Alabama Law Scholarly Commons

Articles | Faculty Scholarship

2013

Financial Intermediaries as Principals and Agents

Kenneth M. Rosen
University of Alabama - School of Law, krosen@law.ua.edu

Follow this and additional works at: https://scholarship.law.ua.edu/fac_articles

Recommended Citation

Kenneth M. Rosen, *Financial Intermediaries as Principals and Agents*, 48 Wake Forest L. Rev. 625 (2013).
Available at: https://scholarship.law.ua.edu/fac_articles/281

This Article is brought to you for free and open access by the Faculty Scholarship at Alabama Law Scholarly Commons. It has been accepted for inclusion in Articles by an authorized administrator of Alabama Law Scholarly Commons.

FINANCIAL INTERMEDIARIES AS PRINCIPALS AND AGENTS

Kenneth M. Rosen[*]

INTRODUCTION

To both understand and to improve different areas of the law, it is important to recognize what drives policymakers to apply laws to help order relationships between various parties rather than leaving them to their own devices. For instance, securities law often uses increased disclosure as a regulatory tool of choice.[1] Importantly, securities law does so because of basic assumptions about how markets work; more specifically, this mode of operation for securities law reflects a belief that information can be incorporated into securities prices, making those prices more accurate and more likely to encourage trading at fair price levels. The notion of an "efficient market hypothesis" classically informs an important interaction of economic theory, legal theory, and policy making in this regard.[2] Accordingly, if parties to transactions, including investors, have access to information through improved disclosures

---

* Associate Professor, The University of Alabama School of Law. Prior to entering the legal academy, I served as a Special Counsel at the United States Securities and Exchange Commission, where among other matters I worked on broker-dealer regulation. I would like to thank Professor Alan Palmiter, the staff of the *Wake Forest Law Review*, and participants in the *Law Review*'s symposium on agency theory for encouraging and engaging in an important discussion of agency theory. I also thank my faculty colleagues and the Alabama Law School Foundation for their support of my research.

1. At the most elementary level, this is exemplified by basic requirements such as the frequent need for the filing of information-filled registration statements as part of the securities offering process. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (2006). Such requirements over time grew to include more continuous reporting requirements, including annual and other periodic company reports under the Securities Exchange Act of 1934. *See The Laws That Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/laws.shtml#secexact1934 (last visited June 9, 2013). And, as policymakers addressed new crises of confidence, additional disclosure requirements were added, as exemplified by provisions in statutes such as the Sarbanes-Oxley Act of 2002. *See id.*

2. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 103–06 (6th ed. 2009).

and markets are efficient at absorbing information, hopefully the parties will be better enabled to enter transactions at the proper prices, which will encourage confidence and further participation in those markets. Thus, legal policy behind improving disclosure and encouraging participation and confidence might facilitate other important goals, such as improving the ability to raise capital and to sustain securities markets through such participation. Certainly, the notion of an efficient market hypothesis is not accepted as absolutely accurate by all parties,[3] yet it is hard to imagine understanding securities policy today without at least taking the notion into account.[4]

To draw a parallel to the foundation of securities law and policy in theories of efficient markets, modern agency theory and its recognition of problems associated with agency relationships and agency costs long have driven the nature of business law. Agency theory helps drive how law has chosen to create rules related to corporate governance and other business-related issues. For instance, since a corporation traditionally separates ownership from control of operations, one must be concerned with the motivation of the individual employees who run the firm as agents and might not always fully share the interests of the owner shareholders. Analysis of such issues in the fields of legal, finance, and economic theory to create a modern notion of agency theory certainly have informed policy.[5] Scholars such as Harvard Business School Professor Michael Jensen have played a significant role in furthering our understanding of the agency problem and its effect on businesses.[6]

Yet, in a time of financial crisis, agency theory as it intersects with business may become less attractive as the understandings behind the theory that informed public policies failed to prevent losses associated with the crisis. This allows some to provocatively question if perhaps modern agency theory has had its day.[7] Interestingly, even important scholars of agency theory, such as

---

3. Various gradations of the hypothesis have been proffered from weak to strong, while some more fundamentally question its associated notions of investor behavior. *See id.* at 103–13.

4. *See id.* at 103 (quoting Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549–50 (1984)).

5. For instance, while shareholders may not control a corporation's operations, they possess corrective powers, such as derivative litigation and proxy voting, which influence the course of a firm led astray by its employees.

6. *See generally, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (using theories of agency, property rights, and finance to explain the impact of agency costs on the structure of the firm).

7. Such questions inform the subject of the *Wake Forest Law Review*'s 2013 business law symposium. Symposium, *Agency Theory: Still Viable?*, 48 WAKE FOREST L. REV. 567 (2013).

Professor Jensen, are offering new ways, such as integrity, to order behavior associated with firms and organizations.[8] However, it would be premature to call agency theory dead. Indeed, a renewed examination of and emphasis on the roots of agency law that predate modern expositions on agency theory and business seem especially timely.

While economic analysis of agency relationships and their effect on businesses has been significant in recent decades, concerns about agency problems and their relation to law are not new. Traditional agency law has long provided legal analysis and redress of issues that today might be characterized as agency costs. The commentaries of Harvard Professor (later Justice) Joseph Story, for example, included the study of agency law in relation to maritime and commercial jurisprudence.[9] More recently, in the early twentieth century, University of Michigan Professor Floyd Mechem outlined agency law in terms of its fundamental components linked to the creation of agency and, perhaps even more importantly, to the duties that needed to be found between agents, principals, and third parties in relation to agency.[10] Although agency courses still exist today, the current number of offerings and student participants may not adequately reflect the importance traditionally placed on understanding agency concepts as part of a legal education.[11]

In this Article, I explore revisiting traditional agency law in a particular context—the financial services field. Organizations involving financial intermediaries in the financial services industry are of special interest given their link to the economy and the level of scrutiny placed on the industry in the wake of various scandals and the financial crisis. Moreover, these organizations are noteworthy for the importance of agency-type relationships to them.

---

8. *See, e.g.*, Michael Jensen, Keynote Address at Wake Forest Law Review Symposium: Agency Theory: Still Viable? (Mar. 22, 2013).

9. *See generally* JOSEPH STORY, COMMENTARIES ON THE LAW OF AGENCY, AS A BRANCH OF COMMERCIAL AND MARITIME JURISPRUDENCE, WITH OCCASIONAL ILLUSTRATIONS FROM THE CIVIL & FOREIGN LAW (1839).

10. *See generally* FLOYD R. MECHEM, OUTLINES OF THE LAW OF AGENCY (2d ed. 1903).

11. The American Casebook Series, around a century ago, for example, included a volume on agency law. *See, e.g.*, EDWIN C. GODDARD, CASES ON PRINCIPAL AND AGENT SELECTED FROM DECISIONS OF ENGLISH AND AMERICAN COURTS (1914). Interestingly, a more modern iteration of the American Casebook Series features a text on broker-dealer regulation. *See* THOMAS LEE HAZEN & DAVID L. RATNER, BROKER DEALER REGULATION (2003). Fortunately, even if numerous students graduate law school today without a formal agency course, they may still gain exposure to agency law principles in other courses, such as business organizations. *See, e.g.*, CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS CASES AND MATERIALS 20–49 (6th ed. 2010).

Thus, they may provide insight not only into the vitality of agency law for such entities but also broader knowledge about the continued significance of agency principles in the modern economy.

Accordingly, this Article proceeds as follows. First, I introduce financial intermediaries and their role in the modern economy. Second, I explore agency-like relationships that are particularly relevant for such intermediaries. Third, I use broker-dealer regulation as a case study of a codification movement for the regulation of intermediaries. Fourth, I explain why codification should be viewed as complementing rather than supplanting traditional agency law. And, finally, I examine issues raised by this Article for future consideration.

I. FINANCIAL INTERMEDIARIES AND THE MODERN ECONOMCY

Financial intermediaries, in the most general sense, are firms and individuals in the world of finance that help grease the wheels of financial transactions. Financial professionals may do so in a variety of ways. For example, they may help connect buyers and sellers or provide liquidity to facilitate a transaction.

Securities brokers and dealers are classic examples of potential intermediaries. Statutory definitions help illustrate the roles of each. With some statutory variances, a broker is "any person engaged in the business of effecting transactions in securities for the account of others."[12] By contrast, a dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[13] One may see a firm called a "broker-dealer," generally indicating that the firm meets both definitions by effecting transactions for others as well as for its own account.

Broker-dealers often are critical to a financial transaction. For example, even when one individual wants to buy a stock and another individual wants to sell it, without the help of securities professionals they may not be able to find one another or the cost of searching for each other on their own might create a prohibitively high transactions cost.[14] This is why many individuals contact their broker for assistance when they want to buy or sell a stock. On exchanges, for example, certain individuals may stand ready as specialists or market makers to take the other side of a transaction

---

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

13. Id. § 78c(a)(5).

14. Marketplaces, like stock exchanges, might further facilitate the matching of buying and selling interests. *Cf.* JOHN R. DOS PASSOS, A TREATISE ON THE LAW OF STOCK-BROKERS AND STOCK-EXCHANGES 6 (Greenwood Press Reprinting 1968) (1882) (noting very early recognition of the value of intermediaries in more general commercial transactions).

when there is an imbalance of buyer and seller interests in conducting a trade.[15] The presence of securities firms, and thus their impact on the economy, is quite large. For example, the Financial Industry Regulatory Authority, Inc. ("FINRA") "is the largest independent regulator of securities firms doing business with the public in the United States."[16] At the end of 2011, "FINRA oversaw nearly 4,500 brokerage firms, approximately 160,000 branch offices and almost 630,000 registered securities representatives."[17] The need for so many individuals and firms to help facilitate securities transactions is not surprising given how common public participation now is for securities markets, whether it be at an individual investor level or through pensions, mutual funds, or other vehicles. Thus, it is hard to overstate the significance of these intermediaries to the broader economy.

Not surprisingly, given the size of the securities business in the United States, the financial intermediaries themselves are becoming more complex business organizations.[18] This makes financial firms especially interesting to study when considering broader agency issues. While some financial firms may have begun as sole proprietorships or partnerships, today one finds financial services firms that are major corporations in their own rights. For example, while Goldman Sachs was founded over 100 years ago, it has grown into the Goldman Sachs Group, Inc., describing itself as "a leading global investment banking, securities and investment management firm that provides a wide range of financial services to a substantial and diversified client base that includes corporations, financial institutions, governments and high-net-worth individuals."[19] In its 2012 Annual Report, Goldman Sachs noted that for 2012 it had net revenues of over $34 billion with a return on average common

---

15. *Inside the NYSE: The Specialist*, N.Y. STOCK EXCHANGE, http://www.nyse.com/pdfs/specialistmagarticle.pdf (last visited June 3, 2013).

16. FIN. INDUS. REGULATORY AUTH., FINRA 2011 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 8 (2012), *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf.

17. *Id.*

18. *See, e.g.*, JPMORGAN CHASE & CO., 2012 ANNUAL REPORT (2012), *available at* http://files.shareholder.com/downloads/ONE/2650030280x0x652147/a734543b-03fa-468d-89b0-fa5a9b1d9e5f/JPMC_2012_AR.pdf (indicating array of financial services and subsidiaries associated with the firm); *see also* Nicola Cetorelli et al., *The Evolution of Banks and Financial Intermediation: Framing the Analysis*, 18 FED. RES. BANK N.Y. ECON. POL'Y REV., July 2012, at 1, 1–2 (explaining how financial intermediaries have become part of a complex, decentralized process).

19. *At a Glance, Who We Are*, GOLDMAN SACHS, http://www.goldmansachs.com/who-we-are/at-a-glance/index.html (last visited June 3, 2013).

shareholder equity of 10.7%.[20] In 1999, Goldman Sachs became a public company and by 2013 had 32,000 employees, a market capitalization of $69 billion, and a full array of corporate governance mechanisms such as 100% independent board committees, a proxy voting process, and the ability of 25% of shareholders to call special meetings.[21]

Although securities broker-dealers are examples of financial intermediaries, they are not the only ones. Other financial instruments have their own intermediaries. For instance, in the futures world there are futures commission merchants who "solicit[] or accept[] orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps and accept[] money or other assets from customers to support such orders."[22] In addition to some intermediaries specializing in transactions in certain instruments, financial institutions can have their own trading desks and sometimes operate in a relatively broad spectrum of activities.[23]

Given the variety and importance of financial intermediaries and institutions in the United States, it is not surprising that some have been scrutinized in the wake of the financial crisis and at times alleged to have been involved in various scandals. It is hard to find consensus on the causes of the financial crisis, but various groups have tried to identify what, in their view, were the contributing factors. For example, the National Commission on the Causes of the Financial and Economic Crisis in the United States offered a take on

20. GOLDMAN SACHS GRP., INC., 2012 ANNUAL REPORT 2 (2013), *available at* http://www.goldmansachs.com/investor-relations/financials/current/annual-reports/2012-annual-report-files/annual-report-2012.pdf.

21. *Governance at Goldman Sachs: Key Facts*, GOLDMAN SACHS, http://www.goldmansachs.com/investor-relations/corporate-governance/corporate-governance-documents/governance-key-facts.pdf (last visited June 3, 2013).

22. *Futures Commission Merchant (FCM)*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/NFA-registration/fcm/index.html (last visited June 3, 2013).

23. After passage of the Gramm-Leach-Bliley Act, one saw an increasing capability of financial services groups to engage in an array of financial activities, although in the wake of the Dodd-Frank Act the continued ability to do so in some instances may fall into question. *See, e.g.*, *Volcker Rule Resource Center*, SIFMA, http://www.sifma.org/issues/regulatory-reform/volcker-rule/overview/ (last visited June 3, 2013). Moreover, it is worth noting that a variety of financial regulators exist in the United States—from the Securities Exchange Commission, to the Commodity Futures Trading Commission, to the Federal Reserve Board, to others—to regulate an array of different types of financial institutions and instruments, rendering the understanding of intermediary regulation particularly complex.

the causes of the crisis in their 2011 final report, *The Financial Crisis Inquiry Report*[24]:

> While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world. The losses were magnified by derivatives such as synthetic securities.
>
> The crisis reached seismic proportions in September 2008 with the failure of Lehman Brothers and the impending collapse of the insurance giant American International Group (AIG). Panic fanned by a lack of transparency of the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived to be "too big to fail," caused the credit markets to seize up. Trading ground to a halt. The stock market plummeted. The economy plunged into a deep recession.
>
> The financial system we examined bears little resemblance to that of our parents' generation. The changes in the past three decades alone have been remarkable. The financial markets have become increasingly globalized. Technology has transformed the efficiency, speed, and complexity of financial instruments and transactions. There is broader access to and lower costs of financing than ever before. And the financial sector itself has become a much more dominant force in our economy.
>
> From 1978 to 2007, the amount of debt held by the financial sector soared from $3 trillion to $36 trillion, more than doubling as a share of gross domestic product. The very nature of many Wall Street firms changed—from relatively staid private partnerships to publicly traded corporations taking greater and more diverse kinds of risks. By 2005, the

---

24. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: THE FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011). *But cf.* Bill Thomas et al., *What Caused the Financial Crisis?*, WALL ST. J., Jan. 27, 2011, at A21 (noting dissent from the report).

> 10 largest U.S. commercial banks held 55% of the industry's assets, more than double the level held in 1990. On the eve of the crisis in 2006, financial sector profits constituted 27% of all corporate profits in the United States, up from 15% in 1980. Understanding this transformation has been critical to the Commission's analysis.[25]

Whether one exactly agrees with this narrative or not, it certainly reflects concern among some about the role of financial institutions and intermediaries in our economy. Such concern likely will be exacerbated as litigation follows in the wake of the crisis and as other scandals involving financial professionals emerge. For example, media has focused on the incarceration of Bernard Madoff after admissions related to an alleged Ponzi scheme.[26]

In addition, after the "London Whale" trades, Congressional investigators have focused on trading practices and engagement in the derivatives market of one of America's biggest financial holding companies, JPMorgan Chase & Company.[27] A news release associated with a hearing before the U.S. Senate Permanent Subcommittee on Investigations, from Senator Carl Levin claimed:

> The whale trades were conducted by traders in the London office of the Chief Investment Office (CIO) of JPMorgan Chase & Co., America's biggest bank and largest derivatives dealer. The Subcommittee's investigation has determined that, over the course of the first quarter of 2012, the CIO used its Synthetic Credit Portfolio (SCP) to engage in high risk derivatives trading; mismarked the trading book to hide losses; disregarded multiple indicators of increasing risk; manipulated risk models; dodged regulatory oversight; and misinformed investors, regulators, and the public about the nature of its risky derivatives trading. The Subcommittee's investigation has exposed not only high risk activities and abuses at JPMorgan Chase, but also broader, systemic problems related to the valuation, risk analysis, disclosure, and oversight of synthetic credit derivatives.[28]

---

25. FIN. CRISIS INQUIRY COMM'N, *supra* note 24, at xvi–xvii.

26. *See* Diana B. Henriques & Jack Healy, *Madoff Goes to Jail after Guilty Pleas*, N.Y. TIMES (Mar. 12, 2009), http://www.nytimes.com/2009/03/13/business/13madoff.html?pagewanted=all&_r=0.

27. *See generally* STAFF OF S. COMM. ON HOMELAND SEC. & GOV'T AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 113TH CONG., JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES (2013) [hereinafter WHALE REPORT] (examining the risks associated with trading practices in derivatives markets).

28. *Senate Investigations Subcommittee Holds Hearing and Releases Report on JPMorgan Chase Whale Trades*, *Newsroom*, CARL LEVIN-U.S. SENATOR FOR MICH. (Mar. 14, 2013), http://www.levin.senate.gov/newsroom/press/release

Again, putting aside views of acceptance of individual inquiries, the level of angst involving financial institutions and intermediaries has real consequences. Recently, the author testified before Congress regarding settlement practices of financial regulators after a federal district court judge rejected a Securities and Exchange Commission ("SEC") settlement with a major financial player, indicating concern about whether the punishment was tough enough.[29] While the Second Circuit at least temporarily stayed the effects of the district court's action,[30] it raises the specter of what other legal players might do if the angst continues or if the perception that problems are not being sufficiently addressed lingers. All of this makes it important to move forward to an inquiry about the presence and importance of agency-like relationships for financial intermediaries.

II. FINANCIAL INTERMEDIARIES AND AGENCY

Having seen the importance of and controversies related to financial intermediaries, it is useful to explore the importance of agency-like relationships to these financial intermediaries.[31] Such relationships are multiple. One might be characterized as the entity acting as the principal to its employees. Another might be one where the client takes the role of the principal.

The first relationship is traditionally recognized as agency-like. Financial entities have natural persons as their employees, thus making those employees naturally capable of being characterized as agents of the organization as principal. Notwithstanding the traditional importance of duties between such agents and principals, such relationships are potentially subject to problems. While Senator Levin and his subcommittee's report on JPMorgan Chase

---

/senate-investigations-subcommittee-holds-hearing-and-releases-report-on-jpmorgan-chase-whale-trades.

29. *See Examining the Settlement Practices of U.S. Financial Regulators: Hearing Before H. Comm. on Fin. Servs.*, 112th Cong. 48–56 (2012) (statement of Kenneth M. Rosen); *see also* SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011); *see generally* Kenneth M. Rosen, *Examining the Role of Settlements in the Enforcement Process by Financial Regulators: The Example of the United States Securities and Exchange Commission*, COMMITTEE ON FIN. SERVICES (May 17, 2012), http://financialservices.house.gov/uploadedfiles/hhrg-112-ba00-wstate-krosen-20120517.pdf.

30. SEC v. Citigroup Global Mkts. Inc., 673 F.3d 158, 160–61 (2d Cir. 2012).

31. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (2006) (explaining that a fundamental agency relationship requires a person to act as a representative or on behalf of another with power to affect the legal rights and duties of the other).

and the whale trades explored problems at the entity,[32] one might view the situation as a problem of employee agents who go rogue against the interests of the principal. The Whale Report offers fascinating insight into apparent, specific agent activities related to allegations, including increasing risk,[33] hiding losses,[34] and disregarding limits.[35]

The traditional implications of the entity as principal and employee as agent can be great, for instance, as they relate to third parties. This plays out in the classic case of *Blackburn v. Witter*.[36] In that case a dairy farmer's widow began taking the advice of an individual employed by a firm, Walston & Company.[37] That employee eventually became a representative for another financial firm, Dean Witter & Company, before getting discharged.[38] The employee convinced the widow to invest in a fictitious company, promising a better return than her existing investment in other stocks he previously suggested.[39] The lower court ruled against the two firms for the widow notwithstanding testimony indicating limits placed on their employees' authority in such matters as well as stock exchange and SEC limits.[40] The widow was not shown to know of such limits, and the lower court reasoned that this was a situation of ostensible authority despite the lack of actual authority, grounding the liability of the firm for the employee's actions.[41] Ostensible authority allows third parties to rely reasonably on their belief in agency even if authority does not exist.[42] On appeal, the firms tried to argue that it was unreasonable for the widow to proceed as she did, given things like the odd nature of receipts received.[43] The appellate court affirmed the judgment, relying heavily on the lower court's factual findings.[44] Whether one agrees with the court, the potential implications of the finding of an agency relationship as occurred here are clear—liability might ensue.

---

32. *See supra* notes 27–28 and accompanying text.
33. WHALE REPORT, *supra* note 27, at 35–95.
34. *Id.* at 96–153.
35. *Id.* at 153–214. The problem of possible rogue employees and risky behavior does not appear to be limited to JPMorgan. *See, e.g.*, Tom Braithwaite & Kara Scannell, *Corzine Blamed for MF Global Collapse*, FIN. TIMES, Apr. 5, 2013, at 13; Kara Scannell & Tom Braithwaite, *Ex-Goldman Trader Pleads Guilty in $8bn Fraud*, FIN. TIMES, Apr. 4, 2013, at 15.
36. 19 Cal. Rptr. 842 (Cal. Dist. Ct. App. 1962).
37. *Id.* at 842.
38. *Id.*
39. *Id.* at 842–43.
40. *Id.* at 843.
41. *Id.*
42. *Id.*
43. *Id.* at 844.
44. *Id.* at 844–46.

Perhaps a more interesting agency-type relationship that might be relevant for financial intermediaries is one where the client of the firm is viewed as the principal and the firm is seen as her agent. Interestingly, when brokers are sued at times for misconduct, something known as the "shingle theory" might be applied. The idea is that when one hangs a shingle indicating you are a professional who serves the client, the client rightfully can have expectations of fair treatment, and failure to live up to those expectations might be deemed fraudulent.[45] At least in the world of broker-dealer relationships, where the scope of such theory is not entirely clear, one might ask if fiduciary notions found in areas like agency law might come into play as well.[46]

Given the arguable presence of agency-type relationships in the world of financial intermediaries, it is useful to explore further the nature of legal requirements on intermediaries.

III. CODIFICATION MOVEMENT

To better understand legal obligations of intermediaries it is useful, as a case study, to focus on one type of intermediary, a broker-dealer, and trends in the development of the regulatory framework for them.[47] In particular, one can focus on the trend towards codification under the federal securities laws.

The regulatory structure for broker-dealers is a complex one that starts with a registration requirement under section 15 of the Securities Exchange Act of 1934 for most who meet the definition of broker or dealer.[48] The complexity stems from the fact that registration does not merely entail the submission of a form to the SEC.[49] Rather the registration requirement, when triggered, indicates a broker-dealer is subject to a broader set of requirements.[50] For instance, the broker-dealer needs to become a member of a self-regulatory organization ("SRO") like FINRA or a registered national securities exchange.[51] Consequently, the registered broker-dealer is not only subject to requirements directly imposed by the SEC but also to rules of the SRO to which it

45. *See* COX ET AL., *supra* note 2, at 1027–30.

46. *See id.*

47. Given differences in how different types of financial intermediaries handling different types of financial instruments are regulated, it is useful to focus on a more manageable subset of broker dealers.

48. *See* Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78o (2006); *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCHANGE COMMISSION (Apr. 2008), http://www.sec.gov/divisions/marketreg/bdguide.htm.

49. *Guide to Broker-Dealer Registration*, *supra* note 48 (following link on main page entitled "How to Register as a Broker-Dealer").

50. *Id.*

51. *Id.*

belongs.[52] Over the years, under significant codification efforts, the rules of these SROs have proliferated to cover matters that can become quite specific and extensive.[53] Issues such as treatment of customers by broker-dealers as well as responsibilities of a firm for its representatives have become more detailed.[54]

The volume of rules is significant. As noted above, many of the nation's broker-dealers belong to FINRA. FINRA actually emerged as a consolidation of the regulatory efforts of the old National Association of Securities Dealers regulatory body and the regulatory arm of the New York Stock Exchange.[55] That effort meant incorporating not only rules from the two prior bodies but also interpretive guidance of rules.[56] Notwithstanding FINRA's creation years ago, the rulebooks are still undergoing a consolidation process as new rules continue to be promulgated.[57] Moreover, there is the possibility that additional SROs' duties might merge into FINRA.[58]

---

52. Because of SEC oversight over the self-regulatory organizations, the system is arguably even more complex:

> First, [the broker-dealer] is regulated by FINRA and any other SRO of which it is a member. Second, it is regulated indirectly by the SEC, through that agency's authority over the SROs. Third, it is regulated directly by the SEC, through the Exchange Act's registration requirement and SEC rules of conduct in a number of areas. Finally, it is regulated by the securities laws . . . of any state in which it does business, to the extent that these laws are not preempted by the federal securities laws. The regulatory overlap is mitigated, however, by allocation of regulatory responsibility between the SEC and the SROs, and among the various SROs.

NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 4.01[F] (4th ed. Supp. 2013) (footnotes omitted).

53. *See, e.g., FINRA Rules*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607 (last visited Sept. 21, 2013).

54. *See 2000. Duties and Conflicts*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5502 (last visited Sept. 21, 2013); *3000. Supervision and Responsibilities Relating to Associated Persons*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5664 (last visited Sept. 21, 2013). The rules can even get into the details of items such as anti-money laundering compliance programs. *See 3310. Anti-Money Laundering Compliance Program*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8656 (last visited Sept. 21, 2013).

55. *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA*, FINRA (July 30, 2007), http://www.finra.org/Newsroom/newsreleases/2007/p036329.

56. *See, e.g., Incorporated NYSE Rule Interpretations*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=611 (last visited Sept. 21, 2013).

57. *FINRA's Rulebook Consolidation Process*, FINRA, http://www.finra.org/Industry/Regulation/FINRARules/P038095 (last visited June 4, 2013).

58. Jacob Bunge, *CBOE May Drop Its Oversight Role*, WALL ST. J., Apr. 23, 2013, at C1.

As one considers potentially even more voluminous and complex rules, it is worthwhile to briefly note that things were not always this way. In his 1882 treatise on brokers and exchanges, John Dos Passos noted that while formal licensing was not required for brokers, they tended not to be random folks off the street.[59] Nor were these brokers without common-law-like principles to guide them.[60] Dos Passos noted the trustee-like nature of the broker, "for the law charges him with the utmost honesty and good faith in his transactions . . . ."[61]

However, the proliferation of SRO rules certainly has potential benefits. These rules arguably provide guidance on right and wrong behavior. Moreover, because they are SRO rules, the organization can enforce them along with the SEC.[62] In a way, this means that the SEC can leverage enforcement resources of the SROs as it seeks to police the markets. However, the proliferation of rules raises an additional question: Do these rules supplement or supplant previous behavioral norms for broker-dealers developed in other contexts, such as agency law?

IV. SUPPLEMENTATION OR REPLACEMENT

In answering whether newly codified rules supplement or supplant norms developed in agency law, it is useful to start by recognizing that, at least sometimes, newly codified rules can confuse seemingly well-settled issues. A useful example of this comes in the form of a state law provision on corporate governance, the charter option for statutory exculpation in Delaware.[63]

Some will recall the controversy created when the Delaware Supreme Court in *Smith v. Van Gorkom*[64] clarified the potential for liability for violations of a duty of care in a Board of Directors' handling of a cash-out merger. In the wake of fears of liability exposure, the Delaware legislature passed legislation that clarified that a corporation had the option to include in its charter a provision

---

59. DOS PASSOS, *supra* note 14, at 101–02.

60. *Id.* at 102–04.

61. *Id.* at 102.

62. *See, e.g.*, *SEC Sues Roberson Stephens Inc. for Profit Sharing in Connection with 'Hot' IPOs*, U.S. SEC. & EXCHANGE COMMISSION (Jan. 9, 2003), http://www.sec.gov/news/press/2003-3.htm (noting settlement of matter pursued by SEC and an SRO); *see also* Luis A. Aguilar, *The Need for Robust SEC Oversight of SROs*, *Public Statements*, U.S. SEC. & EXCHANGE COMMISSION (May 8, 2013), http://www.sec.gov/news/speech/2013/spch050813laa.htm (describing SEC oversight of SROs).

63. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

64. 488 A.2d 858 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

exculpating directors from certain liability.[65] However, while some liability associated with some fiduciary duty breaches could be eliminated under the charter option, not all could. The charter option specifically did not permit removal of liability for certain violations, such as violations of a duty of loyalty and acts not taken in good faith.[66]

What ensued was an interesting jurisprudential adventure. While specific fiduciary duties of care and of loyalty were well established prior to the legislative changes, some wondered whether the good faith language meant that a new, separate fiduciary duty of good faith, apart from loyalty and care, had been created.[67] Not helping the speculation was Delaware court commentary during the litigation surrounding compensation for former Disney President Michael Ovitz.[68] As the litigation proceeded through the years, the courts increasingly focused on the significance and meaning of good faith and bad faith.[69] The serious confusion created by the *Disney* opinions is reflected in the speed with which the Delaware courts seemingly engaged in a course correction. In *Stone v. Ritter*,[70] the Delaware Supreme Court explained:

> This view of a failure to act in good faith results in . . . additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.[71]

The episode is useful in that it shows how codification of issues related to fiduciary duties—and rules related to fiduciary duties that may find their foundation in agency law—can confuse as well

---

65. Tit. 8, § 102(b)(7).

66. *Id.*

67. *See generally, e.g.*, Robert B. Thompson, *The Short, but Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y.L. SCH. L. REV. 543 (2010/2011) (recounting the rise and fall of good faith as a separate fiduciary duty).

68. *See* Kenneth M. Rosen, *Mickey, Can You Spare a Dime?* DisneyWar, *Executive Compensation, Corporate Governance, and Business Law Pedagogy*, 105 MICH. L. REV. 1151, 1157–60 (2007) (describing issues surround the Ovitz compensation situation).

69. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 63–68 (Del. 2006); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 290–91 (Del. Ch. 2003).

70. 911 A.2d 362 (Del. 2006).

71. *Id.* at 370.

as clarify. In some ways the Delaware Supreme Court ultimately reached a place where they worked with anything that might have been in the exculpation statute to reconcile it with more traditional notions of what fiduciary duties were generally considered to be.

This is a useful way of looking at agency law more generally as it interacts with an increasingly codified world of broker-dealer rules. Rather than viewing such rules as replacing traditional agency notions, those who interpret the rules might respect the continued relevance of agency law notions and perhaps even use them to interpret the rules. This seems especially prudent if the rules have some of their foundation in agency law concepts.

Some might object to this approach as a needless dual use of belts and suspenders. In other words, if you have the codified rules belt, you no longer need the suspenders of agency law concepts to hold up the broker-dealer's pants. Yet, perceived redundancy is not always a bad thing. Another story from the world of broker-dealers is useful to illustrate this point and involves the introduction of single-stock futures trading under the Commodity Futures Modernization Act of 2000.[72] Trading these futures was banned for many years prior to the statute's enactment.[73] One of the challenges of ending the ban was selection of an appropriate regulatory framework for the product; more specifically, questions existed as to whether single-stock futures should be treated as securities, traditionally regulated by the SEC, or as futures, traditionally regulated by the Commodity Futures Trading Commission ("CFTC").[74]

Some parties preferred earlier versions of legislation that sought to bifurcate regulatory treatment of the products depending on whether they traded on securities or futures exchanges.[75] Moreover, there were questions as to the rules of the game for intermediaries, such as broker-dealers and futures commission merchants, who might engage in transactions in these new products.[76] Representatives of the SEC expressed concerns related to possible regulatory arbitrage opportunities and the potential for

---

72. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7, 11, 12, & 15 U.S.C.).

73. *See Single-Stock Futures Trading Ban May End*, L.A. TIMES (May 9, 2000), http://articles.latimes.com/2000/may/09/business/fi-28014.

74. *See* William Neikirk, *Gramm, Lugar Confident of Futures Bill Passage*, CHI. TRIB. (May 12, 2000), http://articles.chicagotribune.com/2000-05-12/business/0005120282_1_single-stock-futures-commodity-futures-trading-commission-senators.

75. MARK JICKLING, CONG. RESEARCH SERV., RS20560, THE COMMODITY FUTURES MODERNIZATION ACT (P.L. 106-554) 5 (2003).

76. *Id.*

unequal investor protections on issues such as securities law principles on customer protection issues, like suitability, depending on the type of intermediary an investor used.[77] Eventually, the Chairs of the SEC and CFTC came up with a joint regulatory plan for single-stock futures that largely went into the final enacted version of the Commodity Futures Modernization Act.[78] The products were treated as both securities and futures, and intermediaries trading the products needed to register with both agencies to submit themselves to the different regulatory schemes.[79] To limit administrative burdens of dual registration, special "notice" registration was made available for these purposes.[80] While some might have viewed the dual registration requirement as redundant, as "belts and suspenders," it helped insure that the fuller traditions of customer protection from both the futures and securities worlds were not lost while also trying to limit burdens imposed on registrants. In the process, concerns that regulatory arbitrage opportunities might otherwise exist were alleviated. A similar, positive view could be taken of the use of traditional agency law concepts of duties and responsibilities of principals and agents to help fill gaps and to interpret codified rules related to financial intermediaries.

V. FUTURE CONSIDERATIONS AND CONCLUSIONS

The above argument for the continued, if not increased, relevancy of applying agency law principles in an evolving world of intermediary regulation raises several items for future consideration.

First, what would be the mechanics of using traditional agency principles as suggested? On a basic level, this is not an entirely novel enterprise. As a common law country, in the business law area, we already have seen the migration of agency principles through jurisprudence.[81] Then state court Chief Justice Benjamin Cardozo's famed opinion in *Meinhard v. Salmon*[82] is often cited for its notions about fiduciary duties in the contexts of various business

---

77. *See* Annette L. Nazareth, *Testimony Concerning H.R. 4541, The Commodity Futures Modernization Act of 2000*, U.S. SEC. & EXCHANGE COMMISSION (June 4, 2000), http://www.sec.gov/news/testimony/ts102000.htm.

78. JICKLING, *supra* note 75.

79. *News Story Supplement: Summary of SEC/CFTC Agreement*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/news/extra/cftcagre.htm (last modified Sep. 19, 2000).

80. *Id.*

81. Indeed, that is why so many business organizations case books include agency law sections—this enriches students understanding of other business organizations law that draws on agency law principles.

82. 164 N.E. 545 (N.Y. 1928).

organizations even though Justice Cardozo applied his ideas in a specific context, a case about a joint venture.[83] Moreover, Justice Cardozo's opinion itself was not an entirely original exposition, but instead drew on earlier principles as well.[84] Of course, agency law can be a foundational source for fiduciary concepts.

It is interesting if the ease of application found in the courts can shift to other types of legal fora. This is significant in the securities world, for instance, where arbitration is so frequently used for customer disputes with broker-dealers.[85] To the extent that arbitration is hailed for the ability of decision makers to act with greater flexibility, perhaps arbitration might be even more suited for an active reintroduction of agency law principles as cases are considered.

Second, how do this paper's views on agency fit with ongoing reform efforts? In the wake of scandals and the financial crisis, regulatory reforms sometimes feel like they are introduced at breakneck speed. I would draw attention to the author's previous work counseling caution in enacting multiple reform efforts on similar time frames without paying heed to potential regulatory synergies.[86] That said, there already is an active, statutorily mandated agenda—although it is one that agencies sometimes have difficulty implementing on the prescribed time frames.[87] One item arising out of Dodd-Frank is the idea of new fiduciary standards for investment advisers and broker-dealers.[88] My purpose in this paper

---

83. *See* Kenneth M. Rosen, *Fiduciaries*, 58 ALA. L. REV. 1041, 1041 n.2 (2007).

84. *Id.* at 1041–42.

85. *See* Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 61 (2010) (noting almost all broker-dealers include predispute arbitration agreements in customer agreements).

86. *See generally, e.g.*, Kenneth M. Rosen, *"Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation Reform*, 76 FORDHAM L. REV. 2907 (2008) (examining the ability of the reform processes of the SEC and House of Representatives to yield positive reforms).

87. *See generally, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-195, FINANCIAL REGULATORY REFORM: REGULATORS HAVE FACED CHALLENGES FINALIZING KEY REFORMS AND UNADDRESSED AREAS POSE POTENTIAL RISKS (2013) (explaining risks and delays regulators have encountered in implementing Dodd-Frank reforms). President Barack Obama recently called on regulators to complete implementation of reform provisions. *See Readout of the President's Meeting with Independent Financial Regulators, Office of the Press Secretary*, WHITE HOUSE (Aug. 18, 2013), http://www.whitehouse.gov/the-press-office/2013/08/19/readout-presidents-meeting-independent-financial-regulators.

88. *See* STAFF OF U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT COMMISSION 110 (2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf;

is not to express a final opinion in this ongoing debate. Rather, as this issue continues to evolve, it is useful to note that involved parties should ask what new standards might add to the existing investor protection regime, including common law principles related to investment advisers and broker-dealers, and, moreover, exercise caution to avoid displacing useful, existing principles.

This raises a broader issue related to desires to codify more and more issues in a burgeoning administrative state beyond the world of financial regulation. When engaging in such endeavors, codifiers should be mindful to utilize legal principles that are already in place and to avoid instituting new confusion or undermining positive principles.

In conclusion, it is helpful to turn back to the beginning and, more broadly, to the subject matter of the symposium. Hopefully, this paper provides grounds to continue recognition of agency problems *as well as* traditional solutions even as new crises and scandals emerge. In some ways perhaps by returning to foundational concepts—which themselves seemed based on simpler notions of doing what is right and avoiding what is wrong—we have the opportunity to merge the old with new theories. To vary a popular phrase, it might be useful to find some old wine—libations that have developed a fuller, more complex structure over time—to place in new bottles.

Kyle Colona, *New SEC Fiduciary Duty Standards Loom Large for Financial Service Providers*, MOTLEY FOOL (Mar. 27, 2013), http://beta.fool.com/kcolona/2013/03/27/new-sec-fiduciary-duty-standards-loom-large-for-fi/28124/.