[115] This rationale is logical because the financial professional should reasonably be held liable for his actions if he has assumed control over the account. In truth, if a financial professional has assumed control over his customer's account, she is acting as if there is an implied discretionary agreement because she is acting without the approval of the customer.[116] The courts have devised a number of "tests" to determine whether the financial professional has assumed control over his customer's account.[117]

2. Other Tests

In addition to determining whether a financial professional owes his customer a fiduciary duty based on whether the account was discretionary or nondiscretionary, there have been a variety of tests that have been isolated to impose a fiduciary duty on financial professionals.[118] Most of these tests strike at a similar point of the relationship between a financial professional and his

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[113] David M. Minnick, *Breach of Fiduciary Duty in Securities Arbitration*, 53 J. MO. BAR. 210, 210 (July/Aug. 1997).

[114] *Id.* at 211. The duties "have been enumerated as follows:

> (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 . . .;
> (6) the duty to transact business only after receiving prior authorization from the

customer . . . ." *Id.* (citing Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd,* 647 F.2d 165 (6th Cir. 1981)).

[115] Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 954 (E.D. Mich. 1978)

[116] *See* Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 516 (Colo. 1986) (en banc) (citing *Leib*, 461 F. Supp. at 954).

[117] *See Adams*, 718 P.2d at 516-17. These tests include:

> (1) the broker's past activities as investment advisor; (2) the extent to which the customer followed the broker's advice; (3) the extent to which the broker trades without the customer's prior approval; (4) the frequency of communication between the broker and customer; (5) the investment sophistication of the customer; and (6) the degree of trust and confidence reposed in the broker.

Goforth, *supra* note 16, at 428-29.

[118] *See* Goforth, *supra* note 16, at 417-31. Goforth sets out six "tests" that courts had used to decide to impose a fiduciary duty on brokers. *Id.* These "tests" are: (1) a per se determination that a broker is a fiduciary; (2) a broker is an agent for his principal (customer); therefore, he has a fiduciary duty; (3) if the broker has discretionary authority over the account; (4) the customer places "trust and confidence" in the broker; (5) the broker exercises "control" over the account; and (6) there is a "special agreement" between the customer and the broker. *Id*.

customer – the customer trusts and places confidence in the financial professional to act in the customer's best interests – the essence of a fiduciary duty. The remaining tests focus on control over the account. It has been urged by at least one commentator that an arbitration panel "should focus first on ascertaining the nature of the relationship . . . to determine: (1) whether the account is discretionary or non-discretionary; (2) whether or not the claim is based upon specific recommendations made by the broker; (3) whether there is a mixture of recommendations made, some of which are not followed; and (4) whether there are mere execution services provided by the broker to follow the directives received from the investor."[119]

a. Nature of the Relationship Between the Financial Professional and the Customer

Courts have held financial professionals to a fiduciary duty to their customers based on the general nature of their relationship with the customer.[120] These cases have found a fiduciary duty to exist because of the financial professional's position as an agent of his customer,[121] a "special trust and confidence" placed on the financial professional by the customer,[122] or because of a special agreement, more than a standard brokerage agreement, between the financial professional and the customer.[123] Other courts have looked at the activity of the financial professional to determine whether a fiduciary duty was breached.

b. Violation of SRO Rules

There is a significant amount of overlap between a claim for breach of fiduciary duty and a violation of SRO rules. For example, the NASD requires that a financial professional "make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[124] Some courts have factored a violation of NASD or stock exchange rules into a determination of liability for excessive trading[125] or standard of care,[126] both of which are considered breaches of fiduciary duty. A violation of NASD rules, by itself, however, does not create a private cause of action.[127] Therefore, investors must look to the law to provide such a right.

[119] Minnick, *supra* note 133, at 210.

[120] *See, e.g.*, Clayton Brokerage Co. v. Commodity Futures Trading Comm'n, 794 F.2d 573, 582 (11th Cir. 1986).

[121] *See, e.g.*, Roth v. Roth, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

[122] *See, e.g.*, Stevens v. Abbott, Proctor and Paine, 288 F. Supp. 836, 846 (E.D. Va. 1968).

[123] *See, e.g.*, McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254 (8th Cir. 1984).

[124] NASD Conduct Rule 2310.

[125] *See e.g.*, Miley v. Oppenheimer & Co., Inc., 637 F.2d 318, 333 (5th Cir. 1981).

[126] *See e.g.*, United States v. Bloom, 450 F. Supp. 323 (E.D. Pa. 1978).

[127] Reed v. Bear, Stearns & Co., 698 F. Supp. 835 (D. Kan. 1988); *see also* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (denied private claims under securities acts where the statutory language was silent on whether a private cause of action existed because to imply "a private right of action on the basis of congressional silence is a hazardous enterprise, at best."). *Touche Ross*, 442 U.S. at 571.

c. Representation to the Public as a Professional

Under the "shingle theory," an individual who holds himself out to the public as a financial professional makes a representation that he "will conduct business in an equitable and professional manner."[128] In so doing, if he "solicits another to trust him in matters in which he represents himself to be expert as well as trustworthy and the other is not expert and accepts the offer and reposes complete trust in him, a fiduciary relation is established."[129]

3. Conflicting Views Related to Fiduciary Duties as Applied to Financial Professionals

Despite the case law supporting a fiduciary duty on financial professionals, there is an equal amount of support for the argument that a fiduciary duty does not exist.[130] In some jurisdictions, the question of whether a fiduciary duty applies is unsettled.[131] Most courts have determined that a case-by-case analysis must be done prior to any determination of fiduciary duty.[132] In general, however, the standard of fiduciary duty applied to securities brokers is far short of what Congress intended.[133]

To make matters worse, in November 1999, the SEC proposed a rule entitled "Certain Broker-Dealers Deemed Not To Be Investment Advisers,"[134] that ultimately created an exception to the Advisers Act. The rule provides that a financial professional is exempted from the definition of an "investment adviser," and the corresponding fiduciary duties, as long as (s)he (1) provided advice on a non-discretionary account, (2) provided advice "solely incidental to the brokerage services;" and (3) the financial professional "discloses to its customers that their accounts are brokerage accounts,"[135] This exception has formed the basis on which many financial professionals have provided quasi-fiduciary services for their clients without incurring the express duties related to a traditional fiduciary relationship[136] by presenting financial professionals with an opportunity to provide investment related advice for a fee, as opposed to charging commissions on individual transactions, without registering under the Investment Advisers Act.[137]

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[128] HAZEN, *supra* note 44, § 14.15[3], at 257.

[129] Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992).

[130] *See e.g.*, Minnick, *supra* note 133, at 210-11.

[131] *Compare* Perl v. Smith Barney Inc., 646 N.Y.S.2d 678 (N.Y. 1996) (no fiduciary duty under New York law in ordinary broker-client relationship), *with* Jaksich v. Thomson McKinnon Secs., Inc., 582 F. Supp.485, 502 (S.D.N.Y. 1984) ("Under New York law, brokers maintain fiduciary duties to their customers, and the relationship between the two parties is one of principal and agent.").

[132] *See* Minnick, *supra* note 133, at 211.

[133] Ramirez, *supra* note 29, at 552.

[134] 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275) (Final Rule); Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,226 (Proposed Rule).

[135] *Id*. at 61,227.

[136] *See* Investment Advisers Act Release No. 1845, 64 Fed. Reg. At 61,226. Discussion of this proposed rule was reopened August 18, 2004, and closed September 22, 2004. *See also* Investment Advisers Act Release No. 2278, 69 Fed. Reg. at 51,620 (Aug. 20, 2004).

[137] Borrus, *supra* note 18, at 55.

Rather than recognize fee-based advisory services for what they really are, the SEC rule referred to such advice as merely "re-pricing" of a broker's services."[138] Furthermore, during the period before and after "the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the [Advisers] Act."[139]

The rule has drawn some criticism,[140] including a petition for judicial review by the Financial Planning Association ("FPA").[141] Before the final rule was passed, the Financial Planning Association, which consists of practicing financial professionals, urged the SEC to immediately abandon[142] or amend the proposed rule[143] because it is of the opinion that:

> the Rule is detrimental to consumer protection by allowing broker-dealers to avoid the blanket fiduciary protections of the Investment Advisers Act of 1940 . . . [and b]y eliminating "special compensation" as a critical element in the contractual relationship, the Rule permits stockbrokers to misrepresent their fundamental sales role as one of a fiduciary adviser receiving a fee for advice. Further, it places financial planners[144] at a competitive disadvantage by allowing brokers to market similar programs under less rigorous regulatory standards for disclosure and advertising.[145, 146]

In April 2006, the SEC unanimously approved and adopted the final rule that created this exemption.[147] Most securities brokerage firms are registered

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[138] Investment Advisers Act Release No. 1845, 64 Fed. Reg. At 61,226.

[139] *Id.*

[140] *See* Securities and Exchange Comm'n, *Comments on Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, *at* http ://www.sec.gov/rules/proposed/s72599.shtml (last visited Sept. 15, 2004).

[141] Fin. Planning Ass'n v. SEC, No. 04-1242 (D.C. Cir. Filed July 20, 2004).

[142] Letter from Duane R. Thompson, Group Director, Advocacy, The Financial Planning Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission 2 (June 21, 2004), *available at* http: //www.sec.gov/rules/proposed/s72599/fpa062104.pdf (last visited Sept. 15, 2004). The Financial Planning Association has provided the SEC with five reasons on which they base their request for immediate withdrawal of the Rule. Those five reasons are "Non-Compliance with Administrative Procedures Act . . . . Failure to Provide Clear Regulatory Guidance . . . . Misinterpretation and Misapplication of Discretionary Exemption Authority . . . . Absence of Rule Enforcement . . . . Inconsistent Application of Disclosure Standards to Brokerage Transactions." *Id*. at 2-3.

[143] *Id*. at 6-7.

[144] The Financial Planning Association's use of the term "financial planner" is the equivalent to the "fee-based adviser" discussed herein.

[145] *Id*. at 2.

[146] The members of the Financial Planning Association are governed by the organization's bylaws and code of ethics. To access these materials, see The Financial Planning Association Bylaws, *at http://www.fpanet.org/member/about/principles/ByLaws.cfm* (last visited Sept. 15, 2004), and Code of Ethics, *at http://www.fpanet.org/member/about/principles/ethics.cfm* (last visited Sept. 15, 2004).

[147] Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275).

with the SEC as both a broker-dealer and an investment adviser.[148] Therefore, the rule essentially extends the registration of the broker-dealer to the individual financial professional, without requiring that individual to register, and be subject to the heightened scrutiny of an Investment Adviser. The SEC stated their preference for a fee-based engagement because it would contribute to a reduction in conflicts between the financial professional and the customer by reducing the incentive to churn[149] the account would be virtually eliminated.[150] The FPA continued its opposition to the final rule, and, later that month, filed a petition in the United States Court of Appeals for the District of Columbia challenging the final rule.[151] In March 2007, the court of appeals vacated the final rule.

III. Why Should There Be a Fiduciary Duty?

A. The Existing Framework Did Not Provide Adequate Protection

Existing case law and scholarly writing generally focus on whether there is a fiduciary duty imposed on professionals who hold themselves out as stockbrokers, as well as the factors used to determine that such a duty exists. This seems to be due to the general term used to describe a financial professional—a "stockbroker". In many situations, the application of a fiduciary duty is inconsistent, leaving individual investors at risk. The issue of breach of fiduciary duty is important in financial professional-customer issues because the largest number of cases heard in NASD arbitrations involve a claim of breach of fiduciary duty.[152] The following chart reveals the total number of arbitration cases filed at the NASD arbitration from 2004 through 2004, the number of cases in which a breach of fiduciary duty was alleged and the percentage of the total cases filed in which

Year	Total Cases Filed	Breach of Fiduciary Duty Cases	Percentage
2000	5,558	2,489	45%
2001	6,915	3,485	50%
2002	7,704	4,236	55%
2003	8,945	5,565	62%
2004	8,201	5,426	66%
2005	6,074	3,514	58%
2006	4,614	2,621	57%

148 *Id.*

149 Churning is a term used to describe the activity of a financial professional "from using control over a customer's account to generate excessive trading activity, in view of the customer's financial resources, objectives, and needs, in order to maximize commissions." Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote For Bubbles?*, 70 U. CIN. L. REV. 527, 545 (2002) (citations omitted).

150 Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,228.

151 *See* Fin'l Planning Assoc., *Legal Challenge to SEC's Broker-Dealer Rule*, *at http://www.fpanet. org/member/govt_relation/lawsuit-against-sec-broker-dealer-rule.cfm#factsheet* (last visited Apr. 11, 2007). The FPA also filed a motion to consolidate Case No. 04-1242 (*see* fn. 35, *supra*).

152 *See* NASD, Inc., *Dispute Resolution Statistics*, July 19, 2004, *at http://www.nasdadr.com/ statistics.asp* (last visited August 28, 2004). From 2000 through 2004, the greatest number of cases involved claims of breach of fiduciary duty. *Id*.

breach of fiduciary duty was alleged: . This chart clearly demonstrates that not only has the *number* of cases in which breach of fiduciary duty is alleged increased, but also that the *percentage* of cases in which breach of fiduciary duty is alleged has increased each year. It is apparent from these statistics that customers are feeling betrayed at an ever-increasing rate by their financial professionals.

This presents two questions:

(1) Are customers merely "piggybacking" breach of fiduciary duty claims onto other claims brought to arbitration?
(2) Are financial professionals violating their customers' trust in greater numbers?

While it could certainly be argued that breach of fiduciary duty claims are being added as a matter of course, NASD arbitration award statistics do not suggest that adding such a claim has improved a claimant's chances of winning his case. Although the percentage of cases alleging breach of fiduciary duty climbed from 45% in 2000 to 66% in 2004, the percentage of cases in which damages were *awarded* to claimants did not increase over that period. In fact, the percentage of cases in which an arbitration panel awarded damages to claimants declined.[153]

The increasing number of "breach of fiduciary duty cases" does, however, suggest customers feel that their trust is being increasingly more violated by their financial professional.

B. The Subservient Customer

There are two types of financial professional-customer relationships to differentiate.

1. The first is a purely **transaction-based relationship** in which the customer engages the broker to place an order to buy or sell a security. In this relationship, the customer has the idea for the purchase and maintains possession of his assets at all times. In this situation, it would be unreasonable to hold the financial professional to a fiduciary duty outside the duty owed for each transaction – the customer assumes all responsibility for his investment.
2. The second type of relationship is the more common type, which will be referred to as the **adviser-customer relationship.** In this relationship, the financial professional may provide his customer with recommendations, investment strategies and/or general financial advice, in addition to any other type of advice related to the customer's financial situation. *It is for this situation that a per se rule imposing a fiduciary duty on the financial professional is required.* When a financial professional makes recommendations of any sort, he is acting in the capacity of an investment adviser. In addition, the customer generally relies on the advice offered by the financial professional as he or she would rely on advice provided to them by an attorney, doctor, or other professional. This puts the customer in a subservient position to the "dominant" financial professional. Although the

[153] The annual percentage of all arbitration cases decided in favor of claimant from 2000 through June 2004, are as follows:

2000 – 53%
2001 – 53%
2002 – 55%
2003 – 54%
2004 – 53%
2005 – 43%
2006 – 42%

Id.

Investment Advisers Act provides an exception to the definition of "investment adviser" for a broker who provides advice incidental to his brokerage business, the type of advice that financial professionals tend to provide is far from "incidental."

C. Customer's Reliance on the Advice Provided by the Financial Professional

When a customer agrees to work with a financial professional, he or she places a great deal of trust in that person to do what is right. In the course of their relationship, the customer places a great deal of reliance on the advice of the professional. The elements for a claim of breach of fiduciary duty generally include:

"(1) the existence of a fiduciary relationship between the parties;
(2) a breach of that fiduciary duty;
(3) causation; and
(4) harm.

A fiduciary is a person having a duty to act primarily for the benefit of another in matters connected with his undertaking."[154]

The reliance and trust a customer places with a fee-based financial professional is demonstrated primarily in four ways.

1. By engaging in business as an investment professional, that person conveys that he has superior knowledge, skill, and expertise in financial matters.
2. A fee-based advisor disseminates and conveys recommendations to the customer prior to engaging in any transactions.
3. The customer generally relinquishes control, if not expressly, then implicitly. The customer, even in a nondiscretionary account, gives the financial professional control over their financial position by revealing the intimate details of their personal and financial lives. The NASD requires that, prior to engaging in a trade of any non-money market security, a financial professional must gather certain information from any individual customer to make sure that the transaction is appropriate for the customer.[155] The information a financial professional must obtain includes: "(1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[156]
4. The customer pays the financial professional for his (or her) services. Payment for services is a crucial component in establishing a fiduciary duty because it is the customer providing consideration to the financial professional for the services provided.

D. The Manner of Compensation the Financial Professional Receives Has An Affect on Whether Fiduciary Duties Should Exist

Other than charging a fee to create a financial plan, there are generally two different ways a financial professional is compensated.

1. The first manner of compensation is through a commission that is paid either as a percentage of the investment transaction or at a fixed rate, which is often scaled based on the total amount of the transaction.
2. The second manner of compensation is through a management fee

[154] *See, e.g.*, Dairy Farmers of A., Inc. v. Traveler's Ins. Co., 292 F.3d 567, 572 (8th Cir. 2002).

[155] NASD RULE 2310(a), (b) (2004).

[156] NASD RULE 2310(b) (1)-(4) (2004).

charged as a percentage of assets that the financial professional "manages." Compensation through the charging of a management fee (alternatively referred to as a "wrap fee") has become increasingly popular in the financial services industry.[157] This manner of compensation is favorable to the financial professional because it allows him or her to establish a more constant stream of income, as the fees are deducted from the customer's account on a monthly, quarterly, semi-annual, or annual basis, and paid to the financial professional accordingly. Financial professionals also feel they can spend more time providing service to their customers and less time having to make sales.[158]
Furthermore, by charging a management fee rather than a commission, the financial professional is able to "consolidate multiple types of investments into a single location", which makes "planning and ongoing investment management much easier."[159] Fee-based financial management is also viewed by many financial professionals as a viable alternative to paying commissions on individual transactions.[160]

Financial professionals often fail to deliver the level of service their customers' desire.[161] Despite the benefits to financial professionals, customers do not always receive the benefits for which they pay, and are often left with unfulfilled expectations. In addition, by charging a fee based on the amount of assets under "management", the financial professional conveys that his or her interests are aligned with the customers. However, this is not always the case because a 50% loss in the value of an account under management translates into a pay cut of 50% to the financial professional; such a loss is far more significant to the customer.

Because the SEC viewed paying a management fee as a reasonable alternative to paying commissions on individual transactions, that fact alone did not necessarily bind the financial professional to a continuous fiduciary obligation. However, *the customer* typically views the payment of ongoing management fees as a payment for more than facilitation of the transactions within the account. The manner in which the financial professional is compensated distinguishes not only the service he or she provides, but his customers' expectations; the manner of compensation should be an equally determinative factor in determining the fiduciary duty owed by a financial adviser to his customer.

In purely transactional relationships – to use a loose interpretation of the rule – the current duties owed are adequate. It would be unreasonable to hold a transactional broker accountable for decisions made on the

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[157] *See* John Churchill, *Huge Growth in Fee-Based Brokerage*, REGISTERED REP., Mar. 12, 2004, *available at http://registeredrep.com/news/finance_huge_growth_feebased/index.html* (last visited Aug. 27, 2004).

[158] *See* Kevin McKinley, *Fee-ling Good*, REGISTERED REP., June 1, 2004, *available at http://registeredrep.com/mag/finance_feeling_good/index.html* (last visited Aug. 27, 2004).

[159] *Id*.

[160] *See e.g.*, Dan Jamieson & Rick Weinberg, *Fees Versus Commissions*, REGISTERED REP., Mar. 9, 2001,*available at http://registeredrep.com/news/finance_fees_versus_commissions/index.html* (last visited Aug. 27, 2004).

[161] This statement is supported, in general, by the number of NASD arbitration cases filed annually by customers against fee-based planners. *See e.g.*, *In re* Arcement v. Merrill, Lynch, Pierce, Fenner & Smith, 2004 NASD Arb. LEXIS 1423 (June 22, 2004).

account because the transactional broker is just that – transactional – and his or her responsibility to the customer logically exists only during that specific transaction, and the form of payment is based entirely on each specific transaction; the duty would logically begin when the agreement was entered (at the time the order was taken), and it would end when the agreement was fulfilled (when the order was executed). During that period of time, the broker has the duty to put the customer's interest ahead of all others, not to engage in self-dealing, to fully disclose all material facts related to the transaction (including any potential risk to which the customer might be exposed) and to execute the transaction in a timely manner. However, in the situation in which the customer pays a financial professional for ongoing "management" of his investments, heightened fiduciary duties must apply.

It is important to keep in mind that the Advisers Act was drafted in the wake of the Great Depression and that Congress had a strong interest in *regulating* financial market conduct. Prior to 1999, fee-based account management constituted a relatively small segment of the market. However, from 1999 (when the SEC proposed the rule) through the third quarter of 2003, there was a huge growth in fee-based brokerage accounts, as managed account assets increased by 19%.[162] However, the *transfer* of assets to fee-based accounts was actually *much larger*, because during this period the Standard and Poor's 500 Index dropped by more than 30%.[163] Even the significantly more conservative Dow Jones Industrial Average declined by more than 19% over the same period.[164] Perhaps the fact that the growth in fee-based business coincided with the 2000 – 2002 bear market is merely a coincidence. Perhaps it is not. It is interesting to note that one customer-specific concern raised by the FPA included the fact that under the final rule, a broker-dealer could permit a broker to provide fee-based advice without having to identify conflicts of interest.[165] In light of the investment banking and mutual fund scandals that investors brought to the attention of regulators in the period soon following the SEC's proposal of *Certain Broker-Dealers*, perhaps more disclosure *is* better for everyone.

Broker-dealers continue to report growth in fee-based business. According to Cerulli Associates, Inc., fee-based brokerage account assets increased by more than 37% from September 30, 2003 through December 31, 2006.[166] However, these statistics are a bit misleading because during this same period, the Dow Jones Industrial Average increased by approximately 34%[167] and the Standard & Poors 500 Index increased by more than 40%.[168] Perhaps the negative criticism of relaxed regulation over these accounts made it to the ears of the investing public, after all.

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[162] *See e.g.*, Churchill, *supra* note 30.

[163] The S&P 500 Index closed at 1,469.25 on Dec. 31, 1999 and at 995.97 on Sept. 30, 2003.

[164] The DJIA closed at 11,497.12 on Dec. 31, 1999 and at 9,275.06 on Sept. 30, 2003.

[165] *Id.* at 14.

[166] *See* Churchill, *supra* note 30 (according to Cerulli Associates, "[t]otal assets in fee-based brokerage accounts reached $201.5 billion through the end of third-quarter 2003."); Dan Jamieson, *Wall Street grapples with defeat of rule, uncertain of its effects*, INVESTMENT NEWS, Apr. 9, 2007, *available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070409/FREE/70409001/1009/INIssueAlert01* (last visited Apr. 12, 2007) ("At year end [2006], $277 billion resided in nearly 1 million fee-based brokerage accounts, according to research firm Cerulli Associates.")

[167] The DJIA closed at 9,275.06 on Sept. 30, 2003 and at 12,463.15 on Dec. 31, 2006.

[168] The S&P 500 closed at 995.97 on Sept. 30, 2003 and at 1,418.30 on Dec. 31, 2006.

IV. *Financial Planning Association v. Securities and Exchange Commission*

On March 30, 2007, the United States Court of Appeals for the District of Columbia Circuit issued an opinion[169] that has the potential to significantly impact the fee-based advisory business. In *FPA v. SEC*, the court invalidated the "Merrill Lynch Rule," finding that "the SEC has exceeded its authority in promulgating the final rule."[170] The court was very critical of the arguments raised by the SEC in support of the Rule, finding that the SEC failed "to respect the unambiguous textual limitations" of the Investment Advisers Act[171] and that its arguments contradicted "the SEC's own actions for the last 65 years."[172] The SEC has until May 21, 2007, to seek rehearing from the court of appeals.

While arguing the SEC abused its authority in passing the Rule, the focus of the argument in the FPA's brief was consumer (customer) protection. In fact, the second point raised in the brief was the fact that the Advisers Act imposes fiduciary duties on Investment Advisers, and that these fiduciary duties were necessary to protect the public.[173] In addition, the Consumer Federation of America, Private Investors Arbitration Bar Association, Fund Democracy, and the North American Securities Administrators Association (NASAA) each filed Amicus briefs on behalf of the FPA. Each of these entities focuses on serving the interests of public investors and consumers.

Perhaps most concerning about the *FPA v. SEC* case is the timing of the SEC's actions related to the proposed and final rule. The FPA's brief highlighted the history of the SEC's approach with respect to the Adviser Act's broker-dealer exemption. Specifically, the FPA noted that since the inception of the Advisers Act to 1999, the SEC had implemented the Broker-Dealer exemption explicitly.[174] In the very document that created the initial proposed rule, the SEC continued to observe that broker-dealers were shifting to "advice plus execution"

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[169] No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356 (D.C. Cir. Mar. 30, 2007).

[170] *FPA*, 2007 U.S. App. LEXIS 7356, at *30.

[171] *FPA*, 2007 U.S. App. LEXIS 7356, at *25.

[172] *FPA*, 2007 U.S. App. LEXIS 7356, at *27.

[173] Brief for Petitioner at 5-6, *FPA*, No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356.

[174] *Id*. at 9-11. The following examples were highlighted in the FPA's brief:

In 1940, the SEC's General Counsel stated that the portion of 15 U.S.C. § 80b-2(a)(11)(C)

> Which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.

1940 SEC LEXIS 1466 (1940).

In 1978, the SEC stated that where a broker has two-tiered pricing, a lower charge for traditional brokerage services (no advice) and a higher charge that included providing investment advice, the higher priced services would be regarded as "special compensation for investment advice." Furthermore, if a full service broker-dealer offered a "discount" or "execution only" service, the broker-dealer would not qualify for the exception with respect to all customers who elected not to participate in the "discount" or "execution only" services. 43 Fed. Reg. 19,224 (May 4, 1978).

In 1985 and in 1994, the SEC stated that broker-dealers who imposed additional charges for investment advices would not be exempted from the responsibilities imposed by the Advisers Act. Am. Capital Fin. Servs., Inc., 1985 SEC No-Act. LEXIS 2209, at *5 (Apr. 29, 1985); Townsend & Assocs., Inc., 1994 SEC No-Act. LEXIS 739, at *3 (Sept. 21, 1994).

services.[175] However, rather than require broker dealers who provided these services to comply with the Advisers Act, the SEC sought to change the rules altogether by proposing *Certain Broker-Dealers Deemed Not To Be Investment Advisers*. Rather than put protections in place for the investing public and uphold the integrity of the financial markets, as it is supposed to do, the SEC sided with the broker-dealers and sought to relax Congressionally-implemented regulations. In fact, the FPA highlighted the SEC's statement that although "the Advisers Act was written in such a way that it covers fee-based programs . . . we do not believe that it would be consistent with Congress' intent to apply the Act to cover broker-dealers providing investment advice as part of the package of brokerage services they provide under fee-based brokerage programs."[176] As the FPA noted, while the exception under the Advisers Act applied to situations where "advice is incidental to brokerage services," the SEC attempted to exempt situations where the brokerage services are incidental to the advice.[177]

V. Conclusion

The explosion of fee-based financial planning has impacted the financial services industry. For a variety of reasons, fee-based advisers need to be held to higher standards in how they go about managing their customers' accounts. In an era of enhanced disclosure of public information, financial professionals hold the key to whether the public actually has the opportunity to acquire the publicly-disclosed information, and fee-based advisers convey to their customers that their advice is based on an expert's opinion and is specifically tailored to the individual customer. In general, an individual investor does not have the expertise, training or resources that financial professionals have, and fully entrust their financial affairs to their financial professional. By charging a management fee, the fee-based adviser gives the customer the impression that he is performing a continuous duty, and it is justifiable to hold the fee-based adviser to *per se* fiduciary duties with respect to the customer.

As a result of the decision in *FPA v. SEC*, Wall Street is now forced to come to grips with the fact that fee-based advisors are bound by the fiduciary duties set forth in the Advisers Act. However, the benefits for claimants in arbitration are largely unclear. Because the Advisers Act does not provide for an explicit private right of action for damages, and because the United States Supreme Court declined to imply such a right,[178] any such benefits will have to come more from arbitration panels awarding damages under common law breach of fiduciary duty claims for violations of the duties set forth in the Advisers Act.[179]

In 1987, the SEC stated:

> "[a] person relying on an exclusion from the definition of investment adviser must meet *all* of the requirements of the exclusion . . . [T]he exclusion for broker dealers contained in Section 202(a)(11)(C) would not be available to a broker or dealer . . . if the person receives any special compensation for providing investment advisory services."

Investment Advisers Act Release No. IA-1092, 1987 SEC LEXIS 3487, *17-*18 (Oct. 8, 1987).

[175] *Id.* at 11-13.

[176] *Id.*at 16.

[177] *Id.*

[178] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("TAMA"). However, the Act does provide a private cause of action for rescission of an investment advisory contract. *Id*.

Because the Advisers Act speaks more in terms of "prohibited transactions" and other prohibitions, its explicit provisions are more in the form of antifraud regulation than the imposition of "fiduciary duties". It is from the substance of the Act's provisions and the legislative history that the Supreme Court has found Congress recognized an investment adviser as a fiduciary.[180] Because the Court has reinforced that investment advisers are, in fact, fiduciaries, and because the fiduciary status is based on trust, a breach of duty by an investment adviser should generally satisfy a common law breach of fiduciary duty claim.

While an imposition of a higher fiduciary duty might seem to only benefit the customer, this is not the case. By having a legal standard for whether a fiduciary duty exists, and if so, to what extent, the law would provide fee-based advisers with firm guidelines as to how they operate their advisory practice. A higher standard of care will only improve the industry as a whole, and, as a result, more individuals will feel confident in placing their trust with fee-based advisers and financial professionals in general.

[179] In TAMA, the Supreme Court stated "we hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable." 444 U.S. at 24. However, TAMA concerned whether the antifraud provisions of the Advisers Act conferred a private right of action, similar to the private right of action under the Securities and Exchange Act of 1934. What was not before the Court, and that the Court did not address, was whether a breach of the fiduciary duties imposed by the Act can constitute the basis for a common law claim of breach of fiduciary duty.

[180] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 194. *See also* TAMA, 444 U.S. at 17 ("[i]ndeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.") *Id.*