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Kicking the Can Down the Road: Dodd-Frank’s Attempted Reform on Broker-Dealers


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Kicking the Can Down the Road

In the wake of the 2007–2008 financial crisis, and as a result of widespread calls for a reform of the financial regulatory system, Congress passed the Dodd-Frank Act in 2010. Dodd-Frank called for a number of legal and regulatory changes in the financial industry, including possible reform of the duties imposed on broker-dealers. Currently, broker-dealers are not held to a fiduciary standard. This note contends that despite the inherent dangers currently existing in broker-dealer firms, the implementation of a fiduciary standard is not the solution. Rather, the solution comes from a change in how violations of existing rules are currently policed by the Securities and Exchange Commission.

I. INTRODUCTION

Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010 as a response to the 2007–2008 financial crisis and with an eye toward preventing a reoccurrence. Dodd-Frank aimed to fill the perceived "gaps" in the existing regulatory system in an effort to promote stability and prevent further fraud and abuse in the markets. At 848-pages long, Dodd-Frank contains some of the most sweeping revisions to the current federal regulatory system since the Great Depression.


5. Dodd-Frank delegated a substantial portion of rulemaking to federal agencies, requiring them to write 398 new rules. As such, the current length of Dodd-Frank spans nearly 14,000 pages. Joe Mont, Three Years In, Dodd-Frank Deadlines Missed as Page Count Rises, Compliance WK. (July 22, 2013), http://www.complianceweek.com/three-years-in-dodd-frank-deadlines-missed-as-page-count-rises/article/303986/. As of December 2014, 231 (58.04 percent) of the total 398 rules mandated by Dodd-Frank have been completed, while 94 (23.62 percent) rulemaking requirements remain outstanding. Dodd-Frank Progress Report, Davis Polk, http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/ (last visited Apr. 10, 2015).

One alleged regulatory gap that Dodd-Frank looked to reform is the standard of care applied to broker-dealers in their dealings with customers. Currently, broker-dealers do not owe a fiduciary duty to their customers. Rather, broker-dealers are currently held to a lesser standard of care: the duty of fair dealing, which (similar to a fiduciary standard) is a principles-based standard that provides certain guidelines as to how broker-dealers should act in their everyday dealings with customers. From this duty of fair dealing stems specific regulatory obligations. Despite the fact that broker-dealers are governed by both a principles-based and rules-based approach to regulation, the widespread abuses and unethical business practices exposed during the financial crisis demonstrate that the current model regulating broker-dealers is ineffective. Most commentators believe that the root of the ineffectiveness lies in the “lesser” standard of care applied to broker-dealers—the duty of fair dealing.

7. The Securities Exchange Act of 1934 (“Exchange Act”), the primary legislation governing brokers and dealers, defines “brokers” and “dealers” separately. However, because this note concentrates on broker-dealers as an entity, and because most rules under the Exchange Act do not distinguish between brokers and dealers, this note uses the term “broker-dealer” unless there is a reason to distinguish between the two roles. Note that a broker-dealer is both an agent and a principal. It is an agent when it acts as a broker and effects securities transactions for the accounts of others for a fee, and a principal when it acts as a dealer and buys and sells securities for its own account. Securities Exchange Act of 1934, ch. 404, § 3(a)(4)(A), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78c(a)(4) (2013)) (defining “broker”); id. § 3(a)(5)(A), 15 U.S.C. § 78c(a)(5) (defining “dealer”).


9. Generally, a fiduciary duty obligates one party to act in the best interest of another party, however the nature and scope of the duty is amorphous. See generally Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 DUKE L.J. 879 (1988). “A fiduciary duty may arise either expressly or impliedly” from a formal appointment or it may arise de facto from the specific relationship between the parties. John F. Mariani et al., Understanding Fiduciary Duty, 84 FLA. B.J. 20, 22 (Mar. 2010). Unlike investment advisers (discussed below), “broker-dealers are not categorically bound—by statute, regulation, or precedent—to a per se rule imposing fiduciary obligations toward clients.” Angela A. Hung et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers 10 (2008) [hereinafter Rand Report]. This study, made by the Rand Corporation on request from the SEC, was intended primarily to provide the SEC with information on the current business practices of broker-dealers and investment advisers, and how (if at all) investors perceive or understand these differences. See Research Brief: Investment Advisers and Broker-Dealers, RAND CORP. (2008), http://www.rand.org/pubs/research_briefs/RB9337/index1.html.

10. See generally SEC Staff Study, supra note 8; Arthur B. Laby, Fiduciary Obligations of Broker-Dealers and Investment Advisers, 55 VILL. L. REV. 701, 719 (2010) [hereinafter Laby, Fiduciary Obligations] (“[B]rokers . . . do not owe their customers fiduciary duties.”); 11 N.Y. JUR. 2d Brokers § 81 (“Absent agreement to the contrary, a broker does not owe a fiduciary duty to a purchaser of securities.”).

11. See discussion infra Part II. SEC Staff Study, supra note 8, at 51. Some commentators refer to this duty only as the suitability obligation, but this note contends a more accurate portrayal of the broker-dealer obligations is the duty of fair dealing, within which there are specific suitability obligations.

12. Andrew Clipper & Benjamin Poor, Broker-Dealers As Fiduciaries? How the SEC Staff’s Study Could Raise the Bar for Investment Advice 2 (2012) (“Critics of the suitability standard have argued that it reads like a minimum threshold—insisting that the investment be adequate for the
solution then became to elevate the standard of care to a fiduciary standard, in hopes that this would rein in Wall Street.  

In response to this widespread call for the implementation of a fiduciary standard, Dodd-Frank granted rulemaking authority to the U.S. Securities and Exchange Commission (SEC) to promulgate rules to impose a new standard of care on broker-dealers. Specifically, the fiduciary duty described in Dodd-Frank would require broker-dealers to act in the best interests of their clients without regard to the financial interest of the broker-dealer, and to disclose any conflicts of interest—the same standard investment advisers are currently held to under the Investment Advisers Act of 1940 (“Advisers Act”).

Prior to engaging in any rulemaking, however, Dodd-Frank required the SEC to conduct a study to evaluate the effectiveness of the existing legal and regulatory standards of care for broker-dealers and the potential impact of applying a fiduciary standard of care on broker-dealers, and to deliver the results of this study to Congress within six months of Dodd-Frank’s enactment. Following this mandate, SEC staff released a study in January 2011, making a preliminary recommendation that the SEC exercise its rulemaking authority and apply a fiduciary standard of care to broker-dealers. This study, however, cautioned that it did not necessarily reflect the views of the SEC or any individual SEC commissioner. Indeed, in a jointly released statement, two (of the total five) SEC commissioners expressed their strong disagreement with this preliminary study, noting that it failed to “adequately justify its recommendation that the Commission embark on fundamentally changing the regulatory regime for broker-dealers.”

Nearly five years later, the SEC has yet to exercise its rulemaking authority under Dodd-Frank and implement a fiduciary standard on broker-dealers. In March 2013, however, the SEC took its first steps toward rulemaking and requested information from the industry and public on the costs and benefits of imposing a fiduciary duty investor, but that the quality of the recommendation stops short of the higher standard of care proscribed by fiduciary relationships.” (internal quotation marks omitted)).


14. As noted above, many Dodd-Frank provisions delegate rulemaking to federal agencies. One such delegation is the imposition, if any, of a fiduciary duty on broker-dealers. Therefore, any reform imposed on broker-dealers will come as a result of rulemaking by the SEC. See Mont, supra note 5.


16. See id. § 913(g). The Investment Advisers Act of 1940 (“Advisers Act”) is the primary source of regulation of investment advisers (and, as discussed in Part II, such definition excludes broker-dealers) and is administered by the SEC. See discussion infra Part II.

17. See Dodd-Frank § 913.

18. SEC Staff Study, supra note 8, at ii.

19. Id.

on broker-dealers.\textsuperscript{21} The comment period ended in July 2013,\textsuperscript{22} but the SEC has yet to complete its anticipated cost-benefit analysis.

In November 2013, the SEC Investor Advisory Committee (IAC), a panel established by Dodd-Frank to “represent the interests of small investors,” released a recommendation that the SEC adopt a uniform fiduciary rule.\textsuperscript{23} The IAC did so in the hope of moving the fiduciary duty issue “to the front burner,”\textsuperscript{24} however the SEC appears indifferent. The SEC’s 2014 regulatory agenda, released \textit{after} the IAC’s recommendation, slates the fiduciary duty issue for “long-term action”\textsuperscript{25} and lists it as its fortieth priority out of forty-three items.\textsuperscript{26} Such indifference is due in part perhaps to the difficulties—and impracticalities—associated with implementing such a standard on broker-dealers.\textsuperscript{27}

Further, the five SEC commissioners still appear to be divided over the issue. Chair Mary Jo White and Commissioners Luis A. Aguilar and Kara Stein seem ready to implement a fiduciary standard,\textsuperscript{28} however Commissioners Daniel M. Gallagher and Michael Piwowar remain skeptical.\textsuperscript{29}

\textsuperscript{21} The information requested by the SEC includes: (1) characteristics of retail customers investing through broker-dealers versus characteristics of those investing through investment advisers; (2) information about the types of securities offered to retail customers; (3) information regarding the conflicts of interest faced by both investment advisers and broker-dealers; and (4) information describing the extent to which retail customers are confused about the regulatory status of the person from whom they receive financial advice. \textit{See SEC, Request for Data and Other Information, Exchange Act Release No. 34-69013 (Mar. 1, 2013), available at} \url{https://www.sec.gov/rules/other/2013/34-69013.pdf}.

\textsuperscript{22} \textit{Id.}

\textsuperscript{23} Mark Schoeff, Jr., \textit{Advisory Panel Calls on SEC to Move Fiduciary Duty to Front Burner}, \textit{InvestmentNews} (Nov. 22, 2013), \url{http://www.investmentnews.com/article/20131122/FREE/131129954/advisory-panel-calls-on-sec-to-move-fiduciary-duty-to-front-burner} (“The panel comprises 21 members, including financial industry officials, academicians, consumer advocates and state regulators.”).

\textsuperscript{24} \textit{Id.}

\textsuperscript{25} Long-term action items have a lesser priority than proposed-rule or final-rule stage action items. Mark Schoeff, Jr., \textit{SEC Puts Fiduciary Duty on 2014 Agenda as “Long-Term Action”}, \textit{InvestmentNews} (Dec. 2, 2013, 1:15 PM), \url{http://www.investmentnews.com/article/20131202/FREE/131209997/sec-puts-fiduciary-duty-on-2014-agenda-as-long-term-action}.\textsuperscript{27}


\textsuperscript{27} See discussion \textit{infra} Part III.


\textsuperscript{29} See Melanie Waddell, \textit{SEC’s Gallagher: Fiduciary Rule Likely Not Coming}, \textit{ThinkAdvisor} (Mar. 12, 2014), \url{http://www.thinkadvisor.com/2014/03/12/secsgallagher-fiduciary-rule-likely-not-coming};
This note argues that the ineffectiveness of the current regulatory system as applied to broker-dealers is not the result of an absence of regulation, but rather stems from the lack of adequate enforcement of existing rules and regulations. Following this Introduction, Part II gives a brief overview of the existing regulatory regime, as applied to broker-dealers, to give context to the discussion. Part III uses the infamous case SEC v. Goldman Sachs & Co., wherein Goldman Sachs & Co. ("Goldman") was accused of committing fraud in a complicated securities transaction—which is usually used as an example of why a fiduciary standard is necessary—as a means for demonstrating why imposing such a standard fails to cure problems inherent in broker-dealer firms. Part IV discusses the problems with imposing a fiduciary standard on broker-dealers in general. Part V provides a solution, which comes not from the legislature, but from a change in the SEC’s current enforcement policy. Part VI concludes this note.

II. HISTORICAL OVERVIEW OF BROKER-DEALER AND INVESTMENT ADVISER FIDUCIARY DUTIES

Currently, financial advisers are held to two standards of care: (1) the fiduciary standard, which governs investment advisers; and (2) the duty of fair dealing, which governs broker-dealers. These differing standards come from the fact that broker-dealers and investment advisers are governed by different bodies of law, and also because each group plays a distinct role when providing advice to customers.

A. Standard Imposed on Investment Advisers

Investment advisers, considered fiduciaries, are regulated under the Advisers Act, which takes a principles-based approach to regulation. Under the Advisers Act, an investment adviser is defined as a person that receives compensation for providing advice regarding securities as part of a regular business.


31. SEC Staff Study, supra note 8, at 51.
32. At the time the Securities Act of 1933 ("Securities Act") and the Exchange Act were passed, broker-dealers merely bought and sold securities; they did not offer or provide investment advice to customers. Therefore, broker-dealers were not seen as agents for their customers, as compared with investment advisers, who were viewed as agents. See Allen, supra note 6, at 22; SEC Staff Study, supra note 8, at i.
If a firm meets the definition of investment adviser, then registration is required either under federal or state law.\footnote{\textit{See id.} §§ 203(l), 203(i), 203(m) (codified as amended at 15 U.S.C. § 80b-3). Section 203A, as amended by Dodd-Frank, prohibits investment advisers with less than $100 million in assets under management to register under the Advisers Act. \textit{Id.} § 203A (codified as amended at 15 U.S.C. § 80b-3a).} Investment advisers are considered fiduciaries and, as such, are required to “act solely with the client’s investment goals and interests in mind, free from any direct or indirect conflicts of interest that would tempt the adviser to make recommendations that would also benefit him or her.”\footnote{\textit{See Rand Report, supra note 9, at 13; Information for Newly-Registered Investment Advisers, U.S. Sec. & Exch. Comm’n (Nov. 23, 2010), https://www.sec.gov/divisions/investment/advoverview.htm (noting that the duty is “a fundamental obligation to act in the best interests of [the] clients and to provide investment advice in [the] clients’ best interests. [Advisers] owe [their] clients a duty of undivided loyalty and utmost good faith. [Advisers] should not engage in any activity in conflict with the interest of any client").} While this duty is not specifically articulated in the Advisers Act, the U.S. Supreme Court has construed the antifraud sections of the Advisers Act as imposing such a standard on investment advisers for all dealings with clients.\footnote{Section 206 contains the general antifraud provisions of the Advisers Act and makes it unlawful for investment advisers to engage in fraudulent, deceptive, or manipulative conduct. In 1963, the U.S. Supreme Court held in \textit{SEC v. Capital Gains Research Bureau, Inc.}, 375 U.S. 180, 194 (1963). Even advisers regulated by the states are subject to the antifraud provisions of the Advisers Act and, therefore, are held to this federal fiduciary standard. \textit{See Advisers Act § 206.}} Further, as part of its fiduciary duty, an investment adviser must make a full and fair disclosure of all material facts, especially when the adviser’s interests may conflict with those of customers.\footnote{\textit{See Capital Gains}, 375 U.S. at 191–92 (noting investment advisers must “eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested”); \textit{Form ADV} is the uniform form used by investment advisers to register with the SEC and state securities regulators. The General Instructions for Part 2 of Form ADV states: “Under federal and state law, [advisers] are a fiduciary and must make full disclosure to [their] clients of all material facts relating to the advisory relationship. As a fiduciary, [advisers] also must seek to avoid conflicts of interest with [their] clients, and, at a minimum, make full disclosure of all material conflicts of interest between [themselves and their] clients that could affect the advisory relationship.” \textit{Form ADV: Uniform Application for Investment Adviser Registration, U.S. Sec. & Exch. Comm’n, available at} http://www.sec.gov/about/forms/formadv-part2.pdf (last visited Apr. 10, 2015) (emphasis omitted).} These fiduciary duties have been “categorically” upheld and apply to every investment adviser, whether registered under the Advisers Act or not.\footnote{\textit{S. Rep. No. 86-1760 (1960), reprinted in 1960 U.S.C.C.A.N. 3502, 3509 (specifying that the antifraud provisions in § 206 apply to registered and unregistered investment advisers); \textit{see also Rand Report, supra note 9, at 13.}}

In addition to this extensive fiduciary standard, investment advisers are also subject to the “suitability”\footnote{\textit{SEC Staff Study, supra note 8, at 27–28.}} and “best execution”\footnote{\textit{See Advisers Act § 206(3); In re Portfolio Advisory Serv., LLC, Advisers Act Release No. 2038, 77 SEC Docket 2759, 2002 WL 1343823, at *2 (June 20, 2002) (“An investment adviser’s fiduciary duty includes the requirement to seek best execution of client securities transactions.”).}} standards applicable to broker-dealers.\footnote{\textit{See Rand Report, supra note 9, at 13. For a discussion on suitability and best execution, \textit{see infra pp. 570–71.}}
Though broker-dealers (when acting in a brokerage capacity) give advice to customers with respect to securities transactions, and therefore meet the broad definition of an investment adviser, the Advisers Act excludes broker-dealers from regulation—and hence, from any fiduciary duty obligation—provided the broker-dealer’s investment advice is “solely incidental” to brokerage services and such broker-dealer does not receive “special compensation” for such advice.

Broker-dealers are excluded from the Adviser’s Act because historically broker-dealers were viewed less like advisers—as the name suggests—and more as agents facilitating client transactions. In contrast, investment advisers provide continual investment advice as part of their regular business to less-knowledgeable retail customers. The differences with respect to the length of the relationship, the types of transactions involved, and the sophistication of the parties resulted in (and justify) the two different standards for these two classes of financial advisers.

B. Standard Imposed on Broker-Dealers

In contrast to the principles-based approach to regulation, broker-dealer conduct is largely regulated via a rules-based approach. Broker-dealers are regulated under a myriad of authorities, including the antifraud provisions of the Securities and Exchange Act of 1934 (“Exchange Act”), the Securities Act of 1933 (“Securities

43. See SEC Staff Study, supra note 8, at 15 (noting that the SEC interprets the definition of investment advisers “broadly”).

44. A fee-based account (i.e., an account that charges an asset-based or fixed fee) is considered “special compensation.” Commission-based accounts, like those generally used by broker-dealers, are not considered advisory. See Guide to Broker-Dealer Registration: Division of Trading and Markets, U.S. Sec. & Exch. Comm’n (Apr. 2008), http://www.sec.gov/divisions/marketreg/bdguide.htm [hereinafter SEC Guide to Broker-Dealers].


46. Allen, supra note 6, at 24.

47. Id.

48. See, e.g., Walston & Co. v. Miller, 410 P.2d 658, 661 (Ariz. 1966) (“[T]he broker’s duties, unlike those of an investment adviser . . . are only to fulfill the mechanical, ministerial requirements of the purchase or sale of the security . . . .”).


50. The Exchange Act requires most broker-dealers, whether individuals or entities, to register with the SEC. Securities Exchange Act of 1934, ch. 404, § 15(a)(1), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78o(a)(1)) (requiring registration of most broker-dealers by prohibiting the use by any broker or dealer of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (unless an exemption applies) unless such broker or dealer is registered with the SEC). The Exchange Act regulates securities transactions in the secondary market. With its main goal of investor protection, the Exchange Act sets out a mandatory disclosure process, provides for direct regulation of the markets in which securities are sold, and regulates participants in those markets, including broker-dealers. See generally id. § 15. Section 4 of the Exchange Act established
Act”),51 the SEC rules promulgated thereunder, and specific self-regulatory organization (SRO) rules52—usually those of the Financial Industry Regulatory Authority (FINRA).53 Additionally, most broker-dealers are required to register with the Securities Investor Protection Corporation,54 and may also be subject to state regulation.55

As discussed above, while broker-dealers are not directly subjected to a fiduciary standard, they are subject to the duty of fair dealing, which essentially requires broker-dealers to deal fairly with their customers and in accordance with industry standards.56 This duty stems from the “shingle theory,” and the idea that by being in the securities business and soliciting customers (by hanging out a “shingle”), broker-dealers make an implied promise of fair dealing.57 This concept of fair dealing was first introduced by the SEC in the 1930s, applied under the antifraud provisions of

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52. The securities world puts a lot of emphasis on self-regulation, due to the long-standing belief that industry participants are better equipped to respond to regulatory problems given their expertise and knowledge of the securities industry. As a result, while broker-dealers are subject to SEC oversight, self-regulatory organizations (SRO) are given initial regulatory authority to create and enforce conduct rules and standards governing the securities and brokerage industry. See Allen, supra note 6, at 20. All broker-dealers are required to become members of at least one SRO. Exchange Act § 15(b)(8) (codified as amended at 15 U.S.C. § 78o(b)(8)); see also Robert L.D. Colby et al., Fundamentals of Broker-Dealer Regulation § 2:1.2 (2010).


55. See SEC Guide to Broker-Dealers, supra note 44.

56. SEC Staff Study, supra note 8, at 51.

57. Id. at 51; Hanly v. SEC, 415 F.2d 589, 596–97 (2d Cir. 1969).
the Exchange Act and the Securities Act, 58 and was later affirmed by the courts. 59
The duty of fair dealing acts as a failsafe, protecting investors who may not meet the
required elements for fraud, but are still harmed when they entrust their funds to
broker-dealers. This residual protection was recently affirmed in a U.S. Supreme
Court decision in which the Court held that a client need only prove violations of
professional duties of fair dealing, rather than intentional misstatements or an intent
to deceive. 60 Similarly, the duty of fair dealing is also expressed in FINRA Rule
2010, requiring brokers to adhere to “high standards of commercial honor and just
and equitable principles of trade.” 61

The duty of fair dealing also includes specific regulatory requirements, including
suitability, the duty of best execution, and disclosure obligations.

The suitability obligation—applied also under the antifraud provisions of the
Securities Act, the Exchange Act, SEC rules promulgated thereunder, and specific
SRO rules—generally requires broker-dealers to look to a customer’s specific financial
needs and objectives when making a recommendation. 62 Determining whether a
broker-dealer has made a suitable recommendation is a fact-and-circumstance-based
analysis, depending on the nature of the product, the type of transaction, and the
parties involved. 63 A suitability violation has different mens rea requirements depending
on the rule or section under which the suit was brought. 64

58. The antifraud provisions of the Exchange Act and Securities Act generally prohibit broker-dealers from
engaging in fraud, manipulation, and insider trading activities. See Exchange Act of 1934, ch. 404, § 10(b),
48 Stat. 881 (codified as amended at 15 U.S.C. § 78j(b)) (the principal statutory weapon against fraud, which
prohibits the use of any “device, scheme, or artifice to defraud” and creates liability for any misstatement or
omission of a material fact); id. § 9(a) (codified as amended at 15 U.S.C. § 78i) (punishing market
manipulation); id. § 15(c)(7) (codified as amended at 15 U.S.C. § 78o) (punishing false and misleading
(prohibiting fraud or manipulation in the offer or sale of securities).

59. See Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943); In re Duker & Duker, Exchange Act
Release No. 2350, 1939 WL 36426, at *3 (Dec. 19, 1939) (“Inherent in the relationship between a dealer
and his customer is . . . that the customer will be dealt with fairly, and in accordance with the standards
of the profession.”).

60. SEC v. Zandford, 535 U.S. 813, 814, 819 (2002) (holding that a misstatement or omission was not
required under § 10(b) and Rule 10-b(5) and that § 10(b) should be read flexibly, rather than restrictively).


html?rbid=2403&element_id=9859 (last visited Apr. 10, 2015) (superseding the old suitability rule
under NASD IM-2310-3).

63. For example, FINRA Rule 2111 requires a broker to have a reasonable belief that: (1) a given securities
transaction or strategy is appropriate for the broker to recommend to someone; (2) the transaction or
strategy is appropriate for the broker to recommend to the particular customer based on the customer’s
investment profile; and (3) a series of transactions is not excessive or otherwise unsuitable. FINRA
Rule 2111, supra note 62.

64. If brought under § 10(b) of the Exchange Act or SEC Rule 10b-5, the broker’s unsuitable recommendation
must be a misrepresentation made with scienter. Proving scienter requires a showing of intent to deceive,
The “best execution” rule requires broker-dealers to obtain the best price reasonably possible under the circumstances for their customers.65 This duty applies regardless of whether the broker-dealer is acting as an agent or the principal.66 If applied under the antifraud rules, a broker-dealer may violate Exchange Act § 10b and SEC Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price that has no reasonable relationship to the prevailing market price.67 The FINRA rule governing best execution, in contrast, does not require such scienter and, instead, lays out specific factors for determining reasonableness for a given transaction.68

Finally, broker-dealers are subject to mandatory disclosure obligations.69 The extent of the disclosure obligation generally depends on the scope of the broker-dealer’s relationship with the customer.70 Notably, the rules governing broker-dealers do not actually prohibit such conflicts of interest; they merely obligate broker-dealers

65. The best execution standard stems from common law agency principles. This standard was incorporated in SRO rules and through judicial and SEC enforcement actions. E.g., Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998).


67. SEC Staff Study, supra note 8, at 70; Grandon v. Merrill Lynch & Co., 147 F.3d 184, 189–90 (2d Cir. 1998) (holding that a right of action for failing to disclose price markups exists under SEC Rule 10b-5 against broker-dealers that charged excessive markups without proper disclosure).

68. Factors considered in determining “reasonable diligence” include: (1) the character of the market for the security; (2) the size and type of transaction; (3) the number of markets checked; (4) accessibility of the quotation; and (5) the terms and conditions of the order that resulted in the transaction. FINRA Manual: Rule 5310, Fin. Indus. Regulatory Auth., available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=10455 (last visited Apr. 10, 2015). FINRA Rule 5310 replaced the NASD Rule 2320 rule for best execution.

69. See Exchange Act §10(b). Under Rule 10b-10 the broker-dealer must disclose in what capacity it is making the transaction and whether “the broker or dealer is acting as agent for such customer, as agent for some other person, as agent for both such customer and some other person, or as a principal for its own account; and if the broker or dealer is acting as principal, whether it is a market maker in the security.” 17 C.F.R. § 240.10b-10(a)(2) (2014).

70. SEC Staff Study, supra note 8, at 55.
to acknowledge them.71 Broker-dealers must make these disclosures at or prior to the
completion of a transaction.72

Despite this extensive regulation covering broker-dealer conduct, the recession of
2008, and the numerous frauds exposed in its aftermath, demonstrate that the
current regulatory system must be re-examined. One example of a particularly
egregious business practice involved Goldman73 and its role in the infamous deal
known as ABACUS 2007-AC1 SPV (ABACUS),74 an investment vehicle created by
Goldman that actively misled its customers to the tune of $1 billion dollars.75

III. GOLDMAN AND ABACUS

ABACUS represented not only a “symbol[] of the recent financial fiasco,”76 but
also became the perfect vehicle for those advocating for a fiduciary standard for
broker-dealers.77 As one commentator noted:

71. See 17 C.F.R. § 240.10b-10(a)(2).
72. See id. As seen in SEC v. Tourre, and discussed in Part III.B, infra, such failure to disclose can lead to
SEC prosecution and civil penalties. 950 F. Supp. 2d 666 (S.D.N.Y. June 18, 2013). Fabrice Tourre, for
his part, was ordered to pay roughly $825,000 after he was found liable for defrauding investors. Nate
Raymond & Jonathan Stempel, Big Fine Imposed on Ex–Goldman Trader Tourre in SEC Case, REUTERS
(Mar. 12, 2014, 2:49 PM), http://www.reuters.com/article/2014/03/12/us-goldmansachs-sec-tourre-
idUSBREA2BI1220140312.
73. Goldman Sachs & Co. (“Goldman”) is a prominent global investment banking and securities firm.
Among other things, Goldman is known for its advisory services and proprietary trading. See Who We
Are, Goldman Sachs, http://www.goldmansachs.com/who-we-are/index.html (last visited Apr. 10,
2015).
74. The ABACUS investment vehicle discussed in this note, which was ultimately the subject of the SEC
case against Goldman, was just one of the numerous ABACUS deals that Goldman issued from 2005
through 2008. Gretchen Morgenson & Louise Story, Banks Bundled Bad Debt, Bet Against It and Won,
75. E.g., Dan Wilchins et al., Factbox: How Goldman’s ABACUS Deal Worked, REUTERS (Apr. 16, 2010, 4:30 PM),
[hereinafter Factbox: The ABACUS Deal].
76. Michele Cea, The Settlement Between the SEC and Goldman Sachs of July 2010 and the
Following Misplaced Proposal of Imposing a Fiduciary Duty on Broker-Dealers 3 (2011)
(citations omitted) (internal quotation marks omitted), available at http://ssrn.com/abstract=1923700
(follow “Download This Paper” hyperlink).
77. For example, the chairman for the Committee for the Fiduciary Standard, Knut A. Rostad, noted:

[ABACUS] highlights the wide gap and opposing roles of a broker who is permitted in
law to further his and his firm’s interests at the expense of customers’, and a fiduciary
who is required in law to put his clients’ interests first. This is at the core of why the
fiduciary standard is important.

Kate McBride, Goldman Sachs, Suitability and the Fiduciary Standard, THINKADVISOR (Apr. 21, 2010),
(internal quotation marks omitted). The Committee for the Fiduciary Standard was formed in June
2009 by a group of investment professionals and fiduciary experts to advocate for a fiduciary standard
for all those who give investment and financial advice. Committee Initiatives, The Committee
First, the subject stands out. It involves the “untouchable” Goldman, the world’s major investment banking player, which has often been blamed for its alleged reckless practices, but it regularly managed not to be held accountable. Fabrice Tourre, the Goldman employee directly involved in the case, has a remarkable impact on public opinion and he is featured, justly or not, as the identification of Wall Street’s greed. Second, collateralized debt obligation, the financial tool employed in the transaction, is deemed as one of those instruments that unfolded the subprime mortgage cancer worldwide. Finally, this transaction acquires historical traits due to the considerable sum of money arranged.

Before engaging in a discussion of whether the ABACUS deal resulted from a lack of a fiduciary duty, some background on the deal is necessary to determine exactly what, if anything, Goldman did wrong.

78. See also Raymond & Stempel, supra note 72 (“Tourre became a symbol of the financial meltdown . . . ”).

79. A collateralized debt obligation (CDO) is a type of security whose value and payments are derived from a portfolio of underlying fixed-income assets, such as mortgages, bonds, and loans, which serve as the collateral for the CDO. Because a portfolio is made up of multiple debt obligations, and such obligations vary substantially in risk, the cash flows from CDOs are split into different risk classes (“tranches”). Investors in a CDO choose the tranche that meets their particular needs, and cash flows from these tranches—comprised of the interest and principal payments of the underlying assets—are distributed to the investors in order of seniority based on a set of pre-specified rules. See Goldman Sachs, ABACUS 2007-AC1, at 11 (Feb. 26, 2007), available at http://www.math.nyu.edu/faculty/avellane/ABACUS.pdf. This senior/subordinate structure serves as a sort of internal credit enhancement, with the senior tranche receiving investment grade bonds even though the underlying collateral is subprime debt, because the senior tranche is not actually backed by the underlying collateral but, rather, is backed by the set of rules governing the cash flow from the collateral. However, if the underlying asset in the pool defaults (i.e., when the homeowners default on their mortgages), then losses are allocated from the bottom up (from the junior to the most senior), and senior classes remain unaffected unless the losses exceed the subordinated tranches. This senior/subordinate structure appeared to be risk free. Fin. Crisis Inquiry Comm’n, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, at xxiv (Feb. 25, 2011) [hereinafter Financial Crisis Report], available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf. However, the recent plummeting of the U.S. real estate market and the subsequent financial crisis proved that this appearance was wrong. Even with an internal credit enhancement structure in place, when every mortgagor stops making interest and/or principal payments—as to be expected in a portfolio comprised of mostly subprime mortgages—the losses on these assets become enormous, affecting the entire CDO. E.g., Mark J.P. Anson et al., CAIA Level I: An Introduction to Core Topics in Alternative Investments 696 (2d ed. 2012); Douglas J. Lucas et al., Collateralized Debt Obligations: Structures and Analysis 122–24 (2d ed. 2006).


81. Cea, supra note 76, at 3 (citations omitted) (internal quotation marks omitted).
KICKING THE CAN DOWN THE ROAD

A. Background: The Creation and Structuring of ABACUS

In simple terms, the story of Goldman and ABACUS began in late 2006, near the end of the real estate bubble, when mortgage securities and their underlying mortgages were some of the most attractive investments—mainly because they were seen as relatively safe, and also because they had the possibility of returning extremely high yields. During this time, hedge fund president John Paulson, who was “virtually alone in predicting the fallout from the housing bubble,” approached Goldman seeking to short the housing market by betting against future prospects of mortgage-backed securities. In response, Goldman structured a transaction allowing Paulson to take a short position on a portfolio of residential mortgage backed securities (RMBS). The result was ABACUS, a synthetic collateralized


83. Financial Crisis Report, supra note 79, at 100 (noting that mortgage-backed securities were “supposed to be among the safest investments”); id. at xxiv (“It appeared to financial institutions, investors, and regulators alike that[,] [with respect to CDOs] risk had been conquered: the investors held highly rated securities they thought were sure to perform; the banks thought they had taken the riskiest loans off their books; and regulators saw firms making profits and borrowing costs reduced.”).

84. In 2006, approximately $560 billion of CDOs were sold. Gregory Zuckerman, The Greatest Trade Ever: The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History 172 (2009) (“CDO investments were an instant hit because they had juicy returns . . . .”).

85. John Paulson is the president of Paulson & Co., Inc., a hedge fund founded in 1994. While today Paulson is one of the most well-known hedge fund managers in the industry, in 2006 he was “a Wall Street outsider . . . [considered by many to be] a third-rate hedge fund guy who didn’t know what he was talking about.” Michael Lewis, The Big Short: Inside the Doomsday Machine 106 (2010) (internal quotation marks omitted).


87. The short-selling investor shorts a stock when he or she anticipates a decrease in stock price. If the price drops, the investor can buy back the stock at a lower price, making a profit—or “spread”—on the difference. If the stock rises in price, the investor must buy the stock back at the higher price, and hence loses money on the deal. See Financial Crisis Report, supra note 79, at 543.


89. Levin-Coburn Report, supra note 1, at 396. Residential mortgage backed securities (RMBS) are a specific type of asset-backed securities in which the underlying assets are residential mortgages. RMBS represent groups of mortgages that are pooled together to create the securities, which securities are then sold to investors who receive payments as the homeowners make principal and interest payments on the underlying mortgages. E.g., Mortgage-Backed Securities, U.S. Sec. & Exch. Comm’n, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Apr. 10, 2015).
debt obligation (CDO), whose value derived from the value of the underlying securities—in this case, RMBS.

The structuring of a CDO is a complicated process that generally involves four major players: (1) securities firms, who approve the selection of collateral, structure the underlying assets into tranches, and ultimately sell these assets as securities to investors; (2) CDO managers, who select the collateral and actually manage the CDO portfolio; (3) rating agencies, who assess the tranches in the CDO and assign them credit ratings; and (4) investors.

A CDO, like all derivatives, is zero-sum, meaning it requires investors on both sides of the deal—i.e., those taking a long position and those taking a short position. The investors in a synthetic CDO include: (1) “funded” long investors that pay cash to purchase actual securities issued by the CDO and receive interest if the reference securities perform, but lose their investment if the reference securities default; (2) “unfunded” long investors (the most senior in the payment system) that enter into swaps with the CDO, making money if the reference securities perform, but have to pay if the reference securities deteriorate beyond a certain point and the CDO does not have sufficient funds to pay the short investors; and (3) short investors that buy credit default swaps on the reference securities, pay the premiums that the unfunded investors might receive if the underlying assets appreciate in value, and ultimately make money if the securities fail.

As the securities firm involved in the deal, Goldman was responsible for overseeing the selection of collateral, structuring the deal, and connecting and

90. A synthetic CDO, unlike a traditional CDO, does not own the underlying assets that comprise its portfolio. Rather, a synthetic CDO invests indirectly in assets using credit default swaps (CDS) or other derivatives. See Levin-Coburn Report, supra note 1, at 51. As such, a synthetic CDO is a complex derivative sometimes described as the bet on the performance of another mortgage (or other fixed assets), rather than a real mortgage security. See Financial Crisis Report, supra note 79, at xiv. The value and payment stream of a synthetic CDO derives not from cash assets, like mortgages (as would be the case in a regular CDO), but from premiums paying for credit default swap “insurance” on the possibility that a defined set of “reference” securities will default. The insurance-buying counterparties may own the reference securities as a way of managing the risk of their default, or may be speculators calculating that the securities will default. Id. at 142. As such, synthetic CDOs have been criticized as a way of hiding short position bets against subprime mortgages from unsuspecting triple-A-seeking investors, and contributing to the 2007–2008 financial crisis by amplifying the subprime mortgage housing bubble. Id. at xvi (“The losses were magnified by derivatives such as synthetic securities.”).

91. See Factbox: The ABACUS Deal, supra note 75.


93. A credit default swap (CDS) is a derivative contract in which a protection buyer makes periodic premium payments and the protection seller makes a contingent payment if a reference obligation experiences a credit event, acting as a form of “insurance” to the buyer. In addition to hedging default risk, CDSs can be used as a way to speculate on credit events for the buyer. See Top 10 Financial Crisis Buzzwords: Credit Default Swap, Time Mag., available at http://content.time.com/time/specials/packages/article/0,28804,1847213_1847216_1847180,00.html (last visited Apr. 10, 2015).

94. Financial Crisis Report, supra note 79, at 142.
securing the long investors on the other side of the deal, i.e., the investors that would only make money if the underlying assets appreciated in value. 95 Recall that Paulson’s firm was already the short investor for this deal. The long investors of import that Goldman solicited in ABACUS were foreign banks IKB Deutsche Industriebank AG (IKB) and ABN Amro Group (ABN).

Goldman knew that IKB would be interested in the long position in this deal, but only if an outsider selected the underlying mortgages. 96 As a result, Goldman brought in ACA Management LLC (ACA), an independent asset manager, to act as the CDO manager and select the securities for the underlying portfolio. 97 However, Goldman also allowed Paulson to select the underlying securities for the reference portfolio, despite the fact that Paulson was looking to short these RMBSs, and therefore had incentive to choose risky (“subprime”) mortgages for the portfolio. 98 Ultimately, Paulson proposed forty-nine out of the final ninety assets used in the ABACUS reference portfolio, 99 the majority of which were subprime. 100

Goldman ultimately put together ABACUS, an investment vehicle designed to help IKB, ABN, and Paulson get the exposure they wanted. However, Goldman failed to mention in its marketing materials Paulson’s role in selecting the underlying securities, even though IKB specifically asked for an independent asset manager to select the securities, and even though Paulson was far from independent. 101 Ultimately, IKB invested $150 million in the subprime bonds as the “funded” long investor; ABN, the “unfunded” long investor, invested $909 million, buying protection on its exposure from ACA Financial Guaranty Corp, the parent corporation of ACA. 102

96. Factbox: The ABACUS Deal, supra note 75.
97. Goldman Sachs, supra note 79.
98. See Levin-Coburn Report, supra note 1, at 396 (noting that ABACUS was “the first and only Abacus transaction in which Goldman allowed a third party [[Paulson]] to essentially ‘rent’ its CDO structure and play a direct, principal role in the selection of the assets”).
99. Id. As noted supra note 90, because a synthetic CDO contract is not actually tied to the underlying securities, but instead references them, the portfolio is called a “reference portfolio.” See Goldman Sachs, ABACUS 2007-AC1, at 16–17 (Feb. 26, 2007), available at http://www.math.nyu.edu/faculty/avellane/ABACUS.pdf.
100. Levin-Coburn Report, supra note 1, at 396. Subprime borrowers are considered to be the riskiest class of credit and are characterized by high debt-to-income ratios, low credit scores, and limited net worth. Generally, such borrowers do not qualify for conventional financing, but in the years leading up to the financial crisis, subprime borrowers were able to achieve financing relatively easily. As a result, demand for homes skyrocketed and housing prices began to artificially inflate, deviating from their true value and resulting in a bubble. See Financial Crisis Report, supra note 79; see also Steve Denning, Lest We Forget: Why We Had a Financial Crisis, Forbes (Nov. 22, 2011, 11:28 AM), http://www.forbes.com/sites/stevedenning/2011/11/22/5086/.
102. Factbox: The ABACUS Deal, supra note 75. When ABACUS was downgraded, because ABN Amro Group (ABN) had bought protection on the deal from ACA Management LLC (ACA)—i.e., ABN
Eventually, Paulson’s bet against ABACUS—and the housing market—paid off. By January 2008, at the end of the housing bubble, 99 percent of the underlying mortgage bonds in ABACUS experienced a downgrade as subprime borrowers began defaulting on their loans.103 The long investors in ABACUS lost more than $1 billion, while Paulson’s firm, with its opposite short position, profited by roughly the same amount.104 For its part, Goldman lost approximately $100 million, which was partially offset by the $15 million structuring fee it received from Paulson for creating and marketing ABACUS.105

B. The SEC’s Complaint and Its Aftermath

In April of 2010, the SEC filed suit against Goldman and Tourre for their role in ABACUS.106 The SEC’s complaint accused Goldman and Tourre of misleading the long investors (specifically, IKB) in ABACUS by failing to disclose that Paulson helped choose, and intended to bet against, the mortgage securities underlying ABACUS.107 Specifically, the complaint charged Goldman and Tourre with violations of § 17(a) of the Securities Act,108 § 10(b) of the Exchange Act,109 and SEC Rule 10-b5.110

Though the SEC’s complaint on its face asserted a formal violation of the antifraud rules as its basis for a cause of action, the complaint and subsequent hearings concentrated on the relationship between the parties involved and the


105. See Factbox: The ABACUS Deal, supra note 75.


107. See id.

108. Section 17(a) of the Securities Act prohibits any person from obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact. Securities Act of 1933, ch. 38, tit. I, § 17(a), 48 Stat. 74 (codified as amended at 15 U.S.C. § 77q(a)(2) (2013)). As discussed above, violations of § 17(a) do not require proof of scienter and may be based on proof of negligence. See discussion supra Part II.B.

109. To prove Goldman violated § 10(b) of the Exchange Act, and Rule 10b-5 thereunder, the SEC would have to prove that Goldman’s actions constituted a misrepresentation or a material omission made with scienter. SEC Staff Study, supra note 8, at 61.

110. See Press Release, supra note 106.
responsibilities that Goldman owed to its customers, therefore looking more like a gap-filling, fiduciary-duty analysis rather than an application of a rules-based antifraud analysis. Goldman distinguished its transactional role in ABACUS as that of a market maker rather than an adviser: “As a market maker, we are making buying and selling a thousand times a minute, probably. . . . Advising is where people are coming to us for advice—people are asking us our opinion, where we have an obligation and duty.”

C. The Settlement

On July 14, 2010—mere hours after the Senate confirmed Dodd-Frank and only three months after the SEC filed its complaint against Goldman—the SEC and Goldman reached a settlement where Goldman agreed to pay a fine of $550 million. The SEC called the settlement “a stark lesson to Wall Street firms that no product is too complex, and no investor is too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing.”

111. See id.; R.E. Heubel, Senate Hearing: Lloyd Blankfein vs. Sen. Levin; Goldman Sachs, YouTube (Apr. 27, 2010), available at http://youtu.be/oOpFbjHcxF0?t=14s (“There is such a fundamental conflict of interest . . . when Goldman is selling securities, [] particularly when its own people believe they are bad items, . . . [and then] to go out and sell these securities, . . . is a fundamental conflict of interest and raises a real ethical issue.”).


115. While the SEC settled with Goldman, the case against Tourre went to trial. In August 2013, he was found liable on six of seven counts of securities fraud violations by a Manhattan federal jury. SEC v. Tourre, 950 F. Supp. 2d 666 (S.D.N.Y. 2013). Tourre refused to settle with the SEC, “maintaining that he had done nothing wrong.” Tim Mullaney, Ex-Goldman Trader ‘Fabulous Fab’ Loses Fraud Case, USA Today (Aug. 1, 2013, 9:19 PM), http://www.usatoday.com/story/money/business/2013/08/01/goldman-trader-fabrice-toure-reaction/2609717/. Tourre’s defense rested in part on his belief that he should have been shielded from personal responsibility because he told his bosses about the deal. Shortly before the verdict in August 2013 was announced, Tourre told the Wall Street Journal, “I was a big team player. If there was something wrong with this transaction, wouldn’t people have told me?” Justin Baer, Tourre Interviews: Case Will ‘Stay with Me Forever’, WALL ST. J. (Aug. 1, 2013, 4:12 PM), http://online.wsj.com/news/articles/SB100014241278873323997004578639880516729260.


117. Guerrera et al., supra note 114 (quoting Robert Khuzami, then-director of the SEC’s enforcement division).
While the SEC touted this settlement as a win, the financial world and blogosphere “almost universally” proclaimed Goldman the true victor. In reality, the settlement was nothing but a slap on the wrist for Goldman. While a $550 million fine was, at the time, the biggest penalty levied on a Wall Street bank, to Goldman, the fine was relatively nominal, amounting to roughly 4 percent (or a week’s worth of trading revenues) of the roughly $13 billion in profits Goldman earned during the year leading up to the settlement. Likewise, the settlement amount was well below the $1 billion originally alleged in the complaint. Finally, the settlement merely required Goldman to admit that its marketing materials for ABACUS were “incomplete,” rather than forcing Goldman to admit to any real wrongdoing:

[T]he marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was “selected by” ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson’s economic interests were adverse to CDO investors.

Immediately following the settlement, Goldman’s shares jumped 4.4 percent, resulting in a near $3 billion increase in market capitalization for the firm, and were up an additional 5 percent after hours, adding far more to the firm’s market value than the amount it paid in the settlement. As one commentator noted after the settlement announcement, “Goldman has, effectively, bought its reputation back.”


120. Guerrera et al., supra note 114; White, supra note 118 (noting that a $550 million fine was “big but ultimately a footnote for a company that made $13.39 billion” in the previous year); Julianne Pepitone, Goldman Settles with SEC for $550 Million, CNN Money (July 16, 2010, 6:01 AM), http://money.cnn.com/2010/07/15/news/companies/SEC_goldman/

121. Guerrera et al., supra note 114.


125. Varadarajan, supra note 123.
IV. PROBLEMS WITH IMPLEMENTING A FIDUCIARY STANDARD

Cases like Goldman prove that the unfettered, profit-maximizing culture of firms clearly has an impact on customer protection. However, implementing a fiduciary standard on broker-dealers is not the solution. While the federal securities acts were passed with an aim toward customer protection, they were also passed with the additional goal of ensuring the “least possible interference” with the finance markets. Implementing a fiduciary standard elevates customer protection unnecessarily at the expense of market efficiency and ignores other viable solutions.

While it is true that Goldman was not held to a fiduciary standard during the ABACUS deal, Goldman was held to the antifraud provisions of the Securities Act, Exchange Act, and specific SRO rules governing customer protection. Though the SEC settled with Goldman and, hence, the issue of whether Goldman’s actions were truly fraudulent was never litigated, it seems clear that a good case could have been made against Goldman for violating the antifraud rules. This hypothesis is bolstered by the fact that in August 2013, Tourre (the other named defendant in Goldman) was found guilty of six of seven counts of securities fraud violations for his role in ABACUS.

Further, implementing a fiduciary standard on broker-dealers would have an adverse effect on the market in several ways. First, requiring broker-dealers to act in the best interests of all of their customers would make it harder for firms, if not impossible, to act as a market maker between two clients or to invest on the other side of a client trade, as an agency relationship would require Goldman to act in the best interests of one client, which necessarily comes at the expense of another client. As Lloyd Blankfein, former chief executive officer of Goldman, noted:

We are principals; the act of selling something is what gives us the opposite position of what the client has. If the client asks us for a bid, and we buy it from them, the next minute, we own it, they don’t. If they ask to buy it from us, the next minute, they own it, we don’t. We can cover that risk, but the nature of the principal business and market making is that we are the other side of what our clients want to do.

This distinction between Goldman’s role as a market maker versus its role as an adviser is one of the most contentious aspects of imposing a fiduciary standard on


129. See Sanati, supra note 113.

130. E.g., CEA, supra note 76, at 5–6.

broker-dealers, as many fear the imposition of such duty will drastically impact the ability of these firms to effectuate transactions and enhance the liquidity of markets.\textsuperscript{132} However, Goldman’s role in ABACUS was clearly much more than that of a neutral market maker.\textsuperscript{133} Rather, Goldman “actively marketed” ABACUS to the long investors and, in doing so, favored one client over the other—all while maintaining the image that it was a neutral and objective middleman.\textsuperscript{134} Further, despite the fact that Paulson’s “significant role” in the structuring of ABACUS was obviously adverse to the long investors, such was never disclosed to the other investors, violating the disclosure rules of the Exchange Act.\textsuperscript{135} Goldman not only failed to disclose Paulson’s role, but Tourre,\textsuperscript{136} the vice president principally responsible for ABACUS, also actively misled ACA and IKB into believing that Paulson’s interests were “closely aligned” with their own by suggesting Paulson was an equity investor in ABACUS.\textsuperscript{137} In reality, however, Paulson’s short position “sharply conflict[ed]” with those of the long investors.\textsuperscript{138}

However, while Goldman’s role went beyond that of a neutral market maker (hence, the subsequent SEC case against Goldman), market makers do play an important role by helping to facilitate the sales of financial instruments, therefore increasing the liquidity of markets. The imposition of a fiduciary standard would significantly hinder the ability of broker-dealers to play this role in the market.\textsuperscript{139}

Second, it is hard to justify why sophisticated broker-dealer customers—who come to Goldman to be connected to other investors and have Goldman effectuate the trade such customers were already looking for—should need fiduciary protection at all. As Lloyd Blankfein argued before a Senate subcommittee, “What [our] customers are buying . . . is an exposure, the thing that we are selling to them is supposed to give them the risk they want, they are not coming to us to represent what our views are . . . the institution clients we have wouldn’t care what our views

\textsuperscript{132.} See Cea, supra note 76, at 20; Sanati, supra note 113.

\textsuperscript{133.} See R.E. Heubel, Senate Hearing: Lloyd Blankfein vs. Sen. Levin; Goldman Sachs, YouTube (Apr. 27, 2010), available at https://www.youtube.com/watch?v=oOpFbjHcxF0 (noting that there is a difference between simply betting against the security as a market maker and selling a security to an investor without disclosing their conflicting roles as both market maker and adviser).

\textsuperscript{134.} Sanati, supra note 113.

\textsuperscript{135.} See Press Release, supra note 106.

\textsuperscript{136.} Tourre made headlines when an email he wrote to his girlfriend in 2007 was released to the public: “The whole building is about to collapse anytime now. Only potential survivor, the fabulous Fab . . . standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstruosities [sic] !!!” Tim Mullaney, Ex-Goldman Trader ‘Fabulous Fab’ Loses Fraud Case, USA Today (Aug. 1, 2013, 9:18 PM), http://www.usatoday.com/story/money/business/2013/08/01/goldman-trader-fabrice-tourre-reaction/2609717/ (internal quotation marks omitted).

\textsuperscript{137.} See Press Release, supra note 106.

\textsuperscript{138.} Id.

are.” The difference with respect to broker-dealer customers stands in sharp contrast to customers of investment advisers, who come to advisers looking for professional advice on a particular security and, hence, a fiduciary standard is logical and necessary to ensure that customer’s protection.

Finally, the associated compliance costs of implementing a fiduciary standard on broker-dealers would result in unintended effects on broker-dealer customers. To ensure adherence to this new standard, firms would be forced to upgrade their compliance systems, supervision, and training systems. It would cost, on average, roughly $5 million per firm for these firms to initially develop the necessary infrastructure to comply with a fiduciary duty obligation, and an additional $5 million per year to maintain these systems, procedures, and programs. The effect of this would harm not only the firms but, interestingly, would also spread to middle-income investors, as most firms have expressed that they will either pass on the higher costs to clients by increasing fees or limiting their practice to clients with a minimum amount of assets—a result surely not intended by those advocating for the protection of customer interests.

V. THE SOLUTION

Despite hundreds of pages of law and thousands of pages of regulations, the system itself is not any safer.

The solution to the current problems in the regulation of broker-dealers lies not in imposing yet another rule or regulation on broker-dealers, which would carry with it significant adverse effects but, instead, lies in the enforcement of existing rules and regulations.


142. A study promulgated by the National Association of Insurance and Financial Advisers (NAIFA) showed that nearly 90 percent of financial advisers believed their business costs would increase if the SEC raised the advice bar. Three-quarters of the respondents indicated that they would pass on these higher costs to their clients by imposing or increasing fees. Another 65 percent said they would limit their practice to clients with a minimum amount of assets, effectively limiting financial advice to about half of their current client base. See Letter from Susan B. Waters, Chief Exec. Officer, Nat’l Ass’n of Ins. & Fin. Advisers, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (July 2, 2013), available at http://www.sec.gov/comments/4-606/4606-3099.pdf.

A. The Problem: Quick and Easy Settlements Have No Deterrent Effect

As noted above, the SEC’s case against Goldman seemed to articulate a viable case for securities fraud violations. However, rather than fully prosecute Goldman and hold it accountable for its actions, the SEC instead settled.\footnote{Consent of Defendant Goldman, Sachs & Co., SEC v. Goldman, Sachs & Co., No. 10-CV-3229, 2010 WL 2779309 (S.D.N.Y. July 14, 2010).} This settlement likely did not reflect the inadequacy of the SEC’s case against Goldman but, rather, reflected the SEC’s desire to settle the case quickly and efficiently with minimal use of resources.\footnote{William O. Reckler & Blake T. Denton, \textit{Understanding Recent Changes to the SEC’s ‘Neither Admit nor Deny’ Settlement Policy}, 20 Corp. Governance Advisor 1, 1 (Mar.–Apr. 2012) (noting that the SEC’s settlement policy “has been considered by the SEC to be necessary for efficiency and productivity”); \textit{Rakoff’s Revenge}, Economist (Apr. 13, 2013), http://www.economist.com/news/finance-and-economics/21576132-rejections-settlements-financial-institutions-are-catching-rakoffs ("Settlements are at the heart of how the SEC handles litigation: they are quick and efficient.").} This policy to settle, rather than litigate, makes sense in light of the above-mentioned policy reasons. However, less justifiable is the actual settlement itself, in that it did not require Goldman to admit any wrongdoing.\footnote{Goldman Sachs, Bank of America, Citigroup, and JPMorgan Chase, institutions that were "at the center of the financial crisis," all settled with the SEC without admitting or denying any guilt. James B. Stewart, \textit{S.E.C. Has a Message for Firms Not Used to Admitting Guilt}, N.Y. Times (June 21, 2013), http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html.} This type of settlement, known as a “no admit, no deny” settlement, is typical practice for cases involving securities violations.\footnote{Id.}

No admit, no deny settlements cause more danger in terms of customer protection than an absence of regulatory policies ever could because they fail to provide adequate incentive to follow existing rules. These settlements not only provide firms with a quick and virtually painless resolution with the SEC, but they also shore up subsequent private litigation, as private litigants cannot rely on these settlements to bolster their allegations of wrongdoing.\footnote{Reckler & Denton, \textit{supra} note 145, at 3; see also Donald C. Langevoort, \textit{Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty}, 83 Wash. U. L.Q. 1017 (2005) (describing the difficulties that private litigants bringing securities actions face).} If, however, defendants were required to admit to wrongdoing as part of the SEC settlements, plaintiffs could rely on these settlement admissions in their complaints, helping to strengthen securities suits and, consequently, the deterrent effect against those securities firms.\footnote{For example, a federal judge recently ruled that a class action claim by investors against JPMorgan regarding misleading statements in offering documents for certain RMBS could go forward. This class action certification came \textit{after} JPMorgan’s $13 billion settlement with the U.S. Justice Department. Edvard Pettersson, \textit{JPMorgan Loses Ruling on Class Certification in RMBS Lawsuit}, Bloomberg (Sept. 30, 2014, 9:43 PM), http://www.bloomberg.com/news/2014-09-30/jpmorgan-rmbs-investors-can-proceed-as-group-in-fraud-lawsuit.html. This settlement included a statement of facts wherein JPMorgan “acknowledged” that it “regularly misrepresented to RMBS investors that the mortgage loans in various securities complied with underwriting guidelines.” Press Release, Eric T. Schneiderman, N.Y. Attn’y Gen., A.G. Schneiderman-led State & Federal Working Group Announces $13 Billion}
Likewise, had the SEC settlement required Goldman to admit to wrongdoing, this would have been “vastly more damaging,” not only in terms of the bank’s ongoing legal obligations, but also to the firm’s market value.\textsuperscript{150} In fact, if nothing else, the SEC’s complaint against Goldman demonstrates the power an adverse public opinion can have on a market participant.\textsuperscript{151} The day the SEC filed its complaint against Goldman, Goldman’s share price dropped more than 13 percent, reflecting a reduction of about $10 billion in market value.\textsuperscript{152} Further, the SEC’s subsequent settlement also demonstrates the power of the public’s forgiveness once an issue fades from the public eye.\textsuperscript{153} As noted above, the day the Goldman settlement was announced, Goldman’s shares jumped around 9 percent, demonstrating the interrelated nature of public opinion, market worth, and SEC enforcement action.\textsuperscript{154}

Goldman, as a rational, self-interested market player—when weighing the pros and cons of pursuing a particular course of conduct—will naturally choose the path that maximizes its potential gains. The SEC’s current enforcement policy fails to provide firms like Goldman with the necessary incentives to follow such rules because the costs associated with rule violations currently do not outweigh the potential benefits of pursuing a course of action that produces the highest returns for the firm. Goldman, looking at structuring a $1 billion deal like ABACUS, will choose every time to structure that deal in whatever way possible that makes the most gains if it views the cost in doing so as a single $550 million dollar fine. Instead of having a deterrent effect, then, most firms view enforcement actions by the SEC “as a cost of doing business.”\textsuperscript{155}

Had the SEC fully prosecuted Goldman, or at least forced it to admit to some wrongdoing when settling, there likely would have been a far greater impact on the firm’s practices and policies for the future and, in effect, would have forced Goldman to adequately police its own policies to better guard against such egregious business practices. The incentive—and result—would come not from the top-down implementation of a new fiduciary standard but, rather, would come internally (from the firms themselves) as a result of these firms seeing an actual cost if they choose to violate such rules. Rather than a quick and easy settlement, firms would view violations

\textsuperscript{150.} White, \textit{ supra} note 118.

\textsuperscript{151.} Davidoff et al., \textit{ supra} note 95, at 530–31.

\textsuperscript{152.} Id.


\textsuperscript{154.} See Guerrera et al., \textit{ supra} note 114; Varadarajan, \textit{ supra} note 123; see also Smith, \textit{ supra} note 126 (noting that a firm that continually puts its own needs ahead of those of its customers will ultimately fail).

and SEC enforcement action as causing ongoing legal obligations and continuous decreases in the value of their stock prices, as public opinion seems to correlate with the announcement and subsequent settlements of these firms’ “alleged” wrongdoings.

Interestingly, this push toward actually holding firms accountable for their actions has come not from a change in the SEC’s regulatory policy, or as a result of legislative reforms, but from the courts.

B. The Court’s Role: No More Rubber Stamping

In order for a settlement to be effective, a federal judge must first approve the settlement. Historically, judges, attempting to give agencies such as the SEC appropriate deference, have “rubber-stamped S.E.C. settlements with banks and other defendants accused of civil fraud.”

In November 2011, however, a federal judge for the Southern District of New York, Judge Jed S. Rakoff, made headlines when he issued an order rejecting a promised $285 million settlement of the SEC’s lawsuit against Citigroup Global Markets, Inc. (“Citigroup”), wherein the SEC brought suit against Citigroup for misleading investors in the structuring and marketing of a CDO in violation of the Securities Act. In rejecting the settlement, Judge Rakoff noted that the no

156. SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 331 (2011), vacated and remanded by 752 F.3d 285 (2d Cir. 2014). At issue on appeal was the level of deference a “district court owes an agency seeking a consent decree.” Citigroup, 752 F.3d at 293. The Second Circuit found that the district court applied an incorrect standard of review when it asked whether the settlement was “fair, reasonable, adequate, and in the public interest.” Id. at 294. The court found that the correct standard of review is whether the settlement is “fair and reasonable, with the additional requirement that the public interest would not be disserved.” Id. (citations omitted). Specifically, the court removed the term “adequate” from the standard, noting that adequacy applies to class action settlements, but not to agency review. Id. This decision from the Second Circuit has essentially eliminated the idea that a court in this jurisdiction can require an admission of liability from a defendant as a condition of approving a consent decree. David McAfee, SEC Wants ‘No Admit, No Deny’ Pact with SAC Approved, Law360 (June 16, 2014, 8:16 PM), http://www.law360.com/articles/548634/sec-wants-no-admit-no-deny-pact-with-sac-approved.


159. Complaint at 1, SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11-CV-7387), 2011 WL 4965943. As noted supra in note 156, Judge Jed S. Rakoff’s ruling was overturned, and he ultimately was forced to approve the SEC’s settlement offer. See Wyatt, supra note 156.

160. Citigroup is not an isolated incident in the iconoclastic career of Judge Rakoff, who continually uses his power on the bench to demand more accountability from banks. In July 2014, for example, Judge Rakoff was charged with deciding the ultimate amount of the penalty levied on Countrywide Financial, which Bank of America acquired in 2008, for its fraudulent scheme selling questionable mortgages during the financial crisis, which linked bonuses to how fast bankers could originate loans. Judge Rakoff, calling the scheme “brazen fraud,” ultimately levied a $1.26 billion penalty against Bank of America. United States ex rel O’Donnell v. Countrywide Home Loans, Inc., No. 12-CV-1422, 2014 WL 3734122, at *6 (S.D.N.Y. July 30, 2014).
admit, no deny provision failed to provide the court with enough facts relating to the merits of the case, making it impossible to assess the adequacy of the settlement. 161

Following Judge Rakoff’s lead, other federal judges started demanding more accountability, or at least more information, from defendants before signing off on settlements. 162 In 2011, Judge Richard J. Leon, a federal judge for the District of Columbia, refused to approve a settlement between the SEC and IBM without more information about the allegations. 163 Judge John Kane of Denver rejected a $13 million settlement involving an alleged Ponzi scheme: “I refuse to approve penalties against a defendant who remains defiantly mute as to the veracity of the allegations against him.” 164 New York Judge Victor Marrero blocked a record-setting deal between the SEC and SAC Capital over insider-trading charges, noting: “There is something counterintuitive and incongruous about settling for $600 [million] . . . if it truly did nothing wrong.” 165

Following this critique from the courts, Senator Elizabeth Warren also began criticizing the SEC’s no admit, no deny policy. Tellingly, Senator Warren, in her inaugural Senate Banking Committee hearing in February 2013, chose not to question regulators about their progress in implementing Dodd-Frank but, rather, chose instead to critique the SEC for its legal settlement policy, questioning whether “too-big-to-fail has become too-big-for-trial.” 166 In a March 2013 letter sent to U.S. Attorney General Eric Holder, then-Federal Reserve Chairman Ben Bernanke, and SEC Chair White, Warren brought up the cost to the public of such settlement policy, noting that she was “interested in learning more about how your institution[s] ha[ve] evaluated the cost to the public of settling cases without requiring an admission of guilt rather than pursuing more aggressive actions.” 167

C. The SEC’s Response

Due perhaps to such criticism from the courts and from commentators such as Senator Warren, the SEC has indicated a potential retreat from its no admit, no deny
In the summer of 2013, newly appointed SEC Chair White noted: “[I]n the interest of public accountability, you need admissions. . . . Defendants are going to have to own up to their conduct on the public record. . . . This will help with deterrence, and it’s a matter of strengthening our hand in terms of enforcement.”

Actions do speak louder than words but, in July 2013, the SEC rejected a no admit, no deny settlement offer with hedge fund manager Phil Falcone and his hedge fund Harbinger Capital Partners, both of whom were accused of market manipulation and other acts of misconduct. The SEC instead required a settlement wherein Falcone and Harbinger admitted to acts of wrongdoing, paid an $18 million fine, and banned Falcone from the industry for a period of five years. Notably, however, neither Harbinger Capital nor Falcone actually admitted that their conduct violated the securities laws, but did admit that they acted “recklessly.”

Further, in September 2013, the SEC’s settlement with JPMorgan Chase regarding the “London Whale” trading debacle required the bank to pay a $920 million fine and to admit that it failed to oversee trading that led to a $6 billion loss for investors. In a separate case, the bank also admitted its traders engaged in

168. Reckler & Denton, supra note 145, at 1–2. For a discussion of Senator Warren’s criticism of the SEC’s no admit, no deny policy, see Hopkins, supra note 166.


173. In short, in February 2012, JPMorgan faced nearly $65 billion worth of losses on certain derivatives. To drive down the price of the derivatives in an attempt to prevent further losses, the bank sold roughly $7 billion of the instruments short in a day, creating “artificial selling pressure.” Tim Mullaney, London Whale Costs JPMorgan $100M More, USA Today (Oct. 16, 2013, 2:54 PM), http://www.usatoday.com/story/money/business/2013/10/16/jpmorgan-cftc-fine-london-whale/2993203/. A later Senate report analyzing the matter uncovered systemic failures in the bank’s internal control system: Risk limits, for example, were breached more than 330 times before the bank switched to a more lenient risk-evaluation formula. The Senate report noted: “[T]he whale trades exposed a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements.” Permanenent Subcomm. on Investigations, Comm. on Homeland Sec. & Gov’t Aff., JPMorgan Chase Whale Traders: A Case History of Derivatives Risks and Abuses 7 (Mar. 15, 2013), available at http://www.hsgac.senate.gov/committees/investigations/hearings/chase-whale-traders-a-case-history-of-derivatives-risks-and-abuses.

174. In re JPMorgan Chase & Co., Exchange Act Release No. 70458 (Sept. 19, 2013), available at http://www.sec.gov/litigation/admin/2013/34-70458.pdf. Specifically, JPMorgan was accused of violating the books-and-records provision of the federal securities laws, a provision that prevents companies from misstating their financial results and also requires adequate systems of internal controls to detect and
“reckless” conduct and market manipulation with London trades. After the settlement, the bank announced it would spend $1 billion to improve internal controls to prevent such a crisis from happening again.

However, while the Falcone/Harbinger and JPMorgan settlements represent a slight change from the SEC’s long-standing no admit, no deny settlement policy, it is clear that such settlements are still the norm. For example, in September 2013, the same month the SEC required JPMorgan to admit to some wrongdoing, the agency also released an announcement of settlements with twenty-two other firms accused of antifraud violations—each of which contained the no admit, no deny provision.

Rather than relying on Dodd-Frank’s sweeping reforms to save the public from Wall Street, reform must instead come from holding companies that commit egregious fraud or pose serious threats to investors accountable for their wrongdoings. A tougher approach to settlements will likely have much more of an impact on these firms, and will provide an actual incentive for firms to change their current business practices than would the imposition of yet another regulation.

VI. CONCLUSION

Dodd-Frank set out to reform Wall Street. Part of this reform included the possibility of imposing a uniform fiduciary duty on broker-dealers. This call for reform, in part, stemmed from what was viewed as a regulatory gap in the financial industry, resulting in significant threats to investors such as those exposed by the ABACUS deal. Since the “problem” was too little regulation, Congress crafted a “solution” via Dodd-Frank to fill these so-called regulatory gaps in the financial world.


176. Id.

177. In a memo written by the Enforcement Division of the SEC, then-co-directors George Canellos and Andrew Ceresny noted “most” cases would be settled without defendants admitting or denying any wrongdoing, and further suggested the SEC would only require admissions of wrongdoing when it would be in the public interest. Kara Scannell, SEC Considers Policy Shift on Admissions of Wrongdoing, Fin. Times (June 19, 2013, 4:51 AM), http://www.ft.com/intl/cms/s/0/7a93d5dc-d882-11e2-b4a4-00144feab7de.html#axzz3RC97GWdE.


affect the role of broker-dealers in the market, but merely kicks the can down the road because it fails to confront the root of the problem: the pursuit of unfettered profit at all costs. If customer protection is truly the goal, then the self-interested culture of these firms needs to change. This change will come not from a top-down mandate but, rather, internally from a change in the culture of the firm itself.

The ABACUS deal, then, is important not because it demonstrated the shortcomings of the current regulatory system absent a fiduciary standard, but because it demonstrates the shortcomings of the current SEC no admit, no deny settlement policy. Such settlement policy, while resulting in headline wins for the SEC, fails to have any deterrent effect. Without forcing firms to admit to any wrongdoing, the public spotlight on these firms that appears at the onset of a case virtually disappears along with the settlement of the case and effectively eliminates firms’ ongoing legal obligations. As seen with the Goldman settlement, such a policy effectively allows a firm to buy back its reputation without necessarily forcing it to engage in better business practices.

If the current momentum toward actually holding firms engaged in wrongdoing accountable for their actions continues, then such a change will reform the financial regulatory system. It will incentivize firms to adequately police themselves to prevent rule violations, as they will no longer view breaking the rules as the cost of doing business.