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"Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?"

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Chairman Specter, and Fellow Senators:

I am honored to be before this Committee to discuss the proposed legislation, which would impose a fiduciary duty on brokers and dealers (and investment banks) to act in their clients' best interests and specify criminal penalties for its willful violation. This is an idea that has been discussed for years, but whose time has come because of recent developments. My basic message is that a fundamental hole exists in the financial reform proposals now before Congress that this bill fills. Conflicts of interest played a key role in causing the 2008 financial meltdown. Although no statute can eliminate all conflicts of interest, the proposed statute (with some modest proposed revisions) would compel investment banks to address them more carefully and cautiously. Symbolically, it would also state a simple idea that may have been forgotten by some: the client comes first!

Introduction

At last Tuesday's hearing, several Goldman executives were asked a simple question by Senator Susan Collins from Maine: Did they have a fiduciary duty to act in the best interests of their clients? They all appeared stumped by it, and one (Daniel J. Sparks, the former head of Goldman's mortgage department) responded ambiguously: "I believe we have a duty to serve our clients." Whatever that equivocal answer was intended to mean, the correct answer to Senator Collins's question is simple and (to most) surprising: broker-dealers do not owe a fiduciary duty to their clients,[1] except under special circumstances (such as a discretionary account) or under the law of a very few states (California is different from most other states in

[1] The leading precedents in the Second Circuit are International Order of Foresters v. Donaldson, Lufkin & Jenerette, 157 F.3d 933, 940 (2d Cir. 1998); de Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293 (2d Cir. 2002). The logic of these cases is that a fiduciary relationship requires two critical elements: (1) reliance by the customer on the broker, and (2) domination and control by the broker. See also U.S. v. Chestman, 947 F.2d 551, 568-69 (2d Cir. 1991) (en banc).

this respect).[2] Because the state law of New York applies to our principal capital markets, the truth is that Goldman (or any other New York-based investment banks) owes no general fiduciary duty to its clients.

Instead, investment banks (and broker-dealers generally) owe a much lesser obligation, which arises under the rules of the self-regulatory body with jurisdiction over them. That body – the Financial Industry Regulatory Authority (FINRA) – and its precursors, the NASD and the NYSE, have long promulgated what are known as "suitability rules." These rules, which derive originally from the NYSE's "Know Your Customer Rule," require that the broker-dealer in recommending to the customer the purchase or sale of a security must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[3] Although this means that a broker should not recommend a risky penny stock to an 80 year old widow on a pension, it has little application to institutional investors, and there is no private cause of action for its violation.[4] Moreover, the "suitability" rule requires only that the security is not unreasonable for the particular investor, given that investor's financial position – not that the sale or purchase be in the investor's best interests.

That is the key difference: a fiduciary duty requires the fiduciary to act in the "best interests" of its client, whereas the suitability norm requires only that the recommended security be "within the ballpark" in terms of what the broker knows (if anything) about the investor's needs and financial position. Also, under a suitability standard the broker is under no obligation to disclose (1) its own investment strategies (even when they are adverse to the client's), or (2)

[2] Massachusetts also takes an intermediate position. See Patsos v. First Albany Corp., 741 N.E. 2d 841 (2001).
[3] See NASD Manual, Conduct Rules, Rule 2310(a)(1996).
[4] One small qualification: to a limited extent, egregious violations of the suitability rule (such as in churning cases) may also violated Rule 10b-5. But see O'Connor v. R.F. Lafferty & Co. Inc., 965 F.2d 893 (10th Cir. 1992) (dismissing case on grounds that suitability violations were insufficient to violate Rule 10b-5).

that it believes, or has reasons to know, that a particular security is likely to underperform the general market for such securities.

The idea that an investment professional providing investment advice to its clients should act in the best interests of the client is hardly radical. Investment advisers have been subject to such a duty since 1940 (when Congress enacted the Investment Advisers Act of 1940). Clearly, the sky has not fallen in as a result of this legislative mandate in 1940. Indeed, last year when both the Obama Administration and the House Financial Services Committee proposed a financial reform bill that would have imposed a fiduciary duty (albeit in somewhat milder form) on brokers, the proposal drew little opposition at the time from the securities industry. Instead, the proposal was withdrawn because of fierce opposition from the insurance industry (and some financial advisors) – none of whom would be affected by this legislation. SEC Chairman Mary Schapiro has also supported legislation "that would mandate a uniform fiduciary standard for finance service professionals providing investment advice about securities to investors."[5]

A year ago, the issue of subjecting broker dealers to a fiduciary standard would have been viewed primarily as an issue of consumer protection for retail investors. Today, the issues at stake transcend simply the protection of retail investors (important as that goal is). The Goldman hearings last week and the SEC's complaint against Goldman raise serious issues about the level of integrity in our capital markets. Although I will leave it for the courts to resolve the issues in the SEC's complaint, the idea that an investment banking firm could allow one side in a transaction to design the transaction's terms to favor it over other, less preferred clients of the investment bank (and without disclosure of this influence) disturbs many Americans (including longtime Wall Street analysts). Such conduct is not only unfair, it has an adverse impact on

[5] Most recently, she made the above-quoted comment in a March 9, 2010 letter to Senator Christopher J. Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs.

investor trust and confidence and thus on the health and efficiency of our capital markets. Today, housing finance in the United States is stalled, and it may remain so long as global capital markets distrust the securitization process. To be sure, other participants in the capital markets share responsibility for this distrust (for example, the credit rating agencies), but the prospect that an investment bank can both assemble and sell a portfolio of financial assets to its clients, while betting against that portfolio, does not instill confidence. Reduced confidence means in turn that both investor resistance and a higher cost of capital become likely.

Finally, the case for mandating greater integrity on the part of investment bankers seems particularly justified when the very survival of that industry was attributable to a bailout financed by the American taxpayer. Congress has a responsibility to restrict dubious and risky practices that, while profitable in the short-run, could again injure both the health and integrity of our capital markets over the long run.

II. The Predictable Objections to a Fiduciary Standard

However unremarkable the idea is that a broker-dealer should behave as a fiduciary to its clients, the claim will be made in response by opponents that subjecting investment bankers to such a standard is infeasible, will place broker-dealers in a hopelessly conflicted position, and will expose them to excessive liability. This is a Chicken Little "the-sky-will-fall-in" claim, but its dubious logic needs to be examined. The core of this argument is the correct observation that a securities dealer inherently deals with both sides of the market – buyers and sellers, the "short" and the "long" side. Because the dealer is making a two-sided market, it will be argued that the dealer cannot act exclusively in the "best interests" of either side, because the interests of both sides are inherently adverse.

This is a straw man argument. In the Abacus offering (which supplies the fact pattern for the SEC's complaint against Goldman), Goldman was not a neutral dealer, but a soliciting placement agent. Acting as a placement agent for a securities offering that one has itself designed is very different from a dealer simply quoting a two-sided spread. The fact that Goldman lost money on the deal was because it could not sell out its offering (and so like an unsuccessful underwriter had to absorb the weak securities that it could not sell). As a placement agent selling its own offering, Goldman should have recognized an obligation to act in the best interests of those investors to whom it offered the Abacus offering. To be sure, in the case of a "synthetic" CDO (such as the Abacus offering), there inherently had to be a "short" side that bets against the offering, but Goldman should not have permitted one client to bias the deal in its own favor; nor should it have represented that a neutral and objective portfolio manager was selecting the portfolio if it knew that the "short" side was heavily influencing the selection of the securities in the portfolio.

Put differently, Goldman's obligations should have been the same whether it was selling a "real" CDO (which would have actually owned RMBS securities) or a "synthetic" one (in which credit default swaps are written with respect to "reference" RMBS securities). Investors who relied on Goldman in the case of a "real" CDO would have naturally expected that Goldman would have sought attractive securities that it did not expect to default). Put simply, this is why they came to Goldman: for its expertise and skill. That the CDO was instead a "synthetic" one and thus inherently involved a "short" side (and a credit default swap) changes nothing; the investor in the synthetic CDO should continue to be able to expect that Goldman is seeking attractive securities (not "dogs") to place in its portfolio.

The investor who comes to Goldman seeking to take a short position can suggest a specific portfolio to Goldman, and Goldman can if it wishes take the long side – at its own risk. But Goldman should not be able to pass on the "long" side risk of such a portfolio to its investors, because then it would not be acting in their best interests where the portfolio had been designed to favor the short side. The language in the amendment to S.3217 is consistent with this interpretation.

A second predictable objection will be that a fiduciary duty standard will expose the broker to liability for failure to warn the client (even a sophisticated client) about sudden changes in market conditions or business risks. Markets fluctuate rapidly, and macro-economic events can impact markets suddenly and in surprising ways. Suppose then that commodity prices, interest rates, or currency exchange rates begin to change, and this exposes a particular client to serious risk because of a trading position that he has knowingly taken. Is the broker liable to the client under a fiduciary standard if he does not promptly warn the client and advise him to modify or hedge his position? Carried to an extreme, such an obligation might require a prompt warning within a day or even hours. This would be, I agree, an onerous burden to place on the broker (and courts have declined to do so).[6] But the language in this proposed legislation does not impose any obligation on the broker in such a case. Rather, its fiduciary standard is carefully limited. Currently, it says:

> "A registered broker or dealer that provides investment advice . . . shall have a fiduciary duty to act in the best interests of the investor and to disclose the specific facts relating to any actual or reasonably anticipated conflict of interest . . ."

[6] This is essentially the fact pattern in de Kwiatkowski v. Bear Stearns & Co., 306 F.3d 1293 (2d Cir. 2002). In my judgment, this statute would not change the result in that case.

This limiting language ("that provides investment advice") has several important implications:[7] First, it would exempt the dealer who simply quotes a spread ($8 bid, $8.05 asked), because the broker is not providing investment advice. Nor is the broker under any continuing duty to warn the investor of any change in market conditions, because this language contemplates that the duty arises at the time of the giving of the investment advice. On the other hand, if the broker designs a product and expects to short it a day later, that is a "reasonably anticipated conflict of interest" and must be disclosed.

Another predictable objection will be that this proposed statute is unnecessary because the field is already fully regulated by Rule 10b-5 and by criminal statutes (such as the mail and wire fraud statutes) that reach all forms of securities fraud. This is again a half truth. Although the reach of Rule 10b-5 is broad, it has some well-known limitations. For example, (1) there must be a purchase or sale, and (2) there must be "scienter" – or an intent to defraud. Under proposed Section 15(a)(3)(A), the SEC could take enforcement action even if there was no purchase or sale, because the fiduciary obligation applies to the provision of investment advice to a client (even if a transaction does not occur). Similarly, the SEC could enforce Section 15(a)(3)(A) without showing scienter because fiduciaries are under a duty to do more than not defraud their client, but must act in their "best interests." (I, of course, recognize that there could not be criminal enforcement in the absence of scienter, but the SEC is already authorized by Section 21(d) of the Securities Exchange Act to seek an injunction for any violation of the Securities Exchange Act or the rules thereunder – and so can enforce this provision).

Until recently, it might have been argued that any violation of the proposed criminal provision in Section 15(a)(3)(B) would also violated the "Honest Services Fraud" statute (18 U.S.C. § 1346) and thus was superfluous and unnecessary. But, it is today clear that the Supreme

[7] I suggest below that this "investment advice" limitation could be made even clearer in proposed revised language.

Court is intent on invalidating Section 1346 as unconstitutionally vague. The Court took three cases this year involving Section 1346 and appeared skeptical at their oral argument of the Section's constitutionality.[8] We will know Section 1346's fate by late June. In contrast, the language of proposed Section 15(a)(3)(B) is far less problematic. It clearly is governed by federal law and specifies that its duty is to act in the investors' best interests (whereas Section 1346 referred generally to "the duty of honest services" without defining that duty's content in any way).

A final and frivolous objection is that imposing a fiduciary duty on broker-dealers will give rise to increased and non-meritorious private litigation against them. No private cause of action is proposed by this legislation, and hence, under existing Supreme Court precedents, private parties will not be able to sue based upon the proposed statute.[9] At most, a possibility exists that arbitrators in securities arbitrations may consider this provision in disputes between a customer and a broker (and that to me seems desirable). But clearly this statute will not support a class action.

On this basis, we should expect Section 15(a)(3)(A) to be enforced primarily by SEC civil actions, with only rare use of criminal prosecutions (although the existence of criminal penalties does, of course, carry an in terrorem deterrent threat).

III. Suggested Revisions

One change in the drafting of Section 15(a)(3)(A) seems plainly necessary to carry out its intended effect. Section 15(a)(3)(A) now provides that "a registered broker or dealer that provides investment advice . . . shall have a fiduciary duty . . . ," and Section 15(a)(3)(B) provides that "any person subject to a fiduciary duty under subparagraph (A)" commits a crime

[8] The cases included United States v. Black, 530 F.3d 596 (7th Cir. 2008) and United States v. Skilling, 554 F.3d 529 (5th Cir. 2009).
[9] See, e.g., Touche Ross & Co. v. Redington, 442 U.S. 560 (1979).

when they willfully breach that duty. Unfortunately, there is a gap here. The "registered broker or dealer" in Section 15(a)(3)(A) will almost always be a corporation, limited liability company or other legal entity – and not a natural person. As now drafted, only the legal entity would commit the crime. Possibly, corporate officers could be convicted of aiding and abetting the corporate entity's breach, but it would be simpler to directly impose this duty on the corporate executive or registered representative as well. Thus, I suggest that clause (A) read:

> "3(A) A registered broker or dealer, or any agent, employee or other person acting on behalf of such a broker or dealer, who (1) provides investment advice regarding the purchase or sale of a security or a security-based swap, or (2) solicits or offers to enter into a purchase or sale of a security or security-based swap with an investor, shall have a fiduciary duty to act in the best interests of the investor and to disclose the specific facts relating to any actual or reasonably anticipated conflict of interest relating to that security or transaction or contemplated transaction. The Commission may adopt such rules and regulations to define the full scope and application of this duty, to grant exemptions and to adopt safe harbors, if and to the extent it finds such additional rules, regulations, exemptions and safe harbors necessary or appropriate in the public interest or for the protection of investors."

The foregoing language applies to agents and employees and thus subjects them also to the fiduciary duty and to the criminal penalty in proposed Clause (B). This change is also needed because Section 15(b)(3) of the Securities Exchange Act, which generally covers employees and agents of a broker-dealer, expressly does not apply to Section 15(a). Because these proposed amendments are all to Section 15(a), Section 15(b)(3) would be inapplicable to them. Next, this amendment makes clearer that the broker-dealer must be providing investment advice or soliciting investors to enter a transaction before its fiduciary duty is triggered. Finally, this revision authorizes the SEC to adopt exemptions and safe harbors to the extent consistent with the public interest and the protection of investors. This will respond to any fears of overbreadth or unintended consequences.

With respect to Clause (B), the proposed statute's criminal provision, I have two comments (besides my earlier comment that it will be inapplicable to individuals in the absence of the changes discussed above):

First, criminal liability hinges on the defendant attempting "to effect . . . any transaction" or "to induce . . . the purchase or sale of any security." But a defendant for corrupt or self-interested reasons could seek to convince an investor not to sell or not to purchase securities. For example, the broker might wish to convince the investor not to invest in a transaction offered by a competitor, and this conduct could also breach a fiduciary duty. Although this is a more remote prospect, a modest revisions to Clause (B) could include this conduct as well by prohibiting the communication of materially misleading investment advice.

Finally, there is the question of penalties. This proposed provision will reach a wide range of misconduct, some of it serious, some of it less so. Persons who commit crimes of lesser culpability do not need to face a 25 year sentence. One way to draw a rough but sensible distinction would be to provide that in cases involving gains to the broker-dealer, or losses to investors, of less than $1,000,000, the maximum penalty should be no more than five years. Of course, reasonable people can disagree on at what point a penalty becomes disproportionate to the gravity of the crime. Still, as a former Reporter to the American Bar Association for its standards on "Sentencing Alternatives and Procedures" in connection with its Minimum Standards for Criminal Justice Project, I would point out that the American Bar Association has taken the position that sentences in excess of ten years should be reserved for exceptionally serious offenses committed by exceptionally dangerous offenders. On that basis, I would recommend reducing the 25 year maximum penalty and in addition providing a lower ceiling (probably around 5 years) for offenses that did not result in a high gain or loss.

I do agree, however, that criminal penalties are particularly effective in deterring white collar crime.

CONCLUSION

The time has come for Congress to state clearly that broker-dealers must recognize a fiduciary duty. Eight years ago after the burst of the dot.com bubble and when Enron and WorldCom had just collapsed in fraud, we faced a similar moment when Sarbanes-Oxley was enacted, and we saw then that some securities analysts had ignored their duties to their clients. The now infamous Jack Grubman of Salomon and Citicorp had even proclaimed that wearing multiple hats as both an investment banker to management and an analyst to investors was "not a conflict, but a synergy." That same sentiment seems to have arisen again, proving that some in the industry do not learn. Predictably, this same moment will arise again, years from now perhaps, unless the broker's obligations are more clearly specified. It is time to complete what Sarbanes-Oxley began and clearly state the broker's obligations.

Once, "placing the customer first" was the clearly understood norm for investment banks, as they knew they could only sell securities to clients who placed their trust and confidence in them. That model was also efficient because it told the client that it could trust their broker and did not need to perform due diligence on, or look between the lines of, the broker's advice. But, with the rise of derivatives and esoteric financial engineering, some firms may have strayed from their former business model. Both to protect investors and to maintain market transparency and economic efficiency, the traditional norm that brokers should serve their clients (and not seek to profit from their losses) should be legislatively mandated.