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Abstract

A key component of financial regulatory reform is harmonizing the law governing broker-dealers and investment advisers. Historically brokers charged commissions and were regulated under the Securities Exchange Act of 1934. Advisers charged asset-based fees and were subject to the Investment Advisers Act of 1940, which contains a special exclusion for brokers. In recent years, brokers have changed their compensation structure and many now market themselves as advisers, raising questions about whether they should be treated as such. The Obama Administration’s 2009 White Paper on regulatory reform and draft legislation call for a fiduciary duty to be imposed on brokers that provide advice. In this article, I explore the debate over regulating brokers and advisers and suggest how to resolve it. I make four key claims. First, changes in brokers’ compensation and marketing methods vitiate application of the broker-dealer exclusion and should subject brokers to the Advisers Act. Second, changes in the nature of brokerage, spurred by changes in technology, make the broker-dealer exclusion unsustainable and Congress should repeal it. I then turn to the consequences of regulating brokers as advisers. The third claim is that imposing fiduciary duties on brokers is incompatible with their historical roles as dealers and underwriters. To resolve this tension, the article suggests a compromise that enhances brokers’ duties but does not hobble their ability to perform their traditional functions. Finally, regulating brokers as advisers would overburden the SEC and the article offers alternatives to alleviate the strain.

CONTENTS

Introduction ........................................................................................................................................... 2
I. The Regulation of Broker-Dealers and Investment Advisers ..................................................... 5
   A. Historical Roles .............................................................................................................................. 5
   B. Regulatory Response .................................................................................................................... 7
      1. The Securities Exchange Act ................................................................................................. 7

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INTRODUCTION

Financial regulation in the United States is at a critical juncture. The current financial crisis and the Bernard Madoff investment scandal have ignited reform efforts hotly debated in the corridors of Washington. A key component of reform is revamping the regulation of broker-dealers and investment advisers. Brokerage and advisory firms now perform similar functions, but they are
regulated differently under our antiquated system of securities laws. The Securities and Exchange Commission’s recent attempt to address the inconsistency was vacated by the courts, creating an interregnum period during which final decisions to reshape the law will be made. Change is around the corner. In its 2009 White Paper on regulatory reform, the Obama Administration called for regulatory harmonization and for a fiduciary duty to be imposed on brokers providing advice. These proposals are highly charged and regulators, academics, and industry groups disagree sharply over how to construct this corner of the regulatory edifice.

Individuals and institutions in the United States generally invest through two types of registered securities intermediaries, broker-dealers, regulated under the Securities Exchange Act of 1934, and investment advisers, regulated under the Investment Advisers Act of 1940. The size of this industry is staggering. Broker-dealers report assets of over $5 trillion; investment advisers by some estimates manage approximately $43 trillion.

1 Department of the Treasury, Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation 71 (June 12, 2009) [hereinafter Treasury White Paper].


4 Richard G. Ketchum, Chairman and CEO, FINRA, Remarks at the NAVA Gov’t and Regulatory Affairs Conference (June 8, 2009), available at www.finra.org/Newsroom/Speeches/Ketchum/P118889.
are approximately 11,300 SEC-registered investment advisers. Although brokers, like advisers, give advice, Congress excluded brokers from investment adviser regulation through a special provision, which will be an important part of our story.

Over the past 25 years, changes in the financial services industry have blurred the line between brokers and advisers defying the logic of the bifurcated regulatory scheme. In 2005, a new SEC rule provided that brokerage firms that restructure their compensation and charge an asset-based fee would not be deemed advisers under certain circumstances. In 2007, however, the United States Court of Appeals for the D.C. Circuit vacated the SEC’s regulation. Thus, the questions regarding where to draw the line between brokers and advisers were placed squarely back on the shoulders of the SEC, or of Congress.

The Treasury White Paper and the Administration’s draft legislation attempt to address this debate. The Administration’s draft law would amend both the Exchange Act and the Advisers Act to give the SEC authority to adopt rules requiring broker-dealers and investment advisers to act solely in the customer’s interest, a fiduciary standard of conduct. The White Paper, however, does not analyze the considerable objections to this proposal. And notwithstanding the significant public policy questions raised, there appears to be little scholarly commentary on this topic.

In this article, I explore the debate over the proper regulation of brokers and advisers and provide suggestions on how to resolve it. The article proceeds in three parts. Part I discusses the historical roles of brokers and advisers and the regulatory response to their activities in the 1930s. Part I also provides background on changes in the brokerage industry and the SEC’s response, including the proposal and adoption of Advisers Act rule 202(a)(11)-1, which addressed broker-dealers that might otherwise be deemed investment advisers. I examine the challenge to the rule and the court’s reasoning in vacating it.

Part II argues that the broker-dealer exclusion in the Advisers Act is no longer tenable as a regulatory regime for two reasons. First, changes in the form of

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5. Aguilar, supra note 2.
8. Financial Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).
compensation brokers receive and the labels they use for marketing vitiate
application of the broker-dealer exclusion and should subject brokers that provide
advice to the Advisers Act. Second, because one assumption on which the broker-
dealer exclusion is predicated is no longer relevant in today’s economy, the
exclusion is no longer sustainable and Congress should simply repeal it. Brokers
that give advice should be treated as advisers thereby satisfying the Treasury
Department’s recommendations to harmonize regulation and place a fiduciary duty
on brokers.

Part III takes up objections to this reform. First, I address a fundamental
contradiction that lurks behind imposing a fiduciary duty on brokers. When acting
as dealers or as underwriters, broker-dealer firms are in an adversarial posture vis-
à-vis their customers; this posture competes with the fiduciary norm of putting
one’s customer’s interests before one’s own. I then set forth potential solutions to
this problem. In arriving at these solutions, a compromise must be struck that
enhances the duties of broker-dealers on the one hand but does not hobble their
ability to perform their traditional roles on the other. Second, I address the resource
concerns of treating broker-dealers as advisers. Regulating hundreds of thousands
of brokerage accounts as advisory accounts would overburden the SEC. I put forth
two tentative solutions to ameliorate the burden that would befall the agency. 12

I. THE REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS

A. Historical Roles

Broker-dealers in the United States have always acted as both agent and
principal with respect to their customers. A broker acts as an agent, executing
securities transactions on behalf of a customer, the principal, with another buyer or
seller. A dealer acts as a principal, buying securities from or selling securities to a
customer out of its own account. In the United Kingdom, these functions were
divided until 1986 between stock brokers acting as agents and stock jobbers acting
as dealers. 13 In the United States, regulators determined that the same person may
act in both capacities although, as we shall see, only after an impassioned debate
over the merits of segregating the two.

Brokerage firms provided a number of services for their customers. They
executed transactions, arranged for delivery of securities certificates, maintained

12 One caveat: I shall not address proposals to subject advisers to an SRO or to change the
SEC to a self-funded agency. An SRO for advisers merits extended discussion of topics
such as potential conflicts, additional costs, and which body would be an appropriate SRO.
It appears unlikely, however, that the proposal will come to fruition any time soon. See
Report: Barney Frank Won’t Push for SRO for Advisors, FA NEWS, Aug. 11, 2009,
available at www.financialadvisormagazine.com. Similarly, self-funding calls for a careful
debate over effective supervision and potential conflicts. See Suzanne Barlyn, Compliance
Watch: Idea of Self-Funding Raises Questions, WALL ST. J. ONLINE, Aug. 11, 2009. These
are important topics but merit an article of their own.

13 NICOLAS GRABAR, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS
REGULATION, 1601 PLI/CORP. 11 (May 2007).
custody of funds and securities, and performed record-keeping. Broker-dealer firms also traded for their own accounts and sold securities to the public for their underwriting clients. Brokers have always provided advice to their brokerage customers, including in the 1930s and 1940s when the securities laws were enacted. The SEC determined that advice provided at the time was “extensive and varied.”\textsuperscript{14} To administer services to their brokerage customers, brokers charged a commission on every transaction; dealers charged a mark-up or mark-down on a sale or purchase of securities, which was akin to a commission.\textsuperscript{15} The cost of research was embedded in this charge and not separately itemized or billed.\textsuperscript{16} Brokerage accounts were either discretionary or non-discretionary. In a discretionary account, a customer gave the broker-dealer legal authority like a power of attorney to transact on his behalf. In a non-discretionary account, the broker-dealer was required to contact the customer before each transaction.

As early as the 1930s, some broker-dealers provided distinct advisory services for which they charged a separate fee. This advice generally was given through a separate division or department in the firm.\textsuperscript{17} Customers were charged one fee for advice and a separate commission for each transaction. Thus, all brokers, even those that charged a separate fee for advice, were paid on commission.

The business of investment advisers differed from broker-dealers. Unlike brokers, advisers did not engage in execution or custody-related services. Rather, they provided investment advice for a fee, including asset allocation and portfolio management. The advisory relationship they established with their clients was born out of a need for services that were “supervisory” in nature.\textsuperscript{18} Advisers agreed to discharge their duties on an ongoing basis. They generally undertook to advise the client “at stated intervals” and to keep the client “constantly advised” as to changes to be made in the client’s account.\textsuperscript{19} For these services advisers typically charged an asset-based fee. If the client wanted to purchase securities, the adviser would refer the client to a broker-dealer to perform the execution.

\textsuperscript{14} Adopting Release, supra note 7 at 20428.
\textsuperscript{15} A mark up is the difference between the price offered by other dealers and the higher price charged to a customer who is purchasing; a mark down is the difference between the price bid by other dealers and the lower price that a dealer pays a customer who is selling.
\textsuperscript{17} Twentieth Century Fund, The Security Markets 653 (1938) (“Investment banks and brokerage firms which have established special investment management departments generally follow the fee system initiated by the investment counsel.”).
\textsuperscript{19} Twentieth Century Fund, supra note 17 at 649.
B. Regulatory Response

Before the decade of the 1930s, federal regulation of the securities industry was virtually nonexistent. Although the Interstate Commerce Commission exercised some regulation over common carriers’ issuance of securities, investor protection legislation was limited to the states.20 Starting with Kansas in 1911, most states passed laws to protect investors from nefarious sales practices and other peculations in the offer and sale of securities.21 But federal regulation would have to wait for an economic crisis.

1. The Securities Exchange Act

The Securities Exchange Act of 1934 was the second federal securities law enacted in the Dust Bowl days of the Great Depression.22 The first, the Securities Act of 1933, provided for disclosure and federal registration of securities offerings to the public.23 By contrast, the Exchange Act provided for detailed regulation over the conduct of broker-dealers, including prudential regulation such as capital requirements, and investor protection regulation in the form of antifraud controls. The Exchange Act also established the Securities and Exchange Commission as the federal agency responsible for implementing the securities laws. Just four years later, Congress passed the Maloney Act amendments to the Exchange Act, which established a system of self-regulation for broker-dealers. The Maloney Act resulted in the creation of the National Association of Securities Dealers (NASD), now the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization (SRO) for broker-dealers.24 Thus, by 1940, when the Advisers Act was passed, broker-dealers were already regulated by both the SEC and the NASD.

2. The Investment Advisers Act

The advent of professionals dedicated to providing investment advice to clients occurred around the time of World War I and their numbers grew during the 1930s when, as a result of the Crash, many who were in the business of selling securities migrated to the business of selling advice.25 Starting in 1935, the SEC

21 LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 5-8 (1958) (explaining that although Kansas was not the first state to adopt a securities law, it was the first to adopt a comprehensive statute requiring registration of securities and securities sales representatives).
24 See generally JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 185-86 (3d ed. 2003). The NASD was the predecessor to FINRA. In 2007, FINRA was created through the combination of the NASD and the member regulation, enforcement, and arbitration functions of the NYSE.
conducted a study of investment trusts and investment companies. This study, required by the Public Utility Holding Company Act of 1935, was a monumental undertaking. One of the resulting documents was the Investment Counsel Report, a survey of investment advisers.\footnote{INVESTMENT TRUSTS AND INVESTMENT COMPANIES, supra note 18.}

The Report demonstrated that little was known about the number of investment advisers operating at the time or the amount of assets they managed.\footnote{See H.R. Rep. No. 1775, at 21 (1940).} After the report was published, the SEC held a public hearing where industry representatives shared with the Commission two primary problems they saw in the investment adviser community. The first was harm to the public inflicted by unscrupulous advisers; the second was reputational harm inflicted on legitimate investment advisers when the public could not spot the bad apples in the profession.\footnote{See id.} As a result of these developments, Congress adopted the Investment Advisers Act.\footnote{15 U.S.C. §§ 80b-1 to -21 (2006).} There has never been an SRO for investment advisers. But calls for one, which appear periodically, are again making news.\footnote{Roberta Kar mel, The Future of Self-Regulatory Organizations, N.Y.L.J., June 26, 2009, at 3 (pointing to confusion between roles of brokers and advisers and to Bernard Madoff scandal as reasons for an SRO for advisers).}

At the time the Act was passed, it was considered little more than a “compulsory census.”\footnote{Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong. 48, 50 (1940) (statement of David S. Schenker, Chief Counsel, Securities and Exchange Commission).} The Act defined the term “investment adviser” broadly 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.”\footnote{Investment Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).} Thus, without a special exception, broker-dealers that provided advice would have been swept into the definition and their advisory services would have been regulated under the Advisers Act.

3. The broker-dealer exclusion

Aware that broker-dealers were subject to regulation under the Exchange Act, Congress excluded their advisory services from coverage under the Advisers Act as long as two conditions were met. First, the broker’s advice must be “solely incidental” to brokerage services. Second, the broker must receive “no special compensation” for the provision of advice.\footnote{Investment Advisers Act § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006).} Note that both must be true. If the advice is not solely incidental or the broker receives special compensation, the exclusion is unavailable. The phrase “solely incidental” was not defined. By contrast, we know from contemporaneous evidence that the term “special compensation” was meant to be a proxy for non-commission-based compensation.

\footnotetext[26]{INVESTMENT TRUSTS AND INVESTMENT COMPANIES, supra note 18.}
\footnotetext[27]{See H.R. Rep. No. 1775, at 21 (1940).}
\footnotetext[28]{See id.}
\footnotetext[29]{15 U.S.C. §§ 80b-1 to -21 (2006).}
\footnotetext[30]{Roberta Karmel, The Future of Self-Regulatory Organizations, N.Y.L.J., June 26, 2009, at 3 (pointing to confusion between roles of brokers and advisers and to Bernard Madoff scandal as reasons for an SRO for advisers).}
\footnotetext[31]{Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong. 48, 50 (1940) (statement of David S. Schenker, Chief Counsel, Securities and Exchange Commission).}
The legislative history of the Advisers Act states that the exclusion is applicable as long as broker-dealers “receive only brokerage commissions.”

By enacting the broker-dealer exclusion, Congress distinguished between two groups of broker-dealers, as discussed above. The first consisted of brokers that provided advice in the context of brokerage and were paid on commission. This group was excluded from the Advisers Act. The second consisted of brokers that provided advisory services separately from conventional brokerage and charged a separate fee. This group was deemed to receive “special compensation” and was ineligible for the exclusion.

For many years the broker-dealer exclusion worked well. Brokers and advisers distinguished themselves from one another largely through the type of compensation they charged and were subject to different regulatory schemes. A number of firms were dual registrants – registered with the SEC both as broker-dealers and investment advisers. The SEC, however, regulated those firms on an account-by-account basis. The firm would designate an account as a brokerage account, an advisory account, or both, and so long as the designation was correct, regulators would accord the respective treatment. This distinction between regulatory treatment of the firm as opposed to an account is important; a firm might be registered as an adviser, but it may not treat a particular account as an advisory account. From an investor protection standpoint, what matters most is the regulatory treatment of a particular account, not the registration status of the firm.

The tidy separation between brokers and advisers began crumble initially in the 1980s when brokers started to offer financial planning services, and more significantly in the 1990s when brokerage firms began to use titles such as “adviser” or “financial adviser” for their broker-dealer registered representatives and even encouraged customers to think of the registered representative more as an adviser than a stockbroker. As discussed below, use of such labels should put one on notice that the advice is no longer “solely incidental” to brokerage. Regulators, however, did not respond to this marketing move, and the broker-dealer exclusion continued to separate brokers from advisers. In this respect, brokers were the exception. The Advisers Act contains a similar exclusion for other professionals such as accountants, lawyers, and teachers. These professionals, however, could

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35 Adopting Release, supra note 7 at 20428-29.
36 See id. at 20440 n. 165 (discussing SEC’s “longstanding view” that accounts will be analyzed on an account-by-account basis).
37 Although brokerage accounts are not deemed advisory accounts if the broker-dealer exclusion is applicable, many if not most advisory accounts would be considered brokerage accounts if the firm effected transactions for the accounts. Thus advisory accounts of dual registrants often are subject to both regulatory regimes.
not market themselves as advisers lest their advice no longer be considered “incidental” to their profession.\footnote{THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS 217 (2008).}

C. Changes in Compensation Structure

If the broker-dealer exclusion began to crumble as brokers marketed themselves as advisers, it collapsed under the weight of changes in compensation structure that occurred in the 1990s married with the promotion of advice as the primary service offered to investors. At that time, certain brokerage firms began to offer discounts to customers who were willing to live with fewer services. Other brokers migrated from commission-based compensation to fee-based compensation more typical of investment advisers. To understand these changes, it is helpful to place them in historical context.

1. Competition and two-tier pricing

For close to two hundred years, the amount of a commission paid to buy or sell a security was non-negotiable. Starting with the Buttonwood Tree Agreement of 1792, investors paid a fixed commission to trade. This system remained in place until 1975.\footnote{In reality, the movement toward negotiated rates had begun much earlier. For a brief history, see SELIGMAN, supra note 24 at 303.} As techniques to avoid fixed commission schedules became widespread, their elimination became inevitable. The era of fixed commissions officially ended on May 1, 1975, the day the SEC’s rule prohibiting any exchange from requiring its members to charge fixed commissions became effective, known in the industry as “May Day.”\footnote{See Norman S. Poser, Restructuring the Stock Markets: A Critical Look at the SEC's National Market System, 56 N.Y.U. L. REV. 883, 901 (1981).}

The deregulation of commissions generated widespread change in the stolid world of securities brokerage. Broker-dealers suddenly faced stiff competition from within their own ranks. The advent of discount brokers, such as Charles Schwab, was attractive to investors who were delighted to pay lower commission rates for reduced levels of service. At the same time, development of technology continued to lower the costs of execution.\footnote{See HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 16-58.2 (3d ed. 2009) (explaining that online trading continued the trend of unbundling advice from execution resulting in reduced commissions).}

To compete with the discount houses, some broker-dealers instituted two or more levels of service. Full service brokerage would include execution, advice, delivery and payment services, as well as custody and recordkeeping. Discount brokerage would include use of an electronic trading platform and the ability to trade on-line. Introducing multiple fee structures, however, could vitiate application of the broker-dealer exclusion. When a firm offers a dual fee structure, the SEC staff might attribute the difference in the fees to advice. If this were true,
the additional fee would be considered “special compensation” for advice and abrogate the exclusion. But there was another development even more vexing under the aging regulatory scheme.

2. Migration to fee-based pricing

As broker-dealers were concerned about stabilizing revenue in the wake of competition, the SEC had concerns of its own about the negative aspects of charging commissions, namely the possibility of “churning” in customer accounts. Churning became a widespread problem in the late 1960s. Finally in 1994, then-SEC Chairman Arthur Levitt formed the Tully Committee to address the issue head on. The Committee, named for its Chairman who at the time was Chairman and CEO of Merrill Lynch & Co., was to identify conflicts of interest in the brokerage industry and recommend best practices in compensating registered representatives of broker-dealer firms.

The final report issued in 1995. It concluded, among other things, that firms should base at least a portion of a registered representative’s compensation on assets held in an account regardless of whether any transactions occur. This change in compensation would be beneficial to industry and investors alike by guaranteeing brokers a continued revenue stream and by reducing the risk of churning. At the time, certain broker-dealers reassessed their compensation practices and began to offer fee-based brokerage services in lieu of commissions. This coincided with brokers’ touting advice, not execution, as their primary business.

As fee-based brokerage programs grew, concerns arose that this form of payment could be considered “special compensation” under the Advisers Act because it was not a commission. Brokers were in a quandary. Although they changed only their method of compensation and not their services, they were faced

44 Adopting Release, supra note 7 at 20425 (“Our staff has viewed such a two-tiered fee structure as involving ‘special compensation’ under the Advisers Act.”).
45 Churning is where a broker “engages in excessive trading in disregard of his customer’s investment objectives for the purpose of generating commission business.” Mihara v. Dean Witter & Co., Inc., 619 F.2d 814, 820 (9th Cir. 1980).
48 See Roper, supra note 38.
49 See Enhancing Investor Protection and the Regulation of Securities Markets, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 111th Cong., 1st Sess. (March 26, 2009) (statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission) (stating that the services provided by brokers and advisers are “virtually identical from the investor’s perspective.”).
with application of the Advisers Act in addition to the full panoply of broker-dealer regulation to which they were already subject. Application of the Advisers Act to their services, therefore, appeared capricious and burdensome.

3. Application of the Advisers Act to brokerage accounts

Why would broker-dealers view application of the Advisers Act as burdensome? There are several potential answers to this question. Many believe that the duties imposed on investment advisers exceed those placed on broker-dealers. Advisers generally are considered fiduciaries to their clients; by contrast, brokers are subject to duties of suitability and other requirements. In the case of non-discretionary accounts, however, they are not typically considered fiduciaries.\(^{50}\) Notwithstanding the prospect of owing fiduciary obligations, the primary reason many brokers oppose application of the Advisers Act is due to restrictions on conducting principal transactions imposed on advisers but not brokers.

A principal transaction occurs when an investment adviser, acting as principal for its own account, buys securities from or sells securities to an advisory client. Section 206(3) of the Advisers Act prohibits an adviser from conducting principal trades with advisory clients, a form of self-dealing, unless the adviser, in advance, provides written disclosure to the client of the capacity in which it is acting and obtains the client’s consent.\(^{51}\) The underlying purpose of the provision is to reduce the chance that an adviser, acting as a principal, will dump a “sour issue” on its advisory client.\(^{52}\) The SEC interprets section 206(3) to require disclosure and consent before each principal transaction.\(^{53}\)

Obtaining preapproval before every principal trade is burdensome when markets are dynamic. Due to the speed of electronic trading, many advisers lack the time to comply with the requirements of section 206(3) and still achieve “best

\(^{50}\) Coffee, supra note 2 (contrasting broker’s duties of suitability imposed by FINRA with adviser’s fiduciary duty); Koffler, supra note 2 at 7 (explaining that advisers have a duty to monitor; brokers duties cease with the purchase or sale); Black, supra note 11 at 36-37 (contrasting broker’s duty of suitability with adviser’s fiduciary duty, including duty to monitor and to avoid self-dealing transactions without informed consent).

\(^{51}\) Investment Advisers Act § 206(3), 15 U.S.C. § 80b-6(3) (2006). The prohibition in section 206(3) also applies where an affiliate or controlling person of the investment adviser acts as a principal when trading with the advisory client. LEMKE & LINS, supra note 40 at 217. Section 206(3) also applies to dual registrants (firms registered as both broker-dealers and investment advisers) arranging cross trades between an advisory account and a non-advisory account. The SEC, however, has adopted Advisers Act rule 206(3)-2, 17 C.F.R. § 275.206(3)-2 (2008) to provide relief to firms seeking to arrange these cross trades. LEMKE & LINS, supra note 40 at 212.

\(^{52}\) Investment Trusts and Investment Companies, supra note 31 at 322 (“[I]f a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right.”).

\(^{53}\) Investment Advisers Act Release No. 40, 11 Fed. Reg. 10997 (Feb. 5, 1945) (stating that the requirements of disclosure and consent in section 206(3) must be satisfied before each transaction).
As a result, such transactions generally do not occur and section 206(3) is effectively a ban on principal trading for advisers. The brokerage community, therefore, sought relief from the SEC.

D. The Rise and Fall of Advisers Act Rule 202(a)(11)-1

1. The SEC’s rule

In 1999, the SEC addressed the dilemma faced by broker-dealers in the form of Advisers Act rule 202(a)(11)-1. The proposed rule was designed to prevent application of the Act to broker-dealers solely because they repriced full service brokerage to a fee-based structure or established a two-tier system of pricing, one for full service brokerage and one for execution-only or discount brokerage.

Under the proposed rule, a broker-dealer providing investment advice to a customer would be excluded from the definition of adviser, regardless of the type of compensation received, as long as three conditions were met: (i) the advice provided was non-discretionary; (ii) the advice was solely incidental to brokerage services provided; and (iii) the broker-dealer disclosed to its customers that the customer’s account is a brokerage account. The rule also provided that a broker-dealer providing advice to customers would not be considered an adviser even if it offered execution-only brokerage services and established a two-tier structure of compensation. The rule effectively removed the “no special compensation” prong of the broker-dealer exclusion and added a disclosure requirement. When the SEC first proposed the rule in 1999, it provided immediate “no-action” relief to broker-dealers offering fee-based accounts that otherwise might be subject to the Advisers Act.

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55 Letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Ass’n, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Feb. 7, 2005, at 18 (“We submit that imposing unnecessarily burdensome regulation on principal transactions would be contrary to the interest of broker-dealer customers.”).
57 Id. at 61228.
58 Id. at 61229.
59 Id.
60 Id. at 61227 (“Until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for
The proposal was controversial from the start, generating over 1,700 comment letters. Although brokers generally supported the rule, many advisers implored the Commission not to move forward. They argued that the new brokerage programs were not the same as traditional brokerage and, if adopted, the rule would deny brokerage customers important protections afforded by the Advisers Act. Advisers also lamented the negative competitive effects of the proposed rule, arguing that broker-dealers would be free to offer advisory services but without the attendant regulatory responsibilities. The Financial Planning Association (FPA), an advocacy group for persons who provide and receive financial planning services, led the charge against the asperity of the proposed rule, arguing that it would allow brokers to offer advisory services without the protections Congress intended.\(^\text{61}\)

The SEC did not act on the proposal for nearly five years. In 2004, the FPA filed a petition for judicial review of the 1999 proposal. Shortly thereafter, the SEC reopened the comment period and in January 2005 reproposed the rule.\(^\text{62}\) The gist of the reproposal was the same as the 1999 original, although several modifications were made.\(^\text{63}\) The reproposal drew approximately 300 comment letters again with brokers generally in support and advisers against. In April 2005, the SEC adopted rule 202(a)(11)-1 largely as proposed.\(^\text{64}\) The FPA once again petitioned for review and the U.S. Court of Appeals for the D.C. Circuit consolidated the petitions and issued its opinion in March 2007.\(^\text{65}\)

2. *The decision in Financial Planning Association v. SEC*

In *Financial Planning Association v. SEC*, the United States Court of Appeals for the D.C. Circuit ruled for the FPA, vacating rule 202(a)(11)-1.\(^\text{66}\) The court’s ruling threw into confusion the fundamental issues settled in the SEC’s rulemaking, such as the status of fee-based brokerage accounts, and called into

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\(^\text{63}\) First, the SEC proposed to expand the disclosure to customers about the type of account they had, brokerage or advisory. Second, the reproposal clarified conduct that would not be considered solely incidental to brokerage, such as rendering financial planning services. Third, the SEC added a provision interpreting the exercise of investment discretion as not solely incidental to brokerage. Reproposal, *supra* note 62 at 2723-29.

\(^\text{64}\) Adopting Release, *supra* note 7.

\(^\text{65}\) Financial Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

\(^\text{66}\) *Id.* at 493.
question SEC interpretations about financial planning services and discretionary accounts, which were not the direct subject of the legal challenge. 67

The FPA’s primary argument was that the SEC lacked the statutory authority to adopt the rule. 68 As discussed above, section 202(a)(11) of the Advisers Act defines the term investment adviser. The section also contains exclusions from the definition, such as the exclusion for brokers in section 202(a)(11)(C), as well as exclusions for certain banks, lawyers, accountants, engineers, and others. 69 Section 202(a)(11)(F), subsequently renamed Section 202(a)(11)(G), contains an additional exclusion for “such other persons not within the intent of this paragraph, as the Commission may designate.” 70

The SEC argued that section 202(a)(11)(F) gave it the authority to exclude a subset of brokers from the Advisers Act that would otherwise be covered, namely brokers that do receive special compensation. 71 The SEC argued that these brokers provide investment advice in the same manner as brokers already excluded under section 202(a)(11)(C). Excluding such brokers from the Act, therefore, is consonant with the historical intent of Congress. The FPA countered that the word “other” in section 202(a)(11)(F) does not empower the SEC to rewrite the terms of the statutory exclusion. The group of brokers excluded from the Act was identified by Congress, said the FPA; the SEC may exclude other types of professionals but the SEC may not revise the broker-dealer exclusion by effectively striking the “no special compensation” prong from it. 72

The court held that the SEC rule was inconsistent with the Advisers Act. First, the exclusion was not “within the intent” of the rest of the paragraph as required by Section 202(a)(11)(F). The legislative intent does not support an exclusion for broker-dealers broader than the one in subsection (C). 73 Second, the SEC cannot establish a broader exclusion other than the one in subsection (C) because broker-dealers are not “other persons” as described in subsection (F) – they are already addressed by subsection (C). 74 The court applied the conventional two-step analysis under Chevron, U.S.A., Inc. v. Natural Resources Defense

67 See Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Advisers Act Release No. 2652, 72 F.R. 55126, 55127 (proposed Sept. 24, 2007) [hereinafter Interpretive Release] (“Though the Court did not question the validity of our interpretive positions, it vacated the entire rule, leaving our interpretations potentially in doubt.”).
68 Id. at 487.
71 Financial Planning Ass’n v. SEC, 482 F.3d 481, 488 (D.C. Cir. 2007).
72 Id. at 489; see also Brief of Petitioner at 31-34, Financial Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (Nos. 04-1242, 05-1145).
73 FPA, 482 F.3d at 488-90.
74 Id. at 488-90 (“By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports.”).
Council, Inc. It concluded that, under step one, the text of subsections (C) and (F) is unambiguous, the SEC exceeded its authority, and there was no reason to proceed to step two. In dissent, Judge Garland disagreed sharply that the relevant terms of section 202(a)(11) were unambiguous. Although this dissent likely gave the government ample grounds to appeal the decision to the U.S. Supreme Court, in May 2007, the SEC announced it would stand down.

The FPA decision is causing turmoil in the financial services community. In 2007, the SEC estimated that broker-dealer customers held approximately $300 billion in one million fee-based brokerage accounts. Recognizing the havoc the decision was likely to wreak, the SEC sought and obtained a stay of the court’s mandate until October 1, 2007. Some commentators believed that broker-dealers could continue to rely on the no-action position embedded in the original 1999 proposal. The SEC, however, disagreed. It announced that customers must decide by October 1, 2007, the day the stay was set to expire, whether to convert their fee-based brokerage accounts to advisory accounts or to traditional commission-based brokerage accounts.

The difficult issues, therefore, remain unresolved. Are broker-dealers really providing advice akin to advice provided by advisers? If yes, how should they be regulated? Should we pay attention to the labels brokers employ and the type of compensation they receive when analyzing the application of the exclusion, or look only at function? Is the broker-dealer exclusion functioning as intended or has it outlived its usefulness due to changes in the financial services industry?

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75 467 U.S. 837 (1984). Under step one, a court must determine whether Congress has spoken to the precise question at issue. If yes, that ends the inquiry. The court and the agency must give effect to the will of Congress. If not, the court must determine if the agency’s answer is based on a permissible construction of the relevant statute. Chevron, 467 U.S. at 842-43.
76 FPA, 482 F.3d at 492. The SEC also invoked its statutory authority under section 211(a), which provides authority to issue rules “necessary or appropriate” to the exercise of the functions and powers conferred on the Commission and to “classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters.” Investment Advisers Act § 211(a). The court, however, stated that this provision was unavailing because the SEC could not ignore the will of Congress. FPA, 482 F.3d at 493.
77 FPA, 482 F.3d at 495 (Garland, J., dissenting).
80 June 27, 2007 Order of the U.S. Court of Appeals for the District of Columbia Circuit in FPA v. SEC.
81 Dechert LLP, SEC Not to Appeal Decision Vacating Broker-Dealer Exemption Rule 6 (May 2007).
82 Temporary Rule Release, supra note 79 at 55024.
Finally, if broker-dealers become regulated as advisers, what consequences follow for the firms and for investors and how should regulators respond? I take up these labyrinthine issues in the next two Parts.

II. APPLICATION OF THE BROKER-DEALER EXCLUSION

In this Part, I address the broker-dealer exclusion, which stands in the way of harmonizing the law of brokers and advisers. If brokers that give advice continue to be excluded from the Advisers Act, true harmonization is unlikely. I argue in this Part that the broker-dealer exclusion is no longer applicable to broker-dealers providing advice and no longer sustainable as a regulatory scheme. I make two claims. First, changes in the way brokers market their services as well as changes in the type of compensation charged have altered the nature of the relationship between brokers and their customers. The exclusion should not be available for brokers that market themselves as advisers or charge an asset-based fee.

Second, the exclusion itself should be repealed. Changes in securities trading brought about by changes in technology have rendered brokerage a commodity, which no longer entails the level of judgment and skill required to conduct brokerage services in the bygone era of the early twentieth century. Advice long ago eclipsed in importance the execution of securities transactions. Instead of referring to advice as solely incidental to brokerage, it is today more apt to refer to brokerage as solely incidental to advice. Nowadays, advice is the main course served up to investors; brokerage is the side dish. Since the statutory exclusion rests on the outdated assumption that advice can be solely incidental to brokerage, the exclusion should be repealed.

A. Form and Substance in Broker-Dealer Regulation

Some writers state that one should examine the services brokers and advisers actually perform, not what they are called or how they are compensated. Although it is true that one’s conduct is important, labels used and methods of compensation are relevant to the application of adviser law. I shall first discuss marketing practices and then compensation methods to analyze whether those factors should bear on the application of the Advisers Act and the

83 Walter, supra note 2.
84 In an interesting twist, the substance-over-form argument can be used to argue both for and against treating brokers that give advice as advisers. On the one hand, if brokers are engaged in advisory services, then placing substance over form would favor treating brokers as advisers. On the other hand, if brokers have not changed their function over the past several years and only their labels and compensation structure have changed, then there is no reason to alter their regulation. Indeed, one impetus behind the SEC’s adoption of rule 202(a)(11)-1 was the notion that brokers have not changed their business model, only their form of compensation. As a result, their regulation should not change either. See Adopting Release, supra note 7 at 20426.
imposition of fiduciary duties. I then make the bolder claim that the entire exclusion has lost its footing and should be eliminated.

1. Marketing as an adviser

Marketing methods used by financial services providers bear on the level of protection afforded by the federal securities laws. When considering the interplay among marketing, regulatory treatment, and investor protection, it is important, as mentioned, to distinguish the relationship between the firm and the investor on the one hand from the relationship between the individual broker-dealer registered representative establishing the account and the investor on the other. Recall that in the case of dual registrants (firms registered as both broker-dealers and investment advisers) the SEC regulates the relationship between the firm and the investor on an account-by-account basis.85 The important inquiry is not whether the firm itself is registered, but rather whether the firm will treat a particular account as an advisory account.

The marketing of a brokerage firm or the individual representative as an adviser should bear on the protections investors receive.86 Use of the very word “adviser” connotes a goal of assisting another as opposed to oneself. Consider the word in other contexts. An academic adviser assists a student in choosing classes based on the students’ goals in contrast to which courses suffer from low enrollment or enhance the institution’s profit. An advisory board helps an organization function based on the interests of the institution, not the self-interest of individual board members. Calling oneself an adviser implies that the advice given will be shorn of self-interest. The law of brokers and advisers promotes this theme. Recall that advisers, but not brokers, are prohibited from trading as principals with their clients because of the self-interest inherent in trading for one’s own account.87

The federal securities laws attach great importance to the methods financial services professionals use to market their services. This emphasis is particularly true in the case of the Advisers Act. One example is the so-called private adviser exemption from the registration provisions of the Advisers Act. Under section 203(b), an adviser that would otherwise be required to register is exempt from registration if it has had fewer than 15 clients over the past 12 months, has no investment company client, and does not hold itself out to the public as an investment adviser.88 If an adviser were to advertise itself widely, it would lose the benefit of the exemption and be forced to register regardless of the substance of its conduct.

In addition to the emphasis on “holding out” in the federal securities laws, fundamental tenets of agency and contract look to the same factor. If a broker,

85 See supra note 36.
86 See RAND REPORT, supra note 3 at 74 (stating that typical job titles of employees in brokerage firms include financial advisor, financial consultant, financial representative, and investment specialist).
87 See supra notes 51 to 55 and accompanying text.
88 See Investment Advisers Act § 203(b).
either the firm or the individual representative, agrees to act as an adviser and a client enters into a relationship with the broker based on the representations that the broker will so act, then the relationship should be treated as an advisory relationship and the broker should be held to the standards imposed on advisory professionals. The very definition of agency according to the Restatement (Second) of Agency is “the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” If a broker holds itself out as an adviser, and a customer responds by hiring the broker to act on her behalf, this response triggers an agency relationship and a fiduciary obligation extending to matters within the scope of the agency. Thus, a broker’s fiduciary duties, if it advertises itself as an adviser, would extend beyond execution and encompass the provision of advice.

This eventuality is not just theoretical. When the SEC adopted rule 202(a)(11)-1, it included a provision for a study of the nettlesome issues raised by the rule, such as whether the Commission should seek legislation to integrate broker and adviser regulation. The SEC engaged the RAND Institute for Civil Justice to perform the study, which was published in 2008. The empirical work in the RAND Report demonstrates, among other things, that titles and job descriptions have their desired effects. Investors tend to believe that professionals who use the title of financial adviser or consultant are more similar to advisers than they are to brokers in the services they provide and the duties they owe.

These principles were examined in Geman v. SEC, a Tenth Circuit case, which looked carefully at marketing when analyzing what level of protection the securities laws afford. In that case, a registered broker-dealer and investment adviser offered a wrap fee program to its customers. The firm did not actually recommend particular securities; the advice component was provided by portfolio managers who contracted with the firm. In its promotional literature, the firm undertook fiduciary responsibilities to its customers.

After the firm distributed its promotional materials, it changed its business model. Instead of acting solely as an agent, it began to act as a principal, buying from or selling to its customers. The firm disclosed the change but its literature

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89 RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).
90 Id. at § 13.
91 Adopting Release supra note 7 at 20442.
92 RAND REPORT, supra note 3.
93 Id. at 90 (“Respondents [of survey] tended to believe that financial advisors and consultants are more similar to investment advisers than to brokers in terms of the services provided, compensation methods, and duties.”).
94 334 F.3d 1183 (10th Cir. 2003).
95 In a wrap fee program, a sponsor arranges for several services such as portfolio management, brokerage execution, clearing, custody, and other administrative services to be provided to an investor for a single fee, called a wrap fee. Michael B. Koffler, Wrap Fee Programs: New Challenges in a Familiar Framework, SM064 ALI-ABA 325 (2007).
96 334 F.3d 1183.
97 Id.
referred to new regulatory interpretations and improvements to the firm’s technological capabilities and omitted any reference to the firm’s intent to profit on these transactions.\footnote{Id. at 1187.} In an SEC enforcement action, Geman claimed that the firm should not be held to a fiduciary standard because it was acting as a broker, not an adviser. The court rejected this argument and said that Geman failed to address the “cornerstone” of the SEC’s ruling on this issue, which is that the firm “held itself out” as a fiduciary.\footnote{Id. at 1189.} The customer’s response to the promotional material – entering into an agreement with the firm – established a fiduciary relationship.\footnote{Id.}

The importance of labels and marketing figured prominently in the SEC’s adoption of rule 202(a)(11)-1. Recall that the SEC’s rule would have excluded a brokerage account from the application of the Advisers Act as long as certain conditions were met. One condition the SEC imposed was disclosure by the broker that it was not acting as an adviser with respect to the account at issue. In the original 1999 proposal, the SEC stated that the fact that brokers hold themselves out as advisers raises questions as to whether the advisory services are really incidental to brokerage. At a minimum, the advice offered would not be perceived as solely incidental to brokerage.\footnote{Proposing Release, supra note 56 at 61229 (‘[S]ome broker-dealers offering these new accounts have heavily marketed them based on the advisory services provided rather than the execution services, which raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services.”).} The SEC required brokers taking advantage of the rule to disclose that the account is a brokerage account and not an advisory account.\footnote{Adopting Release, supra note 7 at 20435.} The SEC recognized the importance of labels and sought to address potential investor confusion through disclosure.

This emphasis on marketing is consistent with the way the SEC staff has interpreted the phrase “solely incidental” in the context of similar exclusions for any lawyer, accountant, teacher, or engineer, mentioned above.\footnote{Investment Advisers Act § 202(a)(11)(B), 15 U.S.C. § 80b-2(a)(11)(B) (2008).} In no-action letters, the staff has stated that it will look to three factors in determining whether the exclusion is applicable. The most important of the three is whether the professional holds himself or herself out as an investment adviser.\footnote{See, e.g., Jones & Kolb, SEC No-Action Letter, 1984 WL 45308 (May 7, 1984) (stating that relevant factors are whether the professional holds himself out as an adviser, whether advice is related to other services provided, and whether a separate fee structure exists for advisory services).} If an accountant, for example, holds himself out as an adviser, he can no longer claim his advice is incidental to accounting, and the exclusion is unavailable.

Similarly, the marketing of a broker as an adviser should vitiate the exclusion as well. When marketing the firm as an adviser or holding out the registered representative as providing trusted advice, it is difficult to maintain that the advice provided is incidental to brokerage. The advice component of the broker’s business is more taxing of her skill, more essential to her profitability, and
more important to investors. Advice is the music intended to lure customers to the firm.\textsuperscript{105} Consider an analogy. Today most cinemas have a refreshment concession where customers can buy popcorn, candy, soda, and other snacks. Most moviegoers would probably view the refreshments as incidental to the main line of business – showing the film – even if some people spend more on snacks than the price of a ticket or if the lion’s share of the theater’s profit is attributable to the sale of refreshments. If the theater continued to show movies but referred to itself as a café, restaurant, or snack shop, and advertised itself primarily by its savory snacks and other tempting treats, one would question whether the concession could be viewed as incidental to the picture show.

2. Asset based fees

The second way form is important to the protections afforded by the securities laws relates to the fee paid. Charging an asset-based fee can alter the dynamic of the relationship between a service provider and a customer and highlight the advice component of the services. As a result, the form of compensation may bear on whether a relationship should be considered advisory and regulated as such.

As a technical matter, the receipt of asset-based compensation has made the broker-dealer exclusion inapplicable to brokers receiving such compensation. After the FPA decision, asset-based fees must be considered “special compensation,” which vitiates application of the exclusion. The court’s ruling, however, does not address the more difficult normative issue of whether asset-based fees should transform a brokerage account into an advisory account. Because Congress could reverse the FPA decision with the stroke of a pen by striking the special compensation prong from the broker-dealer exclusion or by deeming asset-based fees not special compensation, the normative question is important.\textsuperscript{106}

Might the nature of compensation affect the nature of the relationship? There are differences from an investor’s perspective with respect to the type of compensation paid that go to the heart of why asset-based fees are preferable in some cases. Paying a commission is a one-time affair, akin to paying a turnpike toll or buying a ticket for an event. An asset-based fee, however, might lead to an expectation by the customer that the financial services professional will perform a tutelary role over the account, carefully husbanding the assets and monitoring

\textsuperscript{105} See RAND REPORT, \textit{supra} note 3 at 104-05. Rand asked respondents what kind of professional services with financial matters they would find most helpful. Possible responses were asset management, college-saving plans, debt management, developing a budget, executing securities transactions, financial planning, investment advising, retirement planning, or other. The top answers were retirement planning, investment advising, financial planning, and estate planning.

\textsuperscript{106} Congress could leave the broker-dealer exclusion in place but revise the text so that a broker would be excluded from the Advisers Act so long as the advice was solely incidental to brokerage. This would permit brokers to take advantage of the exclusion and still charge an asset-based fee.
performance. At a minimum, charging an asset-based fee will raise questions about the nature of the service the investor is paying for.\(^{107}\)

This difference reflects the way the law has developed. Historically firms drew a distinction as we have seen between charging commissions and charging asset-based fees. The payment of a commission was associated with a one-time transaction with no ongoing responsibility to monitor. Asset-based fees provided for an ongoing relationship – keeping the customer “constantly advised” as to what changes, in the opinion of the firm, should be made in the customer’s holdings.\(^{108}\)

This historical difference tallies with the law today. A broker’s “suitability” obligation, for example, arises on the event of a particular securities recommendation.\(^{109}\) Absent a recommendation, no suitability obligation exists. In \textit{de Kwiatkowski v. Bear Stearns & Co.}, the Second Circuit wrote that a broker has a duty neither to monitor an account nor to provide ongoing advice.\(^{110}\) However, when a broker charges an asset-based fee, such as a fee to sponsor a wrap account, the broker is responsible for monitoring.\(^{111}\) An advisory relationship is meant to be ongoing – it is expected to be long-term – continuing in perpetuity until terminated by one side.\(^{112}\) And an adviser as a recipient of an asset-based fee generally has a fiduciary obligation that covers all aspects of relevant activities with respect to the client’s account.\(^{113}\) Vigorous stewardship is the watchword for advisers, as opposed to the suitability of a particular investment.

An analogy to health care services is instructive. A debate has flowered for many years over the benefits of a fee-for-service structure versus a managed care structure funded through prepayment, often called capitation. The fee-for-service structure has been criticized for decades as being too atomistic, resulting in episodic care where doctors fail to establish long-term relationships with their patients.\(^{114}\) By contrast, capitation, at least in theory, should result in better medical planning. A prepayment structure is more akin to an insurance plan and allows for

\(^{107}\) Terri Cullen, \textit{As Schwab Returns to Discount Roots, Small Investors Face Shifting Choices} , WALL ST. J. ONLINE, Aug. 4, 2004 (“[I]nvestors will see a shift away from commissions to asset-based fees -- and that ultimately may make it harder for investors to know exactly what they’re paying for.”).

\(^{108}\) TWENTIETH CENTURY FUND, \textit{supra} note 17 at 649-50.

\(^{109}\) See NASD Rule 2310 (2008).

\(^{110}\) 306 F.3d 1293, 1302 (2d Cir. 2002).


\(^{113}\) Koffler, \textit{supra} note 2 at 6 n.30.

\(^{114}\) Note, \textit{The Role of Prepaid Group Practice in Relieving the Medical Care Crisis}, 84 HARV. L. REV. 887, 900 (1971).
comprehensive benefits, such as clinical care, diagnostic services, and therapy. In the domain of financial services, the Tully Report, discussed above, suggests why the payment of an asset-based fee might change expectations. When a broker-dealer charges a commission, it is compensated only when the customer trades. In many cases, however, the best advice an investor can receive is to “do nothing” as the Tully Report states. The very fact that a “do nothing” recommendation is possible suggests that a broker should be monitoring the account on a continuous basis even when no trading is called for, and not only when the broker might prevail upon the customer to trade. However, a broker-dealer paid on commission, unlike a broker paid an asset-based fee, is not compensated for recommending that the customer “do nothing.” Thus, a customer paying a commission, as opposed to an asset-based fee, might not expect ongoing monitoring and occasional advice not to trade.

This section demonstrates that the broker-dealer exclusion, as it is exists today, should not be available for brokers that market themselves as advisers or charge an asset-based fee. The next section extends the argument with a more ambitious claim that the exclusion should be abolished in its entirety.

B. The Relevance of the Broker-Dealer Exclusion

An assumption underlying the broker-dealer exclusion is that advice can be incidental to brokerage. For brokers that do not charge an asset-based fee or other special compensation, the exclusion is only available if advice is incidental. In this section, I demonstrate that advice generally can no longer be considered incidental to brokerage and the exclusion, therefore, should be repealed. I am not recommending, however, that all brokers that provide advice should be treated the same. In Part III, I propose treating brokers that continue to charge commissions and do not market themselves as advisers, although they provide advice, with a lighter touch than other brokers that provide advice.

115 Id. at 903-05.
116 See Harrell v. Total Health Care, Inc., No. WD 39809, 1989 WL 153066, at *5 (Mo. Ct. App. Apr. 25, 1989) (“A subscriber to Total Health Care, or to any other prepaid medical services plan, expects and assumes that the plan will cover the expenses of medical care.”); Chris Rauber, De-Capitating Managed-Care Contracts: Some Providers Say Global Capitation Has Tied a Noose Around Their Finances, MOD. HEALTHCARE, Sept. 6, 1999, at 52 (capitation payments are “expected to cover any and all healthcare services provided by a hospital, physicians and ancillary services.”); Edward Hirshfeld, The Case for Physician Direction in Health Plans, 3 ANNALS HEALTH L. 81, 85 (1994) (under capitation, “providers are paid a set amount per patient for a period of time, and are expected to provide all necessary services (as defined in the provider contract) to a specific patient population.”).
117 TULLY REPORT, supra note 47 at 10.
Understand the shifting sands between brokerage and advice necessarily raises the question of what Congress meant by the phrase “solely incidental” in the Advisers Act. When the SEC adopted rule 202(a)(11)-1, it stated that the phrase does not mean a minor or unimportant part of something else. Rather, said the SEC, because brokers’ advice was extensive when the Act was passed, the phrase “solely incidental” was meant to describe advisory services that were “in connection with” and “reasonably related to” brokerage services.\(^{118}\)

Even if brokers’ advice in the 1930s were substantial, the “incidental to” requirement suggests that brokerage must be of primary importance and advice secondary or the exclusion is unavailable. Consider the plain language meaning of the adjective “incidental” in the late 1930s when the Advisers Act was debated and drafted. A contemporaneous dictionary from 1938 contains three definitions for the term. The first describes an “incidental” event as “not of prime concern” and “subordinate” and the others similarly suggest one event as subordinate in importance to another.\(^{119}\) A thesaurus from the same year gives as synonyms for “incidental” the following words: accidental, casual, fortuitous, subordinate, contingent, occasional, adventitious, extraneous, and non-essential.\(^{120}\)

The Commission seems to agree that advice “incidental to” brokerage implies that the advice is a side occurrence that arises along with brokerage as the main occurrence. The Commission quotes the SEC’s Annual Report from 1941, which contrasts broker’s advice, on the one hand, and the broker’s “regular business” on the other.\(^{121}\) The primary quarrel between the SEC and the commenters who opposed the rule was whether the phrase “solely incidental” meant that the advice can be expected to occur in conjunction with brokerage (the SEC’s view), or that the advice must happen by chance or on an isolated basis (commenters’ view).\(^{122}\) The plain language meaning supports the commenters.

Regardless of who has the better of this Talmudic argument about how to interpret this 70-year-old adjectival phrase, the roles of brokerage and advice have inverted since that time and, therefore, we should no longer mistake brokerage for

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\(^{118}\) Adopting Release, supra note 7 at 20436 n. 135.
\(^{119}\) WEBSTERS NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1257 (2d ed. 1938). The same dictionary published in 1934 contains the same definitions. WEBSTERS NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1257 (2d ed. 1934).
\(^{120}\) RICHARD SOULE, A DICTIONARY OF ENGLISH SYNONYMS & SYNONYMOUS EXPRESSIONS 280 (Alfred Dwight Sheffield ed., 1938).
\(^{121}\) Adopting Release, supra note 7 at 20436 n.134 and accompanying text (quoting SECURITIES AND EXCHANGE COMMISSION, SEVENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION (1941)).
\(^{122}\) See, e.g., Letter of Duane R. Thompson, Group Director, Advocacy, Financial Planning Ass’n, to Jonathan G. Katz, Secretary, SEC, Feb. 5, 2005, at 10-11 (pointing to definitions of incidental as unpredictable or minor); Letter of Barbara Roper, Director of Investor Protection, Consumer Federation of America to Jonathan G. Katz, Secretary, SEC, Feb. 7, 2007, at 9 (stating that the SEC ignores the “minor or secondary” aspect of the term “solely incidental to”); Letter of Mercer Bullard, Founder and President, Fund Democracy, et al., to Jonathan G. Katz, Secretary, SEC, Feb. 7, 2007 (arguing that even under the SEC’s definitions, “solely incidental to” requires that brokerage be primary and advice resulting as a consequence of specific brokerage transactions).
the main event and view advice as a sideshow. A glance backward at the brokerage profession as it existed in the 1930s demonstrates that transaction execution, which today is largely automated, was once quite cumbersome, requiring the sedulous efforts of several professionals and entailing sound judgment on behalf of the broker. In the Depression era and before, trade execution was a vital function performed by Wall Street firms. As a result, it made sense to consider brokerage as primary and advice secondary. This ordering of brokerage over advice, however, is no longer apt.

1. The historical context of brokerage

Let us take a moment to examine the steps to accomplish a garden variety stock transaction in the 1930s. Say a customer was located at a branch office of an NYSE member firm and wanted to buy 100 shares of stock. The customer’s order was recorded by an order clerk and transmitted over a private wire to the firm’s main office. The main office received the order and handed it to another order clerk, who transmitted it by phone to the floor of the Exchange. The telephone clerk on the floor then prepared an order slip and pressed a button in his booth, which engaged a dedicated number for the firm on a large annunciator board, summoning the floor broker to his booth. With the order ticket in hand, the broker would buy the shares at the best price available.\(^{123}\)

The broker was the customer’s “representative” on the floor, required to exercise his best judgment on the customer’s behalf. Each stock trading on the floor was assigned to a post. When the broker arrived at the relevant post, he had to quickly surmise what the bid and ask prices were for the particular security and, if the order was a market order, he would agree to buy the shares from the broker offering the best price.\(^{124}\) This is one link in the chain where the broker had considerable discretion. An order to buy at market does not mean market price when an order is given but rather at the earliest possible time the trade can be executed. This norm was true in the 1930s, even in the case of great volatility.\(^{125}\) Since the market price is the best price that can be obtained at the time the transaction takes place, the purchase or sale must be made “in the best of faith.”\(^{126}\)

Once the transaction was completed, a reverse series of communications ensued. The broker sent his telephone clerk a memorandum reporting that he bought the shares from the selling broker. The clerk telephoned the report to the main office, which telegraphed the information to the branch, which mailed a confirming memorandum to the customer stating that the firm acquired the shares at the stated price.\(^{127}\) The process just described was for a simple transaction – a round lot (usually 100 shares) bought or sold at market. If the customer wanted to buy fewer than 100 shares, the transaction was arranged through a firm

\(^{124}\) Id.
\(^{126}\) Id.; see Fairbairn v. Rausch, 93 N.Y.S. 666, 669 (1905).
\(^{127}\) Hodges, supra note 123 at 19-24.
specializing in “odd lots,” necessitating another series of circuitous communications. Similarly, in the case of a limit order (an order to trade that is not at market price) yet another onerous set of procedures were employed entailing judgments of their own.

The complexity surrounding the execution of transactions and the judgment entailed in performing that service led courts in the earlier part of the twentieth century to hold that brokers were fiduciaries to their customers. This historical verity is a great irony of the current reform efforts to place fiduciary duties on brokers. One treatise from 1940 went so far to say, “The fiduciary character of the broker acting for his customer is too well fixed to admit of question.”

This designation often arose, however, not because of advice dispensed, but rather because of the complexity accompanying execution. As the difficulties of execution abated, so too has the stringency of the fiduciary duty imposed on broker-dealers and courts now disagree over whether brokers are fiduciaries.

Brokerage was a cumbersome process. It is no wonder that in 1940 Congress referred to advice that was solely incidental to brokerage. Even if advice was extensive and varied, it was dispensed in the context of the performance of brokerage services, which entailed several individuals and firms working in synergy and exercising professional judgment in a way that is unfamiliar today due to advances in technology.

2. Modernization

Changes in technology have eliminated the cumbersome features of manual brokerage described above. Computer technology born in the 1960s and 1970s revolutionized stock brokerage just as it transformed so many aspects of modern life. In the 1980s and 1990s, the New York Stock Exchange poured over

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128 Id.
129 Id.
130 See, e.g., Batterson v. Raymond, 149 N.Y.S. 706 (N.Y. Sup. 1914); Wahl v. Tracy, 121 N.W. 660 (Wis. 1909); Haight v. Haight & Freese Co., 92 N.Y.S. 934 (N.Y. Sup. 1905).
131 BLACK, supra note 125 at 211-212.
132 Cases and commentators generally state that brokers typically are not subject to fiduciary duties unless they have investment discretion over an account. See, e.g., S.E.C. v. Pasternak, 561 F. Supp. 2d 459, 499 (D.N.J. 2008) (“[T]he Supreme Court of New Jersey would likely follow the weight of the authority to hold that a broker is in a fiduciary relationship with a client, where that client maintains an account with the broker in which the broker, not the client, retains discretion.”). Some courts, however, disagree, stating explicitly that this perception is erroneous. United States v. Wolfson, 2008 WL 1969730 (S.D.N.Y. May 5, 2008) ("The essence of the argument is that there is no fiduciary relation between a broker and a customer unless the broker is handling a discretionary account. That is simply not true."). Similarly, California and other state courts hold that brokers generally are fiduciaries. See, e.g., Duffy v. Cavalier, 264 Cal. Rptr. 740, 751 (Ct. App. 1989) ("[T]he relationship between a stockbroker and his or her customer is fiduciary in nature; the distinction between a “sophisticated” investor and an “unsophisticated” one is not controlling in this regard.").
$1 billion into technology and was able to reduce execution time significantly.\textsuperscript{133} The NYSE launched the Design Order Turnaround (DOT) system in 1976 and Super-DOT in 1984, allowing buy and sell orders to reach the specialist electronically.\textsuperscript{134} In 1970, the National Association of Securities Dealers Automated Quotations (NASDAQ) developed the first electronic stock exchange and began trading in 1971. Historically NASDAQ facilitated trading in over-the-counter (OTC) stocks, those stocks which were unable to meet the listing requirements of the conventional exchanges. Before the advent of NASDAQ’s electronic exchange, to get the best price on a thinly-traded OTC stock, a trader might have contacted ten or more firms to obtain prices and then ascertain what quotes other traders in his own firm were getting before determining what he believed was the best price.\textsuperscript{135} This was an arduous process.

The 1990s marked the introduction of electronic communication networks (ECNs), offering fully automated transaction execution services. Instinet, one of the first ECNs, allowed broker-dealers to post their interest in buying or selling NYSE or NASDAQ stocks. Other brokers then could respond to these indications of interest with bids or offers of their own and Instinet would process and report the transaction.\textsuperscript{136} ECNs employ algorithms, step-by-step instructions on how to match trades, such as prioritizing large orders over small ones, or older over newer.\textsuperscript{137} They can electronically route orders to the best market taking into account quote size, quote price, the availability of automatic execution, and relevant costs or rebates.\textsuperscript{138} These algorithms replaced much of the judgment employed by brokerage professionals in years past.

As a result of these breakthroughs, brokerage execution became largely computerized. Customers enjoyed reductions in the cost of trading to fractions of a penny per share. One on-line brokerage boasts commission rates of $0.005 or less per share for stocks and ETFs.\textsuperscript{139} Others offer commission-free trading for certain on-line accounts.\textsuperscript{140} Thus, the idea that most advice provided today by broker-dealers is or could be considered solely incidental to brokerage sounds fanciful. It comes as no surprise that brokerage firms market themselves as providing trusted

\textsuperscript{134} Id. at 898.
\textsuperscript{135} BROOKS, supra note 46 at 22.
\textsuperscript{136} Markham & Harty, supra note 133 at 899.
\textsuperscript{137} Id. at 902.
\textsuperscript{138} Interactive Brokers Quarterly Order Routing Report, Quarter Ending March 31, 2009. When a customer places a limit order, he “takes liquidity” imposing a cost, when he places a market order, he “provides liquidity” reducing costs and allowing rebates. See id.
advice, calling themselves financial advisers, as opposed to stockbrokers. Providing information and advice is signal role of a broker-dealer; the purchase or sale, once a decision to invest is made, is secondary. Since the factual predicate for the exclusion is gone, Congress should repeal it.

This section demonstrates that the solely incidental test is no longer a useful test to distinguish brokers from advisers. One could make a case for leaving the broker-dealer exclusion in place for brokers that do not charge special compensation, that is, for brokers that continue to charge commissions. In 1940, however, Congress decided that both criteria must be met to qualify for the exclusion – the broker must receive no special compensation and advice must be solely incidental to brokerage. Congress believed that an adviser, even one that charges commissions, should be subject to the Advisers Act if its advice was not solely incidental to brokerage. There is no reason to second-guess that wisdom today just because the concept of “solely incidental” advice is no longer viable.

If brokers offering fee-based accounts do not qualify for the exclusion, or if the exclusion is repealed in its entirety, brokers providing advice would be considered advisers and subject to advisers’ fiduciary duties. This development would satisfy the Administration’s call to impose fiduciary duties on brokers giving advice and to harmonize the regulation of brokers and advisers. The call to impose fiduciary duties on broker-dealers, however, raises deep tensions that go to the heart of a broker-dealer’s role and pre-date the Exchange Act itself. Treating brokerage accounts as advisory account also raises significant resource concerns for the SEC. I explain and address these objections in Part III.

III. OBJECTIONS TO TREATING BROKERS AS ADVISERS

If broker-dealers that provide advice can no longer take advantage of the exclusion, they would be regulated as advisers and considered fiduciaries to their clients. Imposing fiduciary duties on broker-dealers, however, presents difficult substantive and procedural issues of its own.

A. The Contradiction in the Broker-Dealer’s Role

1. Dealing and underwriting

The proposal to place fiduciary duties on brokers and harmonize the law governing brokers and advisers focuses on the similarities between them but ignores key differences. These differences, however, bedevil any attempt to resolve the conundrum set forth in Part I. Unlike advisers, broker-dealers often sell

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141 TULLY REPORT, supra note 47 at 3 (“The most important role of the registered representative is, after all, to provide investment counsel to individual clients.”); see also SEC Press Release: SEC Charges Ameriprise in Fraudulent Scheme to Obtain Undisclosed Compensation, July 10, 2009, available at www.sec.gov/news/press/2009/2009-155.htm (“Few things are more important to investors than getting unbiased advice from their financial advisers.”).

142 See Koffler, supra note 2 at 4.
Brokers and Advisers

Oct. 10, 2009

securities from their own inventory, acting in a dealer capacity, and they sell securities on behalf of an issuer, acting as a securities underwriter. The Administration’s White Paper and draft legislation do not distinguish between the broker and dealer roles of most broker-dealer firms.143 The proposal states that a broker that acts as agent cannot be distinguished from an adviser, but it is silent about the firm acting as a dealer and provides no guidance on whether dealers should be treated the same as agents. A legislative fiat declaring brokers to be fiduciaries is too facile a solution. It sweeps under the rug a series of conflicts, which occupied Congress and the SEC in the 1930s, and which must be acknowledged and addressed if regulatory reform is to succeed.

a. Dealers

Many broker-dealers make markets in certain securities or hold securities in proprietary accounts to generate trading profits. As dealers, these firms often buy securities from or sell securities to their customers. Acting as a dealer, however, is anathema to the fiduciary obligation owed to a customer and presents a classic conflict of interest.144 A fiduciary must act in the “best interest” of the customer, the standard generally employed by the courts.145 It is difficult, however, to reconcile a duty to act in the customer’s best interest with the dealer’s role. When acting as a dealer, the firm seeks to buy low and sell high – precisely what the customer seeks. It is hard to see how any dealer can act in the “best interest” of his customer when trading with her.

Moreover, the draft language put forth by the Administration and apparently supported by SEC Chairman Mary Schapiro contains a stricter “sole interest” test.146 The “sole interest” standard is drawn from trust law; it requires the fiduciary to decline any benefit from a transaction involving the trust assets.147 Thus, a sole interest standard would seem to rule out any transaction between a dealer and a customer if the transaction resulted in a benefit to the dealer. Taken literally, it could rule out advising a client and receiving a fee for providing advice because collecting a fee arguably is not in the client’s “sole interest.” The Administration’s proposal leaves unanswered how a strict fiduciary duty can be reconciled with this historical role.

This fundamental contradiction in the dealer’s role was the subject of a highly charged debate in the critical first years after the Exchange Act was passed.

143 See 1337, note 1 at 71; see also Draft Legislation, supra note 9.
145 See, e.g., SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008) (“Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors.”).
146 Schapiro, supra note 49 (“I support the standard contained in the bill Treasury recently put forth, which would require broker-dealers and investment advisers to act solely in the interests of their customers or clients when providing investment advice.”).
An early draft of the Act would have prohibited a broker from acting as a dealer or underwriter. The reason behind the prohibition, championed by John T. Flynn, a member of the Senate Banking Committee staff, was the inherent conflict when persons acting as agents for their customers enter the market and trade for themselves. Flynn, however, lost the fight and the controversial provision was stricken. Instead, Congress directed the SEC to study the feasibility of segregating the role of brokers and dealers. The resulting study was the Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, issued in June 1936. Conducting the study presented a second bite at the apple for Flynn and reprised the earlier legislative battle. An early draft recommended partial segregation, prohibiting broker-dealers from underwriting securities. Rankling its authors, however, the Commission rejected this proposal and opted for more tepid recommendations for yet more study.

Shortly after this second bruising battle, Flynn published his unexpurgated views in The New Republic. He excoriated the SEC for its “watery timidity” and recounted the abuses that have arisen from firms acting in multiple roles as “one of the most sordid and outrageous chapters in the history of American finance.” Flynn’s critique prefigured the SEC’s later attempts to resolve the conflict. The Commission has attempted to address the contradiction through application of the so-called “shingle theory.” In adopting the shingle theory, the SEC tried to strike a compromise. It would not condemn dealers from profiting from their customers, but it prohibited them from purchasing or selling securities substantially below or above market prices. The price had to be reasonable.

148 John T. Flynn, Other People’s Money, THE NEW REPUBLIC, Jan. 8, 1936, at 253 (“[N]o man whose primary function is a fiduciary one – that of an agent – should be permitted to enter the market in which he appears as an agent for others and to trade in that market for himself.”).
149 See SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (June 20, 1936) (“SEGREGATION REPORT”); for a discussion see SELIGMAN, supra note 24 at 144.
150 SEGREGATION REPORT, supra note 149 at 109; SECURITIES AND EXCHANGE COMMISSION, SECOND ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 23 (1936); see also SELIGMAN, supra note 24 at 148-149.
152 In a series of cases, the SEC held that when a firm transacts as a dealer, it nevertheless undertakes to act on the customer’s behalf. The theory was affirmed in Charles Hughes & Co., Inc. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944). The approach was called the “shingle” theory since the firm has hung out its shingle and thereby offered to act on the customer’s behalf and subject itself to enhanced duties.
153 The determination of whether prices are substantially below or above market could only be made on a case-by-case basis. Duker & Duker, 6 SEC 386.
154 Duker & Duker, 6 SEC at 389 (dealer must charge price “which bears a reasonable relation to the prevailing price” or disclose information to allow the customer to make an informed decision with regard to the transaction).
The compromise struck by the shingle theory stops short of requiring a dealer to act as a fiduciary. A fiduciary must act in the principal’s interest, treating the customer as it would treat itself. And there is the nub of the problem. It is in the customer’s interest not only to be treated reasonably, but also to sell at the highest possible price or purchase at the lowest. Thus, a fiduciary is not only obliged to deal with his principal fairly and reasonably, he also is obliged to help ensure that the customer receive or pay the best price possible. For a selling customer to receive the highest possible price, however, the dealer must pay the highest possible price, which is diametrically opposed to the dealer’s own interest. The SEC’s compromise – prohibiting an unreasonable price – was a satisfactory compromise but it is a non-fiduciary compromise. The gap between prohibiting an unreasonable price and helping the customer obtain the best price is vast, and it represents the difference between the duty of fair dealing and the fiduciary obligation.

b. Underwriters

Similar tensions arise when a broker-dealer engages in an underwriting. When a corporation raises money through the sale of securities to the public, it typically hires a broker-dealer to distribute the securities in a firm commitment or best efforts underwriting. In the first, the broker-dealer purchases the securities from the issuer and resells them to participating dealers or directly to investors.

155 See, e.g., Burdett v. Miller, 957 F.2d 1375, 381 (7th Cir. 1992) (“A fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith – in fact to treat the principal as well as the agent would treat himself.”); United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) (“The essence of a fiduciary relationship is that the fiduciary agrees to act as his principal's alter ego.”).

156 One might respond by stating that a dealer’s mark-up or mark-down is nothing more than a fee paid by a customer to buy or sell a security. This definition is consistent with common usage of the term. See Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18042, 18058 (proposed April 10, 2009). Charging a fee is not prohibited under a “best interest analysis.” Trustees, which owe strong fiduciary duties to trust beneficiaries, are permitted to charge a fee to administer a trust. MARY F. RADFORD, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 975 (2009) (“For some time a trustee has been allowed compensation in the United States.”). A principal trade, therefore, is arguably akin to charging a fee, and, therefore, consistent with one’s fiduciary duty. A mark-up or mark-down, however, is a unique type of fee; it is structurally different from a stated commission or asset-based fee. It is less transparent because it is built into the purchase or sale price of the security, and it is less likely to be separately analyzed by an investor, even if disclosed. Perhaps this explains the rules and interpretations imposed by FINRA with respect to limitations on mark-ups and mark-downs. See FINRA IM-2440-1 (Mark-Up Policy) (reaffirming five percent policy as a guide to determining what constitutes an unreasonable mark-up).

157 Participating dealers are not in privity with the issuer. They purchase from the lead underwriter or underwriters and sell to their own customers, pocketing the spread between what the pay for the shares and the sale price to investors. They are not subject to underwriter liability, but face liability under other provisions of the federal securities laws.
In the second, it agrees to use its best efforts to sell the securities on the issuer’s behalf at a pre-set price. In both cases, the firm’s métier is to complete the offering – move the merchandise – and get on with the next deal.

Acting on behalf of both the issuer and investor client raises a conflict of duty. This conflict is similar to a conflict of interest, but instead of a conflict between the broker-dealer’s self-interest and its duty to a customer or client, the firm is faced with conflicting demands of two opposing clients. The SEC recognized many years ago that simultaneously performing underwriting and retail brokerage can pull a firm in two directions. On the one hand, the firm must consider the needs of its issuer client to complete its capital raising. On the other hand, the firm must consider the interest of its customer in making a sound investment. The pressure on the broker-dealer to complete the underwriting can be overwhelming. The firm’s profit depends on the success of the distribution. Moreover, the inability to sell the shares signals to Wall Street that the broker-dealer is off its game possibly hindering future efforts to obtain business. These pressures serve up a strong incentive to sell the shares and may diminish a broker’s objectivity to its customer.

2. Resolving the fiduciary tension for broker-dealers

a. Dealers

How do we resolve these tensions? If brokers that give advice are to be regulated advisers, they would be required to act in the “best interest” of their

MARC STEINBERG, SECURITIES REGULATION 190 (5th ed. 2008). Although not underwriters, they face the same pressures to sell the shares to avoid holding the securities on their own books and to demonstrate to the market that they are successful participants in the deal. For an overview, see NASD, Exchange Act Release No. 17,371 (Dec. 12, 1980); STEINBERG, supra note 157 at 189.

Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, pt. I, at 439 (1st Sess. 1963) (explaining that multiple functions such as underwriting and brokerage leads to conflicts because each function entails separate obligations to particular persons).

In a firm commitment underwriting, unsold shares remain in the firm’s inventory and may be sold at a loss. In a best efforts underwriting, the firm may only receive a fee if all or a requisite number of the shares are sold. See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 120 (6th ed. 2009).

See Billings v. Credit Suisse First Boston Ltd., 426 F.3d 130, 139 (2d Cir. 2005) (“Underwriters have strong incentives to manipulate the IPO process to facilitate the complete distribution and sale of an issue. Underwriting is a business; competitive forces dictate that underwriters associated with successful IPOs will attract future business.”); COX, ET AL., supra note 160 at 119.

Temporary Rule Release, supra note 79 at 55027 (“[T]he broker-dealer’s incentives to ‘dump’ securities it is underwriting are greater for sales by a broker-dealer acting as an underwriter than for sales by a broker-dealer not acting as an underwriter of other securities in its inventory.”).
customers, which is in tension with their role as dealer. Recall that advisers are subject to the principal trading rule discussed above. Thus, one possible way to resolve this tension is to prohibit brokers that give advice from conducting any principal trading. This solution, however, would be severe and potentially eliminate much of the principal market for securities held by broker-dealers, a result presumably not intended by policy-makers advocating harmonization. As a result, a solution must be sought that is harmonious with fiduciary norms. I discuss two candidates below – disclosure and limitations on trading – rejecting the first and supporting the second.

i. Disclosure

The SEC had to address principal trading by broker-dealers after the FPA case was decided. As a result of that decision, broker-dealers offering fee based accounts became subject to the Advisers Act and to the prohibition on principal trading. The SEC recognized that fee-based customers who depended on access to principal transactions with their broker-dealer might be harmed. In late 2007, the SEC adopted a temporary rule, which relieved some of the restrictions of section 206(3) and permitted written or oral disclosure before a principal transaction occurs as long as other disclosures are made.

One potential solution is to adopt this temporary rule as permanent for all broker-dealers providing advice. Compelling more disclosure to combat conflicts of interest, however, is not necessarily in the client’s interest for several reasons. First, the philosophy of disclosure often assumes that information disclosed to individual investors will be filtered through advisers, brokers, lawyers, or other intermediaries. In the context of disclosure of principal trading, however, that filtering process is unlikely to occur since it is the broker-dealer itself propounding the disclosure.

Second, the theory behind disclosure assumes the recipient is aware of the direction and the magnitude of the bias caused by the conflict. Magnitude, in particular, is hard to estimate. Even if a customer understands that advice is biased, knowing how much to discount the advice is problematic. Behavioral finance teaches that this difficulty is exacerbated by influences, such as anchoring.

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163 Temporary Rule Release, supra note 79 at 55023.
164 Id. at 55028
166 Daylian M. Cain, George Loewenstein, & Don A. Moore, Coming Clean But Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest, in Don A. Moore, et al., Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine, and Public Policy 109 (2005).
where final judgments often are tied to initial starting points, even if those starting points are erroneous.\textsuperscript{167}

A third reason disclosure alone might not be effective – and may even be counterproductive – stems from the fact that regulators tend to view disclosure only from the perspective of investors. The orthodox view of disclosure is that investors should receive adequate information to make their own decisions.\textsuperscript{168} This view, however, ignores the effects disclosure might have on the dis closer as opposed to the disclosee. Empirical evidence indicates that requiring disclosure influences the behavior of those doing the disclosing to bias their advice more than they would have without making disclosure.\textsuperscript{169} These findings have important implications for the entire philosophy of disclosure that underlies much of the federal securities laws. Although I cannot explore those implications here, at a minimum, they raise questions with regard to whether disclosure of conflicts alone is an appropriate elixir.

\textit{ii. Limitations on trading}

A better solution is to permit both brokers and advisers to engage in principal transactions but only for readily marketable liquid instruments. This idea is not new. Ten years ago, the SEC staff commenced work on a rule proposal to provide principal trading relief in the case of readily marketable high quality equity and debt securities.\textsuperscript{170} Under this approach, the risk of dumping or unfair pricing

\begin{footnotesize}
\textsuperscript{167} See, e.g., Daniel Kahneman, Ilana Ritov, & David Schakade, Economic Preferences or Attitude Expressions? An Analysis of Dollar Responses to Public Issues, in DANIEL KAHNEMAN & AMOS TVERSKY, CHOICES, VALUES, AND FRAMES 665-66 (2008) ("Tasks in which respondents indicate a judgment or an attitude by producing a number are susceptible to an anchoring effect: the response is strongly biased toward any value, even if it is arbitrary, that the respondent is induced to consider as a candidate answer.").


\textsuperscript{169} Daylian M. Cain, George Loewenstein, & Don A. Moore, The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, 34 J. LEG. STUD. 1, 7 (2005). The study authors have provided two possible explanations for this result. Cain, et al., supra note 166 at 115. The first, strategic exaggeration, occurs where the advisor, knowing that disclosure might cause her advice to be discounted, will try to counteract that effect by skewing the advice even further. The second, moral licensing, occurs when disclosure is perceived to level the playing field and, consequently, the adviser may feel less obliged to worry about the interests of the recipient and, instead, pay more attention to her own self-interest.

\end{footnotesize}
would be diminished because it is relatively easy to obtain retrospective pricing information for these securities.\textsuperscript{171} As the SEC has explained, the “key issue” in unfair pricing allegations is determining the market price on which retail markups are based.\textsuperscript{172} Restricting principal trading to highly liquid securities addresses this concern. Moreover, since brokers and advisers already must maintain detailed books and records of their transactions, ex post surveillance should not be overly burdensome.\textsuperscript{173}

The difficulty lies in determining which securities should be considered readily marketable. At least one commenter on the SEC’s temporary rule provided a framework for identifying these securities. They include (i) certain money market instruments; (ii) U.S. government debt securities; (iii) investment grade corporate and municipal debt instruments; and (iv) large capitalization U.S.-exchange listed stocks.\textsuperscript{174} Although determining which securities qualify would be a fraught exercise, the SEC is in the business of drawing such lines and the rulemaking process, inviting notice and comment by interested parties, seems appropriate for this task. Once the particular securities are identified, firms should be able to code them for permissible principal trading. A final question, even in the case of liquid securities, is what mark up will be considered reasonable and what considered fraudulent, but existing law on this subject is well-developed.\textsuperscript{175}

\textit{b. Underwriters}

A more difficult problem looms in reconciling a broker-dealer’s conflict between the duty owed to the underwriting client on the one hand and the duty owed to customers on the other. As long as broker-dealers engage in securities distributions, this conflict is inevitable, but it might be possible to strengthen existing structures designed to protect investors during a securities distribution, particularly against fraudulent conduct.\textsuperscript{176} Although protecting against fraud is not tantamount to promoting a fiduciary duty, these structures as explained below might be strengthened to guard against abuses that might occur when the pressures to complete a distribution are high.

As a preliminary matter, the conflict may be less widespread than imagined for two reasons. First, a large percentage of securities distributed in


\textsuperscript{174} Jordan, supra note 171.

\textsuperscript{175} See \textit{LOSS & SELIGMAN}, supra note 24 at 3834-3843. Under this approach, a dealer still could hold securities that do not qualify as highly liquid, but it could not sell those securities to its own customers. Presumably the firms would establish information barriers separating the desk investing in illiquid securities and the persons dealing with customers.

\textsuperscript{176} COX, ET AL., supra note 160 at 115.
underwritings are sold to institutional as opposed to individual investors. Institutions typically are sophisticated investors and can fend for themselves.  
Second, there are a number of gatekeepers that play an important role in the underwriting process, such as auditors, lawyers, and the underwriters themselves. As stated, however, the underwriter is conflicted in a way that the lawyers, auditors, and other gatekeepers are not. My proposals, therefore, focus on the broker-underwriter, suggesting ways its role might be enhanced to resolve the tension in making it a fiduciary to its customers.

i. Prioritizing the broker’s duty

In propounding a fiduciary standard for brokers, Congress could clarify that the broker-dealer’s primary duty runs to the investor, not the underwriting client. Consider the nature of the duty owed to each. The duty to the investor includes, first and foremost, preservation of assets – a negative duty not to harm her by steering her to an unremunerative investment. By contrast, the duty to the issuer is a positive duty to assist the issuer in attaining its business goals. Elsewhere, I have described that in cases where a fiduciary faces a conflict of duty, the negative duty not to harm one client trumps the positive duty to assist another. Like the physician’s Hippocratic Oath, the first principle is “do no harm.” Consequently, when recommending that customers purchase securities sold in an underwriting, the broker must ask itself if the investment, although promoting the positive duty to assist the underwriting client, might at the same time harm the buyer.

Although regulators and courts occasionally refer to the duty underwriters owe to investors, they are less clear than they might be in stating that the duty to the customer trumps. In the classic formulations, such as Feit v. Leasco Data Processing Equipment Corp., courts equate the underwriter’s duty owed to the issuer with the broker’s duty owed to the investor: “Their duty is to the investing public under Section 11 as well as to their own self-interest and that duty cannot be

177 THOMAS LEE HAZEN, 1 LAW SEC. REG. § 4.24 (6th ed. 2009) (describing institutional investors as “sufficiently sophisticated” and with “sufficiently strong bargaining positions so as not to need the protections of federal registration.”). One should be careful not to overstate this point because sales to omnibus accounts controlled by advisers might be deemed sales to institutional investors. In that case, however, the adviser should have sufficient expertise to evaluate the transaction on a client’s behalf.

178 See JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 4 (2006) (discussing role of gatekeepers, such as auditors, attorneys, and investment bankers and highlighting reputational capital that would be lost if they condoned wrongdoing).

179 Arthur B. Laby, Resolving Conflicts of Duty in Fiduciary Relationships, 54 AM. U. L. REV. 75, 77-78 (2004) (arguing that when faced with a conflict of duties, courts resolve it in favor of the negative duty of loyalty representing minimum conduct to which the fiduciary must adhere as opposed to the positive duty of care, which is an open-ended duty to benefit the principal).

taken lightly.”

This formulation is too tepid if the broker-dealer is to owe a fiduciary duty to an investor. When disputes arise over whether an underwriter owes a fiduciary duty to an issuer, courts should recognize that the duty to the customer denudes the duty toward the issuer.

ii. Use of a Qualified Independent Underwriter

An additional possible reform to help ensure that an underwriter acts in a fiduciary capacity with respect to customers is to require an issuer conducting a public offer to engage an independent outsider to superintend the offering, with a skeptical eye to ensuring the interests of investors. One possibility is use of a so-called Qualified Independent Underwriter (QIU). NASD Conduct Rule 2720 requires a QIU to conduct its own due diligence and provide a pricing opinion when a conflict exists between an issuer and an underwriter participating in a distribution.

QIUs are employed when an issuer and an underwriter are affiliated or when an underwriter is conducting a distribution of its own shares. Under these facts, the relationship between the issuer and the underwriter is too close; acting together, they may not have the best interests of the investing public in mind. Consequently, although an affiliation between an issuer and an underwriter is permitted, a QIU must step in to help ensure investors are protected.

It is noteworthy that the NASD rule exempts certain types of transactions, such as an offering of a class of securities for which a bona fide market exits or a class of securities in one of the four highest rated categories of a Nationally Recognized Statistical Rating Organization. This exemption is consistent with the proposal above to permit principal trading in highly liquid securities.

The QIU model, however, is not a perfect fit. Typically a QIU does not receive a separate fee for its QIU-related services; rather, the QIU is one of the underwriters participating in the offering. Participating in the offering, however, raises questions about independence and efficacy. Thus, a better solution may be to require an underwriter serving as a QIU to refrain from participating in the

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182 This conflict is not just theoretical. In several recent cases, courts have held that an underwriter may owe a fiduciary duty to its underwriting client. EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31-33 (N.Y. 2005) (although underwriting agreement for an IPO did not itself create fiduciary duty, advisory relationship between underwriter and issuer was marked by trust and confidence and was fiduciary); Breakaway Solutions, Inc. v. Morgan Stanley & Co. Inc., No. Civ. A. 19522, 2004 WL 1949300, at *13 (Del. Ch., Aug. 27, 2004) (holding that issuer sufficiently alleged fiduciary relationship with defendant underwriters).
186 NASD Rule 2720(c)(3)(B); NASD Rule 2720(15)(g).
187 See PRIFTI, supra note 184.
underwriting and limit its fees to those earned by serving as a QIU. Even there, a QIU may be too passive if it wants to avoid alienating other broker-dealers it hopes to join in a future syndicate. This risk, however, may be countered by the enhanced reputation the QIU would enjoy if it were perceived as rigorous, which could result in more, not fewer, QIU engagements.

This Part began by demonstrating that placing fiduciary duties on brokers providing advice is inconsistent with their historical role. Only by acknowledging the tensions and finding ways to address them can reforms be effective. Aside from the tensions discussed in this section, eliminating the broker-dealer exclusion also would raise resource concerns. I turn to those administrative challenges in the next section.

B. Resource Constraints

Adding a large number of advisers and advisory accounts to the SEC’s regulatory purview would be burdensome for the agency. The SEC is chronically understaffed and lacks the resources to thoroughly oversee the adviser community today. The lack of resources has worsened in recent years. When the Obama Administration proposed financial services reform, critics charged that it did not publish a feasibility study or assess costs. Unless the SEC’s budget is significantly enhanced, an unlikely prospect, any attempt to determine whether broker-dealers should be regulated as advisers must consider the costs imposed and identify regulatory alternatives to minimize them.

In its rulemaking initiatives, the SEC estimated that fee-based accounts operated by broker-dealers hold approximately $300 billion. Moreover, if Congress removes the broker-dealer exclusion from the Advisers Act, this figure of $300 billion may be small compared to the total number of brokerage accounts, including commission-based accounts, which would be treated as advisory accounts. In this section, I review two possible regulatory approaches to address limited resources. The first is to raise the monetary threshold for the amount of assets under management that triggers SEC registration for investment advisers. The second and preferred solution is to exempt from Advisers Act registration certain broker-dealers providing advice, while preserving antifraud regulation under the Advisers Act for the exempt firms. As mentioned, establishing an SRO for advisers and restructuring the agency to be self-funded are alternatives that merit discussion but beyond the scope of this article.

188 Compliance Program of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925, Investment Advisers Act Release No. 2107, 68 Fed. Reg. 7038, 7039 (proposed Feb. 5, 2003) (“Our current resources permit us to conduct routine examinations of each of the 966 fund complexes and each adviser only once every five years, and during these examinations we are unable to review every transaction.”).
189 See Posner, supra note 10.
1. Registration thresholds

The SEC could increase the amount of assets under management triggering Advisers Act registration. In 1996, Congress split the regulation of advisers between the SEC and the state regulators. In the National Securities Market Improvement Act (NSMIA), Congress determined that the larger investment advisers, those with at least $25 million of assets under management, should register with the SEC while the smaller advisers should register with the relevant state securities regulator. The $25 million threshold has not changed since 1996 although doing so would be easy to accomplish. In section 203A of the Advisers Act, Congress gave the SEC explicit rulemaking authority to revise the dollar amount.

One objection to this approach is that it merely shifts a burden from the SEC to the states. Although I am unable to assess how individual states would fare, it is noteworthy that the umbrella organization for the state securities regulators, the North American Securities Administrators Association, Inc. (NASAA) advocates this change. In Congressional testimony, Fred J. Joseph, Colorado Securities Commissioner and NASAA President, stated that, in light of the passage of time, the SEC should expand the class of advisers subject to state registration by raising the threshold from $25 million to $100 million. Even small advisers today, he explained, might have more than $25 million of assets under management.

A second objection is that placing advisers under the jurisdiction of the states could be burdensome for the advisers. Under the Advisers Act, if an adviser registers with the SEC, it cannot be subject to the registration requirement of any state. When an adviser is not SEC-registered, several states may claim that the adviser must register. Thus, instead of registering with one jurisdiction (the SEC), a state-registered adviser may suddenly be obliged to register with New York, New Jersey, Connecticut, and Florida, each with its own set of requirements and charging its own fee.

The most critical question is whether pushing more regulation of advisers to the state level is appropriate from an investor protection standpoint. Enhancing the assets under management threshold, however, would not preclude SEC

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regulation of advisory accounts that are also brokerage accounts. Many brokerage accounts that would become regulated as advisory accounts would retain their status as brokerage accounts. As such, they would continue to be regulated by the SEC and FINRA.

2. Exemption from registration

i. Regulation versus registration

An alternative to address the large number of brokerage accounts, which would suddenly become advisory accounts, is to exempt certain of the firms offering the accounts from the registration provisions of the Advisers Act with respect to the accounts. The regulation of investment advisers and advisory accounts operates on a two-tier level. Under the scheme adopted by Congress, any person or firm that falls within the definition of adviser in section 202(a)(11) is regulated as an adviser unless excluded from the definition by statute. (The broker-dealer exclusion is one such exclusion.) All advisers are subject to the general antifraud provision of the Act, section 206, but not to most other provisions, which only apply to advisers that are registered or required to be registered with the SEC. 195 (The principal trading rule in section 206 is an exception; it applies to all advisers.) Moreover, when the SEC has adopted rules under the Act, even rules under section 206, it generally has made those rules applicable only to registered advisers. 196

Congress determined that certain advisers covered by the statute should be exempt from registration, although they remain subject to the statutory antifraud provision. In section 203(b) of the Act, Congress established several exemptions, the most notable of which is the private adviser exemption, applicable to firms with fewer than fifteen clients over the past year, that do not advise a registered investment company, and that do not hold themselves out to the public as an investment adviser. Using section 203(b) as a model, Congress could exempt some or all broker-dealers from adviser registration either through a statutory change or

196 See, e.g., Investment Advisers Act Rule 204A-1, 17 C.F.R. § 275.204A-1 (2008) (requiring an adviser registered or required to be registered to prepare a code of ethics); Investment Advisers Act Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1 (2008) (prohibiting any adviser registered or required to be registered from making certain advertisements); Investment Advisers Act Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2 (2008) (establishing custody rules for advisers registered or required to be registered); Investment Advisers Act Rule 206(4)-7 (requiring any adviser registered or required to be registered to adopt and implement compliance policies and procedures).
through granting the SEC explicit rulemaking authority to exempt this population from registration.

One problem with an exemptive approach is that enforcement of the antifraud protections would be difficult. There is generally no private right of action under the Advisers Act.\textsuperscript{197} Enforcement, therefore, would be limited to those instances when the SEC discovered potential fraud and commenced an investigation. Most solutions, however, raise problems of their own. Placing enhanced duties on brokers under the Advisers Act and the threat of an SEC enforcement action for breach of those duties, married with the possibility of state-law claims based on fraud or breach of fiduciary duty, may be preferable to leaving the current system in place where brokers can function like advisers but are stripped of the attendant obligations.

\textit{ii. Implementing an exemptive approach}

There are several options to implement this general exemptive approach. One possibility preserves the current broker-dealer exclusion. Instead of excluding those brokers from the Advisers Act in its entirety, as section 202(a)(11)(C) does today, however, some experts have suggested that Congress could exempt those brokers from the registration provisions. As a result, brokers that do not receive special compensation and provide advice “solely incidental” to brokerage would be exempt from registration, although they would remain subject to section 206. They also would be considered fiduciaries to their clients and comply with the principal trading rule. They would not, however, be subject to the myriad statutory and rule provisions applicable only to registered advisers. This approach, however, would be difficult to implement because, as explained in Part II, advice generally speaking is no longer “solely incidental” to brokerage. Thus, any scheme that relies on that anachronism should be dismissed, although it is a helpful starting point to consider other alternatives.

A second possibility is to provide an exemption from Advisers Act registration for any broker-dealer providing advice so long as that broker is registered with the SEC as a broker-dealer, subject to regulation by FINRA, and the provision of advice is subject to current broker-dealer rules. This approach would lean on the current regulatory scheme governing broker-dealers but it also would ensure that the antifraud provision of the Advisers Act, and the adviser’s fiduciary duty, applied to broker-dealers providing advice. For these brokers, adviser registration is arguably less important because the accounts already would be subject to detailed disclosure requirements in filings with the SEC and FINRA and subject to inspections and examinations. The problem with this approach, however, is that it would permit many dual registrant firms to deregister as investment advisers. Deregistrations would include firms advising discretionary accounts or wrap accounts, currently subject to Advisers Act regulation. These firms could move the accounts to the broker-dealer arm of their business and then deregister as an adviser, or stop treating the accounts as advisory accounts. This

\textsuperscript{197} Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 24 (1979).
approach, therefore, would result in less investor protection than provided by the current system.

It should be obvious that determining which broker-dealers should be exempt from adviser registration raises many of the thorny issues present today. Any regulatory solution, therefore, must be nuanced. A better approach would take into account the two characteristics discussed in Part II.A above, namely whether a broker-dealer markets itself as an adviser and whether it charges an asset-based fee. As discussed, holding oneself out as an adviser may lead an investor to expect that she is receiving protections under the Advisers Act and, in any case, this marketing may give rise to fiduciary duties by dint of the application of the law of agency. For regulators to ensure that customers entering into a relationship based on brokers’ marketing of advisory services receive the complete protections afforded by the Advisers Act, only those brokers not holding themselves out as advisers should be exempt from registration. Brokers that offer discretionary advice or a wrap account would be swept into the registered category because such services cannot be offered without holding oneself out as providing advice.

In addition, as discussed, customers with fee-based accounts may assume they are entering into a long-term relationship and receiving fiduciary protections. In crafting the exemption, Congress could take into account whether a broker providing advice receives special compensation. As long as a broker providing advice was paid on commission (did not receive special compensation) and did not market itself as an investment adviser, the broker, or the accounts established under these conditions, would be exempt from the registration provisions of the Advisers Act.

One could object to this approach as well. Congress and the SEC may wish to encourage firms to migrate to fee-based accounts. By giving relief to commission-based accounts, Congress would be establishing the wrong incentives. Although this concern should not be ignored, asset-based accounts present problems of their own because there is an incentive for the broker to ignore the account knowing that a fee will be forthcoming in any event – a problem called “reverse churning.”\(^{198}\) The problems inherent in commission-based accounts, in other words, are matched by a different set of problems in fee-based accounts. Thus, policy-makers may wish to avoid the heavy hand of encouraging one type of account over another. Finally, just to be clear, under this alternative, if a broker dispenses advice but does not hold itself out as an adviser and charges only commissions, it still would be considered an adviser for purposes of the antifraud provision of the Advisers Act and subject to fiduciary duties, but it would be exempt from Advisers Act registration with respect to the relevant accounts.

This section addresses the administrative consequences of regulatory reform. It is easy to call for more regulation, but resources are finite and more resources devoted to regulation in one area mean fewer in others. Requiring a large

\(^{198}\) LEMKE & LINS, supra note 40 at § 2.113 (“[C]oncern has been expressed that wrap fees may give rise to ‘reverse churning’ (i.e., a lack of trades in an account that otherwise would have been made had the client been paying separate commissions for them.”), available on Westlaw, at SECREGINA s 2:113.
number of brokers to become regulated as advisers might be a hollow gesture unless the SEC can conduct inspections and examinations and follow up with enforcement actions when needed. I hope the proposals discussed here will enliven the discussion of how this might be accomplished.

CONCLUSION

The financial crisis and the recent proposals for financial regulatory reform have put the longstanding debate over how to regulate broker-dealers and investment advisers in the crosshairs of Congress and government regulators. The SEC attempted to resolve the debate through rulemaking but the D.C. Circuit Court cut short the SEC’s attempt. The court’s decision, however, has given occasion for broader reflection on how to regulate financial services providers.

The broker-dealer exclusion, unquestioned for many years, has lost its value as brokers act more like advisers. Regardless of whether Congress abolishes the exclusion, brokers that dispense advice should be considered fiduciaries and their customers should receive the protections in the Advisers Act. There are objections, however, to placing fiduciary duties on brokers. An obligation to act in the sole interest – or even the best interest – of a customer cannot easily be squared with the self-interest inherent in trading for one’s own account or the interest of a broker-dealer in completing a distribution for an issuer. Although the tensions should not serve as obstacles to reform, we must address them before stipulating that brokers should be fiduciaries.

In addition, regulating brokers that give advice as advisers would swell the number of advisers subject to registration and have sweeping implications for the SEC’s resources. Here too, Congress and the SEC must arrive at a practical solution to ensure that a change in the regulation of broker-dealers can be implemented without detracting from the SEC’s other programs. I sketch alternatives to that end, such as revising the monetary threshold for registration or exempting brokers from adviser registration while subjecting them to the SEC’s antifraud authority under the Advisers Act.

It is a truism that crisis calls for change. The corporate debacles of 2000 and 2001 resulted in the Sarbanes-Oxley Act of 2002. The 1987 market break caused the exchanges to install circuit breakers, which can shut down markets to prevent volatility. The near-collapse of several wire houses in the late 1960s prompted Congress to establish the Securities Investor Protection Corporation to ensure brokerage customers are not impoverished when a firm fails. This pattern can be traced to the birth of the SEC in 1934 and earlier. The financial crisis of 2008 will be no different. Reform is around the corner and deciding which duties should be imposed on brokers is ripe for resolution. Before Congress and regulators act, however, they should recognize the strains potential reforms could produce and avert them.