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Reforming the Regulation of Broker-Dealers and Investment Advisers

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INTRODUCTION

The Challenges of Investing in Securities Markets for the Retail Investor

When the U.S. economy faltered, individual American investors watched their hard earned savings disappear overnight. Investor confidence seemed irreparably shaken. Revelations of wrongdoing ensued: the market fraud committed by stockbroker and investment adviser Bernie Madoff, the architect of a $65 billion Ponzi scheme[1]; the collapse of large, highly reputed financial firms like Bear-Sterns and Lehman Brothers[2]; and the $700 billion taxpayer-funded bailout of the U.S. Financial System.[3] These scandals fueled concerns about inadequate regulation and an aggressive Congressional response to overhaul and re-evaluate current regulations that impact the sale of securities.

Congress, in an effort to institute regulatory reforms to protect consumers and the U.S. financial system, enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which President Barack Obama signed into law on July 21, 2010.[4] The lengthy, 894-page legislation also included provisions to re-evaluate the different regulatory schemes imposed on securities professionals, such as broker-dealers and investment advisers, who regularly interact with individual consumers. A top legislative concern remained protecting consumers from fraud and restoring investor confidence in securities markets.

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[1] Diana B. Henriques, *From Prison, Madoff Said Banks 'Had to Know' of Fraud,* THE NEW YORK TIMES, FEB. 15, 2011.
[2] Floyd Norris, *The Regulatory Failure Behind the Bear Sterns Debacle,* THE NEW YORK TIMES, APR. 4, 2008.
[3] EMERGENCY ECONOMIC STABILIZATION ACT§12 U.S.C. 5201 (2009).
[4] THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT §12 U.S.C. 5301 (2011) [hereinafter "Dodd-Frank Act"]. The 894 page act contains many ambitious financial reform goals, including: 1) identifying and regulating systemic risk; 2) proposing an end to too-big-to-fail; 3) expanding the responsibility and authority of the Federal Reserve; 4) Restricting discretionary regulatory interventions; 5) reinstating a limited form of Glass-Stegall (the Volcker Rule); and 6) regulating and increasing transparency of derivatives.

Still, even after the Dodd-Frank Act, investing in U.S. securities markets can prove a daunting and risky endeavor to the retail investor.[5] As a result, many individuals that seek to invest and accumulate wealth through the stock market turn to securities professionals, such as stockbrokers or investment advisers, to guide their investment decisions.[6] However, this model presents an inherent conflict. Both parties seek to earn a profit, and consumers often hold the weaker position. Without effective oversight, individual consumers remain vulnerable to predatory marketing practices.

In order to protect consumers from unscrupulous securities professionals and increase the transparency of these transactions, the federal government and private self-regulatory organizations (SROs) remain active overseers of broker-dealers[7] and investment advisers.[8] However, the regulations (and regulators, for that matter) governing broker-dealers and investment advisers remain separate and distinct.[9] This paper seeks to examine the two differing regulatory schemes and propose a methodology to reform the regulation of broker-dealers and investment advisers in order to better protect individual investors.

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[5] Section 913 of the Dodd-Frank Act defines a retail customer as a person or legal representative that receives personalized investment advice from a broker-dealer or investment adviser regarding securities, and subsequently uses this advice for personal, family or household purposes. For more information, see 15 U.S.C. § 78(c)(4)(A).

[6] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGUGLATION; CASES & MATERIALS (2009) at 1003.

[7] Section 3(a)(4) of the '34 Act defines a broker as a person who engages in the business of effecting securities transactions for another's account; Section 3(a)(5) of the '34 Act defines a dealer as a person who buys or sells securities for his own account. Many securities professionals are dually registered, hence the terminology broker-dealer. For more information, see JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS (2009) at 1019.

[8] Investment Advisers are defined as persons who are in the business of giving investment advice but do not buy, sell, or execute trades for investors. For more information, see JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS (2009) at 1075.

[9] Barbara Black, *Fiduciary Duty, Professionalism and Investment Advice,* University of Cincinnati College of Law Public Law & Legal Theory Research Paper Series, Working Paper No. 10-24, March 28, 2010.

Standards of Care and the Broker-Dealer Exclusion

Currently broker-dealers and investment advisers are held to differing standards of care. While investment advisors are held to a legal standard of "fiduciary duty," broker-dealers are not, and remain accountable only for egregious misconduct, such as committing fraud on the market.[10] This regulatory gap, often called the broker-dealer exclusion, sparked debates among regulators, legislators and scholars concerned with consumer protection and unwanted securities litigation.[11] Recent legislative provisions have recommended closing this gap through harmonizing regulations between these two groups of securities professionals.

The Dodd-Frank Act also revisited this broker-dealer exclusion, specifically as it relates to retail investors, under §913.[12] While the Dodd-Frank Act regrettably failed to eliminate the broker-dealer exclusion, it did require the Securities & Exchange Commission ("SEC") to conduct an investigation that examined the consequences and impact that the divergent fiduciary vs. non-fiduciary status of investment advisers and broker-dealers had on retail investors.[13] At

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[10] BLACK, *supra* at 2.

See 15 U.S.C.§77q(a)(1988), which provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce, or by the use of the mails, directly or indirectly –

(1) To employ any device, scheme, or artifice to defraud, or
(2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) To engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[11] BLACK, *supra* at 2.

[12] *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011.

[13] "The Dodd-Frank Act" Title IX, § 913

A retail customer is defined under § 913 as a natural person, or the legal representative of a natural person, who (1) receives personalized investment advice about securities from a broker or dealer or investment advisor; and (2) uses such advise primarily for personal, family or household purposes."

the conclusion, the Commission's report recommended the adoption of a uniform fiduciary standard between broker-dealers and investment advisors.[14]

This paper contends that merely adopting the Commission recommendations to harmonize fiduciary standards of broker-dealers and investment advisors is too broad a mandate to have a meaningful impact on securities markets.[15] Many factors, like the current compensation structure of securities professionals, and the changing landscape of securities sales, make a broad mandate an inadequate response.[16] ***In order to meaningfully harmonize the standards of fiduciary status between broker-dealers and investment advisers, while adequately providing consumer protection, this paper recommends that Congress adopt a rebuttable presumption that the law view retail investors with assets below a certain threshold as unsophisticated investors.*** Adopting such a presumption will enable both parties to better understand their obligations to one another, facilitate dispute resolution, and reduce unwanted securities litigation by shifting burdens of production and proof at trial.

Part I of this paper briefly examines the legislative history governing the regulations of broker-dealers and investment advisers, the legal implications of fiduciary status and the suitability rule. Part II reviews the SEC Commission Report findings and recommendations. This section examines the practical challenges of adopting a uniform fiduciary standard in light of the current structure of broker-dealer compensation. This section also discusses the legal concept of sophisticated and unsophisticated investors. Finally, Part III examines the concept of

[14] The Commission report sought to evaluate the effectiveness of existing legal or regulatory standards and the presence of potential regulatory gaps. Key considerations included evaluating whether or not consumers were confused by the differences in the standards of care; the current regulators and standards governing investment advisers and broker-dealers; the impact of any changes on retail customers and more. For more information, please see the Commission report (*As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.6.)

[15] DONALD L. LANGEVOORT, *Brokers as Fiduciaries,* University of Pittsburgh Law Review, Spring 2010 (71 U. Pitt. L. Rev. 439), 4.

[16] LANGEVOORT, *Supra* at 5.

rebuttable and conclusive presumptions. It discusses the legal implications of adopting a rebuttable presumption that the law view retail investors with assets below a certain threshold as unsophisticated. It is important to note that concerns abound on this topic with respect to institutional investors. While Part III will contain a brief discussion to put this issue in context, substantive discussions on institutional investor sophistication remain outside the scope of this paper.[17]

I. The Legislative History Governing The Regulations of Broker-Dealers & Investment Advisers

In order to understand the importance of harmonizing standards between broker-dealers and investment advisers, it remains critical to understand the historical context of existing regulations, and the legal standards currently imposed upon broker-dealers and investment advisers.

The SEC & Broker-Dealers

Congress enacted the Securities Exchange Act of 1934 ("The '34 Act") to create mechanisms to hold publicly-traded companies accountable for disclosure and to protect investors from fraud perpetrated by unscrupulous companies and their representatives.[18] One of the most important provisions of the '34 Act is the requirement for continuous mandatory disclosure by certain publicly traded companies.[19] The '34 Act also governs the regulation of

[17] For additional information on institutional investor sophistication, please consult the following law review journal article: Normal S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors* (Brigham Young University Law Review), 2001.
[18] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS (2009) at 5.
[19] The '34 Act requires continuous disclosure requirements for three (3) categories of companies: those that have securities listed on national exchanges; those companies with assets that exceed $10 million and are held by at least 500 persons; and companies that have filed a registration statement required under the '33 Act. Examples of continuous disclosure documents include proxy filings, annual reports, and other federally required information. For more information, consult the 1934 Securities Exchange Act, Sections 12(b), 12 (g) and 15(d) or see JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS (2009) at 7.

broker-dealers. The law defines a broker under 15 U.S.C. §78(c)(4)(A) as "any person engaged in the business of effecting transactions in securities for the account of others."[20] The law defines a "dealer" under 15 U.S.C. §78(c)(5)(A) "as any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[21] Many securities professionals are dually registered.

Despite the intent of the federal government to require transparency from publicly traded companies, statistics show that the principal audience for this federally required data consists of investment analysts and professional analysts, who use and interpret the data for themselves. These professionals formulate advice or recommendations, and use the broker as the conduit to convey information to the average individual investor.[22] This information transfer process, known as "filtering", has positive effects and negative ones.[23] While it helps reduce information overload for the individual investor, it also poses potential conflicts of interest, particularly if a broker-dealer or his firm holds positions in securities that could benefit from sales or purchases.[24]

In its oversight capacity, the SEC's "Guide to Broker-Dealer Registration" provides an outline of generally required rules of conduct for these securities professionals. Broker-dealers must comply with antifraud provisions, which impose a prohibition of issuing false or misleading statements, material omissions or engaging in fraudulent or manipulative acts as they relate to the purchase and sale of securities.[25] Several provisions of the '34 Act also require the SEC to oversee broker-dealer obligations, in particular the following: a duty of fair dealing; a duty to

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[20] 15 U.S.C. §78(c)(4)(A)
[21] 15 U.S.C. §78(c)(5)(A)
[22] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1003.
[23] *Id. at* 1003.
[24] *Id.* at 1003.
[25] "Conduct Regulation of Broker-Dealers." At S.E.C. Website, http://www.sec.gov/divisions/marketreg/bdguide.htm#V

recommend suitable securities for their customers (the suitability requirement); a duty of best execution; a customer confirmation rule; a disclosure of credit terms; restrictions on short sales; trading during an offering; and restrictions on insider trading.[26]

The Suitability Rule & SROs

The intention of these anti-fraud provisions is to prevent broker-dealers from issuing false or misleading statements, omitting material facts, or committing any other fraudulent or manipulative acts related to the purchase and sale of securities.[27] Concerns abound regarding the increasingly fragmented nature of securities markets, particularly since ethical concerns governing broker-dealers typically turn on obligations of firms to "make informed and suitable recommendations, to avoid churning[28], unauthorized trades, and excessive markups."[29] ***The requirement that broker-dealers recommend securities that are suitable for the investment goals and needs of their customers forms the basis of the suitability rule.***[30]

The SEC and independent self-regulatory organizations ("SROs") regulate and oversee the conduct of broker-dealers.[31] The Financial Industry Regulatory Authority ("FINRA") scts rules and examinations for broker-dealers, and also serves as the enforcer for the SEC's rules of

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[26] Conduct Regulation of Broker-Dealers." At S.E.C. Website, http://www.sec.gov/divisions/marketreg/bdguide.htm#V, See '34 Act Sections 9(a), 10(b), and 15 (c)(1) and 15(c)(2)
[27] Conduct Regulation of Broker-Dealers." S.E.C. Website, http://www.sec.gov/divisions/marketreg/bdguide.htm#V, See '34 Act Sections 9(a), 10(b), and 15 (c)(1) and 15(c)(2)
[28] Churning refers to a broker's excessive buying and selling of securities in a customer's account for the purpose of generating commissions. For churning to occur, an investor's broker must exercise control over the investment decisions in a customer's account. Churning may violate SEC Rule 15c1-7 and other securities regulations. For more information, visit: http://www.sec.gov/answers/churning.htm
[29] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1004.
[30] For more information on FINRA's Suitability Rule (NASD Rule 2310) and the New York Stock Exchange Suitability Rule (Rule 405) visit: http://www.sec.gov/answers/suitability.htm
[31] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1020.

conduct.[32] While the SEC retains independent authority, FINRA plays a prominent, supervisory role of broker-dealers.[33] As we shall see in the next section, the distinction between regulators and rules of conduct between broker-dealers and investment advisers gave rise to the recommendation by the Commission Report for a harmonized standard between the two classifications of securities professionals.

Investment Advisers

While retail investors may turn to broker-dealers for investment advice, a great number of investors also turn to professional investment counselors and financial planners.[34] Unlike broker-dealers, investment advisers do not execute trades in a customer's account, but provide investment recommendations and often deduct a management fee for advisory services.[35] As with broker-dealers, this practice, which revolves around profit-motivated securities sales and purchases, lends itself to conflicts of interest and the perpetration of fraud against investors.[36]

Regulators of Investment Advisors

Investment advisers may dispense advice through personalized consultations or advisory letters sent en masse to a group of subscribers.[37] Both types of communication remain regulated by the Investment Advisers Act of 1940, which provides broad regulatory framework for

[32] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1022.
[33] Id. at 1022.
[34] Id. at 1075.
[35] Id. at 1075.
[36] Id. at 1075.
[37] Id. at 1075.

protecting consumers from the abuses of unscrupulous or incompetent advisers.[38] An investment adviser is defined under Section 202 (11) of the Investment Adviser's Act as any person

> "who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[39]

The law also prohibits investment advisers from engaging in activities that can perpetuate fraud or dishonest behavior toward clients.[40] While the statutory definition includes an array of exclusions,[41] its most notable exclusion refers specifically to broker-dealers "whose advisory activities are solely incidental to the conduct of that business."[42] This is known as the broker-dealer exclusion.

After registration, an investment adviser remains subject to regulatory requirements and disciplinary provisions – similar to those of broker-dealers – that may include suspension or revocation of adviser abilities, fines or any other disciplinary behavior as applicable for willfully violating provisions of federal securities laws.[43] Absent an exemption, investment advisers must keep records, file reports, adopt written advisory policies, and remain subject to inspection upon threat of civil penalties.[44] **The SEC recently adopted an amended rule 206(4) under the**

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[38] Id. at 1076.
[39] Id. at 1076.
[40] Investment Advisers Act of 1940 § 206(3). Prohibited Activities include: "(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as a broker or dealer for a person other than such client, knowingly effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."
[41] Among the exclusions are: (1) most banking activity; (2) lawyers or other professionals providing incidental investment-related services; (3) **broker-dealers** whose advise is incidental to regular business; (4) media publications and other publications of general circulation; (5) persons whose advise relates to government securities. For more information, see JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1076.
[42] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1076.
[43] Id. at 1078.
[44] Id. at 1078.

Fiduciary Obligations, The Shingle Theory & The Suitability Rule

In light of the distinctions between broker-dealers and investment advisers, it is important to understand why the concept of fiduciary status in the context of broker-dealers and investment advisers remains under debate. Two different standards and regulators now exist. Broker-dealers are regulated under the '34 Act and regulated principally by FINRA, while investment advisers are regulated under the Investment Advisers Act of 1940 and overseen largely by the SEC.[51] Broker-dealers work for "customers" while investment advisers manage "clients."[52] Most notably, the broker-dealer relationship does not give rise to fiduciary obligations unless the broker-dealer can effect trades without the customer's knowledge, whereas the investment adviser is viewed as a fiduciary in the eyes of the law.[53] Fiduciary claims are some of the most common claims brought in arbitration, including claims of undisclosed revenue sharing payments.[54]

The importance of fiduciary duty is perhaps best demonstrated by the recent demise of Bernie Madoff's sham investment company and its effect on retail investors, who lost large sums of money. Bernie Madoff was one of many investment advisors and broker-dealers. The SEC reported that over 11,000 investment advisors are registered with the Commission and manage more than $38 trillion for more than 14 million clients.[55] Similarly, the Commission and FINRA oversee approximately 51,000 broker-dealers, who hold over 109 million retail and institutional accounts.[56]

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[51] BLACK, *supra* at 4.
[52] BLACK, *supra* at 5.
[53] BLACK, *supra* at 5.
[54] Mercer Bullard, Papers on a Fiduciary Duty for Broker-Dealers: The Fiduciary Study: A Triumph of Substance Over Form?" The Trustees of Boston University, Review of Banking & Financial Law, Fall 2010. (30 Rev. Banking & Fin. L. 171).
[55] *Id. At 4.*
[56] *Id. At 4.*

The presence (and conversely, the absence) of a fiduciary responsibility has far reaching implications. Scholars find as a unifying characteristic that a fiduciary relationship is defined as "a substitute for the entrustor" where the "fiduciary obtains power for the purpose of enabling the fiduciary to act effectively."[57] In other words, once a fiduciary relationship is established, the fiduciary owes the client "at the very least disclosure of all information material to the transaction at hand, including conflicts of interest."[58] Most courts have historically been reluctant to impute fiduciary status to broker-dealers (with one exception: a sophisticated investor).[59] Also required under the fiduciary standard are duties of loyalty and care. This means that advisers with conflicts of interest must either eliminate the conflict or inform the client about these potential conflicts.[60]

However, advocates of the Shingle Theory argue that once a customer seeks out a broker-dealer to effect trades and to provide advice and counsel, that broker-dealer has represented himself as an entrustor, or fiduciary, to their customers by the mere act of hanging out his shingle.[61] Many disgruntled investors invoke the shingle theory under federal securities laws to hold broker-dealers accountable through their implicit representation that they will deal fairly and honorably with their customers.[62]

Scholars argue that the shingle theory imputes an obligation for fair dealing and implies that a breach of such duty can easily be inferred as fraudulent.[63] Sanctions against brokers are governed by Rule 10(b)-5, which are part of the general rules and regulations promulgated under

[57] BLACK, *supra* at 11.
[58] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1028.
[59] Id. at 1028.
[60] "Executive Summary," *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.3
[61] Roberta S. Karmal. "Is the Shingle Theory Dead?" 52 Wash. & Lee L. Rev., 1271, 1995.
[62] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1029.
[63] Id. at 1029.

the '34 Act that deem it unlawful to engage in fraud in the connection with the purchase or sale of a security. [64] In contrast, investment advisors are governed under a completely different standard than broker-dealers and automatically deemed fiduciaries.[65]

This merges with the suitability requirements imputed on broker-dealers and investment advisers. This guideline, set forth by the SEC and known as the suitability rule, requires that securities professionals offering services and investment advice recommend investments suitable to their customer's investment objectives. An example of a suitability violation would consist of a broker recommending a risky, speculative security for a conservative investor, such as an elderly widow seeking to invest her retirement savings without a means to replace any substantial trading losses or a complete understanding of the potential for sizeable losses.[66] Suitability remains an important consideration, particularly when an investor lacks sophistication of the market and relies on the trust of a broker-dealer.

It is important to note that while this paper favors harmonizing broker-dealer and investment adviser fiduciary obligations, opponents point to a number of factors against unifying the standards, most notably, the increased cost to businesses due to heightened government regulation. Other opponents point to the rise in arbitration proceedings and lawsuits against broker-dealers, and question whether or not further regulatory requirements will adversely affect the ability of securities professionals to operate efficiently in our current market structure. Part II will review these concerns in light of this paper's proposed recommendations for practically implementing a uniform fiduciary standard, but finds these concerns unwarranted given the

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[64] Id. at 1029.
[65] *Id.* at 1079.
[66] Norman S. Poser, "Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors." Brigham Young University Law Review 1493, 2001.

government's overriding objective and public policy determination to encourage participation in U.S. securities markets.[67]

II: The Commission Report Findings, Implementation of a Uniform Fiduciary Standard and Sophisticated v. Unsophisticated Investors

The Commission Report Findings

Section §913 of the Dodd-Frank Act called for the SEC to evaluate the different regulatory regimes governing broker-dealers and investment advisers. Regulators and Congress grew concerned that these differing standards created a tremendous amount of investor confusion.[68] The SEC published its report in January 2011. The Commission's multi-disciplinary research approach relied on input and comments from interested parties, including retail investors; representatives of the financial services industry; state securities regulators; SROs such as FINRA and the North American Securities Administrator Association ("NASAA").[69] The Commission report remained chiefly concerned with the personalized advice retail customers received from broker-dealers and investment advisers as they related to securities.[70] These concerns arose due to overwhelming concerns about fraud and a lack of accountability for broker-dealers.[71]

The Commission report evaluated the following: the effectiveness of existing legal and regulatory standards for personalized investment advice about securities to retail customers; and

[67] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 5.
[68] "Executive Summary," *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.2.
[69] *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.3.
[70] Id. at 3.
[71] Id. at 3.

the impact of legal or regulatory shortcomings on the protection of retail customers.[72] Ultimately, the Commission report recommended the institution of a uniform fiduciary standard between broker-dealers and investment advisors.[73] The Staff recommended in particular the promulgation of rules to promote best codes of conduct, and require securities professionals to act in the best interests of their customers without regard to the interests of the broker-dealer or investment adviser.[74] In addition to rules that promulgate a uniform standard of conduct, the Commission encouraged the implementation of a uniform fiduciary standard that encompassed a Duty of Loyalty.[75] The goal of this standard was for securities professionals to eliminate or disclose material conflicts of interest to customers or clients.[76]

Implementation of a Uniform Fiduciary Standard

The Commission findings also strongly supported the implementation of a uniform fiduciary standard, and pointed to the benefits conferred on retail investors. Specifically, the findings indicated that a uniform standard would: increase investor protection and investor awareness; accommodate different models and preserve investor choice, which remains particularly important in an era of consumer choice and autonomy;[77] and hold investment

[72]In this special study, the Commission proposed requiring disclosure of precise amounts of revenue sharing payments. The Commission also considered whether or not the fiduciary distinction causes confusion to retail customers. The study evaluated the impact of eliminating the broker-dealer exclusion and studied the additional potential costs to consumers from potential regulatory changes. For more information, see the Commission Report, "*As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission*". January 2011, p. 2-3.

[73] *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.6.
[74] Id. at 6.
[75] Id. at 7-8.
[76] Id. at 7-8.
[77] Andrea Ryan, Gunnar Trumbull and Peter Tufano. "A Brief Postwar History of Consumer Finance." Harvard Business School (2010), p. 4.

Investment Adviser's Act, which enables the SEC to promulgate a fiduciary standard for broker-dealers that provide personalized investment services."[45]

The principal purpose behind these disclosure requirements for broker-dealers and investment advisers is to facilitate the legal principle of *caveat emptor,* or, let the buyer beware.[46] The Investment Advisers Act of 1940 was the last in a series of investor-protection provisions enacted by Congress, designed to curtail abuses in the securities industry that contributed to the 1929 stock market crash and subsequent Great Depression.[47]

The legislative goals and guiding principles of the Investment Advisers Act of 1940 were to preserve the ability of investment advisers to offer customized advice to clients; to eliminate conflicts of interest between adviser and client; and to protect "unsophisticated investors"[48] by providing "bona fide investment counsel."[49] In Securities and Exchange Commission v. Capital Gains Research 375 U.S. 180 (1963), the court reaffirmed these goals and deemed investment advisers as "fiduciaries" owing to the "delicate fiduciary nature of an investment advisory relationship."[50] The assignation of an inherent fiduciary status for investment advisers, but not broker-dealers, remained a source of contentious debate. The Dodd-Frank legislation and its provisions examining these differing standards re-affirms that the matter remains unresolved amongst scholars, legislators and securities professionals.

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[45] Morrison & Forester. "The Dodd-Frank Act: A Cheat Sheet" (2010), *available at* *http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf*

[46] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1080.

[47] Securities and Exchange Commission v. Capital Gains Research. 375 U.S. 180 (1963). See also JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1079.

[48] An investor is deemed sophisticated if they possess sufficient understanding and intelligent to evaluate a broker's recommendations and exercise judgment independently. An unsophisticated investor lacks these skills. For further discussion on this topic, see Norman Poser's Law Review Article "Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors, published in 2001 in the Brigham Young University Law Review. (2001 B.Y.U.L. Rev. 1493)

[49] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1081.

[50] *Id.* at 1081.

advisers and broker-dealers to the same professional standards; and facilitate investors receiving advice that is in their best interests.[78]

Opponents of imputing a harmonized fiduciary status on brokers-dealers and investment advisers fear the costs associated with additional regulation.[79] They maintain that the imposition of the entire investment adviser regime would present onerous requirements for brokers. One most visible requirement is that investment advisers register in the state s where they conduct business.[80] Opponents of unifying the regulatory regimes point to the fact that additional registration requirements for brokers could potentially increase the cost of business for securities firms and reduce investor choice.[81] These concerns remain unwarranted and reflect merely the preference of private business to remain autonomous from substantial governmental regulation.[82]

Furthermore, while preserving investor choice and keeping costs low remains a principal concern for private securities firms and the federal government, it is also important to recognize that federal policy favors retail investor participation in securities markets.[83] The absence of individual investor involvement, sometimes referred to as a crisis in investor confidence, remains one of the chief concerns during the current U.S. economic challenges.[84] Ultimately, the federal

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[78] *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.9.
[79] Currently broker-dealers register only with the SEC. Opponents of the harmonized standard fear that imposing the equivalent requirements for broker-dealers and investment advisers would lead to duplicative registrations for broker-dealers, reduce investor choice and increase costs. For more information, see: *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.140.
[80] Currently broker-dealers register only with the SEC. Opponents of the harmonized standard fear that imposing the equivalent requirements for broker-dealers and investment advisers would lead to duplicative registrations for broker-dealers, reduce investor choice and increase costs. For more information, see: *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.140.
[81] *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.140-141.
[82] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1029.
[83] Id. at 1029.
[84] Id. at 1029.

government remains motivated to maximize investor participation in securities markets and to balance consumer protection with regulatory oversight.[85] Unless investors feel confident that adequate safeguards exist to protect them from predatory brokerage practices, fraud and other forms of misconduct, retail participation in the securities markets could precipitously decline.[86]

Even with current regulatory regimes, challenges remain. For instance, the SEC received over 3,000 complaints against online brokers in 1999, an increase of almost 200% from 1998, and a 1200% increase from 1997.[87] Concerns abound that some online brokers invoke a predatory behavior to "entice unsophisticated investors to trade online and encourage investment purchases that are not appropriate."[88] Promulgating laws and codes of conduct that inspire trust and confidence from investors is the only way to encourage investor participation in securities markets. These external factors, coupled with the near collapse of the U.S. economy, formed the basis for provisions of the Dodd-Frank Act.

Sophisticated v. Unsophisticated Investors

Opponents of a harmonized fiduciary standard also point to the equally concerning rise in arbitration by disenchanted retail investors who subsequently bring suitability violations.[89] In her scholarly article, Renee Barnett describes the tale of Lael Desmond, a 27-year-old graduate student that convinced an arbitration panel to compensate him for $40,000 in fees and compensatory damages when he traded stock with an online broker.[90] Mr. Desmond's principle

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[85] Id. at 1029.
[86] Renee Barnett. "Comment: Online Trading and National Association of Securities Dealers' Suitability Rule: Are Online Investors Equally Protected?" The American University Law Review, June 2000 (49 Am.U.L.Rev.1089)
[87] Id. at 4.
[88] Id. at 4.
[89] Id. at 4.
[90] Id. at 5.

argument rested on his lack of knowledge about the risks of trading on margin.[91] Lawsuits such as Mr. Desmond's bring to light the concern about investor sophistication and a retail investor's ability to adequately understand the risks in the securities market. Prof. Barnett postulates that lawsuits like Desmond's are likely to continue in troubled economic times, when hungry brokers are desperate for commissions and less business savvy investors are lured by the promise of easy returns in a down market.[92] The concept of balancing retail investor sophistication with fiduciary standards will be further discussed in Part III of this paper.

Ultimately, the Commission sought to evaluate these concerns in its recommendations. Its conclusions rest chiefly on the implementation of a uniform fiduciary standard without completely overhauling the broker-dealer exclusion.[93] Rather, the Commission called for additional rule-making by the SEC as part of its overriding goal to protect investors, while taking into consideration the current U.S. model for broker-dealer compensation.[94]

Two types of broker-dealer relationships can arise between the securities professional and their customer. In some instances, a broker merely executes the wishes of a client, i.e. buy 100 shares of a particular stock. In this instance, the client dictates the terms, and the broker merely effectuates the trade. However, lawsuits like Mr. Desmond's raise concerns about investor suitability and sophistication, as well as questions of whether or not brokers must exercise a duty of care.

In the second instance, brokers aggressively push and market securities to their customer list. It is important to remember that the typical method of compensation in the stock brokerage

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91 Id. at 5.
92 Id. at 6.
93 *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act: This is a Study of the Staff of the U.S. Securities and Exchange Commission.* January 2011, p.144.
94 Id. at 158.

industry comes in the form of commissions that result from spreads or simply transaction volume, or a per transaction basis.[95] This can create a conflict of interest for brokers to encourage an investor to buy and sell actively, without regard to the quality of those transactions, and similarly also lead to policy questions as to the benefits of excessive trading over securities exchanges.[96] In some instances, the broker also maintains control over the client's account, and can effectuate trades and transactions without the client's approval or consent. These instances have led to the most frequent allegations and demands for a fiduciary level of care to be imposed on broker-dealers.[97]

The SEC's promulgation of rules and codes of conduct is intended to curtail and address these conflicts of interest. However the evolving nature and heightened competition of the securities business has raised concerns about overly enthusiastic brokers who misrepresented the nature and risk of the securities they are selling.[98] Similarly, scholars of securities regulations, such as Prof. Donald Langevoort, point to the fact that some investors pay significantly more for investments sold through a broker channel, without any guarantees of better performance.[99] A chief concern raised is that sellers of these securities (broker-dealers) possessed a greater knowledge of the risk associated with the products or services that they aggressively marketed to retail customers.[100] This knowledge gap poses substantial risks to less wealthy, less sophisticated participants in the securities markets.

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[95] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 1003.
[96] Id. at 1004.
[97] BLACK, *supra* at 11.
[98] POSER, *supra* at 4.
[99] LANGEVOORT, *supra* at 11.
[100] LANGEVOORT, *supra* at 6.

An investor's sophistication plays a key role in determining whether or not an investment is suitable or not.[101] An investor is deemed sophisticated if (s)/he possess sufficient understanding and intelligence to evaluate a broker's recommendations and exercise judgment independently.[102] An unsophisticated investor lacks these skills.[103] Claims brought under Rule 10b-5, which prohibits fraud connected with sales of securities, focus on the sophistication of an investor, and raises the question of whether the investor "justifiably relied on the misstatements or omissions."[104] The natural filtering process that occurs in the marketplace presents ripe opportunities for savvy broker-dealers to prey on an unsophisticated investor's lack of understanding and knowledge in the marketplace.

Opponents of this seemingly paternalistic mindset might argue that broker-dealers perform a critical sales function in the securities markets, and that retail investors must know their security and that *caveat emptor* should prevail to protect investment firms from unnecessary lawsuits that rest on suitability claims.[105] In other words, it is the responsibility of the buyer to fully educate himself on the risks of certain securities and independently exercise judgment as to whether or not to participate in the purchase or sale of a particular security.

While this raises a valid viewpoint, it is important to remember that the current state of the securities market has given rise to the evolution and creation of complex derivatives, some of which are custom-made by broker-dealers for the sole purpose of selling to select groups of

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[101] POSER, *supra at 5.*
[102] LANGEVOORT, *supra* at 7.
[103] LANGEVOORT, *supra* at 7.
[104] POSER, *supra* at 5.
[105]Broker-dealers are required to adhere to the "know-your-customer" rule, whereby they understand the investment needs and risks relevant to their particular customers. On the flip side, securities professionals advocate that investors need to take an active interest in their own investments and adhere to a "know-your-security" rule, where they understand the potential risks and benefits of investments in a particular security. For more information, see: LANGEVOORT, *supra 8.*

customers.[106] In this rapidly evolving financial world, driven by increased competition, new technology and new investment instruments, frequently the only individuals that may fully understand the complexities of these new financial instruments are the firms and individuals that create them.[107] This creates challenges to the traditional notions of investor sophistication.

Experts who have studied institutional investor sophistication find that decisions to purchase stock remain largely motivated by the advice of others, turning even a sophisticated investment officer into "easy prey for a skillful and highly motivated securities salesman." [108] While the sophistication of institutional investors remains outside the scope of this paper, this data is relevant because it demonstrates the susceptibility of sophisticated, skilled financial professionals, to succumb to unsuitable securities recommendations. It is only a logical extension that the average retail investor lacks even more knowledge about securities and could prove an easy target for a manipulative broker-dealer, hungry for an easy commission.

PART III: RECOMMENDATION THAT CONGRESS ADOPT A REBUTTABLE PRESUMPTION

In light of the concerns regarding fiduciary duty, suitability and investor sophistication, it is logical that Congress adopt a method to protect investors and create a framework for further SEC regulation under the recommendations of the Dodd-Frank Commission Report. To further encourage participation in securities markets while deterring fraud, it is imperative that Congress adopt a rebuttable presumption under the law to view retail investors below a certain investment threshold as unsophisticated investors. The significance of this status is that it would create

[106] POSER, *supra* at 5.
[107] Id. at 5.
[108] Id. at 6.

simple and effective way to deter unsuitability claims and aggressive broker-dealer or investment adviser pitches to inappropriate client bases.[109]

Furthermore, the adoption of such a standard would protect both parties. Presumptions shift burdens of production and burdens of proof during litigation. In the case of broker-dealers and investment advisers, the parties would have more information about their obligations to each other. In the event of a dispute, it would be easier for the parties to evaluate the merits of their claims and their likelihood to prevail in court.

The Significance of a Rebuttable Presumption

Currently the law accords a legal status to two types of presumptions – rebuttable and conclusive. A rebuttable presumption that a retail investor below a certain investment threshold is unsophisticated means that the law *assumes* the investor is unsophisticated unless the broker-dealer could rebut the presumption by introducing evidence of sophistication.[110] This differs from a conclusive presumption, a rule of substantive law, which makes the details of any individual's circumstances largely irrelevant.[111] Creating a rule that retail investors below certain investment thresholds are unsophisticated would simply result in the creation of a legal rule that removes the question of suitability and sophistication for many types of investors that could potentially bring claims against broker-dealers or investment advisers to court. [112] Furthermore, such a standard would deter unscrupulous securities professionals from marketing securities to unsuitable retail investors.

[109] Id. at 8.
[110] Id. at 8.
[111] Id. at 9.
[112] Id. at 9.

Presumptions of Sophistication

In the institutional context, courts have not adopted any presumptions for or against sophistication and considered the cases on an individual basis. [113] However some experts, such as Professor Langevoort, have argued in favor of structuring securities sales to institutions in a fashion that is similar to sales of private placement offerings to qualified investors.[114] The term "private placement" refers to the placement of a debt or security that is exempt from registration with the SEC because the transaction is not offered to the general public.[115] These types of transactions traditionally remain restricted to accredited investors.[116]

Accredited Investors

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[113] *Id.* at 10.
[114] LANGEVOORT, *supra* at 9.
[115] Mark Carey, Stephen Prowse, John Rea, and Gregory Udell. "The Economics of the Private Placement Market," The Federal Reserve Board, December 1993.

[116] The '33 Act defined an accredited investor as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person: (1)Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors; Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer; Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii) and any entity in which all of the equity owners are accredited investors. For more information, please visit: http://www.sec.gov/answers/accred.htm

An accredited investor is an investor that has a high net worth, the value of which is defined by federal securities law.[117] The status of purchasers as accredited investors is important under several SEC Rules of law – Rule 505 and 506 – which restrict the availability of certain offerings to a limited pool of investors.[118] Accredited investors are conclusively presumed to be sophisticated.[119] It is only when a purchaser does not meet the standards of accreditation that an issuer must "undertake the difficult, and risky, task of evaluating the sophistication of the purchaser."[120]

A natural person whose net worth exceeds $1 million qualifies as an accredited investor.[121] The SEC recently proposed the promulgation of a new standard of rules which would increase the net worth standard for accredited investors. The SEC proposed these modifications in order to comply with the provisions under §413 of the Dodd-Frank Act.[122] The goal behind narrowing the scope of accreditation was to ensure that investors participating in higher risk investments understood – and could afford – to lose the income invested. The SEC's new

[117] The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

1. A bank, insurance company, registered investment company business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
3. a charitable organization, corporation, or partnership with assets exceeding $5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;
7. a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year;
8. or a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

For more information, visit http://www.sec.gov/answers/accred.htm.

[118] JAMES COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 2009) at 283.

[119] *Id.* at 283.

[120] *Id.* at 283.

[121] *Id.* at 284.

[122] Securities and Exchange Commission Proposed Rule No. 33-9177, "Net Worth Standards for Accredited Investors." Jan. 25, 2011

proposed rule seeks to adjust the accredited investor qualification to a person with a net worth in excess of $1 million, excluding the primary residence of such person (previously the value of the primary residence was included in the net worth calculation).[123] The Dodd-Frank Act required the removal of this inclusion of the primary residence in order to ensure a higher threshold of wealth under the term accredited investor.[124]

The reason for this change is to advance the regulatory purposes promulgated under the Dodd-Frank Act. The changes are appropriate and consistent with the purposes outlined under §413(a)[125] of the Dodd-Frank Act, which aim to remove the "value of the primary residence" from the calculation of net worth for the purposes of identifying if an investor is accredited or not.[126] This aims to protect investors from betting their homes and assuming greater risk than is suitable for their resources and investment goals. This modification would undoubtedly reduce the number of accredited investors.[127] The SEC's proposed rule identified that a 2007 Federal Reserve Board Survey of Consumer Finances estimated 10,496,312 of the 116,122,128 U.S.

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[123] The rule proposes defining an accredit investor as

Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of purchase, exceeds $1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property.

For more information, see: Securities and Exchange Commission Proposed Rule No. 33-9177, "Net Worth Standards for Accredited Investors." Jan. 25, 2011

[124] Securities and Exchange Commission Proposed Rule No. 33-9177, "Net Worth Standards for Accredited Investors." Jan. 25, 2011

[125] The text of Section 413(a) reads as follows:

The Commission shall adjust any net worth standard for an accredited investor, as set forth in the rules of the Commission under the Securities Act of 1933, so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person, except that during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person.

[126] Securities and Exchange Commission Proposed Rule No. 33-9177, "Net Worth Standards for Accredited Investors." Jan. 25, 2011

[127] *Id.* at 9.

households (9.04%) qualified as accredited investors.[128] The proposal under §413(a) would reduce this number to 6,858,335 households, or 5.91% as the total estimated number of accredited investors. In other words, the Dodd-Frank Act and the proposed SEC rule will reduce the number of individuals that can invest in certain securities as *accredited investors.*

This proposal is logical in light of the federal concerns that prompted the enactment of the Dodd-Frank Act. The U.S. financial crisis fueled concerns regarding investor unsuitability, lack of investor understanding of complex financial concepts, and a regulatory response to protect investors. In litigation concerning sophistication, the court determined in Mark v. FSC Securities Corp. 870 F.2d 331 (6th Cir. 1989) that "the best tactic for an issuer seeking to eliminate any question about the exemption's availability is to limit an issuance to accredited investors."[129] In other words, limiting the purchase requirements to only certain investors assures suitability and reduces litigation.

Consequently, the adoption of a rebuttable presumption that the law view retail investors below a certain threshold as unsophisticated investors is similar to the relevance of limiting participation in certain securities investments to only accredited investors. First, it would deter, under penalty of civil sanctions, the practices of unscrupulous broker-dealers and investment advisers from preying on retail investors that simply cannot afford to take great risks in the securities markets. This is because the very presence of a rebuttable presumption would shift the burden of proof during litigation to the securities professional that recommended the security. If the investor did not meet the income requirements to participate, the law would turn to the

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[128] *Id.* at .9. For more information, visit http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.
[129] Mark v. FSC Securities Corp., F. 2d 331 (6th Cir. 1989).

securities professional to prove that the recommendation remained valid and appropriate for the investor.

Second, the adoption of such a standard would avoid frivolous lawsuits and arbitration hearings against securities professionals. This is because of the shifted burden of proof. A securities professional would not be permitted to sell a security to an unsuitable candidate, or one that did not meet the investment threshold. Adopting a presumption would likely find its way as a rule of conduct incorporated into the oversight responsibilities of the SROs that monitor and oversee broker-dealers and investment professionals. While regulating the conduct of the securities professional would remain in the hands of the SRO, the presence of such a standard would create bright-line rules and tests for enforcement. Third, adoption of a rebuttable presumption would restore and stabilize retail investor confidence and participation in the securities markets by creating clear guidelines of conduct and restricting access to individuals who simply cannot afford the risks of participating in securities markets.

Why Government Involvement Remains Necessary

Critics of this concept might view the presumption as overly paternalistic. Opponents would also point to the federal government interfering in matters that are outside of its concern. This is likely the same argument advanced by opponents of the Dodd-Frank Act and its predecessor, the 2002 Sarbanes-Oxley (SOX) Act. Notable critics of Sarbanes-Oxley included well-respected scholar Roberta Romano, who dubbed the SOX legislation as an example of "quack corporate governance" and "an enormous policy blunder" legislated under emergency circumstances.[130] Professor Romano argued that Congress created SOX in reaction to several

[130] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521 (2005).

high profile corporate fraud and insolvency cases.[131] This dramatic change, Professor Romano argued, overstepped the delicate balance between the federal and state relationship on corporate governance. Prof. Romano called SOX a policy blunder that created costly regulatory approaches for corporations. These costs would limit and restrict innovation and the free market economy, according to Professor Romano.[132]

Scholars who agree with Professor Romano, such as Prof. Stephen Bainbridge, call the Dodd-Frank Act onerous legislation that over-steps the boundaries of regulation and free market.[133] Such experts would likely shudder at the notion of a rebuttable presumption that investors below certain thresholds of wealth should not participate in the securities markets because it imputes government intervention in the decisions of private individuals.

This paper argues that bigger government remains necessary to protect investors as the U.S. struggles to regain its firmer economic ground in light of the nation's recent economic woes. The crisis of investor confidence led to the enactment of the Dodd-Frank Act, and its predecessor, SOX. Despite passionate pleas from business and lobbying groups, the federal government deemed SOX regulations so essential that they remain in existence today. Opponents of the Dodd-Frank Act, or advocates of smaller government, contend that drastic measures associated with financial distress and reform should not justify excessive government intervention.[134]

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[131] Id.
[132] Id.
[133] Stephen Bainbridge, "Dodd-Frank: Quack Federal Corporate Governance, Round II." 2010, p.5
[134] Jim Hawkins. "Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress. Indiana Law Journal, Vol. 86:1361.

These same scholars contend that in order for government standards to be effective, they must be narrowly tailored to avoid misguided and overly broad policy implications.[135] If regulations become too onerous, critics contend, the regulations risk eliminating the presence of smaller financial services institutions and providers that tailor to a narrow niche of individuals. For example, those service providers that tailor to the less wealthy segment of the U.S. population may no longer be able to provide services, if the extent of regulation becomes too onerous. However these concerns remain unwarranted. Government regulation protects consumers, just as it did in the aftermath of the Great Depression. Excessive investor risk led to the current economic woes, an aggressive legislation remains crucial to remedying the nation's financial missteps.

While critics of the Dodd-Frank Act will likely continue to raise concerns about excessive government entanglement in the securities markets, a repeal of the Dodd-Frank Act remains unlikely, particularly given the historical precedence of SOX remaining in effect. This paper does not intend to offer opinions on the merits of the Dodd-Frank Act, but merely contend that its complex rules and requirements pose an opportunity to craft a framework to implement a uniform fiduciary standard for broker-dealers and investment advisers through the adoption of viable groundwork. In other words, if the measures of the Dodd-Frank Act truly do remain here to stay, it is up to regulators to shape the legislation to further the goal of consumer protection.

CONCLUSION

As the U.S. economy struggles to repair itself, the government, business and the American people will play a vital role. The Dodd-Frank Act represents not only an ambitious overhaul of the U.S. regulatory regime, but also a concerted effort on the part of legislators to

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[135] HAWKINS, *Supra* at 1361.

study, evaluate, and prevent catastrophic financial events that impacted the U.S. economy between 2007-2009. In addition to identifying and mitigating systemic risks in the system,[136] equally important is protecting consumers from exploitation and abuse. Consumers will form the lifeblood of rebuilding the U.S. economy. The consumer finance sector impacts the main players in the financial services sector, including banks, mutual funds, insurance companies, brokerage firms, government bodies, and more.[137] The U.S. economy needs consumers to make payments, save and invest, borrow money, and manage risk.[138]

In order to repair investor confidence, it remains critical that the regulations and fiduciary duties of broker-dealers harmonize with those requirements of investment advisers. As we recognize the important role consumers play in rebuilding the economy, equally important is to repair their confidence in regulatory oversight to prevent the repetition of previous events. The Dodd-Frank legislation goes a long way in setting a stronger framework for better oversight.

However, the legislation overlooked (perhaps by design) the critical area of harmonizing fiduciary standards between broker-dealers and investment advisers. Individuals in these professions play a key role in actively recruiting new individuals to securities markets and in managing the money of investors. Currently both professions are held to different standards, whereby investment advisers are obligated under duties of fiduciary obligation, while broker-dealers may act as free-wheeling sales agents.

The Dodd-Frank Act mandated the study of the impact of this distinction and came to the conclusion, like many scholars, that harmonizing the regulations would increase accountability

[136] Viral Archarya, Thomas F. Cooley, Matthew Richardson and Ingo Walter, Regulating Wall Street: the Dodd-Frank Act and the New Architecture of Global Finance. (2011), p. 11
[137] Andrea Ryan, Gunnar Trumbull and Peter Tufano. "A Brief Postwar History of Consumer Finance." Harvard Business School (2010), p. 4.
[138] *Id.* at 5.

among financial services firms and enhance consumer protection and confidence in the longer term. Key to minimizing investor fraud and abuse by securities professionals is the concept of suitability of investments based on a retail investor's objectives and goals, and the notion of sophistication.

This paper strongly advocates the adoption of a rebuttable presumption that the law view retail investors below a certain threshold as unsophisticated. The SEC has begun to re-examine the net worth of accredited investors, and this paper contends that a similar standard should apply to retail investors that participate in the securities markets. This will minimize predatory practices and deter unscrupulous broker-dealers and investment advisers from preying on unsuitable investors. It will also facilitate arbitration and securities litigation, by creating a clear framework that will allow parties to assess the merits of their claims before litigation. Adding this vital component will strengthen the U.S. economy and restore confidence in U.S. securities markets.

The regulatory reforms enacted are undoubtedly onerous. However the financial condition that befell the United States in the past decade is frequently compared and contrasted against the lessons learned from the 1930s, when America was struggling to emerge from the Great Depression. Historians consider financial crises as recurring phenomena that can bring the financial system to a halt, and often lead "to sharp economic contractions."[139] The contractions that occurred in the pre-1934 era eventually inspired "the great expansion of financial regulation and the creation of many of the central regulatory institutions – the FDIC and the SEC – that we rely on to this day."[140]

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[139] *Id.* at 13.
[140] *Id.* at 11.

Only time will provide an opportunity to judge the efficacy and impact of the Dodd-Frank legislation, and the other suggested reforms. Despite the concerns of smaller government advocates that such regulatory oversight will stifle innovation, it is important to remember that reforms that protect consumers from unethical marketing practices and predatory behavior will ultimately help expand the U.S. economy. Consumers are a vital part of this equation and with the help of consistent, fair, and effective oversight, both big business and consumers may flourish.