

# **BROKERS AND INVESTMENT ADVISERS - ADDRESSING THE QUESTION OF FIDUCIARY STANDARD IN A COMPARATIVE CONTEXT**

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*With the increasing sophistication witnessed by financial markets, regulatory authorities across the globe have made conscious efforts to reorient their approach towards monitoring transactional activities; yet, they have failed to recognise the changes experienced by brokerage operations. This paper seeks to shed light on the emergence of advisory brokers in the contemporary context which has exhibited substantial similarity to functions traditionally performed by investment advisers. While advisory relationships have been typically classified as fiduciary in the capital market jurisprudence, brokers have continued to evade such responsibility, despite operating in an unauthorised advisory capacity. This paper establishes a legal basis for harmonising rules of conduct governing advisers and brokers in order to respond effectively to the dynamic market practices influencing broker-investor interactions. Demonstrating sensitivity to the issue of meaningful investor protection, this paper attempts to initiate a debate on questions of liability of advisers and brokers acting as fiduciaries in the Indian context, while culling out specific policy points surrounding the choice of a prescriptive/proscriptive model.*

## **I. INTRODUCTION**

Fiduciaries are usually characterised as individuals exercising discretionary decision-making authority, on behalf of and for the benefit of their beneficiaries, and are subjected to the highest standards of care.<sup>1</sup> It is critical to acknowledge that the conceptual understanding of fiduciaries has traditionally been by function, and not by title/position. This implies that determination of fiduciary relations fundamentally involves inquiring into the transfer of discretionary power, and is not limited to inquiries merely into the designations or official posts enjoyed by the individual in question.<sup>2</sup> Retail investors usually rely on transactional decisions made by fiduciaries, as they attribute significant

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<sup>1</sup> Arthur J. Jacobson, *Capturing Fiduciary Obligation: Shepherd's Law of Fiduciaries*, 3 *Cardozo L. Rev.* 519, 520-521 (1982).

<sup>2</sup> *Id.*, 522.

value to the trust and good faith shared in such relationships.<sup>3</sup> On account of the growing dependence of investors on fiduciaries in the current capital markets regime vis-à-vis management of financial assets, the question of application of fiduciary standards to these market participants has assumed centrality in the regulatory policy discourse.

It is in this situation that, unlike investment advisers, brokers have conventionally been viewed as specialists in providing services of an ‘execution-only’ nature. Consequently, they evade application of fiduciary standards by claiming that they do not influence their clients’ decision-making process.<sup>4</sup> On the other hand, investment advisers assist individuals or institutions in making key investment decisions and strategies. Additionally, in some cases, they are involved in financial planning and pension consultation, thereby directly dictating the trends of investment undertaken by parties in the market. Such discernible divergence in the nature of operations performed by the two financial market intermediaries, namely brokers and investment advisers, has justified the differentiated treatment of the latter as fiduciaries.<sup>5</sup> However, with the United States (‘US’) Labour Department, accompanied by the Securities Exchange Commission (‘SEC’), recently arguing for standardisation of fiduciary duties for both investment advisers and broker-dealers,<sup>6</sup> the issue has garnered unprecedented prominence in the global context.<sup>7</sup> Utilising this legislative sentiment, I attempt to evaluate the merits of such policy reorientation, especially in the Indian context, as well as the impact of current market practices and securities regulations on its efficacy.

I begin by tracing the jurisprudential narrative, defining the manner in which fiduciary obligations have been traditionally applied in the case of investment advisers. Part II of this paper outlines the scope of functions carried out by advisers, and tests the rationality of the application of fiduciary standards vis-à-vis their relationship with clients. I utilise this analysis as an opportunity to evaluate the contesting conceptualisations of fiduciary relations and obligations, as articulated by scholars such as Rebecca Lee, Darryn Jensen, Matthew Conaglan and Paul Miller. Using a comparative analysis framework, I also make a reference to the regulatory devices employed in the US and India

<sup>3</sup> James J. Angel & Douglas McCabe, *Ethical Standards for Stockbrokers: Fiduciary or Suitability?*, 115(1) J. of Business Ethics 186-187, (June 2013).

<sup>4</sup> Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. Pitt. L. Rev. 483, 490-92 (2003).

<sup>5</sup> *Id.*

<sup>6</sup> Nathaniel Graham, *Brokers, Advisors and the Fiduciary Standard*, Columbia Law School’s Blog on Corporations and The Capital Markets, October 13, 2015, available at <http://cls-bluesky.law.columbia.edu/2015/10/13/brokers-advisors-and-the-fiduciary-standard/> (Last visited on March 13, 2016).

<sup>7</sup> Justin Baer & Andrew Ackerman, *SEC Head Backs Fiduciary Standards for Brokers, Advisers*, The Wall Street Journal, March 17, 2015, available at <http://www.wsj.com/articles/sec-head-seeks-uniformity-in-fiduciary-duties-among-brokers-advisers-1426607955> (Last visited on March 13, 2016).

for monitoring the functioning of such market intermediaries. In Part III, I scrutinise the viability of importing such fiduciary standards from the realm of investment advisers to that of brokers. Reflecting upon the policy pragmatism guiding such differentiated regulatory treatment concerning advisers and brokers, I rely on the line of argumentation endorsed by Professor Arthur Laby.<sup>8</sup> Moreover, I discuss the potential for a theoretical conciliation between the US and Indian regulatory framework on broker liability. Finally, in Part IV, I attempt to carve out the criticism faced by the proposed utilisation of fiduciary standards to address the central issue of broker liability. Part V presents my conclusions.

## II. INVESTMENT ADVISERS: EXAMINING THE CONTOURS OF FIDUCIARY OBLIGATIONS IN FINANCIAL MARKETS

### A. LITMUS TEST FOR A FIDUCIARY RELATIONSHIP

The theoretical justification provided for application of fiduciary obligations to investment advisers, arising from the inherent presence of trust and confidence in such relationships, is based upon the ‘fiduciary powers theory’ proposed by Paul Miller.<sup>9</sup> The theory highlights the exercise of substitutive legal capacity by fiduciaries, for they decide as well as act on behalf of their beneficiaries. It also helps in understanding the regulatory logic for fiduciary obligations, as the theory clarifies the wide-ranging powers of fiduciaries who assume the legal position of their clients while trading in financial markets.<sup>10</sup>

However, it is critical to guard against a generic application of fiduciary principles to financial actors performing advisory functions, as was remarked upon in the Canadian case of *Hodgkinson v. Simms*.<sup>11</sup> In this case, the appellant approached the respondent for obtaining advice pertaining to real-estate tax shelter investments and was subsequently convinced to direct his funds to four projects. It was discovered later, when the property market crashed, that the respondent had an undisclosed financial association with the real-estate developers involved in those projects. On hearing the facts of the case, the Supreme Court of Canada attempted to define fiduciary liability within the realms of ‘power-dependency’ and vulnerability of investors in stock market transactions, emphasising on essential virtues of trust, loyalty and confidence

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<sup>8</sup> Arthur B. Laby, *Fiduciary Obligations of Brokers-Dealers and Investment Advisers*, 55 Vill. L. Rev. 701,702 (2010).

<sup>9</sup> See Paul Miller, *The Fiduciary Relationship* in *Philosophical Foundations of Fiduciary Law* 63, 65 (2014 ed.).

<sup>10</sup> *Id.*, 72.

<sup>11</sup> *Hodgkinson v. Simms*, (1994) 3 SCR 377.

in such relationships.<sup>12</sup> Thus, the operational autonomy enjoyed by investment advisers, coupled with their ability to influence the interests of their clients, generates a power dynamic, necessitating application of fiduciary standards to such relationships.<sup>13</sup> Scholars have often reiterated this condition of enjoying discretion while acting for others to rationalise classification of brokers, who simply execute client instructions, as non-fiduciaries.<sup>14</sup>

Recognising the need for preventing the prospects of abuse in such relationships, the Investment Advisers Act was introduced in the US in 1940.<sup>15</sup> The Act is an anti-fraud statute, as it places an embargo on specific kinds of fraudulent conduct by parties involved in providing money management advice, whilst also imposing registration and disclosure-centric obligations on such advisers.<sup>16</sup> This legislative instrument is the result of a Congressional study that had observed growing instances of such conflicts of interests, which hinders the ability of investment advisers to objectively pursue the best interests of their clients.<sup>17</sup>

With a proliferation of reports highlighting cases where investment advisers rendered biased data to investors while prioritising their own financial interests,<sup>18</sup> the centrality of a duty of loyalty, within the model of fiduciary obligations, assumed relevance. In the case of advisers, the duty has been operationalised within the paradigm of ‘disinterestedness’, acknowledging the principle that this advisory relationship does not involve mere provision of information.<sup>19</sup> The act of giving advice necessarily involves judgment, as it requires the fiduciary to customise the advice as per the circumstances of the advisee, thereby underlining the subjectivity of the process, as opposed to a mechanical presentation of information.<sup>20</sup> Consequently, the duty of loyalty, viewed from the prism of disinterestedness, aims to guard against consciously

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<sup>12</sup> Keith Farquhar, *Hodgkinson v. Simms: The Latest on the Fiduciary Principle*, 29 U. Brit. Colum. L. Rev. 383, 384-385 (1995).

<sup>13</sup> Lorna Schnase, *An Investment Adviser’s Fiduciary Duty*, August 01, 2010, available at <http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/lornaschnaseFiduciary-Duty-Paper.pdf> (Last visited on March 15, 2016).

<sup>14</sup> Miller, *supra* note 9, 36-37.

<sup>15</sup> Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 Ala. L. Rev. 1083, 1094-1095 (2007).

<sup>16</sup> Barry Barbash & Jai Massari, *The Investment Advisors Act of 1940: Regulation by Accretion*, 39 Rutgers L. J. 627, 627-628 (2008).

<sup>17</sup> *Id.*

<sup>18</sup> Robert E. Plaze, *Regulation of Investment Advisers by the US Securities and Exchange Commission*, September, 2016, available at [www.stroock.com/siteFiles/PAFile120.pdf](http://www.stroock.com/siteFiles/PAFile120.pdf) (Last visited on March 14, 2016).

<sup>19</sup> Lionel Smith, *Fiduciary Relationships: Ensuring the Loyal Exercise of Judgement on Behalf of Another*, 130 L. Q. Rev. 608, 619-620 (2014).

<sup>20</sup> Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for breach of Fiduciary Duty*, 23 J. Corp. L. 112-113 (1997).

attempted manipulation, which plagues this inherently subjective advisory process.<sup>21</sup>

Investment advisers are assumed to enjoy at least ‘partial transfer of autonomy’,<sup>22</sup> which characterises their authority to exercise judgment on behalf of their clients, and their concomitant ability to influence the latter’s financial position in the markets. Such a relational dynamic between clients and investment advisers demonstrates the value of preventing a conflict between parties’ interests, thus elucidating the dominance of the proscriptive dimension of fiduciary content.<sup>23</sup> Since the characterisation of investment advisers as fiduciaries has been relatively unchallenged, the American regulatory regime, through the enactment of the Dodd-Frank Act, 2010, went a step further by proposing a scheme for uniformly applying such fiduciary standard to broker-dealers and advisers.<sup>24</sup> The discussion surrounding this issue shall be tackled in Part III.

### B. A CONTENT-ORIENTED ANALYSIS OF THE FIDUCIARY OBLIGATIONS OF INVESTMENT ADVISERS

Under the Investment Advisers Act, 1940, the fiduciary duty imposed on advisers, which has been articulated using broad language, requires them to act in their clients’ best interests, in a disinterested manner, and to uphold their duty to advise in good faith.<sup>25</sup> As explained by the US Supreme Court in *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*,<sup>26</sup> the scope of fiduciary obligations which correspond to advisory operations, is defined as “the need to adhere to a strict fiduciary standard including a duty of utmost good faith, full and fair disclosure of all material facts, and an obligation to use reasonable care to avoid misleading clients”.<sup>27</sup> The judicial pronouncement emerged against a factual background involving the adviser profiting on its own account by directing the client to invest in securities wherein the advisory firm had a stake. This decision, which provided the jurisprudential foundation for viewing investment advisers as fiduciaries, can be understood on three levels.

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<sup>21</sup> *Id.*, 77.

<sup>22</sup> *Id.*

<sup>23</sup> Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors under the Law of Agency*, 2013, available at <http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/07/Robert-H-Sitkoff.pdf> (Last visited on April 19, 2016).

<sup>24</sup> Helene Cooper, *Obama Signs Overhaul of Financial System*, The New York Times, July 21, 2010, available at <http://www.nytimes.com/2010/07/22/business/22regulate.html> (Last visited on March 17, 2016).

<sup>25</sup> Investment Advisers Act of 1940, §206. See also Laby, *supra* note 8, 729.

<sup>26</sup> *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 1963 SCC OnLine US SC 206 : 11 L Ed 2d 237 : 375 US 180 (1963), ¶201 (*per* Arthur Goldberg J.).

<sup>27</sup> *Id.*

*First*, the manner in which judicial inquiry<sup>28</sup> has been carried out in cases of breach of fiduciary duty by investment advisers has justified suggestions of dependence on the ‘no profit rule’ or the ‘no conflict rule’. It has been subsequently clarified that, on a theoretical level, the ‘no profit rule’ requires fiduciaries to account for any unauthorised profit which they make in connection with the fiduciary office,<sup>29</sup> whereas the ‘no conflict rule’ requires them to abstain from entering in a position where they are likely to encounter a conflict of interest.<sup>30</sup> It is argued that these two rules represent the essence of fiduciary responsibilities, since they involve guarding against abuse of the foundational trust and faith governing such relationships.<sup>31</sup> In cases where advisers have directed clients to invest in assets in which they possess a personal stake, the ‘no profit rule’ has been demonstrated to be a subset of the ‘no conflict rule’, as the liability within the fiduciary framework premises itself upon the presence of a conflict.<sup>32</sup>

*Second*, the duty of care vis-à-vis investment advisers which has been established in the legislative framework reaffirms Birks’ attempt to explain fiduciary obligations as the highest degree of obligatory altruism that places the twin duty to promote the interests of another with care, and to act disinterestedly.<sup>33</sup> Moreover, the width of content attributed to fiduciary obligations of investment advisers within the ‘duty of care’ paradigm also reignites the prescriptive versus proscriptive debate.<sup>34</sup>

*Third*, the judicial approach to advisory firms as fiduciaries essentialises the principle that breaches of fiduciary duty deal with both actual and potential conflict of interest, as observed in *Monetta Financial Services v. Securities and Exchange Commission*.<sup>35</sup> In this case, the appellant was involved in allocation of shares received in Initial Public Offerings (IPOs) to its advisory clients. At the same time, the appellant also distributed some shares to other non-client trustees without disclosing the fact that they had already given shares to trustee clients. Subsequently, there were allegations of fraud and inequitable distribution against Monetta Financial Services, since they were deemed to be more inclined to retain advisory clients and prioritise their interests over those

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<sup>28</sup> *Boardman v. Phipps*, (1967) 2 AC 46 : (1966) 3 WLR 1009.

<sup>29</sup> Rebecca Lee, *Rethinking the Content of the Fiduciary Obligation*, 73 Conv. & Prop. Law. 242-243 (2009).

<sup>30</sup> *Id.*, 244.

<sup>31</sup> Darryn Jensen, *Prescription and Proscription in Fiduciary Obligations*, 21 King’s L. J. 333, 333-334 (2010).

<sup>32</sup> *Securities and Exchange Commission v. K.W. Brown & Co.*, 555 F Supp 2d 1275 (SD Fla. 2007).

<sup>33</sup> Peter Birks, *Lionel Cohen Lecture: The Content of Fiduciary Obligations*, 34 Israel L. Rev. 3, 38 (2000).

<sup>34</sup> Jensen, *supra* note 31, 333-354.

<sup>35</sup> *Monetta Financial Services v. Securities and Exchange Commission*, 390 F 3d 952 (7th Cir 2004).

of the other trustees.<sup>36</sup> The courts, as illustrated in this case, have adopted a strict attitude while applying fiduciary standards to advisory relations, as they require immediate disclosure even in situations of mere potential for abuse, with the investment adviser facing no current conflict of interest.<sup>37</sup> Such a ruling had the effect of imposing disclosure requirements for advisers in cases involving a prospective interest, wherein the client's circumstances present a reasonable probability for materialisation of conflict in the near future.<sup>38</sup>

### C. DRAWING PARALLELS IN THE INDIAN CONTEXT

The history of regulation of investment advisers within the fiduciary framework dates back to the 1930s in the American context. However, the Indian regulatory regime only recently responded to the peculiar problems posed by their functioning within the domestic financial markets. Under §11(2) (b) of the Securities Exchange Board of India ('SEBI') Act, 1992 ('SEBI Act'),<sup>39</sup> the securities market regulator has the power to lay down regulations governing the registration and working of investment advisers. However, only in 2007 was the need for institutionalising a dedicated regulatory regime for these market intermediaries considered by SEBI, via its Concept Paper.<sup>40</sup> As a part of this exercise, SEBI contemplated the definitional scope of critical terms namely, 'investment advisers' and 'investment advice'.<sup>41</sup>

Subsequently, in 2011, SEBI floated a Concept Paper on the subject, which proposed a framework for guiding the performance of investment advisory activities.<sup>42</sup> This led to the formulation of the SEBI (Investment Advisers) Regulations, 2013 ('2013 Advisers Regulations').<sup>43</sup> Regulation 15(1) of the SEBI Advisers Regulations explicitly requires such advisers to act in a fiduciary capacity towards their clients, necessitating prompt disclosure of all conflicts of interest.<sup>44</sup> Furthermore, the roles and responsibilities identified for the purpose of regulating their performance, and stipulated under Regulations 15-22, seek to streamline certain fiduciary duties commonly found in the Indian as well as American contexts. Some of these duties can be identified as – the duty of disclosure of material facts to the client; the duty of segregating

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<sup>36</sup> *Id.*

<sup>37</sup> Laby, *supra* note 8, 723-726.

<sup>38</sup> *Id.*, 718-719.

<sup>39</sup> The SEBI Act, 1992, §11(2).

<sup>40</sup> SEBI, *Concept Paper on Regulation of Investment Advisers*, October 31, 2011, available at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1317044891201.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1317044891201.pdf) (Last visited on March 20, 2016).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Anup Bansal, *Advisers Hesitating to Register with SEBI May Be Wrong*, Livemint, August 10, 2015, available at <http://www.livemint.com/Money/5HMnPoXrUsvi5JEsEeu4AN/Advisers-hesitating-to-register-with-Sebi-may-be-wrong.html> (Last visited on March 21, 2016).

<sup>44</sup> SEBI Investment Advisers Regulations, 2013, Reg. 15(1).

alternate businesses (construction of Chinese Walls<sup>45</sup>); and the duty to act in best interests of the client (risk profiling and reasonable study obligations<sup>46</sup>).

It can be observed that the case of the investment advisers is representative of the regulatory dynamism demonstrated by SEBI. With the advent of the SEBI (Portfolio Managers) Regulations, 1993, encompassing the fiduciary nature of investment adviser-client relation, the regulatory intent was to foster trust and confidence amongst investors.<sup>47</sup> However, owing to the growth of investment advisers as a unique subset of portfolio managers dedicated towards rendering of advisory services, the 2013 Advisers Regulations provide a dedicated framework for their registration.<sup>48</sup>

With the SEBI Concept Paper explicitly defining the content of the advisers' fiduciary duties, on lines of confidentiality and pursuance of client's best interests,<sup>49</sup> the actualisation of fiduciary liability in India has reignited the prescriptive versus proscriptive debate. On a preliminary level, the debate signifies the tussle between two opposing schools of thought, wherein scholars such as Remus Valsan endorse the conceptualisation of prescriptive fiduciary duties associated with positively serving the interests of the beneficiary.<sup>50</sup> It requires fiduciaries such as investment advisers to conduct themselves in a manner whereby performance to the detriment of their clients can form the basis of a cause of action.<sup>51</sup> On the other hand, the proscriptive model, which aims at exacting loyalty and fidelity from advisers, has enjoyed consistent academic support.<sup>52</sup> Under this model, the principles of fiduciary obligations are couched in a negative language, requiring regulatory bodies to articulate rules stating "things that a fiduciary must abstain from".<sup>53</sup>

While the regulatory iteration of confidentiality highlights the need for advisers to refrain from certain acts (negative articulation of fiduciary

<sup>45</sup> This refers to established procedures aimed at ensuring that individuals do not come into possession of information in conflict with material they already possess in large commercial institutions. See Leo Herzel and Dale Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 Bus. Law. 73, 74-75 (November, 1979).

<sup>46</sup> Sambhav Ranka & Pratibha Jain, *Investment Advisers Regulations Notified- Do you Need to Register?*, January 25, 2013, available at [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/1580/html/1.html?no\\_cache=1](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/1580/html/1.html?no_cache=1) (Last visited on April 25, 2016).

<sup>47</sup> Bansal, *supra* note 43.

<sup>48</sup> *Id.*

<sup>49</sup> SEBI, *supra* note 40, 8.

<sup>50</sup> Remus Valsan, *Understanding Fiduciary Duties: Conflict of Interest and Proper Exercise of Judgment in Private Law*, March 2012, 43-44, available at <http://www.collectionscanada.gc.ca/obj/thesecanada/vol2/QMM/TC-QMM-110522.pdf> (Last visited on March 22, 2016).

<sup>51</sup> Benjamin J. Richardson, *Fiduciary Law and Responsible Investing: In Nature's Trust* 107-108 (2013).

<sup>52</sup> Tina Cockburn & Leanne Wiseman, *Disclosure Obligations in Business Relationships* 43-44 (1996).

<sup>53</sup> *Id.*



content), the use of the 'best interests' threshold brings out the importance of consciously performing certain positive acts while serving the client. Additionally, there have been subsequent clarifications from SEBI extending the width of such obligations with respect to the procurement and use of investor information so as to ensure operational integrity.<sup>54</sup>

Despite such attempts to restore financial discipline, the recent SEBI order in *HBJ Capital Services (P) Ltd., In re*<sup>55</sup> exemplifies the manner in which an explicit recognition of fiduciary relations between advisers and their clients, under the 2013 Advisers Regulations, has been resented by the financial intermediaries.<sup>56</sup> The case involved HBJ Capital and its directors engaging in acts of rendering investment advisory services without obtaining the requisite authorisation from SEBI. Relying upon different channels of communication such as SMS and e-mail, the company's officials were heavily involved in advertising their advisory operations, convincing investors to trade as per their instructions; yet, the company conducted itself as an unregistered entity. As a consequence, SEBI placed a ban on the company and its promoters and directors from engaging in any investment advisory service in the future.<sup>57</sup>

With reports suggesting that SEBI received merely seventy applications in the six months following the introduction of the reframed regulatory setup in 2013, it is reasonable to conclude that there still exists a large chunk of intermediaries providing unauthorised investment tips, thereby putting the retail investor population at significant risk.<sup>58</sup> Such a tendency to act as unregistered entities, consciously avoiding the fiduciary liability framework, has been further exacerbated by a passive regulatory response to brokers and sub-brokers who casually offer their advice in the media, yet conveniently avoid the application of fiduciary duties.<sup>59</sup> Unfortunately, such a scenario has caused SEBI to reconsider the efficacy of the 2013 Advisers Regulations, with the rule of caveat emptor<sup>60</sup> continuing to plague the securities market.

<sup>54</sup> Uma Shashikant, *Impact of SEBI Regulation on Investment Advisers*, The Economic Times, January 28, 2013, available at [http://articles.economictimes.indiatimes.com/2013-01-28/news/36596525\\_1\\_investment-adviser-investor-investment-products](http://articles.economictimes.indiatimes.com/2013-01-28/news/36596525_1_investment-adviser-investor-investment-products) (Last visited on May 22, 2016).

<sup>55</sup> HBJ Capital Services (P) Ltd., In re, 2015 SCC OnLine SEBI 349, ¶13.

<sup>56</sup> *SEBI Bars HBJ Capital from Acting as Investment Advisers*, Money Control, June 17, 2015, available at [http://www.moneycontrol.com/news/market-news/sebi-bars-hbj-capitalacting-as-investment-advisers\\_1488621.html](http://www.moneycontrol.com/news/market-news/sebi-bars-hbj-capitalacting-as-investment-advisers_1488621.html) (Last visited on May 22, 2016).

<sup>57</sup> *Id.*

<sup>58</sup> Aarati Krishnan, *So Much Advice, So Few Advisers*, The Hindu, October 26, 2013, available at <http://www.thehindubusinessline.com/portfolio/so-much-advice-so-few-advisers/articles5276047.ece> (Last visited on May 23, 2016).

<sup>59</sup> *Id.*

<sup>60</sup> Conventionally, it is discussed as the principle requiring buyers to take responsibility for purchases made in the market. Contextualising this term in the present debate reveals the manner in which unsophisticated retail investors continue to trade at the mercy of the financial intermediaries. Within the existing regulatory framework, the term is used as an excuse to keep the investors remediless despite recurrent conflict of interest violations. See Robert P. Sieland,

*D. CHOOSING SIDES IN THE FIDUCIARY  
JURISPRUDENTIAL DEBATE- PRESCRIPTIVE V.  
PROSCRIPTIVE*

The regulatory articulation of fiduciary duties vis-à-vis investment advisers has significant implications on the jurisprudence governing this field, as it necessitates a reconsideration of the debate surrounding the prescriptive versus proscriptive content of fiduciary obligations. It is essential to bear in mind that the duty of care and the need to act in the best interest of the client foments divisive opinions as it is considered as a specific fiduciary duty in the American jurisprudence, but is not labelled in such a manner in other common law jurisdictions.<sup>61</sup>

Within the academic realm, the classification of duty of care as a fiduciary duty has sparked debate, wherein the dominant discourse favours its treatment as a non-fiduciary tortious duty, similar to the approach followed in common law jurisdictions.<sup>62</sup> Interestingly, the rationale governing such an approach is founded on the belief that fiduciary law is singularly directed towards curbing abuse of discretionary power, and is exhausted by the duty of loyalty.<sup>63</sup>

However, the debate, when placed within the investment adviser regulatory framework, highlights the difficulties with endorsing a strictly-proscriptive view vis-à-vis the content of fiduciary obligations. It is in this context that common law jurisdictions, including Australia,<sup>64</sup> have brought out the concern of policy pragmatism associated with the difficulty of enforcing positive obligations on fiduciaries. Additionally, the discussion has centred around the potential chilling effect of such positive fiduciary standards on entrepreneurial activity.<sup>65</sup> The theorisation of prescriptive obligations has often faced criticisms of uncertain and confusingly expansive articulation, inevitably leading to excessively strict imposition of standards of skill and care.<sup>66</sup> Consequently, such unpredictable regulatory assessment actuates the chilling effect, by pushing financial actors into a damaging state of caution, and by curbing economically desirable conduct in the market.<sup>67</sup>

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*Caveat Emptor! After all the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. Ill. L. Rev. 531, 532-533 (2003).

<sup>61</sup> Paul B. Miller, *A Theory of Fiduciary Liability*, 56 McGill L. J. 235, 282-284 (2011).

<sup>62</sup> *Id.*

<sup>63</sup> *Canson Enterprises Ltd. v. Boughton & Co.*, (1991) 3 SCR 534.

<sup>64</sup> *Breen v. Williams*, (1996) 186 CLR 71.

<sup>65</sup> Beth Nosworthy, *Finding the Fiduciary: Recognition of the Director-Shareholder Relationship in Closely Held Companies*, 54-55 (2013), available at <https://digital.library.adelaide.edu.au/dspace/bitstream/2440/80723/8/02whole.pdf> (Last visited on March 21, 2016).

<sup>66</sup> Thomas Malooney, Paul Lawrence & Angela Hamarich, *Fiduciary Duties, Broker-Dealers and Sophisticated Clients: A Mismatch That Could Be Made Only in Washington*, 3 J. Sec. L. Reg. Comp. 340-341 (2010).

<sup>67</sup> *Id.*

Further, several scholars, including Matthew Conaglen and Darryn Jensen, have emphasised upon the prophylactic nature of fiduciary duties, which require fiduciaries to undertake no positive acts, but to merely refrain from breaching the two central rules – the ‘no profit’ and the ‘no conflict’ rules.<sup>68</sup> Drawing from this school of thought, fiduciary obligations have been conventionally conceptualised within the proscriptive paradigm.<sup>69</sup>

It is in this context that the trustee-beneficiary relationship exists as the only exception, wherein certain positive duties of care are imposed upon the trustee. Drawing from Jensen’s line of argumentation, the determination of fiduciary liability is principally isolated from inquiries into sub-optimal outcomes, since it is impractical to identify an ‘end-position’ to such responsibilities.<sup>70</sup> Jensen’s understanding is rooted in the bias for the proscriptive framework, which tends to guard against entering into subjective questions of reasonable exercise of skill and competence.

Consequently, the imposition of prescriptive duties necessarily requires the judiciary to identify the quantum of benefits to be enjoyed by the beneficiaries (end-position), as a result of the actions of fiduciaries.<sup>71</sup> Similarly, Conaglen endorses a theoretical standpoint, which directs attention towards the rationale governing fiduciary obligations that he describes as “insulating from influences likely to distract from proper performance of the duty-owner’s non-fiduciary duties”.<sup>72</sup>

Such explicit carving out of the dichotomy, between fiduciary liability as proscriptive duties guarding against self-interestedness of fiduciaries, and other positive duties as non-fiduciary duties affecting the beneficiary, needs to be viewed sceptically. It is submitted that the source of such scepticism lies with the application of the ‘best interests’ test in *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*<sup>73</sup> The test, as articulated in this case, adopts a prescriptive approach, requiring the advisers to perform certain positive functions while acting at all times in the best interests of investors. The case illustrates the American inclination towards the ‘best interests’ standard, which explicitly imposes a positive duty to disclose conflicts, and to ensure suitability of securities’ recommendations and ‘best execution’ of client transactions.<sup>74</sup>

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<sup>68</sup> Jensen, *supra* note 31; See also Matthew Conaglen, *The Nature and Function of Fiduciary Loyalty*, 121 L. Q. Rev. 452 (2005).

<sup>69</sup> Robert Flannigan, *The Boundaries of Fiduciary Accountability*, 2004 N. Z. L. Rev. 215 (2004).

<sup>70</sup> Jensen, *supra* note 31, 334.

<sup>71</sup> Lusina Ho & Pey-Woan Lee, *A Director’s Duty to Confess: A Matter of Good Faith*, 66(2) Cambridge L. J. 348-364 (2007).

<sup>72</sup> Conaglen, *supra* note 68, 452-453.

<sup>73</sup> *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 1963 SCC OnLine US SC 206 : 11 L Ed 2d 237 : 375 US 180 (1963).

<sup>74</sup> Laby, *supra* note 8, 718.

The employment of similar language in the SEBI-approved ‘Code of Conduct for Investment Advisers’ (‘Code of Conduct’), under the 2013 Advisers Regulations,<sup>75</sup> has buttressed the argument in favour of introducing prescriptive obligations in the Indian regulatory framework. Such imposition of positive liability standards on investment advisers under the Code of Conduct is a product of regulatory emphasis on inculcating a culture of efficiency in the market. It needs to be appreciated that the expansive scope of prescriptive standards, articulated as a part of this Code, is not a peculiar consequence of the theorisation of fiduciary actors in the market.<sup>76</sup>

With academicians such as Remus Valsan and Paul Finn accounting for a broader formulation of fiduciary duties as a set of both proscriptive and prescriptive obligations,<sup>77</sup> the fiduciary jurisprudence developed in the advisory sphere has garnered support for Rebecca Lee’s proposition that “[...] if the fiduciary does act in a way which may affect the interests of the beneficiary, his fiduciary duty is to act solely towards the enhancement of the interests of the beneficiary, which duty then becomes positive and directional”.<sup>78</sup>

It is critical to note the inherent flexibility pervading the fiduciary jurisprudence, which casts doubt upon the reliability of sponsoring a strictly proscriptive notion of liability. The generic idea of fiduciary duty often includes positive duties of care, confidentiality and candour; yet, the failure to streamline a definite set of such positive obligations has led to scholarly discourse avoiding imposition of the prescriptive paradigm on fiduciaries.<sup>79</sup> Professor Peter Birks, while commenting upon the content of fiduciary obligations, creates an intriguing distinction between two statements, so as to support the prescriptive paradigm - “Trustee’s duty of care is not a fiduciary obligation” and “Trustee’s duty of care is a fiduciary obligation but, is not as such distinguishable from any contractual or non-contractual duty of care”.<sup>80</sup> I seek to argue in favour of the distinction carried out by discussing the rationale governing such differentiation. The second statement supports my argument that a positive duty of care often constitutes the backbone of fiduciary obligations; though it might draw its roots from tortious or contractual standards; yet, this duty can be identified as a fiduciary obligation. It implies that this duty of care is not peculiar to fiduciary

<sup>75</sup> SEBI (Investment Advisers) Regulations, 2013, Schedule III.

<sup>76</sup> See SEBI, *Frequently Asked Questions: SEBI (Investment Advisers) Regulations*, 2013, 7-8 (2014), available at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1424862077270.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1424862077270.pdf) (Last visited on September 24, 2016) (SEBI while clarifying the duties of advisers under the regulatory framework tends to treat the obligation to act in a fiduciary capacity as distinct from the remaining set of commitments to act fairly and honestly while exercising due care and diligence.).

<sup>77</sup> Valsan, *supra* note 50, 43-44; See also Paul D. Finn, *Fiduciary Obligations* 15-16 (1977).

<sup>78</sup> Lee, *supra* note 29, 237.

<sup>79</sup> Valsan, *supra* note 50, 44.

<sup>80</sup> Birks, *supra* note 33, 36-37.

law and enjoys extensive presence in contractual instruments, wherein parties, despite being non-fiduciaries, might impose a similar duty of care.<sup>81</sup>

While Australia and the United Kingdom ('UK') have consistently argued against such integration of positive rules into the content of fiduciary obligations, relying upon the criticisms highlighted before, on the other hand, North America has been noted to have accepted both proscriptive and prescriptive rules.<sup>82</sup> As the SEBI regulations have imposed upon investment advisers certain duties of disclosure, diligence and fairness in treatment,<sup>83</sup> it is argued that such obligations arise "as a direct consequence of their fiduciary role";<sup>84</sup> thus, creating a case against the strict proscriptive school of thought.

Such regulatory treatment of advisory services as fiduciary relationships essentialises the need to address the debate in a nuanced manner by acknowledging the existence of prescriptive duties so as to facilitate a better understanding of the content of fiduciary obligations. The possibility of incorporating a prescriptive notion is a pre-condition to preventing the regulatory framework from stagnating in any jurisdiction.<sup>85</sup>

### III. SCRUTINISING THE CASE FOR UNIFORM APPLICATION OF FIDUCIARY STANDARDS IN THE OPEN MARKET-PLACE

The policy discussion in the US securities market has firmly responded to allegations of 'biased financial advice',<sup>86</sup> by backing the move for uniform application of fiduciary standards. While the regulatory move has been heavily contested, in this chapter, I seek to examine the justifiability of such 'at-par' treatment of advisers and brokers in light of their functional overlap as well as the implications of such an imposition of fiduciary liability.

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<sup>81</sup> Jensen, *supra* note 31, 340.

<sup>82</sup> Andrew Stafford & Stuart Ritchie, *Fiduciary Duties: Directors and Employees 2-3* (2nd ed., 2015).

<sup>83</sup> SEBI (Investment Advisers) Regulations, 1992, Schedule III.

<sup>84</sup> Lionel Smith, *Can we be obliged to be selfless?* in *Philosophical Foundations of Fiduciary Law* 157-158 (2014).

<sup>85</sup> Kelvin Low, *Whither Prescriptive Fiduciary Duties?*, available at <http://www.law.hku.hk/obligationsvii/wp-content/uploads/Low.pdf> (Last visited on March 18, 2016).

<sup>86</sup> Dave Michaels, *SEC Joins Battle on Broker Bias that Could Remake Industry*, Bloomberg, March 17, 2015, available at <http://www.bloomberg.com/news/articles/2015-03-17/sec-will-develop-fiduciary-duty-rule-for-brokers-white-says> (Last visited on March 23, 2016).

## A. *BROKERS AS FIDUCIARIES IN REGULATORY FRAMEWORKS*

Traditionally, brokers have been distinguished from investment advisers as intermediaries who are involved in merely giving effect to securities transactions for others, and who are responsible for the execution but refrain from providing any investment advice.<sup>87</sup> Under the Investment Advisers Act, 1940, there exists an explicit statutorily mandated differentiation, with brokers being defined as individuals who provide such advisory services only if incidental to the conduct of their business and who receive no special compensation.<sup>88</sup>

Additionally, in the Indian context, the SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992 ('1992 Broker Regulations') also recognises the prospect of brokers advising clients in making decisions concerning retention/disposition of certain securities. Use of such broad regulatory language while defining the roles and responsibilities of brokers has caused confusion, blurring the line between these two financial sector participants.<sup>89</sup> It is in this context that academicians have endorsed the stance that unlike investment advisers, brokers do not act in the capacity of financial managers exercising influence over their clients' securities/assets.

The regulatory silence on the question of fiduciary capacity of brokers under the 1992 Broker Regulations, unlike the 2013 Advisers Regulations dealing with investment advisers, is often cited as a reason for academic inclination towards classifying brokers as non-fiduciaries. However, SEBI framed the Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market Regulations, 2003 ('PFUTP Regulations') strictly prohibiting brokers from entering into front-running trade,<sup>90</sup> thereby demonstrating sensitivity to the position of trust and confidence enjoyed by such financial intermediaries.<sup>91</sup> Therefore, it can be argued that regulatory conceptualisation of the role of brokers as market participants operating in a fiduciary capacity has not been rejected out rightly in the Indian securities market jurisprudence.

<sup>87</sup> Lydia Amamoo, *Why Brokers are not Investment Advisers: ERISA's Fiduciary Duty Only Applies to Those Who Provide Investment Advice to Pension Plans*, 9 Cardozo Pub. L. Pol. Eth. J. 119,120 (2010).

<sup>88</sup> Investment Advisers Act of 1940, §80b-2(a)(3).

<sup>89</sup> Donald Langevoort, *Brokers as Fiduciaries*, 71 U. Pitt. L. Rev. 439, 441-442 (2010).

<sup>90</sup> See SEBI PFUTP Regulations, 2003, Reg. 4(2) (Front running refers to- "a practice whereby a securities or commodities trade takes a position to capitalise on advance knowledge of large upcoming transaction expected to influence the market price."); See also John Downes & Jordan Goodman, *Dictionary of Finance and Investment Terms* 330-331 (9th ed., 2014).

<sup>91</sup> Mobis Philipose, *SEBI Should Draft Front Running Rules Carefully*, Livemint, November 26, 2012, available at <http://www.livemint.com/Money/rcYcXDB5srce2MHTknxKK/Sebi-should-draft-front-running-rules-carefully.html> (Last visited on May 27, 2016).

## B. LOCATING THE FIDUCIARY

Interestingly, the argument surrounding influence is heavily rooted in the understanding of fiduciary powers theory, as proposed by Paul Miller, which locates elements of a fiduciary relation in advisory interactions.<sup>92</sup> As discussed before, his theory assists in identifying the elements of trust, confidence and discretion, which are central to the functioning of investment advisers as fiduciaries in the securities market. Utilising this model, I attempt to demonstrate the manner in which these elements have gradually assumed criticality in client-broker interactions, thus challenging the traditional conception of a broker merely yielding to the directions or influence of its client.

The US SEC has often reported instances of brokers avoiding official titles of investment advisers, by facilitating sale of diverse services with minimal liability, thus creating a systemic foundation for the prevalence of such malpractices.<sup>93</sup> Furthermore, there has been a visible rise in brokerage programs integrating non-brokerage activities, including provision of advice, which highlights the gradual convergence between the execution and advisory segments of business in this sector.<sup>94</sup> It is critical to note that advisory services have assumed centrality in the brokerage industry, and have ceased to be solely incidental to the daily order of business, which further raises concerns surrounding the neutrality of recommendations by brokers.<sup>95</sup>

Such transgression of brokers into roles traditionally performed by the investment advisers has had a larger implication on the financial market, by creating ‘crossover of job functions’.<sup>96</sup> In *Wald v. Financial Marketplace Securities LLC*,<sup>97</sup> the respondent was registered as a brokerage fund, yet it assisted the appellant with such a wide range of services that the latter was under the impression that the respondent was his ‘financial and investment advisor’.<sup>98</sup> While the Court refused to grant legitimacy to such an ill-informed opinion of the client regarding his transactions with the respondent, it was observed

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<sup>92</sup> Miller, *supra* note 9.

<sup>93</sup> For the purposes of regulatory convenience, the presumption has always been in favour of exempting brokers from fiduciary duties as long as they retain their official title as brokers. Relying on this, the brokers have avoided officially associating themselves with the investment advisory market segment by claiming that the non-brokerage activities carried out are a by-product of their brokerage services, despite exercising significant influence over their client’s investment decision making. See Amamoo, *supra* note 87, 125.

<sup>94</sup> John Wasik, *Merrill Rule: a Bad Deal for Individual Investors*, Bloomberg, August 2, 2004, available at [http://www.sddt.com/News/article.cfm?SourceCode=20040802ff&\\_t=Merrill+rule+a+bad+deal+for+individual+investors#.WE24nOZ942w](http://www.sddt.com/News/article.cfm?SourceCode=20040802ff&_t=Merrill+rule+a+bad+deal+for+individual+investors#.WE24nOZ942w) (Last visited on March 25, 2016).

<sup>95</sup> Francis J. Facciolo, *Do I have a Bridge for You: Fiduciary Duties and Investment Advice*, 17 U. Penn. J. Bus. L. 101, 108 (2014).

<sup>96</sup> Amamoo, *supra* note 87, 135.

<sup>97</sup> *Wald v. Financial Marketplace Securities LLC*, 2009 WL 3209930.

<sup>98</sup> Amamoo, *supra* note 87, 136.

that clients who are inept to understand the nuances of their business relations often rely on advice provided by brokerage firms, thus enabling such brokers to charge for a wide range of activities and yet to evade fiduciary liability.<sup>99</sup>

Additionally, the rise of ‘advisory brokers’ in India, coupled with the upsurge in asset-based fees in this sector, has further reduced the operational gap between advisers and brokers.<sup>100</sup> Responding to such market reorientation, and reacting to the role played by brokers in the NSEL Scam, SEBI officials have publicly conceded to the need for better regulatory oversight in light of the crucial function of risk management carried out by these financial market participants.<sup>101</sup>

Cognizant of the advent of advisory operations vis-à-vis the traditional functioning of brokers, the need for placing responsibility on them via application of uniform fiduciary standards in cases of default has assumed unprecedented prominence. It is in this context that institutions such as the National Institute of Securities Market, involved in educating securities market participants in India, have also characterised the importance of fiduciary duty as a precondition to adequate protection of client interests in their interactions with brokers.<sup>102</sup>

In light of such transformation in broker operations, regulatory bodies have commented that “retail customers today see little difference between a broker and an adviser”.<sup>103</sup> Drawing from the discussion above, it is submitted that the broker-client relationship, in contemporary times, has risen above the rendering of execution services, and has paved its way into the advisory sector. While mere provision of advice does not warrant application of fiduciary standards, scholars such as Arthur Laby have hinted at an inquiry into granting of informal discretion by customers to their brokers.<sup>104</sup> Such examination reveals that brokers often exercise effective control over their clients’

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<sup>99</sup> *Id.*

<sup>100</sup> Rajesh Mascarenhas & Baiju Kalesh, *India Infoline to Wind up Retail Broking Unit; to Focus on Advisory-Based Services*, October 26, 2013, available at [http://articles.economicstimes.indiatimes.com/2013-10-26/news/43415769\\_1\\_broking-business-chairman-nirmal-jain-iifl](http://articles.economicstimes.indiatimes.com/2013-10-26/news/43415769_1_broking-business-chairman-nirmal-jain-iifl) (Last visited on March 25, 2016).

<sup>101</sup> Palak Shah, *SEBI to Probe Brokers, Check for Fund Diversion*, Economic Times, August 2, 2013, available at [http://articles.economicstimes.indiatimes.com/2013-08-02/news/41008342\\_1\\_nsel-brokers-commodity-segment](http://articles.economicstimes.indiatimes.com/2013-08-02/news/41008342_1_nsel-brokers-commodity-segment) (Last visited on May 23, 2016).

<sup>102</sup> NISM Certification, *Job-Profile: Broker/Dealer*, available at <http://nism.ac.in/certification/index.php/careers-and-jobs-in-indian-securities-markets/broker-deale> (Last visited on May 24, 2016).

<sup>103</sup> Mary L. Schapiro, *Testimony Concerning Enhancing Investor Protection and Regulation of Securities Markets, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, March 26, 2009, available at <http://www.sec.gov/news/testimony/2009/ts032609mls.htm> (Last visited on March 25, 2016).

<sup>104</sup> Laby, *supra* note 8, 715-716.



accounts, thus enjoying discretionary trading authority, without any corresponding legal instrument recognising such delegation formally.<sup>105</sup>

In the strict legal sense, it has been argued that a client cannot rely upon a broker's recommendation/advice on securities, yet the level of trust reposed in brokers that has evolved over time necessitates regulatory regimes to respond to the changing market practice. Since the task of outlining brokers' fiduciary duties has assumed an ad-hoc nature, cases on the lines of *O'Malley v. Boris*<sup>106</sup> have shed light upon instances of effective control being exercised by brokers on their clients' accounts. In this case, the respondent acted as any traditional broker with minimal investment-making authority. Subsequently, it was given control to choose a 'sweep' account<sup>107</sup> for their clients, thus enabling the respondent to direct excess cash in the brokerage account to more lucrative investment avenues. Responding to such a fact situation, the Court ruled in favour of the plaintiff, treating the brokers as fiduciaries, thereby imposing on the respondent the fiduciary duty of disclosure concerning any conflict of interest related to the choice of the sweep account.<sup>108</sup>

Contextualising the theoretical approach endorsed by Paul Miller and Lionel Smith, such crossover of operations has been emphasised as the essential characteristic of the "mutual conferring and acceptance of power"<sup>109</sup> within broker-client relationships. Such exchange of power is illustrated by the gradual willingness of clients to concede their investment discretion vis-à-vis allocation of funds in favour of their brokers. The regulatory bodies ought to be wary of the willingness of brokers to accept such ceding of effective power by clients.<sup>110</sup> Such transfer of power inevitably results in the employment of advisory interactions as tools to alter investor decision-making autonomy, which only serves to make the case for a uniform application of fiduciary standards stronger.

Utilising this approach, it is submitted that the nature of broker advice has attracted the concept of Hohfeldian powers,<sup>111</sup> wherein brokers

<sup>105</sup> See *Cruse v. Equitable Securities of New York, Inc.*, 678 F Supp 1023 (SDNY 1987), ¶1030-31.

<sup>106</sup> *O'Malley v. Boris*, 742 A 2d 845, 849 (Del. 1999).

<sup>107</sup> It refers to accounts wherein cash below/above a certain level is "swept" into money market funds at the end of each business day. See Cullen Roche, *When You Should Hold Cash in Your Brokerage Account*, Market Watch, March 13, 2015, available at <http://www.marketwatch.com/story/when-you-should-hold-cash-in-your-brokerage-account-2015-03-13> (Last visited on September 27, 2016).

<sup>108</sup> *O'Malley v. Boris*, 742 A 2d 845, 849 (Del. 1999).

<sup>109</sup> Miller, *supra* note 9.

<sup>110</sup> *Id.*

<sup>111</sup> The concept was propounded by Wesley Newcomb Hohfeld to scrutinise the juridical relationship between parties within the rights-duties framework. It discusses the correlativity of power-liability wherein power refers to authority derived/sanctioned in law enabling one party to impact the legal position or relationship of another. Such exercise of power justifies the need to establish a corresponding liability mechanism. See Miller, *supra* note 9, 71.

acting as fiduciaries execute transactions as well as influence the buying and selling decisions of the holders of securities.<sup>112</sup> While often treated as a juridical construct, the concept is useful in examining the nature of powers enjoyed by brokers who transgress into the advisory sector, thereby enabling them to alter their client's trading relations. Consequently, the application of this concept reveals the constantly evolving legal capacity of brokers in the capital market, wherein their role has become strikingly similar to the investment advisers.<sup>113</sup>

Such enjoyment of operational autonomy, traditionally unknown to brokers, has accentuated the debate surrounding the application of the 'best interests' standard within the fiduciary framework.<sup>114</sup> Considering that brokers are increasingly using their discretionary influence to guide investors' decision-making in a direction which favours their personal financial interests, the commission-based model<sup>115</sup> for these financial intermediaries has further fuelled the cause of policy reformulation.

On the other hand, academic discourse on this issue has argued that the main objectives of brokers differ significantly from those of investment advisers, and that the different levels of training required for the two professions justify variegated application of liability standards.<sup>116</sup> Despite such criticism of the proposed move, I find merit in a uniform application of fiduciary standards, and will scrutinise the objectives sought to be achieved as well as the potential difficulties associated with its implementation, moving beyond the current theoretical discourse.

### C. ESSENTIALISING GOALS OF INVESTOR PROTECTION

It is critical to note that the rationale governing such imposition of fiduciary obligations can be traced to its content, which essentialises virtues of loyalty and preventing deceitful conduct, and emphasises on the high agency costs<sup>117</sup> associated with advisory activities. Drawing from the predominantly

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<sup>112</sup> Smith, *supra* note 19, 618.

<sup>113</sup> *Id.*, 619.

<sup>114</sup> Bressler, Amery & Ross PC, *FINRA Supports the SEC's Uniform Fiduciary Standard over the DOL's Approach, But the Debate is Far from Over*, May 28, 2015, available at <http://www.lexology.com/library/detail.aspx?g=50b9fb1d-a91b-41a8-88b3-be52523cc907> (Last visited on March 25, 2016).

<sup>115</sup> Under this model, the financial intermediary receives compensation depending on the transactions executed by their clients vis-à-vis financial products sold by a particular company. See John Robinson, *Who's the Fairest of them all? A Comparative Analysis of Financial Advisor Compensation Models*, January, 2006, available at <http://www.hwm.wfadv.com/files/15310/Microsoft%20Word%20-%20Who's%20the%20Fairest%20-%20Compliance%20Version%20Jul09.pdf> (Last visited on September 23, 2016).

<sup>116</sup> Amamoo, *supra* note 87.

<sup>117</sup> It refers to the cost of managing the relationship and resolving any conflicts of interest. See Joseph H Golec, *Empirical Tests of a Principal-Agent Model of the Investor-Investment*

proscriptive nature of fiduciary obligations, their importance lies in the difficulty in determination of self-interest vis-à-vis investment recommendations by brokers.<sup>118</sup>

Since its inception, the SEBI Act has ensured that the regulatory focus is maintained on the issue of investor protection, with the Preamble and §11(1) of the Act explicitly placing the duty of furthering and protecting interests of investors in securities on the regulatory body.<sup>119</sup> Under §11(2)(b) of the SEBI Act, the Board has been placed with the responsibility to regulate the functioning of stock brokers and sub-brokers, which is often viewed as a function branching out of the primary regulatory obligation to maintain fair market practices in light of the rising involvement of retail investors.<sup>120</sup> In the Indian context, the argument for application of uniform fiduciary standards to brokers and advisers is linked to the manner in which the securities market's investor composition has gradually transformed over the last two decades.<sup>121</sup>

The Harshad Mehta and Ketan Parekh scam, which garnered attention in the 1990s, exemplified the manner in which stock brokers, as financial intermediaries, resorted to unethical activities exploiting their suspicious connections with banks. Utilising fraudulent inter-bank transactions, the brokers engaged in heavy buying of stocks driving up the price, thereby creating a short-term bubble only to sell at high profits causing the markets to ultimately crash.<sup>122</sup> Such market manipulation practices, which exponentially increased the risk of uncertainty linked to capital markets, became a major deterrent to investment in the market.<sup>123</sup> Despite the institutionalisation of SEBI and several other legislative measures, reports prepared by Neelamegamand Srinivasan, D. Sakriya and Delhi-based Society for Capital Markets have highlighted the declining confidence of retail investors in the market.<sup>124</sup>

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*Advisor Relationship*, 27 J. of Fin. & Quant. Ana. 81, 83-84 (1992).

<sup>118</sup> Laby, *supra* note 8, 738.

<sup>119</sup> Preamble of the SEBI Act, 1992 states as follows- "An Act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto."; See also The SEBI Act, 1992, §11(1) which states as follows- "Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit".

<sup>120</sup> The SEBI Act, 1992, §11(2).

<sup>121</sup> K. Balanaga Gurunathan, *An Investors' Requirements in Indian Securities Market*, 8 Delhi Bus. Rev. 31, 33-34 (2007).

<sup>122</sup> Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 N. Eng. J. Int'l & Comp. L. 238 (2006).

<sup>123</sup> *Id.*, 36.

<sup>124</sup> See R. Neelamegam & R. Srinivasan, *Investors' Protection: A Study of Legal Aspects* (1st ed., 1996); See also D. Sakriya, *SEBI and Securities Market in India* (1st ed., 2000); See also N. Gopalsamy, *Capital Market: The Indian Financial Scene* 268-276 (2005).

In a developing economy like India, the issue of investor protection assumes greater importance due to a greater proportion of unsophisticated retail investors holding a stake in the market. Such inexperienced investors are often more vulnerable to being defrauded by financial intermediaries functioning as private agencies.<sup>125</sup> It is in this context that the policy move to extend fiduciary liability to brokers can be treated as a mechanism to institutionalise principles of corporate accountability and ethics within the domestic capital markets regime.<sup>126</sup>

As brokers have gradually started enjoying greater visibility in the advisory segment, the integrity of capital markets can be potentially compromised, and it is this impending moral hazard that regulatory bodies need to urgently respond to. While the rhetoric of overregulation is theorised as an instrument imposing a chilling effect on market activities, the question of autonomy and power granted to brokers rendering advisory services is linked to concerns of investor protection and fiduciary obligations. In the given scheme of affairs, Donald Langevoort best describes securities regulation as a measure to close down the investor ‘expectation gap’ created by the issuer of securities.<sup>127</sup> Such a gap reflects a confidence crisis plaguing the market, and brings out the inadequacy of auditing, corporate filings and current market mechanisms as reliable correctives.<sup>128</sup>

The securities market continues to suffer from an expectation gap so far as investor protection is concerned, and such a deficit will only augment, if the issue of brokers advising investors in a self-interested manner - moving beyond conventional boundaries of execution - remains unaddressed.<sup>129</sup> It is submitted that a uniform fiduciary standard regime vis-à-vis brokers and advisers relies upon the premise that “[i]nstitutional fiduciaries are especially unlikely to take legal risks, because they face personal risk [...]”<sup>130</sup>

#### D. EVALUATING THE COURSE OF IMPLEMENTATION

While the recent suggestions calling for extension of fiduciary obligations to broker operations have generated diverse opinion, it is essential to note that the traditional regulatory approach in several jurisdictions has not completely refrained from such treatment of brokers as fiduciaries. In the UK,

<sup>125</sup> Bharati Pathak, *The Indian Financial System: Markets, Institutions and Services* 108-109 (3rd ed., 2010).

<sup>126</sup> *Id.*

<sup>127</sup> Donald Langevoort, *Managing the Expectations Gap in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 Vill. L. Rev. 1139, 1141-1142 (2003).

<sup>128</sup> Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 University of Chicago Law Review 1233, 1240-1241 (2002).

<sup>129</sup> *Id.*, 1139.

<sup>130</sup> Bernard Black, *Shareholder Passivity Re-Examined*, 89 Mich. L. Rev. 520, 531 (1990).

an Act titled 'An Act to Restrain the Number and Ill Practice of Brokers and Stock-Jobbers' was passed in 1697, requiring brokers to guard against any conflict of interest and to undertake obligations similar to the contemporary fiduciary content.<sup>131</sup> Furthermore, in the US jurisprudence, the historical approach has supported this view, with the 1861 case of *Conkey v. Bond*<sup>132</sup> holding that a broker is liable for breach of fiduciary duty by being positioned in a relationship of agency.<sup>133</sup>

Drawing from the studies of William Herman Black, brokers have been known to not just execute client's instructions, but also to enjoy the entrustment of their assets, thus requiring an application of the relevant standards of loyalty.<sup>134</sup> However, in the latter half of the 20th century, the discourse surrounding such utilisation of fiduciary standards was side-lined in order to ensure financial discipline amongst brokers, owing to the prominence of the 'shingle theory' and 'suitability standard'.<sup>135</sup> Interestingly, the theory was introduced as a modern regulatory rule in 1930s by the US SEC and implied that "when a broker [...] solicits business, he is impliedly representing that he will deal fairly and openly with the prospective investors."<sup>136</sup> This theory emphasised upon reasonability of conduct, thus essentialising investor protection and disregarding concerns of proving fiduciary relations. American courts have adopted a similar approach and disengaged themselves from enquiries of fiduciary obligations in broker-client relations.<sup>137</sup> In the American jurisprudence, the suitability standard, which requires brokers to transact only in those securities which are suitable to the client, now forms a crucial component of the modern approach to treatment of brokers as fiduciaries as it places implied obligations of due diligence.<sup>138</sup> Consequently, it is submitted that such theories are not rooted in federal securities law, and have contributed to the resultant ambiguity arising vis-à-vis the determination of the central question – Whether brokers are fiduciaries?<sup>139</sup>

It is in this context that subjectivity has plagued judicial analysis wherein courts have determined this question on a case-to-case basis, by scrutinising the nature of client-broker interaction, degree of discretion delegated and reliance of the investor on the advice provided.<sup>140</sup> Unfortunately, the current SEBI Regulations dealing with brokers refrain from engaging in

<sup>131</sup> Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots 1695-1696* (1998).

<sup>132</sup> *Conkey v. Bond*, 36 NY 427 (1867).

<sup>133</sup> Laby, *supra* note 8, 720.

<sup>134</sup> *Id.*

<sup>135</sup> Weiss, *supra* note 20, 88-89.

<sup>136</sup> Amamoo, *supra* note 87, 129-130.

<sup>137</sup> *Id.*

<sup>138</sup> Weiss, *supra* note 20, 96-97.

<sup>139</sup> Facciolo, *supra* note 95, 104-105.

<sup>140</sup> *Lefkowitz v. Smith Barney, Harris Upham & Co., Inc.*, 804 F 2d 154, 155 (1st Cir 1986); *See also Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F 3d 1293 (2nd Cir 2002).

classification of brokers as fiduciaries and place minimal obligations on these financial actors.<sup>141</sup>

While the PFUTP Regulations attempt to prevent brokers from adversely affecting investors by imposing sanctions for manipulation/deceit,<sup>142</sup> it does nothing to rebut the assumption of brokers as non-fiduciaries whose activities are restricted to merely executing transactions. The consequence of such an approach, which clearly differentiates between the roles of investment advisers and brokers, has led to the formation of these regulations which fail to recognise the market realities.

In the application of this framework, SEBI has continued to hold on to the belief that “[...] brokers act on the advice of their clients [...]”<sup>143</sup> and any advice offered by brokers to clients continues to be treated as non-binding and uninformative in nature, thereby not possessing the potential to reveal situations of conflict of interests. Subsequently, the utility of the ‘no conflict’ and the ‘no profit’ rules, exposing the peculiarities of fiduciary relations, remains alien to the manner in which the regulations have been traditionally applied to broker operations.

On the other hand, Indian High Courts<sup>144</sup> have entertained the theoretical possibility of treating stock brokers as fiduciaries. Further, the Central Information Commission in *Monica and Priyanka Jain v. SEBI*<sup>145</sup> imported principles of a fiduciary relationship to deal with the request for information exchanged between the broker and the client. In this case, the appellants pleaded SEBI to grant them access to information privately held by the brokers in question. In the recent 2016 case of *SEBI v. Kishore Ajmera*<sup>146</sup>, the brokers and sub-brokers in question were charged for fraudulent practices while engaging in unnatural trading of illiquid scrips, causing an abnormal inflation in the market. The Supreme Court gave effect to the concept of investor protection, thus compelling brokers to subscribe to a higher threshold of duty of care. The academic discourse surrounding this issue has rightly noted the paradoxical nature of the situation. It is noted that the Securities Appellate Tribunal in the past has also applied standards of reasonable skill and care to broker operations in securities market.<sup>147</sup> Further, scholars such as John Biggs have commented upon the dichotomous manner in which the ambivalence of regulatory

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<sup>141</sup> See generally SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992.

<sup>142</sup> SEBI PFUTP Regulations, 2003, Regs. 3, 4.

<sup>143</sup> See Securities Appellate Tribunal (Mumbai), *Triumph International Finance Ltd. v. SEBI*, 2007 SCC OnLine SAT 24.

<sup>144</sup> *V.M. Francis v. Central Bank of India*, 1990 SCC OnLine Ker 245 : (1990) 2 KLT 983, ¶15.

<sup>145</sup> *Central Information Commission, Monica v. SEBI*, 2009 SCC OnLine CIC 14115, ¶3.

<sup>146</sup> *SEBI v. Kishore R. Ajmera*, (2016) 6 SCC 368.

<sup>147</sup> *Sharedeal Financial Consultants (P) Ltd. v. SEBI*, 2003 SCC OnLine SAT 18 : (2003) 4 Comp LJ 148.

bodies such as SEBI on this issue has led to brokers satisfying a higher professional standard, whilst successfully arguing against the application of fiduciary principles.<sup>148</sup>

There is thus an urgent need to realign the framework governing brokers and advisers in the Indian context to eliminate such a paradox. The limited and fickle jurisprudence on this subject has highlighted the inherent complexity, and the necessity for the policy move to uniformly apply fiduciary standards to advisers and brokers.

#### IV. EXISTING LOOPHOLES IN THE PROPOSAL: FINDING A WAY FORWARD

Despite the optimism surrounding the extension of fiduciary liability to brokers, one needs to be cautioned against the complicated actualisation of fiduciary principles within the existing regulatory framework for brokers. Currently, the 1992 Broker Regulations delineate the basic roles and responsibilities for brokers by requiring them to maintain accounts/records to efficiently execute client orders and to prevent any conflicts.<sup>149</sup>

However, the practical application of the proposal to uniformly apply fiduciary standards to advisers and brokers possesses the potential for causing excessive indeterminacy. Its impact can expose brokers to the risks of regulatory uncertainty, as they continue to remain unaware of the implications of scrutinising their daily operations as per fiduciary standards. Such a leap of faith, espoused in the American regulatory context, has attracted criticism on the grounds of indeterminacy.

While arguing against the blanket application of fiduciary norms, scholars such as Barbara Black have highlighted the grossly open-ended and ad-hoc framework that articulates the obligations imposed on brokers, which can further generate inefficient results for the stock market.<sup>150</sup> Considering the cost of fiduciary language and in light of its ambiguity and inability to systematically lay down consistent liability standards, there is an urgent need to display regulatory clarity while effectuating this 'one rule fits all' method.<sup>151</sup>

Through the proposed statutory treatment, the regulatory intent can be understood on the lines of a 'blanket liability scheme', with a view to significantly reduce the monitoring and enforcement costs associated with the

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<sup>148</sup> John H. Biggs & Matthew Richardson, *Modernising Insurance Regulation* 250-251 (2014).

<sup>149</sup> See SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992, Chapter IV.

<sup>150</sup> Barbara Black, *Brokers and Advisers- What's in a Name?*, 11 *Fordham J. Corp. & Fin. L.* 31, 32-33 (2005).

<sup>151</sup> Malooney, *supra* note 66, 340-341.

activities of such financial intermediaries.<sup>152</sup> It has been argued that such application of fiduciary liability would enable regulatory bodies such as SEBI to refrain from engaging in an expensive fact-finding process, with the assumption being in favour of brokers acting as advisers. However, it is the inherent vagueness of the suggested reform which raises concerns about its enforcement.<sup>153</sup>

Contextualising this issue, it is submitted that such ambiguity surrounding the proposal garners criticism in the policy-oriented discourse on two levels.

*First*, the impact of such application of fiduciary liability can potentially be felt by brokers who have stuck to the conventional operational boundaries of execution and have consciously refrained from providing investors with any advice.<sup>154</sup> Recognising the limitations of distinguishing advisory brokers from execution brokers owing to the similarity in their day-to-day operational patterns, the dual hazards generated in the process can be identified as increased investor confusion and burdensome litigation for rule-abiding brokers.<sup>155</sup>

*Second*, scholarly discourse has commented upon the redundancy of open-ended fiduciary principles in light of the ability of beneficiaries and fiduciaries to enter into alternate contractual arrangements defining such liability in a more precise form.<sup>156</sup> However, it is necessary to be cautioned against such fiduciary contractualism, characterised as the “shallow efforts of lawyers’ economics”.<sup>157</sup> This approach posits that fiduciary duties are duties possessing no special moral footing, and trace their origin and enforcement value from the contractual instrument, just like any other contractual undertaking. It is necessary to transcend such a simplistic perspective, as the rationale governing application of fiduciary liability is clearly distinguishable from contractual agendas.<sup>158</sup>

Drawing from the academic discussion on this subject, the instrument of fiduciary principles has been traditionally relied upon by courts to plug contractual gaps so as to promote the interests of the beneficiary, who is usually viewed as the weaker party.<sup>159</sup> In contrast to such an approach, a con-

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<sup>152</sup> Amamoo, *supra* note 87, 152.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*, 153.

<sup>155</sup> David King, *Key Issue in Industry: How Advisers are Paid*, Investment News, October 18, 2009, available at <http://www.investmentnews.com/article/20091018/REG/310189989> (Last visited on May 15, 2016).

<sup>156</sup> Facciolo, *supra* note 96, 108-109.

<sup>157</sup> Scott FitzGibbon, *Fiduciary Relationships are not Contracts*, 89(2) Marq. L. Rev. 306-309 (1999).

<sup>158</sup> *Id.*

<sup>159</sup> James Gordley, *Equity in Exchange*, 69 Cal. L. Rev. 1587-1588 (1981).



tractual arrangement places both parties at equal footing, and is indifferent to the perceivable variance in the degree of power enjoyed by the beneficiary, and that of the fiduciary that influences the former's decision.<sup>160</sup>

A scrutiny of such transactional power-play helps in delineating the principle of informational asymmetry,<sup>161</sup> which is reflected in broker-client relations, and forms the fundamental basis for application of fiduciary standards, so as to counter such differential positioning in the capital markets. On the other hand, Richard Posner rightly points out that, on a theoretical plane, contract law does not require parties to behave altruistically towards one another, as the field of law does not endorse the philosophy that "I am my brother's keeper", unlike the fiduciary jurisprudence.<sup>162</sup>

Trotting along the lines of market efficiency vis-à-vis application of fiduciary obligations, Nathaniel Graham has questioned whether forcing brokers to adhere to fiduciary standards can generate positive economic outcomes.<sup>163</sup> Reports have suggested that application of fiduciary liability has not trickled down to professional ethics of advisers, as they continue to result in more cases of misconduct.<sup>164</sup> Such a finding challenges the fundamental assumption of investor protection guiding the move for uniform application of fiduciary standards.<sup>165</sup> With findings continuing to suggest that the rate of complaints is higher, owing to the varied range of products and services offered by advisers as opposed to brokers, the 'investor protection' justification for the regime change has been questioned.

However, it is submitted that the criticism has primarily been directed towards imposition of positive obligations of 'duty of care' and 'best interests' standards, which continue to occupy a controversial place even in discussions concerning investment advisers. The paper argues in favour of a cautious application of fiduciary liability to brokers engaging in advisory services, and it is in this context that a stage-by-stage application of universal fiduciary standards is endorsed.

It is also essential to implement regulatory changes, taking into account the sensitivity of the market in which parties operate. As a result, the level of sophistication significantly differs in American securities market, when

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<sup>160</sup> *Id.*

<sup>161</sup> This refers to situations of difference in the quality and the quantity of information possessed by various stakeholders in the market. See PM Healy & Krishna Palepu, *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of Disclosure Literature*, 31 J. Acc. & Eco. 406-407 (2001).

<sup>162</sup> See *Original Great American Chocolate Chip Cookie Co., Inc. v. River Valley Cookies Ltd.*, 970 F 2d 273, 280 (7th Cir 1992).

<sup>163</sup> Graham, *supra* note 6.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

compared to the regime followed in the Indian context.<sup>166</sup> There is a stronger case for importing fiduciary liability to brokers in the domestic capital markets, as the implementation of such norms can encourage participation of unsophisticated retail investors by safeguarding them against several transactional risks.<sup>167</sup>

There continues to be discernible regulatory uncertainty on the subject of application of fiduciary liability standards on brokers, with SEBI failing to address the theoretical distinction between advisory roles and mere execution roles which are performed by financial intermediaries. The recent judgment of the Supreme Court in *SEBI v. Kishore R. Ajmera*<sup>168</sup> clarified that the Code of Conduct, attached to the 1992 Broker Regulations, requires such brokers and sub-brokers to adhere to the highest standards of financial integrity.

With the judicial opinion on this subject heavily inclined towards characterising broker-client relations as fiduciary, the advisory-execution distinction, although not entirely distinct, has definitely exposed the gap in the current regulatory framework.<sup>169</sup> In order to guard against the prospective ill-effects of an uncertain investor sentiment, there is an urgent need for the judiciary and the regulatory framework to arrive at a common point, and to conclusively settle this debate. While Schedule VII attached to the 1992 Broker Regulations comprehensively articulates the range of duties that brokers owe generally and specifically to their clients, as well as to other stock brokers,<sup>170</sup> it is essential to explicitly capture the question of fiduciary capacity within the current regulatory regime. I seek to suggest changes at two levels.

*First*, as far as the Code of Conduct<sup>171</sup> is concerned, the language of duties of brokers to investors requires to be amended as follows:

“7. Investment Advice: A stock-broker cannot make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities if the brokers feels appropriate to do so based on information of the client relating unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The stock-broker should seek such information

<sup>166</sup> *Id.*

<sup>167</sup> Steven D. Irwin, Scott A. Lane & Carolyn W. Mendelson, *Wasn't my Broker Always Looking out for my Best Interest?: The Road to Become a Fiduciary*, 12 Duq. Bus. L. J. 50-51 (2009).

<sup>168</sup> *SEBI v. Kishore R. Ajmera*, (2016) 6 SCC 368.

<sup>169</sup> See Biggs, *supra* note 148, 200-210.

<sup>170</sup> SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, Schedule VII.

<sup>171</sup> *Id.*, Schedule II.

from clients, whenever deemed necessary he feels it is appropriate to do so.”

The rationale governing this change is that it responds to the current market practice of ascendancy of advisory brokers. Such normalcy of brokers rendering advisory services has prompted the author to argue in favour of its treatment as an activity in the ordinary course of business for the purposes of monitoring. In the current model Code of Conduct, SEBI, as a general rule, rejects the idea of brokers advising clients on matters of investment. It is in this context that the use of the word ‘can’ clarifies that brokers who continue to operate within the traditional boundaries of providing execution services will not be attracting liability standards, following the abovementioned proposed duty.

*Second*, as far as General Obligations and Responsibilities laid down in Chapter IV is concerned, I propose amending Regulation 17 of the 1992 Broker Regulations<sup>172</sup> to introduce the following provisions-

“Regulation 17(1): A broker while making recommendations shall act in a fiduciary capacity towards its clients and shall disclose all conflicts of interests as and when they arise.”

“Regulation 17(2): A broker shall not receive any consideration by way of remuneration or compensation or in any other form from any person other than the client being advised, in respect of the underlying products or securities for which advisory services are provided.”

Through the abovementioned regulatory amendments, I seek to counter the much discussed pitfalls of the ‘one size fits all’ approach. Recognising the enforcement costs associated with imposing fiduciary standards, it is critical to not engage in an overambitious overhauling of the current regime. Hence, the use of the qualifier ‘while making recommendations’ represents a cautious attitude, as I seek to ensure that the regulatory classification of brokers as fiduciaries, in its initial phase, restricts itself to only acts involving them acting in an advisory capacity. Such an approach is reflective of the theoretical position endorsed by the ‘crossover of job operations’ model, as witnessed in the current market operations, wherein brokers are invariably providing a wide range of services assuming the role of an advisor, thus giving effect to the ‘mutual conferral and acceptance of power’ discussed above.

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<sup>172</sup> *Id.*, Reg. 17 (The regulation requires every stock broker to keep and maintain books of account, records and documents such as register of transactions, clients ledger; cash book, bank pass book, written consent of clients, etc. Furthermore, there is a duty on the stock broker to intimate SEBI of the place where the books of account, records and documents are maintained and furnish the same at the close of each accounting period if so required within the stipulated duration.).

It is critical to appreciate that investment advisers in their daily course of business always reflect shades of a fiduciary relationship, unlike brokers who are usually theorised as non-fiduciary financial intermediaries responsible for giving effect to client instructions. The language of the proposed Regulation 17(1) attempts to strike a balance between protecting interests of investors, who are vulnerable to exploitative practices of advisory brokers, while preventing it from wreaking havoc on rule-abiding brokers. Such differentiated treatment of the two sets of brokers find support in Paul Miller's 'fiduciary powers theory', which justifies strict imposition of fiduciary obligations in cases where one party reposes an ascertainable level of faith, trust and confidence in the decision-making of the other party.<sup>173</sup> In the prevailing scheme of affairs, rule-abiding brokers would theoretically fail to act in a substitutive legal capacity vis-à-vis their clients, thus enjoying the degree of discretion necessitating their regulatory treatment as fiduciary actors.

Furthermore, on the issue of disclosure, I seek to rely on Professor Lawrence A. Hamermesh's analysis on this subject, who argues that the positive act of disclosure finds relevance in transactions attracting conflict *vis-à-vis* fiduciaries, which concern the breach of the duty of loyalty.<sup>174</sup> Utilising this finding, it has been argued that the origin of duty of disclosure is "rooted in the fiduciary duty of loyalty", and forms a crucial component of the proscriptive model.

Trotting along similar lines, Regulation 17(1), while emphasising upon the value of disclosing any conflict of interest to client, leaves a lot for the judiciary to interpret and determine, thus generating concerns surrounding unpredictable rule-making. While the fiduciary jurisprudence is underdeveloped in India, the role of cross-jurisdictional borrowing cannot be overstated in such circumstances, considering the 2004 UK Case of *Item Software (UK) Ltd. v. Fassihi*,<sup>175</sup> which extensively discusses such duty of disclosure, in the context of disclosure of misconduct by a director. In this case, the respondent was the sales and marketing director of the appellant company, and conducted negotiations with a third party concerning the renewal of an agreement. However, during the course of such negotiations, the respondent independently approached the same third party with more favourable terms, and failed to disclose this fact to the appellant company.<sup>176</sup> The Court of Appeal ruled that the duty of disclosure was to be imposed on the director, with the intent of ensuring that the fiduciary does not undertake activities prejudicing the interests of the beneficiary, thus centralising the virtue of 'single-minded loyalty'.<sup>177</sup>

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<sup>173</sup> Miller, *supra* note 9, 36-37.

<sup>174</sup> Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49(5) Vand. L. R. 1091-1092 (1996).

<sup>175</sup> *Item Software (UK) Ltd. v. Fassihi*, 2004 EWCA Civ 1244.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

Such a standard, requiring fiduciaries to disclose any conflict of interest capable of adversely affecting their beneficiaries, and of compromising the value of loyalty which is central to such relationships, can also be adopted in the Indian scenario. I seek to utilise this amendment to effectuate regulatory cognizance of the duty of disclosure as an integral component of fiduciary jurisprudence, which can gradually pave the way for the prescriptive school of thought in the domestic context. It is such imposition of *prima facie* positive duties within the prescriptive framework - which has also garnered support from Remus Valsan and Paul Finn - that can enable SEBI to achieve the intended objective of institutionalising principles of integrity, ethicality and efficiency in the modern capital markets regime.<sup>178</sup>

Through this provision, I am sponsoring an approach within the proscriptive paradigm, placing the duty on brokers to refrain from “intentionally prejudicing their client’s interest while ensuring benefits continue to accrue for them via third party payments.” It is to be noted that the contribution of judicial determination in regulating securities market will assume unprecedented prominence due to the circumstantial nature of cases concerning breach of fiduciary obligations.<sup>179</sup> However, the importance of regulatory emphasis on avoidance and prompt disclosure of conflict situations cannot be overstated, if one accounts for the theory of ‘expectation gap’ plaguing the market. It is the widening of such an expectation gap that illustrates an increase in the trust deficit, combating which has been the foremost policy goal of SEBI for the last two decades.<sup>180</sup>

## V. CONCLUSION

Through this paper, I have attempted to examine the manner in which the scope and content of fiduciary obligations has developed, *vis-à-vis* investment advisers, and have employed the jurisprudence in this field to identify authority, discretion and trust as central elements of such relationships. With capital markets around the world suffering from an investor confidence crisis, the regulatory move to import implementation of fiduciary standards to the brokerage sector seems certain.

Market practices have witnessed the gradually evolving role of brokers who have seamlessly integrated into the investment advisory sector, thereby demonstrating elements of discretion and autonomy in their dealings with clients, without attracting much regulatory attention. This has necessitated academic cognizance of the gradual expansion of application of fiduciary obligations, and its widening scope *vis-à-vis* inclusion of a prescriptive code of conduct. Amidst such scheme of affairs, the Indian capital markets regime

<sup>178</sup> Langevoort, *supra* note 127, 1140.

<sup>179</sup> Black, *supra* note 150, 49-50.

<sup>180</sup> See Preamble of the SEBI Act, 1992.

continues to be governed by the archaic 1992 Broker Regulations for brokers. Unsurprisingly, despite the regulatory ambiguity on this subject, the judiciary has stepped in to prioritise the concerns of retail investors, and has made a conscious effort to treat brokers as fiduciaries in a nevertheless irregular fashion. While the merits of the ‘uniform fiduciary standard’ proposal have been heavily debated, it constitutes the first step towards acknowledging the changing realities of the financial services sector in the country.

This article is an attempt to shed light on the question of ‘brokers as fiduciaries’, which has been alien to the Indian academia, even though it has garnered enough attention in the American policy dialogue. Within the contours of this discussion, I have highlighted the instrumentalisation of fiduciary duties as a tool for creating incentives for financial intermediaries to act in the best interests of their clients. The proposal centralises the duty of disclosure, which assumes tremendous significance in a domestic market suffering from rampant self-dealing and conflict of interest scenarios, thus inevitably needing observance of the virtue of ‘single-minded loyalty’ by intermediaries.

Further, the changing transactional power-play, witnessed in terms of broker-client relations, requires to be neutralised by regulatory dynamism. However, the discernible rise of advisory brokers in India needs to be treated with caution, and the amendments suggested in the paper ensure that the application of uniform fiduciary standard refrains from affecting operations of ‘execution-only’ rule-abiding brokers.

Despite its merits, the existing policy move has been criticised on grounds of its open-ended language, resulting in excessive enforcement costs and unstable application. The role of the judiciary will prove to be critical in determining the interpretive framework for theorising fiduciaries in the financial market, and for determining the corresponding duties arising out of operating in such capacity. Given the recent trend of brokers enjoying discretionary control over accounts of clients, the objective of investor protection ought to be prioritised in the regulatory discussions, and the imposition of fiduciary standard can serve as a timely confidence-building measure.