THE FINANCIAL SERVICES INDUSTRY'S HISTORIC PATTERN OF OPPOSITION TO REFORM: "WOLF" IS THE ONLY CRY

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Asset managers who provide investment advice have long opposed the imposition of fiduciary duties, arguing that the imposition of a fiduciary standard will increase costs and create inefficiencies. Likewise, after financial crises, reform efforts have been historically opposed by the financial services industry with false claims that the reforms will hurt the real economy, market efficiency and investors. Recent arguments against imposition of a fiduciary standard on stockbrokers echo the arguments that the industry has marshaled to oppose past calls for reform.

A. Historical Illustrations of Wall Street's Opposition to Reforms

The evolution of financial markets is rife with examples of resistance to transparency and regulation. Stock manipulation, misinformation, insider trading, collusion and watered stock were accepted realities as far back as the early 19th Century and periodically led to liquidity crises, panics, recessions and depressions. The creation and implementation of exchange rules requiring transparency came slowly in response to these scandals. The development of American regulatory framework has been far from linear, as "for every two steps forward, there was one step backward."[1]

The first act of attempted regulation occurred in 1825 when the first iteration of a stock exchange, the Exchange Board asked New York Gas Light Company for financial information so that "the public might be informed through us," but his attempt at transparency was refused.[2]

It was not until later on in the nineteenth century, when state and federal authorities had yet to exercise regulatory jurisdiction, that a financial scandal culminated in the creation of a minimal regulatory rule. Famed market manipulator Jay Gould flooded the stock market in 1869 with secretly issued

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1. B. MARK SMITH, TOWARD RATIONAL EXUBERANCE: THE EVOLUTION OF THE MODERN STOCK MARKET 12 (2001).

2. *Id.* at 6.

Erie Railroad shares, prompting an exchange rule that the total number of shares be listed, not to protect the public, but for the benefit of the exchange itself. Gould's response was a failed attempt to start a competing stock market with no registration rules.[3]

In the 19th century, stock dividends typically exceeded bond yields, as compensation for the risk associated with investing in an unregulated stock market. Companies were typically valued based upon current earnings and not estimated future earnings.[4] As the Wall Street Journal noted in 1899, ninety-five percent of the time a stockholder "is obliged to take the word of managers-with all that implies-for the company's net earnings".[5]

Financier J.P. Morgan's response to a financial crisis during the early twentieth century shows that a cavalier attitude regulation toward regulation continued to prevail. After a panic linked to his firm's trading, J.P. Morgan was confronted by a reporter with the question "(d)on't you think that since you are being blamed for a panic that has ruined thousands of people and disturbed a whole nation, some statement is due to the public?"[6] Morgan growled in response "I owe the public nothing."[7] This panic, created by attempted monopolistic stock accumulation to create the country's largest railroad, caused President Theodore Roosevelt to use the Sherman Antitrust Law to successfully sue J.P. Morgan and those responsible for the panic.[8] J.P. Morgan's shock at the interference from regulation was expressed when he proposed to President Roosevelt that "(i)f we have done anything wrong, send your man to my man and they can fix it"[9] referring to the idea that the Attorney General should travel to New York and compromise with Morgan's lawyers.

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3. *Id.* at 11-12.

4. *Id.* at 21.

5. *Id.* at 25.

6. *Id.* at 40.

7. *Id.* at 40.

8. Northern Securities Co. v. United States, 24 S. Ct. 436 (1904). Needlessly fearful of disruption to business interests, Justice Brewer wrote in his apologetic concurring opinion: "I have felt constrained to make these observations for fear that the broad and sweeping language of the opinion of the court might tend to unsettle legitimate business enterprises, stifle or retard wholesome business activities, encourage improper disregard of reasonable contracts and invite unnecessary litigation." *Id.* at 467-68 (Brewer, J., concurring).

9. SMITH, *supra* note 1, at 43.

Roosevelt remarked to his Attorney General that Morgan regarded the government "as a rival (stock market) operator, who either intended to ruin all his interests or else could be induced to come to an agreement to ruin none."[10]

In response to the panic of 1907 Senator Nelson W. Aldrich noted that "(s)omething has to be done. We may not always have Pierpont Morgan with us to meet (another) banking crisis."[11] Congress subsequently created the Federal Reserve System, which was intended to act as a lender of last resort to banks. The Federal Trade Commission, created in 1914, mandated annual financial statements following the New York Stock Exchange "having finally eliminated the notorious Unlisted Department in 1910"[12] which had been created for the express purpose of avoiding public financial disclosures.[13]

Concurrent to the creation of the Federal Trade Commission, the House of Representatives Pujo Committee called for legislation in 1912-13 to end insider trading and the regulation of margin percentages, thereby making it illegal to manipulate stocks and mandating regulation of new stock issues. To the contrary, Clarence Barron argued in his *Barron's Financial Weekly* that insider trading and manipulative practices did not harm long run valuations of stocks and therefore was not an impediment to investors.[14] This view of insider trading was echoed when public disclosure of insider information, attributed to a J.P. Morgan Director, caused a spike in a stock price. The Wall Street Journal noted that it would be well if other corporate insiders were similarly so "public spirited" in sharing insider information.[15] Wall Street successfully delayed the Pujo Committee trading recommendations for another two decades.[16]

10. *Id.*

11. *Id.* at 56. J.P. Morgan's response to this panic is lore. He organized a bailout of insolvent firms by the solvent, locking bankers in his study until they hatched a plan. *E.g.,* Alan Feuer, *For Playing Solitaire or Saving the Economy,* N.Y. TIMES, March 18, 2009, *available at* http://www.nytimes.com/2009/03/19/nyregion/19rooms.html?_r=0. The parallels to The Great Recession are obvious.

12. SMITH, *supra* note 1, at 58.

13. *Id.* at 12-13.

14. *Id.* at 77-78.

15. *Id.* at 84.

16. *Id.* at 58.

Shortly before the crash of 1929, Senator Carter Glass of Virginia held Senate hearings in March 1928 and asked "(w)hat percentage of the public speculating in stocks of the stock exchange understand the real intrinsic value of the stocks in which they deal?"[17]

On February 2, 1929 the Federal Reserve sent a letter that it would not lend to banks for purposes of stock speculations on margin.[18] "A storm of criticism ensued"[19] and Barron's questioned whether the Fed "was adequately interpreting the times" as so many believed lofty stock valuations and speculations were justified.[20]

During Congressional questioning after the crash of 1929, obstructive responses from the president of the New York Stock Exchange ("NYSE"), Richard Whitney, caused Senator Peter Norbeck to fume "(y)ou don't grant that anything in the market is illegal. You don't grant anything. You're hopeless."[21] When the Securities and Exchange Act of 1934 proposed banning insider trading and pools to manipulate stock prices, Whitney responded that "the nation's securities markets would dry up" if enacted.[22] Wall Street only stopped its opposition to market regulation in 1938 after its chief spokesman Whitney filed for bankruptcy and was sentenced to incarceration for fraud that was uncovered by the very investigative reforms he had so vociferously fought.[23]

Another example of costly industry obstruction to reforms was seen when the Securities and Exchange Commission decided to forbid fixed high-cost fees for trading as mandated by stock exchange rule. Objection was voiced by James J. Needham, Chairman, New York Stock Exchange, Inc., who claimed that the change "could have a serious adverse effect on the capital-raising capabilities of Corporate America and on the interests of some 30 million individual American investors."[24] Speaking to financial executives, Needham

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17. *Id.* at 92.

18. *Id.* at 98.

19. *Id.* at 99.

20. *Id.* at 100.

21. *Id.* at 119.

22. *Id.* at 122.

23. *Id.* at 132.

24. James J. Needham, Chairman, New York Stock Exchange, Inc., Fail-Safe or Fail-Certain: The Final Push to Securities Legislation, Remarks at a Luncheon of The

claimed: "What should concern you is that the departing brokers will automatically take with them a substantial part of the order flow in listed stocks -- some 125,000 orders a day by the most recent estimates -- which is really what makes the stock exchanges work. And if that happens, the biggest losers are going to be the corporations and their millions of stockholders."[25] Needham's self-serving prognostications failed to come true, as evidenced by increases in trading volume after the end of fixed trading fees.

Congressional testimony regarding the need for reforms in the wake of The Great Recession prompted similar denials. For example, Conrad Voldstad, Chief Executive Officer of the International Swaps and Derivative Association, Inc. ("ISDA"), testified that "corporate end-users did not create significant derivative risk nor did they suffer large derivative losses. A case for mandatory clearing of their derivatives activity cannot be made based on systemic risk."[26] However, disinterested scholars disagree with Voldstad,[27] and the Financial Crisis Inquiry Commission concluded that the crisis was avoidable and listed unregulated derivatives as one cause.[28]

Financial Executives Institute (April 2, 1974) *available at* http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1974_0402_NeedhamFail.pdf

25. *Id.* at 4.

26. Press Release, International Swaps and Derivative Association, Inc., ISDA's 25th Annual Meeting Highlights Industry's Efforts to Make Derivatives Safer (April 22, 2010), *available at* http://www.isda.org/media/press/2010/press042210.html.

27. *E.g.,* Robert A. Jarrow, *The role of ABSs, CDSs, and CDOs in the Credit Crisis and the Economy*, *in* RETHINKING THE FINANCIAL CRISIS 231-32 (Alan S. Blinder, Andrew W. Lo & Robert S. Solo, eds. 2012) (Financial institutions' use of credit derivatives led to their failure because they had "too little equity capital and collateral backing the buying and selling of these derivatives."); Austin Murphy, *An Analysis of the Financial Crisis of 2008: Causes and Solutions*, 17 OAKLAND J. 61, 69 (2009) ("The current mortgage crisis itself seems to have been largely caused by the mispricing of [credit default swaps]."), *available at* http://www2.oakland.edu/oujournal/files/17_financial_crises.pdf.

28. "The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble. While the business cycle cannot be repealed, a crisis of this magnitude need not have occurred. To paraphrase Shakespeare, the fault lies not in the stars, but in us. Despite the expressed view of

Finance professionals have historically resisted every regulation and reform proposed, frequently raising arguments that echo the arguments currently being offered in opposition to the imposition of a fiduciary standard on stockbrokers. Their predictions of increased costs, inefficiency and spillover effects to the real economy have consistently proven to be unfounded.

B. Conflicted Investment Advice is Costly to Investors[29]

The Council of Economic Advisors ("CEA") "estimates the aggregate annual cost of conflicted advice is about $17 billion each year."[30] The

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man on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs. The tragedy was that they were ignored or discounted. There was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices, dramatic increases in household mortgage debt, and exponential growth in financial firms' trading activities, unregulated derivatives, and short-term 'repo' lending markets, among many other red flags. Yet there was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner." Conclusions of the Financial Crisis Inquiry Commission, at xvii (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_conclusions.pdf.

29. The Department of Labor published and The White House has on its website a chart listing 10 peer-reviewed studies documenting the deleterious effects of conflicted advice to investors. The Effects of Conflicted Investment Advice on Retirement Savings, at 13, Table 4 (2015), *available at* https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

30. "A new report from the President's Council of Economic Advisers shows that that the current, broken regulatory environment creates misaligned incentives that cost working and middle class families billions of dollars a year—with some individual families losing tens of thousands of dollars of their retirement savings. These incentives cause some Wall Street brokers to encourage working and middle class families to move from low-cost employer plans to IRA accounts that typically entail higher fees—and to steer working and middle class families into higher-cost products within the IRA market. Many advisers currently act as fiduciaries and provide advice in their clients' best interest, but many others do not." Press Release, The White House, Fact Sheet: Middle Class Economics: Strengthening Retirement Security by Cracking Down on Backdoor Payments and Hidden Fees (Feb. 23, 2015) https://www.whitehouse.gov/the-press-office/2015/02/23/fact-sheet-middle-class-economics-strengthening-retirement-security-crac.

Department of Labor has proposed rules that would impose a fiduciary duty on those who manage retirement funds[31] and the SEC is again contemplating similar rules.[32] These rules are vital because of the growth of the asset management portion of the financial services sector and increased complexity of financial offerings.[33]

These rules are vital because of the growth of the asset management portion of the financial services sector and increased complexity of financial offerings. "At its peak in 2006, the financial services sector contributed 8.3 percent to United States GDP, compared to 4.9 percent in 1980 and 2.8 percent in 1950."[34] This explosion in finance is due to rents[35] from "two activities:

31. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21928 (April 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510).

32. The SEC is "at the beginning" of its fiduciary rulemaking process, and in her "personal view," the SEC Chairwoman Mary Jo White believes the SEC should enact such a rule under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Melanie Waddell, *SEC Chief White: Fiduciary Rulemaking Just Getting Started*, THINKADVISOR, March 24, 2015, *available at* http://www.thinkadvisor.com/2015/03/24/sec-chief-white-fiduciary-rulemaking-just-getting; Melanie Waddell, *SEC's White Supports Fiduciary Rule for Brokers, Third-Party Audits*, THINKADVISOR, April 2, 2015, *available at* http://www.thinkadvisor.com/2015/04/02/secs-white-supports-fiduciary-rule-for-brokers-thi.

33. "Unfortunately, finance stands out in all three dimensions: innovation happens very fast; financial engineering provides an extremely flexible tool to exploit agency problems; and the principles (be they shareholders in publicly traded companies or taxpayers) are dispersed and almost incapacitated to move. For this reason, financial products designed to prey on existing agency problems are very diffused." Luigi Zingales, President, *Does Finance Benefit Society?*, American Finance Association Presidential Address, at 16 (Jan. 2015), *available at* http://faculty.chicagobooth.edu/luigi.zingales/papers/research/Finance.pdf.

34. Robin Greenwood & David Scharfstein, *The Growth of Finance*, 27-2 J. OF ECON. PERSP. 3, 3 (2013), *available at* http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.27.2.3.

35. "An excess payment made to or for a factor of production over and above the amount expected by its owner. Economic rent is the positive difference between the actual payment made for a factor of production (such as land, labor or capital) to its owner and the payment level expected by the owner, due to its exclusivity or scarcity. Economic rent arises due to market imperfections; it would not exist if markets were perfect, since competitive pressures would drive down prices."

asset management and the provision of household credit."[36] This outbreak of fees to the financial industry has garnered the moniker the financialization[37] of America.

A significant percentage of this money (about 25%) flowing to the financial sector[38] is rents estimated to be 2% of GDP (Gross Domestic Product) or $280 Billon per year in 2010.[39] Thus using this 2% rents estimate of GDP, in 2014[40] this extrapolates to $348B. Summing up a decade of rents

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Economic Rent, INVESTOPEDIA, http://www.investopedia.com/terms/e/economicrent.asp (last visited Sept. 7, 2015).

36. Greenwood & Scharfstein, *supra* note 34, at 5.

37. *E.g., Financialization*, INVESTOPEDIA, http://www.investopedia.com/terms/f/financialization.asp (last visited Sept. 7, 2015).

38. "Workers in the financial sector have shared impressively in this growth: in 1980, the typical financial services employee earned about the same wages as his counterpart in other industries; by 2006, employees in financial services earned an average of 70 percent more. Attracted by high wages, graduates of elite universities flocked into the industry. In 2008, 28 percent of Harvard College graduates went into financial services, compared to only 6 percent between 1969 and 1973. Graduates from the Stanford MBA program who entered financial services during the 1990s earned more than three times the wages of their classmates who entered other industries." Greenwood & Scharfstein, *supra* note 34, at 4-5 (internal citations omitted).

39. "I must conclude that the finance industry's share of GDP is about 2 percentage points higher than it needs to be and that this represents an annual misallocation of resources of about $280 billion for the United States alone." Thomas Philippon, *Finance Versus Wal-Mart: Why are Financial Services so Expensive?*, RETHINKING THE FINANCIAL CRISIS 245 (Alan S. Blinder, Andrew W. Lo & Robert S. Solo, eds. 2012). "All told, during the period 1980–2007, total asset management fees grew by 2.2 percentage points of GDP, which is over one-third of the growth in financial sector output. By contrast, drawing on data broker-dealers file with the Securities and Exchange Commission . . . the other main activities of the securities industry—underwriting, trading, and commissions—do not appear to explain a significant share of growth in the securities industry and the financial sector." Greenwood & Scharfstein, *supra* note 34 at 11. GDP in 2014 was $17.4 trillion and thus 2.2% extrapolates to $383.2 billion.

40. *GDP (current US$)*, THE WORLD BANK, http://data.worldbank.org/indicator/NY.GDP.MKTP.CD (last visited Sept. 7, 2015).

at 2% of GDP per year[41] extrapolates to an astounding $3.028 Trillion![42] As one scholar describes: "If the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension, with a double loss to society: talents are wasted in search for better duping opportunities and the mistrust towards the financial sector increases."[43]

C. Investors Rely On Interpersonal Trust in Selecting Underperforming Active Managers[44]

Brokerage firms argue that each investor is unique and the active management of assets benefits market efficiency. But studies show that the

41. *Id.*

42. "Finally, when investors overpay for active management, it creates rents in the sector. These rents lure talented individuals away from potentially more productive sectors. Indeed, during the period of rapid growth in asset management, finance attracted more talent, at least as measured by the number of students entering finance from elite universities. The cost of this reallocation of talent depends, in large measure, on the industries that top students would have otherwise entered and the marginal value of additional talent entering finance. If, for example, students shifted into finance from science and engineering, where rents are low and marginal productivity potentially higher, then the talent reallocation is costly to society. By contrast, the social costs are much lower if the marginal entrant into finance would have otherwise sought a career in other rent-seeking sectors, such as parts of legal services. In a recent study of MIT undergraduates, Shu shows that finance attracts the best students, as measured by their characteristics at the time of admission." Greenwood & Scharfstein, *supra* note 34, at 17 (internal citations omitted).

43. Zingales, *supra* note 33, at 22.

44. "The data consistently provide overwhelming support for low-cost indexing as an optimal strategy for individual investors. 2011 was a particularly good year for indexing, because 84 percent of large capitalization fund managers were outperformed by the large-cap Standard and Poor's 500 Index. In addition, 82 percent of bond fund managers were outperformed by the Barclays U.S. Aggregate Bond Index. Similar numbers were recorded for managers of European stocks, emerging market equities, and small-cap managers. Over longer periods of time, about two-thirds of active managers are outperformed by the benchmark indexes, and the one-third that may outperform the passive index in one period are generally not the same as in the next period. . . . I showed that there is little persistence in superior performance; indeed, whatever persistence there is in mutual fund returns

higher commissions and costs associated with active management have not been accompanied by increased returns.[45]

Yet, today an asset manager does not need to inform his client about the superior risk adjusted returns via lower cost passive investing and its long-term superior returns and is free to recommended high-cost active management strategies so long as they can be justified as suitable for the investor as defined by Financial Industry Regulatory Authority (FINRA).

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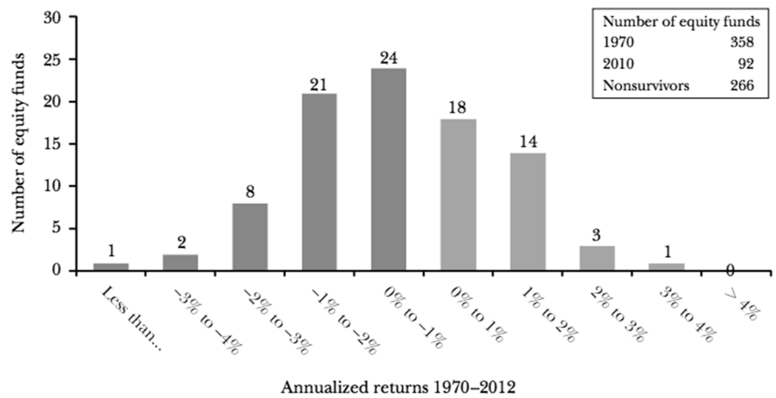
reflects the fact that very high-cost funds do tend to exhibit somewhat consistent negative relative returns." Burton G. Malkiel, *Asset Management Fees and the Growth of Finance*, 27-2 J. OF ECON. PERSP. 97, 102 (2013) (internal citations omitted). Similarly, "Morningstar studied the behavior of mutual fund investors from 2000 through 2011 and found that investors lost billions through their return-chasing behavior. Had they simply bought and held a broad-based index fund, they would have improved their return by almost 2 percentage points per year. The major inefficiency in financial markets today involves the market for investment advice, and poses the question of why investors continue to pay fees for asset management services that are so high. It is hard to think of any other service that is priced at such a high proportion of value." *Id.* at 108 (internal citations omitted).

45. "It might be argued that even if active management has not produced excess returns for investors, the increase in fees supported socially useful arbitrage activities, which made the market more efficient. But there is no evidence that our markets were less efficient before the increase in fees. In a less-efficient market, managed funds would show better returns than unmanaged funds. But, according to Jensen, even before 1980, active managers did not outperform their benchmarks. My own work comparing the returns of active managers versus passive index funds during the 1970s and 1980s showed no evidence that opportunities to earn excess returns existed before 1990. So the higher fees do not seem necessary to increase efficiency in the US equity and bond markets, as these markets showed no unexploited inefficiencies even before the increase in fees." *Id*. at 104 (internal citations omitted). "One could argue that the costs of active management can be justified by the benefits of promoting price discovery and market efficiency. But there is no evidence that the stock and bond markets were any more efficient in 2011 than they were in 1980." *Id*. at 105.

The underperformance of active management is well known to those in the industry as reflected in the graph below.[46]

Figure 1

Returns of Surviving Funds: Mutual Funds 1970 to 2012, Compared with S&P Returns



Source: Author using data from Lipper Analytic Services.

As seen in the bar graph, "[t]he direct cost of professional asset management, at 1.3 percent of assets, is high. The present value of this fee paid over 30 years amounts to approximately one-third of the assets initially invested—a large price to pay a manager who does not outperform passive benchmarks."[47] Instead studies show that the excess rents harm market efficiency by being a misallocation of capital.[48]

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46. Graph republished with permission. *Id.* at 103. E.g., "In addition to voluminous research documenting poor performance of equity mutual funds, some papers document net-of-fees underperformance by bond mutual funds and hedge funds." Nicola Gennaioli, Andrei Shleifer & Robert Vishny, *Money Doctors*, 70 J. OF FIN. 91, 94 (2015) (internal citations omitted). *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING (11th ed. 2015) for a survey of the genre and treatment on the failure of active management strategies.

47. Greenwood & Scharfstein, *supra* note 34, at 13.

48. *See supra* note 45.

The majority of investors are financially illiterate and unable to grasp these concepts, so they look for professional advice.[49] Thus, trust is the primary reason for the selection of an asset manager[50] and yet asset managers insist upon not being a fiduciary.

> Advertising by the fund industry is geared to promote the idea that investing is very complicated, that "experts" are required to help, and that actively managed funds are really worth the high prices that are charged. Critics such as Bogle have suggested that the fund industry is principally a marketing industry and advertisements are often misleading. Fund performance is often advertised as "outstanding," but the fine print reveals that this is true only for a carefully selected and limited time and against a carefully selected peer group or benchmark.[51]

D. Advertising Trust[52] Leads to "*pure redistribution from the duped to the dupers*"[53]

More than past returns, interpersonal trust in the asset manager is the cornerstone of the investor's selection criteria.[54] Studies show that "(m)any

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49. "In the case of households, there is evidence that many households do not understand the financial products they buy or their costs. As a result, such households also probably do not understand that it is hard to identify managers who can consistently generate risk-adjusted excess returns. Gennaioli, Shleifer, and Vishny suggest that trust is at least as important for manager selection as the desire for outperformance." Greenwood & Scharfstein, *supra* note 34, at 15 (internal citations omitted).

50. *E.g.,* Gennaioli, Shleifer & Vishny, *supra* note 46.

51. Malkiel, *supra* note 44, at 106.

52. The authors of Coarse Thinking and Persuasion make an interesting examination of the methods Merrill Lynch used in its advertising to generate trust by their type of advertising over the long term in both up and down markets. Sendhil Mullainathan, Joshua Schwartzstein & Andrei Shleifer, *Coarse Thinking and Persuasion*, 123 Q. J. OF ECON. 557, 604 (2008).

53. Zingales, *supra* note 33, at 22.

54. *E.g.,* Press Release, Public Investors Arbitration Bar Association, Federal Action Needed to Stop U.S. Brokerage Firms Misleading Investors About Role as Fiduciaries, Which Firms Deny to Block Arbitration Claims (March 25, 2015), *available at* http://piaba.org/piaba-newsroom/press-release-federal-action-needed-

leading investment managers and nearly all registered investment advisors advertise their services based not on past performance but instead on trust, experience, and dependability."[55] Trust however, "describes confidence in the manager that is based on personal relationships, familiarity, persuasive advertising, connections to friends and colleagues, communication, and schmoozing."[56]

A fiduciary asset manager could aid the financially illiterate investor in obtaining superior returns on a risk adjusted basis compared to holding cash or simply keeping his money in a bank. Some amount of easily managed risk is necessary in order to not lose money since the rates of return for cash deposits in banks hardly keeps pace with rates of inflation. Many different types of investors, "ranging from relatively poor employees asked to allocate their defined contribution pension plans to millionaires hiring 'wealth managers' rely on experts to help them invest in risky assets and thus earn higher expected returns. On their own, these investors would not have the time, the expertise, or the confidence to buy risky assets, and just leave their money in the bank."[57]

In light of the relationship of trust and confidence between investor, a parallel between the trust obligations of asset managers and doctors is apt:

> In our view, financial advice is a service, similar to medicine. We believe, contrary to what is presumed in the standard finance model, that many investors have very little idea of how to invest, just as patients have a very limited idea of how to be treated. And just as doctors guide patients toward treatment, and are trusted by patients even when providing routine advice identical to that of other doctors, in our model money doctors help investors make risky investments and are trusted to do so even when their advice is costly, generic, and occasionally self-serving. And just as many patients trust *their* doctor,

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stop-us-brokerage-firms-misleading-investors-abou. UBS Bank, Ameriprise Financial and Wells Fargo have all denied a fiduciary duty during arbitrations but their advertising promises it. *Id.* Examples by each firm include, respectively: "until my client knows she comes first"; "our advisors are ethically obligated to act with your best interests at heart"; "a healthy relationship with your Financial Advisor should make you feel that your best interests are the top priority, no matter what is happening in the market and no matter the size of your portfolio." *Id*.

55. Gennaioli, Shleifer & Vishny, *supra* note 46, at 92 (internal citations omitted).

56. *Id.*

57. *Id.* (internal citations omitted).

> and do not want to go to a random doctor even if equally qualified, investors trust *their* financial advisors and managers.[58]…We think of money doctors as families of mutual funds, registered investment advisors, financial planners, brokers, funds of funds, bank trust departments, and others who give investors confidence to take risks.[59]

But of course, investors often come to money managers with erroneous ideas, misled in part by deceptive advertising, just as a patient who needs surgery may state she does not want surgery or may have an erroneous belief that some over-the-counter supplement is a cure. "Do trusted money managers correct investors' errors, or pander to their beliefs? In our model, managers have a strong incentive to pander, precisely because pandering gets investors who trust the manager to invest more, and at higher fees. Trust-mediated money management does not work to correct investor biases. In equilibrium, money managers let investors chase returns by proliferating product offerings."[60]

This exploitation is possible because there is no broad-based fiduciary obligation. One study described this exploitation: "We find empirical evidence suggesting that financial advisors act opportunistically to the detriment of their clients."[61] Another study found that "(i)nvestors who rely more heavily on advice have a higher volume of security transactions and are more likely to invest in products for which the bank has incentivized its advisors—and which, as we show, generate higher revenues."[62]

The final irony of this exploitation of trust is that it leads to increased market volatility and decreased arbitrage thus decreasing market efficiency

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58. *Id*.

59. *Id*.

60. *Id*. at 93.

61. Jeremy Burke, Angel A. Hung, Jack W. Clift, Steven Garber & Joanne K. Young, *Impacts of Conflicts of Interest in the Financial Services Industry* 2 (Rand Corp., Working Paper No. WR-1076, 2014), *available at* http://www.dol.gov/ebsa/pdf/conflictsofinterestreport4.pdf.

62. Andreas Hackethal, Roman Inderst & Steffen Meyer, *Trading on Advice* 27-28 (Centre for Econ. Policy Research, Discussion Paper No. DP8091, 2010), *available at* https://www.ebs.edu/fileadmin/redakteur/funkt.dept.economics/Colloquium/Papers_FT_2010/Paper_Inderst_rely_advice_oct2010_broad.pdf. "Why do people trade? Because they are told to!" *Id*. at 1.

and harm to the real economy outside the financial sector.[63] "Much of the 'duping' and fraud is pure redistribution from the duped to the dupers."[64] As the graph below illustrates,[65] research finds that "the effect of financial development on economic growth is bell-shaped: it weakens at higher levels of financial development."[66] Note that the U.S. financial system has over developed beyond efficiency to be inefficiently comparable to the underdeveloped country Ecuador.

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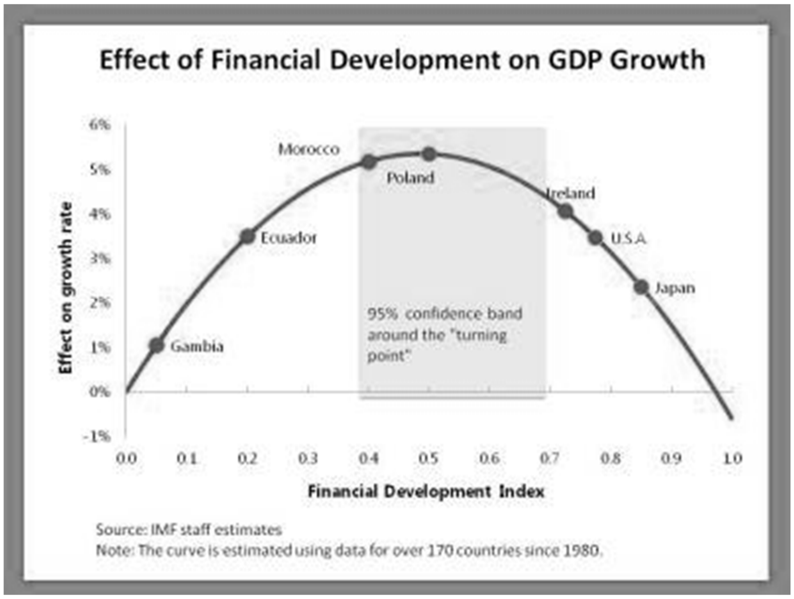
63. "With massive amounts of investor wealth guided by such trust relationships, capital following noise trading strategies is increased, and arbitrage capital correspondingly diminished. In equilibrium, markets become more volatile." Gennaioli, Shleifer & Vishny, *supra* note 46, at 112. *E.g.,* "More recent evidence has challenged that more credit is always good. Arcand et al. find that there is a non-monotone relationship between credit to GDP and growth, with a tipping point when credit to the private sector reaches around 80-100% of GDP. At this level, the marginal effect of financial depth on output growth becomes negative. To a similar conclusion arrive Cecchetti and Carroubi. In fact, Schularick and Taylor go further and establish that lagged credit growth is a highly significant predictor of financial crises and that financial stability risks increase with the size of the financial sector. Similarly, Mian and Sufi identify in the rise of the ratio of debt to GDP (the flip side of credit to GDP) the main culprit of the 2007-08 financial crisis. If anything, the empirical evidence suggests that the credit expansion in the United States was excessive. The problem is even more severe for other parts of the financial system. There is remarkably little evidence that the existence or the size of an equity market matters for growth. Da Rin et al. find that in Europe the opening of a 'New' market for smaller companies had a positive and significant effect on the proportion of private equity funds invested in early stage ventures and high-tech industries." Zingales, *supra* note 33, at 10 (internal citations omitted). Similarly, another study concludes that "[I]n the equilibrium where skilled labour works in finance, the financial sector grows more quickly at the expense of the real economy. . . . [C]onsistent with this theory, financial growth disproportionately harms financially dependent and R&D-intensive industries." Stephen G. Cecchetti & Enisse Kharroubi, *Why Does Financial Sector Growth Crowd Out Real Economic Growth?* 1 (Bank of Int'l Settlements Working Paper No. 490, 2015), *available at* https://www.bis.org/publ/work490.htm.

64. Zingales, *supra* note 33, at 22.

65. Ratna Sahay, et al., *Rethinking Financial Deepening: Stability and Growth in Emerging Markets* 16 (Int'l Monetary Fund Staff Discussion Note No. 15/8, 2015) (with permission).

66. *Id*. at 5.



Cries about the harms of regulation are false. Research shows "there is very little or no conflict between promoting financial stability and financial development. Better regulation is what promotes financial stability and development."[67]

E. Wall Street is Pulling Out the Stops to Thwart the Department Of Labor's Rule Making Efforts to Create Fiduciary Obligations

On April 20, 2015, the Department of Labor proposed a new fiduciary standard for persons and entities providing investment advice to employee plans and owners and beneficiaries of IRAs (the "Proposal").[68] The proposal's comment period expired in July 2015 with thousands of comments ranging from individuals, businesses, bar associations, and trade associations. Before the comment period ended, Wall Street took the unusually extreme step to

67. *Id*.

68. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21928 (April 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510).

lobby congressional representatives to defund the Department of Labor's ability to implement the rules creating fiduciary obligations.[69]

In testimony during the United States Department of Labor's Public Hearings on 'Conflicts of Interest' Proposal, on August 10, 2015, Kenneth E. Bentsen, Jr., President and CEO, SIFMA[70] stated: "We believe the rule, as drafted, will reduce choice and increase cost, and individual savers will have a more complex and confusing landscape. The proposal is also exceedingly complex and would establish an onerous compliance regime that conflicts with existing securities laws, while subjecting advisers to a new private right of action."[71]

Presently, under Section 3(21) of the Employee Retirement Income Security Act of 1974, a person can be an investment fiduciary by "rendering investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so."[72] Under the present ERISA rules, an individual or entity is considered to give "investment advice" if it meets all the elements of a five-part test. The five parts are:

1) providing advice;
2) on a regular basis;
3) pursuant to a mutual agreement or understanding;
4) that the advice is the primary basis for an investment decision; and
5) the advice is individualized based on the particular needs of the plan or participant.[73]

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69. Mark Schoeff Jr., *Momentum to Defund DOL Fiduciary Rule Seems Unstoppable*, INV. NEWS, Jun. 25, 2015, *available at* http://www.investmentnews.com/article/20150625/FREE/150629945/momentum-to-defund-dol-fiduciary-rule-seems-unstoppable.

70. "SIFMA" is the acronym for the Securities Industry and Financial Markets Association, a trade association that represents broker-dealers, banks and asset managers. SIFMA, *About*, http://www.sifma.org/about/ (last visited Sept. 7, 2015).

71. Kenneth E. Bentsen, Jr., President and CEO, SIFMA, Testimony before the U.S. Dep't of Labor 2 (Aug. 10, 2015), *available at* file:///C:/Users/Acer/Downloads/SIFMA%20Testimony%20before%20U.S.%20Department%20of%20Labor%20on%20Proposed%20_Conflict%20of%20Interest_%20Rule%20(08-10-2015).pdf.

72. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. at 21933.

73. *Id.*

In 1974, with IRAs only recently approved for use and 401(k) accounts a glimmer on the horizon, the Department of Labor's five-part test fit with the then-available offerings for plan sponsors and participants. Now with multiple types of IRAs, the prevalence of 401(k) accounts, rollovers, early-withdrawal plans, the availability of a wide array of alternative investments, and fee laden mutual funds, the old test no longer covers the scope of adviser activities.[74]

The 2015 proposal updates the definition of "investment advice" to now govern advisors, who in 1974, would have been considered fiduciaries. Under the Department of Labor's proposed definition, a person or entity renders "investment advice" by (1) providing investment or investment management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner or fiduciary, and (2) either (a) acknowledging the fiduciary nature of the advice, or (b) acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets.[75] When such advice is provided for a fee or other compensation, direct or indirect, the person giving the advice is a fiduciary.[76]

Broken into elements, the Proposal re-defines "investment advice" as

1) for a fee or other compensation, direct or indirect;
2) providing investment or investment management recommendations or appraisals;
3) to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner or fiduciary; and
4) acknowledging the fiduciary nature of the advice; or
5) acting pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan assets.

The financial services industry's main complaint about this new definition is that it will limit the scope of products and securities it can offer to investors,

74. *Id. See also* U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, FACT SHEET: DEFINITION OF THE TERM "FIDUCIARY" (2011), *available at* http://www.dol.gov/ebsa/newsroom/fsfiduciary.html.

75. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21956-57.

76. *Id*. at 21957.

thus potentially limiting the overall returns on retirement assets.[77] Reading between the lines, the underlying issue is whether the high-commission products such as non-traded real estate investment trusts, variable annuities, private placements, and structured products can be sold by brokers acting as fiduciaries.

Despite the financial services industry's vocal opposition, the proposed definition contains myriad exceptions, including the "Best Interest Contract prohibited transaction exemption" or "BIC exemption."[78] The BIC exemption permits broker-dealers, associated persons, and insurance agents who provide fiduciary investment advice to IRA owners, self-directed plan participants and sponsors of small IRAs to receive commissions and compensation provided they acknowledge their fiduciary status, promise to follow basic standards of impartial conduct, adopt policies and procedures reasonably designed to minimize conflicts of interest, disclose basic information on existing conflicts, and the cost of providing advice.[79] The proposed exemption contemplates a private right of action for violations, but expressly permits the requirement that customers arbitrate such claims.[80]

Ultimately, it appears the financial services industry's biggest issue is acknowledging it provides a fiduciary duty to its clientele. Whether a broker-dealer, Associated Person, or insurance agent is required to admit it is serving as a fiduciary will destroy financial services sector and drive the American economy into the ground remains unseen. From past experience with the implementation of far greater regulatory frameworks, the imposition of a long-needed fiduciary duty does not appear to be the economy-destroying bogeyman.

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77. *See, e.g.*, Bruce Kelly, *DOL Fiduciary Rule Could Hurt Nontraded REIT Sales: LPL's Casady,* INV. NEWS (Apr. 30, 2015) *available at* http://www.investmentnews.com/article/20150430/FREE/150439995/dol-fiduciary-rule-could-hurt-nontraded-reit-sales-lpls-casady. "LPL CEO and chairman Mark Casady said that, in a worst case scenario, alternative investments would not be allowed in retirement accounts under the current version of the DOL proposal, which was released this month." *Id.*

78. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. at 21948.

79. *Id.* at 21929.

80. *Id.* at 21948.

Conclusion

The history of financial services industry's reaction to any form of regulation has been one of outrage at any challenge to the lucrative *status quo,* accompanied by dire predictions that reforms will harm market efficiency, the real economy and investors themselves. The financial services industry's current opposition to the adoption of a fiduciary standard echoes its response to past calls for regulation. Despite industry predictions, the imposition of a fiduciary standard is unlikely to cause cost increases, inefficiencies or other negative spillover effects of any significant magnitude. Instead, it is poised to increase market efficiency and improve investor returns.