Fiduciary duties, broker-dealers and sophisticated clients: A mis-match that could only be made in Washington

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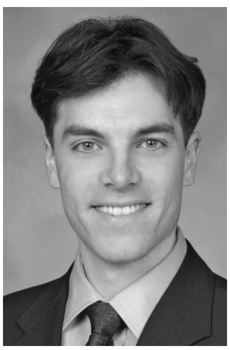

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ABSTRACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act took aim at many of the perceived flaws of Wall Street, including the relationship between broker-dealers' and their clients. Initial proposals sought to impose fiduciary duties on broker-dealers relations with retail investors, but after the Securities and Exchange Commission (SEC) sued Goldman Sachs over the Abacus synthetic CDO, the debate expanded to extending fiduciary 'protection' to institutional investors as well. The final bill leaves these issues unresolved and potentially subject to further rulemaking by the SEC.

This paper traces the progression of the fiduciary standard legislative proposals and analyses the final provisions of the Dodd-Frank Act. It then addresses and counters the flawed rationales asserted by proponents of imposing fiduciary duties on broker-dealer interactions with institutional investors, arguing that their proposals would be unworkable, unnecessary and result in an economically undesirable paradigm shift from the existing disclosure-based regulation system. The paper observes that the market economy relies on the ability of broker-dealers to operate on multiple platforms with institutional investors and to be market leaders in the creation of innovative financial products. Imposing a fiduciary standard of conduct would stunt these important activities by creating uncertainty regarding the scope of broker-dealer responsibility and potential liability. Lastly, criminalising breaches of a fiduciary standard (as one of the proposed bills suggested) would only exacerbate the negative consequences that flow from imposing such a standard.

Keywords: fiduciary duty, institutional investors, broker-dealer, Dodd-Frank

INTRODUCTION

The financial crisis and subsequent demand for reform triggered many debates, including whether broker-dealers should owe a fiduciary duty to their retail customers. The highly publicised lawsuit by the Securities and Exchange Commission (SEC) against Goldman, Sachs & Co. (Goldman) relating to its structuring and selling a synthetic collateralised debt obligation known as Abacus expanded this debate.[1] In addition to focusing exclusively on retail investors, lawmakers and commentators began to ask whether broker-dealers should also owe a fiduciary duty to institutional investors — the hedge funds, pension funds, private equity funds and other large sophisticated investors that buy not only publicly traded stocks and bonds but also transact with broker-dealers across many investment platforms.

Although to some extent the debate over broker-dealer fiduciary duties has been framed by differing views concerning the merits of the SEC's case against Goldman, this paper will not weigh in directly on what is fundamentally a disclosure dispute and an already thoroughly examined subject.[2] What struck the authors and, based on their informal survey, many others in the financial community who watched the Congressional questioning of various Goldman executives and employees was Congressional members' lack of a clear understanding of the products and services that broker-dealers sell to institutional investor clients. Without a clear understanding of what broker-dealers do, and an appreciation that for certain transactions they help to structure and/or market there inevitably have to be both investors who are winners and losers, it is impossible to create a clear and coherent standard of conduct.

This paper will attempt to aid the debate by first examining how it has evolved to this point and then placing the question in a real world context by examining the normal business interactions between broker-dealers and their institutional investor clients in order to understand better whether subjecting broker-dealers and investment bankers to fiduciary standards and potential criminal penalties for any failure to live up to those standards makes sense. For a variety of reasons explored herein, the authors suggest as a matter of both law and economics, it does not.

THE DODD-FRANK BILL: A PLATFORM FOR THE FIDUCIARY DUTY DEBATE

The recent set of reform proposals to create new federal fiduciary duties for broker-dealers was spurred on by the collapse of the financial markets and was aimed initially at providing greater protection to retail customers. The rationale for imposing a fiduciary duty on broker-dealers in their dealings with their retail customers was, in part, a paternalistic concern to provide greater protection for the presumed unsophisticated retail customer.[3] Another argument for the move was the perceived blurring of roles between investment advisers and broker-dealers from the perspective of retail investors.[4] In particular, it was believed that more broker-dealers were providing investment recommendations as part of their brokerage services,[5] and many broker-dealers were instituting discount brokerage accounts that had fees based in part on assets in the customer's account.[6]

Commentators argued that this shift created a greater need for consistency between the regulatory regime governing the conduct of investment advisers and that governing broker-dealers. Broker-dealers are currently regulated under the Securities Exchange Act of 1934. Congress excluded them from the standards for investment advisers established by the Investment Advisers Act of 1940 (the 'Advisers Act'),[7] so long as any investment advice given to a client is solely incidental to its business as a broker-dealer and it does not receive any special compensation for rendering such advice.[8] As a result, broker-dealers generally do not owe a fiduciary duty to customers under state law but are instead governed by suitability rules.[9] Generally, these suitability rules require that a broker-dealer recommending to a customer the purchase or sale of a security have reasonable grounds for believing that the recommendation is suitable.[10] The broker-dealer's recommendation should be reasonable but does not need to be in the best interest of the customer.[11]

A different, higher standard of conduct is imposed on investment advisers pursuant to the Advisers Act.[12] Although the Advisers Act does not explicitly refer to a fiduciary duty, the United States Supreme Court has repeatedly recognised that '§ 206 [of the act] establishes "federal fiduciary standards" to govern the conduct of investment advisers'.[13]

The US Senate and the House of Representatives initially each passed bills taking a different approach to harmonising the two regulatory regimes. The House version of the financial reform legislation, passed in December 2009, mandated that the Commission adopt rules establishing that broker-dealers adhere to a fiduciary standard when providing personalised investment advice to their retail customers.[14] The Senate version, passed in May 2010, would have required the SEC to study the issues surrounding harmonisation of broker-dealer and investment adviser regulation.[15] If the study were to have uncovered regulatory gaps in the protection of retail investors receiving investment advice, the SEC would have been required to draft rules within two years to address such gaps.[16]

After the SEC filed its complaint against Goldman, legislators renewed their focus on the creation of a federal fiduciary responsibility with respect to broker-dealers and their institutional investor clients.[17] Senator Arlen Specter (D-Pa.) made the first and most far-reaching proposal. His bill would not only have created a new federal fiduciary regime for broker-dealer relationships with institutional investors, but would also have imposed criminal sanctions on anyone who wilfully violated these newly developed fiduciary duty and disclosure obligations.[18] Senator Barbara Boxer (D-Cal.) also proposed an amendment to impose a fiduciary duty on broker-dealers for all advice to any pension plan or employee benefit plan, and any state or local governments and their agencies, and endowments, and specifically including advice concerning commodities and derivatives investments.[19]

Although these proposals were not included in the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd Frank') that emerged from the conference committee,[20] the legislation retains provisions that place the issue squarely on the table for the foreseeable future. Most directly, Dodd-Frank would empower the SEC to 'promulgate rules to provide that, with respect to a broker or dealer, when providing personalised investment advice about securities to a retail customer (**and such other customers as the Commission may by rule provide**), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under' the Investment Advisers Act.[21] The emphasised language permits the SEC to impose this fiduciary standard on the provision of investment advice to investors other than retail investors.

The legislation also permits the SEC to 'facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and … examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and protection of investors'.[22] Yet again, this language is broadly applicable to all investors, not just retail investors, and leaves open the possibility that the SEC could enact rules imposing a fiduciary duty on broker-dealer interactions with institutional investors as advocated by Senators Specter and Boxer. Even the definition of retail investor is quite broad, covering 'a natural person, or the legal representative of such natural person, who:

1. receives personalised investment advice about securities from a broker, dealer, or investment adviser;
2. uses such advice primarily for personal, family or household purposes'.[23]

The legislation, therefore, leaves plenty of room for the SEC to consider imposing heightened duties on broker-dealers in their dealings not just with the proverbial 'widows and orphans', but also with investors generally considered by other securities laws to be 'sophisticated' including qualified institutional buyers, accredited investors and eligible contract participants.[24] While the SEC may not take the bait, the breadth of the legislative provisions, together with the requirement that the SEC report within six months on whether there exist legal or regulatory gaps between the regulation of broker-dealers and investment advisers,[25] promise to keep alive the debate about imposing heightened standards on broker-dealers when they engage with institutional investors.

THE FLAWED RATIONALES FOR A FIDUCIARY DUTY STANDARD FOR TRANSACTIONS WITH INSTITUTIONAL INVESTORS

There have been several basic arguments for imposing heightened duties on broker-dealers, none of which fit well into the relationship between a broker-dealer and its institutional clients. A primary argument, made in several contexts by SEC Commissioner Luis Aguilar, is that over the past decades, the services provided by brokers and dealers to investors have evolved and that brokers and dealers often provide investment advice in the same manner as investment advisers regulated by the Advisers Act.[26] Thus, the argument goes, this creates an opportunity for regulatory arbitrage by broker-dealers. The standard of conduct of brokers and dealers when providing investment advice should therefore be harmonised with the standard of conduct imposed on investment advisers in order to close this gap.

Whatever force these arguments may have for extending the fiduciary mantle over investment advice given by broker-dealers to retail clients, they do not logically justify imposing fiduciary duties on broker-dealer interactions with institutional investors, such as pension funds or hedge funds, for example, that often have retained their own professional investment advisers to make their investment decisions. Such counterparties have no reasonable expectation that they are dealing with their broker-dealers on anything but an 'arms-length' basis. They are also unlikely to share with their broker-dealers either sufficient information about the composition of their investment portfolios or concerning their investment strategies for the broker-dealers to provide any meaningful guidance.[27] As a practical matter, assigning broker-dealers a duty they have no way to fulfil is a patently unworkable construct and simply will promote litigation aimed at effecting the inappropriate *post hoc* shifting of investment risk.

In testimony before a sub-committee of the US Senate on Senator Specter's proposed bill, Professor John C. Coffee argued the legislation was necessary to rectify a failure to prevent conflicts of interest, a 'fundamental hole' that in his view played a key role in the 2008 meltdown.[28] He argued that legislation was needed 'to protect investors and to maintain market transparency and economic efficiency' and return to the traditional norm that brokers should seek 'to serve their clients (and not seek to profit from their losses)'.[29] Professor Coffee would go so far as to impose criminal penalties for violators in order to take advantage of their '*in terrorem deterrent* threat'.[30]

In attempting to make his case for these changes, Professor Coffee relies heavily on the Abacus paradigm.[31] In Professor Coffee's view, Goldman should have had a fiduciary responsibility to see that the institutional investors that took the 'long side' of that transaction had exposure to what Goldman viewed as 'attractive securities'.[32] Professor Coffee, however, does not even begin to explain why Goldman, under his paradigm, should not have also had a fiduciary duty to insure that the institutional client that invested in the 'short side' of the transaction had exposure to securities that would make money for their position. Importantly, because, as noted earlier, this was a synthetic CDO investment, it required Goldman to find both long and short investors, who were making opposite bets in what amounts to a zero sum investment.

Moreover, while there could be only one winner in this investment, there did not have to be a loser. Whether, and to the extent, either side of the Abacus transaction lost any money depended entirely on whatever additional hedging decisions they made — a subject on which

Goldman had no apparent knowledge or input.

While it could be argued that Goldman should not have created new CDO investment products once it, as an institution, formed a view that the products were too risky (assuming *arguendo* it ever formed such a view), such a viewpoint would be extraordinarily naïve. No broker-dealer could afford not to provide the investment products its clients want nor could any of them have been sufficiently prescient to anticipate if, and when, the mortgage market might collapse in the unprecedented way it did. The seeds for decline in that market had been sown ten years earlier in the 1998 dramatic downturn in global securities markets. Following that decline, the mortgage market made a rapid recovery because federal policies, including unusually low interest rates,[33] averted a decline in real estate markets — the only major market that did not decline in 1998. Anecdotally, many market professionals believed from the early 2000 period on, based on historical trends, that despite this federal intervention, eventually the real-estate market would also decline. If any broker-dealer had stayed out of the highly lucrative mortgage market for the decade it took for the ultimate collapse to happen, it would probably not be in business today.

A different and more sophisticated perspective on this general topic was offered some years ago by Professor Donald C. Langevoort in his paper 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers'.[34] Professor Langevoort focuses on brokers' efforts to cultivate trust from their purchasers in order to be more successful salesmen. He argues that from a law and economics perspective their successful efforts to obtain this trust justify the imposition of the costs related to a higher standard of conduct.[35] While acknowledging that retail investors, given the disparity in market information and expertise, are the most susceptible to these efforts to cultivate trust, Professor Langevoort is of the view that even institutional investors are prone to vest such trust in their brokers as to obscure their own detached investment decision-making.[36] He does not take a normative position on institutional investor gullibility, but rather argues that if this dynamic is recognised, it is more efficient to put a burden on the broker-dealer than to hold investors accountable for not being sufficiently cautious.[37] Although he proposes that current standards imposed on broker-dealers need to be re-examined, he does not advise that the government go so far as to impose a fiduciary standard.[38]

Implicit in Professor Langevoort's argument that broker-dealers should have greater duties to even their sophisticated institutional investor clients is a belief that broker-dealers have greater access to information, know more and may even be smarter and more talented than their clients and therefore should have greater responsibility as the sellers rather than the buyers of their financial products. The most recent financial crisis provided a good laboratory test for both Professor Langevoort's explicit and implicit theories.

Obviously, most, if not all, of the nation's major banks made a major mistake in their investments in mortgage-related securities necessitating an unprecedented federal financial bailout. One would expect that hedge funds, which under Professor Langevoort's theories would be the gullible victim of a sales effort to make similar investments, would have suffered equal harm. In fact, this does not appear to be the case at all.[39] One explanation for this that has been advanced, which is contrary to Professor Langevoort's trust in others thesis, is that the incentive and reward compensation structure of hedge funds, which attracts top notch talent and cultivates their 'independent culture', allowed hedge funds to remain immune to the mortgage bust.[40] John Paulson, for instance, bought the largest mortgage database in the country and hired extra analysts to learn of patterns in default rates.[41] Other hedge funds that did not engage in such research simply avoided buying such risky assets since they had their own funds at risk.[42] Further, hedge funds, unlike other investors, were too cautious to rely on the advice of rating agencies.[43] In 2007, the year the mortgage bubble burst, hedge funds were up by 10 per cent; even the hedge funds specialising in mortgages and other asset-backed securities ended the year flat, avoiding the types of losses suffered by their peer investment companies.[44]

Overall, the arguments for expanding the duties of brokers to institutional investors are flawed. Neither Commissioner Augilar nor Professor Coffee sufficiently examine whether their rationales translate to the world of institutional investors. While Professor Langevoort's position appears reasonable on some levels, even the moderate alterations to legal standards and the sales process he seeks do not appear to be necessary. Moreover because of the reasons investigated below, the costs that would be imposed on the broker-dealer community if heightened duties and legal standards were adopted would, in the end, result in higher costs to the economy as a whole as these same sophisticated investors attempt to leverage this new duty of broker-dealers into some kind of putative insurance on their investments.

FIDUCIARY DUTY IS AN INAPPROPRIATE STANDARD FOR BROKER-DEALER TRANSACTIONS WITH SOPHISTICATED INVESTORS

A significant problem with imposing a fiduciary duty is, as Dean Larry E. Ribstein explained in his testimony before Congress, 'fiduciary duties' are too 'amorphous' a concept to provide clear guidance to market participants.[45] Professor Barbara Black concurred in this concern, noting that 'the cost of fiduciary language is its vague and amorphous quality and its failure to develop clear and consistent standards' that can be enforced.[46] The imposition of 'ill-defined' rules can chill legitimate behaviour, such as the creation of new and innovative financial products, and would not achieve their deterrence objective. Moreover, Dean Ribstein contended that these negative outcomes would be exacerbated if, as advocated by some, wilful fiduciary breaches were criminalised.[47]

The imposition of fiduciary duties on broker-dealers' relationships with sophisticated investors is particularly misplaced. Such duties would present a wholesale paradigm shift from what until now has been disclosure-based securities regulation and would sow the seeds for widespread economic disruption. The regime of private placements and unregistered securities offerings, which has made up an increasingly larger part of our capital markets,[48] is premised on the notion that sophisticated investors can take care of themselves.[49] While this premise may be under attack in some circles,[50] if one takes any account of the normal course of dealing between these sophisticated parties, it is difficult to conclude that such investors are unaware of the conflicts that may exist for a broker-dealer. More than anything, this was at the heart of the criticism levied on the Congressional questioning of Goldman — it lacked any appreciation for the context of the market in which these parties operate.

As a quick reference to how sophisticated investors are conditioned to understand the role of broker-dealers in securities transactions, peruse any disclosure document for a private offering of securities. There are numerous pages describing the potential conflicts of interest that may exist for the broker-dealer selling the security to the investor, including, in many cases, the multiple roles played by the broker-dealer or its affiliates in that very transaction. As a common sense check, ask whether the investment adviser working for Vanguard or Blackrock does not recognise that the broker-dealer that has structured and is now selling it a highly complex derivative is making money on the sale, and that some other part of the broker-dealer's corporate family, or another of the broker-dealer's 'clients', may have short positions on that same investment. It becomes readily apparent that any trust being placed in a broker-dealer, outside a formal investment advisory relationship, is done with a full appreciation of their potential multiple roles and the attendant risks.

Moreover, broker-dealers interact with their sophisticated clients on several different platforms. This varied relationship presents significant complications for the idea that broker-dealers should owe fiduciary duties of some sort to their 'clients'. In fact, a broker-dealer may deal with the same person as a 'client', 'customer', or 'counterparty', depending on the transaction. Defining the particular conditions in which heightened duties would apply to their interactions would be challenging, if not impossible, to put into practice without serious adverse effects on the market.

Excluding for the moment proprietary trading where, quite obviously, broker-dealers are not following Professor Coffee's so-called traditional norm and are in fact trying to make money off their trading counterparties' losses, there appear to be multiple basic roles that broker-dealers may play with respect to sophisticated investors:

- Recommending a particular security (or derivative transaction) to an investor for purchase or soliciting the sale by a client of a particular security.
- Acting as a prime broker for an investor's purchase and sale of securities.
- Entering into financial contracts (ie, swaps, repurchase agreements, securities lending agreements) with investors.
- Structuring a financial instrument to be sold to the market, in response to a client initiative and objective.
- Structuring a financial instrument to be held by the broker-dealer with the ability to sell in the future.
- Structuring a financial instrument to be sold to the market, initiated by market demand or the expectation of market demand.
- Trading securities as a market-maker.

Using the barometer suggested by Professor Langevoort to measure the appropriateness of imposing heightened duties, each of these roles involves a different degree of trust solicited by the broker-dealer and provided by the client. On one side of the spectrum, when the broker-dealer recommends that a client consider purchasing a particular security, there is likely to be some level of trust granted by the client in the judgment of the broker, at least as to the suitability of the security. It may simply be trust in that broker-dealer's judgment of how that security fits into the investor's overall investment approach, but some deference is being provided, and thus some control relinquished. Even in this scenario, however, the investor retains the discretion to decide whether to purchase the security. This remains a far cry from the paradigm case for imposing heightened duties: the investment adviser that has discretionary authority over the client's funds.[51]

At the other end of the spectrum, when a broker-dealer is making a market in a security, its entire role in the transaction is meant to match a willing buyer and a willing seller at a price they find mutually beneficial. The seller and the buyer almost certainly have different views of the market in the security being traded, either or both of which may differ from the views of the broker standing in the middle of the trade. It is contrary to the nature of this transaction to assume any deference is being provided to the broker-dealer's view. Its utility is simply as a financial intermediary that has access to the broader market.

The legislation does not attempt to handle these diverse conditions with any dexterity. Instead, it would determine when and in what contexts the fiduciary standard applied based on the question of whether the broker-dealer was 'providing personalised investment advice'.[52] So on top of the amorphous fiduciary duty standard,[53] the legislation layers an indiscernible measure of the scope of application. To say it will be a difficult task to apply this test to a broker-dealer's daily activities is an understatement. As Professor Ribstein warned, such an imprecise dictate would likely lead to fear of an overbroad application, and a chilling effect that reduces beneficial economic activity.[54]

The example of the broker-dealer receiving a mandate from an investor to structure a financial instrument to be sold to the market is a fine example. In such a case, will the broker-dealer be providing personalised investment advice when it sells the structured security to the investor? Or would the duty be owed to the sponsor of the transaction? If the structured security underperforms, is there a presumption that the broker-dealer, by working with the sponsor to structure the transaction, placed the interests of the sponsor ahead of the investor? Will the investor now look to the broker-dealer as a guarantor of the investment performance of the securities that it will purchase?

One might suggest that the cure for an overbroad rule is to allow brokers and dealers to contract out of it. But if that is the case, there is no need for the legislation in the first place, other than to place a thumb on the scales for sophisticated parties that should not need that assistance to bargain for what they truly want. Increasing the costs to broker-dealers of complex securities transactions may be consistent, however, with other lawmaking being pursued by the federal government through slightly different avenues.

PLACING THE RISK OF COMPLEX SECURITIES ON BROKER-DEALERS — AN ALTERNATIVE RATIONALE?

A common target of legislators and regulators in recent years has been the role of the broker-dealer in the creation and sale of structured finance products such as collateralised debt obligations. Perhaps, then, the true value to critics of Wall Street of the imposition of a fiduciary duty is that it will increase the potential liability of the broker-dealer, an indirect way of imposing the 'skin in the game' requirement that various federal rulemaking proposals are seeking more directly.[55]

As described above, the structured product is the most difficult position in which to discern to whom the broker-dealer owes a duty, as it is often facing multiple 'clients'. In the first instance, it is working in cooperation with the sponsor of the transaction who may have approached the broker-dealer to, for example, securitise assets it owns in order to generate cash more efficiently. At the back end of the transaction, it may be offering the resulting securities to investors that have an appetite for exposure to the underlying assets. In most cases, the sponsor (who is taking a short position on the assets by putting them into the securitisation vehicle) and the investor (who is taking a long position) will be directly adverse to each other.

One could construct a law and economics argument that given the superior information the broker-dealer must possess vis-à-vis the investor, the broker-dealer should be responsible for more of the liability for any losses on the structure. To date, that disparity of information has been dealt with through the requirement that all material information about the underlying assets be disclosed to the investor.[56] If the proper amount of disclosure is made, then the broker-dealer has a defence against the poor performance of the security. The imposition of a fiduciary duty with respect to purchasers of the security would eliminate that defence, and could force the broker-dealer to retain that contingent liability with respect to every security that it sold.

To the extent the purpose of such legislation is to incentivise broker-dealers to create less 'risky' investment products, this again is an economically naïve concept. For example, for many pension funds today, the greatest risk is underfunding due not only to losses suffered because of recent market developments, but also because there appears to have occurred a long-term reduction in the returns they can expect from both the debt and equity markets. There is also, in some economists' view, a real risk of deflation. A number of what appear to be inherently risky financial products like credit default swaps, and other derivatives, private equity investments, and commodities investments, in the context of a large investment portfolio can actually improve performance as well as reduce or hedge risks.

One of the greatest strengths of our economy has been the ability of our broker-dealers to be market leaders in the creation of these innovative investment products. It would appear contrary to our national interest to abdicate this leadership position to some other jurisdiction, when, because of the fundamental demand for such products, they will continue to be created and sold to sophisticated investors looking for opportunities for attractive returns.

Additionally, the proposed regulatory paradigm shift would also shift market risks and therefore is likely to have the unintended consequence of exacerbating the 'too big to fail' problem with which the US Congress continues to wrestle.[57] Broker-dealers would be asked essentially to insure all of the securities they sell to their customers, as any customer with an investment loss will seek to capitalise on the inherent conflicts of interest that will continue to exist for a broker-dealer that not only sells, but makes markets in and structures, securities. While many hedge funds, pension funds, and other investors on the buy side of the industry suffered losses as a result of CDOs, mortgage-backed securities deals and other complex securities, it was the losses on those securities suffered by WaMu, Lehman Brothers and Bear Stearns, and those central players in the banking system that survived solely due to the massive federal bailout, that truly shook the economic system to its core. It cannot be the case that we want to further concentrate the risk of structured securities with the banks whose financial distress can have the largest global impact. Yet the imposition of a fiduciary duty in this context would appear to do just that, and the negative impact could only be greater with criminal liability attached.

CRIMINALISATION AND FEDERALISATION OF FIDUCIARY DUTIES — MAKING A BAD IDEA WORSE

Experience has taught us that criminal indictments are the equivalent of a death sentence for a broker-dealer or other professional firm, even if the firm is ultimately vindicated by the criminal justice system.[58] Even if somehow the markets could be assured that the criminal sanction would be reserved for individuals and not institutions, it would not be an appropriate remedy in this context. It has long been a basic principle of our criminal laws that we only deprive an individual of his or her liberty if they have deliberately committed an act they had clear advance notice was a crime. As noted above, the fiduciary standard provides no clear, advance bright line guidelines. Conduct that at the time seemed to the actor to be benign or at worst negligent could, with the benefit of hindsight, appear to be a breach of a fiduciary standard.

Moreover, a cynical, but the authors submit, accurate takeaway from the experience of the past two decades during which the US Congress has continued to federalise and criminalise perceived inappropriate 'white collar' criminal behaviour that was once left solely to the tort system to address is that the actual successful prosecutions of these crimes are few and far between. Anecdotally, it would appear that if you are unlucky enough to be a key executive associated with a major financial disaster that has piqued the public interest, you will be indicted (perhaps regardless of whether you in fact committed any crime).[59] Such a regime is unfair, arbitrary and highly unlikely to have any deterrent effect.

Finally, the authors also question the wisdom of federalising the law of fiduciary duty, which would result from incorporating the obligation into a federal statute. This is an area where the states, especially the Chancery Courts in Delaware,[60] have done a very good job in balancing a host of often competing financial and public policy considerations to fashion a code of business conduct. It is also an area where the law needs to evolve quickly as the organisations and businesses of the parties subject to regulation continue to change to keep pace with our rapidly evolving markets and economy. The US Congress's recent efforts at financial reform demonstrate, if nothing else, that the federal legislative process is slow, clumsy and politicised and thoroughly unsuitable for taking on the role of making the subtle fine-tuned judgments that defining and policing a fiduciary regime require. Nor does it make sense for the Federal courts — which would be overwhelmed by the new cases that would result from this proposed dramatic expansion of their jurisdiction — to take this responsibility away from the highly competent and specialised Delaware Chancery business court that has led the way on these issues.

CONCLUSION

It is perhaps not surprising that a government that seems increasingly committed to attempting to pass laws seeking to eliminate all of the risks of daily life would try its hand at legislating away the risks of investing. The laws of economics, however, are not so malleable. The lesson of the past few years sadly learned by even market professionals believing in so-called fail-safe investment strategies, ranging from diversification to Madoff, is that there is no free lunch. There is a correlation between potential risk and potential return that cannot be avoided, and there will always be winners and losers in a free market system. Adoption of federal legislation designed to provide fiduciary protections to sophisticated institutional investors who have no need for such protections will not only fail to provide them any greater meaningful protection but will also have a number of the unintended negative consequences that have been discussed in this paper.

References

(1) The SEC alleged that Goldman misled investors by failing to disclose that a hedge fund, Paulson & Co ('Paulson'), played a significant role in choosing the reference obligations in the Abacus portfolio. Because Paulson, in effect, had a short position in the securities sold to investors, it had an incentive to select mortgage-backed securities it expected to default. Complaint at 1, *SEC v. Goldman Sachs & Co.*, 10-CV-03229-BSJ (SDNY filed 16th April, 2010). Goldman offered a number of responses, including that the nature of synthetic CDOs requires there be a short investor, that Paulson's involvement in the transaction was disclosed or otherwise known, that an experienced, independent selection agent had a role in selecting the reference obligations for the portfolio, that the specific reference obligations were disclosed, and that Goldman itself was a long investor and lost US$90m in the deal. Nevertheless, the SEC complaint resulted in a firestorm of criticism of Goldman in the press concerning its perceived conflicts of interest. See, eg, Gretchen Morgenson & Louise Story, 'Clients Worried About Goldman's Duelling Goals', *New York Times*, 18th May, 2010, at A1. On 15th July, 2010 Goldman and the SEC reached a settlement that required Goldman to pay US$550m.

(2) See, eg, Paul Krugman, 'Looters in Loafers', *New York Times*, 18th April, 2010, at A23; Jake Bernstein & Jesse Eisinger, 'The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going', *Pro Publica*, 9th April, 2010, available at http://www.propublica.org/feature/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble.

(3) See John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, Testimony before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary (4th May, 2010).

(4) Angela Hung, *et al.*, 'Investor and Industry Perspectives on Investment Advisers and Broker–Dealers' (Rand Institute for Civil Justice, 2008).

(5) Tamar Frankel, 'Fiduciary Duties of Brokers–Advisers–Financial Planners and Money Managers' 8–12 (Boston Univ. Sch. of Law, Working Paper No. 09-36, 2009); Arthur B. Laby, 'Reforming the Regulation of Broker–Dealers and Investment Advisers', 65 BUS. LAW. 395, 400-01 (2010); SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Broker and Dealer xiv, xvi (1936).

(6) Hung, ref. 4 above, at 14.

(7) 15 U.S.C. §§ 80b-1, *et seq*.

(8) 15 U.S.C. § 80b-2(a)(11)(C).

(9) FINRA Manual, NASD Rules, Conduct Rule 2310(a) (1996); *de Kwiatowski v. Bear, Stearns & Co.*, 306 F.3d 1293 (2d Cir. 2002).

(10) *Ibid*; See also Coffee, ref. 3 above.

(11) Barbara Black, *Fiduciary Duty, Professionalism, and Investment Advice* 8 (Univ. of Cincinnati Pub. Law Research, Working Paper No. 10-24, 2010).

(12) 15 U.S.C. § 80b-6.

(13) *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 US 11, 17 (1979) (citing *Santa Fe Indus., Inc. v. Green*, 430 US 462, 471 n.11 (1977); *Burks v. Lasker*, 441 US 471, 481-82 n.10 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 US 180, 191-92 (1963)).

(14) Wall Street Reform and Consumer Protection Act 2009, H.R. 4173, 111th Cong. § 7103 (2009), available at: http://docs.house.gov/rules/finserv/III_hr_finsrv.pdf.

(15) Restoring American Financial Stability Act 2010, S. 3217, 112th Cong. § 913 (2010).

(16) *Ibid* § 913(f)(1).

(17) The idea for creating fiduciary protection, for even sophisticated institutional investors, is not a new one. Arguments for such 'reforms' have almost reflexively followed notable financial scandals and failures over the past 15 years beginning with the claims

against Bankers Trust & Co. resulting from its sale of derivatives to Proctor & Gamble. See, eg, Barbara Roper, Director of Investor Protection, Consumer Federation of America, Testimony before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary 3 (4th May, 2010); Kelley Holland, Linda Himelstein, & Zachary Schiller, 'The Bankers Trust Tapes', *Business Week*, 16th October, 1995.

(18) 156 Cong. Rec. S3109, SA 3806 (daily edn. 4th May, 2010).

(19) 156 Cong. Rec. S3104, SA 3792 (daily edn. 4th May, 2010).

(20) Conference Report to accompany H.R. 4173, Report 111–517, 111th Congress (2010).

(21) *Ibid* § 913(g)(1) (emphasis added).

(22) *Ibid* § 913(h)(1) & (2).

(23) *Ibid* § 913 (g)(1)(B)(2).

(24) Although the definition of retail investor limits its reach to natural persons (and therefore would not apply to qualified institutional buyers, for example), the other relevant language includes no such limitation.

(25) Dodd-Frank, ref. 21 above § 913(b)(1) & (2).

(26) Luis Aguilar, Commissioner, SEC, 'SEC's Oversight of the Adviser Industry Bolsters Investor Protection' (7th May, 2009), available at: http://www.sec.gov/news/speech/2009/spch050709laa.htm.

(27) Notably, investments that appear extremely risky when examined strictly on their own, can actually contribute to hedging and lowering the overall risk of an investment portfolio.

(28) Coffee, ref. 3 above, at 1.

(29) *Ibid* at 11.

(30) *Ibid* at 8.

(31) *Ibid* at 5.

(32) *Ibid* at 6.

(33) See Scott E. Harrington, 'Moral Hazard and the Meltdown', *Wall St. Journal*, 23rd May, 2009.

(34) Donald C. Langevoort, 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers', 84 Cal. L. Rev. 627 (1996).

(35) *Ibid* at 631.

(36) *Ibid* at 630–31.

(37) *Ibid* at 671–73.

(38) *Ibid* 697. Professor Langevoort recommends a number of what he terms 'moderate policy prescriptions', including (i) recognising common sense exceptions to the customer's duty to read, (ii) reforming disclosure practices to cause disruption in the selling process, and (iii) examining the scienter of the firm, not the individual broker. *Ibid* at 681–696.

(39) See Sebastian Mallaby, 'Learning to Love Hedge Funds', *Wall St. Journal*, 11th June, 2010.

(40) *Ibid*.

(41) *Ibid*.

(42) *Ibid*.

(43) *Ibid*.

(44) *Ibid*.

(45) Larry E. Ribstein, Associate Dean for Research, & Mildred Van Voorhis Jones Chair, University of Illinois College of Law, Testimony before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary 1 (4th May, 2010).

(46) Black, ref. 11 above, at 14.

(47) Ribstein ref. 45 above, at 8.

(48) Glenn M. Reiter & Stephen B. Grant, 'Resales of US Privately-Placed Securities', Int'l Fin. L. Rev., January 1989, at 20; Kellye Y. Testy, 'The Capital Markets in Transition: A Response to New SEC Rule 144A', 66 Ind. L. J. 233, 241–46 (1990); Elena Schwieger, 'Redefining the Private Placement Market After Sarbanes-Oxley: NASDAQ's Portal and Rule 144A', 57 Cath. U. L. Rev. 885, 887 (2007–08).

(49) Testy, ref. 48 above, at 270–71.

(50) See, eg Lisa K. Bostwick, 'The SEC Response to Internationalisation and Institutionalisation: Rule 144A Merit Regulation of Investors', 27 Law & Pol'y Int'l Bus. 423, 439–42 (1996).

(51) Of course, when the investment adviser is the broker-dealer, current law already

imposes stricter responsibilities. See *SEC v. Zandford,* 535 US 813 (2002); *Rolf v. Blythe, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2nd Cir. 1978).

(52) Dodd-Frank, ref. 20 above, § 913(c)(1).

(53) See Ribstein, ref. 45 above, at 1–2.

(54) *Ibid* at 5, 8.

(55) See, eg, Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitisation or Participation After 30th September, 2010, Amendments to 12 C.F.R. § 360.6 (proposed 11th May, 2010) (requiring originators to retain 5 per cent of an economic interest in the structure).

(56) Indeed, one fact that is conveniently ignored by those who would impose new duties on the broker–dealer community is that in the Abacus transaction, the investors in the Abacus securities were provided with the same basic information about the assets as Goldman and Paulson; the difference was that their analysis of the market led them to a different view on how the securities would perform. See 'The SEC vs. Goldman: More a Case of Hindsight Bias Than Financial Villainy', *Wall St. Journal*, 19th April, 2010; Sebastian Mallaby, 'In SEC vs. Goldman, Who's Really at Fault?', *Washington Post*, 21st April, 2010.

(57) Resolution Authority for Large, Interconnected Financial Companies Act of 2009, div. D, tit. XII, Enhanced Resolution Authority, available at: http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf.

(58) The sad case of Arthur Andersen is a poignant example of this point. Despite ultimately being held not responsible for any criminal violation in connection with its audit of Enron, *Arthur Andersen LLP v. United States*, 544 US 696 (2005), its indictment relating to its work on that matter was a death knell for that firm, which employed 85,000 individuals and which had revenues of about US$10bn dollars. See David F. Hawkins & Jacob Cohen, 'Arthur Andersen LLP', *Harvard Business Review*, 13th February, 2003. The earlier experience of the investment banking firm Drexel, Burnham & Lambert, which also in its heyday employed 53,000 people and had annual revenues of US$5.3bn, demonstrated the equal vulnerability of financial firms. Brett Duval Fromson, 'Did Drexel Get What it Deserved?', *Fortune*, 12th March, 1990.

(59) The recent successful prosecutions of former Enron executives, Kenneth Lay and Jeffrey Skilling, for activities that the Supreme Court of the United States has now held were not criminal, *Skilling v. United States*, No. 08-1394, 2010 WL 2518587, 561 US (24th June, 2010), provide poignant examples that human lives are also as vulnerable to misplaced prosecutions as great institutions. See also Jennifer S. Recine, 'Note: Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act', 39 Am. Crim. L. Rev. 1535 (2002); Oleg Rezzy, 'Sarbanes-Oxley: Progressive Punishment for Regressive Victimisation', 44 Hous. L. Rev. 95, 99–104 (2007); Peter J. Henning, 'Admitting Misconduct While Avoiding Charges', *New York Times*, 25th January, 2010, available at: http://dealbook.blogs.nytimes.com/2010/01/25/for-monday-am-admitting-misconduct-while-avoiding-charges/.

(60) For an overview of policymaking agencies of Delaware corporate law, see generally Lawrence A. Hamermesh, 'The Policy Foundations of Delaware Corporate Law', 106 Colum. L. Rev. 1749, 1752–61 (2006).