PARSING THE PRESCRIPTIVE PREROGATIVE: FIDUCIARY AND BEST INTEREST OBLIGATIONS IN THE REGULATION OF FINANCIAL ADVICE

Adam B. Fovent[*]

ABSTRACT

Since the Financial Crisis of 2007-2008, fiduciary and fiduciary-like "best interest" obligations have occupied center stage in competing efforts to regulate the provision of financial advice. These efforts have spanned the United States Department of Labor's controversial failed attempt to expand the reach of investment adviser fiduciary status with respect to employee retirement plans, the Securities and Exchange Commission's Regulation Best Interest and Fiduciary Interpretation concerning the standard of conduct required of broker-dealers and registered investment advisors, respectively, and proposed and final rulemakings from multiple states, including Massachusetts, New Jersey, and Nevada. Each such effort to incorporate fiduciary and fiduciary-like "best interest" obligations into regimes for the regulation of financial advice must grapple with a fundamental design issue that besets regulation more generally – the degree of precision and detail with which to articulate legal commands.

This paper examines the implications of the nature and conceptual foundations of fiduciary and fiduciary-like "best interest" obligations for this question of precisional optimality, demonstrating that the efficacy of such obligations requires, or at least traditionally presupposes, a broad, prophylactic approach to the articulation of legal commands. This paper then examines the various recent regulatory initiatives, along with judge-made and international comparators, in order to develop a typology of regulatory design approaches along the twin dimensions of "rule"-like precisional detail and "standard"-like prophylactic breadth. By doing so, regulatory design approaches are identified that may allow statutory and regulatory drafters to better balance the prophylactic benefits of broadly articulated fiduciary and fiduciary-like obligations with the increased certainty and cost benefits of more detailed and precise specifications.

TABLE OF CONTENTS

[*] *B.Sc., J.D. (Sydney), LL.M. (Harvard).* *The author wishes to express his appreciation to Professor Howell E. Jackson of Harvard Law School and Mitchell J. Cleaver for comments on an early version of this paper, and to the editors for their helpful review and comments. All views and errors contained herein remain the author's own.*

INTRODUCTION

In reflecting on the financial environment that precipitated the Wall Street Crash of 1929, Justice Harlan Fiske Stone observed that:

> [M]ost of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that "a man cannot serve two masters" . . . No thinking man can believe that an economy built upon

> a business foundation can permanently endure without some loyalty to that principle.[1]

Almost a century later, the place of fiduciary and fiduciary-like obligations in the regulation of the financial industry continues to engender vexed debate. While the fiduciary paradigm of loyalty can be observed in a range of contexts in modern financial regulation,[2] the place of such obligations in relation to the provision of financial advice is a matter of acute ongoing controversy.

Since the Financial Crisis of 2007–2008, there have been a range of proposed, finalized and sometimes failed regulatory attempts to impose fiduciary and fiduciary-like "best interest" obligations in relation to the provision of financial advice. The U.S. Department of Labor (DOL) was the first out of the gate, issuing a highly controversial final rule in the closing year of the Obama Administration that purported to expand the circumstances in which a person would be deemed to be rendering investment advice and thereby accrue fiduciary obligations with respect to an employee benefit plan, under the Employee Retirement Income Security Act of 1974 (ERISA), or with respect to an Individual Retirement Account or other tax preferred plan, under the Internal Revenue Code.[3] Under the ERISA regime, a fiduciary is required to discharge their duties "solely in the interests of [retirement plan] participants and beneficiaries"[4] and "for the exclusive purpose of…providing benefits to participants and their beneficiaries."[5] After a series of delays and postponements,[6] the DOL's rulemaking with respect to this provision of the final rule was then vacated *in toto* by a split decision of the United States Court of Appeals for the Fifth Circuit.[7] The baton was then picked up by the United States Securities and Exchange Commission (SEC), which was required by section 913(b) of the Dodd–Frank Wall Street Reform and Consumer Protection Act to conduct a study of the standards of care required in providing financial advice to retail investors under the current regimes governing investment advisers (under the Investment Advisers Act of

---

[1] Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8–9 (1934).
[2] *See generally* Howell E. Jackson & Talia B. Gillis, *Fiduciary Law and Financial Regulation*, *in* OXFORD HANDBOOK OF FIDUCIARY LAW 851, 859 (Evan J. Criddle et al. eds., 2019).
[3] Definition of the Term "Fiduciary"; Conflict of Interest Rule–Retirement Investment Advice, 80 Fed. Reg. 20,945 (Apr. 8, 2016) (codified at 29 C.F.R. pts. 2509, 2510 & 2550).
[4] 29 U.S.C. § 1104(a)(1).
[5] 29 U.S.C. § 1104(a)(1)(A)(i).
[6] See*, e.g.*, Definition of the Term "Fiduciary", 82 Fed. Reg. 16902, 16902 (Apr. 7, 2017) (to be codified at 29 C.F.R. pt. 2510); 18-Month Extension of Transition Period and Delay of Applicability Dates 82 Fed. Reg. 56,545, 56,545 (Nov. 29, 2017) (to be codified at 29 C.F.R. pt. 2550).
[7] Chamber of Com. of the United States v. United States Dep't of Lab., 885 F.3d 360, 388 (5th Cir. (2018).

1940), and broker-dealers (under the Securities Exchange Act of 1934).[8] On June 5, 2019, the SEC adopted a package of rulemakings and interpretative releases relating to the provision of financial advice, including Regulation Best Interest, concerning the standard of conduct required of broker-dealers in making recommendations to retail customers,[9] and a new interpretation clarifying the fiduciary standard of conduct for investment advisers under the Investment Advisers Act of 1940 (the Fiduciary Interpretation).[10]

These federal regulatory initiatives have been joined by state counterparts, with multiple states pursuing their own fiduciary rulemakings. Effective July 1, 2017, the Nevada Legislature amended that state's statutory definition of "financial planner" to remove exceptions for broker-dealers and investment advisers[11] and to whom fiduciary obligations will now accrue by virtue of the statutory obligations imposed on Nevada financial planners.[12] In addition, on January 18, 2019, the Nevada Office of the Secretary of State, Securities Division released draft regulations furthering detailing the acts, practices and courses of business that violate the fiduciary duty and to specify exempt forms of conduct.[13] On April 15, 2019, the New Jersey Bureau of Securities released a proposed rulemaking that would subject broker-dealers and their agents to fiduciary obligations when providing investment advice or making recommendations to a customer, and codify the fiduciary obligations of "investment advisers and investment adviser representatives."[14] After a series of delays during the COVID-19 pandemic, the New Jersey Bureau of Securities announced that it would not adopt the proposal and the proposal expired on January 1, 2022.[15] Elsewhere, the Massachusetts Securities Division adopted regulatory amendments which subjected broker-dealers and their agents to fiduciary obligations when making recommendations and providing

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78(o).
[9] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).
[10] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Exchange Act Release No. 86,031, 84 Fed. Reg. 33669 (July 12, 2019) (to be codified at 17 C.F.R. pt. 276).
[11] NEV. REV. STAT. § 628A.010.
[12] NEV. REV. STAT. § 628A.020.
[13] Notice of Draft Regulations and Request for Comment (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE ch. 90).
[14] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. 493(a), 493, 494 (proposed Apr. 15, 2019) (to be codified at N.J. ADMIN. CODE ch. 13:47A-6.4).
[15] Press Release, Andrew J. Bruck, Acting Att'y Gen. et al., New Jersey Bureau of Securities Proposal for Fiduciary Rule Will Expire as Bureau Continues Efforts to Protect Investors in an Evolving Market (Dec. 24, 2021), https://www.njoag.gov/new-jersey-bureau-of-securities-proposal-for-fiduciary-rule-will-expire-as-bureau-continues-efforts-to-protect-investors-in-an-evolving-market/.

investment advice to customers.[16] However, soon after going into effect, the Massachusetts amendments were challenged and, at least at first instance, struck down in court as invalid on administrative law grounds.[17]

This ongoing invocation of the fiduciary paradigm in modern financial regulation represents a remarkable instance of the persistence of a legal concept across time. By some accounts, the fiduciary paradigm of loyalty, or at least the fiduciary nomenclature, stretches back to the *fiducia* and *fideicommissarius* of Roman law.[18] More proximally in time, it was those courts which historically exercised equity or chancery jurisdiction, with their acute concern with matters of conscience, which developed what we now know as the fiduciary paradigm of loyalty.[19] By and large, institutions of uniquely chancery character are no more.[20] In most jurisdictions within the United States,[21] and indeed, in most nations in the Anglo-American legal tradition, the procedural administration of equity and common law has been fused for decades, with some questioning the ongoing distinctive jurisprudential identity of the principles developed by the courts of chancery.[22] Yet it is to the law of fiduciary obligations, a subject at the very heart of the principles of equity developed by courts historically exercising chancery jurisdiction, which debates concerning loyalty and the protection of clients' best interests in modern financial markets continue to turn.[23]

A number of reactions and perspectives are apparent in the responses to these competing fiduciary initiatives, many of which can be understood as instances of the stakeholder battles often inherent to new regulatory efforts. For example, a great deal of commentary has focused on the apparently competing imperatives of consumer choice, as touted by industry stakeholders, and consumer protection, as touted by consumer organizations.[24] State regulatory initiatives in particular have attracted strident industry opposition, including on the asserted basis that state

---

[16] Adopting Release, William Francis Galvin, Sec'y of the Commonwealth of Mass., Amendments to Standard of Conduct Applicable to Broker-Dealers and Agents – 950 MASS. CODE REGS. 12.200 (Feb. 21, 2020), http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.
[17] Robinhood Fin., LLC v. Galvin, No. 2184CV00884, 2022 WL 1720131 at *15 (Mass. Super. Ct. Mar. 30, 2022).
[18] *See* Myron T. Steele, *The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties,* 26 NOTRE DAME J. L., ETHICS & PUB. POL'Y 3, 6 (2012).
[19] *See id.* at 13–14, 17.
[20] *See Court of Equity*, CORNELL UNIV. L. SCH., LEGAL INFO. INST., https://www.law.cornell.edu/wex/court_of_equity#:~:text=A%20court%20of%20equity%20is,or%20specific%20performance%20among%20others (last updated July 2022).
[21] Exceptions include Delaware, Mississippi, New Jersey, and Tennessee. *Id.*
[22] Charles T. McCormick, *The Fusion of Law and Equity in United States Courts*, 6 N.C. L. REV. 283, 285 (1928).
[23] Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 742 (2010); Myron T. Steele, *supra* note 18, at 14.
[24] *See, e.g.*, Letter from Barbara Roper and Micah Hauptman, Consumer Fed'n of Am., to Secretary Galvin, Massachusetts Sec. Div. (January 6, 2020), (on file with author).

regulatory initiatives that go beyond Regulation Best Interest will negatively impact consumer choice and access to investment products.[25] Academic literature on standards of conduct in the provision of financial advice has explored in detail the different business models and compensatory structures of broker-dealers and investment advisers.[26] Discourse in this regard often emphasizes the ongoing nature of investment advisor relationships and their asset-based fee structures, in contradistinction to the more episodic and traditionally commission-based interactions of broker-dealers with their clients. With the proliferation of state rulemakings, a number of other commentators have approached the imposition of fiduciary obligations in the provision of financial advice through the prism of federalism, whether focusing on questions of pre-emption by federal law[27] or expressly recommending that states be given greater purview "to experiment with different levels of regulation to achieve the proper balance between investor protection and giving financial advisers flexibility to serve their clients' best interest."[28]

In contradistinction, this paper considers these various regulatory initiatives from a regulatory design perspective. For regulators, any attempt to implement a regime of fiduciary or fiduciary like obligations in relation to the regulation of financial advice must grapple with a fundamental design issue that besets regulatory efforts more generally – the degree of precision and detail with which to articulate legal commands. Drawing on established literature on the distinction between "rules" and "standards," this paper explores what the origins, nature, and conceptual underpinnings of fiduciary and fiduciary-like "best interest" obligations have to say about this issue of prescriptive detail.

Part I proceeds by way of an initial survey of the main accounts in the law and economics literature of the distinction between "rules" and "standards," their relative costs and benefits, and the determination of precisional optimality in the articulation of regulatory regimes. After providing a brief description of fiduciary obligations and the fundamental elements necessary for the implementation of such obligations, part II considers conceptual and functional considerations particular to the law of fiduciary obligations which, it is argued, are important considerations in any conceptual cost/benefit analysis of the degree of precisional

---

[25] *See* Letter from Kenneth Bentsen Jr., President and CEO, SIFMA, to Secretary Galvin, Massachusetts Sec. Div. (January 6, 2020) (on file with author).
[26] *See, e.g.*, Laby, *supra* note 23*,* at 701.
[27] *See, e.g.*, Kevin Smedley, *New Jersey's Rule Proposal for Applying a Uniform Fiduciary Standard to Broker-Dealers: Why State Fiduciary Action is Required to Protect Investors,* 15 RUTGERS BUS. L. J. 304, 330-35 (2020); Maria E. Vaz Ferreira, *Staying True To NSMIA: A Roadmap for Successful State Fiduciary Rules After Reg BI*, 94 ST. JOHN'S L. REV. 557, 559 (2021).
[28] Chase Ponder, *Fiduciary Standards and Best Interests: Should States Take the Lead?*, 24 N.C. BANKING. INST. 241 (2020).

specification that should be employed in incorporating fiduciary and fiduciary-like "best interest" obligations into regimes for the regulation of financial advice. In this regard, consideration is given to both the modern economic and functional accounts of fiduciary obligations as well as the internal moral logic and assumptions of the law of fiduciary obligations and chancery jurisprudence more generally. It is argued that each provides support for the view that the efficacy of fiduciary-type obligations requires, or at least traditionally presupposes, a broad, prophylactic approach to the articulation of legal commands.

Part III then develops a typology of regulatory design approaches to the application of fiduciary and fiduciary-like "best interest" obligations to the provision of financial advice along the twin dimensions of "rule"-like precisional detail and "standard"-like prophylactic breadth. The SEC's Regulation Best Interest and Fiduciary Interpretation, proposed and final state rulemakings, and both judge-made case law and international comparators are then parsed and analyzed through the prism of this typology.[29] In doing so, certain regulatory design approaches are identified as potentially limiting the social benefits sought to be attained in the regulation of financial advice by compromising prophylactic breadth in the pursuit of the increased certainty through "rule"-like specification or the provision of prescriptive safe harbors. Other regulatory design approaches are identified which may be viewed as better balancing the prophylactic benefits of broadly articulated fiduciary and fiduciary-like obligations with the increased certainty and cost benefits of more detailed and precise specifications, such as through the imposition of broadly articulated obligations with non-exhaustive specification of subsidiary rules or factors and considerations, or through the provision of *a priori* interpretive guidance.

I. THE QUESTION OF PRESCRIPTIVE DETAIL IN REGULATORY DESIGN

Before examining the question of prescriptive detail in the specific context of the regulation of financial advice, a brief account of the broader discourse on the optimal approach to regulatory system design and the "rules" vs. "standards" distinction is appropriate. Broadly stated, standards-based approaches to regulatory system design are generally said to rely on broad "standards," "principles," or high-level norms of behavior, whereas rules-based approaches to regulatory system design are said to rely more on detailed prescriptive rulemaking addressing specific kinds of conduct.

[29] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318, 33318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

A. Critiques of the rules vs. standards dichotomy

It must be acknowledged at the outset that the dichotomy of "rules" and "standards" is an imperfect instrument through which to pursue analysis of the question of precisional optimality. Criticisms of the dichotomy between rules and standards relate both to its application to individual legal commands or provisions and its application to regulatory systems and regimes writ large.

Aside from initial terminological difficulties, with usage in the literature spanning "rules", "principles", "standards", and "norms", there are clear difficulties in terms of the classification of individual provisions or legal commands as "rules" or "standards". For example, one conceptual approach to classification distinguishes rules and standards on the basis that the latter are "characterized by generality, abstractness, or universality", whereas the former are "specific, concrete, and particular". [30] The problem with this approach is that it posits a binary classification of legal provisions according to descriptive sorting factors that are not binary in nature. As Cunningham has described, a more attractive conceptual approach may be to approach these descriptors as adjectival and continuous in nature, thus allowing legal provisions to be sorted along a continuum and compared in a relative rather than absolute fashion.[31] In line with this notion of a continuum of regulatory design approaches, this paper refers to specific regulatory provisions as being more or less "rule"-*like* or "standard"-*like*, eschewing the use of these labels as binary descriptors.

As noted above, the extent to which the dichotomy between "rules" and "standards" can sensibly be applied to regulatory systems or regimes writ large, as opposed to individual provisions, has also been the subject of criticism.[32] In order to be able to characterize a regulatory system or regime as a whole as being "rules"-based or "standards"-based, analysis could proceed by first classifying each individual legal command or provision within the regulatory system or regime as being a rule or standard. However, as Cunningham has pointed out, it does not necessarily follow from the rule or standard classification of individual provisions within a regulatory regime that it makes sense to describe the regulatory regime of which the provisions form part as being "rule"- or "standard"-based.[33] For example, even if the individual provisions of a regulatory regime can be classified as "rules" or even "rule"-like, account would need to be taken of the decision making norms governing the interpretation and application of

[30] Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1409, 1420 (2007).
[31] *Id.* at 1421.
[32] *Id.*
[33] *Id.* at 1426.

the regime, which may very well operate in a decidedly purposive fashion.[34] Further, the individual legal commands and provisions that make up a regulatory regime do not exist independently of each other, and regard would need to be had to the way in which individual provisions within a regulatory regime interact with and provide context for each other.[35]

B. Economic analyses of optimal precision in rulemaking

There is an established and relatively well developed law and economics literature concerning the question of the optimal level of precision in legal rulemaking, with seminal early articles by Isaac Ehrlich and Richard Posner, and by Colin Diver, and more recent work by Louis Kaplow.[36] Although the present work does not purport to be a dedicated writing in the law and economics tradition, at least not in the sense of a pursuit of quantitative cost/benefit analysis, the economic analysis of precision in legal rulemaking provides a useful heuristic in the present pursuit of insights pertinent to the regulation of financial advice. Primary, but not exclusive, reliance is placed on the analysis of precision in legal rulemaking developed by Diver.

1. Foundational assumptions and assertions

Before exploring the economic analysis of legal rulemaking, some preliminary groundwork is needed. Instead of adopting a rigid dichotomy between "rules" and "standards," a more realistic conception of legal drafting recognizes that the formulation of legal commands spans a "specificity-generality continuum".[37] Accordingly, the term "rule" (and cognates) is used by some commentators to refer to *any* articulation or formulation of a legal command, the level of detail or precision of which may vary, rather than as in strict contradistinction to a "standard".[38] The tendency in this paper is to refer to specific articulations of legal commands as being "rule"-like or "standard"-like, using these labels for their descriptive value rather than as strict binary categories.

To provide clarity at the outset, it is necessary to describe what references to "precision" in legal rulemaking mean. Ehrlich and Posner offer an analytically attractive explanation of the concept of precision in this regard, venturing that "the fewer and simpler the facts to which definite

---

[34] *Id.* at 1428.
[35] *Id.* at 1430.
[36] *See* Isaac Ehrlich and Richard A. Posner, *An Economic Analysis of Legal Rulemaking,* 3 J. LEGAL STUD. 257, 257 (1974); Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE. L. J. 65, 65 (1983); Louis Kaplow, *Rules Versus Standards: An Economic Analysis,* 42 DUKE. L. REV. 557, 557 (1992).
[37] To adopt language employed in Ehrlich & Posner, *supra* note 37, at 257, 260. An alternative approach classifies provisions on a rules-principles spectrum according to vagueness, as per Cunningham, *supra* note 31, at 1423 (2007).
[38] Ehrlich & Posner, *supra* note 37, at 258–60.

legal consequences attach, the more precise is a legal obligation."[39] That is, precision in rulemaking is about factual specificity. Diver ventures that precision subsumes three particular sub-variables – transparency, accessibility, and congruence.[40] On this account, a rule is transparent if it is formulated with words that are "well-defined and universally accepted meanings within the relevant community," accessible if it is "applicable to concrete situations without excessive difficulty or effort," and congruent if "the substantive content of the message communicated . . . produces the desired behavior."[41] As Diver frankly acknowledges, there are obvious problems in terms of the feasibility of objective evaluation or measurement of the transparency, accessibility, and congruence of different rule formulations, and optimal precision of legal rulemaking may very well entail trade-offs between these individual precisional sub-variables.[42]

2. Identifying the optimal degree of precision

On the economic analysis of rulemaking, the optimal degree of precision is that which results in the greatest net social benefit, taking into account the social costs and benefits of different potential articulations of legal commands along the specificity-generality continuum.[43] A rulemaker seeking to maximize social benefit would increase precision of articulation so long as the additional social benefit from doing so exceeds the additional increment of cost.[44] It is not possible to derive any general conclusions as to the optimal degree of precision in legal rulemaking that should be employed in drafting as an abstract pursuit. This is because the optimal degree of precision will depend on the particular costs and benefits implicated by particular rules or areas of regulation. With that said, certain recurrent categories of costs and benefits have been identified in the literature as having particular bearing on precisional optimality.[45]

An obvious category of benefits warranting consideration encompasses the social benefit derived from the effect of the relevant legal commands in discouraging, deterring, or controlling socially undesirable conduct or behavior, and encouraging socially desirable conduct or behavior. In this regard, increased precision might be expected to promote increased compliance through clarity and ease of application and enforcement and thereby greater social benefit.[46]

[39] Ehrlich & Posner, *supra* note 37, at 261.
[40] Diver, *supra* note 37, at 67.
[41] *Id.*
[42] *Id.* at 67–68.
[43] Ehrlich & Posner, *supra* note 37, at 261; Diver, *supra* note 37, at 72.
[44] Ehrlich & Posner, *supra* note 37, at 261; Diver, *supra* note 37, at 72.
[45] Diver, *supra* note 37, at 73–74.
[46] Ehrlich & Posner, *supra* note 37, at 262.

With that said, ever increasing levels of precision will not always be desirable or possible. One relevant category of costs stems from misalignment between the linguistic formulations of rules and the actual intended subject for regulation. There is social cost associated with the potential over-inclusiveness or under-inclusiveness that may accompany attempts to articulate legal commands with varying levels of precision and specificity.[47] To the extent that a legal command is articulated in an over-inclusive fashion, it will cover socially desirable conduct that was not intended to be regulated, deterred or prohibited.[48] On the other hand, to the extent that a legal command is formulated in an under-inclusive fashion, it may fail to cover the very conduct that was intended to be regulated. As Ehrlich and Posner observe in their analysis, these risks flow from "[t]he inherent ambiguity of language and the limitations of human foresight and knowledge."[49]

The costs of rulemaking have an obvious bearing on the question of precisional optimality. The articulation of legal commands of greater precision along the generality-specificity continuum will be relatively more costly to promulgate, both due to the cost of obtaining and evaluating information and due to the direct costs of formulating legal commands exhibiting greater factual specificity and detail.[50] On the other hand, the costs of applying and complying with a legal command of lesser precision might be expected to be greater, due to increased opacity and uncertainty, increased disputation, and/or the need for legal advice.[51]

As foreshadowed above, the relative importance attributed to these different categories of costs and benefits will vary with the type of legal command or area of regulation under consideration. For example, in some circumstances, the social costs from discouraging socially desirable behavior that was not intended to fall within a certain legal command may give potential over-inclusiveness a particular salience. Likewise, where the social costs from failure to deter forms of socially undesirable behavior that were intended to be regulated would be high, concerns about under-inclusiveness may dominate.

3. Kaplow's account of rules vs. standards

Louis Kaplow has provided an additional economic analysis of legal rulemaking which distinguishes "rules" and "standards" based on the time at which they are given content.[52] On this account, rules are given content *ex ante,* in that permissible conduct is articulated at the outset. Standards,

---

[47] Ehrlich & Posner, *supra* note 37, at 268; Diver, *supra* note 37, at 73.
[48] Ehrlich & Posner, *supra* note 37, at 263.
[49] Ehrlich & Posner, *supra* note 37, at 268.
[50] Ehrlich & Posner, *supra* note 37, at 267; Diver, *supra* note 37, at 73.
[51] Ehrlich & Posner, *supra* note 37, at 270–71; Diver, *supra* note 37, at 74 (1983).
[52] Kaplow, *supra* note 37, at 559–60.

on the other hand, are given content *ex post*, requiring an adjudicator not only to determine factual issues but also to identify what conduct is permissible. With that said, Kaplow acknowledges that the dichotomy is imperfect, and that legal commands may be of mixed character.[53] Framed in this way, the question of optimal precision in legal rulemaking resolves into the question of whether content should be given to a legal command in advance or an *ex post* basis.

The cost differentials between "rules" and "standards" feature prominently in Kaplow's account of the desirability of the respective approaches to articulating legal commands. Like the analysis of Divers considered above, Kaplow emphasizes that the initial promulgation costs for a "rule" are greater than those for a "standard," whereas the cost of interpreting, complying with, and applying "standards" are greater than for they are for "rules."[54] These propositions flow naturally from the definition of "rules" and "standards" in terms of the point in time at which they are given content.

An important aspect of Kaplow's analysis is the notion of a "rule equivalent to a standard." This analytical construct serves to clarify the notions of over-inclusiveness and under-inclusiveness discussed above by disaggregating the question of complexity from the question of when to give content to a legal command. By positing a hypothetical "rule" equivalent to a "standard", with the same content and detail as the relevant "standard", the question of complexity is eliminated, allowing for analysis based solely on the question of when to give content to the legal command. On this analysis, the notions of over-inclusiveness and under-inclusiveness can logically only arise when the comparison is between a "standard" and a "rule" short of the "rule" equivalent to the "standard".

Kaplow acknowledges that it may appear that "some legal commands cannot plausibly be formulated as rules."[55] However, it is important to recognize that the notion of giving content to "rules" *ex ante* is not necessarily an all or nothing proposition. Indeed, it may be that some measure of content can be determined in advance, whilst leaving scope for *ex post* adjudication. Kaplow thus suggests that determining relevant criteria in advance may be desirable in terms of cost savings and guidance for individuals, as may be the adoption of presumptions, exclusions or inclusions.[56]

[53] *Id.* at 561.
[54] *Id.* at 569–86.
[55] *Id.* at 599.
[56] *Id.* at 600.

II. FIDUCIARY DETERMINANTS OF PRECISIONAL OPTIMALITY

After providing a brief description of fiduciary obligations and the fundamental elements necessary for the implementation of such obligations, this Part III examines the leading economic and functional accounts of fiduciary obligations, as well as the internal moral logic and assumptions of the law of fiduciary obligations and chancery jurisprudence more generally, with a view to identifying what these accounts have to say about the degree of precision with which to design and articulate fiduciary and fiduciary-like obligations. This examination will demonstrate that, on each such account, the efficacy of fiduciary-type obligations requires, or at least traditionally presupposes, a broad, prophylactic approach to the articulation of legal commands. It is argued that these conceptual and functional insights particular to the law of fiduciary obligations and the determinants of its efficacy should loom large in any conceptual cost/benefit analysis of the degree of precisional specification to be employed in incorporating fiduciary and fiduciary-like "best interest" obligations into regimes for the regulation of financial advice.

A. A brief primer on fiduciary obligations

Shortly stated, the law of fiduciary obligations is fundamentally and acutely concerned with issues of loyalty. In the oft-quoted rhetoric of Justice Benjamin Cardozo, "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties."[57] Originally and most closely associated with the obligations of trustees, fiduciary obligations now pervade a range of other legal contexts and relationships.

An obvious threshold issue in considering any regime of fiduciary obligations concerns the identification of those parties to whom the obligations will accrue. In the judge-made law of fiduciary obligations, courts exercising chancery jurisdiction have traditionally recognized certain status-based relationships in which fiduciary obligations are invariably owed – for example, trustee/beneficiary, attorney/client, and partner/partner. At the same time, it is well recognized in equity jurisprudence that fiduciary obligations may also arise on an ad hoc basis according to identification of equitably salient facts and circumstances. Various candidates have been advanced as encapsulating the unifying themes or core characteristics of the relationships giving rise to fiduciary obligations, including that they represent relationships of "trust and confidence" or involve an undertaking or agreement to act for or on behalf of or in the interests of another in the exercise of a power or discretion

[57] Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

which will affect the interests of that person.[58] With the ongoing incorporation of fiduciary and fiduciary-like obligations into different statutory and regulatory regimes, the accrual of such obligations must also be understood in terms of the articulation of regulatory perimeters. Viewed through that lens, accrual may depend on the "formal definition" of a regulatory category or status and the categorical application of regulatory standards to in scope entities or may instead turn on the "functional definition" of an act or economic function.[59]

Where fiduciary obligations apply, the core fiduciary obligation is one of loyalty. Beyond this point, opinions and jurisdictions in the Anglo-American tradition diverge. The source of the ensuing complexity is conveyed by the oft-repeated proposition that "not every breach of duty by a fiduciary is a breach of fiduciary duty."[60] In the United States, the twin duties of loyalty and care are generally viewed as core fiduciary obligations.[61] In other common law jurisdictions, including England and Australia, it is generally accepted that a duty of care is not fiduciary in character, even though often owed coincidently with a fiduciary duty of loyalty.[62] Even confining attention to the duty of loyalty, which is incontrovertibly fiduciary, there are diverging views as to the nature of the fiduciary duty of loyalty. Courts in the United States have referred to the duty of loyalty as an affirmative obligation to act in the best interest of another.[63] In other common law jurisdictions, the duty of loyalty is viewed as a proscriptive obligation not to obtain any unauthorized benefit from the fiduciary relationship and not to be in undisclosed conflict of duty and interest (or of duty and duty).[64]

Most regimes incorporating fiduciary obligations also provide some mechanism by which the harshness of fiduciary obligations is mollified or by which their breach may be excused. Under the judge-made law of fiduciary obligations, this generally entails permitting conduct that would otherwise be in breach of fiduciary obligation on the basis of *ex ante* informed consent, or allowing for *ex post* ratification of breach. Statutory and regulatory regimes often expressly address the effect of disclosure and informed consent, and may also provide that certain conduct or

---

[58] *See Hosp Prods Ltd v United States Surgical Corp* (1984) 156 CLR 41 (Austl.) (Mason, J.).
[59] *See* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry*, 77 WASH. U. L.Q. 319, 364, 367 (1999).
[60] Bristol and West Bldg. Soc'y v. Mothew [1998] Ch 1, 16. (UK).
[61] *See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law,* 91 BOS. UNIV. L. REV. 1039, 1043 (2011).
[62] Dyson Hedon, *Modern Fiduciary Liability: The Sick Man of Equity?*, 20 TR. & TRS. 1006, 1007–8 (2014).
[63] *See* Jordan v. Glob. Nat. Res. Inc., 564 F. Supp. 59, 67–68 (S.D. Ohio 1983).
[64] See *Breen v Williams* (1996) 186 CLR 71, 113 (Austl.) (Gaudron and McHugh JJ).

circumstances are exempt or excluded from the operation of the relevant fiduciary or fiduciary-like obligations.

B. Economic rationalizations of fiduciary obligations

The contractarian account is the dominant economic rationalization of the law of fiduciary obligations. Originating in the early 1990s from the seminal writings of Robert Cooter and Bradley J. Freedman, and Frank H. Easterbrook and Daniel R. Fischel, a more recent and updated account has been given by Robert H. Sitkoff.[65] At the core of the contractarian account is the notion of an agency problem whenever one person engages another to act on their behalf in circumstances where the latter will undertake imperfectly observable discretionary actions.[66] At the inception of such relationships, it will generally be impossible, or exceedingly expensive, for the parties to completely specify the resolution of all possible contingencies.[67] On the contractarian account, the law of fiduciary obligations represents an attempt to provide the terms that would have been preferred by the parties and included in a completely specified contract had the parties been able to formulate one.[68]

The contractarian account of fiduciary obligations is formulated most stridently in the original work of Judge Frank H. Easterbrook and Daniel R. Fischel.[69] In their view, the defining characteristic of a fiduciary *relationship* is the fact of impossibly high transaction costs, but there is nothing special about fiduciary *obligations* themselves.[70] Fiduciary obligations are simply presumptive contractual terms which apply in the absence of explicit terms providing otherwise.[71] One of the lingering difficulties with the contractarian account of fiduciary obligations, at least in this more absolute form, has been the irreducible core of fiduciary obligations. That is, the notion that certain aspects of fiduciary obligations are mandatory in nature and cannot excluded by contract. Sitkoff has proposed a potential resolution in this regard: that the content of the irreducible core represents content that an informed party would never concede when contracting someone to act on their behalf.[72]

---

[65] Robert Cooter and Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences,* 66 N.Y. UNIV. L. REV. 1045, 1045 (1991); Frank H. Easterbrook and Daniel R. Fischel, *Contract and Fiduciary Duty,* 36 J. L. & ECON. 425, 426 (1993); Sitkoff, *supra* note 62, at 1039–40.
[66] Easterbrook, *supra* note 66, at 427.
[67] *Id*.
[68] *Id*.
[69] *Id*.
[70] *Id.* at 438.
[71] *Id*.
[72] Sitkoff, *supra* note 62, at 1045–48.

For present purposes, however, further exploration is needed of the function that fiduciary obligations are said to serve on the contractarian account. Cooter and Freedman approached the law of fiduciary obligations on the basis that all relationships giving rise to such obligations involve one person, the beneficiary, entrusting another, the fiduciary, with management and control of an asset.[73] Cooter and Freedman then analyze the fiduciary's conflicted position in terms of a decision tree.[74] Given a particular opportunity or occurrence, a fiduciary could act in their own interest, by taking "self-regarding acts", or act in the interest of the beneficiary, by taking "other regarding acts."[75] Like Easterbrook and Fischel, Cooter and Freedman posit that it would be impossible for the fiduciary's behavior in all circumstances to be dictated in advance and, moreover, that it will generally be prohibitively costly for the beneficiary to continually monitor the fiduciary's behavior.[76] Accordingly, where the fiduciary takes self-regarding action, that action may or may not be observable to the beneficiary and as a result the expected sanctions for the fiduciary will be insufficient to achieve deterrence.[77] The disgorgement remedies available for breach of fiduciary obligation, as well as the presumption in the law of fiduciary obligations that the fiduciary has acted in self-interest from the appearance of a conflict, thus serve as ways to increase expected sanctions so as to achieve greater deterrence.[78] On this account, fiduciary obligations can be understood as an attempt to induce the fiduciary to act in an other-regarding fashion in circumstances where the necessary action cannot be completely specified *a priori*.

C. The functional account of equity as anti-opportunism

Henry Smith has proposed a functional account of fiduciary obligations, and equity more generally, as a form of "anti-opportunism."[79] It is self-evident that an undertaking to act on someone else's behalf or in their interest, of the sort that will result in the accrual of fiduciary obligations under traditional principles of equity, gives rise to risks of opportunism.[80] In this regard, Smith correlates his conception of opportunism expressly with concerns about self-dealing and failures to avoid situations of conflict of interest.[81] On Smith's functional account of fiduciary obligations, equity's approach to opportunism is to adopt a presumptive stance against the fiduciary on the occurrence of particular

[73] Cooter, *supra* note 66, at 1045.
[74] *Id.* at 1056.
[75] *Id.* at 1048.
[76] *Id.* at 1046–47.
[77] *Id.* at 1051.
[78] *Id.* at 1051–56.
[79] Henry E. Smith, *Why Fiduciary Law is Equitable*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 261 (Andrew S. Gold et al. eds., 2014).
[80] *Id.* at 261.
[81] *Id.* at 261.

proxies for opportunistic action.[82] An individual subject to fiduciary obligations is thus presumed to be being opportunistic on the basis of the proxies of self-dealing and conflict of interest, rather than an inquiry being conducted into the actual substance of the transaction and its impact on the principal.[83]

There are a number of insights that can be drawn from Smith's functional account of fiduciary obligations which may inform precisional optimality in the incorporation of fiduciary obligations into regimes for the regulation of financial advice. Implicit in this account of fiduciary obligations, and as observed in relation to the internal moral logic of the principles of equity examined below, is the intuition that complete *a priori* specification of opportunistic conduct is not possible – hence the reliance on broad prophylactic proxies for such behavior. Indeed, Smith defines opportunism as "behavior that is undesirable but that cannot be cost-effectively captured – defined, detected, and deterred – by explicit *ex ante* rulemaking."[84] As Smith puts it, "if the value of promoting a given type of transaction is not very high but it is extremely hard to differentiate from a class of transactions that involves opportunism, then it makes sense for the former to be swept along in a prophylactic ban, with an apparent lack of concern with mental states."[85] Indeed, Smith's account explicitly contemplates that the over-inclusive nature of the proxies through which the law of fiduciary obligations operate is a consequence of the nature of the opportunism problem.[86]

D. The distinctive internal moral logic of equity jurisprudence

Having examined the above economic and functional accounts of fiduciary obligations, it is appropriate to examine further what the assumptions and principles underlying the judge-made law of fiduciary obligations, as developed by courts exercising chancery jurisdiction, has to say about how such obligations should be incorporated into regimes for the regulation of financial advice.

In exploring these questions as to the optimal means of incorporating fiduciary obligations into regimes for the regulation of financial advice, it should be borne in mind that the interrelationship between statute and the principles of equity has a long history. The law of trusts, for example,

---

[82] *Id.* at 262.
[83] *Id.* at 262.
[84] Henry E. Smith, *An Economic Analysis of Law Versus Equity* 9 (Oct. 22, 2010) https://law.yale.edu/sites/default/files/area/workshop/leo/document/HSmith_LawVersusEquity7.pdf.
[85] Smith, *supra* note 80, at 271 (citing Matthew Conaglen's exploration of the prophylactic aspect of fiduciary obligations. *See* MATTHEW CONAGLEN, FIDUCIARY LOYALTY: PROTECTING THE DUE PERFORMANCE OF NON-FIDUCIARY DUTIES 59 (2010)).
[86] Smith, *supra* note 80, at 280.

emerged historically in England in response to the Statute of Uses.[87] Indeed, there is a growing body of literature examining the ways in which statute has influenced the emergence and development of equitable doctrines, and the ways in which equity may respond to, and interact with, statutory rights and duties.[88] One aspect of this field of discourse concerns the incorporation of general law concepts into statutory and regulatory regimes. In most common law jurisdictions, there is some measure of recognition of the principle of statutory construction that where a statutory provision employs a term of accepted general law meaning, the statute will bear that meaning unless context dictates otherwise.[89] The point was once put colorfully by Windeyer J of the High Court of Australia:

> [W]e cannot interpret [the provisions of a statute] as if they were written on a tabula rasa with all that used to be there removed and forgotten. Rather [they are] written on a palimpsest, with the old writing still discernible behind.[90]

Relevantly for present purposes, this statutory incorporation of general law concepts is evident in the case law of the Supreme Court of the United States regarding ERISA. The use of the term "fiduciary" as a status upon which the obligations under ERISA affix has thus been described as serving to "codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in . . . the law of trusts."[91]

The focus here lies in the other direction. That is, the concern here is with how the assumptions and principles underlying the judge-made law of fiduciary obligations may inform the most efficacious regulatory design approach to incorporating fiduciary and fiduciary-like obligations into statutory and regulatory regimes governing the provision of financial advice. Undoubtedly, the courts do not speak directly to such questions, and the obligations imposed by a statutory or regulatory regime employing fiduciary language will not necessarily perfectly track the law of fiduciary obligations as developed judicially. With that said, unless such regimes are to draw on the law of fiduciary obligations in name only, it stands to reason that the assumptions and principles underlying the judicially developed law may provide some measure of guidance as to the efficacious reincarnation of fiduciary obligations in statutory or regulatory form.

---

[87] David T. Smith, *The Statute of Uses: A Look at its Historical Evolution and Demise*, 18 CASE W. RSRV. L. REV. 40, 58 (1996).

[88] *See, e.g.*, Mark Leeming, *Equity: Ageless in the 'Age of Statutes',* 9 J. EQUITY 108, 124–26 (2015).

[89] In Australia, *see, e.g.*, *Aid/Watch Inc v Comm'r Tax'n* (2010) 241 CLR 539, [23] (Austl.). In the United States, *see, e.g.*, Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 739–40 (1989). *contra* Taylor v. United States, 495 U.S. 575, 593–95 (1990) (where established common law meaning was inconsistent with statutory purpose.).

[90] *Vallance v The Queen* (1961) 108 C.L.R. 56, 76 (Austl.).

[91] Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989).

In particular, it may be observed that the law of fiduciary obligations, as developed and applied by courts exercising chancery jurisdiction, operates on the basis of certain moral intuitions and assumptions. Importantly, many areas of equity jurisprudence assume, sometimes explicitly but often implicitly, that a comprehensive *a priori* specification of the kinds of misconduct that would bind the conscience is not possible. This approach pervades the history of the principles of equity, and was clearly evident as early as the famous 17th-century conflict between equity and common law in England which culminated in the *Earl of Oxford's Case.*[92] On the chancery side, Lord Ellesmere LC gave an enduring account of the distinctive approach of courts exercising chancery jurisdiction, in the following terms:

> The Cause why there is a Chancery is, for that Mens Actions are so divers and infinite, [t]hat it is impossible to make any general Law which may aptly meet with every particular Act, and not fail in some Circumstances.[93]

Echoing similar sentiments in the Supreme Court of the United States, Justice Arthur J. Goldberg in *SEC v. Capital Gains Research Bureau Inc.*[94] cited the following remarks attributed to Lord Hardwicke, who served as Lord Chancellor in the United Kingdom in the 18th century:

> [W]ere a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.[95]

These remarks demonstrate both an important moral intuition upon which equity is based, and certain consequences of how it operates. The intuition is to the great variety and unpredictability of human conduct, and thus the impossibility of complete *a priori* anticipation or specification. The consequences of this intuition resound in equity's tendency to rely on broad, prophylactic norms of conduct, rather than the articulation of rigid and detailed legal commands. James Allsop, Chief Justice of the Federal Court of Australia, has thus described equity as permeated by norms and

---

[92] The Earl of Oxford's Case in Chancery, 21 E.R. 485, 486 (1615).
[93] *Id*.
[94] Securities & Exchange Commission v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 283 (1963).
[95] The footnote in *Capital Gains* gives the following attribution: Letter of Lord Hardwicke to Lord Kames, dated June 30, 1759, printed in PARKES, HISTORY OF THE COURT OF CHANCERY, 508 (1828) (quoted in SNELL, PRINCIPLES OF EQUITY, 496 (25th ed. 1960)).

values "and often expressed thus rather than by rules that are precisely linguistically expressed."[96]

These observations concerning the principles of equity more generally flow through into the law of fiduciary obligations. Consider the duty of loyalty and, in particular, its proscription of conflicts of duty and interest and profiteering from the fiduciary relationship. Accepting the existence of exceptions for *ex ante* authorization and *ex post* ratification of conflicted transactions and profit from the fiduciary office, the general approach of the law of fiduciary obligations is that disloyalty is presumed in instances of conflict of interest and profit from fiduciary office, without the necessity of inquiring into the fiduciary's state of mind or harm to the beneficiary.[97] The rationale of equity in not making such inquiries was explained in a late 19th century decision from New York as follows:

> The law permits no one to act in such inconsistent relations. It does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction, or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case. It prevents frauds by making them, as far as may be, impossible, knowing that real motives often elude the most searching inquiry…
>
> The value of the rule of equity to which we have adverted, lies, to a great extent, in its stubbornness and inflexibility. Its rigidity gives it one of its chief uses as a preventive or discouraging influence, because it weakens the temptation to dishonesty or unfair dealing on the part of the trustees, vitiating, without attempt at discrimination, all transactions in which they assume the dual characters of principal and representative.[98]

Likewise, Sir Laurence Street, a leading equity jurist and former Chief Justice of the Supreme Court of New South Wales, put the point as follows:

> The courts have also looked askance upon situations in which a man occupying a position of trust engaged in activities involving a potentiality of serving interests other than those which his position requires him to serve. It is, of

[96] *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50, [271]-[272] (Austl.).
[97] *See* RESTATEMENT (THIRD) OF AGENCY § 8.02 (AM. L. INST. 2005); Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage, 950 F.2d 60, 67 (1st Cir. 1991).
[98] Munson v. Syracuse, G. & C. Geneva & Corning R.R. Co., 8 N.E. 355, 358 (N.Y. 1886).

> course, far from the truth to suggest that, where a conflict arises between duty and self interest, the latter will always, or even more frequently than not, prevail. But such a situation is fraught with the risk that human frailty will prove unequal to the resolution of the moral issues involved in the conflict.[99]

Lord Eldon, one of the great English scions of the principles of equity, explained the basis for this approach, in the context of self-dealing, as follows:

> This doctrine as to purchases by trustees, assignees, and persons having a confidential character, stands much more upon general principle than upon the circumstances of any individual case. It rests upon this; that the purchase is not permitted in any case, however honest the circumstances; the general interests of justice requiring it to be destroyed in every instance; as no Court is equal to the examination and ascertainment of the truth in much the greater number of cases.[100]

The reticence of courts exercising chancery jurisdiction to inquire into the "truth" of transactions has been explained in more modern terms in Bogert's *Law of Trusts and Trustees,* highlighting the broad prophylactic approach of the law of fiduciary obligations:

> In its wish to guard the highly valuable fiduciary relationships against improper administration, equity deems it better to forbid disloyalty and strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests.[101]

In this regard, one way of interpreting the approach of the chancery courts is as reflecting an implicit moral judgment that it is preferable to bear the costs of over-inclusiveness rather than risk under-inclusiveness.

E. Implications

That leaves the question of how these accounts relate to the problem of precision in the incorporation of fiduciary obligations into regimes for the

---

[99] *Bonds & Securities (Trading) Pty Ltd v V. Glomex Mines N.L.* [1971] 1 NSWLR. 879, 891 (Austl).
[100] *Ex parte* James (1803) 32 E.R. 385, 388 (Eng.).
[101] Green Charitable Trust, 172 Mich. App. 298, 324 (Ct. App. 1988) (citing BOGERT, TRUSTS AND TRUSTEES § 543 (2d ed. revised)).

regulation of financial advice. There are obvious arguments that can be made about the promulgation costs and compliance costs associated with implementing such obligations with relatively greater or lesser levels of prescriptive detail, as explored further below. However, the argument here is that the salience of the different costs and benefits bearing on precisional optimality warrant consideration not just in the abstract, but rather in a fashion acute to the nature and conceptual underpinnings of the subject matter and kinds of legal commands sought to be articulated.

The agency problem contemplated in the contractarian account clearly subsists in the regulation of financial advice in that it concerns relationships in which one person engages another to act on their behalf in circumstances where the later may undertake imperfectly observable discretionary actions. Accepting the substantially greater information gathering and drafting resources of regulators, the assumption that regulators can do what the individual parties to a transaction cannot is not immediately attractive. That is, it is not clearly the case that regulators can predict and address all possible contingencies within a single relationship, let alone all such relationships that fall within the relevant regulatory perimeter. Similarly, it may be accepted that a court, faced with deciding only particular factual disputes as they come before it, is in a very different position to a regulator with the benefit of a full record and information gathering powers. However, the experience and intuitions of the courts that developed the law of fiduciary obligations sound a clear warning as to the feasibility of *a priori* specification of the great variety of disloyal conduct that may attend relationships of trust and confidence. Indeed, on Smith's functional account of fiduciary obligations, opportunistic conduct, by definition cannot be cost-effectively specified *ex ante*.[102]

On the basis of the foregoing, it may be preferable, as a regulatory design approach, to avoid attempting complete prescriptive specification in the incorporation of fiduciary obligations in statute or regulation by placing reliance on broader, more inclusive formulations. Put differently, the pursuit of detailed specification at the expense of prophylactic breadth may compromise the very social benefits sought to be attained by the imposition of fiduciary and fiduciary-like obligations in the regulation of financial advice.

III. A TYPOLOGY OF REGULATORY DESIGN APPROACHES

That the nature and conceptual foundations of fiduciary and fiduciary-like "best interest" obligations support the view that the efficacy of such obligations requires or is dependent on prophylactic breadth is an important

[102] Smith, *supra* note 80, at 264.

consideration in a conceptual cost/benefit analysis of precisional specification. However, that fact itself provides limited practical assistance in terms of drafting regimes for the regulation of financial advice which incorporate such obligations. Accordingly, this Part IV gives consideration to the continuum of available regulatory design strategies, ranging from low-cost, broad prophylactic articulations to high-cost, detailed specification. The intention is to develop a typology of different regulatory design approaches that employ different potential compromises between preserving the prophylactic breadth of "standard"-like articulations of legal commands and the certainty and guidance of detailed *ex ante* "rule"-like specifications. While these two extremes may seem competing or mutually exclusive on first impression, regulatory design approaches are identified below that provide statutory and regulatory drafters different ways to maintain the prophylactic benefits of broadly articulated fiduciary and fiduciary-like obligations whilst simultaneously providing varying levels of certainty and guidance by *ex ante* specification.

A graphical representation of the twin-dimensions of "rule"-like precisional detail and "standard"-like prophylactic breadth is employed throughout this Part IV to illustrate the initial state of each regulatory design approach and how it may be expected to change over time. Quadrants representing different permutations of high and low prophylactic breath and precisional detail have been designated for ease of reference – and not to suggest a binary, as opposed to continuous, nature of these descriptor variables.

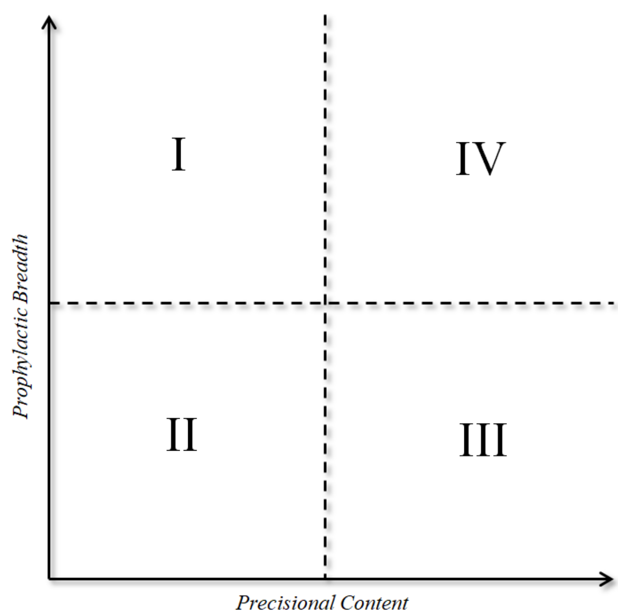


Figure 1: *Graphical representation of twin-dimensions of precisional detail and prophylactic breadth*

A. Type A – Pure "standards"-based regulatory design approach

An obvious regulatory design approach is to rely on broad, prophylactic articulation without attempting to provide any more detailed *ex ante* specification or "rule"-like content. Such an approach obviously carries low promulgation costs for regulators, avoids the risk of under-inclusiveness, and fully maintains the prophylactic breadth necessary for the efficacy of fiduciary and fiduciary-like obligations. However, by definition, such an approach provides little by way of *ex ante* guidance to financial advisers and thus would likely entail higher compliance costs.

With that said, the *ex post* development of a body of decisional case law or regulatory enforcement actions may provide, over time, a source of guidance as to the requisite content of the broadly articulated obligation. That is, while a pure "standards"-like approach would initially fall squarely in Quadrant I of the graphical representation above (viz., high prophylactic breath, low precisional content), over time such an approach would migrate towards Quadrant IV (viz., high prophylactic breadth, high precisional content), as follows:

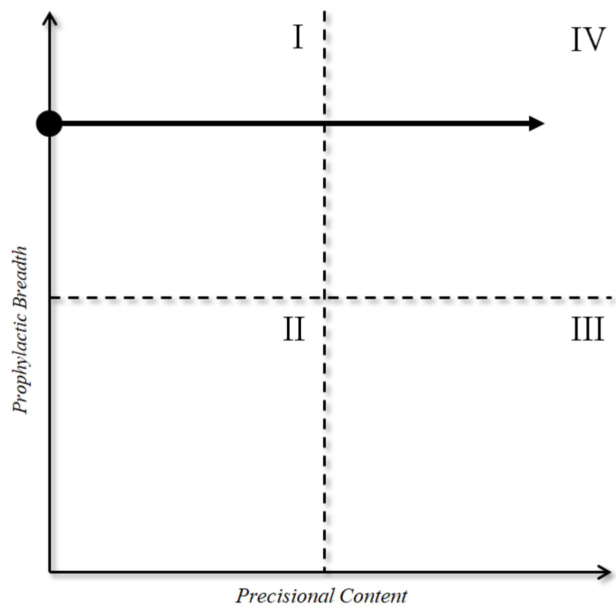


***Figure 2:** Pure "standards"-based approach tends towards Quadrant IV over time*

The judicial imposition of fiduciary obligations in relation to the provision of financial advice exemplifies this Type A pure "standards"-based approach and its accretion of precisional content over time. Indeed, the phenomenon of a Type A approach tending to migrate towards Quadrant IV has been observed (albeit not in this author's terminology) in the general law context by Robert Sitkoff in terms of the development of "subsidiary" or "implementing" rules at general law as a means of addressing recurrent fact patterns and scenarios that implicate the broadly expressed duty of loyalty applied by chancery courts.[103] Such subsidiary rules provide certainty and guidance in that they establish certain conduct as incontrovertibly and definitely required, whilst leaving a broader, more prophylactic articulation of the relevant duty in place so as to avoid under-inclusion. Sitkoff makes an observation that is particularly pertinent to the discussion here of addressing under-inclusion whilst providing certainty and guidance to financial advisers:

> [T]he subsidiary rules offer the normal benefit of simple rules, reduced decision costs, without increasing error costs by providing a roadmap for strategic avoidance behavior. If the fiduciary acts in a manner that is inimical to the principal's interests but that does not fall within one or another subsidiary rule, the principal may invoke the broad, open-ended duties of loyalty and care.[104]

The following sections provide a more detailed exposition of the judicial imposition of fiduciary obligations in relation to financial advice under state law and in comparative international jurisdictions. Although the judicial imposition of fiduciary obligations is proffered as exemplifying the Type A regulatory design approach, it is obviously readily susceptible to use in drafting statutory or regulatory regimes.

1. State judicial imposition of fiduciary obligations in relation to financial advice

That the provision of financial advice may be subject to fiduciary obligations has been recognized in the judge-made law of various states. The accrual of fiduciary obligations as a matter of state law in this regard is often described as depending on the discretionary or non-discretionary nature of the client's account.[105] However, a closer examination of the case law reveals two distinct approaches to the accrual of fiduciary obligations to stockbrokers and other like financial advisors under state law.

An appreciation of the equitable principles governing the imposition of fiduciary obligations more broadly will illustrate how these two distinct approaches diverge. On the one hand, there are certain kinds of statuses or relationships that courts exercising equitable jurisdiction have traditionally recognized as giving rise to fiduciary obligations. An individual subject to fiduciary obligations by virtue of such relationships is sometimes referred

[103] *See* Sitkoff, *supra* note 62, at 1044–45.
[104] *Id.* at 1045.
[105] Laby, *supra* note 23, at 723–25.

to as a "per se" fiduciary or a "status-based" fiduciary. In this regard, it is uncontroversial that the relationships of trustee/beneficiary, attorney/client, agent/principal, and director/company, give rise to fiduciary obligations.[106] On the other hand, fiduciary obligations may arise absent one of these traditionally emphasized relationships, arising instead due to the existence of equitably salient facts and circumstances. An individual subject to fiduciary obligations in this way is sometimes referred to as an "ad hoc" fiduciary. Although approaches vary, fiduciary obligations will generally only be imposed on an ad hoc basis where the circumstances evince an undertaking to act in the interest of another person,[107] or a reposing of trust and confidence.[108]

2. Status-based approaches to the fiduciary obligations of stockbrokers under state law

The accrual of fiduciary obligations to stockbrokers and like financial advisors under the law of some states reflects the status-based approach to the accrual of fiduciary obligations. The central premise of state law jurisprudence exhibiting this approach is the view that the relationship between stockbroker and client is an agency relationship, in the legal sense of the term, and thus one which courts of equity have traditionally recognized as giving rise to fiduciary obligations.

The law of California exemplifies this approach. In *Twomey v Mitchum, Jones & Templeton Inc.,* Sims J, writing for the California Court of Appeal for the First District, reasoned from the recognized fiduciary status of agents to the proposition that the "relationship between broker and principal is fiduciary in nature."[109] Likewise, in *Black v. Shearson, Hammill & Co.,* it was observed that a stockbroker "owes [a fiduciary duty] to his customers, whom he ordinarily serves as agent".[110] In *Duffy v King Cavalier,* Judge Barry-Deal reiterated this reasoning, observing that the fiduciary obligations of stockbrokers, like those of any agent, arise from the stockbrokers' status as a common law agent of their principal.[111]

Judge Barry-Deal went on to reject an argument by the appellants that the fiduciary obligations of stockbrokers are limited to circumstances

[106] Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539, 541 (1949).
[107] *Id.* at 540.
[108] RESTATEMENT (THIRD) OF AGENCY: GENERAL FIDUCIARY PRINCIPLE §8.01 cmt. c (2006) ("[A] a court may…determine that one person's relationship with another warrants the imposition of fiduciary obligation to some degree on the basis that one party to the relationship has in fact reposed trust and confidence in the other and has done so consistently with the other's invitation").
[109] Twomey v. Mitchum, Jones & Templeton Inc., 262 Cal. App. 2d 690, 709 (Ct. App. 1968).
[110] Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 367 (Ct. App. 1968).
[111] Duffy v. King Cavalier, 215 Cal. App. 3d 1517 1529, 1534 (Ct. App. 1989).

where the broker actually controls the client's account, describing the argument as a misreading of *Twomey* and subsequent case law.[112] In this regard, Judge Barry Deal explained that: "[t]he question is not whether there is a fiduciary duty, which there is in every broker-customer relationship; rather, it is the *scope or extent* of the fiduciary obligation, which depends on the facts of the case."[113] That is, the judge viewed non-discretionary accounts as giving rise to fiduciary obligations, albeit ones the scope of which is narrowed by the limited and non-continuing nature of the agency relationship in such accounts.[114]

This status-based approach to the accrual of fiduciary obligations to stockbrokers and other financial advisors is also apparent in the case law of other states. The South Carolina Court of Appeals in *Cowburn v. Leventis*, for example, observed that "[a] broker or dealer of securities is an agent of the buyer, and therefore, generally owes the buyer fiduciary duties," which the court found

> "often include[s] the duty to account for all funds and property belonging to the buyer, to refrain from acting adversely to the buyers interest, to avoid engaging in fraudulent conduct, and to communicate any information he or she may acquire that would be to the buyers advantage."[115]

Likewise, in *Martin v. Heinold Commodities Inc.*, the agency status of a commodities derivatives broker was recognized as giving rise to fiduciary obligations.[116] The Supreme Court of Illinois stressed, however, that "an agent's fiduciary duty is limited to actions occurring within the scope of his agency."[117] In *O'Malley v. Boris,* the Supreme Court of Delaware succinctly stated the relevant principles of Delaware state law as follows:

> The relationship between a customer and stock broker is that of principal and agent. The broker, as agent, has a duty to carry out the customer's instructions promptly and

---

112 *Id.* at 1534–35.
113 *Id.* at 1535.
114 *Duffy v. King Cavalier*, 215 Cal. App. at 1535–36. *See* Apollo Capital Fund, LLC v. Roth Cap. Partners, LLC, 158 Cal. App. 4th 226, 246 (Ct. App. 2007); *In re* Nuveen Funds/City of Alameda Sec. Litig., No. C 08-4575 SI, 2011 WL 1842819 (N.D. Cal. May 16, 2011), *aff'd sub nom*. Nuveen Mun. High Income Opportunity Fund v. City of Alameda, Cal., 730 F.3d 1111 (9th Cir. 2013).
115 Cowburn v. Leventis, 619 S.E.2d 437, 447 (S.C. Ct. App. 2005).
116 Martin v. Heinold Commodities Inc., 510 N.E.2d 840, 844 (Ill. 1987). The Supreme Court of Illinois cited *In re* Rosenbaum Grain Corp., 103 F.2d 656, 660 (7th Cir. 1939), which remarked that "[o]n the stock and commodity exchanges, the broker and his customer stand to each other as principal and agent. This relation, contemplating as it does the holding by the broker of the customer's money and other property, is primarily fiduciary in nature."
117 *Id.* at 845.

> accurately. *In addition, the broker must act in the customer's best interests and must refrain from self-dealing unless the customer consents, after full disclosure. These obligations at times are described as fiduciary duties of good faith, fair dealing, and loyalty***.** They are comparable to the fiduciary duties of corporate directors, and are limited only by the scope of the agency.[118]

As these brief illustrations should serve to demonstrate, the distinguishing feature of the status-based approach is the invariable accrual of fiduciary obligations to stockbrokers on the basis of their agency status, with the significance of an account being discretionary or non-discretionary sounding in the scope and nature of those fiduciary obligations, rather than in determining their accrual.

3. Ad hoc approaches to the fiduciary obligations of stockbrokers under state law

In other states, fiduciary obligations do not invariably accrue to stockbrokers and other like financial advisers, but rather accrue on an ad hoc basis only.[119] It is in the context of these states only that it can accurately be said that the accrual of fiduciary obligations to stockbrokers and other like financial advisors is dependent on the discretionary or non-discretionary nature of the client's account.

In *Paine, Webber, Jackson & Curtis, Inc v. Adams*, for example, the Supreme Court of Colorado declined "to adopt a rule that a stockbroker/customer relationship is, per se, fiduciary in nature," opining that "proof of practical control of a customer's account by a broker will establish that the broker owes fiduciary duties to the customer with regard to the broker's handling of the customer's account."[120] Likewise, in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Boeck,* the Supreme Court of Wisconsin held that a stockbroker "does not owe a fiduciary duty to an investor-customer who makes all of the investment decisions, unless there is an express agreement placing a greater obligation on the broker or other special circumstances."".[121] In line with the description of the ad hoc approach to the accrual of fiduciary obligations described above, the Supreme Court of Wisconsin in *Boeck* referred to the need for "a formal commitment to act for the benefit of another . . . or from special circumstances from which the law will assume an obligation to act for another's benefit."[122]

---

[118] O'Malley v. Boris, 742 A.2d 845, 849 (Del. 1999) (emphasis added).
[119] *E.g.*, Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck, 377 N.W.2d 605 (Wis. 1985).
[120] *Paine v. Adams*, 718 P.2d at 517 (emphasis omitted).
[121] *Merrill Lynch v. Boeck*, 377 N.W.2d at 609.
[122] *Id*.

Echoing this approach, the law of Massachusetts appears to draw a distinction between a "simple" broker-customer relationship and a "full" relationship broker and principal.[123] A "simple" broker-customer relationship, in the nature of a mere business arrangement or engagement to buy on behalf of another, is not viewed as giving rise to fiduciary obligations.[124] However, a "full" relation of principal and broker will give rise to fiduciary obligations, having regard to factors such as the discretionary nature of the account and the extent to which the client in question entrusted their stockbroker to select and execute transactions on their behalf.[125]

The crucial difference between the two approaches to the threshold issue of the accrual of fiduciary obligations to stockbrokers and like financial advisors as a matter of state law can thus be seen to depend on the emphasis given to agency status. In states where stockbrokers and like financial advisors are not treated as agents, and absent some other established category of relationship, the accrual of fiduciary obligations is parsed on an ad hoc basis through the search for a fiduciary undertaking or the reposing of trust and confidence. It is in this regard that the discretionary or non-discretionary nature of a client's account attains salience in terms of the accrual of fiduciary obligations.

In either case, and as noted above, U.S. courts generally regard a fiduciary's obligations as entailing twin duties of loyalty and care. Courts have expressed different opinions as to the relevance of disclosure in the context of judicially imposed fiduciary obligations. In particular, there are different views as to whether the relevance of disclosure is by way of a positive obligation, or rather as a basis for informed consent providing exculpation from what would otherwise constitute a breach of fiduciary obligation. In line with the former view, some courts clearly speak in terms of a positive duty of disclosure.[126] On the other hand, and more obviously in line with the latter view, the Supreme Court of Delaware in *O'Malley v. Boris* observed that a broker fiduciary "must act in the customer's best interests and must refrain from self-dealing unless the customer consents, after full disclosure."[127] The point for present purposes, however, is simply to illustrate the recognition under state law that, in some circumstances, the provision of financial advice is subject to broad, prophylactic judicially imposed fiduciary obligations.

123 Patsos v. First Albany Corp., 741 N.E.2d 841, 848 (Mass. 2001).
124 *Id.*
125 *Id.*
126 See Klein v. First Edina Nat'l Bank, 196 N.W.2d 619, 622 (Minn. 1972); Appletree Square I Ltd. P'ship v. Investmark, Inc., 494 N.W.2d 889, 892 (Minn. App. 1993).
127 O'Malley v. Boris, 742 A.2d 845, 849 (Del. 1999).

4. Comparative perspectives – judicial imposed fiduciary obligations of Australian financial advisers

That fiduciary obligations may constrain the action of stockbrokers and other financial advisers is recognized in other common law jurisdictions in the Anglo-American legal tradition. In Australia, the courts recognize that fiduciary obligations may accrue both on the basis of certain established categories of relationship, such as trustee/beneficiary, agent/principal, and director/company, but also on an ad hoc basis in particular factual circumstances.

In *Thornley v Tilley,* a case considering the entitlement of stockbrokers to deal on their own behalf with stock purchased on margin account by customers, Justice Isaacs of the High Court of Australia adopted an agency-status based approach to stockbroker fiduciary obligations similar to that employed by some U.S. state courts.[128] His Honour described the employment of the respondent-stockbrokers as "one of agency at their discretion to buy and carry shares" for the appellant and observed that such an employment "constitutes a fiduciary relation."[129] Consequently, and subject to special circumstances displacing the general rule, Justice Isaacs explained that a stockbroker "cannot make profit for himself out of the principal's investments."[130]

Subsequent Australian case law has taken a more ad hoc circumstance-specific approach to the accrual of fiduciary obligations to stockbrokers and financial advisers. In what is the seminal exposition of fiduciary obligations under Australian law, Justice Mason, subsequently Chief Justice of the High Court of Australia, described the critical feature of those relationships of trust and confidence which give rise to fiduciary obligations as being "that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense."[131] In *Daly v Sydney Stock Exchange,* a case stemming from the insolvency of a firm of stockbrokers, Gibbs CJ observed that "Normally, the relation between a stockbroker and his client will be one of a fiduciary nature."[132] His Honour noted that a stockbroker's fiduciary obligations arise "when, and because, a relationship of confidence exists between the parties", and emphasized that the firm in question had held itself out as an adviser on matters of investment and undertook to advise the appellant client, who had relied on the advice provided by the firm.[133]

---

[128] *Thornley v Tilley* (1925) 36 CLR 1, 11–12 (Austl.).
[129] *Id.*
[130] *Id.* at 12
[131] *Hosp Prods Ltd v United States Surgical Corp* (1984) 156 CLR. 41, 96–97 (Austl.).
[132] *Daly v Sydney Stock Exch. Ltd* (1986) 160 CLR 371, 377 (Austl.).
[133] *Id.*

In this regard, it is recognized that fiduciary obligations may accrue to a financial advisor even in transactions in which the advisor has an obvious commercial self-interest, provided the requisite undertaking is present.[134]

In Australia, the "distinguishing or overriding duty of a fiduciary is the obligation of undivided loyalty."[135] Although a duty of care and skill may be owed in equity by an individual occupying a fiduciary office, it does not follow that the duty of care is itself fiduciary in nature.[136] Furthermore, the duty of loyalty itself is not regarded as an affirmative obligation to act in the best interest of another, but rather as a *proscriptive* obligation not to obtain any unauthorized benefit from the fiduciary relationship and not to be in undisclosed conflict of duty and interest (or of duty and duty).[137]

The stringency of this approach in the context of stockbrokers and investment advisers is illustrated by a 1968 decision of the Supreme Court of New South Wales.[138] Having observed that the special status of a stockbroker as agent and adviser of their client gives rise to obligation on the stockbroker not to put himself into a position where personal interest and duty to the client conflict, Justice Street concluded that "[a] broker is precluded by the very nature of his position…from participating in what is commonly called playing the market."[139] As his Honour explained:

> [A stockbroker] occupies a position which imposes on him important obligations towards his client… [T]he involvement of a broker in either a short or long position in a particular stock, resulting from a course of business in which he buys or sells that stock for his own account, will give him a personal interest in the fluctuations of the market. There is thereby introduced an element of direct personal conflict with his duty to advise and act for his clients uninfluenced by collateral considerations arising from his own position as a trader.[140]

In Australia, the existence of informed consent is viewed as negating what would otherwise constitute a breach of fiduciary obligation.[141] What constitutes informed consent is a question of fact determined by reference

---

[134] *Aequitas Ltd v Sparad No 100 Ltd (formerly Australian European Fin Corp Ltd)* [2001] NSWSC 14, 307 (Austl.).
[135] *ASIC v Citigroup Glob. Mkts. Austl. Pty Ltd [No. 4]* (1994) 14 ASCR 109, 110–11 (Austl.).
[136] In the United Kingdom, see Mothew v Bristol [1998] Ch 1, 16 (AC) (appeal taken from Eng.). In Australia, see *Permanent Bldg Soc'y v Wheeler (WA)* (1994) 11 WAR 187, 235–39 (Austl.).
[137] *Breen v Williams* (1996) 186 CLR. 71, 113 (Austl.) (appeal taken from Wales).
[138] *See generally Hewson v Sydney Stock Exch Ltd* [1968] 2 NSWR 224 (Austl.).
[139] *Id.* at 231.
[140] *Id.*
[141] *Maguire v Makaronis* (1997) 188 CLR 449, 466 (Austl.).

to all relevant circumstances, including disclosure.[142] On that approach, it is incumbent on a fiduciary to make disclosure if they wish to avoid breach of fiduciary obligation, but there is no duty of disclosure.

The Australian jurisprudence also emphasizes that the scope of an adviser's fiduciary obligations may vary. An adviser may be subject to fiduciary obligations as to some aspects of their relationship with a client but not others,[143] and the scope of the relevant obligations will vary according to the nature of the relationship and the factual circumstances.[144] The point for present purposes, however, is simply to illustrate the judicial imposition of fiduciary obligations articulated in broad prophylactic terms. However, by virtue of the common law method, these broad articulations are given content and more detailed exposition over time through adjudication and the accumulation of case law.

B. Type B – "Standards"-based approach supplemented with ex ante presumptions

An incremental modification in regulatory design approach supplements the use of broad, "standard"-like articulations with the *ex ante* articulation of subsidiary presumptions. This approach maintains all the benefits of the broad, prophylactic articulation of fiduciary and fiduciary-like obligations, including in ensuring their efficacy, whilst also promising some degree of increased certainty and guidance for regulated entities. Furthermore, although this approach carries some additional promulgation costs, those costs may reasonably be expected to be less than a full or even partial detailed, "rule"-like specification. The main disadvantage of this approach stems from the nature of legal presumptions. So long as the subsidiary presumptions are truly presumptions, in that they are rebuttable, the *ex ante* certainty and guidance provided to regulated entities may be questioned. In that regard, regulated entities would not know with certainty whether the relevant presumption would actually be applied to their facts and circumstances in an *ex post* adjudication. Of course, the *ex post* development of a body of decisional case law concerning both the overarching broad, prophylactic articulation and the subsidiary presumptions would be expected provide additional certainty and guidance over time.

This Type B regulatory design approach may thus be understood as initially falling in Quadrant I (viz., high prophylactic breath, low precisional content) of the graphical representation above, albeit with

[142] *Id.*
[143] *Austl Sec & Invs Comm'n v Citigroup Glob Mkts Austl Pty Ltd [No. 4]* [2007] FCA 963 at [285] (Austl.) (Jacobson, J.).
[144] *Id.* at [285]–[88].

higher initial precisional content than a Type A approach, but may be expected over time to migrate towards Quadrant IV (viz., high prophylactic breadth, high precisional content) over time, as follows:

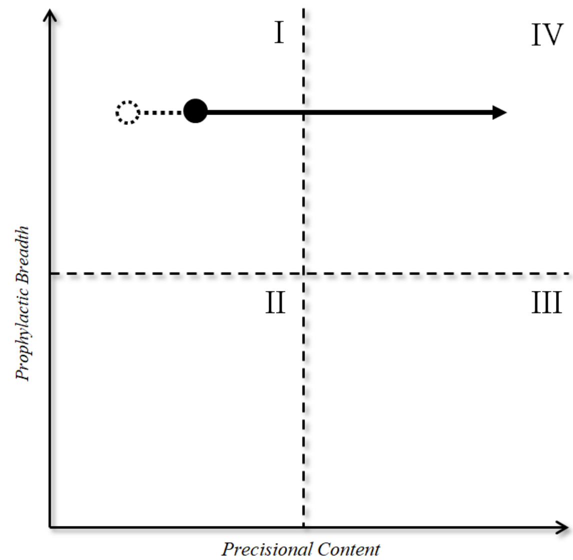


Figure 3: *Supplementing "standard"-like articulations with presumptions to provide greater ex ante precisional content*

The Massachusetts final rule and the draft fiduciary regulations proposed by the New Jersey Bureau of Securities provide examples of this Type B regulatory design approach, as explained below.

1. Massachusetts' final fiduciary rule

On February 21, 2020, the Massachusetts Securities Division adopted regulatory amendments which would subject broker-dealers and their agents to fiduciary obligations when making recommendations and providing investment advice to customers.[145] Although these amendments went into effect, they were recently struck down on administrative law grounds at first instance in the Superior Court of Massachusetts.[146] With that said, the Massachusetts amendments are still illustrative as an example of the posited Type B regulatory design approach.

---

[145] Adopting Release, William Francis Galvin, Secretary, Massachusetts Securities Division, Amendments to Fiduciary Conduct Standard Regulations – 950 MASS. CODE REGS. 12.200 (Feb. 21, 2022). http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.

[146] Robinhood Fin., LLC v. Galvin, No. 2184CV00884, 2022 WL 1720131 at *15 (Mass. Super. Ct. Mar. 30, 2022).

By way of necessary context, under Massachusetts statute, the Secretary of the Commonwealth, within whose office the Massachusetts Securities Division operates, is empowered to impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action where it is found that (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, or other similarly situated individuals "has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business."[147]

The Massachusetts fiduciary rule took the form of a regulatory provision establishing a fiduciary duty of broker-dealers and agents.[148] Specifically, under the amendments, a broker-dealer or its agent would be deemed to have engaged in "unethical or dishonest conduct or practices" by "[f]ailing to act in accordance with a fiduciary duty to a customer when providing investment advice or recommending an investment strategy, the opening of or transferring of assets to any type of account, or the purchase, sale, or exchange of any security."[149] As the adopting release made clear, this was intended to run "during the period in which incidental advice is made in connection with the recommendation of a security to the customer."[150] However, this episodic duty would extend beyond the duration of the recommendation in certain circumstances. In particular, the amendments provided that it would also constitute "unethical or dishonest conduct or practices" for a broker-dealer or its agents to fail "to act in accordance with a fiduciary duty to a customer during a period in which the broker-dealer or agent:

> 1. Has or exercises discretion in a customer's account, unless the discretion relates solely to the time and/or price for the execution of the order;
> 2. Has a contractual fiduciary duty; or
> 3. Has a contractual obligation to monitor a customer's account on a regular or periodic basis, as such regular or periodic basis is determined by agreement with the customer."[151]

The Massachusetts amendments provided that each broker-dealer or agent must adhere to twin "duties of utmost care and loyalty to the

---

147 MASS. GEN. LAWS ch. 110A, § 204(a)(2)(G).
148 950 MASS. CODE REGS. 12.207.
149 950 MASS. CODE REGS. 12.207(1)(a).
150 Adopting Release, William Francis Galvin, Secretary, Massachusetts Securities Division, Amendments to Fiduciary Conduct Standard Regulations – 950 MASS. CODE REGS. 12.200 (Feb. 21, 2022) http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.
151 950 MASS. CODE REGS. 12.207(1)(b).

customer" in order to meet their fiduciary obligations.[152] Articulating each duty in turn, the amendments provided that "[t]he duty of care requires a broker-dealer or agent to use the care, skill, prudence, and diligence that a person acting in a like capacity and familiar with such matters would use, taking into consideration all of the relevant facts and circumstances."[153] The regulatory duty of care would also require a broker-dealer or agent to make reasonable inquiry, including as to "1. The risks, costs, and conflicts of interest related to all recommendations made and investment advice given; 2. The customer's investment objectives, risk tolerance, financial situation, and needs; and 3. Any other relevant information."[154] With respect to the duty of loyalty, the amendments provided that "[t]he duty of loyalty requires a broker-dealer or agent to: 1. Disclose all material conflicts of interest; 2. Make all reasonably practicable efforts to avoid conflicts of interest, eliminate conflicts that cannot reasonably be avoided, and mitigate conflicts that cannot reasonably be avoided or eliminated; and 3. Make recommendations and provide investment advice without regard to the financial or any other interest of any party other than the customer."[155]

Although the duty of loyalty is articulated in three limbs, each limb is articulated in broad, prophylactic terms, as opposed to being fact-specific as would be expected with a more detailed "rule"-like specification. For example, in providing that the duty of loyalty requires disclosure of all material conflicts of interest, the amendments did not purport to prescribe any particular form of disclosure, nor seek to define what constitutes materiality in this context. Accordingly, these three limbs are best characterized as reflecting a broad, "standard"-like articulation, rather than "rule"-like legal commands. Indeed, the Massachusetts amendments went on to provide more fact-specific subsidiary guidance by way of a presumption that it will constitute a breach of the duty of loyalty for a broker-dealer or agent to make a recommendation "if the recommendation is made in connection with any sales contest."[156] In addition, the amendments further supplemented the overarching three-limbed duty of loyalty by express provision that "[d]isclosing conflicts alone does not meet or demonstrate the duty of loyalty."[157] As a result, the Massachusetts amendments can be regarded as an example of a minimalist Type B regulatory design approach, largely relying on broadly articulated "standard"-like provisions but supplemented with some fact-specific additional detail through presumption.

[152] 950 MASS. CODE REGS. 12.207(2).
[153] 950 MASS. CODE REGS. 12.207(2)(a).
[154] *Id.*
[155] 950 MASS. CODE REGS. 12.207(2)(b).
[156] 950 MASS. CODE REGS. 12.207(2)(d).
[157] 950 MASS. CODE REGS. 12.207(2)(c).

2. New Jersey's Proposed Fiduciary Regulations

On April 15, 2019, the New Jersey Bureau of Securities released a proposed rulemaking that would subject broker-dealers and their agents to fiduciary obligations in certain circumstances. [158] As noted in the Introduction, after a series of delays during the COVID-19 pandemic, the New Jersey Bureau of Securities announced that it would not adopt the proposal and the proposal expired on January 1, 2022.[159] For present purposes, however, the New Jersey proposal warrants attention as an example of the Type B regulatory design approach.

By way of background, it is "unlawful for any person to act as a broker-dealer, agent, investment adviser or investment adviser representative . . . in [New Jersey] unless that person is registered or exempt from registration" under New Jersey statute.[160] It is "unlawful for any person who receives, directly or indirectly, any compensation from another person for advising the other person as to the value of securities or their purchase or sale . . . to engage in dishonest or unethical practices."[161] Furthermore, registration may be denied, suspended or revoked if an entity "has engaged in dishonest or unethical practices in the securities, commodities, banking, insurance or investment advisory business."[162]

The notion of "dishonest or unethical practices" is given content in New Jersey regulations, specifically in Title 13, Chapter 47A, Subchapter 6 of the New Jersey Administrative Code. The rules in Subchapter 6 apply to "[f]ederal covered advisers to the extent that the conduct alleged is fraudulent or deceptive, or to the extent permitted by the National Securities Markets Improvement Act of 1996."[163] As it currently stands, Subchapter 6 currently contains a laundry list of 64 items which are included in the concept of "dishonest or unethical practices,"[164] including the following:

> 3. Recommending to a customer an investment strategy, or the purchase, sale, or exchange of any security or securities *without reasonable grounds to believe that such strategy,*

[158] N.J. DIV. OF CONSUMER AFFS, BUREAU OF SEC., PROPOSED RULE: FIDUCIARY DUTY OF BROKER-DEALERS, AGENTS, INVESTMENT ADVISERS, AND INVESTMENT ADVISER REPRESENTATIVES, 51 N.J .Reg. 493 (Apr. 15, 2019), https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx.
[159] N.J. DEP'T OF L. AND PUB. SAFETY, *New Jersey Bureau of Securities Proposal for Fiduciary Rule Will Expire as Bureau Continues Efforts to Protect Investors in an Evolving Market* (Dec. 24, 2021), https://www.njoag.gov/new-jersey-bureau-of-securities-proposal-for-fiduciary-rule-will-expire-as-bureau-continues-efforts-to-protect-investors-in-an-evolving-market/.
[160] N.J. STAT. ANN. § 49:3-56.
[161] N.J. STAT. ANN. § 49:3-53.
[162] N.J. STAT. ANN. § 49:3-58.
[163] N.J. ADMIN. CODE § 13:47A-6.1.
[164] N.J. ADMIN. CODE § 13:47A-6.3.

> *transaction, or recommendation is suitable* for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, and any other relevant information known by the broker-dealer.[165]

The New Jersey Bureau of Securities proposed rulemaking would have introduced a new section into Subchapter 6A, establishing a regulatory fiduciary duty of broker-dealers, agents and advisors.[166] Under the proposed rulemaking, it would have constituted a "dishonest or unethical business practice" for a broker-dealer or its agent to fail "to act in accordance with a fiduciary duty to a customer when making a recommendation or providing investment advice."[167] The proposed rulemaking would have provided that where a broker-dealer is making an episodic recommendation, as opposed to ongoing investment advice, the fiduciary duty extends "through the execution of the recommendation and shall not be deemed an ongoing obligation."[168] Similarly, it would have provided that it constitutes a "dishonest or unethical business practice" for an adviser, or a broker-dealer or its agent acting as an adviser, who has discretionary authority over a customer's account or who is subject to a contractual fiduciary duty to fail "to act in accordance with a fiduciary duty to a customer when providing investment advice."[169]

In order to satisfy the proposed regulatory fiduciary duty, a broker-dealer, agent, or adviser would have been required to satisfy the twin duties of care and loyalty.[170] With respect to the duty of care, the proposed rulemaking would have provided as follows:

> When making a recommendation or providing investment advice, the duty of care requires a broker-dealer, agent, or adviser to use the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with

---

[165] *Id.* (emphasis added).
[166] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. 493(a), 494 (proposed Apr. 15, 2019) (to be codified at N.J. ADMIN CODE § 13:47A-6.4).
[167] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 494 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(a)(1)).
[168] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 494 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(a)(1)(i)).
[169] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 494 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(a)(2)).
[170] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 494 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)).

> such matters would use taking into consideration all of the facts and circumstances.[171]

With respect to the duty of loyalty, the proposed rulemaking would have provided:

> When making a recommendation or providing investment advice, the duty of loyalty requires that a recommendation or the advice is made without regard to the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity and its officers, directors, agents, employees, or contractors, or any other third-party.[172]

Viewed in isolation, these twin articulations are analogous to the Type A regulatory design approach described above and the broad, prophylactic articulation of fiduciary obligations under judge-made law. Indeed, the New Jersey Bureau of Securities described these provisions in the proposal summary as codifying the common law duty of care and the common law duty of loyalty.[173] However, the proposed rulemaking would have supplemented the duty of loyalty with a number of subsidiary presumptions. This would have included a presumption of breach of the duty of loyalty for "offering or receiving direct or indirect compensation to or from the broker-dealer, its agent, or adviser for recommending the opening of or transfer of assets to a specific type of account, or the purchase, sale, or exchange of a specific security that is not the best of the reasonably available options."[174] In addition, the proposal rule would have provided that "[t]here shall not be a presumption that disclosing a conflict of interest in and of itself shall satisfy the duty of loyalty."[175] In describing these presumptions, the New Jersey Division of Securities indicated that it was "concerned about harmful incentives, such as sales contests, that encourage and reward conflicted advice" and noted its view that "simply disclosing conflicts does not provide adequate protection and does not shield investors from potential financial harm of conflicted advice."[176] At the same time, the proposed rulemaking would have provided that "it shall

[171] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 496 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)(1)).
[172] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 497 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)(2)).
[173] *Id.*
[174] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 497 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)(2)(i)).
[175] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 497 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)(2)(ii)).
[176] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives 51 N.J. Reg. 493, 494 (2019).

not be deemed a breach of the fiduciary duty owed to a customer when the broker-dealer or agent receives a transaction-based fee, provided that the fee is reasonable and is the best of the reasonably available fee options and the duty of care is satisfied."[177]

While the presumptions included in the Massachusetts final rule and the New Jersey Bureau of Securities proposed rule are not extensive, they do demonstrate the posited Type B regulatory design approach of combining broad, prophylactic "standard"-like articulations with subsidiary presumptions. That is, the Type B approach clearly demonstrates that the prophylactic breadth-dependent efficacy of fiduciary obligations can be maintained in conjunction with attempts to provide additional detail through the *ex ante* specification of presumptions. At the same time, the Type B approach also demonstrates that the additional certainty and guidance provided by presumptions may be limited, whether because of uncertainty as to how and when the presumption will be rebutted or because, as here, the presumptions are not extensive.

C. Type C – "Standards"-based approach supplemented with interpretive guidance

An alternative regulatory design approach is to supplement the broad, "standard"-like articulation of fiduciary or fiduciary-like "best interest" obligations with *ex post* agency interpretations, as opposed to *ex ante* specification within the relevant organic statute or regulations themselves. Again, this approach maintains all the benefits of the broad, prophylactic articulation of fiduciary and fiduciary-like obligations, including in ensuring their efficacy, but provides increased certainty and guidance for regulated entities.

The main disadvantage of this approach lies in the nature of agency interpretations and the hierarchy of legal sources. Agency interpretations may not always be timely, and may be costly to develop. The nature of agency interpretations, and their promulgation by way of expository prose rather than as more detailed and structured regulatory provisions, may itself engender uncertainty and issues of interpretation. Furthermore, the additional certainty and guidance provided by agency interpretations will be of most relevance in business-as-usual conditions and in interactions with the promulgating regulator. Whether reliance on such interpretations is ultimately vindicated in litigation will be subject to questions of agency deference and the whims of the judicial process. Of course, a body of decisional case law concerning the overarching broad, prophylactic

[177] Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, 51 N.J. Reg. at 497 (to be codified at N.J. ADMIN CODE § 13:47A-6.4(b)(3)).

articulation will develop over time. Furthermore, agency interpretations may be clarified, amended, supplemented, or replaced over time. Indeed, this may happen in response to specific factual circumstances or market developments, and thus this process of interpretative accretion will also provide increased certainty and guidance over time.

This regulatory design approach may thus be understood as initially falling in Quadrant I (viz., high prophylactic breath, low precisional content), albeit with higher initial, precisional content than a Type A approach, but may be expected over time to migrate towards Quadrant IV (viz., high prophylactic breadth, high precisional content).

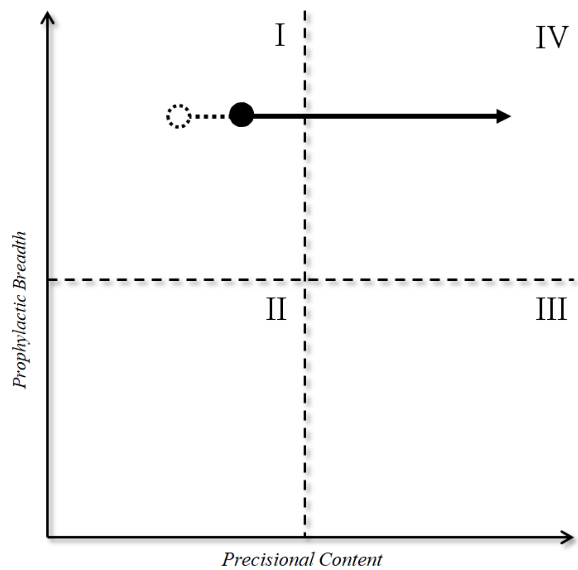


Figure 4: *Supplementing "standard"-like articulations with interpretative guidance*

The federal regulation of registered investment advisors, including the SEC's recent Fiduciary Interpretation, provide an example of this Type C regulatory design approach as examined below.

1. The fiduciary obligations of registered investment advisers & the Fiduciary Interpretation

As noted in the Introduction to this paper, investment advice is provided by two kinds of federally regulated firms, broker-dealers regulated under the Securities Exchange Act of 1934 and investment advisors registered pursuant to the Investment Advisers Act of 1940. Fiduciary obligations have traditionally had a more salient role in the regulatory regime which governs investment advisers registered under the Investment Advisers Act. A brief description of the schema of the

Investment Advisers Act is provided here, including the historical case law which first recognized the fiduciary obligations of investment advisers.

At the outset, the core concept of an "investment adviser" in the schema of the Investment Advisers Act must be recognized. Subject to a range of exceptions, an "investment adviser" is defined by statute to mean "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities".[178] Of itself, this illustrates the threshold issue of articulating a regulatory perimeter within which individuals will accrue fiduciary obligations.

With that said, the imposition of fiduciary obligations on registered investment advisers is not explicit on the text of the Investment Advisers Act of 1940, following instead from an approach to statutory interpretation that incorporates and "reads in" in traditional equitable principles. By way of context, it is unlawful for an investment adviser to engage in the business of providing investment advice in the course of interstate commerce unless they are registered pursuant to the Investment Advisers Act of 1940.[179] Regardless of their registration status, any investment adviser who engages in the business of providing investment advice in the course of interstate commerce is subject to the broad anti-fraud provision of the Investment Advisers Act of 1940.[180] In addition to proscribing any

---

[178] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).
[179] 15 U.S.C. § 80b-3.
[180] 15 U.S.C. § 80b-6 ("It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and

device, scheme, or artifice to defraud, and any transaction, practice, or course of business operating as a fraud or deceit on a client, the anti-fraud provision also proscribes principal transactions absent antecedent disclosure and consent of the client to the capacity in which the investment adviser is acting in such transactions.[181]

2. Origins of the fiduciary obligations of registered investment advisors

It was via an interpretation of this statutory anti-fraud provision as contemplating the broad, equitable conception of fraud, as opposed to the narrower common law conception of the tort of deceit, that it was established that fiduciary obligations accrue to investment advisers under the Investment Advisers Act.[182] In the seminal decision of the Supreme Court of the United States on this point, *SEC v Capital Gains Research Bureau Inc,* Justice Goldberg recounted the origins of the Investment Advisers Act in the Wall Street Crash of 1929 and the Great Depression, and described the Act as reflecting

> A congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser …to render advice which was not disinterested.[183]

Contrary to the approach of the lower courts, which drew more heavily on the common law of fraud and would have read the Act's antifraud provision to require proof of intent to injure and actual injury to clients, Goldberg J observed that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."[184] His Honour went on to quote a passage derived from Joseph Story's *Commentaries on Equity Jurisprudence,* which describes the equitable conception of fraud as follows:

> Fraud…in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an

> prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative").

[181] *Id.*
[182] Securities & Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–99 (1963).
[183] *Id.* at 191–92.
[184] *Id.* at 193.

> undue and unconscientious advantage is taken of another.[185]

Justice Goldberg concluded that this understanding of the meaning of fraud, in its broad equitable sense, reinforced the view that Congress did not intend to require proof of intent to injure and actual injury as part of the Act's anti-fraud provision, which was to be read "flexibly to effectuate its remedial purpose."[186] As the Supreme Court would subsequently explain in a footnote in *Santa Fe Industries Inc v Green*, this reading of fraud as contemplating the broader equitable conception was premised on the recognition of a congressional intention "to establish federal fiduciary standards for investment advisers."[187] As a result, Goldberg J went on to conclude that "[t]he statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested."[188]

3. The SEC's Fiduciary Interpretation

The above origins of the fiduciary obligations of registered investment advisers are apt to give the impression of a Type A, pure "standards"-based regulatory design approach. However, the reality is that the SEC has provided various forms of guidance to regulated entities and the public throughout the lifetime of the Investment Advisers Act, including through agency interpretations, staff interpretations, and no-action letters.[189] Most recently, through its Fiduciary Interpretation, the SEC has articulated its interpretation of the standard of conduct expected of investment advisers and attempted to give content to the broad fiduciary obligations recognized by the Supreme Court in *Capital Gains.*[190] Without purporting to summarize the Fiduciary Interpretation in its entirety, the discussion that follows demonstrates how agency interpretation may be used to provide supplementary certainty and guidance in the context of broad, prophylactic fiduciary obligations.

As might be expected, the Fiduciary Interpretation commences by recognizing that the Investment Advisers Act "establishes a federal fiduciary duty for investment advisers."[191] In line with the notion here of a broad, prophylactic "standard"-like articulation, the SEC acknowledges

---

[185] *Id.* at 194 (citing JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE §187 (1st ed., 1836)).
[186] *Cap. Gains Rsch. Bureau*, 375 U.S. at 195.
[187] Santa Fe Industries Inc. v. Green, 430 U.S. 462, 472 n.11 (1977). *Id.* n 11.
[188] *Cap. Gains Rsch. Bureau*, 375 U.S. at 201.
[189] SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/regulation/staff-interpretations/no-action-letters (last visited Oct. 24, 2022).
[190] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 (Jul. 12, 2019) (to be codified at 17 C.F.R. pt. 276).
[191] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,670.

that "[t]he investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship" and "is not specifically defined in the Advisers Act or Commission rules."[192] The SEC goes on to explain that "the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own" and that this "obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty."[193] The SEC later indicates its experience that "the principles-based fiduciary duty imposed by the Advisers Act has provided sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[194]

Against this background, the SEC in the Fiduciary Interpretation then attempts to give more concrete, fact- and relationship-specific guidance as to the requirements of the broad, overarching federal fiduciary obligations of investment advisers. Thus, the SEC acknowledges that "the specific obligations that flow from the adviser's fiduciary duty depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal."[195] At the same time, the SEC confirms that "the relationship in all cases remains that of a fiduciary to the client" and that "an adviser's federal fiduciary duty may not be waived."[196]

Turning to the duty of care, the SEC articulates its interpretation of this aspect of investment advisers' fiduciary obligations as including three specific sub-obligations, namely (1) the duty to provide advice that is in the best interest of the client, (2) the duty to seek best execution of a client's transactions, and (3) the duty to provide advice and monitoring over the course of the relationship.[197] Each of these sub-obligations is given further prescriptive content in the course of the Fiduciary Interpretation. For example, with respect to the duty to provide investment advice that is in the best interest of the client, the SEC explains that, at a minimum, this would require reasonable inquiry into a retail client's financial situation, level of financial sophistication, investment experience, and financial goals in order to develop a reasonable understanding of the retail client's objectives.[198] Indeed, the Fiduciary Interpretation goes so far as to list specific examples of information that would need to be gathered, such as current income, investments, assets and debts, marital status, tax status, insurance policies

---

[192] *Id.*
[193] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,671.
[194] *Id.*
[195] *Id.*
[196] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,672.
[197] *Id.*
[198] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,673.

and financial goals.[199] Similarly, the Fiduciary Interpretation explores in detail what it means for an investment adviser to have a reasonable belief that advice is in the best interest of the client. This includes guidance and examples addressing specific factual circumstances, such as the appropriateness of derivatives for hedging as opposed to speculative purposes when advising a retail client with a conservative investment objective, and the need for heightened scrutiny and active monitoring when advising a retail client as to high risk products such as penny stocks, thinly-traded securities, or complex products like leveraged and inverse exchange traded funds.[200] The Fiduciary Interpretation similarly provides guidance with respect to the contents of the other sub-obligations of the duty of care. Thus, the SEC explained that an investment adviser fulfils the duty to seek best execution "by seeking to obtain the execution of securities transactions on behalf of a client with the goal of maximizing value for the client under the circumstances occurring at the time of the transaction."[201] The SEC further explained that "the determinative factor is not the lowest possible commission cost, but whether the transaction represents the best qualitative execution."[202] With respect to the duty to provide advice and monitoring over the course of the relationship, the SEC explains that this duty may be more or less extensive depending on the circumstances, and that "the scope of the duty to monitor will be indicated by the duration and nature of the agreed advisory arrangement."[203]

Turning to the duty of loyalty, much of the guidance provided by the SEC concerns the nature and effect of disclosure. In this regard, the SEC indicates its view that "while full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent prevent the presence of those material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest."[204] The Fiduciary Interpretation provides considerable detail on what qualifies as "full and fair" disclosure, including that disclosures must be "sufficiently specific" and that "disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists."[205] The SEC also explained that "[w]hether the disclosure is full and fair will depend upon, among other things, the nature of the client,

---

[199] *Id.*
[200] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,673–74.
[201] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,674–75.
[202] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,675.
[203] *Id.*
[204] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,676.
[205] *Id.*

the scope of the services, and the material fact or conflict" and that full and fair disclosure for an institutional client may differ from full and fair disclosure for a retail client.[206] The Fiduciary Interpretation notes that investment advisers are subject to certain prescriptive disclosure requirements, including the requirement to deliver a "brochure" under Part 2A of Form ADV satisfying certain minimum disclosure requirements, and the new requirement to deliver a relationship summary to retail clients at or before entering into an investment advisory agreement.[207]

As noted above, the intention is not to provide a complete summary of the Fiduciary Interpretation, but rather to demonstrate how agency interpretation can be used to supplement a broad overarching fiduciary obligation with more fact-specific, precisional content. This Type C regulatory design approach thus reflects another way to retain the benefits of the overarching broad, prophylactic articulation of fiduciary or fiduciary-like obligations in terms of avoiding under-inclusiveness and combating opportunism, whilst also providing more "rule"-like certainty and guidance to regulated entities.

D. Type D – Subsidiary "rule"-like specification

An alternative regulatory design approach combines the broad articulation of the relevant fiduciary or fiduciary-like "best interest" obligations with non-exhaustive "rule"-like sub-specification. This could entail, for example, the provision of fact-specific examples of conduct that does or does not satisfy the relevant overarching articulation, or the enumeration of certain factors, circumstances, or considerations that may or must be taken into account by adjudicators making an *ex-post* determination of compliance with the overarching obligation.[208]

Alternatively, this may entail the specification of specific forms of conduct or particular facts and circumstances that are exempt or excluded from the overarching broadly articulated obligation. This general approach mirrors the suggestion in the law and economics literature that under-inclusion can be addressed by backing up more detailed "rule"-like legal commands with a broader, "standard"-like articulation of legal command.[209] To like effect, one commentator has advocated an approach of "backstop ambiguity," wherein regulators "delineate specific violations

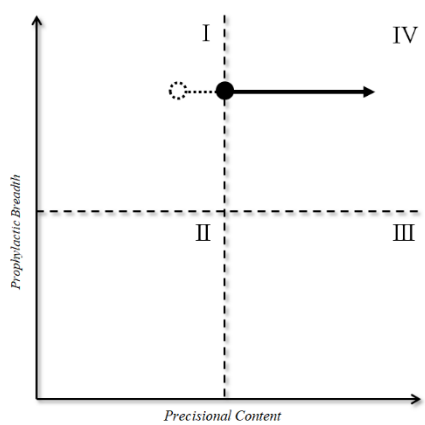
[206] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. at 33,677.
[207] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg 33,677–78.
[208] *See generally* Cass R. Sunstein, *Problems with Rules,* 83 CAL. L. 953, 963-964 (1995).
[209] Ehrlich & Posner, *supra* note 37, at 268.

where it is possible to do so, but should retain catch-all provisions stated in general terms."[210]

While such an approach would bear higher promulgation costs than a pure, "standards"-based approach, it is reasonable to assume that at least some of the sub-specification can be achieved at low cost insofar as it represents obvious, non-controversial examples clearly within the mischief of the relevant regulatory initiative. Furthermore, such an approach would provide a higher measure of certainty and *ex ante* guidance to financial advisers while retaining the benefits of the overarching broad, prophylactic articulation in terms of avoiding under-inclusiveness and combating opportunism.[211] In addition, as with the approaches examined above, *ex post* adjudication may be expected to provide increased guidance and precisional content over time.

As illustrated below, a regulatory design approach employing non-exhaustive sub-specification begins from a position of prophylactic breadth supplemented by relatively higher precisional content, the amount of which may vary, and over time may be expected to migrate further towards or into Quadrant IV with the accretion of further precisional content, as follows:

Figure 5: *A Type D approach; the initial amount of precisional content will vary*



The draft fiduciary regulations proposed by the Nevada Securities

[210] Julian J. Z. Polaris, *Backstop Ambiguity: A Proposal for Balancing Specificity and Ambiguity in Financial Regulation,* 33 YALE L. & POL'Y REV. 231, 233 (2014).
[211] Of course, where the sub-specification is of permissive factors and considerations, rather than prescribing sub-rules or binding examples of prohibited or permitted conduct, financial advisers would not know *ex ante* whether the relevant factor actually required certain conduct of them in their particular circumstances, nor how much weight would ultimately be given to each factor.

Division provides an example of this approach and are examined in more detail below. Under Nevada statute, "[a] financial planner has the duty of a fiduciary toward a client."[212] The term "financial planner" is defined to mean, subject to certain exceptions, "a person who for compensation advises others upon the investment of money or upon provision for income to be needed in the future, or who holds himself or herself out as qualified to perform either of these functions."[213]

Effective July 1, 2017, the Nevada Legislature amended this definition to remove previously available exceptions from "financial planner" status for broker-dealers and investment advisers.[214] The same legislative amendments also provide that "[a] broker-dealer, sales representative, investment adviser or representative of an investment adviser shall not violate the fiduciary duty toward a client" imposed on financial planners.[215] It is unclear whether this means a broker-dealer, sales representative, investment adviser or representative of an investment adviser is invariably considered a financial planner and subject to fiduciary obligations as such, or only where such entities or individuals satisfy the definition of financial planner set out above. In any event, accompanying statutory amendments empowered the Nevada Securities Administrator to promulgate regulations defining or excluding an act, practice or course of business of a broker-dealer, sales representative, investment adviser or representative of an investment adviser as a violation of the statutory fiduciary duty owed by Nevada financial planners.[216]

On January 18, 2019, in exercise of this authority, the Nevada Office of the Secretary of State, Securities Division released draft regulations detailing the acts, practices and courses of business that violate the fiduciary duty and specifying exempt forms of conduct.[217] The draft regulations appear to address the ambiguity regarding "financial planner" status noted above by providing that "[a] broker-dealer or sales representative *who provides investment advice to clients, manages assets, performs discretionary trading, utilizes [certain titles], or who otherwise establishes a fiduciary relationship with clients,* owes a fiduciary duty to their clients."[218] Through a series of detailed sections, the Nevada draft regulation then provides a range of subsidiary "rule"-like provisions and exemptions which provide content and specificity to said fiduciary

---

[212] NEV. REV. STAT. § 628A.020.
[213] *Id.*.
[214] 2017 Nev. Stat. 1795
[215] 2017 Nev. Stat. 1795, 1797; NEV. REV. STAT. § 90.575.
[216] NEV. REV. STAT. § 90.575.
[217] Notice of Draft Regulations and Request for Comment (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE ch. 90).
[218] Notice of Draft Regulations and Request for Comment, sec. 1 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE ch. 90).

obligation. Instead of summarizing the entirety of the draft regulation, a number of illustrative examples will be explored below.

One form of subsidiary "rule"-like specification evident in the Nevada draft regulations entails the exemption of certain scenarios or circumstances from the otherwise applicable fiduciary obligation. One example of this approach is the provision of an "Episodic Fiduciary Duty Exemption."[219] Where the exemption applies, a broker-dealer or sales representative does not have an ongoing duty to keep informed regarding a client's financial circumstances and obligations, their fiduciary duty ending once the specific episodic advice in question is received by the client, the relevant transaction completed, and any required disclosures have been made.[220]

The Episodic Fiduciary Duty Exemption only applies where certain factual conditions are met, including that the broker-dealer or sales representative does not create periodic financial plans for the client, provide ongoing investment advice, or perform discretionary trading for the client, and that the client solicited the specific investment advice provided.[221] A separate section of the Nevada draft regulations provides a series of five fact-specific exemptions from the fiduciary duty standard.[222] For example, one such draft exemption confirms that "[a] broker-dealer or sales representative who executes an unsolicited transaction for a client whose assets are not managed by the broker-dealer or sales representative, and has otherwise complied with all applicable laws, self-regulatory rules, and firm policies and procedures governing their conduct related to that transaction, does not owe a fiduciary duty to the client for that transaction unless the client receives investment advice, discretionary trading services, ongoing contractual services or a financial plan from the broker-dealer or sales representative."[223]

Another form of subsidiary "rule"-like specification evident in the Nevada draft regulations is the provision of conduct that is not a *per se* violation of fiduciary duty.[224] For example, notwithstanding the overarching fiduciary duty, the draft provisions provide that "[t]he sale of a proprietary product by a broker-dealer or sales representative alone is not a breach of the fiduciary duty" provided that conduct is otherwise in compliance with the law and applicable rules of self-regulatory

---

[219] Notice of Draft Regulations and Request for Comment, sec. 2 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE. ch. 90).
[220] *Id.*
[221] *Id.*
[222] Notice of Draft Regulations and Request for Comment, Section 5 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE. ch. 90).
[223] *Id.*
[224] Notice of Draft Regulations and Request for Comment, Section 6 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE. ch. 90).

organizations, and the client is advised of the proprietary nature of the product and all associated risks.[225] Similarly, the draft provisions provide that "[a] broker-dealer or sales representative does not breach the fiduciary duty by receiving transaction-based commission for sales, so long as it is in the client's best interest to be charged by transaction as opposed to other types of fees, and the commission is reasonable."[226]

The Nevada draft regulation also illustrates subsidiary "rule"-like specification in the form of the non-exhaustive listing of forms of conduct that do represent breaches of fiduciary duty.[227] While some of the items listed are articulated in broad, prophylactic terms, such as recommending a security or investment strategy not in the client's best interest, by and large the listed items are more "rule"-like and fact specific in character. Examples in this regard include failing to perform adequate and reasonable due diligence, failing to provide offering documents, failure to comply with best execution rules, failure to disclose bad actor disqualifications, and limiting the availability of securities to certain clients.[228]

As noted above, the intention is not to provide a complete summary of the Nevada draft regulations. The examples above should suffice, however, to demonstrate the use of a broad overarching fiduciary obligation with different forms of non-exhaustive "rule"-like sub-specification. Indeed, the Nevada draft regulations demonstrate a number of different examples of the Type D regulatory design approach of attempting to provide certainty and *ex ante* guidance through detailed "rule"-like sub-specification while retaining the benefits of the overarching broad, prophylactic articulation in terms of avoiding under-inclusiveness and combating opportunism.

E. Type E – Safe harbors and deeming provisions

Another regulatory design approach involves the articulation of a broad, "standard"-like fiduciary obligation or fiduciary-like "best interest" obligation combined with provisions that deem compliance therewith if specified more detailed sub-requirements are met. The extent to which this approach avoids the disadvantages of under-inclusion through the incorporation of the background prophylactic articulation will depend on the strength of the deeming or presumption that arises from meeting the more detailed specification of required conduct. If the presumption is irrebuttable, and operates in the nature of a safe harbor, the effect of the broader, background prophylactic articulation in addressing under-

---

[225] *Id.*
[226] Notice of Draft Regulations and Request for Comment, Section 6 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE ch 90).
[227] Notice of Draft Regulations and Request for Comment, Section 8 (Jan. 18, 2019) (to be codified at NEV. ADMIN. CODE ch 90).
[228] *Id.*

inclusion may be expected to be minimal. Since compliance with the more precisely specified requirements will always ensure a financial adviser is deemed to have been acting in compliance with the broader articulation, there will be little room for that broader prophylactic articulation to operate in terms of conduct not anticipated or contemplated by the more detailed specification. Put another way, by undercutting the broad, prophylactic articulation of fiduciary and fiduciary-like obligations, safe harbors and deeming provisions may in fact compromise the efficacy of those obligations and the social benefits sought to be gained by their imposition in relation to the provision of financial advice.

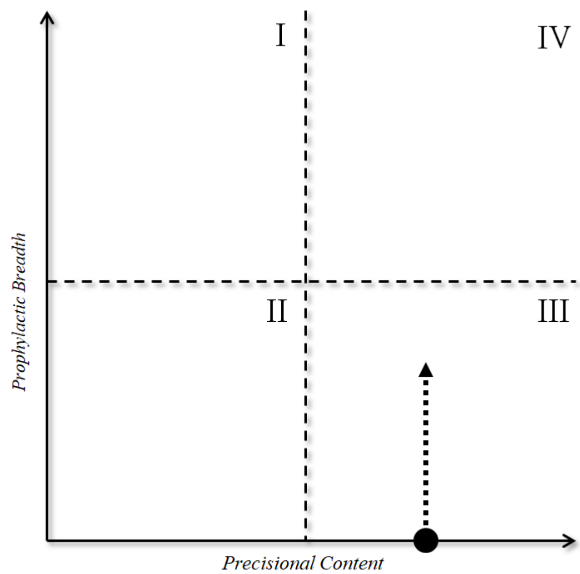


Figure 5: *A Type E safe-harbor approach may compromise prophylactic breadth*

The discussion that follows explores two instances of this Type E regulatory design approach, the SEC's Regulation Best Interest addressing the standard of conduct expected of broker-dealers and the comparative experience of Australia's statutory regulation of financial advisers.

1. Regulation Best Interest

As its name suggests, Regulation Best Interest ostensibly imposes an obligation on broker-dealers, and associated persons of broker-dealers, to act in the "best interest" of retail customers.[229] More specifically, Regulation Best Interest imposes an obligation to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations), without placing the financial or other interest of the broker-dealer or associated person, ahead of the interest of the retail

[229] 17 C.F.R. § 240.15l-1.

customer.[230] Notably, the obligation is to act in the best interest of the retail customer *at the time the recommendation is made*, as opposed to being an ongoing obligation.[231]

At least at this threshold level, the regulatory design approach being taken in the SEC's Regulation Best Interest seems to include a broad, prophylactic articulation of a best interest obligation. While the SEC notably avoided terming this obligation a fiduciary obligation, the SEC acknowledged that it "crafted Regulation Best Interest to draw on key principles underlying fiduciary obligations."[232] Indeed, the adopting release refers to this overarching best interest obligation throughout as the "General Obligation"[233] and the SEC made a point of declining to define "best interest."[234]

Notwithstanding the ostensible prophylactic breadth of this threshold articulation of a best interest obligation, Regulation Best Interest goes on to provide that the General Obligation can be satisfied by compliance with four sub-obligations.[235] Specifically, compliance with each of the "Disclosure Obligation", the "Care Obligation", the "Conflict of Interest Obligation," and the "Compliance Obligation" will satisfy the general best interest obligation.[236]

The Disclosure Obligation amounts to a requirement that at or prior to the time of making a covered recommendation, the broker-dealer or associated person provides the retail customer full and fair disclosure, in writing, of all material facts relating to the scope and terms of the relationship with the retail customer.[237] Further, all material conflicts of interest *associated with* the recommendation must be disclosed to the retail customer.[238] This includes disclosure of the fact that the broker-dealer or natural person is acting as a broker-dealer or associated person thereof, of the material fees and costs that apply to the retail customer's transactions,

---

230 17 C.F.R. §240.15l-1(a)(1).
231 *Id.*
232 Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,320 (July 12, 2019) (to be codified at 17 C.F.R. pt. 276). *See also* Commissioner Hestor Pierce, *What's in a Name? Regulation Best Interest v. Fiduciary* (July 24, 2018), https://www.sec.gov/news/speech/speech-peirce-072418.
233 Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,320 (July 12, 2019). *See also* Commissioner Hestor Pierce, *What's in a Name? Regulation Best Interest v. Fiduciary* (July 24, 2018), https://www.sec.gov/news/speech/speech-peirce-072418.
234 Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,320. *See also* Commissioner Hestor Pierce, *What's in a Name? Regulation Best Interest v. Fiduciary* (July 24, 2018), https://www.sec.gov/news/speech/speech-peirce-072418. *Id.* 33334.
235 17 C.F.R. § 240.15l-1(a)(2).
236 *Id.*
237 17 C.F.R. § 240.15l–-1(a)(2)(A).
238 17 C.F.R. § 240.15l–-1(a)(2)(B).

holdings, and accounts, and of the type and scope of services provided to the retail customer.[239]

The Care Obligation requires a broker-dealer or associated person to exercise reasonable diligence, care, and skill to (1) understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (2) have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based on their investment profile and the risks and rewards of the recommendation, and does not place the financial or other interest of the broker-dealer or associated person ahead of the interest of the retail customer; and (3) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customers' best interest when taken together and in light of the retail customers' investment profile.[240]

The Conflicts of Interest Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest associated with a recommendation to a retail customer.[241] Such policies and procedures must also be reasonably designed to identify and mitigate any conflicts of interests associated with such recommendations that create an incentive for a natural person who is an associated person of the broker-dealer to place the interest of the broker-dealer or associated person ahead of the retail client,[242] to identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations,[243] and to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[244] Finally, the Compliance Obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[245]

In describing the relationship between the General Obligation and the four sub-obligations in the adopting release, the SEC explained that the "specific component obligations expressly set forth what it means to act in

[239] 17 C.F.R. § 240.15l–-1(a)(2)(A).
[240] 17 C.F.R. § 240.15l–-1(a)(2)(ii)(C).
[241] 17 C.F.R. § 240.15l–-1(a)(2)(iii)(A).
[242] 17 C.F.R. § 240.15l-1(a)(2)(iii)(B).
[243] 17 C.F.R. § 240.15l-1(a)(2)(iii)(C).
[244] 17 C.F.R. § 240.15l-1(a)(2)(iii)(D).
[245] 17 C.F.R. § 240.15l-1(a)(2)(iv).

the best interest of the retail customer in accordance with the General Obligation," and that "[t]he specific component obligations of Regulation Best Interest are mandatory, and failure to comply with any of the components would violate the General Obligation."[246] Thus, the SEC takes the position that "Regulation Best Interest does not establish a safe harbor" because "compliance with a safe harbor is optional, and failure to comply with the terms of the safe harbor does not necessarily violate the relevant legal requirement."[247] With that said, Regulation Best Interest ostensibly imposes a general best interest obligation only to provide that that obligation shall be satisfied by compliance with the more detailed specified sub-obligations. It is difficult to describe this regulatory design approach other than as the sub-obligations subsuming the prophylactic breadth with which the general best interest obligation itself would otherwise operate. This is seemingly confirmed by the following observation in the SEC's proposal:

> [T]he best interest obligation does not impose any obligations other than those specified by the rule: namely, to act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of the retail customer's interest, by complying with each of the components as set forth in paragraph (a)(2) of the rule.[248]

As explained above, a distinct consequence of this design approach is that it may sacrifice social benefit due to the importance of prophylactic breadth for the efficacy of best interest obligations and fiduciary obligations more generally. That is, there is a danger of under-inclusiveness resulting from the pursuit of increased certainty and guidance through incorporation of the more precisely specified sub-obligations which subsume the overarching general best interest obligation.

2. Comparative perspectives – Australia's "Future of Financial Advice" regime

These concerns are validated by the experience with Australia's regime for the regulation of retail financial advice, adopted in the aftermath of the Financial Crisis as the "Future of Financial Advice" (FOFA) reforms.[249] In

---

[246] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,333 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).
[247] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. at 33,333.
[248] Regulation Best Interest, 83 Fed. Reg. 21,574, 21,598 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).
[249] The "Future of Financial Advice" reforms were enacted as part of the *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012*. The operative provisions may be found in Part 7.7A of the *Corporations Act 2001* (Cth) pt 7.7A (Austl.).

particular, the Australian experience clearly illustrate the risk that a regulatory safe harbor or deeming provision may leave little to no room for an overarching obligation to operate.

The FOFA regulatory regime applies to the provision of personal advice to a person as a retail client, with certain exceptions for basic banking and insurance products.[250] In terms of the obligations of financial advice providers, the FOFA regime first articulates a broad, prophylactic requirement that a "provider must act in the best interests of the client in relation to the advice."[251] Having done so, the FOFA regime then provides that a financial advice provider satisfies the broadly articulated best interest duty if they can prove that they have satisfied certain prescriptive requirements, including identifying the objectives and circumstances of the client, conducting a reasonable investigation into the financial products that might achieve those of the objectives, and basing all judgements in advising the client on the client's relevant circumstances.[252]

Although the Australian Securities and Investments Commission (ASIC) first secured civil penalties under the FOFA regime in 2017, the

---

[250] *Corporations Act 2001* (Cth), s 961(1) (Austl.). Compliance with these reforms has been compulsory since July 1, 2013.

[251] *Corporations Act 2001* (Cth), s 961B(1) (Austl.) ("The provider must act in the best interests of the client in relation to the advice").

[252] *Corporations Act 2001* (Cth) s 961B(2) (Austl.) ("The provider satisfies the duty in subsection (1), if the provider proves that the provider has done each of the following:

> (a) identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions;
> (b) identified:
>> (i) the subject matter of the advice that has been sought by the client (whether explicitly or implicitly); and
>> (ii) the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the client's relevant circumstances);
>
> (c) where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information;
> (d) assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice;
> (e) if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:
>> (i) conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter; and
>> (ii) assessed the information gathered in the investigation;
>
> (f) based all judgements in advising the client on the client's relevant circumstances;
> (g) taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances").

available judicial consideration of the relevant statutory language suggests that the deemed compliance approach does indeed give rise to potential under-inclusion.[253] Thus, Justice Moshinsky of the Federal Court of Australia viewed the broader prophylactic articulation and the more detailed specification of required conduct as operating in terms of an overarching best interest duty with a safe harbor for providers accused of breaching the best interest duty.[254] The dominant importance of the specification of requirements in the safe-harbor under this regulatory design approach is clearly revealed by ASIC's stance in the case before Justice Moshinsky:

> ASIC contended that, in a "real world" practical sense, [the safe harbor specification] was likely to cover all the ways of showing that a person had complied with [the best interest duty] and, in this way, a failure to satisfy one or more of the limbs of [the safe harbor] is highly relevant to the Court's assessment of compliance with the best interests duty.[255]

Implicit in this argument is a view as to the exhaustiveness and effectiveness of the specification of the safe harbor requirements under the FOFA regime which is clearly at odds with the view adopted in chancery courts and the more modern economic and functional accounts of fiduciary obligations that complete *a priori* specification is impossible and that prophylactic breadth is necessary for the efficacy of fiduciary-like obligations. Indeed, Justice Black of the Supreme Court of New South Wales, writing extra-judicially, has observed that the effect of the safe harbor in the FOFA regime "significantly limits the scope of the duty . . . so that it operates primarily as a narrower 'suitability' requirement rather than a wider 'best interest' requirement.[256] As part of the recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Commissioner Kenneth M Hayne, former justice of the High Court of Australia, described the effect of the safe harbor as follows:

> By prescribing particular steps that must be taken, and allowing advisers to adopt a 'tick a box' approach to

---

[253] *See generally Australian Securities and Investments Commission, in the matter of NSG Services Pty Ltd v NSG Services Pty Ltd* [2017] FCA 345 (Fed. Ct. of Austl.).
[254] *See id.* at [17].
[255] *See* Australian Securities and Investments Commission, in the matter of NSG Services Pty Ltd v NSG Services Pty Ltd [2017] FCA 345, VID 585 of 2016, 18 (Fed. Ct. of Australia). *Id.* [18].
[256] Justice Ashley Black, *Conflict of Interest Regulation after the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, SUP. CT. OF N.S.W. (Mar. 29, 2019), http://www.supremecourt.justice.nsw.gov.au/Documents/Publications/Speeches/2019%20Speeches/Black_20190329.pdf.

> compliance, the safe harbour provision has the potential to undermine the broader obligation for advisers to act in the best interests of their clients.[257]

Commissioner Hayne's final report recommended that the Australian government consider whether it is necessary to retain the safe harbor and "[u]nless there is a clear justification for retaining that provision, it should be repealed."[258]

As the Australian experience demonstrates, while a regulatory design approach combing a broad, prophylactic "standard"-like articulation with a more detailed, "rule"-like safe harbor or deeming provision may provide increased *ex ante* certainty and guidance for financial advisers, it does so at the cost of prophylactic breadth. Accordingly, such an approach entails potential under-inclusion and may compromise the social benefits sought to be achieved by imposing a fiduciary or fiduciary-like "best interest" obligation.

F. Type F – Exclusively "rule"-like regulatory design approaches

Even if it is accepted that complete *a priori* specification of what a financial adviser should do in their client's best interest in all situations is impossible,[259] it would still seem to be open to regulators to attempt a detailed specification, albeit incomplete, of particular forms of required or prohibited conduct without use of an overarching, "standard"-like articulation. While no specific example of this regulatory design approach is offered, such an approach would seem attractive on the basis of factual-specificity – financial advisers would have the benefit of higher levels of certainty and guidance in the form of detailed, fact-specific "rule"-like legal commands, and would presumably bear lower costs in terms of compliance costs. The promulgation costs of such an approach would obviously be higher than the bare articulation of a broad, prophylactic articulation. Furthermore, this approach would carry clear risks of under-inclusion, in terms of circumstances which cannot be predicted or addressed *a priori,* potentially compromising the efficacy of the best interest duty and the social benefits sought to be derived from its imposition. This is the warning of the internal moral logic of equity and the other accounts of fiduciary obligations – the impossibility of *a priori* specification of the infinite variety of forms that disloyalty may take.

---

[257] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report: Volume 1,* at 177 (Feb. 4, 2019),)
https://www.royalcommission.gov.au/system/files/2020-09/fsrc-volume-1-final-report.pdf.
[258] *Id.* at 178.
[259] In the nature of Kaplow's rule equivalent to a standard. *See* Kaplow, *supra* note 37, at 559–62.

IV. Conclusion

This paper set out to explore the issue of prescriptive detail in the incorporation of fiduciary and fiduciary-like "best interest" obligations into regimes for the regulation of financial advice. The core argument advanced here has been that an examination of the internal moral logic and intuitions applied by the chancery courts which developed fiduciary obligations, as well as more modern functional and economic accounts of fiduciary obligations, suggests that fiduciary and fiduciary-like obligations depend on prophylactic breadth for their efficacy as a means of addressing disloyalty. This fundamental insight as to the importance of prophylactic breadth for the efficacy of such obligations should be borne in mind when incorporating such obligations into regimes for the regulation of financial advice. In particular, consideration needs to be given to the risk that when broad, prophylactic articulations are eschewed under-inclusiveness may compromise the social benefits sought to be attained from the incorporation of fiduciary obligations into regimes for the regulation of financial advice.

At the same time, both promulgation and compliance costs are an important countervailing consideration when considering the degree of certainty and detail with which to promulgate regulations. Accordingly, this paper sought to develop a typology of regulatory design approaches along the twin dimensions of "rule"-like precisional detail and "standard"-like prophylactic breadth. In so doing, this paper identified a number of regulatory design approaches that allow statutory and regulatory drafters to maintain the prophylactic benefits of broadly articulated fiduciary and fiduciary-like obligations whilst simultaneously providing increased certainty and compliance cost benefits through more detailed and precisely specified legal commands. This includes regulatory design approaches supplementing the articulation of fiduciary and fiduciary-like "best interest" obligations in broad, prophylactic terms with more detailed subsidiary presumptions, interpretative guidance, and/or detailed subsidiary "rule"-like legal commands. As this paper explored with respect to Regulation Best Interest and the experience of the Australian statutory regulation of financial advice, regulatory design approaches relying on safe harbors and deeming provisions should be approached with more caution. The danger of these approaches is that in seeking to provide greater certainty and prescriptive guidance, such a regulatory design approach may inadvertently sacrifice the prophylactic benefits of a broadly articulated fiduciary or fiduciary-like obligation and thereby compromise the social benefits sought to be obtained by imposing such obligations.