April 10, 2018

Via Electronic Submission

Chairman Jay Clayton
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Standards of Conduct for Investment Advisors and Broker-Dealers

Dear Chairman Clayton:

Thank you for the opportunity to submit a comment regarding the Securities and Exchange Commission's ("the Commission") highly anticipated fiduciary rule that will set forth standards of conduct for investment advisors and broker-dealers. As a current law student at Georgetown University, I had the opportunity to write a research paper that examined the current and proposed fiduciary rules of the Department of Labor ("the Department") and the Commission and I came to the conclusion that both the Department and the Commission would benefit by focusing on the common law definition of 'fiduciary' when drafting their respective rules.

The common law goes into great detail describing what a fiduciary relationship is, who is considered a fiduciary, and what duties are owed by fiduciaries. It is important for the Commission to focus on the common law when deciding what standards investment advisors and broker-dealers should be subject to. The common law is expansive, offers great insight, and even though it is spread across multiple sources it can be summarized as follows: a fiduciary relationship involves 1) a personal relationship of trust and confidence; 2) that involves power asymmetries; 3) in which the fiduciary is acting on behalf of another; 4) for the benefit of the other person; 5) in which the fiduciary is subject to equitable duties; 6) these duties typically cannot be delegated away; and 7) both parties have manifested their intent to enter into such a relationship. By incorporating this definition into its rule, the Commission will be able to put forward a federal level definition of 'fiduciary,' establish a reasonable disclosure requirement, and broaden its enforcement authority.

First, by incorporating this common law definition into its rule the Commission will be furnishing a federal level definition of 'fiduciary.' Because of the breadth of the definition, the Commission will have extensive latitude to describe in what circumstances investment advisors and broker-dealers are considered common law fiduciaries. The Commission will have flexibility in the amount of guidance it chooses to give to the industry regarding the specific circumstances that give rise to a fiduciary relationship and may choose to provide that information in the new rule itself or with future guidance and no-action letters. Incorporating the common law definition of 'fiduciary' will also give the Commission the opportunity to say what duties are owed by fiduciaries, many of which are well described in the common law.

Second, because the common law requires two parties to manifest an intent to enter into a fiduciary relationship, the Commission's rule should include a disclosure requirement. Investment advisors and broker-dealers should have an affirmative duty to disclose that they are subject to fiduciary duties in the circumstances in which they are considered common law fiduciaries. Additionally, in the circumstances in which investment advisors and broker-dealers are not entering into fiduciary relationships, they should be required to disclose that they are not subject to fiduciary duties but rather are held to other standards of care. This disclosure requirement would be consistent with the common law, would be complementary to the other disclosure requirements used by the Commission, and would put retail investors on notice regarding the duties owed to them.

Lastly, by incorporating such a definition into its rule, the Commission will broaden its enforcement authority. Rather than using the anti-fraud provisions found in Section 206 of the Investment Advisors Act of 1940, and the rules promulgated thereunder, as the primary tool of enforcing fiduciary duties, the Commission will be able to rely upon this rule as an alternative authority for enforcing those duties.

With the Department's fiduciary rule vacated and its future unknown, the Commission is well positioned to use the authority given to it under Dodd-Frank to promulgate its own fiduciary rule, setting standards of conduct for investment advisors and broker-dealers. When drafting its rule, it is important for the Commission to focus on the common law. The common law definition of 'fiduciary' is extensive and will help settle the uncertainties surrounding the question of who is subject to fiduciary duties.

Thank you for your time and consideration. Please feel free to contact me with any questions or comments that you may have.

Sincerely,

Matthew Bodziak
J.D. Candidate – May 2018
Georgetown University Law Center

Enclosed:

- *What is a Fiduciary? From the Department of Labor to the SEC, Fiduciaries in the Finance Industry*. My research paper that sets out my analysis of the common law and my conclusion that the Commission should focus on the common law when drafting its fiduciary rule.

What is a Fiduciary?

From the Department of Labor to the SEC, Fiduciaries in the Finance Industry

Matthew Bodziak

December 18, 2017

Introduction

In 2017 the Department of Labor's (DOL) long-awaited fiduciary rule went into effect and since has caused much debate and confusion amongst federal regulators and the private industry. The legality of the rule has come into question, its ambiguity has caused uncertainty, and the rule's cost/benefit weighing has been questioned. Despite these concerns, and despite a new administration, this rule is still on the books.

In 2011, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Securities and Exchange Commission (SEC) reported blurring of roles between investment advisors and broker-dealers and how that has resulted in doubtfulness surrounding who is actually subject to fiduciary duties. The SEC has been authorized to create a uniform fiduciary rule that will provide clarity for the current state of play, but their rulemaking is still in the comment phase.

Both the DOL and SEC are well situated to provide the industry and consumers with clarity regarding who is subject to fiduciary duties. Last month the DOL implemented an eighteen-month delay of important aspects of their fiduciary rule and the SEC has reiterated that it is their priority to make a fiduciary rule. When creating and revising their fiduciary rules, these agencies need to act in unity and need to rely on the common law. Even though fiduciary

common law is spread across various sources, when synthesized it provides the best answer for solving the ambiguity currently faced by the DOL and SEC.

Department of Labor

The recent fiduciary rule promulgated by the Department of Labor is one example of how the concept of a fiduciary relationship is being blurred. The DOL administers the Employee Retirement Income Security Act (ERISA), which "is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans."[1] ERISA is an example of Congress defining what a fiduciary is and what duties are owed by the fiduciary; in fact, much of what Congress defined is very similar to portions of the common law definition.[2] The muddling of the definition of fiduciary is not from the Act. Congress has the authority to define what duties are owed by whom and even the common law definition of a fiduciary takes into account the concept that a fiduciary relationship can be limited in scope.[3] For this act, Congress chose to provide some modifications to the definition of fiduciary.

The muddling of the fiduciary concept resulted from the DOL's recent fiduciary rule promulgation. The fiduciary rule expands the scope of who is covered as a fiduciary when giving investment advice or recommendations to or in the context of a fund covered by the Act.[4] Opponents of the rule argue that it brings non-fiduciaries into the definition of fiduciary,

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[1] Department of Labor, *ERISA*, https://www.dol.gov/general/topic/retirement/erisa (last visited Dec. 17, 2017).
[2] *See* Employee Retirement Income Security Act of 1974 §§ 3, 404, 29 U.S.C.A. §§ 1002, 1104 (West 2017).
[3] Restatement (Second) of Torts § 874 (Am. Law Inst. 1979).
[4] *See* 29 C.F.R. 2509 (2016).

further arguing that these entities do not have a relationship of trust and confidence with the covered fund.[5] Commissioner Piwowar of the SEC further argues that the DOL's fiduciary rule not only obscures the concept of a fiduciary, but that it also misconstrues the relationships of broker-dealers and the regulation surrounding those relationships.[6]

The DOL fiduciary rule says that anyone who provides a recommendation for a fee is a fiduciary. This rule is not limited to recommendations made to covered plans, but also covers recommendations that are provided to fiduciaries in charge of the plan.[7] The scope of this rule includes into the fiduciary category not just investment advisors servicing a covered fund, but also broker-dealers and others who only indirectly provide services to the fund.[8] It also gives the DOL more authority to regulate IRAs, with which it has shared authority with the IRS.[9]

This rule naturally brings up important questions. First, did the Department of Labor overstep their legal authority by bringing in non-fiduciaries as fiduciaries in order to regulate them? Second, did this rule create more, and not less, ambiguity regarding who is considered a fiduciary? Third, do the benefits outweigh the costs? This third question will be analyzed in the later cost/benefit analysis section.

The fiduciary common law helps answer the first two questions. As further analyzed in greater detail later in this paper, a fiduciary relationship can be limited in scope and can involve

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[5] *See* Paul Schott Stevens, *Letter to the Secretary of the Department of Labor* (July 21, 2015), https://www.ici.org/pdf/15_ici_dol_fiduciary_overview_ltr.pdf.
[6] Michael S. Piwowar, *Comment Letter in Response to the Department of Labor's "Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions"* (July 25, 2015), https://www.sec.gov/news/public-statement/piwowar-comment-dol-fiduciary-rule-prohibited-transaction-exemptions.
[7] *See* 29 C.F.R. 2509 (2016).
[8] *See Id.*
[9] *See* 29 C.F.R. 2509 (2016); Internal Revenue Code § 4975, 26 U.S.C.A. § 4975 (West 2017).

some delegation of authority.[10] With regards to limited scope, the DOL rule makes a broker/dealer subject to fiduciary duties only in a limited scope - when the broker-dealer gives a recommendation to a covered plan or to an entity somehow connected to that plan.[11] The DOL should argue that it does not subject that broker-dealer to fiduciary duties in all aspects of its business; rather, only in such situations where a relationship of trust and confidence is involved. Additionally, and as analyzed in the common law section of this paper, fiduciaries are allowed to delegate some duties to third parties.[12] If a broker-dealer provides a recommendation to a fiduciary of a covered fund, in which that fiduciary accepts that recommendation, the DOL should argue that such a situation would be the same as if the fiduciary of the covered fund delegated authority, the scope of which matched the scope of the recommendation, to the broker-dealer. Naturally, the corresponding fiduciary duty would flow with the delegated authority to the broker-dealer. Therefore, the common law exemplifies how the DOL fiduciary rule is not an incorrect expansion of the fiduciary relationship, but rather a clear demonstration how the common law fiduciary relationship applies in the ERISA context.

Securities and Exchange Commission

The SEC has long taken the view that one is a fiduciary if he gives financial advice for compensation, a concept that is one aspect of the common law fiduciary definition.[13] This definition provided the distinction between investment advisors (fiduciaries) and broker-

[10] *See* Restatement (Second) of Torts § 874 (Am. Law Inst. 1979) (a fiduciary relationship can be limited in scope); Restatement (Second) of Trusts § 171 (Am. Law Inst. 1959) (non-delegation concept).
[11] *See* 29 C.F.R. 2509 (2016).
[12] Restatement (Second) of Trusts § 171 (Am. Law Inst. 1959).
[13] *See* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisors and Broker-Dealers* (January 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

dealers (not fiduciaries). However, following the financial crisis Congress tasked the SEC with studying the financial industry and the SEC's report indicates that only incorporating the advice for a fee aspect of the common law fiduciary definition was not enough.[14] The line between investment advisors and broker-dealers has blurred and knowing who is subject to fiduciary duties is unclear.[15]

Broker-dealers offer various brokerage services and dealer services to investors, as well as ancillary services combined with the brokerage or dealer services. Brokerage and dealer services involve trading securities and the difference is dealers act as principal trading on their own account whereas brokers trade as agents.[16] Broker-dealers typically were not viewed as giving personalized investment advice and thus not subject to fiduciary duties like investment advisors.[17] They are subject to some duties, such as a suitability requirement, that must be met when transacting with customers.[18]

The distinction between broker-dealers and investment advisors has blurred and some ancillary services offered by broker-dealers involve giving personalized advice and even create relationships of trust and confidence between the broker-dealer and client.[19] This supports the proposition that even broker-dealers should be subject to fiduciary duties. In fact, courts have determined that broker-dealers do owe fiduciary duties in some instances.[20] Relationships of

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[14] *See Id.*
[15] *See Id.*
[16] *See Id.*
[17] *See Id.*
[18] *See Id.*
[19] *See United States. v. Szur*, 289 F.3d 200 (2d Cir. 2002); Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (January 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[20] *See Davis v. Merrill Lynch*, 906 F.2d 1206 (8th Cir. 1990).

trust and confidence and discretion over client assets are two key factors that courts view as indicators that broker-dealers can owe fiduciary duties.[21]

The SEC and courts are not the only ones to have taken notice of the ambiguity surrounding the applicability of fiduciary duties. Congress, in the legislative history of the Dodd-Frank Wall Street Reform and Consumer Protection Act, noticed this too. Congressman Kanjorski summarized the ambiguity precisely:

> I can't go through all the elements, but for the first time in history we're going to allow the regulators to study and come up with rules and regulations that allow a fiduciary relationship between broker-dealers, investment advisers, and their clients-their customers. Most people in this country think that already exists. It doesn't. After this bill and the use of those new regulations, it will.[22]

It is clear that the reason Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requiring the SEC to conduct a study and permitting them to enact a fiduciary rule, was to fix the ambiguity surrounding fiduciary duties in the finance industry. The SEC conducted their study, shed light on the ambiguity, and has made a public request for comments regarding a potential fiduciary rule.[23] Even though the SEC's most recent request for comment is their second such request, the new Chairman of the SEC has indicated that a fiduciary rule is a priority of his.[24] After only a few months in his position, SEC Chairman Jay Clayton told Congress about the Commission's interest in a fiduciary rule:

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[21] *See United States v. Skelly*, 442 F.3d 94 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200 (2d Cir. 2002).
[22] 156 Cong. Rec. H5233, H5236 (2010).
[23] *See* Jay Clayton, *Public Comment for Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisors and Broker-Dealers* (June 1, 2017), https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31.
[24] *See Id*; *see also* Jay Clayton, *Testimony on Examining the SEC's Agenda, Operation, and Budget*, Before the Committee on Financial Services, United States House of Representatives (Oct. 4, 2017).

> As for Commission action related to standards of conduct, the SEC has been reviewing this area for some time. In recognition of the vast changes in the marketplace since the SEC last solicited information four years ago, on June 1, 2017, I issued a statement seeking public input on standards of conduct for investment advisers and broker-dealers… I also hope that my June 2017 statement will shape constructively the conversation on this important matter, so that we can properly tailor an approach or package of approaches that we believe will best address the issues identified.[25]

Next Steps for the DOL and SEC

Last month the DOL finalized a rule that delays important portions of their fiduciary rule by eighteen months.[26] The next day the Chairman of the SEC reiterated that it is the SEC's priority to promulgate a fiduciary rule.[27] Both agencies now have time to dive into the common law as they go through their respective rulemaking processes. When doing so it is important for these two agencies to work together and incorporate a unified approach.

Both the SEC and DOL regulate broker-dealers and investment advisors. A unified regulatory approach will be highly advantageous and is even in line with the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[28] A unified approach will benefit society overall because it will minimize agency overlap which will provide for better utilization of resources and save tax payers money. It will provide investors with a clearer picture of what protections are afforded to them and when. It will provide industry with more clarity which will in turn create a disincentive for companies to raise prices, but at the same time it will provide these two agencies with clearer authority to go after breaches of fiduciary duties.

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[25] Jay Clayton, *Testimony on Examining the SEC's Agenda, Operation, and Budget*, Before the Committee on Financial Services, United States House of Representatives (Oct. 4, 2017).
[26] *See* 29 C.F.R. 2550 (2017).
[27] *See* Bruce Kelley, *Day After DOL Delay, SEC's Jay Clayton Calls a Fiduciary Rule a Priority*, InvestmentNews (Nov. 28, 2017).
[28] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1736 (2010).

The SEC is currently in the process of making a rule and is reviewing comments, but what rule should be promulgated is still being debated. The legislative history of the Dodd-Frank Wall Street Reform and Consumer Protection Act indicates that Congressman Kanjorski envisioned the SEC making a uniform standard for broker-dealers and investment advisors when they give investment advice.[29]

Mark Schoeff's recent article in *InvestmentNews* highlights the main arguments being made for and against such a uniform fiduciary rule.[30] Proponents of a uniform rule say it would keep broker-dealers honest (they would not be able to convey a fiduciary status when they actually are not subject to one) and it would protect against conflicts of interests.[31] Opponents of the rule vary in their reasons of disagreement.[32] Some say the duties owed by broker-dealers and investment advisors should not change but that more disclosure should be required.[33] Others argue that the duties owed by broker-dealers should be increased but not to the level of fiduciary.[34] Other opponents argue that a uniform rule would hurt what it means to be an investment advisor.[35]

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[29] *See* 156 Cong. Rec. H5233, H5236 (2010).
[30] Mark Schoeff, Jr., *Battle Lines Form as SEC Considers New Fiduciary Rule*, InvestmentNews (Sept. 6, 2017).
[31] *See Id.*
[32] *See Id.*
[33] *See Id.*
[34] *See Id.*
[35] *See Id.*

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the SEC to promulgate a rule that heightens the standard that broker-dealers are subject to in circumstances when they provide personalized investment advice to consumers.[36]

When promulgating such a rule, the SEC should adapt the common law definition of a fiduciary relationship into the rule. The common law definition can be synthesized into seven key principles: a fiduciary relationship involves 1) a personal relationship of trust and confidence; 2) that involves power asymmetries; 3) in which the fiduciary is acting on behalf of another; 4) for the benefit of the other person; 5) in which the fiduciary is subject to equitable duties; 6) these duties cannot be delegated away; and 7) both parties have manifested their intent to enter into such a relationship. The authority behind these principles is discussed in a later section of this paper, but in short, it is important to emphasize that a fiduciary relationship is a relationship of trust and confidence that subjects the fiduciary to equitable duties.

By first incorporating such a definition into its rule, the SEC will be able to ensure that their rule captures individuals and entities that act within relationships of trust and confidence without overreaching and subjecting someone to fiduciary standards when their conduct is not within the scope of a fiduciary relationship. For example, a broker-dealer should not always be subject to fiduciary duties nor should they always be excluded from them. By having a relationship-based definition of fiduciary, the SEC would be able to give guidance of when a broker-dealer has entered into a relationship of trust and confidence and thus subject to a fiduciary standard.

[36] Dodd-Frank Wall Street Reform and Consumer Protection Act § 913, 134 Stat. 1736, 1827 (2010).

Likewise, the DOL should make use of their eighteen-month delay by utilizing the common as they review their rule. The common law provides the Department of Labor with a starting point when making a unified approach with the SEC, gives them justification for the legality of their rule, and provides clarity for any remaining ambiguity surrounding the rule.

Cost/Benefit Analysis

While reviewing the current DOL rule and while creating a new SEC rule, both agencies need to focus on maximizing societal welfare as they weigh the costs and benefits of their rules. Currently, the DOL rule has some ambiguity. That is not necessarily bad though. An ambiguous rule can provide an agency with broad discretion and have a chilling effect on the industry. Because of the ambiguity, industry will not know exactly where the line is and will error by being extra cautious. This can result in extra protections for consumers. Ambiguity can have its drawbacks though. Consumers may not understand when they are and are not protected. Industry may pass along the costs of being extra cautious on to consumers and may limit the products they provide to consumers.

The common law provides the DOL with justification for their rule and the industry with more clarity. More clarity means less costs for companies and ultimately cheaper prices and more options for consumers. This clarity, being based on the common law concept of a relationship of trust and confidence, still requires case-by-case fact inquires. Therefore, there still is some ambiguity and this ambiguity allows the DOL to retain some discretion and authority.

The SEC should learn from this. The common law provides a balance. On the one hand industry gains from having a clear fiduciary definition derived from the common law. These

gains are either passed on to consumers or at least keep prices from rising. On the other hand, the common law still contains some ambiguity. That ambiguity will provide the SEC with grounds for further rulemaking and enforcement actions. Those additional regulatory items will provide additional protections for consumers.

Even though societal welfare is the goal, giving the consumer a great deal of attention is appropriate because at the heart of a fiduciary relationship is the individual, the consumer, giving up power in hopes of receiving something in return. That consumer is vulnerable, and what that consumer receives not only benefits him but benefits society overall.[37] Fiduciary relationships in the financial industry allow everyday investors access to expertise without the risk of being harmed.[38]

Additionally, the consumer is at the heart of both the SEC and DOL. The SEC's mission statement has three parts: 1) protect investors; 2) maintain fair, orderly, and efficient markets; and 3) facilitate capital formation.[39] This mission statement does give the SEC discretion in deciding whether to focus on the industry and capital formation or consumers and protecting investors. However, the SEC's "Division of Investment Management (Division) works to protect investors, promote informed investment decisions and facilitate appropriate innovation in investment products and services through regulating the asset management industry."[40] This is strong evidence that the SEC should give a lot of focus to the consumer when analyzing

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[37] *See* Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983).
[38] *See Id.*
[39] U.S. Securities and Exchange Commission, *About the SEC*, https://www.sec.gov/about.shtml (last modified Nov. 15, 2017).
[40] U.S. Securities and Exchange Commission, *Division of Investment Management*, https://www.sec.gov/investment/Article/investment_about.html (last modified Aug. 2, 2013).

fiduciary relationships. Furthermore, the DOL directly puts the focus on providing protection for individuals. The Department of Labor describes the Employee Retirement Income Security Act as "a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans."[41]

Why Not Look to Federal Fiduciary Law?

Federal law lacks a concise definition of what a fiduciary relationship entails. The current situations surrounding the DOL and SEC exemplify the ambiguity surrounding the fiduciary concept and are examples that indicate that both agencies can benefit from a clear definition of fiduciary. In recent history, there has been a push to codify the common law fiduciary definition; however, only so much progress has been made and some actions have undercut common law principles.[42]

Key legislation surrounding fiduciary relationships governed by the SEC and DOL, the Investment Advisors Act, Investment Company Act, and Employee Retirement Income Security Act, do not provide comprehensive definitions of fiduciary. The Investment Advisors Act only mentions 'fiduciary' three times but none of those sections deal with the duties or definition of a fiduciary.[43] The Investment Company Act contains a discussion of fiduciary duties, but the discussion is limited to the context of personal misconduct and fees charged by advisors but does not provide a comprehensive definition of fiduciary.[44] The Employee Retirement Income

[41] Department of Labor, *ERISA*, https://www.dol.gov/general/topic/retirement/erisa (last visited Dec. 17, 2017).
[42] Melanie B. Leslie, *Common Law, Common Sense: Fiduciary Standards and Trust Identity*, 27 Cardozo L. Rev. 2713, 2713 (2006).
[43] Investment Advisors Act of 1940 §§ 202(a)(2), 202(a)(24), 203(e)(2)(B), 15 U.S.C.A. §§ 80b-2(a)(2), 80b-2(a)(24), 80b-3(e)(2)(B) (West 2017).
[44] Investment Company Act of 1940 § 36, 15 U.S.C.A. § 80a-35 (West 2017).

Security Act has specific requirements for fiduciaries involved with covered plans, primarily prudence and diversification, but its definition of a fiduciary only applies to individuals covered under the act and only enumerates select characteristics and duties that are required.[45] This enumeration does not encompass the entirety of what a fiduciary is; rather, it is a policy decision by Congress picking which aspects they wanted in the legislation. Additionally, the SEC has often relied upon the Supreme Court's determination that the Investment Advisors Act is a demonstration of Congress' recognition of the fiduciary nature of investment advisors.[46]

In *SEC v. Capital Gains Research Bureau, Inc.* the Court adapted a federal fiduciary duty by bringing to light Congress' recognition that the investment advisory relationship is one of a fiduciary.[47] The Court went so far as to put weight on and quote the "declaration of policy" of the original bill:

> "Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected -- . . . (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients. "It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section." S. 3580, 76th Cong., 3d Sess., § 202. [48]

The Court also gave weight to Congress' discussion regarding the fact that "leading investment advisors emphasized their relationship of trust and confidence with their clients" and the importance of not going against the client's best interest.[49] Both the Court and Congress

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[45] Employee Retirement Income Security Act §§ 3, 404, 29 U.S.C.A. §§ 1002, 1104 (West 2017).
[46] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
[47] *See Id.*
[48] *Id* at 189.
[49] *Id* at 190.

demonstrated the importance of the common law fiduciary relationship. However, even though the Court adapted a federal level fiduciary concept, they focused their attention to the case at hand and only applied the common law duty of disclosure to the case.[50]

SEC v. Capital Gains Research Bureau, Inc. has given the SEC greater authority; however, SEC enforcement actions are not explicitly based upon breaches of common law fiduciary duties but rather are often based on disclosure issues or breaches of various anti-fraud provisions.[51] The issue still remains that a comprehensive definition of a fiduciary, that incorporates the key aspects of a common law fiduciary, is missing at the federal level.

Fiduciary at Common Law

The common law provides the best solution for the situations faced by both the DOL and SEC in regards to their fiduciary rules. In order to utilize this solution, the common law needs to first be analyzed in the aggregate, because it is spread across multiple sources of law. After that, it can then be synthesized into fundamental principles that can be applied to the situations currently faced by the DOL and SEC.

The most important aspect of fiduciary common law is the relationship; it is a relationship of trust and confidence that includes an explicit expectation that the fiduciary will act in the beneficiary's interests and is characterized by asymmetries of power.[52] The *Restatement (Second) of Trusts* is very descriptive of what a common law fiduciary is.

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[50] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
[51] *See* Securities and Exchange Commission, *In the Matter of Hennessee Group LLC*, Release No. 2871, Administrative Proceeding File No. 3-13454 (April 22, 2009); Securities and Exchange Commission, *In the Matter of Arleen W. Hughes*, Release No. 4048 (Feb. 18, 1948).
[52] *See* Andrew S. Gold and Paul B. Miller, *Philosophical Foundations of Fiduciary Law* (2014); Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983).

> *Fiduciary relation.* A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation. A fiduciary is normally under a duty not to delegate to a third person the performance of his duties as fiduciary. See § 171. As to matters within the scope of the relation he is under a duty not to profit at the expense of the other and not to enter into competition with him without his consent, unless authorized to do so by a proper court or by the provisions under which the relation arose. See § 170(1). If the fiduciary enters into a transaction with the other and fails to make a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside by the other. See § 170(2).[53]

The *Restatement* goes further and explains that within a fiduciary relationship a person is subjected to dealing with the beneficiary's property for the benefit of the beneficiary, the relationship is entered into intentionally, and the relationship creates equitable duties owed by the fiduciary.[54] Common examples that meet this definition are attorney/client, guardian/ward, and principal/agent.[55]

The law of agency defines a fiduciary relationship as one in which the "agent" acts on behalf of the "principal," both parties have manifested their assent to this relationship, and the relationship results in a power transfer to the agent.[56] The *Restatement* gives examples of fiduciary relationships similar to those found in the *Restatement (Second) of Trusts*: lawyer/client, general partner/partnership, and corporation/officer.[57] *Black's Law Dictionary* also gives similar examples: trustee/beneficiary, guardian/ward, principal/agent, attorney/client, and defines these relationships as ones in which a person is under the duty to act for the benefit of another.[58]

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[53] Restatement (Second) of Trusts § 2 cmt. b (Am. Law Inst. 1959).
[54] Restatement (Second) of Trusts § 2 (Am. Law Inst. 1959).
[55] *Id* at cmt. b.
[56] Restatement (Third) of Agency §§ 1.01, 1.01 cmt. c (Am. Law Inst. 2006).
[57] *Id* at cmt. c.
[58] Black's Law Dictionary (10th ed. 2014), fiduciary relationship.

A fiduciary relationship has a finite scope and does not necessarily extend to all dealings between two individuals.[59] A fiduciary who is acting on behalf of another person or giving advice to another person is only subject to fiduciary duties that fall within the scope of the matters that created the fiduciary relationship.[60] Further, a fiduciary acts for the benefit of another in matters that are within the scope of the relationship.[61] The law of agency says that "not all relationships in which one person provides services to another satisfy the definition of agency."[62] The law of trust indicates that even in circumstances where a fiduciary relationship does not exist, another relationship such as one of confidentiality may exist.[63]

Important Principles of the Common Law

Next, the best way to understand when a fiduciary relationship exists is to synthesize the common law down to its core principles. Current literature has provided the legal industry with much insight into the important principles of fiduciary common law.[64] In addition, the following seven principles are derived from various common law sources, provide a good example of what the common law entails, and are very applicable for the current rulemaking situations faced by the DOL and SEC. A fiduciary relationship is best characterized by 1) a relationship of trust and confidence; 2) that involves power asymmetries; 3) in which the fiduciary is acting on behalf of another; 4) for the benefit of the other person; 5) in which the

[59] Restatement (Second) of Torts § 874 (Am. Law Inst. 1979).
[60] *Id.*
[61] Black's Law Dictionary (10th ed. 2014), fiduciary.
[62] Restatement (Third) of Agency § 1.01 cmt. c (Am. Law Inst. 2006).
[63] Restatement (Second) of Trusts § 2 cmt. b (Am. Law Inst. 1959).
[64] See Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983); Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing (April 21, 2017).

fiduciary is subject to equitable duties; 6) these duties cannot be delegated away; and 7) both parties have manifested their intent to enter into such a relationship.

First, a fiduciary relationship involves a relationship of trust and confidence.[65] The existence of such relationship is strong evidence that someone who is not normally considered a fiduciary is in fact one, but only within the context of that relationship of trust and confidence.[66]

Second, a fiduciary relationship involves power asymmetries that result from a delegation of power from the beneficiary to the fiduciary.[67] The *Restatement* describes this common law attribute in great detail:

> The common-law definition requires that an agent hold power, a concept that encompasses authority but is broader in scope and connotation. The terminology of "power" is neutral in that it states a result but not the justification for the result. An agent who has actual authority holds power as a result of a voluntary conferral by the principal and is privileged, in relation to the principal, to exercise that power.[68]

Tamar Frankel argues that this power asymmetry is a central feature of a fiduciary relationship and is required in order for the fiduciary to be able to act effectively.[69] What powers are entrusted to the fiduciary may vary depending on the nature and scope of the fiduciary relationship entered into.[70]

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[65] *See* United States v. Szur, 289 F.3d 200 (2d Cir. 2002); SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990).
[66] *See Id.*
[67] Restatement (Third) of Agency § 1.01 cmt. c (Am. Law Inst. 2006).
[68] *Id.*
[69] Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 809 (1983).
[70] *See Id.*

Third, the fiduciary is acting on behalf of another, as exemplified by a principal/agent relationship.[71] The fiduciary acts as a representative and can affect the legal rights of the beneficiary.[72]

Fourth, this relationship is entered into for the benefit of the consumer.[73] The beneficiary is entrusting his property with the fiduciary with an expectation that a service will be provided that benefits him. This benefit goes even further. By allowing these relationships that involve asymmetries of power, society as a whole benefits.[74] Many aspects of today's world are complicated, especially financial planning. By providing people with access to experts in this field, people can benefit by overcoming these complications.[75] To counteract the power asymmetries involved in these relationships, the fiduciary is held to a higher standard of care.[76]

Fifth, the fiduciary is held to a higher standard of care and thus owes equitable duties.[77] The most common duties owed by a fiduciary are the duty of loyalty and the duty of care.[78] The duty of loyalty "is a duty to prevent misconduct, refrain from self-interested behavior, and

[71] Restatement (Third) of Agency § 1.01 (Am. Law Inst. 2006).
[72] *See Id* at cmt. c.
[73] Restatement (Second) of Trusts § 2 (Am. Law Inst. 1959); *see also* Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing (April 21, 2017).
[74] *See* Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983).
[75] *See Id.*
[76] *See Id.*
[77] Restatement (Second) of Trusts § 2 (Am. Law Inst. 1959).
[78] *See Air Line Pilots Ass'n Int'l v. O'Neill*, 499 U.S. 65 (1991); Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation* Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing, (April 21, 2017); Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983).

avoid conflicts of interest."[79] The fiduciary is "under a duty not to profit at the expense of the beneficiary."[80] More specifically, this duty requires the fiduciary to act solely in the interest of the beneficiary.[81] The 'solely in the interest of the beneficiary' is an important part of this equitable duty and has been enforced by the SEC.[82] Outside of the consideration received for entering into the relationship, a fiduciary should not be benefitting from the personal relationship entered into with his client.[83]

The duty of care creates a requirement for the fiduciary "to make reasonable efforts to achieve a result."[84] This duty focuses on the process and diligence undertaken by the fiduciary.[85] Similar to the duties of loyalty and care, but specific to the investment industry, the duty of prudence is owed by fiduciaries involved in investment decisions.[86] This duty requires the fiduciary to exercise "reasonable care, skill, and caution" when making investment decisions for the beneficiary.[87] In addition to the duties of loyalty, care, and prudence, fiduciaries are also subject to the duty of disclosure.[88]

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[79] Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing (April 21, 2017); *see also* Restatement (Third) of Trusts § 78 (Am. Law Inst. 2007).
[80] Restatement (Second) of Trusts § 170 cmt. a (Am. Law Inst. 1959).
[81] Restatement (Second) of Trusts § 170 (Am. Law Inst. 1959).
[82] *See* 57 SEC-Docket 1952-155, *In the Matter of Joan Conan*, Release No. IA-1446 (Sep. 30, 1994).
[83] *See Id.*
[84] Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing (April 21, 2017) (referencing Restatement (Third) of Agency § 8.08 (Am. Law Inst. 2006)).
[85] *See* Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, Forthcoming in Research Handbook on Mutual Funds, Elgar Publishing (April 21, 2017).
[86] Restatement (Third) of Trusts § 90(a) (Am. Law Inst. 2007).
[87] *Id.*
[88] *See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); Restatement (Second) of Trusts § 2 cmt. b (Am. Law Inst. 1959).

Fiduciary duties come from the nature and scope of the relationship entered into. Because of this fiduciaries in the finance industry have often been subject to other equitable duties. These duties often arise in scenarios when a fiduciary is subject to fiduciary relationships with multiple clients. A duty not to favor one client over another is seen in the SEC's Form ADV.[89] This duty often arises when clients pay different fees. The risk is the fiduciary will have an incentive to favor the clients paying higher fees (such as performance-based fees).[90] Not only is disclosure required for these potential conflicts, but the fiduciary must act affirmatively to not favor one client over the other.[91] As seen in the *Guggenheim Partners Investment Management* settlement, a situation where the investment advisor favored the client that provided a personal loan to one of the advisors, fiduciaries owe a duty not to favor one client over another.[92] Similarly, when the fiduciary is allocating different investments to its clients, the fiduciary must not favor one client over the other when doing the allocation.[93]

Sixth, the duties owed by a fiduciary cannot be delegated away.[94] The *Restatement* is very clear: when in a fiduciary relation, the fiduciary has a duty to perform the duties owed by him.[95] It is "a duty to the beneficiary not to delegate to others the doing of acts which the

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[89] Form ADV, Part 2A, Item 6, https://www.sec.gov/about/forms/formadv-part2.pdf (last visited Dec. 17, 2017).
[90] *See Id.*
[91] *See Id*; SEC Enforcement Actions, *In the Matter of Guggenheim Partners Investment Management, LLC*, IA-4163 (Aug. 10, 2015).
[92] SEC Enforcement Actions, *In the Matter of Guggenheim Partners Investment Management, LLC*, IA-4163 (Aug. 10, 2015).
[93] *See* 62 SEC-Docket 1010-31, *In the Matter of McKenzie Walker Investment Management, Inc.*, Release No. IA-1571 (July 16, 1996).
[94] Restatement (Second) of Trusts § 171 (Am. Law Inst. 1959).
[95] *Id* at cmt. a.

trustee can be reasonably required personally to perform."[96] Even though a fiduciary cannot delegate away his primary duties, he may delegate away some other duties.[97] However, there is no clear line of what can be delegated away; rather, the *Restatement* says one should look at what is being delegated away, the amount of discretion given to the third party, the value of the delegation, and whether the fiduciary already has the required resources to do the delegated act.[98]

The seventh and final aspect of a fiduciary relationship is that both sides have manifested their intent to enter into the relationship.[99] The intent to enter into a fiduciary relationship should not be hidden from either party, but rather each sides' manifestation should be an external expression of their intent.[100] A manifestation of intent may be done by a written document, by spoken words, or by conduct.[101] The *Restatement* gives factors that help in determining if a manifestation of intent has occurred for situations that lack written documents: the personal situation of each party, such as age, gender, competence, and financial condition; the purpose of the relationship; the assets or power being entrusted to the fiduciary; and the circumstances surrounding the manifestation.[102]

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[96] Restatement (Second) of Trusts § 171 (Am. Law Inst. 1959).
[97] *See Id* at cmt. d.
[98] *Id.*
[99] *See* Restatement (Second) of Trusts § 2 (Am. Law Inst. 1959); Restatement (Third) of Agency § 1.01 (Am. Law Inst. 2006).
[100] *See* Restatement (Second) of Trusts § 2 cmt. g (Am. Law Inst. 1959).
[101] Restatement (Second) of Trusts § 4 cmt. a (Am. Law Inst. 1959).
[102] *See id.*

Common Law Principles Seen in Case Law

These important common law principles have been utilized by the courts and the below cases will provide the SEC and DOL with insights into how the common law can be utilized for their rulemakings.

Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928)

In this case, Meinhard and Salmon entered into a real estate joint venture together to improve a hotel owned by a third party. During the course of the venture the third party informed Salmon of another real estate deal he was planning. Salmon agreed to do the deal with the third party but did not inform Meinhard of the opportunity. Meinhard eventually found out and sued Salmon in equity. The court found for Meinhard saying that the relationship was one of a fiduciary and an equitable duty was breached by not disclosing the opportunity to Meinhard. The court determined that the joint venture was akin to a partnership and that there was a transfer of power over day to day authority. When looking at the key principles articulated in this paper, there was a personal relationship of trust and confidence, there was a power transfer where one party had the authority to act for the other, the actions provided benefits to the other party, the power was not delegated away, and Meinhard and Salmon intentionally entered into the agreement.

Boxer v. Husky Oil Co., 429 A.2d 995 (Del. Ch. 1981)

The court in this case bolsters the common law concept that fiduciary duties are equitable duties:

> An alleged breach of fiduciary duty has historically served as a basis for equitable jurisdiction. Pomeroy describes equitable jurisdiction as “practically exclusive in proceedings for an account and settlement of partnership affairs”. 4 Pomeroy's Equity Jurisprudence, (5th Ed.) s 1421 at 1078. Where the relationship between the parties

> imposes an equitable obligation to account, equity has always taken jurisdiction over the controversy, even where there may be an adequate remedy at law.[103]

United States v. Szur, 289 F.3d 200 (2d Cir. 2002)

In this case the court emphasized the common law idea that fiduciary obligations are based upon a relationship, not a title:

> Although it is true that there "is no general fiduciary duty inherent in an ordinary broker/customer relationship," *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.,* 157 F.3d 933, 940 (2d Cir.1998), a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.[104]

SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990)

In this case the court reaffirmed the idea even a broker-dealer, who often is not subject to fiduciary duties, can still enter into relationships of trust and confidence and thus be subject to fiduciary duties. In this case the court put emphasis on the fact that Ridenour cultivated personal relationships over multiple years with his clients and that these relationships involved clear power asymmetries – the court described Ridenour as sophisticated and his clients as gullible.

Conclusion

The Department of Labor has implemented an eighteen-month delay for their fiduciary rule and the Securities and Exchange Commission is still accepting comments for their future rule. Both agencies are well positioned to make sound rulemaking. During each rulemaking process, each agency needs to rely upon the fiduciary common law and work together to achieve a unified regulatory scheme. The DOL should use the common law as strong

[103] *Boxer v. Husky Oil Co.*, 429 A.2d 995, 998 (Del. Ch. 1991).
[104] *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002).

justification that their rule has not incorrectly expanded the scope of a fiduciary relationship, as guidance and clarification regarding who falls within the fiduciary category, and as a demonstration that the benefits of the rule outweigh its costs. While receiving comments and writing its rule, the SEC should use the common law as the foundation for describing what a fiduciary relationship is.

The definition of a fiduciary relationship and who is subject to it is a topic being debated today and has been very contentious within the finance industry. The situations surrounding the Department of Labor and the Securities and Exchange Commission provide good examples of the ambiguity surrounding the concept of fiduciary.

The Department of Labor has authority to enforce fiduciary duties within the scope of the Employee Retirement Income Security Act. The Act provides a fiduciary definition and defines duties owed by individuals who meet that definition. The definition and duties have similarities to the common law definition of a fiduciary relationship; however, Congress decided that only select portions of the common law needed to be incorporated into the act. The Department recently promulgated a fiduciary rule that expands the scope of who falls within the Act's definition of a fiduciary. This rule has been criticized primarily because it includes as fiduciaries those who have been viewed typically as not being subject to fiduciary duties, such as broker-dealers who work with fiduciaries of covered funds. The Department of Labor has sense been reviewing their rule and recently implemented another delay.

The Securities and Exchange Commission, pursuant to section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, was tasked with studying the relationships of broker-dealers, investments advisors, and similar financial professionals, providing a thorough

analysis and report of those relationships, and deciding whether the Commission should promulgate a fiduciary rule based upon their findings. The report highlights the blurring distinction between broker-dealers and investment advisors and how this blurring has resulted in uncertainty of who is subject to fiduciary duties. The SEC has not yet promulgated a fiduciary rule; however, they are currently accepting comments and the new Chairman has indicated his desire to promulgate such a rule.

The common law definition of fiduciary provides the most comprehensive definition of what a fiduciary relationship entails. Even though the common law is spread across various sources of law, it can be synthesized into seven principles and those principles should be utilized by both the DOL and SEC. Those principles are 1) a relationship of trust and confidence; 2) that involves power asymmetries; 3) in which the fiduciary is acting on behalf of another; 4) for the benefit of the other person; 5) in which the fiduciary is subject to equitable duties; 6) these duties cannot be delegated away; and 7) both parties have manifested their intent to enter into such a relationship.

If the common law definition of fiduciary, as analyzed in this paper, is adapted into the SEC's fiduciary rule and if it is used by the DOL when reviewing their rule, the SEC and DOL will benefit, the industry as a whole will be given more clarity, and consumer welfare will increase. This definition will give the DOL further justification that their rule is not impermissibly expanding the concept of fiduciary. This definition will also give the SEC the ability to provide clear guidance regarding when broker-dealers fall into the definition of fiduciary and will also provide them with more authority to base its future rulemaking and enforcement actions upon. This definition will provide the industry with clearer guidance: fiduciary is based upon a

relationship, not a title. This clarity will allow the industry to save costs and offer more products to consumers. Lastly, consumer welfare will increase because investors will be provided with more protection, better products, and potentially cheaper prices.