EXTENDING FIDUCIARY DUTIES TO BROKER-DEALERS: YES, WE CAN & YES, WE SHOULD

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I. INTRODUCTION

With three simple words – Yes We Can – Barack Obama won the hearts and minds of millions of Americans and became the 44th President of the United States of America. President Obama, then-senator, spoke those words almost three years ago during a time when America's economy was in no apparent danger. A time when the Dow Jones Industrial Average had reached record highs, soaring above 14,000 points.

Since then, however, America's economy has been hard hit by the global financial crisis. A crisis in which Americans witnessed the Federal Government bail out financial institutions like Citigroup and Bank of America, only to witness others collapse, such as financial giants Lehman Brothers and Bear Stearns. In the midst of the financial turmoil, investor confidence plummeted, the financial markets crumbled, and politicians scrambled to find a solution.

As these events unfolded, many investors were left holding risky investments, most of which were represented as safe and secure. As a result, arbitration claims filed with the Financial Industry Regulatory Authority (FINRA) sky-rocketed. In defending these cases, broker-dealers took a hard-line approach, labeling the global financial crisis as the "perfect storm" and a "once-in-a-century credit tsunami." Wall Street – ironically – blamed the very financial markets and credit rating agencies it was responsible for maintaining.

But as much as these events propelled America's economy towards a recession, they also cleared the path towards much needed financial reform. During the summer of 2009, President Obama proposed sweeping overhaul of the United States financial regulatory system, calling it "a transformation on a scale not seen since the reforms that followed the Great Depression." One year later, on July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which among other measures, includes provisions for creating a uniform fiduciary standard for professionals who provide personalized investment advice to customers.

Currently, the fate of a uniform fiduciary standard rests in the hands of the U.S. Securities and Exchange Commission (SEC). Specifically, section 913 of the Dodd-Frank Act gives the SEC the authority to write rules that would create a uniform fiduciary standard for broker-dealers. The SEC, however, can only create these rules after it studies the effectiveness of existing standards of care for broker-dealers and investment advisers. As it stands now, investors who turn to financial professionals often do not realize that there is significant difference between the standards of care of brokers and investment advisers.

Accordingly, this Comment will argue that a uniform fiduciary standard will protect investors by increasing their chances of succeeding in cases under Rule 10b-5 of the Securities Exchange Act of 1934. Part II will provide a brief overview of the different standards of care of broker-dealers and investment advisers. Part III will conclude by examining the proposed uniform fiduciary standard's impact on securities litigation and arbitration in connection with the "Prospectus Defense," which is a common defense used by brokerage firms in Rule 10b-5 cases.

II. BROKER-DEALERS VS. INVESTMENT ADVISERS: A BRIEF OVERVIEW

In 2005, the SEC recognized the importance of creating a uniform fiduciary standard for professionals providing investment advice to customers, calling for a study to address whether brokers who provide financial advice should be subjected to fiduciary obligations normally imposed on advisers.[1] Four years later, the financial crisis paved the way for the Obama Administration to propose major financial reform "to increase fairness for investors."[2] One such way of increasing fairness was to "establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers."[3]

As the Obama Administration recognized, investors who turn to financial professionals for investment advice are often either unaware of or confused about the differences between broker-dealers and investment advisers.[4] Indeed, in a 2008 report, the authors concluded that many survey participants "did not understand key distinctions between investment advisers and broker-dealers — their duties, the titles they use, the firms for which they work, or the services they offer."[5] Specifically, although broker-dealers and investment advisers often provide the same financial services, they are regulated under different frameworks.

Investment advisers, who are regulated under the Investment Advisers Act of 1940,[6] are held to a fiduciary duty standard of care, which requires them to act in the best interests of their clients and make full and fair disclosure to clients with respect to conflicts of interest.[7] Although the Advisers Act does not expressly impose a fiduciary duty upon investment advisers, the United States Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.*,[8] evaluated the history of the Advisers Act and found that Congress intended for the Act to be interpreted broadly.[9] The Supreme Court then held that Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers by operation of law.[10] Years later, the Supreme Court, in *Transamerica Mortgage Advisors, Inc. v. Lewis*,[11] reaffirmed that the Advisers Act established

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[1] *See Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Exchange Act Release No. 34-51523, 70 Fed. Reg. 20424 (Apr. 19, 2005) (proposing study that would address whether "broker-dealers who provide investment advice but who are excepted from the Investment Advisers Act [should] nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers").

[2] *See* U.S. DEPT. OF TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, 71 (2009).

[3] *Id*.

[4] *Id*.

[5] *See* Angela Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, 112, 117 (2008), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

[6] The Advisers Act describes an investment adviser at "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11) (2010).

[7] *See Information for Newly-Registered Investment Advisers* (Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations) (stating that investment advisors "have a fundamental obligation to act in the best interests of [their] clients and to provide investment advice in [their] clients' best interests. [They] owe [their] clients a duty of undivided loyalty and utmost good faith. [They] should not engage in any activity in conflict with the interest of any client…" *available at* http://www.sec.gov/divisions/investment/advoverview.htm.

[8] 375 U.S. 180 (1963).

[9] *Id*. at 195.

[10] *See id*. at 195-96.

[11] 444 U.S. 11 (1979).

"federal fiduciary standards" for investment advisers.[12]

Conversely, broker-dealers, who are regulated under the Securities Exchange Act of 1934,[13] are not held to a fiduciary standard of care in most states, but rather, a "suitability" standard of care and "know your customer"[14] requirement. The Financial Industry Regulatory Authority (FINRA),[15] formerly known as the National Association of Securities Dealers (NASD),[16] imposes upon broker-dealers suitability and due diligence obligations when recommending investments to customers.[17] Specifically, Rule 2310(a) outlines the "suitability" obligation, providing that in recommending securities to customers, a member "shall 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."[18] With respect to due diligence, subsection (b) of the rule places an affirmative duty on the broker before a recommended order can be executed to "make reasonable efforts to obtain information concerning the customer's financial status; the customer's tax status; the customer's investment objectives; and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[19]

III. THE UNIFORM FIDUCIARY STANDARD'S IMPACT ON THE PROSPECTUS DEFENSE IN RULE 10b-5 CASES

The line of demarcation between broker-dealers and investment advisers has not protected investors from fraudulent and deceptive acts. Instead, many investors have been lured into a false sense of security by placing their trust and confidence in their brokers, only to later find out that their brokers did not owe them a fiduciary duty. Consequently, the absence of a fiduciary relationship has left investors vulnerable to securities fraud, which has been one of the main factors that led to the financial crisis.

A particular area where this is apparent is where investors rely on their brokers' advice only to later find out that their reliance was unjustifiable, barring them from recovering any damages. In securities litigation and arbitration cases, the concept of "justifiable reliance" has become a reoccurring theme through what has commonly become known as the "Prospectus Defense."[20] To defeat the prospectus defense, investors must "justify" their reliance on their

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[12] *Id*. at 17-18.

[13] The Exchange Act defines a broker to include "any person engaged in the business of effecting transactions in securities for the account of others," while a dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. §§ 78c (a)(4), (a)(5) (2010).

[14] *See* NYSE Rule 405, DILIGENCE AS TO ACCOUNTS.

[15] On July 26, 2007, the SEC approved the merger between the enforcement and arbitration functions of the New York Stock Exchange and NASD, creating "[FINRA], a single watchdog for brokers from Wall Street to Main Street." *See* Carrie Johnson, *SEC Approves One Watchdog for Brokers Big and Small*, WASH. POST., July 27, 2007, at D02.

[16] In July 2007, the NASD officially changed its name to FINRA and its internet domain from www.nasd.com to www.finra.org. *See* FINRA's News Release, *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA*, *available at* http://www.finra.org/Newsroom/NewsReleases/2007/p036329 (last visited Aug. 27, 2010).

[17] *See* FINRA Rule 2310, RECOMMENDATIONS TO CUSTOMERS (SUITABILITY).

[18] *Id*.

[19] *Id*.

[20] The scope of this Comment is limited to material misrepresentations since material omissions do not require

broker's oral representations that contradicted risk disclosures in written materials, such as a prospectus.[21]

According to the SEC, delivery of a prospectus does not absolve a broker of liability for misleading oral statements.[22] As an independent United States governmental agency, the SEC is responsible for enforcing federal securities laws and regulating the securities industry.[23] Within this enforcement context, the SEC has held that, "a registered representative may be found in violation of the NASD's rules and federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to the customers."[24] In fact, the SEC – in its commitment to protecting investors – has long held that "those who sell securities by means of representations inconsistent with [information in prospectuses] do so at their peril."[25]

As the largest self-regulatory organization for all securities firms in the United States, FINRA also adheres to this principle. FINRA regulates firms by adopting and enforcing rules and regulations.[26] In publishing *Regulatory Notices*, FINRA provides brokerage firms with timely information on a variety of issues, such as recently approved rules and amendments, proposed rules on which FINRA solicits comment, and legal interpretations and guidance relating to existing rules.[27] A review of these notices reveals that FINRA has taken the position that risk disclosures in a prospectus do not insulate brokers from responsibility for making oral representations that contradict written risk disclosures.[28]

Despite the SEC's and FINRA's position that delivery of a prospectus should not absolve broker-dealers of liability for oral misrepresentations, the prospectus defense often comes into play in Rule 10b-5 cases. Specifically, if investors bring a claim under Rule 10b-5 of the Securities Exchange Act of 1934,[29] the prospectus defense may apply because Rule 10b-5

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positive proof of reliance. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (explaining that when deceit arises from nondisclosure in a Rule 10b-5 cases, positive proof of reliance is not a prerequisite to recovery).

[21] Section 2(10) of the 1933 Securities Act broadly defines "prospectus" to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . ." 15 U.S.C. § 77b(a)(10) (2010); *see also* Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 574-75 (1995).

[22] *See In re* Ross Secs., Inc., 41 S.E.C. 509, 510 (1963).

[23] http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 27, 2010).

[24] *See* Dep't. of Enforcement v. Reynolds, 2001 NASD Discip. LEXIS 17, at *35 (June 25, 2001); *see also In re* Klein, 52 S.E.C. 1030, 1036 (1996) (holding that broker's delivery of a prospectus to an investor did not excuse broker's failure to inform the investor fully of the risks of the investment package the broker proposed); *In re* Foster, 51 S.E.C. 1211, 1213 n.2 (1994) ("Notwithstanding [broker]Foster's distribution of the prospectuses, he is liable for making untrue statements of material facts and omitting to state material facts.").

[25] *See Ross*, 41 S.E.C. at 510.

[26] http://www.finra.org/AboutFINRA/index.htm (last visited Aug. 27, 2010).

[27] *See* FINRA's Regulatory Notices, *available at* http://www.finra.org/Industry/Regulation/Notices/2009/index.htm.

[28] *See* NASD Notice to Members 94-16, *NASD Reminds Members Of Mutual Fund Sales Practice Obligations* (Mar. 1994); *see also* NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds*, at 49 (Feb. 2003); NASD Notice to Members 03-71, *NASD Reminds Members of Obligations When Selling Non-Conventional Investments*, at 765 (Nov. 2003); NASD Notice to Members 04-30, *NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds*, at 339 (Apr. 2004).

[29] Rule 10b-5 provides that "it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would

requires justifiable reliance as an element.[30] In determining justifiable reliance, courts use an eight-factor balancing test,[31] which was first employed by the Tenth Circuit in *Zobrist v. Coal-X Inc.*[32] Under this balancing test, courts examine the following factors: (1) the plaintiff's sophistication and expertise in financial and security matters; (2) whether a long standing business or personal relationships exist between the plaintiff and the defendant; (3) the plaintiff's access to relevant information; (4) *whether the defendant owed a fiduciary relationship to the plaintiff*; (5) whether the defendant concealed the fraud; (6) the plaintiff's opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.[33]

However, if the SEC adopts a uniform fiduciary standard, courts will have to modify the balancing test in Rule 10b-5 cases involving oral misrepresentations. Under this modified version, courts will no longer need to determine whether a fiduciary relationship exists (*i.e.*, Factor No. 4), because a fiduciary relationship will always exist between investors and broker-dealers. The potential impact under this model is significant. While the existence of a fiduciary relationship is not a controlling factor in a court's justifiable reliance analysis,[34] the existence of a fiduciary relationship appears to increase an investor's chances of defeating the prospectus defense in 10b-5 cases. Indeed, a review of case law examining whether investors were justified in relying on their brokers' oral misrepresentations is telling. In cases in which a *fiduciary duty did not exist*, courts have often found that the investor's reliance was *unjustifiable*.[35] In contrast, in cases in which a *fiduciary duty existed*, courts have often found that the investor's reliance was *justifiable*.[36] Therefore, the existence of a uniform fiduciary standard will provide investors with strong evidence to succeed in 10b-5 cases by overcoming the justifiable reliance element.

The notion that the existence of a fiduciary relationship will enable investors to satisfy the justifiable reliance element in 10b-5 cases stems from the fact that a breach of fiduciary duty cause of action *does not* require reliance as an element.[37] According to both the Restatement

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operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2010).

[30] Rule 10b-5's language does not support a reliance requirement; however, since Rule 10b-5 is an implied cause of action, courts defined its elements and incorporated the reliance element from common law deceit. *See* Dunn v. Borta, 369 F.3d 421, 430 (4th Cir. 2004) ("Such federal claims have no statutorily-defined elements; rather, they were judicially created. And because the causes of action under section 10(b) and Rule 10b-5 are implied, the responsibility of defining those claims rests with the courts."); *see also* Basic v. Levinson, 485 U.S. 224, 243 (1988) (noting that reliance is an element of a Rule 10b-5 cause of action).

[31] *See, e.g.*, Kennedy v. Josephthal & Co., 814 F.2d 798, 804-05 (1st Cir. 1987); Brown v. E.F. Hutton Group, Inc., 991 F.2d. 1020, 1032 (2d Cir. 1993); Myers v. Finkle, 950 F.2d 165, 168 (4th Cir. 1991); Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991); Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992); Atari Corp. v. Ernst & Whinney, 981 F.2d 1025, 1029 (9th Cir. 1992); Zobrist v. Coal-X Inc, 708 F.2d 1511, 1516 (10th Cir. 1983); Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989).

[32] 708 F.2d 1511 (10th Cir. 1983).

[33] *Id*. at 1516 (emphasis added); *see also* Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976); G.A. Thompson & Co., Inc. v. Partridge, 636 F.2d 945, 955 (5th Cir. 1981); Nye v. Blyth Eastman Dillon & Co., Inc., 588 F.2d 1189, 1197 (8th Cir. 1978); Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 176-77 (9th Cir. 1976), *cert. denied*, 429 U.S. 896 (1976).

[34] *See* cases cited *supra* note 31.

[35] *See, e.g.*, *Kennedy*, 814 F.2d at 805; *Zobrist*, 708 F.2d at 518-19; *Brown*, 991 F.2d at 1032-33; *Davidson*, 973 F.2d at 1400-1401; Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1030 (4th Cir. 1997).

[36] *See, e.g.*, *Myers*, 950 F.2d at 168-69; *Bruschi*, 876 F.2d at 1530; Carr v. Cigna Sec., Inc., 95 F.3d 544, 548 (7th Cir. 1996); Holdsworth v. Strong, 545 F.2d at 696-97 (10th Cir. 1976); *Molecular Tech. Corp*., 925 F.2d at 918.

[37] Stanley v. Richmond, 41 Cal. Rptr. 2d 768, 776 (Ct. App. 1995); *see also* Brown v. Brewer, 2009 U.S. Dist. LEXIS 47535, at *7-8 (C.D. Cal. May. 29, 2009); Malone v. Brincat, 722 A.2d 5, 12 (Del. 1993) (stating that

(First) and Restatement (Second), "a fiduciary relation exists between two persons when one of them is under a duty to act for or to give *advice* for the benefit of another upon matters within the scope of the relation."[38] Under this standard, providing advice is an integral part of a fiduciary duty relationship. In fact, advice has taken over as the primary service performed by broker-dealers.[39] For years now, broker-dealer registered representatives have been labeling themselves as financial advisers, financial consultants, financial representatives, and investment specialists.[40] Since reliance on advice is a key component to a fiduciary relationship, investors should be entitled to rely on their brokers as fiduciaries, and therefore, not have to justify their reliance. For example, in discussing a fiduciary obligation, one commentator has explained:

> This missing element of reliance is perhaps one of the more interesting and often misunderstood aspects of the fiduciary obligation. Although many cases discuss the question of whether a borrower actually relied on the lender, and, if so, whether such reliance was reasonable under the circumstances, the *fiduciary relation does not require reliance, reasonable or otherwise.* One scholar expressed this point quite clearly when he wrote, "*the law entitles the entrustor to rely on the fiduciary's trustworthiness. The entrustor is therefore not required to show that he actually relied on the fiduciary* and the fiduciary has the burden of justifying self-dealing transactions."[41]

Further support for such a proposition is inherent in the nature of a fiduciary obligation with respect to trust and honesty. The Third Circuit, in *Straub v. Vaisman & Co.*,[42] perhaps explained it best, stating:

> A sophisticated investor is *not barred by reliance upon the honesty* of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts.[43]

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causation is not an element of an action for breach of fiduciary duty of disclosure).

[38] RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) (emphasis added).

[39] *See* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan G. Katz, Secretary, SEC, Sept. 24, 2004, *available at* http://www.consumerfed.org/pdfs/broker-dealer_rule_comment_ltr_09202004.pdf.

[40] *See* Hung, et al., *supra* note 5, at 74.

[41] Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 731 (1994) (quoting Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 824-25 (1983)) (emphasis added); *see also* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (explaining that "a fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior").

[42] 540 F.2d 591 (3d Cir. 1976).

[43] *Id*. at 598 (emphasis added); *see also* Professional Serv. Indus. v. Kimbrell, 834 F. Supp. 1289, 1301-03 (D. Kan. 1993) (finding reliance unjustifiable in the absence of a long-standing business relationship and fiduciary duty. "The absence of such a relationship would give PSI less reason to trust the Kimbrells, and thus weighs in Kimbrell's favor."); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 631 (1996) (explaining that "[o]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor . . . is quite likely and, for that reason alone, worthy of some protection").

With this principle in mind, the court rejected the defendant's argument that the investor's lack of due diligence rendered his reliance unreasonable.[44] The court explained that the broker "abused this trust [between him and the investor] to promote a transaction which otherwise would have been received with caution" by exploiting the business relationship in which the broker knew the investor was not likely going to investigate the merits of the recommendations.[45]

Since integrity is the mainstay of commerce, the presence or absence of some type of fiduciary relationship, whether it be imposed by law or as a matter of fact based on a long standing relationship of trust and confidence, should justify an investor's failure to investigate misrepresentations. For example, in *Zobrist*, the court charged the investor with constructive knowledge of the written risk disclosures found in the Private Placement Memorandum, and therefore, held that the investor's reliance on the defendants' oral misrepresentations was unjustified.[46] While weighing the factors, the court appeared to be mainly concerned with the fact that the defendants did not conceal their fraud from the investor since "they provided him with information and warnings which exposed the representations as false."[47] Under those circumstances, the court found that the investor acted recklessly "by intentionally closing his eyes to and failing to investigate the contradiction between the misrepresentations and the information in the memorandum."[48] In short, the apparent lack of due diligence by the investor trumped the intentional misrepresentations by the defendants.[49]

Although the investor's apparent failure to investigate the misrepresentations in the face of contradictory written risk disclosures appeared to be the court's primary concern in *Zobrist*, the absence of a fiduciary relationship and the lack of evidence of any long standing business or personal relationship also contributed to the court's finding. [50] Specifically, the court stated that while it was true the investor – who was a sophisticated businessman – had previously participated in investments with the broker, there was no evidence of any long standing business or personal relationship that would have justified the investor's reliance on the broker's oral misrepresentations.[51]

Therefore, if a uniform fiduciary standard existed at the time *Zobrist* was decided, the outcome should have been different. The existence of such a standard likely would have, at the very least, filled the void of a long standing business or personal relationship, which would have in turn, justified the investor's reliance on the misrepresentations. For instance, in limiting its holding, the court stated that "[w]e do not say that such reliance might not be justified under *different factual circumstances*."[52] The existence of a fiduciary relationship would have

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[44] *Straub*, 540 F.2d at 598.
[45] *Id*.
[46] 708 F.2d 1511, 518 (10th Cir. 1983).
[47] *Id*.
[48] *Id*. at 1518-19.
[49] *See id*.
[50] *Id.*
[51] *Id.*
[52] *Zobrist*, 708 F.2d at 1518 (emphasis added); *see also* Carr v. Cigna Sec., Inc., 95 F.3d 544, 548 (7th Cir. 1996) (limiting its holding like *Zobrist*, stating, "[w]e do not say that a written disclaimer provides a safe harbor in every fiduciary case. Not all principals of fiduciaries are competent adults; not all disclaimers are clear; and the relationship may involve such a degree of trust invited by and reasonably reposed in the fiduciary as to dispel any duty of self-protection by the principal.)" Therefore, *Carr* further supports the proposition that the existence of a fiduciary relationship or a long standing relationship will provide an investor with evidence to succeed in a 10b-5 claim despite the receipt of a prospectus that contradicted oral representations.

undeniably created a different circumstance, providing the investor a compelling reason, and thus, justification for accepting his broker's contradictions.

A different factual circumstance, however, was not necessary in finding that the investor's reliance was justified. According to Judge Holloway's dissenting opinion in *Zobrist*, he would have found in the investor's favor under the current factual circumstances of the case without the existence of a fiduciary relationship. Therefore, the existence of a fiduciary relationship should have been *more* than enough to find the investor's reliance justifiable. Specifically, in rejecting the investor's apparent recklessness, Holloway opined that "the federal policy of deterring intentional misconduct in securities dealings outweighs the policy of deterring negligent behavior by investors."[53] Holloway further explained that "[t]he majority's resolution of this issue defeats the main purpose of the securities law to protect from fraud and misrepresentation, unsoundly striking the balance in favor of the wrongdoers by penalizing a plaintiff for his neglect or recklessness in not discovering the defendants' intentional wrongs."[54] Therefore, "[t]he defendants are instead exonerated by a theory of constructive knowledge imputed to the plaintiff of the defendants' exculpatory boilerplate. Fashioning such a rule favoring those found guilty of knowing misconduct frustrates the important policy of the securities law and the [10b-5] Rule."[55] As a result, Holloway would have ruled in the investor's favor irrespective of whether a fiduciary relationship existed.

The Tenth Circuit's holding in *Holdsworth v. Strong*[56] further supports the proposition that a fiduciary relationship would have altered the outcome in *Zobrist.* In this case, on the basis of misrepresentations by a close business and personal friend, the plaintiff sold his stock in the corporation without first examining the corporate books and records.[57] Under those circumstances, the court found that the plaintiff's reliance was justifiable despite his sophistication and failure to investigate because the defendant had carefully cultivated the plaintiff's trust and confidence over a long period of time, and then used that trust to encourage the sale.[58]

With this in mind, the investor in *Zobrist* – despite his sophistication and apparent recklessness in failing to investigate the misrepresentations – should have been able to meet the justifiable reliance element if a uniform fiduciary duty existed at the time his case was decided. Specifically, like the investor in *Zobrist*, the investor in *Holdsworth* was sophisticated and failed to investigate the misrepresentations.[59] However, the court – unlike *Zobris*t – found that the investor's reliance was justified.[60] The key to reaching this conclusion was, of course, due to the existence of a long standing personal relationship.

A further review of circuit decisions in this context further reveals that the absence or presence of some form of a fiduciary relationship is often determinative on whether an investor's reliance is justifiable. While applying the eight-factor balancing test from *Zobrist*, the First Circuit, in *Kennedy v. Josephthal & Co.*,[61] found that the investors unjustifiably relied on their

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[53] *Zobrist*, 708 F.2d at 1522 (Holloway, J., dissenting).
[54] *Id*.
[55] *Id.* at 1520; *see also* Luksch v. Latham, 675 F. Supp. 1198, 1203 n.7 (N.D. Cal. 1987) (noting the force of Judge Holloway's dissent).
[56] 545 F.2d 687 (10th Cir. 1976).
[57] *Id*. at 689.
[58] *Id.* at 696-97.
[59] *Id*.
[60] *See id.*
[61] 814 F.2d 798 (1st Cir. 1987).

broker's oral misrepresentations.[62] In reaching this conclusion, the court found that although the investors had previously dealt with a particular broker from the brokerage firm, the investors did not deal with that same broker with respect to the investment at issue.[63] Under those circumstances, the court stated that the existence of a fiduciary duty was suspect since "[t]here was no record of trust between appellants [the investors] and Sinclair [broker]."[64] The court's reference to the investors' prior dealings with a specific broker from the brokerage firm implies that if the investors had dealt with that same broker with respect to the investment at issue, there might have been the trust necessary to find the investors' reliance justifiable.

The Second and Eight Circuits have also found reliance unjustifiable in the absence of a fiduciary relationship. In the Second Circuit case of *Brown v. E.F. Hutton Group, Inc.*,[65] none of the investors alleged the existence of a fiduciary relationship or of a longstanding business or personal relationship with the brokerage firm or its brokers.[66] The court, after weighing additional factors, ultimately concluded that the investors' reliance was unjustifiable as a matter of law.[67] Likewise, the Eighth Circuit, in *Davidson v. Wilson*,[68] did not find a fiduciary or longstanding relationship of trust between the investors and broker.[69] Although both cases, like many others, discussed other *Zobrist* factors in ultimately finding investors' reliance unjustifiable, the common missing factor in these cases was some sort of fiduciary relationship.[70]

Conversely, in cases in which courts found an investor's reliance justifiable, a fiduciary relationship was present. In *Myers v. Finkle*,[71] the Fourth Circuit held that summary judgment was inappropriate since there were genuine issues of material of fact as to whether there was a long standing personal and business relationship between the investors and defendants.[72] Specifically, the investors had claimed that they were "social friends" with the defendants, and had worked with them for years prior to the transaction at issue.[73] And in *Bruschi v. Brown*,[74] the Eleventh Circuit stated that "[the broker] was [the investor's] investment advisor and was more knowledgeable as to the economic and tax risks of the investment" and "as [the investor's] offeree representative [the broker] undertook a fiduciary obligation to act in [the investors] best interests."[75] The common denominator in these cases was the *presence* of some sort of fiduciary

[62] *Id*. at 805.
[63] *Id.*
[64] *Id*.
[65] 991 F.2d. 1020 (2d Cir. 1993).
[66] *Id*. at 1032.
[67] *Id*. at 1033.
[68] 973 F.2d 1391 (8th Cir. 1992).
[69] *Id*. at 1400-01.
[70] *See also* Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1030 (4th Cir. 1997) (finding reliance unjustifiable. Defendants "were not the agents of the Bank, but rather interacted with the Bank at arm's length in principal-to-principal dealings, and no common law fiduciary duty was ever created."); Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118, 125 (4th Cir. 1990) (finding reliance unjustifiable. "There [was] no evidence of a long standing relationship between the insurers and EPIC" and "there was no fiduciary relationship between EMI and the insurers. As a result, any dealings between EMI and the insurers should have been conducted as an arm's-length transaction").
[71] 950 F.2d 165 (4th Cir. 1991).
[72] *Id*. at 169.
[73] *Id*. at 168.
[74] 876 F.2d 1526 (11th Cir. 1989).
[75] *Id*. at 1530.

relationship, not the *absence* of a fiduciary relationship like in cases in which an investor's reliance was unjustifiable.[76]

Accordingly, although courts claim that no one factor from the eight-factor balancing test is determinative on whether an investor's reliance is justifiable, a closer examination reveals a different story. The presence or absence of some type of fiduciary relationship, whether it be imposed by law or as a matter of fact based on a long standing relationship of trust and confidence, is a key factor, and perhaps the most determinative factor, in cases involving Rule 10b-5 claims. This appears to be the case even in circumstances involving sophisticated investors who received a prospectus that contradicted their broker's oral representations. Indeed, common sense dictates that investors should be entitled to rely on their fiduciary's trustworthiness, and therefore, not be required to prove that their reliance was justified.[77]

IV. CONCLUSION

The financial crisis has left many investors holding risky investments that were marketed as safe and secure in which broker-dealers did not have their customers' best interests in mind. Consequently, securities fraud cases filed through FINRA increased during this time. In defending these cases, broker-dealers often utilize the "Prospectus Defense," seeking to avoid accountability for their fraudulent and deceptive acts. A uniform fiduciary standard, however, will alleviate these problems. Since most investors primary reason for seeking and retaining financial professionals, such as brokers and investment advisers, is to receive and rely on

[76] *See also* Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991) (finding that a reasonable juror could conclude that plaintiffs did not act recklessly in relying on alleged misrepresentations reliance. None of the plaintiffs personally knew or had a fiduciary relationship with the defendants).

[77] The author of this Comment is currently working on a sequel to this Comment entitled: *Unjustifying the Justifiable Reliance Element in Rule 10b-5 Cases* in which it is argued that since the presence of a fiduciary relationship often results in courts finding that investors were justified in relying on their brokers' oral misrepresentations, justifiable reliance in 10b-5 cases should be presumed or not required at all. In fact, justifiable reliance should not be required irrespective of whether the SEC adopts a uniform fiduciary standard. Indeed, the Supreme Court, in Basic v. Levinson, 485 U.S. 224, 243 (1988), has stated that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." However, the Court also recognized that "[t]here is . . . more than one way to demonstrate the causal connection." *Id*. Moreover, since a Rule 10b-5 cause of action is implied, courts defined its elements and incorporated the reliance element from common law deceit. *See* Dunn v. Borta, 369 F.3d 421, 430 (4th Cir. 2004); RESTATEMENT (SECOND) OF TORTS § 525 (1977). The Supreme Court, however, has stated that "[a]ctions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims." *See Basic*, 485 U.S. at 244 n.22 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-745 (1975)). In addition, section 12(a)(2) of the Securities Act of 1933 does not require reliance as an element to recover damages. *See* Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014, 1032-33 n.10 (5th Cir. 1990) ("We do not suggest that a purchaser has any duty to find out the truth under section 12(a)(2) . . . indeed, a purchaser who is actually ignorant that a seller's representation is inaccurate or incomplete may recover even though the full truth is apparent from materials in her possession. The concept of a plaintiff's constructive knowledge has no place in section 12(a)(2) actions."); *see also* Wright v. Nat'l Warranty Co., 953 F.2d 256, 262 (6th Cir. 1992) ("Unlike a Rule 10b-5 claim, however, reliance on alleged misrepresentations or omissions is not an element of a section 12(a)(2) cause of action. Because of this, a purchaser's investment sophistication is immaterial to a section 12(a)(2) claim. A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy."). Likewise, most states' blue-sky statutes (state securities acts) also do not require investors to prove reliance. *See* Bowden v. Robinson, 136 Cal. Rptr. 871, 877-78 (Ct. App. 1977) (stating that California's blue sky act "conspicuously avoids the requirement of actual reliance. The legislature is again expressing its intention to afford the victims of securities fraud with a remedy without the formidable task of proving common law fraud [which requires reliance])."

financial advice, a uniform fiduciary standard will ensure that all financial professionals providing investment advice act in the best interests of their customers. In addition, since investors should be entitled to rely on their financial professionals as fiduciaries, a uniform fiduciary standard will give investors the evidence they need to overcome the justifiable reliance element in Rule 10b-5 cases. After all, when brokers provide investment advice and seek to gain investor trust, it only makes sense to hold them to the same fiduciary standard as investment advisers.