Note

AGENTS OF CHANGE: THE FIDUCIARY DUTIES OF FORWARDING MARKET PROFESSIONALS

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> They're not afraid because other than Bernie Madoff, when was the last time someone on Wall Street faced any real punishment? . . . Sure, a few go to jail once in a while, but they're usually out in a few months and then on the speaking circuit. That's not exactly a deterrent against bad behavior that's making you millions.
>
> – Matt Taibbi[1]

> [I]nnovation creates challenges . . . .
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> It can foster incredibly complex financial products that fail to live up to buyers' expectations, but generate fees for their creators and sellers. This complexity can bury important information needed for effective decision-making, so that even the most sophisticated are unable to make informed judgments about risk and payoff. Finally, it can mask old-fashioned manipulation and fraud. But whether innovation is used for good or ill, to improve the system or to manipulate it—it creates a challenge for regulators . . . to keep up with the industries they regulate.
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> – Securities and Exchange Commission (SEC) Chairman Mary Schapiro[2]

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† Duke University School of Law, J.D. expected 2012; University of Virginia, B.A. 2009. I would like to thank Professor James Cox for his invaluable insight and guidance in developing and completing this Note. I am also grateful to the editors of the *Duke Law Journal* for their diligent editing work throughout the publication process. My deepest gratitude goes to my parents, Susan and Louis, and my sister, Jennie, for their support and encouragement in all of my endeavors.

1. David Sirota, *To Deter Crime, Get Tough on Wall Street*, IN THESE TIMES (Nov. 20, 2010), http://www.inthesetimes.com/article/6683/to_deter_crime_get_tough_on_wall_street (quoting Matt Taibbi, author and journalist for *Rolling Stone* magazine) (internal quotation marks omitted).

2. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Brodsky Family Lecture at Northwestern University School of Law (Nov. 9, 2010), *available at* http://www.sec.gov/news/speech/2010/spch110910mls.htm.

ABSTRACT

In the wake of the financial crisis of 2008, the legal system struggles to effectively regulate forwarding market professionals—broker-dealers and investment advisers who invest client funds with third parties. Defining the fiduciary duties these forwarding market professionals owe their clients when they invest funds with third parties raises complex issues concerning due diligence, postinvestment monitoring of investments, and disclosure of material facts. Weak regulatory standards, advances in technology in the financial-services industry, and changes in the scope of services provided by broker-dealers emphasize both the inadequacies of the system created by the Securities Exchange Act of 1934 (1934) Act and the Investment Advisers Act of 1940 (IAA) and the urgent need for a new regulatory standard. This Note contends that agency law provides a clear framework for defining the fiduciary duties that forwarding market professionals owe their clients for third-party investments. It then explains how the SEC is well situated to establish a fiduciary duty for forwarding market professionals based on agency principles under the Dodd-Frank Act.

INTRODUCTION

For decades, Bernie Madoff operated a Ponzi scheme, manipulating almost $65 billion in financial investments to create a facade of profitability.[3] Although Madoff engaged in blatantly criminal activity and was appropriately prosecuted,[4] the legal system struggles to regulate forwarding market professionals—broker-dealers and investment advisers[5] who invest client funds with third parties such as Madoff. As of 2012, regulations did not usually impose fiduciary duties on broker-dealers and only nebulously described the fiduciary duties that investment advisers owe their clients.[6] Scandals

3. Frances Romero, *Bernie Madoff Scandal: Where Are They Now?*, TIME (Mar. 12, 2010), http://www.time.com/time/specials/packages/article/0,28804,1971588_1971589_1971575,00.html.

4. *See generally The Madoff Case: A Timeline*, WALL ST. J. (Mar. 12, 2009), http://online.wsj.com/article/SB112966954231272304.html (providing a timeline of the events of the Madoff Ponzi scheme).

5. Throughout this Note, the terms "broker-dealers" and "investment advisers" generally reference financial institutions. Individual broker-dealers and investment advisers exist, but they often work for these larger financial institutions.

6. Under the framework created by the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)), and the Investment Advisers Act of 1940 (IAA), ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (2006)), broker-dealers need only make recommendations that are "suitable" to their clients.

such as Madoff's investment scheme highlighted the need for more stringent regulatory standards, including heightened duties of due diligence and postinvestment monitoring, for forwarding market professionals. In this regard, the economic crisis of 2008 has presented lawmakers, administrative agencies, and jurists with new regulatory challenges.[7]

In the aftermath of the Madoff scandal, regulators such as Massachusetts Secretary of State William Galvin focused their attention on the broker-dealers and investment advisers who invested client funds with Madoff.[8] Regulators, for example, have targeted Fairfield Greenwich Group (FGG), which allegedly received coaching from Madoff to avoid Securities and Exchange Commission (SEC) inquiries and had possessed at least constructive knowledge—if not actual knowledge—of Madoff's illegal Ponzi scheme.[9] Despite Madoff's suspect activities at the time, FGG did not notify its clients that it had invested their funds with Madoff.[10] Because the due-diligence standards created by the Securities Exchange Act of 1934 (1934 Act)[11] and the Investment Advisers Act of 1940 (IAA)[12] did not clearly require FGG to report Madoff's activities to clients, FGG was able to settle pending claims against it without admitting any wrongdoing.[13]

Similarly, investment adviser J. Ezra Merkin, the head of the hedge fund Gabriel Capital Corporation, moved $2.4 billion of client

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Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005). Broker-dealers are excluded from regulation under the IAA as long as the advice they provide to clients is "solely incidental" to their brokerage services and they receive no "special compensation" for the advice. Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006); *see also infra* Part I.

7. *See generally* Douglas J. Elliott, *Some Thoughts on US Financial Reforms*, BROOKINGS (Dec. 1, 2010), http://www.brookings.edu/~/media/Files/events/2010/1201_europe_economics/elliott_working_paper.pdf (describing recent regulatory developments in response to the financial crisis).

8. Svea Herbst-Bayliss, *Mass. Regulator Will Not Settle Madoff Feeder Suit*, REUTERS, Aug. 14, 2009, *available at* http://www.reuters.com/article/idUSTRE57D3X820090814 ("Galvin's office is particularly interested in finding people who invested indirectly with Madoff by putting their money into funds that ultimately handed the cash to his firm . . . .").

9. Beth Healy, *Galvin Won't Settle Madoff Case*, BOS. GLOBE, Aug. 14, 2009, at B7.

10. Herbst-Bayliss, *supra* note 8.

11. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)).

12. Investment Advisers Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (2006)).

13. *In re* Fairfield Greenwich Advisors LLC, No. 2009-0028, 2009 WL 3157459, at *1 (Mass. Sec. Div. Sept. 8, 2009).

funds into Madoff's investment scheme without his clients' knowledge.[14] By ignoring warnings that Madoff's profits were "too good to be true,"[15] Merkin failed to act in his clients' best interests when he neglected to perform adequate due diligence and disclose his investment decisions to his clients.[16] Although prosecutors have generally recognized the existence of some fiduciary duty to clients in these cases,[17] regulations under the 1934 Act and the IAA offer limited guidance as to the extent of forwarding market professionals' duties.

Financial-services regulation has long merited attention and attempts at reform,[18] and the Madoff scandal underscored the need for a new regulatory standard.[19] By raising issues about whether and to what extent due diligence, postinvestment monitoring of investments, and disclosure of material facts are required,[20] the Madoff scandal highlighted the particularly difficult problem of defining the fiduciary duties that broker-dealers and investment advisers owe their clients when investing funds with third parties. Technological advances in the financial-services industry and changes in the scope of services provided by broker-dealers have revealed both the inadequacies of the system created by the 1934 Act and the IAA and the need for a harmonized regulatory standard.[21] Although

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14. Martha Graybow, *Merkin Charged with Civil Fraud in Madoff Case*, REUTERS, Apr. 6, 2009, *available at* http://www.reuters.com/article/idUSTRE53548420090406.

15. *Id.*

16. *See id.* ("New York University and other investors also have sued Merkin, saying he put their money with Madoff without their consent.").

17. *See, e.g.*, Robert Chew, *Madoff Feeder Merkin Charged by Cuomo*, TIME (Apr. 6, 2009), http://www.time.com/time/business/article/0,8599,1889740,00.html ("In total, Merkin is charged with 720 breaches of fiduciary duty in raising, through social and charitable connections, over $4 billion, which he turned over to third-party money managers, like Madoff.").

18. For instance, in 2005, the SEC allowed broker-dealers to charge asset-based fees and still avoid regulation as investment advisers in certain circumstances. Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51523, Advisers Act Release No. 2376, 70 Fed. Reg. 20,424 (Apr. 12, 2005). The U.S. Court of Appeals for the District of Columbia Circuit vacated the SEC's new rule in 2007. Fin. Planning Ass'n v. SEC, 482 F.3d 481, 493 (D.C. Cir. 2007)*; see also* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 398 (2010) (discussing this sequence of events).

19. *See* Elliott, *supra* note 7, at 7 ("I believe that the legislative and regulatory changes do considerably more good than harm and are of real value . . . .").

20. *See infra* Part III.

21. *See infra* note 41 and accompanying text.

scholars have contemplated certain regulatory changes,[22] such as eliminating the broker-dealer exclusion in the IAA,[23] such suggestions presuppose a division between brokerage and advisory services[24] that does not reflect actual developments in the financial-services market.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[25] Congress created the opportunity to reform in the financial-services industry by giving the SEC discretion to establish a new framework of forwarding market professionals' fiduciary duties.[26] Specifically, section 913(g) of the Dodd-Frank Act allows the SEC, after a six-month study period, to recognize a new fiduciary duty for broker-dealers and investment advisers.[27] The SEC, after conducting such a study, described the need for a new heightened fiduciary duty, but it has yet to articulate the contours of that duty.[28] This Note proposes an innovative approach to the regulation of forwarding market professionals by applying agency principles to create the new framework. Agency law provides a strong conception of the duties of due diligence and postinvestment monitoring that forwarding market professionals owe their clients and would remedy deficiencies in the regulatory structure created by the 1934 Act and the IAA. Regardless of the statutory distinctions between broker-dealers and investment advisers, these financial institutions owe their clients fiduciary duties clearly defined in agency law when they invest funds with third parties.

Part I of this Note explores the fiduciary duties that forwarding market professionals owe their clients for third-party investments under case law, the 1934 Act, and the IAA, and argues for a revised fiduciary standard. It first provides a brief regulatory history of broker-dealers and investment advisers. It then describes the low bar set by the "suitability" standard for broker-dealers and explains how,

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22. *See, e.g.*, Black, *supra* note 6, at 54–55 (arguing that broker-dealers should be prohibited from holding themselves out as advisers and that their obligations should be expanded if they hold themselves out as more than broker-dealers); Laby, *supra* note 18, at 399 (proposing the harmonization of regulations of investment advisers and broker-dealers because such individuals no longer offer different services).

23. Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006).

24. *See infra* Part I.

25. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

26. *See infra* notes 202–11 and accompanying text.

27. Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 124 Stat. at 1828–29 (codified at 15 U.S.C. § 78o(k)–(*l*), 80b-11(g)–(h)) (Supp. IV 2010).

28. *See infra* notes 206–08 and accompanying text.

even when a fiduciary duty is established for forwarding market professionals, the applicable framework promotes silence instead of an affirmative duty of care toward clients. Part II of this Note discusses the general application of agency principles to the financial-services industry and describes how broker-dealers and investment advisers form agency relationships with their clients. Part III then articulates the clearly defined fiduciary duties these forwarding market professionals would owe their clients under an agency-law framework and outlines how these duties could have been applied to forwarding market professionals involved in the Madoff scandal.

I. THE INADEQUATE UNDERSTANDING OF FINANCIAL INSTITUTIONS' FIDUCIARY DUTIES TO CLIENTS IN THE CONTEXT OF THIRD-PARTY INVESTMENTS UNDER THE 1934 ACT AND THE IAA

The system of obligations and fiduciary duties for broker-dealers and investment advisers created by the 1934 Act and the IAA does not adequately protect clients from abuse. Section A of this Part provides a brief history of the regulatory framework governing broker-dealers and investment advisers. Section B then describes the sources of the obligations that broker-dealers have toward their clients with respect to funds managed by third parties. Lastly, Section C argues that even when a fiduciary duty is established for investment advisers under the framework created by the 1934 Act and the IAA, it promotes silence on the part of forwarding market professionals and does not effectively define the affirmative duties that these professionals owe their clients in the context of third-party investments.

A. Implications of the Historical Divide Between Broker-Dealers and Investment Advisers

The regulatory history of broker-dealers and investment advisers explains the complex and indeterminate fiduciary duties that these forwarding market professionals have traditionally owed their clients. The 1934 Act defines brokers as persons "engaged in the business of effecting transactions in securities for the account of others."[29] The 1938 Maloney Act[30] amendments to the 1934 Act established a system

29. Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2006).

30. Maloney Act, ch. 677, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o–3 (2006)) (adding section 15A to the 1934 Act).

of self-regulation for broker-dealers through the National Association of Securities Dealers (NASD), an organization whose functions would later be assumed by the Financial Industry Regulatory Authority (FINRA).[31]

Investment advisers occupy a different market niche. The IAA defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[32] Rather than provide transactional brokerage services like those supplied by broker-dealers, investment advisers offer continuous financial advice to clients and are compensated separately for their services. Investment advisers charge an asset-based fee for continued discretionary management of investments.[33] Broker-dealers generally charge commission-based fees for their services,[34] although some broker-dealers also provide advisory services for a separate fee.[35]

The IAA, which establishes a broker-dealer exclusion,[36] further sharpens the distinction between investment advisers and broker-dealers. This exclusion prevents regulation of broker-dealers under the IAA if the advice provided by such professionals is "solely incidental" to brokerage services and if the broker-dealers do not receive "special compensation" for the advice.[37] An examination of congressional intent sheds light on the rationale for excluding broker-dealers from regulation under the IAA: because broker-dealers were already regulated under the 1934 Act, Congress likely did not intend the IAA to apply to institutions already facing federal regulation.[38]

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31. Maloney Act, 52 Stat. at 1070 ("Any association of brokers or dealers may be registered with the Commission as a national securities association pursuant to [the requirements of the Maloney Act and the SEC]. . . ."); *see also* Stephen J. Nelson, *Commentary: A Gap in Regulation of the OTC Markets*, TRADERS MAG. (Jan. 26, 2010), http://www.tradersmagazine.com/news/otc-markets-finra-corporate-actions-104993-1.html ("To correct this oversight, Congress created Section 15A of the Exchange Act in 1938, which instituted something called a 'national securities association.' The National Association of Securities Dealers, Inc., FINRA's predecessor, was established in 1939." (quoting Maloney Act, 52 Stat. at 1070)).

32. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).

33. *Id.* (defining the scope of investment advisers' activities).

34. Laby, *supra* note 18, at 400.

35. *Id.* at 401.

36. Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C).

37. *Id.*; Laby, *supra* note 18, at 403.

38. *See* Black, *supra* note 6, at 41 ("In the SEC's view, the congressional intent behind the IAA was to regulate as investment advisers those persons whose activities were not already

Nevertheless, an earlier draft of the IAA did not explicitly exclude broker-dealers from coverage,[39] and the exclusion was added later without commentary.[40] Although this exclusion made sense in an era when broker-dealers provided a significant transactional service, technological advances since the drafting of the 1934 Act and the IAA have rendered this reasoning outdated.[41]

Although broker-dealers and investment advisers have historically operated under this dichotomous framework, subsequent legislative action has recognized the need for reform. The Dodd-Frank Act, passed on July 21, 2010,[42] presents an apt opportunity for the SEC to establish a new framework of fiduciary duties for financial institutions.

B. *The Limited Obligations of Broker-Dealers and Investment Advisers*

As of 2012, regulations only weakly defined the duties that broker-dealers and investment advisers owe their clients. Broker-dealers generally have no fiduciary duties to their clients, and the fiduciary duties of investment advisers do not adequately establish the level of due diligence required for third-party investments.

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subject to federal securities regulation. Since broker-dealers were already regulated under the [1934 Act], Congress carved out an exclusion to permit broker-dealers to provide investment advice to their brokerage customers without subjecting them to additional regulation." (footnote omitted)).

39. S. 3580, 76th Cong. § 45(a)(16) (1940); *see also* Black, *supra* note 6, at 41–42 (describing the ambiguous legislative history surrounding the broker-dealer exclusion).

40. S. 4108, 76th Cong. § 22(a)(11) (1940); H.R. 10065, 76th Cong. § 202(a)(11) (1940); *see also* Black, *supra* note 6, at 42 ("In this version, Title II had its own definitional section and its own definition of 'investment adviser' that included the broker exclusion. There was no commentary explaining the addition." (footnote omitted)).

41. *See* Laby, *supra* note 18, at 412 ("Changes in securities trading brought about by changes in technology have rendered brokerage a commodity, which no longer entails the level of judgment and skill required to conduct brokerage services in the bygone era of the early twentieth century."); *see also id.* at 404 ("The tidy separation between brokers and advisers began to crumble initially in the 1980s when brokers started to offer financial planning services, and more significantly in the 1990s when brokerage firms began to use titles such as 'adviser' or 'financial adviser' for their broker-dealer registered representatives and even encouraged customers to think of the registered representative more as an adviser than a stockbroker. . . . [U]se of such labels should put one on notice that the advice is no longer 'solely incidental' to brokerage. Regulators, however, did not respond to this marketing move, and the broker-dealer exclusion continued to separate brokers from advisers.").

42. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

1. *Broker-Dealers*. Under the system created by the 1934 Act and the IAA, broker-dealers must adhere to a mere suitability standard, which requires only that broker-dealers provide recommendations for investments that meet clients' specific needs.[43] Unless broker-dealers have advisory discretion over a client's investments, they are not bound by fiduciary duties and thus have no further obligations to their clients beyond the point of sale.[44] Therefore, broker-dealers generally do not have a duty to monitor client investments after an initial transaction.[45]

Because broker-dealers usually have no fiduciary duties to their clients under the 1934 Act and its related regulations, they can proceed with self-dealing transactions as long as the transactions are also suitable for their clients[46] and they disclose the self-dealing to their clients.[47] Although this system facilitates broker-dealers' acting as principals in transactions with their clients,[48] it also opens the field to abusive practices. For example, under the suitability standard, broker-dealers are not obligated to recommend the best possible investment option for their clients or to act in their clients' best interests.[49] The potential for abuse under such a standard is made even greater by the fact that the requirement to disclose self-dealing has been narrowly interpreted by courts.[50] For instance, in *Shivangi v.*

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43. *See* Black, *supra* note 6, at 36 ("When making a recommendation to purchase a security, broker-dealers have obligations to make only recommendations that are suitable for the customer, based on the customer's financial situation and financial objectives.").

44. *Id.*

45. *Id.*

46. *Id.* at 36–37.

47. 17 C.F.R. § 240.10b-10 (2011).

48. Because broker-dealers do not usually establish a fiduciary relationship with their clients under the framework set up by the 1934 Act and the IAA, they can engage in self-dealing by selling securities to clients from their own accounts as principals. *See* Laby, *supra* note 18, at 407 ("Particularly in non-discretionary accounts, brokers are not typically considered fiduciaries. Notwithstanding the prospect of owing fiduciary obligations, the primary reason many brokers oppose application of the Advisers Act is due to restrictions on conducting principal transactions imposed on advisers but not brokers." (footnote omitted)).

49. *See* David Serchuk, *Suitability: Where Brokers Fail*, FORBES (June 24, 2009, 6:00 AM EDT), http://www.forbes.com/2009/06/23/suitability-standards-fiduciary-intelligent-investing-brokers.html ("Your stock broker or investment adviser could be a straight arrow, scouring the financial world for the very best products, but it's entirely likely they aren't. They could just as easily push you into 'house' products that help them reap better commissions. The fact is, the latter situation is far from uncommon as brokers are typically not legally bound to find the 'best' products for you, merely ones that are considered 'suitable.'").

50. *See, e.g.*, Benzon v. Morgan Stanley, No. 3:03-0159, 2004 WL 62747, at *1, *4 (M.D. Tenn. Jan. 8, 2004) (dismissing claims brought against Morgan Stanley for its failure to disclose

Dean Witter Reynolds, Inc.,[51] the Fifth Circuit declined to hold the defendant brokerage firm liable for "failing to disclose that [its] account executives receive[d] higher compensation for principal trades of over-the-counter stocks in which Dean Witter [was] a market maker than for other sales."[52] Critically, the court determined that the brokerage firm had not intended to deceive its clients.[53]

Even when broker-dealers have fiduciary duties because they take on an advisory role, the framework provided by the 1934 Act and the IAA does not adequately define such duties in a postsale context.[54] The IAA, which regulates broker-dealers who do not meet the criteria for the broker-dealer exclusion,[55] fails to elaborate on postinvestment fiduciary duties.

2. *Investment Advisers*. Unlike broker-dealers, investment advisers have broad fiduciary duties to their clients under the IAA, related regulations,[56] and relevant case law.[57] These fiduciary duties

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the allocations and incentives it had given to employees to sell certain investments); Castillo v. Dean Witter Discover & Co., No. 97 Civ. 1272(RPP), 1998 WL 342050, at *9, *11 (S.D.N.Y. June 25, 1998) (holding that a brokerage firm was not liable for failing to disclose that its "brokers [had] received more compensation in conjunction with the sale of Dean Witter proprietary products than in conjunction with the sale of other products"); Black, *supra* note 6, at 37 ("Courts, however, have not held firms liable for failing to disclose that the firm's compensation system may give account executives incentives to sell particular securities.").

51. Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885 (5th Cir. 1987).

52. *Id.* at 886.

53. *See id.* at 889 ("The record supports the district court's finding of no actual intent to deceive. The record contains no evidence that Aitken or Dean Witter actually intended to deceive the Shivangis by failing to disclose the compensation information, nor does it establish that Aitken recommended the stock because of his unusual compensation. Rather, Aitken recommended Keldon Oil stock because Dean Witter's best analyst considered it a good investment."). If a client asks for investment advice and broker-dealers provide false or misleading information, the broker-dealers may be liable for fraud, but this liability does not arise from fiduciary duties. Black, *supra* note 6, at 36.

54. *See infra* Part I.B.2.

55. *See supra* note 23 and accompanying text.

56. *See* 17 C.F.R. § 275.206(4)-7 (2011) ("If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you: (a) . . . . Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act . . . ."). When claims arise against investment advisers, plaintiffs often use Rule 10b-5 of the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2011), *see, e.g.*, IDS Bond Fund, Inc. v. Gleacher NatWest Inc., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,471, ¶ 96,826 (D. Minn. May 1, 2001) (holding that a failure to disclose to clients material facts relating to an investment constituted a Rule 10b-5 violation).

arise from investment advisers' advisory role and nominally encompass both initial investments and postinvestment monitoring.[58] Investment advisers must obtain written prior consent from clients before initiating self-dealing transactions and must also advise clients of potential conflicts of interest.[59] Despite these safeguards, the fiduciary duties of investment advisers pose serious implementation problems and are not adequately defined in the postinvestment context.

For instance, although investment advisers must perform some initial due diligence, the degree of that due diligence and the extent to which investment advisers must disclose their findings to clients are unclear. Generally, due diligence "in the corporate finance context . . . refer[s] to the process of investigating a company's business, legal and financial affairs in preparation for a possible transaction."[60] Nonetheless, the specific due-diligence requirements for potential investments with third parties are ambiguous and may vary greatly.[61] Given such variance, investment advisers often negotiate due-diligence measures with their clients as a matter of contract.[62]

Due diligence can entail "perform[ing] a sensitivity analysis to determine the key drivers and risk factors for [a] business," "review[ing] [a] company's capital expenditure plans (for maintenance and for growth)," "compar[ing] [a] company's key financial statistics with the statistics of competitors," and

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57. *E.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship.'" (quoting 2 LOUIS LOSS, SECURITIES REGULATION 1412 (2d ed. 1961)); *see also* Black, *supra* note 6, at 38 ("It is well established that the relationship between an investment adviser and his customer is a fiduciary one.").

58. *See* Black, *supra* note 6, at 38 ("[W]here the investment adviser's duties include management of the account, he is under an obligation to monitor the performance of the account to make appropriate changes in the portfolio.").

59. *Id.*

60. John J. Clarke, Jr. & Lisa Firenze, *Due Diligence and Potential Liabilities*, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 2008, at 119, 128 (PLI Corporate Law & Practice, Course Handbook Ser. No. B-1702, 2008).

61. *See id.* ("The determination of how much diligence is necessary or appropriate or what constitutes a 'reasonable investigation' generally will vary depending on the specific facts and circumstances." (quoting Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (2006))).

62. *See* Douglas J. Schulz, *Due Diligence: Securities Applications and Regulatory Requirements, 2011*, 17 PIABA B.J. 353, 357 (2010) ("[I]t's not uncommon for a private placement memorandum (PPM) or prospectus to state that the general partner or investment advisor will conduct 'due diligence' as to any investments made.").

"calculat[ing] whether [a] debt or equity offering will cause [a] company to violate financial covenants in the company's financing documents."[63] Although a wide array of possible due-diligence measures exists, "[it] is difficult to establish a uniform set of due diligence procedures for all transactions. . . . Steps that are appropriate for one offering may not be appropriate for another."[64] In the financial-services industry, this lack of uniformity leads to uncertainty regarding what specific duties of due diligence investment advisers owe their clients.[65]

Given the lack of transparency in the financial-services market,[66] investment advisers sometimes fail either to perform the basic level of due diligence or to disclose negative results to clients. For instance, in the aftermath of the Madoff scandal, some clients sued financial institutions that had invested client funds with Madoff for breach of contract and failure to perform due diligence.[67] Nevertheless, clients usually cannot identify potential claims against financial institutions until after the damage has been done—largely because of the lack of transparency and the reactionary nature of the regulatory system.[68]

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63. Valerie Ford Jacob, *The Due Diligence Process from the Underwriter's Perspective*, *in* CONDUCTING DUE DILIGENCE IN M&A AND SECURITIES OFFERINGS 2009, at 135, 146 (PLI Corporate Law & Practice, Course Handbook Ser. No. B-1746, 2009) (describing the various responsibilities of due diligence); *see also* Clarke & Firenze, *supra* note 60, at 131–33 (providing another list of various aspects of due diligence for financial firms).

64. Clarke & Firenze, *supra* note 60, at 128.

65. *See supra* note 61 and accompanying text.

66. *See* Michael Barr, Assistant Sec'y for Fin. Insts., U.S. Dep't of the Treasury, Remarks at the Financial Times Global Finance Forum on "Reforming the Global Financial System" (Feb. 12, 2010), *available at* http://www.mondovisione.com/media-and-resources/news/assistant-us-treasury-secretary-for-financial-institutions-michael-barr-remarks- ("The financial sector, under the guise of innovation, piled ill-considered risk upon risk. The lack of transparency hid the growing wedge in incentives facing different players in the system.").

67. *See* Sanford P. Dumain, *The Madoff Fraud: A Plaintiffs' Lawyer's Perspective*, *in* RESPONSE TO PONZI AND OTHER SCHEMES: ALTERNATIVE INVESTMENT FUNDS UNDER SCRUTINY, 43, 48 (PLI Corporate Law & Practice, Course Handbooks Ser. No. 1758, 2009) ("There have been numerous complaints filed alleging that defendants breached their fiduciary duty by not conducting sufficient due diligence or in failing to exercise reasonable care in connection with their clients' investments. . . . Investors may be able to sue their investment advisers and/or other third parties on the basis of breach of contract."). Professor Dumain further elaborates that claims may arise under unjust enrichment, common-law fraud, negligent misrepresentation, and other causes of action. *Id.* at 48–49.

68. *See supra* note 66 and accompanying text.

C. Silence—Not Disclosure—Appears To Be the Governing Principle

Even when adequate due diligence has been performed, case law sets a low threshold for disclosing results to clients by punishing only misstatements of material fact.[69] Because usually only misstatements—not omissions—give rise to liability, investment advisers and broker-dealers often remain silent about the benefits and detriments of potential third-party investments. Cases such as *Van Alstyne, Noel & Co.*[70] and *Black v. Shearson, Hammill & Co.*[71] show that, because the regulatory system focuses on active misstatements and does not adequately define affirmative duties, forwarding market professionals often remain silent about negative aspects of potential third-party investments to avoid liability.[72] As the Supreme Court has said, "Silence, absent a duty to disclose, is not misleading . . . ."[73]

For instance, in *Van Alstyne*, the SEC sanctioned a broker-dealer for making positive statements about a potential investment when he possessed material nonpublic information revealing negative attributes about the company.[74] Although the undisclosed information had been confidential, the SEC ruled that Van Alstyne, the broker-dealer, should not have made any statements concerning the company in question because once the firm had volunteered positive information, it should also have revealed negative information.[75] The ruling in *Van Alstyne* properly disciplined the particular market

69. *See* Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 133–41 (2004) (outlining sources of fiduciary duties for financial institutions).

70. Van Alstyne, Noel & Co., Exchange Act Release No. 4699, 33 S.E.C. 311 (Apr. 8, 1952).

71. Black v. Shearson, Hammill & Co., 72 Cal. Rptr. 157 (Ct. App. 1968).

72. Many forwarding market professionals have taken further steps to protect themselves by establishing "Chinese walls," or barriers to the flow of nonpublic information within the firm. Laby, *supra* note 69, at 139–40. Even though these Chinese walls may promote compliance with duties of loyalty, they can also work against clients' best interests because "the institution would not be using all information that it had received to the benefit of a particular customer." Tender Offers, Securities Act Release No. 6239, Exchange Act Release No. 17,120, Investment Company Act Release No. 11,336, 45 Fed. Reg. 60,410, 60,415 (Sept. 12, 1980).

73. Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1987); s*ee also* Laby, *supra* note 69, at 136–37 ("[W]hen upholding a duty of loyalty to one person (preserving confidentiality), one may not breach a duty of loyalty (affirmative misstatements) to another. . . . If questioned on a matter about which one has confidential information, one must remain silent. If the truth calls for breaching confidentiality, the only option is to say nothing at all.").

74. *Van Alstyne, Noel & Co.*, Exchange Act Release No. 4699, 33 S.E.C. at 312–17.

75. *Id.* at 321.

professional in question,[76] but its logic may lead to two problems in practice. First, *Van Alstyne*'s reasoning incentivizes silence in the first instance to avoid incurring a duty of full disclosure; second, it fails to define what specific due-diligence obligations financial institutions owe their clients in the context of third-party investments.

Similarly, the fiduciary standard nominally addresses the continued monitoring of third-party investments, but it does so weakly because it focuses only on active misstatements. In *Black*, a financial institution was found liable for fraud because it had made positive statements concerning a potential investment even though a partner on the company's board later discovered the investment was faltering.[77] Although the partner had not initially known his statements were false, he had "permitted them to stand after he learned the truth and before respondents relied on them."[78] The court concluded that the partner had a duty to correct his earlier, innocently made misstatement.[79] Although the court properly described the partner's duty to disclose material postinvestment information, it did not provide any guidelines for an affirmative duty to perform postinvestment monitoring. Rather, it focused on the duty to disclose once relevant postinvestment information has been discovered.

The elaborations found in statutes, regulations, and case law of the fiduciary duties that forwarding market professionals owe clients for third-party investments do not adequately protect clients. The existing framework fails to define the affirmative duties forwarding market professionals owe their clients in the context of third-party investments and sets a weak regulatory standard by focusing on active misstatements. Broker-dealers and investment advisers, aware that partial disclosure creates a duty to disclose fully all aspects of a prospective investment, often remain silent to limit their liability.[80] Additionally, although these financial institutions have a duty to disclose material facts that they discover in the postinvestment context, case law does not impose an affirmative duty to perform

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76. *Id.* at 312–17.

77. Black v. Shearson, Hammill & Co., 72 Cal. Rptr. 157, 158–59 (Ct. App. 1968).

78. *Id.* at 159–60.

79. *See id.* at 162 (holding the defendant liable for not correcting his misstatement).

80. In the context of *Van Alstyne*, Professor Arthur Laby elaborates, "[O]nce the broker released positive information about the company, it had a duty to disclose negative information as well. The firm should have simply refrained from making statements regarding the company's prospects." Laby, *supra* note 69, at 134–135.

postinvestment monitoring of investments. Clients would benefit greatly from the establishment of a concrete affirmative duty for financial institutions to perform postinvestment monitoring when client funds are handled by third parties.[81]

II. ESTABLISHING A FIDUCIARY DUTY FOR FINANCIAL INSTITUTIONS BASED ON PRINCIPLES OF AGENCY LAW

Demonstrating the need for more clearly specified fiduciary duties in the financial-services industry constitutes only the first step toward remedying the problems created by the framework of the 1934 Act and the IAA.[82] This Part II argues that although scholars and regulators have overlooked agency law as a potential source for defining forwarding market professionals' fiduciary duties, agency principles are nonetheless applicable to the financial-services context. Section A describes how agency relationships often arise between forwarding market professionals and their clients. Section B describes the relevance of agency law to the financial-services industry and argues that agency law has the potential to resolve common criticisms against expanding the fiduciary duties of broker-dealers and investment advisers.

A. Broker-Dealers and Investment Advisers Often Establish Agency Relationships with Their Clients

Independent of the regulatory framework established by the 1934 Act and the IAA, forwarding market professionals often form agency relationships with their clients when they invest client funds with third parties. Under agency law, a fiduciary relationship "arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."[83] Contractual terms or industry norms do not determine the existence of an agency relationship; rather, an

81. *See infra* notes 173–80 and accompanying text.

82. *See* SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943) ("But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?").

83. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

agency relationship is determined by mutual assent between an agent and a principal.[84]

Because agency law focuses on the mutual assent of a principal and an agent, rather than on distinctions regarding whether advice was "solely incidental" to transactional services,[85] attention should be given to the reasonable expectations of both the client and the forwarding market professional. Financial institutions and their clients, in actions if not in words, often consent to an agency relationship that mandates continued monitoring and due diligence. Clients, for their part, expect a fiduciary relationship and assent to an interaction in which broker-dealers and investment advisers will guide them through the investment process as their financial agents. A poll of 1,319 clients of financial institutions revealed that "[m]any of them [were] wrong in their belief that . . . broker-dealers . . . are currently held to a fiduciary standard."[86] Moreover, broker-dealers often embrace this misconception by marketing themselves as financial agents.[87] Even though mutual assent to the consequent relationship might not be explicit, a manifestation of assent does not necessarily have to occur in writing under agency law, but rather can be derived from words or actions.[88] When a financial institution and its clients mutually agree to enter a business relationship involving continuous advice and monitoring of investments, they establish a broad agency relationship.

Although agency law has not yet been applied to forwarding market professionals' investing activities with third parties, courts have previously held that financial institutions can generally establish agency relationships with their clients. For instance, in *Merrill Lynch*

84. *See id.* § 1.02 ("An agency relationship arises only when the elements stated in § 1.01 are present. Whether a relationship is characterized as agency in an agreement between parties or in the context of industry or popular usage is not controlling."); *see also id.* § 8.07 ("An agent has a duty to act in accordance with the express and implied terms of any contract between the agent and the principal.").

85. *See supra* Part I.A.

86. Shepherd Smith Edwards & Kantas LTD LLP, *Most Investors Want Fiduciary Standard for Investment Advisers and Broker-Dealers, Say Trade Groups to SEC*, STOCKBROKER FRAUD BLOG (Oct. 12, 2010), http://www.stockbrokerfraudblog.com/2010/10/most_investors_want_fiduciary.html. In 2010, a number of trade organizations sent a letter to SEC Chairman Mary Schapiro highlighting this survey of clients of financial institutions. *Id.*

87. *See infra* note 41.

88. *See* RESTATEMENT (THIRD) OF AGENCY § 1.03 ("A person manifests assent or intention through written or spoken words or other conduct.").

Pierce Fenner & Smith, Inc. v. Cheng,[89] the D.C. Circuit held that Merrill Lynch had violated duties derived from its agency relationship[90] with Cheng, its client, by overpurchasing options in violation of specific instructions from Cheng.[91] Similarly, in *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*,[92] the Fifth Circuit found a violation of a duty derived from an agency relationship[93] when Lehman Brothers purchased stocks on behalf of its clients despite increases in the stock prices from the original prices quoted to the clients.[94]

Investment advisers often establish a broad agency relationship with their clients because the parties mutually assent to a continuous business interaction involving discretionary advice and postinvestment monitoring.[95] For example, in *IDS Bond Fund, Inc. v. Gleacher NatWest, Inc.*,[96] investment advisers were found to be agents of their clients when they purchased $62 million in debt securities issued by the defendant to fund the expansion of a foreign steel mill for their clients' accounts.[97]

Broker-dealers require closer analysis. Broker-dealers, by definition, act on behalf of their clients.[98] Because both parties assent to their roles, an agency relationship exists. Still, the scope of this relationship may be narrower than that of investment advisers and their clients because traditional broker-dealers generally provide only transactional services as opposed to continuous advisory services.[99] In

89. Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124 (D.C. Cir. 1990).

90. *Id.* at 1128 ("We hold that basic principles of agency law control here and that those principles required Grace to inform the Chengs of their right to reject the unauthorized options.").

91. *Id.* at 1126.

92. Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc., 794 F.2d 198 (5th Cir. 1986).

93. *Id.* at 200 ("The relationship between a securities broker and its customer is that of principal and agent . . . .").

94. *Id.* at 199.

95. *See supra* note 32 and accompanying text.

96. IDS Bond Fund, Inc. v. Gleacher NatWest Inc., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,471 (D. Minn. May 1, 2001).

97. *See id.* ¶ 96,827 ("The Investment Advisers were the agents for the Plaintiffs when it made the decision to purchase and/or purchased the Notes on behalf of Plaintiffs.").

98. Securities and Exchange Act of 1934, 15 U.S.C. § 78c(a)(4)(A) (2006) (defining broker-dealers as persons "engaged in the business of effecting transactions in securities for the account of others").

99. *See supra* notes 32–35 and accompanying text.

Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,[100] although the court found an agency relationship between the broker-dealer and its client,[101] it also found that this relationship entailed no more than the obligation "simply to buy and sell."[102] According to the court's description, the relationship ended when the transaction had been completed: "The risk of the venture [was] upon the customer who profit[ed] if it succeed[ed] and los[t] if it fail[ed]."[103] Additionally, as cases such as *Walston & Co. v. Miller*[104] demonstrate, the agency relationship between a broker-dealer and its clients can also extend over a number of transactions, leading to further fiduciary duties under agency law.[105] In *Walston*, the client had hired a broker-dealer to purchase and sell sugar contracts over a four-month period, establishing an agency relationship for that term.[106]

Thus, agency law often creates a strong fiduciary relationship between forwarding market professionals and their clients—a relationship that ought to shift the relevant analysis away from the arbitrary distinctions of the regulatory system imposed by the 1934 Act and the IAA. Rather than adhering to a distinction between broker-dealers and investment advisers, agency law creates a uniform framework that establishes fiduciary duties for forwarding market professionals whenever clients trust these financial institutions to act on their behalf with regard to third-party investments.

B. *The Relevance of Agency Law to the Financial-Services Industry*

Regulators and academics have largely ignored the application of agency law to financial institutions.[107] In this regard, establishing an

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100. Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 110 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972).

101. *Id.* at 111.

102. *Id.*

103. *Id.*

104. Walston & Co. v. Miller, 410 P.2d 658 (Ariz. 1966) (en banc).

105. *Id.* at 660 (describing an agency relationship between a broker-dealer and its client that extended over a four-month period).

106. *Id.*

107. *See* Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1188 (2003) ("To many legal academics, agency law is a backwater subject, long banished from the formal law school training except for brief introductory reference in corporations or business associations."). Some scholars have begun to recognize the general application of agency law to the financial industry, although this concept has not yet been applied to forwarding market professionals. *See, e.g.*, Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955, 986 (1995) ("As an offshoot of the law of trusts, agency theory imposes this same

agency framework for fiduciary duties represents a shift from the deficient statutory distinction between broker-dealers and investment advisers.[108] The inattention to the relevance of agency law in this context has forgone a potentially useful vehicle for describing the fiduciary relationships that both broker-dealers and investment advisers often establish with their clients.[109] Agency law "permeates an extraordinary amount of everyday law,"[110] including many aspects of business law.[111] Moreover, the law of agency is malleable and informed by decades of experience in a variety of settings; its principles and holdings are well tested.[112] This flexibility allows agency law to avoid many of the criticisms that some scholars have expressed concerning the expansion of fiduciary duties for forwarding market professionals.

For instance, despite the arguments of some scholars that contract law sufficiently protects clients,[113] agency law presents a more feasible safeguard for client funds invested with third parties. Although clients could theoretically contract to ensure that forwarding market professionals sufficiently perform due-diligence procedures, "the transaction costs involved in drawing up a detailed prior agreement covering all possible discretionary uses of power over the life of the relation would not only be enormous, but also would probably exceed the benefits of the proposed relation."[114] More general documents that would limit transaction costs might fail to

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unrelentingly high duty on the agent as fiduciary. The agency relationship is important because it is a standard business form." (footnote omitted)); Laby, *supra* note 18, at 414 ("If a broker holds itself out as an adviser, and a customer responds by hiring the broker to act on her behalf, this response triggers an agency relationship and a fiduciary obligation extending to matters within the scope of the agency."). *But cf.* Langevoort, *supra* at 1189 ("[A]gency law itself has not systematically been evaluated to see whether, or how well, its black-letter rules fit when the principal is an organization and the problem under consideration operates at agency's shared border with corporation law."). *See generally* Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535 (2005) (arguing that agency law could establish a fiduciary duty for broker-dealers to warn clients that an unrecommended purchase is unsuitable).

108. *See supra* notes 29–37 and accompanying text.

109. *See* Langevoort, *supra* note 107, at 1188 ("[I]ntellectual inattention to such a profound area of private ordering is dangerous.").

110. *Id.*

111. *See id.* ("[Agency law] appl[ies] anyplace that one person (the agent) agrees to act on behalf of another (the principal) to carry out the principal's affairs under the principal's control. It covers most employment relationships, and a good bit else." (footnote omitted)).

112. *See infra* Part III.A.

113. Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 813 (1983).

114. *Id.*

provide the specificity needed to protect individual clients.[115] Conversely, a fiduciary duty arising from agency-law principles would allow for a flexible framework that would avoid these transaction costs yet still establish specific obligations supported by a substantial body of case law.

Furthermore, although some cases have described how contract law's implied covenant of good faith protects clients,[116] failure to perform due diligence with respect to third-party investments is often not consistent with the type of good-faith understanding envisioned in such cases.[117] For instance, although some forwarding market professionals, such as FGG, allegedly acted in bad faith by investing client funds with Madoff despite actual or constructive knowledge of his illegal activity, many others merely failed to perform adequate due diligence and did not necessarily act in bad faith.[118] As the following Part of this Note describes,[119] an agency framework would establish affirmative duties of initial due diligence and postinvestment monitoring independent of the duty of good faith.

Although some scholars contend that market mechanisms can successfully regulate the financial-services industry and negate the need for a heightened fiduciary duty,[120] in practice, disparities in information and industry sophistication between financial institutions and their clients limit the application of such market mechanisms.[121] As was seen with the financial institutions that invested with Madoff, clients largely do not raise due-diligence concerns when they are enjoying steady profits.[122] Clients of FGG, for example, did not begin

115. *Id.*

116. *See, e.g.*, Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986) (noting that if the negotiating parties "would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith," then the act indeed would have constituted such a breach).

117. *See, e.g.*, Easton v. Strassburger, 199 Cal. Rptr. 383, 386–92 (Ct. App. 1984) (holding agents liable for their failure to perform adequate due diligence even though the court implicitly acknowledged that the agents did not act in bad faith). This case is discussed further in Part III.A.

118. *See supra* notes 8–17 and accompanying text.

119. *See infra* Part III.

120. *See* Frankel, *supra* note 113, at 812 ("If the entrustor has the power to terminate the fiduciary relation, the fiduciary may be deterred from abusing his power. Additionally, a fiduciary competing in the market for employment may wish to please his entrustor in order to enhance his reputation, to obtain more business, or to advance in the employee ranks.").

121. *See supra* note 66 and accompanying text.

122. *See* Graybow, *supra* note 14 (noting that investment adviser Merkin accepted $470 million in fees while investing with Madoff).

to question their investments until the market collapsed in 2008.[123] Also, because market mechanisms correct relevant issues in an ex post rather than an ex ante manner, they do little to protect client funds before a loss is realized, as seen in the case of FGG. Agency law, by contrast, outlines clear ex ante fiduciary duties that forwarding market professionals owe their clients in the context of third-party investments.

III. THE SPECIFIC DUTIES FORWARDING MARKET PROFESSIONALS WOULD OWE THEIR CLIENTS FOR THIRD-PARTY INVESTMENTS UNDER AGENCY LAW

This Part outlines the specific fiduciary duties that forwarding market professionals would owe their clients according to an agency framework and then considers how these duties would have applied to particular cases in the financial-services industry. First, Section A uses the Restatement (Third) of Agency[124] and relevant case law to elaborate on the specific duties that arise under agency law as applied to forwarding market professionals. Although agency law has not yet been applied to broker-dealers and investment advisers engaging in third-party investments,[125] analogous agency cases in various commercial contexts illuminate relevant principles. Next, Section B examines events in the financial-services industry, such as the Madoff investment scandal, and highlights how fiduciary duties arising from agency law could have been applied to these broker-dealers and investment advisers. As examples from the financial-services industry show, agency law could be used effectively to define clear fiduciary duties for forwarding market professionals with respect to client funds handled by third parties. Finally, Section C explains how a regulatory framework for forwarding market professionals based on agency principles could be implemented under the Dodd-Frank Act.

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123. *See* Healy, *supra* note 9 ("More recently, as the 2008 stock market collapse gathered steam, Fairfield clients pressured the firm to explain Madoff's operation and strategy. The executives could not answer many of these questions, and acknowledged in internal e-mails the gaps in their knowledge. Yet, according to Galvin's complaint and prehearing memorandum, they continued to assure customers they had done ample due diligence."); *see also* Frankel, *supra* note 113, at 812–13 ("[T]he power to terminate is an ineffective safeguard unless the entrustor can discover the abuse of power and the fiduciary knows he is subject to scrutiny.").

124. RESTATEMENT (THIRD) OF AGENCY (2006).

125. *See supra* Part II.

A. Agency Law's Exacting Standard

Agency law provides a framework of clearly defined duties that could be applied to broker-dealers and investment advisers that they invest client funds with third parties. Fiduciary duties based on agency law would include duties of care, competence, diligence, and good conduct on the part of the fiduciary to maximize the value of its clients' property.[126] Cases applying agency law illustrate that when these forwarding market professionals perform initial due diligence and postinvestment monitoring of third-party investments, they should use all reasonably available resources to investigate the third party.[127] Broker-dealers and investment advisers should review all relevant documents, perform additional due diligence for the potential investment, investigate any areas of concern, and ensure that the transaction meets regulatory requirements. After performing this high level of due diligence, financial institutions should then be required to disclose all material facts to their clients. Additionally, broker-dealers and investment advisers would have an obligation under agency law to perform postinvestment monitoring of the third parties. As agents who claim "to possess special skills or knowledge,"[128] broker-dealers and investment advisers should use the full breadth of these skills to represent their clients' interests by thoroughly investigating potential third-party investments.

First, agency law would require that forwarding market professionals review all relevant documents concerning third-party investments for potential problems that might warrant further investigation. For instance, in *Steed Finance LDC v. Nomura Securities International, Inc.*,[129] Steed hired AMRESCO Advisors, Inc.

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126. *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."); *see also id.* § 8.08 ("Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge."); *id.* § 8.10 ("An agent has a duty, within the scope of the agency relationship, to act reasonably and to refrain from conduct that is likely to damage the principal's enterprise.").

127. *See id.* § 8.08 (describing the specific duties an agent owes to a principal); *see also supra* note 63 and accompanying text.

128. *Id.* § 8.08.

129. Steed Fin. LDC v. Nomura Sec. Int'l, Inc., No. 00 Civ. 8058(NRB), 2004 WL 2072536 (S.D.N.Y. Sept. 14, 2004).

as its agent[130] to perform due diligence on a potential investment in subordinate commercial mortgage pass-through certificates.[131] Steed claimed that the defendants, the sellers of the certificates, had made misleading statements about the investment,[132] but the defendants ultimately proved that they had made full disclosures to AMRESCO, which had failed to perform its due diligence by not adequately reviewing those disclosures.[133] Though AMRESCO's due-diligence team leader claimed that he had never seen the relevant litigation disclosures,[134] the court found that AMRESCO had indeed received these documents and that, by not reviewing the documents, AMRESCO had failed to meet its duty of due diligence under agency law.[135] In this case, review of the disclosures would have revealed the potential concerns that sophisticated market professionals should have noticed.[136]

Next, agency law would require further due-diligence measures beyond mere document review. Such measures might entail investigating references for a potential investment and meeting with relevant officers of the third-party company. For instance, in *In re Rich*,[137] the defendant, "an accountant and former managing partner of J. Manning Winikus & Co.,"[138] had a fiduciary duty because of his agency relationship[139] with his client, Ruth Wolfert.[140] Wolfert had

130. *See id.* at *6 (specifically defining an agency relationship between AMRESCO and Steed).

131. *Id.* at *1.

132. *Id.* at *3.

133. *See id.* at *4 ("Defendants assert that a Litigation Disclosure revealing all relevant information was delivered directly to Steed and to its delegate, AMRESCO, whom Steed had hired to conduct due diligence in connection with the D5 Trust, and thus that all information which Steed claims was withheld was disclosed and, accordingly, plaintiff was not misled.").

134. *See id.* at *5 ("Larry Hicks, the head of AMRESCO's due diligence team, stat[ed] that he never saw the Litigation Disclosure (which was allegedly included in the Asset Summary Report) and was not aware of its contents.").

135. *See id.* at *6 ("[C]ontrary to Mr. Hicks' recollection, the Asset Summary Report was received by AMRESCO, who was acting as Steed's agent to perform pre-purchase due diligence . . . ." (emphasis omitted) (footnote omitted)).

136. *See id.* at *7 ("The disclosures in the Asset Summary Report certainly contained sufficient 'red flags' that a sophisticated investor should have realized that more due diligence was warranted. In fact, even ordinary investors are not permitted to ignore obvious warning signs.").

137. *In re* Rich, 353 B.R. 796 (Bankr. S.D.N.Y. 2006).

138. *Id.* at 799.

139. *Id.* at 805–07.

140. *Id.* at 800.

transferred $169,500 to the defendant for investment.[141] The defendant invested his client's funds in two investment schemes, through which he lost substantial portions of the funds.[142] Despite claims to the contrary by the plaintiff—the executor of Wolfert's estate—the court ruled that the defendant had indeed performed adequate due diligence.[143] Critically, with the two investments, the defendant had ensured the existence of the U.S. Treasury bonds that were to be redeemed, had met with relevant officers, had performed a criminal background check on one of the potential third-party companies, had examined relevant financial statements, and had contacted references.[144] As this case demonstrates, only extensive due diligence beyond initial document review would meet agency law's exacting fiduciary standard.

This heightened due-diligence standard would remedy the ineffective and ambiguous requirements created by the statutory framework of the 1934 Act and the IAA[145] by imposing a more stringent standard whenever a financial institution does not review documents or obtain other readily available information that would have revealed areas of concern for a potential third-party investment. The need for such a heightened standard is exacerbated by the fact that any weak requirements of due diligence under the system erected by the 1934 Act and the IAA have largely been applied only to investment advisers; broker-dealers have not faced similar requirements.[146] The adoption of an agency framework would

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141. *Id.*

142. *Id.* at 800–02.

143. *Id.* at 812. The court denied the plaintiff's motion for summary judgment in this case because the defendant's due-diligence efforts created a question of fact as to whether he had breached his agency relationship. *Id.*

144. *See id.* at 807–08 ("The Debtor claims that his due diligence consisted of: (i) confirming the existence of the U.S. Treasury Bonds that would allegedly be redeemed; (ii) speaking directly with a 'person' who George claimed to be an intermediary for the holders of the U.S. Treasury Bonds; (iii) sending a business consultant to Europe to verify parts of George's story; (iv) checking police records as to George's background; and (v) speaking to a director of a Dreyfus mutual fund about George generally."); *id.* at 810 (describing that, for the second investment, "(i) [the defendant] inquired about Mintus at Citibank, where [he and the decedent] both had accounts, and concluded that Citibank found her reliable; (ii) he contacted the references provided by Mintus and was told that she was responsible and reliable; (iii) he met with Mintus several times and brought a business associate with him; they both allegedly felt that Mintus was sincere; and (iv) he examined records of Mintus' prior investments, which allegedly reflected enormous profits").

145. *See supra* notes 63–65 and accompanying text.

146. *See supra* Part I.

mandate a heightened duty of due diligence both for broker-dealers and investment advisers operating in this context.

Furthermore, in the event that due diligence were to reveal any areas of concern, agency law would require forwarding market professionals to review those areas of concern through in-depth investigation. Agency case law in the real-estate context elaborates on this principle.[147] In *Easton v. Strassburger*,[148] real-estate brokers acted as agents to inspect a house for a potential sale.[149] Although the agents had inspected the house prior to sale and had noticed potential problems with the soil, they neglected to request soil tests and did not inform their clients of the potential complications.[150] Later, soil erosion damaged the house, resulting in a loss of $213,000.[151] When the California Court of Appeals rejected the plaintiff's fraud claim against the agents, it implicitly admitted that the agents had not acted in bad faith.[152] Nevertheless, the court found them liable for negligence[153] because they had violated their "affirmative duty to conduct a reasonably competent and diligent inspection of the residential property listed for sale."[154]

Agency law would thus expand upon the due-diligence requirements imposed by the 1934 Act and the IAA by establishing negligence as the standard for fiduciary violations.[155] As applied to the financial-services industry, broker-dealers and investment advisers would be required to investigate of any possible concerns that reasonable market professionals would have noticed in a potential third-party investment. Even negligent ignorance of concerns

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147. *See* Easton v. Strassburger, 199 Cal. Rptr. 383, 391–92 (Ct. App. 1984) (holding a real-estate broker liable for failing to investigate potential soil problems that later caused massive property damage).

148. Easton v. Strassburger, 199 Cal. Rptr. 383 (Ct. App. 1984).

149. *See id.* at 385–86 ("Appellant was represented in the sale of the property by its agents Simkin and Mourning.").

150. *See id.* at 386 ("There is also evidence they were aware of certain 'red flags' which should have indicated to them that there were soil problems. Despite this, the agents did not request that the soil stability of the property be tested and did not inform respondent that there were potential soil problems.").

151. *Id.* at 385.

152. *See id.* at 387 ("As noted, however, appellant's liability was here grounded on negligence rather than fraud.").

153. *Id.* at 397.

154. *Id.* at 390 (footnote omitted).

155. *See id.* at 387 ("We are concerned here only with the elements of a simple negligence action . . . .").

warranting investigation would establish liability under agency law.[156] Under the existing regulatory system, courts have sometimes looked to whether financial institutions have acted in good faith;[157] agency law would provide a more exacting standard that would hold financial institutions liable for negligent failure to perform due diligence regardless of their good faith.

Additionally, agency law would require forwarding market professionals to ensure that potential transactions meet all regulatory requirements. *AFA Private Equity Fund 1 v. Miresco Investment Services*[158] provides an analogous case to illustrate this point. In that case, the plaintiff had purchased 73,600 shares of Series B preferred stock for $1 million in Miresco, a wholesale distributor of area rugs.[159] The plaintiff utilized broker-dealer Sanders Morris Harris (SMH) as the placement agent for the transaction,[160] and the stock purchase agreement explicitly stated that "SMH was to act as an agent for Plaintiff and other investors."[161] In that capacity, "SMH was to assure that all documents and instruments incident to the stock transaction were satisfactory in substance and form."[162] Although the court found that SMH had aptly performed due diligence to find irregularities in Miresco's financial statements and had disclosed the results to the plaintiff,[163] the court denied SMH's motion to dismiss, given evidence that its due diligence had failed to discover that the transaction was potentially an unregistered sale of securities.[164] As applied to financial institutions, this case expands conceptions of fiduciary duties by supporting the proposition that broker-dealers and investment

156. *See supra* notes 152–54 and accompanying text.

157. *See supra* notes 116–18 and accompanying text.

158. AFA Private Equity Fund 1 v. Miresco Inv. Servs., No. 02-74650, 2005 WL 2417116 (E.D. Mich. Sept. 30, 2005).

159. *Id.* at *1.

160. *Id.*

161. *Id.* at *10.

162. *Id.* The agreement further stated "that SMH would conduct a due-diligence investigation and inform Plaintiff whether, in its good faith judgment, there were any material facts that would make the investment inadvisable, and that SMH would assure that the business, assets, financial condition, and operations of Miresco were substantially as represented to SMH." *Id.*

163. *See id.* at *2 ("Sometime in June, 2002, SMH representatives informed Plaintiff that there were accounting irregularities relating to the financial position of Miresco.").

164. *See id.* at *9 ("SMH must present evidence showing that the securities at issue here are exempt from registration under the rules adopted by the SEC under § 4(2)."). The court ruled against SMH's motion to dismiss. *Id.* at *12.

advisers should investigate whether an investment comports with relevant regulations.

After performing due diligence, broker-dealers and investment advisers should disclose all material facts concerning potential third-party investments.[165] An agency-law framework for disclosure of material facts to clients would eliminate the option of silence that often occurs under the framework created by the 1934 Act and the IAA[166] and would encourage the free flow of information from financial institutions to their clients.[167] For example, in *Thomas & Wong, General Contractor, Inc. v. Wallace*,[168] the plaintiffs employed Wallace as an agent to negotiate their investment in BDV, a company that "intended to finance various business operations, including a mobile checkcashing business."[169] Thomas & Wong requested that Wallace complete a specific due-diligence list.[170] Wallace failed to disclose material facts regarding the investment, and BDV subsequently defaulted on the loan.[171] The court denied Wallace's

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165. *See, e.g.*, Thomas & Wong, Gen. Contractor, Inc. v. Wallace, No. 1 CA-CV 08-0634, 2010 WL 475690, at *4 (Ariz. Ct. App. Feb. 11, 2010) (holding an agent responsible for withholding material facts related to the results of due diligence in a particular transaction).

166. *See supra* notes 74–76 and accompanying text.

167. *See* RESTATEMENT (THIRD) OF AGENCY § 8.11 (2006) ("An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal; and (2) the facts can be provided to the principal without violating a superior duty owed by the agent to another person.").

168. Thomas & Wong, Gen. Contractor, Inc. v. Wallace, No. 1 CA-CV 08-0634, 2010 WL 475690 (Ariz. Ct. App. Feb. 11, 2010).

169. *Id.* at *1.

170. *See id.* at *2 ("Before funding the loan, Tarapaski wanted the due-diligence checklist completed; in particular, he wanted to confirm the existence of the gold doré collateral and ensure that both the certificate of insurance for the gold and the safekeeping receipt that prohibited the gold from being moved without consent had been assigned to Thomas & Wong. Wallace agreed to attend a gold viewing to confirm the existence of the gold on behalf of Thomas & Wong, and assured Tarapaski that the certificate of insurance and the safekeeping receipt had been assigned to Thomas & Wong.").

171. *See id.* ("Unbeknownst to Tarapaski, six days earlier, on March 6, 2007, Wallace instructed Cane O'Neill to release $275,000 to a company called L Trust, for the purchase of the Minneapolis condominium; Wallace never disclosed this fact to Tarapaski. On March 21, 2007, Wallace authorized an additional $20,000 disbursement to L Trust, without Tarapaski's knowledge, for reasons she could not explain. Further, despite agreeing to do so, Wallace never personally viewed the gold to confirm its existence." (footnote omitted)); *see also id.* at *3 ("Despite repeated assurances that the primary loan would fund, it never closed and BDV defaulted on its obligation to Thomas & Wong."). The court further elaborated on Wallace's deficient due diligence and subsequent disclosure by explaining that

motion for judgment as a matter of law,[172] supporting the notion that under agency law, agents must disclose all known material facts regarding potential investments as part of their duty of due diligence. Unlike the regulatory framework created by the 1934 Act and the IAA, agency law would emphasize that silence concerning material facts does not mitigate liability.[173]

Finally, under agency principles, broker-dealers and investment advisers would owe their clients a continuous duty to monitor investments, even after the initial transaction. For instance, in *SCF Arizona v. Wachovia Bank, N.A.*,[174] Wachovia had explicitly become an agent of SCF through an investment contract.[175] Wachovia had subsequently purchased $25 million of bonds issued by Lehman Brothers Holdings with its client's funds.[176] Although the housing bubble made this a strong investment at the time, SCF alleged that because the housing bubble burst in late 2007, Wachovia either should have withdrawn these funds as part of its duties to monitor continuously the investment of SCF funds or should have warned SCF of this new risk.[177] SCF provided evidence that, even as late as

> [a]lthough Wallace initially told Tarapaski that the gold had been sent to Salt Lake City to melt for sale, and then claimed that $12 million had been realized from the sale, Tarapaski ultimately learned that the gold had never been melted or sold. In Tarapaski's subsequent personal attempt to track and seize the gold, he found containers with what appeared to be gold concentrate; but tests later revealed that the material in the containers was worthless.

Id. at 3.

172. *See id.* at *9 ("The record reflects sufficient evidence for the jury to find that Wallace breached this duty to Thomas & Wong by failing to disclose material information.").

173. *See id.* (describing Wallace's silence concerning material facts); *see also In re* Swartz, 630 P.2d 1020, 1026 (Ariz. 1981) (en banc) ("As an agent with fiduciary duties to his co-investors, respondent owed them the obligation of fully disclosing all material facts concerning the sale of the Denny Ranch.").

174. SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513(WHP), 2010 WL 5422505 (S.D.N.Y. Dec. 14, 2010).

175. *See id.* at *1 ("Paragraph 1 of the Agreement, titled 'Creation of Agency Relationship,' provided that SCF 'hereby authorizes [Wachovia] to act as its Agent in arranging for loans of securities of [SCF] currently in the possession or control of First Interstate Bank of Arizona ('Bank') in accordance with the terms and conditions of this Agreement.'" (alterations in original)).

176. *Id.* at *2.

177. *See id.* at *3 ("As the 'housing bubble' began to burst in late 2007, SCF alleges that it became 'apparent that investment banks and other institutions which had bet heavily on the housing market by investing in mortgage-backed securities might sustain severe losses.'" (quoting First Amended Complaint at 12, *SCF Ariz.*, No. 09 Civ. 9513(WHP) (S.D.N.Y. Dec. 14, 2010))); *id.* at *5 ("Rather than challenging Wachovia's decision to invest in Lehman bonds, SCF claims that Wachovia breached the contract months later in failing to 'maintain' and 'protect' the collateral by selling the Lehman bonds or advising it of the increased risk.").

the summer of 2008, Wachovia could have sold the bonds without incurring substantial losses.[178] Despite this opportunity, Wachovia had failed to withdraw the funds, and after Lehman filed for bankruptcy, the bonds lost almost their entire value.[179] SCF had specifically invested its funds with Wachovia and had authorized Wachovia as its agent because of SCF's lack of sophisticated knowledge and Wachovia's purported market expertise.[180] The court denied Wachovia's motion to dismiss the claim for breach of fiduciary duty, relying on evidence that Wachovia "[had known], or should have known, about the increased risk of its Lehman investment beginning in the spring of 2008."[181]

Thus, under an agency regime, forwarding market professionals would face a continuous duty to use reasonable diligence in monitoring the postinvestment status of client funds. Forwarding market professionals would be required to monitor both the specific investment and the market surrounding the investment.[182] Rather than premising liability only on active misstatements, and rather than adopting the weak monitoring standard exemplified by cases such as *Black v. Shearson, Hammill & Co*,[183] agency law would provide a concrete affirmative duty of postinvestment monitoring for financial institutions when they invest client funds with third parties. Additionally, because broker-dealers do not face a duty of

178. *See id.* at *3 ("While the Lehman bonds were not trading at par in the spring and summer of 2008, their market value was sufficiently high that Wachovia could have sold them without incurring substantial losses.").

179. *Id.*

180. *Id.* at *2 ("SCF alleges that because it lacked knowledge and sophistication with regard to securities lending transactions, it 'relied exclusively on Wachovia's expertise, integrity and professional judgment' to administer the securities lending program and to perform its duties as agent 'in the best economic interests of SCF.'" (quoting First Amended Complaint, *supra* note 177, at 7)).

181. *Id.* at *9, *11.

182. Postinvestment due diligence would entail similar measures as due diligence in the initial investment context. In addition to having to monitor the specific investment, forwarding market professionals would also be required to maintain diligent awareness of the overall performance of the market for the investment. *See, e.g.*, *id.* at *3 ("While SCF acknowledges that the Lehman investment was 'initially a suitable one,' it claims that the collapse of Bear Stearns & Co. ('Bear Stearns') and other 'significant market indications' in 2008 should have alerted Wachovia that the Lehman investment 'might no longer be' safe. According to the Complaint, the Bear Stearns collapse indicated that similar 'weaknesses . . . might affect other banks, including Lehman,' and that the market no longer viewed Lehman bonds as a low-risk investment." (omission in original) (citations omitted) (quoting First Amended Complaint, *supra* note 177, at 13)).

183. *See supra* notes 77–81 and accompanying text.

postinvestment monitoring under the regulatory system created by the 1934 Act and the IAA,[184] an agency framework would appropriately heighten broker-dealers' duties to their clients in the context of third-party investments.

As case law demonstrates, agency law would provide well-articulated fiduciary duties for forwarding market professionals. Broker-dealers and investment advisers, when acting as their clients' agents, would be required to review all relevant documents concerning potential third-party investments. In addition to this preliminary requirement, they would have to perform further due diligence, such as meeting with relevant officers and investigating recommendations for potential investments. Financial institutions would then need to then investigate any potential concerns that a reasonable market professional would have noticed. Moreover, under an agency framework, forwarding market professionals would have to ensure that the transaction complies with relevant regulations. These financial institutions would then be required to disclose to clients relevant facts discovered during due-diligence investigations. Lastly, duties of forwarding market professionals under agency law would extend past an initial investment and include an affirmative duty of postinvestment monitoring.

B. Examples of Breaches of Due Diligence and Postinvestment Monitoring Duties by Forwarding Market Professionals

When broker-dealers and investment advisers considered placing client funds with Madoff, the due diligence required under an agency-law framework would have brought to their attention numerous concerns about Madoff's purported investment strategy. As early as 1999, some financial experts, such as Harry Markopolos, began to suspect that Madoff was engaging in illegal activity.[185] After performing due diligence, Markopolos concluded that Madoff's operations merited serious investigation; he submitted a full report to the SEC in 2005.[186]

184. *See supra* notes 44–45 and accompanying text.

185. Craig M. Douglas, *Madoff Had Early Skeptic in Boston Gumshoe*, BOS. BUS. J. (Dec. 16, 2008, 1:15 PM EST), http://www.bizjournals.com/boston/stories/2008/12/15/daily23.html.

186. Justin Fox, *Harry Markopolos Really Did Have the Goods on Bernie Madoff*, TIME (Dec. 18, 2008), http://business.time.com/2008/12/18/harry-markopolos-really-did-have-the-goods-on-bernie-madoff.

Many financial institutions that invested in Madoff's scheme failed to meet agency law's basic requirements of reviewing relevant documents to determine whether any potential concerns existed; others recklessly disregarded Madoff's dubious activity.[187] Before public discovery of Madoff's fraud, hedge fund manager Merkin was suspicious of Madoff and was warned by two trusted colleagues that this investment was "too good to be true" and might be a Ponzi scheme.[188] Under an agency framework, even negligent inattention to these concerns when reasonable due diligence would have discovered them would result in a breach of the duties arising from an agency relationship.[189] At best, financial advisers such as Merkin were negligent in the performance of due diligence and would have faced liability under relevant agency law.

Not long after the collapse of Madoff's fund, Irving Picard, the court-appointed liquidating trustee of Madoff's firm, filed suit against numerous forwarding brokers who had invested with Madoff for ignoring suspicious signs from Madoff's operations and for failing to engage in postinvestment monitoring of the investments.[190] One of the most prominent of these suits was the case against JPMorgan Chase & Co. (JPMorgan), who Picard alleged had gained $1 billion in fees for investments with Madoff despite having been "willfully blind" toward Madoff's nefarious activities.[191] JPMorgan "admitted in the months before Madoff's arrest that . . . returns had been too good—especially in down markets—to [have been] believable, but for years

187. *See* Jim Zarroli, *Madoff's Victims May Still Have More To Lose*, NPR (Dec. 13, 2010), http://www.npr.org/2010/12/13/132032517/madoff-s-victims-may-still-have-more-to-lose ("One theory involves the so-called forwarding brokers or investment advisers who were recommending to their clients that they invest their money with Madoff. Picard has alleged that several of them were reckless in not being aware that Madoff was engaged in a huge Ponzi scheme, or that they just turned a blind eye to it." (quoting Professor James D. Cox)).

188. Graybow, *supra* note 14.

189. *See* RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) ("[T]he agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.").

190. *See* Amended Complaint (Redacted), Sec. Inv. Protection Corp. v. Bernard L. Madoff Inv. Sec. LLC, No.1:11-cv-00913 (CM) (MHD) (S.D.N.Y. June 24, 2011) 2011 WL 2551979.

191. *See* Colin Barr, *JPMorgan and Madoff: Tighter than You Thought?*, CNN MONEY (Dec. 2, 2010, 2:50 PM ET), http://finance.fortune.cnn.com/2010/12/02/jpmorgan-and-madoff-tighter-than-you-thought ("JP Morgan was willfully blind to the fraud, even after learning about numerous red flags surrounding Madoff. . . . While many financial institutions enabled Madoff's fraud, JPMC was at the very center of that fraud, and thoroughly complicit in it." (quoting David J. Sheehan, counsel for the trustee) (internal quotation marks omitted)).

they pretended that was not the case."[192] Even if JPMorgan was not immediately aware of Madoff's fraudulent activity when it first invested in Madoff's scheme, the subsequent—and suspiciously steady—returns of 10 percent to 12 percent should have prompted some skepticism.[193] Under agency case law, JPMorgan would have been liable for failing to perform its duty of postinvestment monitoring.[194] If the questionably steady profit flow had become a concern after initial investment, JPMorgan would have been required to investigate this issue further as part of its postinvestment monitoring duties under agency law.

Madoff constructed a fraudulent scheme rife with warning signals, many of which reasonable financial institutions should have noticed. The due diligence requirement under an agency framework would have compelled these financial institutions to discover the suspicious nature of Madoff's investment plan. Although the consistent 10 percent to 12 percent returns on investments that Madoff offered were "within the realm of possibility, if just barely,"[195] financial institutions that performed adequate due diligence would likely have realized that, in the words of one journalist, "consistency at the highest level isn't bad; it's impossible."[196] Ultimately, "nothing in which you are putting millions of dollars is so wonderful that it cannot withstand scrutiny."[197] Agency law's exacting framework would protect clients from schemes such as Madoff's by providing clearly defined duties of due diligence and postinvestment monitoring for forwarding market professionals.

192. Scott Shifrel, *Madoff Trustee Sues Bank for Being 'Blind*,*'* N.Y. DAILY NEWS, Dec. 3, 2010, at 24 (omission in original) (quoting Deborah Renner, counsel for Irving Picard) (internal quotation marks omitted).

193. *See* Paul Sullivan, *The Rules That Madoff's Investors Ignored*, N.Y. TIMES (Jan. 6, 2009), http://www.nytimes.com/2009/01/06/your-money/06wealth.html ("Mr. Madoff's returns were too good to be true, but no one wanted to believe that.").

194. *See, e.g.*, SCF Ariz. v. Wachovia Bank, N.A., No. 09 Civ. 9513(WHP), 2010 WL 5422505, at *6 (S.D.N.Y. Dec. 14, 2010) (describing the duty of postinvestment monitoring under agency law).

195. Sullivan, *supra* note 193.

196. *Id.* Sullivan further elaborates that "[i]t defies logic that someone so well versed in a market with as many unforeseeable glitches as baseball would believe that an equally imperfect world—investing—could be so steady." *Id.*

197. *Id.*

C. Implementation Under the Dodd-Frank Act

Agency law would provide a strong framework for defining the fiduciary duties that forwarding market professionals owe their clients. Although a heightened regulatory structure might initially increase transaction costs in the financial-services industry as forwarding market professionals adapt to the new system,[198] it also would offer the best remedy for many of the problems highlighted by the economic crisis of 2008 and its fallout.[199] Although fiduciary duties arising from agency law exist independent of statutory requirements, the Dodd-Frank Act presents an apt opportunity to implement agency principles in statutory form.[200] An agency framework would replace the antiquated distinction between broker-dealers and investment advisers and would establish a fiduciary duty for forwarding market professionals when both the forwarding market professional and its clients manifest assent for the financial institution to act on the client's behalf with regard to third-party investments. The specific contours of this fiduciary duty would reflect agency case law in analogous commercial contexts.[201]

Title IX of the Dodd-Frank Act expressly authorizes the SEC to establish a clearly defined fiduciary duty for broker-dealers and investment advisers after a six-month study period.[202] Congress did

198. *See, e.g.*, Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 275 (2010) ("But when new forms are chosen because they reduce regulatory costs and increase transaction costs compared to the old structure, we lose twice: efficiency is reduced by the increase in transaction costs, and the regulatory burden is shifted onto those who cannot engage in arbitrage. Worse yet, if everyone engages in the arbitrage, all we have done is increased transaction costs with no net change in the incidence of the regulatory burden.").

199. *See supra* Part II.B.

200. A statutory fiduciary duty, based on principles of agency law, for financial institutions regarding funds handled by third parties would comport with the specific requirements of the Dodd-Frank Act. For instance, Congress in that legislation has explicitly authorized the SEC to establish a "best interest" standard for investment advice that broker-dealers and investment advisers provide to clients. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L No. 111-203, § 913(g)(1), 124 Stat. 1376, 1829 (codified at 15 U.S.C. § 78o(k) (Supp. IV 2010)). Although broker-dealers face a low "suitability" standard, the Dodd-Frank Act includes statutory provisions that are meant to harmonize regulations of broker-dealers and investment advisers, *id.,* so the SEC could provide that broker-dealers have a continuing fiduciary duty of postinvestment monitoring if both the broker-dealer and his client manifest assent to such a relationship.

201. *See supra* Part III.A. As the cases cited in that Section indicate, a statutory framework based on agency law would create a private cause of action.

202. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 124 Stat. at 1828–29 (codified at 15 U.S.C. §§ 78o(k)–(*l*), 80b-11(g)–(h)) (amending the 1934 Act and the

not require the SEC to provide a new statutory fiduciary duty for financial institutions, but the SEC will likely use this opportunity in some form.[203] In January 2011, the SEC released a study,[204] as required by section 913(b) of the Dodd-Frank Act.[205] Although the SEC study does not explicitly recommend a fiduciary duty based on agency law, the SEC's study highlights the need for a "uniform fiduciary standard" applicable to both broker-dealers and investment advisers.[206] In the study, the SEC specifically "recommends the consideration of rulemakings that would apply expressly and uniformly to both broker-dealers and investment advisers."[207] This fiduciary standard would be "no less stringent than [the standard] currently applied to investment advisers under Advisers Act Sections 206(1) and (2)."[208] Applying agency-law standards to the forwarding activities of broker-dealers and investment advisers would satisfy these wishes.

At the beginning of 2012, the SEC had not yet implemented a heightened fiduciary duty for forwarding market professionals pursuant to the results of the January 2011 study. Still, many experts have called for the SEC to use this provision of the Dodd-Frank Act to establish a new regulatory framework for defining fiduciary duties in the financial-services industry.[209] Significantly, Congressman Barney Frank, coauthor of the Dodd-Frank Act, sent a letter to the SEC requesting that it establish a new fiduciary framework for the financial-services industry independent of the regulatory system

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IAA to allow the SEC to provide new fiduciary duties for broker-dealers and investment advisers).

203. SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 82 (2010), *available at* http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf.

204. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

205. Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(b), 124 Stat. at 1824–25 (codified at 15 U.S.C. § 78o note).

206. *Id.* at vi.

207. *Id.* at v.

208. *Id.* at v–vi.

209. For example, "[a] petition signed by about 5,200 financial planners [was] delivered to the Securities and Exchange Commission, urging it to impose a universal fiduciary duty on anyone providing retail investment advice." Mark Schoeff, Jr., *Insurers Want Fiduciary Duty Killed: Planners*, INV. NEWS (June 26, 2011, 6:01 AM ET), http://www.investmentnews.com/article/20110626/REG/306269971.

created by the 1934 Act and the IAA.[210] Critics of the January 2011 study noted that it did not provide a clear framework for establishing a heightened fiduciary duty, and they argued that "[a] stronger analytical and empirical foundation than provided by the Study [should be] required before regulatory steps are taken that would revamp how broker-dealers and investment advisers are regulated."[211] As this Note demonstrates, agency law would provide such a framework, informed by decades of case law. The agency-law framework more clearly defines the fiduciary duties broker-dealers and investment advisers owe their clients when they invest funds with third parties.

CONCLUSION

The aftermath of the Madoff investment scandal highlighted the need for regulatory reform in the financial-services industry. Forwarding market professionals such as FGG and Merkin ignored obvious warning signs about Madoff's suspicious behavior and failed to perform adequate due diligence before investing client funds with Madoff.[212] Independent of regulations under the 1934 Act and the IAA, specific duties arise under agency law that would have protected the clients of these financial institutions.

Regulations of forwarding market professionals based on the 1934 Act and the IAA do not provide sufficient safeguards for clients. Under these regulations, broker-dealers face a mere suitability standard as long as the investment advice provided is "solely incidental" to brokerage services.[213] Even when fiduciary duties do arise for financial institutions, in practice, these obligations often

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210. Letter from Rep. Barney Frank, Ranking Member, H. Comm. on Fin. Servs., to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (May 30, 2011), *available at* http://media.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf ("If Congress intended the SEC to simply copy the '40 Act and apply it to broker-dealers, it would have simply repealed the broker-dealer exemption—an approach Congress considered but rejected. The new standard contemplated by Congress is intended to recognize and appropriately adapt to the differences between broker-dealers and registered investment advisors.").

211. Statement, Kathleen L. Casey & Troy A. Paredes, Comm'rs, U.S. Sec. & Exch. Comm'n, Statement Regarding Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011), *available at* http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

212. *See* Graybow, *supra* note 14 ("The lawsuit against Merkin contends that at least two of his trusted colleagues repeatedly told him Madoff's returns were too good to be true—one warning that Madoff's money management business could be a Ponzi scheme, Cuomo said.").

213. *See supra* Part I.B.

promote silence rather than disclosure.[214] Only material misstatements are treated as clear violations of fiduciary duties, and withholding negative information violates fiduciary obligations only after a broker-dealer or investment adviser has already provided some positive information on a potential investment with a third party.[215]

Agency law would help establish a much-needed framework for reform in the financial-services industry. Broker-dealers and investment advisers often form an agency relationship with their clients based on the mutual assent of both parties. Moreover, agency case law provides a detailed analysis of specific fiduciary duties that forwarding market professionals would owe their clients when they invest funds with third parties. For instance, these financial institutions would be required to review all relevant documents concerning a potential third-party investment and also to perform more extensive due-diligence procedures, such as meeting with officers of the third party and performing a detailed background check of the potential investment. Additionally, broker-dealers and investment advisers would be required to investigate any causes for concern that arise from a potential third-party investment and to disclose these results to their clients. Lastly, under an agency-law framework, forwarding market professionals would have a continued duty of due diligence and postinvestment monitoring.

The Dodd-Frank Act presents an ideal opportunity to establish a statutory fiduciary duty for forwarding market professionals based on principles of agency law. Title IX of the Dodd-Frank Act specifically authorizes the SEC to define a new heightened fiduciary duty for broker-dealers and investment advisers. Although the SEC has not yet taken advantage of this opportunity, both industry experts and politicians have called for a new framework of fiduciary duties independent of the statutory requirements created by the 1934 Act and the IAA. Agency law would provide this framework by clearly outlining the specific duties forwarding market professionals owe their clients for third-party investments.

214. *See supra* Part I.C.

215. *E.g.*, Van Alstyne, Noel & Co., Exchange Act Release No. 4699, 33 S.E.C. 311, 321 (Apr. 8, 1952).