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I. INTRODUCTION

Much commentary has been directed to the role of fiduciary duties in commercial contexts, particularly under corporate and federal securities laws. An important area of commerce that has not attracted comparable attention is the trading of commodity futures contracts.[1] This is unfortunate. As evidenced by such events as the Stock Market Crash of 1987, the futures industry plays an important role in the economy and is becoming critical to the efficient operation of the securities markets.[2] Moreover, recent judicial and administrative decisions have left the law of fiduciary duties in the futures industry in an uncertain and confusing condition.[3] This too is unfortunate, as well as unfair, to market participants.

This Article reviews the nature and background of the fiduciary duty concept, focusing on its traditional application under the

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1 A commodity futures contract is a bilateral contract pursuant to which the seller (or "short") agrees to sell a specified amount of a specified commodity for delivery at a stated date in the future. Conversely, the purchaser (or "long") agrees to purchase the contract. The terms of the contract are standardized. The only term that is negotiated is the price. Orders for futures contracts are transmitted for execution to a pit on the floor of the exchanges where floor traders and floor brokers compete for their execution.

2 REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 55 (1988) ("From an economic viewpoint, what has been traditionally seen as separate markets—the markets for stocks, stock index futures, and stock options—are in fact one market.").

Over twenty years before the 1987 crash, a congressional report found that the "futures markets are playing an increasingly important role in the pricing and marketing of the Nation's commodities." S. REP. NO. 1131, 93d Cong. 2d Sess. 18 (1974). Concern was also expressed that "unsophisticated investors" were being "fleeced of their life savings." 120 CONG. REC. H2928 (Apr. 11, 1974) (remarks of Rep. Brown). To remedy such concerns, a new federal agency was established, the Commodity Futures Trading Commission, Pub. L. No. 93-463, 88 Stat. 1389 (1974). It was thought that this agency would be "comparable in stature and responsibility to the Securities and Exchange Commission." 120 CONG. REC. S18,865 (Oct. 10, 1974) (remarks of Sen. Talmadge).

3 *See infra* notes 189-302 and accompanying text.

law of trusts and its expansion into other fields. The Article examines the important economic role being played by the futures markets. It then explores the nature of the participants in those markets as a prelude to an analysis of their need for the protective umbrella of fiduciary duties. The Article also reviews governmental efforts to impose fiduciary duties on the futures industry and the less than enthusiastic reception of the courts to those efforts.

Finally, the Article proposes the abandonment of further attempts at applying across-the-board fiduciary duties in the futures industry. To date, those duties have been so amorphous and uncertain in nature as to be of little benefit to those supposedly being protected. The uncertainty of their scope has also placed an unnecessary burden on commodity professionals charged with such duties. The Article advocates that specific rules be promulgated to impose certain, special duties on commodity professionals in order to benefit the limited class of customers who need such protection.

II. THE ROLE OF THE COMMODITY FUTURES MARKETS

A. *Hedging*

Commodity futures trading began on the Chicago commodity exchanges in the middle of the nineteenth century.[4] Trading in futures grew steadily over the years,[5] and today, these markets play an important role in the nation's economy.[6] This is due principally to the fact that futures contracts are used to hedge commercial risks.

When used for hedging, futures markets effectively operate as insurance contracts against adverse price changes.[7] To illustrate, a large trucking company is concerned that rising fuel costs will

4 WILLIAM CRONON, NATURE'S METROPOLIS: CHICAGO AND THE GREAT WEST 123-25 (1991); G. HOFFMAN, FUTURE TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES 28-29 (1932).

5 *See generally* 5 FEDERAL TRADE COMM'N, REPORT ON THE GRAIN TRADE (1921); JERRY MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION (1987).

6 *Supra* note 2.

7 For a general discussion of hedging with futures, see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 358 (1982); United States v. New York Coffee and Sugar Exch., 263 U.S. 611 (1924); United States v. Grady, 225 F.2d 410, 415 (7th Cir. 1955); THOMAS HIERONYMUS, ECONOMICS OF FUTURES TRADING 107-08 (2d ed. 1977); Donald A. Campbell, *Trading in Futures Under the Commodity Exchange Act*, 26 GEO. WASH. L. REV. 215, 218-19 (1957).

impair its profitability because its long-term haulage contracts do not allow price adjustments for fuel price increases. To guard against the risk of fuel price increases, the trucking company could buy petroleum futures contracts on the New York Mercantile Exchange. In the event fuel oil prices increase, the trucking company will experience a profit on the futures contract. The trucking company can then use the profits to offset the increased prices paid for the actual diesel oil. If prices were to instead decrease, the trucking company would experience a loss on the futures contract. That loss, however, would be offset by the decreased cost of the actual diesel fuel. Consequently, whether prices went up or down, the trucking company would assure itself of a stable price for its fuel oil, and its profit margin would be assured.[8]

The same approach could be taken by the airline company that fears another outbreak of violence in the Middle East, which would cause a drastic increase in jet fuel prices. Similarly, large commercial farmers can assure themselves of a specified price before planting crops, and those concerned with interest rate risks can guard against such dangers by using futures contracts on a broad array of interest-bearing instruments.[9]

Portfolio managers may also guard against market risks through so-called stock index futures contracts. Indeed, many institutional investors now seek to "index" their portfolios so as to assure that they perform as well as the overall market. This is because modern portfolio theory suggests that it may not be possible to outperform the market.[10] Stock index futures can be used to assist in this indexing or to guard against anticipated market drops. For example, a portfolio manager anticipating a drop in the stock market will not want to sell out a broad-based portfolio because of the transaction costs involved. Moreover, the manager may want to hold the securities on a long-term basis. In that situation, the portfolio manager can simply sell futures contracts on a

8 The failure to hedge may be a violation of the fiduciary duties of the directors of a company with hedgeable price risks. Brane v. Roth, 590 N.E.2d 587 (Ind. Ct. App. 1992). There may, however, be pitfalls in this process. *See generally* Ryder Energy Distrib. Corp. v. Merrill Lynch Commodities, Inc., 748 F.2d 774 (2d Cir. 1984).

9 *See generally* FEDERAL RESERVE ET AL., A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS II-15 to II-20 (1984) [hereinafter TRADING IN FUTURES]; I TREASURY/FEDERAL RESERVE STUDY OF TREASURY FUTURES MARKETS 6-7 (May 1979).

10 *See generally* Thomas L. Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law,* 70 N.C. L. REV. 137 (1991).

stock index in an amount equivalent to the value of the portfolio. In the event of a market decline, the profits will offset the diminished value of the portfolio. In the event that the trader erred, and the market does not drop, there will be a loss on the futures contracts that can be offset against the portfolio gain. The cost of *the error in judgment, therefore, becomes the relatively low transaction costs associated with the futures contracts plus the giving* up of the profits on the portfolio. If, however, the portfolio manager is correct in his judgement, then the profitability of the portfolio will be much enhanced.[11]

Futures contracts also make available a broad array of strategies for traders. These include such things as dynamic hedging, arbitrage transactions, and so-called program trading. Dynamic hedging involves complicated strategies used to adjust hedges to meet changing market conditions.[12] Arbitrage transactions are many and complicated in form, but generally involve an effort to take advantage of price disparities between markets, including the cash markets and related futures or options contracts.[13] Program trading involves computerized programs that signal traders when to buy or sell upon the occurrence of certain market events.[14]

Concerns have been expressed that these exotic trading strategies could lead to a market "melt down"[15] or a "cascade scenario" in which program trading would generate sell orders in the face of a falling market in ever increasing amounts. Some market participants thought this could result in a self-fulfilling prophecy of succeeding waves of falling market prices to the point where the market collapses.[16] The Stock Market Crash of 1987 did little to assuage such concerns.[17] Indeed, that trauma raised grave concerns as to whether the existing regulatory structure is adequate to

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11 *See generally* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 7 (Jan. 1988) [hereinafter MARKET MECHANISMS]; U.S. CONGRESS, OFFICE OF TECHNOLOGY AND ASSESSMENT, ELECTRONIC BULLS & BEARS: U.S. SECURITIES MARKETS & INFORMATION TECHNOLOGY 79-80 (Sept. 1990) [hereinafter BULLS AND BEARS]; SEC DIVISION OF MARKET REGULATION REPORT, *The October 1987 Market Break* 1-1 to 1-2 (Feb. 1988).

12 NICHOLAS DEB KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES 10-11 (1987).

13 SEC DIVISION OF MARKET REGULATION, THE ROLE OF INDEX-RELATED TRADING IN THE MARKET DECLINE ON SEPTEMBER 11 AND 12 .1986 5-6 (1987).

14 KATZENBACH, *supra* note 12, at 10-11.

15 *Id.* at 1; Martin Mayer, *Some Watchdog! How the SEC Helped Set the Stage for Black Monday*, BARRON'S, Dec. 28, 1987, at 18.

16 GENERAL ACCOUNTING OFFICE, FINANCIAL MARKETS: PRELIMINARY OBSERVATIONS ON THE OCTOBER 1987 CRASH 31 (1987).

17 *See generally* MARKET MECHANISMS, *supra* note 11.

deal with the enlarged role being played by futures contracts in the nation's financial markets and in the United States economy.[18]

B. *Price Discovery*

Price discovery is another benefit of the futures markets. It is thought that traders bring information to the market.[19] That information sets prices in the trading pits by competitive auction bids and offers. Those prices are then widely reported through newspapers and on radio and television.[20] Farmers depend on these price reports to determine what crops to plant or when to market their livestock. Futures prices also provide a mechanism for determining the value of precious metals,[21] for pricing oil,[22] and even for pricing the securities markets.[23] This is an important economic contribution, and this pricing function underscores the importance of the futures markets to the national and international economy.

C. *Speculation*

Speculators are necessary to provide liquidity to the marketplace. Speculators offset the risks of hedgers and provide a source of liquidity when hedging risks cannot exactly be offset in the marketplace.[24] That is, commercial firms requiring sales transactions to hedge risks will not exactly offset, either in time or quantity, the hedging needs of other commercial firms with risks that involve the purchase of futures contracts. Speculators fill this gap and provide the cushion and liquidity necessary to assure that

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18 *See generally* Jerry W. Markham & Rita McClay Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993 (1988).

19 BULLS AND BEARS, *supra* note 11, at 71.

20 HIERONYMUS, *supra* note 7, at 35.

21 *See, e.g.*, N.Y. TIMES, Dec. 13, 1991, at D13 (futures price reports in metals and oil trading on United States exchanges); FIN. TIMES, Dec. 11, 1991, at 30 (same).

22 *See, e.g.*, N.Y. TIMES, *supra* note 21, at D13; FIN. TIMES, *supra* note 21, at 30.

23 An SEC staff study concluded that:

> [A]s a result of the increasing use of the futures markets by institutional investors, . . . the character of the market has changed to the point where the "price discovery" feature of the derivative [futures] market is leading, rather than following, price trends in the underlying equity markets.

MARKET MECHANISMS, *supra* note 11, at 3-6.

24 CHICAGO BOARD OF TRADE, COMMODITY TRADING MANUAL 109 (Lloyd Besant et al. eds., 1985).

hedging transactions can be effected. Speculators also bring information to the marketplace to aid its pricing function.[25]

Of course, excessive speculation is not desirable. It may distort prices and prevent the efficient operation of the marketplace. Excessive speculation can cause a market collapse and loss of public confidence.[26] To lessen these concerns, Congress has authorized limits on the amount of speculation that may be engaged in by any one trader or group of traders acting together.[27]

D. *Growth of the Futures Markets*

The commodity futures markets have grown dramatically in recent years. In 1970, trading volume for all futures contracts was some thirteen million contracts.[28] By 1980, annual volume had increased to over ninety million contracts.[29] In 1990, volume was over two hundred and seventy million contracts.[30] A large part of this growth was attributable to the creation of so-called financial futures contracts such as index futures contracts and futures on government securities. Virtually nonexistent before 1970, trading in financial futures grew to over forty million contracts by 1982,[31] and by 1990, financial futures accounted for some one hundred eighty million of the futures contracts traded that year.[32] Financial futures transactions now far outnumber agricultural futures, which had been the initial basis for futures trading.[33]

Traders in the futures markets have also undergone a metamorphosis. In the 1930s, the Department of Agriculture conducted

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25 *See generally* United States v. Dial, 757 F.2d 163, 165 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985); COMMODITY FUTURES TRADING COMM'N, A STUDY OF THE NATURE, EXTENT AND EFFECTS OF FUTURES TRADING BY PERSONS POSSESSING MATERIAL, NON-PUBLIC INFORMATION 14 (1984); MARK J. POWERS, GETTING STARTED IN COMMODITY FUTURES TRADING 17-18 (4th ed. 1983).

26 This danger has been expressly recognized by Congress. 7 U.S.C. § 5 (1988). *See generally* John H. Stassen, *Propaganda as Positive Law: Section 3 of the Commodity Exchange Act (A case Study of How Economic Facts Can Be Changed by Act of Congress)*, 58 CHI.-KENT L. REV. 635 (1982).

27 7 U.S.C. § 6a (1988).

28 FUTURES INDUS. ASS'N, VOLUME OF FUTURES TRADING: 1960 THROUGH 1989 (1989).

29 *Id.*

30 CFTC ANN. REP. 95 (1990).

31 Y.L.A. Eason, *Financial Futures: A Hot New Act*, N.Y. TIMES, Apr. 24, 1983, at 1.

32 CFTC, *supra* note 30, at 87. This figure includes futures contracts on foreign currencies and precious metals, as well as interest rate and index futures. It does not include options contracts traded on futures exchanges.

33 *Id.*; *see* Barbara Donnelly, *Goldman Pitches Commodity Futures as Safe and Yield-Bearing Investments*, WALL ST. J., July 22, 1991, at C1 (Wall Street is seeking to increase trading in a commodity futures contracts).

a survey of futures market participants. This survey revealed that the largest number of traders were farmers.[34] Their overall commercial sophistication, especially in an area as complex as futures trading, was questionable.[35] Moreover, many of the individual speculators participating in the futures markets were unsophisticated individuals. For example, the Department's survey found that market participants included six dead men, eighteen undertakers, twelve candy store proprietors, and a large number of laborers, students, manicurists, widows, secretaries, stenographers, housewives, and unemployed individuals. A number of doctors, dentists, and lawyers were also in the market.[36]

In 1949, a government report reviewed trading in some 9,000 commodity futures accounts. Almost one-third of the traders were sophisticated traders engaged in business in some form. Farmers were also numerous, as were a "surprisingly large number of retired persons," and there were also a number of clerical personnel trading. In addition, there were numerous professionals such as lawyers and doctors.[37] The report also found that the great majority of individual speculators lost money in the futures markets. Their net losses were six times their net profits.[38]

A 1970 survey of traders showed a somewhat more sophisticated profile of individual futures speculators. By this time, small nonprofessional traders were generally well educated, over forty-five years of age, and earned over $10,000 per year in 1970 dollars. Most of these traders were lawyers, doctors, dentists, and business professionals.[39] A 1978 market survey of financial futures traders also found that professionals and institutions dominated overall trading. Although that survey showed continued participation by a number of retired persons, housewives, students, and other nonprofessionals, they were responsible for only a small portion of total trading.[40]

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34 D.B. BAGNELL, U.S. DEP'T OF AGRIC., CIRCULAR NO. 397, ANALYSIS OF OPEN COMMITMENTS IN WHEAT AND CORN ON THE CHICAGO BOARD OF TRADE 8 (1936), *noted in* Campbell, *supra* note 7, at 220 n.20.

35 Legislative reports and hearings during this period are replete with claims that farmers were being fleeced directly or indirectly by large operators on the futures markets. *See generally* MARKHAM, *supra* note 5, at 22-26.

36 CONG. REC. S8289-8293 (May 29, 1936).

37 BLAIR STEWART, USDA TECHNICAL BULLETIN NO. 1001, AN ANALYSIS OF SPECULATIVE TRADING IN GRAIN FUTURES 46 (1949).

38 *Id.* at 129-30.

39 POWERS, *supra* note 25, at 10-11.

40 RONALD B. HOBSON, COMMODITY FUTURES TRADING COMM'N, FUTURES TRADING IN

A 1984 survey enhanced this picture even more. By then, individual or noncommercial traders held less than one-third of outstanding financial futures contracts.[41] Ninety percent of those individual traders had attended college and about forty percent had graduate or professional degrees. A majority of these individuals had net worths (excluding residence and personal effects) in excess of one hundred thousand dollars. In fact, twenty-eight percent of individual stock index futures traders had net worths in excess of five hundred thousand dollars. Only five to twelve percent of these noncommercial index traders had net worths of less than twenty-five thousand dollars.[42]

These figures demonstrate that the market is dominated by large or sophisticated traders. Nevertheless, a small number of participants can rightfully be viewed as relatively poor, unsophisticated individuals. Their role in the futures markets, however, continues to diminish. Today some seventy-five percent of futures contracts are held by commercial firms and professional traders. Only about one quarter of futures contracts involve small individual, noncommercial traders. Presumably, if the 1984 trend continues, most of that shrinking cadre would be well educated and relatively wealthy.[43]

This evolution in the makeup of the market paralleled developments in the securities markets where institutional traders have also become dominant.[44] Indeed, it was these institutional traders

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FINANCIAL INSTRUMENTS (1978).

41 TRADING IN FUTURES, *supra* note 9, at IV-7.

42 *Id.* at V-4 to V-5.

43 BULLS AND BEARS, *supra* note 11, at 72-73. Brokerage firms are increasing their marketing efforts to induce even more institutional investors into the futures markets. *See, e.g.*, Stanley W. Angrist, *The Big Money Gives Futures a Whirl*, WALL ST. J., May 11, 1992, at C1; Donnelly, *supra* note 33; *see also* Michael Siconolfi, *PaineWebber Cancels Futures Fund; Firm Loses $1.2 Million Arbitration*, WALL ST. J., June 25, 1991, at C21. Small investors continue to express less interest in the market.

44 Direct stock ownership by individuals dropped from approximately 84% in 1965 to about 53% last year. William Power, *Small Investor Continues to Give up Control of Stocks*, WALL ST. J., May 11, 1992, at C1. The phenomena of increased institutional trading in the securities markets has been occurring for some time. An SEC study found that, in 1970, institutions held some 40% of equity securities, up from 26% in 1958. *Institutional Investor Study, Report of the Securities and Exchange Commission*, H.R. DOC. NO. 64, 92d Cong. 1st Sess. IX (1971). "Small investors have been leaving the stock market for about twenty years, a trend that accelerated in 1987." BULLS AND BEARS, *supra* note 11, at 28. Today, institutional trading constitutes a majority of the securities markets with institutional assets growing from $2.1 trillion in 1981 to $5.2 trillion in 1988. *Id.* at 32-33. *See generally* Randall Smith, *Mutual Funds Have Become Dominant Buyers of Stock*, WALL ST. J., May 22, 1992, at C1.

who turned to the futures markets to hedge their financial risks and to take advantage of the low transaction costs and liquidity of the futures markets. The Stock Market Crash of 1987 is also proof of the dominant role of the institutions. During that period, institutions were selling billions of dollars worth of futures contracts in very short periods of time. For example, on October 9, 1987 ("Black Monday"), portfolio insurers sold futures contracts equivalent in value to some four billion dollars of stock.[45]

The changing nature of the futures markets raises serious questions as to whether fiduciary duties and their attending costs should be imposed on an industry in which only a small number of traders are so ill-educated or impoverished as to need such protection. Nevertheless, to leave even this small number of traders without adequate regulatory safeguards seems harsh, particularly since these markets are held open to the public under an exclusive federal regulatory umbrella.[46] Before examining those issues, however, a review of the nature and background of fiduciary duties and their application to the futures industry is needed.

III. THE FIDUCIARY DUTY CONCEPT

A. *Beginnings*

Fiduciary duties stem from the law of trusts. Some scholars assert that trusts originated in ancient Roman law,[47] while others claim that trusts arose from fifth-century German law.[48] Still oth-

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45 REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 36 (1988). *Coming to Terms With Futures*, THE ECONOMIST, Nov. 23, 1991, at 85 (discussion of the continuing dangers of large scale futures traders).

46 7 U.S.C. § 5 (1988) (transactions in futures "are affected with a national public interest" and "are carried on in large volume by the public generally . . . . rendering regulation imperative for the protection of . . . commerce and the national public interest.").

47 One author traced the trust concept to the Roman law of 170 B.C. H.L. Wilgus, *Corporations and Express Trusts as Business Organizations*, 13 MICH. L. REV. 71, 83 (1914). Justice Story also traced the fiduciary duties imposed on partnerships to Roman law. J. STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP, 261 (1841), *noted in* Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427, 465 (1991); *see also* Kenneth W. Curtis, *The Fiduciary Controversy: Injection of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationships*, 20 LOY. L.A. L. REV. 795, 797 (1987) (fiduciary duty concept is derived from the Roman law).

48 Ann Van Wynen Thomas, *Note on the Origin of Uses and Trusts—Waqfs*, 3 SW. L.J. 162 (1949).

One scholar on trusts and fiduciary duties found a breach of fiduciary duty by a steward in the Bible. Austin W. Scott, *The Fiduciary Principal*, 37 CAL. L. REV. 539 (1949). An early mention of the trust concept is also found in Shakespeare's *Merchant of Venice*.

ers assert that trusts originated from concepts developed under Islamic law that were brought to England by the returning Crusaders.[49] Whatever the case, the Statute of Uses that was adopted in England in 1536 firmly cemented the trust concept into English jurisprudence.[50]

The trust concept was thereafter expanded and developed more fully by the equity courts in England.[51] In the words of Professor Maitland, "Of all the exploits of equity, the largest and most important is the invention and development of the trust."[52] The English courts even went so far as to suggest that the trust relationship is a "principle of humanity" and that it exists for "preservation of mankind."[53] By the late 1800s, the law of trusts was a separate branch of the law of England.[54] At the turn of the century, some twenty percent of the capitalized value of all English assets were held in trust.[55]

The trust concept was largely, if not exclusively, borrowed by the United States from England.[56] By the late 1800s, the law of

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See Duties and Dangers of Trustees, 118 LAW TIMES 299 (1905).

49 Thomas, *supra* note 48. The trust may have been in existence in England even before the Crusades. Wilgus, *supra* note 47, at 85.

50 AUSTIN W. SCOTT, THE LAW OF TRUSTS AND ESTATES § 1 (3d ed. 1967); Austin W. Scott, *The Trusts as an Instrument of Law Reform*, 31 YALE L.J. 457, 462-63 (1922) [hereinafter *Law Reform*] (discussing Statute of Uses).

Another form of trust, the bailment, traces its history to the thirteenth century. 2 F. POLLOCK & F. MAITLAND, THE HISTORY OF ENGLISH LAW 155 (2d ed. 1898); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

51 The application of trust law in the Chancery courts appears to have first received wide notice in Keech v. Sanford, 25 E.R. 223 (1726). By 1737, Lord Hardwicke was credited with creating a "science of trust law" in England. Brendan F. Brown, *Lord Hardwicke and the Science of Trust Law*, 11 NOTRE DAME LAW. 319, 322 (1935-36).

52 Austin W. Scott, *The Progress of the Law, 1918-19: Trusts*, 33 HARV. L. REV. 688 (1919-20).

Professor Maitland also stated, "If we were asked what was the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence, I cannot think that we could have any better answer to give than that this, namely, the development from century to century of the trust idea." 3 MAITLAND, COLLECTED PAPERS 271, 272 (1911), *noted in Law Reform, supra* note 50, at 457.

53 Robert Flannigan, *The Fiduciary Obligation*, 9 OXFORD J. LEG. STUD. 285 (1989) (citations omitted).

"It was chiefly by means of uses and trusts that the feudal system was undermined in England." *Law Reform, supra* note 50, at 457.

54 Ernest A. Jelf, *Where to Find Your Law*, 99 LAW TIMES 396 (1895).

55 W.G. Hart, *The Law of Trusts*, 127 LAW TIMES 535 (1909). England even established a very successful Office of Public Trustee to administer trusts of those who wanted to commit their funds to government management. Murry L. Jacobs & Edmund N. Cahn, *The Fiduciary of the Future*, 5 ST. JOHN'S L. REV. 32, 40 (1930-31).

56 A treatise on trust law in the United States published in 1882 cited some 200 cases, of which some 175 were from English law reports, while the remaining cases where

trusts had become so sufficiently established in the United States that the Harvard Law School was able to offer a separate course on the subject.[57] A survey by the American Banker's Association also determined that by 1929 more than a thousand millionaires were employing trust devices for the disposal of their estates. Trusts managed by banks exceeded one hundred thousand in number, and assets held by banks and trusts exceeded five billion dollars.[58] Although the Stock Market Crash of 1929 was a setback for trustees,[59] its effects were not permanent. By 1975, bank trust departments were managing some $400 billion of assets and private noninsured pension funds amounted to approximately $125 billion.[60] Today, a large proportion of securities are held by insti-

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from courts on the Atlantic coast. Austin W. Scott, *Fifty Years of Trusts*, 50 HARV. L. REV. 60 (1936).

> In the intervening two and half centuries [from the introduction of the trust in England], the notion of the high standard incumbent on a fiduciary has spread from its original homeland in the law of trusts has subjected a diverse variety of entrepreneurs—directors, partners, agents, employees—to its colonizing sway.

Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975).

57 Scott, *supra* note 56. The first article published in the *Harvard Law Review* was also concerned with the law of trusts. *See* J.B. Ames, *Purchaser for Value Without Notice*, 1 HARV. L. REV. 1 (1887).

58 Henry A. Shinn, *Exoneration Clauses in Trust Instruments*, 42 YALE L.J. 359 (1933); *see also* N. Gilbert Riddle, *Trust Investments: Their Extent and Some Related Economic Problems*, 5 LAW & CONTEMP. PROBS. 339 (1938) (discussion of the extent of assets held in trust in the United States during the 1930s). These figures reflect the fact that the corporate or bank trustee had become a thriving business as a result of the complexity and popularity of trusts. Leonard S. Fulton, *On the Advantages and Limitations of Corporate Trustees, With Special Reference to the Public Trustee of England*, 34 LAW Q. REV. 304 (1818); Jacobs & Cahn, *supra* note 55 (a major development in the law of trusts was the determination to allow corporations to be trustees); *see also* Randall J. LeBoeuff, *National Banks as Fiduciaries in New York*, 5 CORNELL L.Q. 128 (1920) (discussion of banks as fiduciaries). For a discussion of particular concerns raised by bank trustees, see Comment, *Fiduciaries—Self Dealing—Requirement of Two Parties to a Contract*, 37 COLUM. L. REV. 1405 (1937). *See also* Diane S. Lacandro, Note, *The Comptroller's Regulation—an Illusory Remedy to the Fiduciary Dilemma of National Banks in Light of* Slade v. Shearson, Hammill & Co., 9 LOY. U. CHI. L.J. 667 (1978) (discussion of conflicting fiduciary duties that bank trust departments may encounter).

59 The stock market crash of 1929 resulted in some serious dilemmas for trustees. For example, there was concern that trustees could be surcharged for failing to sell or for delays in selling trust investments in a drastically declining market. George G. Bogert, *The Trustee's Duty with Regard to Conversion of Investments*, 1 U. CHI. L. REV. 28 (1933). Bogert stated that, "Since 1929 the great reductions in the market prices of bonds and stocks, the defaults in interest payments, the passing of dividends, and the shrinkage of security margins on mortgages, have all raised questions as to the suitability of various trust investments." *Id.* at 28; *see also* George P. Woodruff, *Legal and Investment Standards of Trustees*, 4 FORDHAM L. REV. 391 (1935) (the melting away of stock and bond prices following the stock market crash of 1929 posed special problems for trustees).

60 Edward S. Herman, *Conflicts of Interest in Commercial Bank Trust Departments and*

tutions with fiduciary duties for the investment of those holdings, particularly pension funds.[61] Their holdings are now valued in the trillions of dollars.[62] These figures reflect Professor Scott's view that the trust is "the most effective instrument in effecting the disposition of private property."[63]

B. *The Law of Trusts*

The law of trusts, as developed from English law and its transplantation in the United States, holds that a "trust" relationship exists between an administrator, or "trustee," who controls certain special relationships. The beneficiary of that relationship is the *cestui que trust*. This special "fiduciary" relationship imposes duties and obligations on the trustee that are not found in contractual arms-length relationships.[64]

"The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty."[65] This duty intensifies in a trust relationship where the trustee is acting in his own interests.[66] "The trustee, like the executor, the guardian, or the agent, and similar parties, owes the one whom he represents a duty to act solely in the interests of the beneficiary; he is not permitted to consider his own personal advantage."[67] This means, for example, that a trustee may not profit at the expense of the beneficiary.[68]

Corporate Fund Asset Management, 114 TR. & EST. 786 (1975); Joseph V. Rizzi, *Trustee Investment Powers: Imprudent Application of the Prudent Man Rule*, 50 NOTRE DAME LAW. 519 (1975).

61 *See generally* BULLS AND BEARS, *supra* note 11, at 28-29.

62 WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTORS 25-39 (1992).

63 Scott, *supra* note 52.

64 The English courts seemed to recognize that there can be no "universal, all purpose definition of the fiduciary relationship." R.P. Austin, Note, *Commerce and Equity—Fiduciary Duty and Constructive Trust*, 6 OXFORD J. LEGAL STUD. 444, 445-46 (1986).

65 2 AUSTIN W. SCOTT, THE LAW OF TRUSTS 856 (1939). The law seeks the *undivided* loyalty of the trustee. John G. Aldridge, Note, *Trusts—The North Carolina Fiduciary Powers Act and The Duty of Loyalty*, 45 N.C. L. REV. 1141 (1967).

The New York Court of Appeals recently affirmed this duty of loyalty stating that it is "elemental that a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect." It is an "inflexible rule of fidelity." Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989). For a general description of fiduciary obligations, see P.D. FINN, FIDUCIARY OBLIGATIONS (1977).

66 SCOTT, *supra* note 65, at 909; *see also* Roger A. Clapp, *A Fiduciary's Duty of Loyalty* 3 MD. L. REV. 221 (1939) (discussing judicial decision rendered in 1726 on a trustee's duty of loyalty).

67 GEORGE BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES 3 (2d ed. rev. 1984).

68 1 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 2.5 (4th ed.

Moreover, "[i]f the fiduciary enters into a transaction with the beneficiary and fails to make a full disclosure of all circumstances known to him affecting the transaction, or if the transaction is unfair to the beneficiary, it can be set aside by him."[69] A trustee making a contract for the benefit of the trust may be held personally liable.[70] The trustee may also be held liable for the negligence of agents hired by the trustee.[71] Legislative efforts were undertaken, however, to ease this near strict liability[72] that sometimes caused "widespread terror and desolation among trustees."[73]

1987). *See generally* Austin W. Scott, *The Nature of the Rights of the Cestui Que Trust,* 27 COLUM. L. REV. 269 (1917).

Lord Hardwicke said that, "[A] trust is an office necessary in the concerns between man and man, and if faithfully discharged, attending with no small degree of trouble and anxiety, so that it is an act of great kindness in anyone to accept it." Knight v. Earl of Plymouth, 1 Dick. 120, 126, 21 Eng. Rep. 214, 216 (1747), *noted in* G.M.U. Young, *Trustee Investment Standards and Responsibilities in England—Past and Present,* 11 REAL PROP. PROB. & TR. J. 711, 711 (1976).

69 1 SCOTT & FRATCHER, *supra* note 68, at 43 ("These are characteristics of all fiduciary relations, although they are to be found in a peculiarly intense degree in the relation between trustee and beneficiary."); *see* Michoud v. Girod, 45 U.S. (4 How.) 552-56 (1846) (stating that trustees should not conduct business with the trust estate); John M. Hadsall, *Conflict of Interest When a Trustee Invests Trust Funds* 14 CHI.-KENT L. REV. 329 (1935-36).

70 Austin W. Scott, *Liabilities Incurred in the Administration of Trusts,* 28 HARV. L. REV. 725, 725 (1915).

71 *Id.* at 726. This is because "[n]othing is better settled than that the trustee is not an agent of the *cestui que trust.*" *Id.* at 736. Liability may also fall on a passive trustee for mere negligent acts. *See* Wych v. East India Co., 3 P. Wms. 309, 24 Eng. Rep. 1078 (Ch. 1734), *noted in* Alvin E. Evans, Note, *The Colluding and the Mistaken Trustee,* 17 KY. L.J. 382, 383 (1929) (discussing the effects of negligent nonaction by a trustee); *see also* Benjamin Harris, Jr., Comment, *Liability of a Trustee: Balancing Gains Against Losses,* 23 KY. L.J. 338 (1935) (trustees are not allowed to offset gains from one breach of trust against losses from another breach of trust). *See generally* George G. Bogert, *The Liability of an Inactive Co-trustee,* 34 HARV. L. REV. 483 (1920).

72 *The Judicial Trustees Act of 1896,* 150 LAW TIMES 543 (1898). It was thought by some that perhaps the standards for trustees were too high because their formulation had been left entirely to chancery judges:

> Now please mark that trustee-law has grown up under chancellors and equity judges, who whilst laying down—or rather building up—trustee-law have not been aided by juries in finding facts, and have not been obliged to guide juries by stating law to them. This absence of the jury element has had a most important bearing: no jury would have condemned trustees as chancellors have done, and no chancellor would have laid down to juries laws which chancellors have unconsciously by degrees formulated and evolved, whilst under no obligation to express them in clear language to non-legally educated minds.

The Difficulties and Dangers Encountered by Trustees When Acting as (a) Vendors, (b) Purchasers, and (c) Mortgagors—Mr. Ince's Bill "To Amend the Law Relating to the Liabilities and Duties of Trustees—The Status of Solicitors, 80 LAW TIMES 169 (1886).

73 *The Duty and Perils of Trustees in the Investment of Trust-Funds,* 48 LAW TIMES 250

Trustees also became subject to a number of limitations on their handling and investment of trust property. For example, at an earlier period, trustees were not allowed to lend on the credit of individuals "however unimpeachable their credit may be."[74] Additionally, while trustees could invest trust property, "they must be careful to lend no more than *two-thirds* of the value of the mortgaged property, if it be land."[75]

At an early stage in English law, equity chancellors allowed trustees to invest trust funds in joint stock companies.[76] Trustees could also safely invest in the stock of the East India Company, but they were left with such delicate questions as whether they could participate in a "commutation" of that stock without court approval that could not be obtained before subscriptions for the commutation were filled.[77] Unfortunate experiences, such as the South Sea Island Bubble, suggested that stricter standards were needed.[78] Eventually, the chancery court in England adopted a rule that precluded investments by trustees in anything other than government securities.[79]

In the United States, a "prudent" trustee rule evolved from an 1830 decision by the Supreme Judicial Court of Massachusetts. In *Harvard College v. Amory*,[80] the court stated that in making trust investments, trustees must use "sound discretion" and must act in the same manner as "men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering

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(1870).

The role of the trustee was described by one early commentator as being "burdensome, thankless, unremunerative to the unskilled almost dangerous. The trustee must derive no benefit or advantage from his position. He must not even take a few days shooting over the estate; game rights must be left for the benefit of the trust estate." *Duties and Dangers of Trustees*, 118 LAW TIMES 299 (1905). For a discussion of the more modern duties of trustees in England, see William F. Fratcher, *Fiduciary Administration in England*, 40 N.Y.U. L. REV. 12 (1965).

74 *A Practical Summary of the Law of Trustees*, 27 LAW TIMES 170 (1856) (emphasis in original).

75 *Id.*

76 Ellen L. Nylund, *Investments by Trustees*, 20 CHI.-KENT L. REV. 331, 331-32 (1942).

77 *Trustees and the Commutation of East India Stock*, 56 LAW TIMES 193 (1874). A commutation apparently involves an exchange of securities. BLACK'S LAW DICTIONARY 280-81 (6th ed. 1990).

78 For a discussion of the South Sea Island Bubble and its effect on trust law in England, see Young, *supra* note 68.

79 *See generally* Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory* 69 N.C. L. REV. 87, 88 (1990).

80 26 Mass. (9 Pick.) 454, 446 (1830).

the probable income, as well as the probable safety of the capital to be invested."[81] The courts in the United States, however, split on whether a trustee could prudently invest in corporate securities.[82]

Later, state legislatures adopted "legal" lists of securities that specified particular investments that could be legally made by trustees of trust funds.[83] Initially, those lists did not permit investment of trust funds and common stocks, but the statutes were gradually eased to allow such investments.[84] Trustees were also allowed to include the corpus of several trusts into so-called common trust funds, which allowed large scale management even for small trust funds.[85] In addition, several states came to recognize modern portfolio theory that assesses a portfolio as a whole and

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81 *Id.* at 469 at 461. The prudent-person rule envisions:

> The preservation of the trust estate and not the risking of it in the hope of increasing its value, is the true policy. The trustee must exercise his own judgment and use such care and skill as he has in making the investments. This ordinarily involves investigation as to the safety of the investment and the probable income to be derived therefrom. He must prudently avoid placing 'all his eggs in one basket' and is required so to diversify his investments as to minimize the risk of a considerable loss. In addition, the trustee must be constantly vigilant in his maintenance of the trust estate.

Stuart M. Wright, *The Measure of the Trustee's Liability for Improper Investments*, 80 U. PA. L. REV. 1105, 1106 (1932) (footnotes omitted).

82 *See* Ernest G. Strand, *New York's Partial Prudent Man Rule*, 25 N.Y.U. L. REV. 583 (1950). For a discussion of the evolution of the so-called prudent-person rule, see Rizzi, *supra* note 60. *See also* Edward V. Atnally, *The Investment Responsibilities of Fiduciaries*, 114 TR. & EST. 286 (1975) (discussing the continuance of the prudent-person rule in New York); David M. Tralins, *Contemporary Fiduciary Investments: Why Maryland Needs the Prudent-Man Rule*, 12 U. BALT. L. REV. 207 (1983) (discussing the prudent-person rule).

The prudent-person rule has been adopted by other countries. *See, e.g.*, Frank J. Finn & Peter A. Ziegler, *Prudence and Fiduciary Obligations in the Investment of Trust Funds*, 61 AUSTL. L.J. 329 (1987).

83 For a discussion of legal lists, see Gustav B. Margraf, *Laws Relating to the Investment of Trust Funds, 1930-1937*, 5 LAW & CONTEMP. PROBS. 399 (1938); D. W. Markham, *Trust Investments in North Carolina*, 14 N.C. L. REV. 160 (1935); William R. White & Irving A.J. Lawres, *The Modernization of Legal Lists*, 5 LAW & CONTEMP. PROBS. 386 (1938).

In 1871, the Massachusetts legislature allowed courts to authorize trustees to invest in mortgages to repair or rebuild buildings. This was done in order to finance the rebuilding of Boston after its Great Fire. Comment, *The Development of the Powers of Trustees*, 47 HARV. L. REV. 510, 514-15 (1934).

84 Colorado, for example, amended its constitution in 1950 to eliminate a prohibition against the investment of trust funds in common stocks and corporate bonds. Charles A. Baer, *The "Prudent-Man Rule" Now Applies to Investments by Fiduciaries*, 28 DICTA 213 (1951); *see also* Loren C. Ipsen, *Trends in the Liability of Corporate Fiduciaries*, 24 IDAHO L. REV. 443 (1988) (discussing the evolution of the prudent-person standard).

85 Comm. on Inv. by Fiduciaries, *Investments by Fiduciaries in Common Trust Funds*, 11 REAL PROP. PROB. & TR. J. 28 (1976).

allows the introduction of risk elements for diversity and other purposes into a prudently managed portfolio.[86] These investments may include futures and options, which had long been considered the most speculative of ventures.[87]

C. *Expansion of the Fiduciary Concept*

Trusts "are in their essence a social institution,"[88] and the concept had enough elasticity that equity courts could use trust concepts to deal flexibly and remedially with special relationships other than formal trusts.[89] The courts in England eventually recognized that some relationships to which trust principles were applied were not trusts in the true sense of the word.[90] For this

86 One author has asserted that legal notions of investment prudence by fiduciaries have still been left far behind by changes in the markets and economic concepts. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT-MAN RULE (1986). For a discussion of the modern day application of the prudent-person rule, see John W. Church, Jr. & Richard B. Seidel, *Rearming the Prudent Man*, 125 TR. & EST. 24 (1986); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles and Corporate Investment*, 38 UCLA L. REV. 277 (1990); William J. Wilkie, *Defining Fiduciary Prudence: How Old Standards are Applied to Modern Situations*, 125 TR. & EST. 29 (1986). *See generally* Secondary Mortgage Market Enhancement Act, Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified at 12 U.S.C. § 1701 (1988) (federal statute expanding the "legal" investments of federally insured financial institutions). A committee of the National Conference of Commissioners on Uniform State Laws is also now revising the Uniform Principal and Income Act to recognize modern portfolio management by fiduciaries.

87 Haskell, *supra* note 79, at 90-91. *See generally* Louis A. Laurino, *Investment Responsibility of Professional Trustees*, 51 ST. JOHN'S L. REV. 717 (1977) (discussing the prudent man rule for corporate trustees); Bevis Longstreth, *Tailoring Prudence: Using Circumstances, Not Absolutes, to Judge Fiduciaries*, 125 TR. & EST. 14 (1986); Comment, *Prudent Trustee's Investment in Common Stock - Permissive or Mandatory*, 52 NW. U. L. REV. 788 (1958) (discussing the prudent man rule); Note, *Standard of Care for Corporate and Professional Trustees*, 42 VA. L. REV. 665 (1956).

If used as a hedging device, instruments such as futures and options may actually decrease risk. *See supra* notes 7-11 and accompanying text; *see also* Louis S. Headley, *A Trustee in a World of Changing Values*, 5 LAW & CONTEMP. PROBS. 355 (1938) (discussing the trustee's duties to maintain purchasing power of a trust and the dilemma that this presents to a trustee). *See generally* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent-Man Rule*, 62 N.Y.U. L. REV. 52 (1987).

It has been suggested that the prudent-person rule should further be expanded to allow "non-traditional" investments based on political or social goals. Leslie J. Bobo, Comment, *Non-Traditional Investments of Fiduciaries: Re-examining the Prudent Investor Rule*, 33 EMORY L.J. 1067 (1984).

88 Pierre LePaulle, *An Outsider's Viewpoint of the Nature of Trusts*, 14 CORNELL L.Q. 52, 61 (1928).

89 Thurman Arnold, *The Restatement of the Law of Trusts*, 31 COLUM. L. REV. 800, 823 (1931).

90 The illusive nature of the fiduciary obligation has led to some difficulties in capturing its definition. J.C. SHEPHERD, LAW OF FIDUCIARIES 3-5 (1951); Arthur J. Jacobson, *Capturing Fiduciary Obligation: Shepherd's Law of Fiduciaries*, 3 CARDOZO L. REV. 519 (1982).

reason "[t]he word fiduciary (which earlier had received very little judicial support)[91] was adopted to describe these situations which fell short of the now strictly-defined trust."[92] By application of fiduciary principles, a court could stop injustice or set aside transactions that were unfair or inequitable.[93] For example, the "constructive trust" was created to address wrongdoing and unfairness in the disposal of property acquired through the breach of a fiduciary duty.[94]

Similarly, "purchase money resulting trusts" were used to protect a party that paid for property but allowed title to be taken in the name of another person.[95] The doctrines of constructive and resulting trusts were developed essentially to do equity.[96] As Dean Pound observed, the constructive trust is a purely remedial institution.[97]

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91 An early example of the use of the term fiduciary is in Bishop of Winchester v. Knight, 1 P. Wms. 406, 407 (1717), *noted in* L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 72 n.11.

92 Sealy, *supra* note 91, at 71-72 (footnote omitted). Equity courts "carefully refrained from setting bounds to the principles which control those in fiduciary capacities. By retaining this elasticity, the chancellors were able to extend their reach to all devices invented by unfaithful fiduciaries." Comment, *The Duty of Loyalty of a Trustee*, 8 OHIO ST. L.J. 75 (1941) (footnote omitted).

93 One author has stated that, "'Fiduciary responsibility' is something of a half-way house between a legal requirement and an ethical standard." A.A. Sommer, *Fore-Word: Fiduciary Duties—The Search for Content*, 9 LOY. U. CHI. L.J. 525, 531 (1978).

94 SCOTT & FRATCHER, *supra* note 68, § 495; *see also* D.W. Fox, *Constructive Trusts in a Company Setting*, 1986 J. BUS. L. 23 (general discussion of constructive trusts); *Constructive Trusts*, 38 LAW TIMES 212 (1893-94) (discussion of how a person may become a constructive trustee); Jacob L. Keiden, Comment, *Equity—Constructive Trusts—Thieves and Embezzlers as Constructive Trustees*, 35 MICH. L. REV. 798, 800 (1937) (constructive trusts permit the profits of the wrongdoer to be recovered); Lucian Morehead, Comment, *Constructive Trust as a Remedy for Fraud*, 14 TEX. L. REV. 252 (1936) (discussing constructive trusts).

A Uniform Fiduciaries Act sought to establish rules to determine whether a person had sufficient notice to make him a constructive trustee. Note, *Legislation—The Uniform Fiduciaries Act*, 81 U. PA. L. REV. 863 (1933); Alwine L. Mulhearn, Comment, *Good Faith in the Uniform Fiduciaries Act*, 9 TUL. L. REV. 618 (1935).

95 J. Glenn Edwards & M.T. Van Hecke, *Purchase Money Resulting Trusts in North Carolina*, 9 N.C. L. REV. 177, 178 (1930).

96 George P. Costigen, *The Classification of Trusts as Expressed, Resulting and Constructive*, 27 HARV. L. REV. 437 (1914); *see also* Edwards & Van Hecke, *supra* note 95, at 178 ("[A]lthough it has produced much litigation and perhaps some perjury, the [purchase money resulting trust] device seems to have worked fairly well.").

97 Roscoe Pound, *The Progress of Law, 1918-19: Equity*, 33 HARV. L. REV. 420, 421 (1919-20). *See generally* Note, *Resulting and Constructive Trusts in Kentucky*, 20 KY. L.J. 383-394 (1931-32).

Fiduciary duties have also been applied to "confidential relations" in which there is an inequality of business intelligence or dependence.[98] In early equity, for example, a breach of confidence could be found where an individual was dependent on the fiduciary's advice because the fiduciary was a professional adviser, an expert, or had greater knowledge about the subject matter.[99] Today, fiduciaries who use confidential information may be held liable for the profits from such activities.[100] The definition of what constitutes a confidential relationship that is subject to such fiduciary duties is somewhat uncertain.[101] At the least, some inequality of the parties may be required.[102]

The law of fiduciary duties continues to retain its elasticity. As one author notes, "The twentieth century is witnessing an unprecedented expansion and development of the fiduciary law."[103]

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98 George C. Bogert, *Confidential Relations and Unenforceable Express Trusts*, 13 CORNELL L.Q. 237, 240 (1928); *see also* Peed v. Peed, 325 S.E.2d 275, 282 (N.C. Ct. App.) (constructive trusts often involve a violation or abuse of a confidential relationship), *cert. denied*, 330 S.E.2d 612 (N.C. 1985).

Breach of confidence was one of the traditional areas of concern for Chancery courts. *See, e.g.*, F.W. MAITLAND, EQUITY (2d ed. 1936), *quoted in* Sealy, *supra* note 91, at 69 ("These three give place in court of conscience, Fraud, accident and breach of confidence.").

99 Sealy, *supra* note 91. Initially, liability for a breach of fiduciary duty in a confidential relationship turned on whether there was fraud, undue influence or other abuse of the confidence. SCOTT & FRATCHER, *supra* note 68, § 2.5. One author has stated that the status of a confidential relationship may be in the process of being converted into a higher degree of fiduciary relationship, as has occurred in the case of doctors and patients. Frankel, *supra* note 50, at 796.

100 RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958); Peter Birks, *The Remedies for Abuse of Confidential Information*, 1990 LLOYDS MAR. & COM. L.Q. 460; Richard D. Worrell et al., Note, *Imposition of a Constructive Trust in New England*, 41 B.U. L. REV. 78, 83 (1961).

If a confidential relationship is found to exist then "the utmost good faith and frankness must characterize all transactions between the parties." George W. McQuain, Note, *Equity—Fiduciary or Confidential Relations—What Constitutes*, 39 W. VA. L.Q. 52, 52 (1932).

101 In United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992), the Second Circuit stated that, "Reposing confidential information in another . . . does not by itself create a fiduciary relationship." *Id.* at 568.

102 Bogert, *supra* note 98, at 240. Bogert notes that Professor Pomeroy had stated that Chancery refused to define the term confidential relations "in order to preserve for itself complete liberty of action." *Id.* at 237 (quoting JOHN N. POMEROY, EQUITY JURISPRUDENCE § 956 (4th ed. 1918)).

103 Frankel, *supra* note 50, at 796. One author has stated that, "Foreign jurists are amazed and foreign publicists somewhat perplexed at the widespread application of the trust concept . . . and at our universal reliance on the trust and readiness to project it into international affairs." Nathan Isaacs, *Trusteeship in Modern Business*, 42 HARV. L. REV. 1048 (1929).

This has included determinations that doctors[104] and union leaders are fiduciaries;[105] and one author has advocated that fiduciary principles be used to govern relations among parent and child.[106] The rules of professional responsibility for lawyers are based upon fiduciary principles.[107] It has also been suggested that fiduciary duties should be imposed on businesses to protect workers who are displaced by layoffs or plant closings,[108] and on investors and businesses to impose social responsibility.[109] In addition, efforts are under way to impose fiduciary duties on banks for the protection of their depositors and borrowers.[110] Fiduciary duties have even been applied to criminalize activities by government officials who seek to profit from their office.[111]

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104 Frankel, *supra* note 50, at 796.

105 *Id.*; *see also* House v. Schwartz, 188 N.Y.S.2d 308, (N.Y. Sup. Ct. 1959) (officers of labor union are fiduciaries of assets of the union).

106 Connie K. Beck et al., Comment, *The Rights of Children: A Trust Model*, 46 FORDHAM L. REV. 669 (1978); Mark E. Swindle, Comment, Tyra v. Woodson: *Breach of a Fiduciary Relationship and the Constructive Trust*, 26 BAYLOR L. REV. 91 (1974). Trust devices have also been used to apportion matrimonial or "palimony" property. Brian H. Davis, *Implied, Resulting or Constructive Trusts?* 1989 DENNING L.J. 52. *But see* United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc) (fiduciary duties do not arise simply by reason of family relationships, including matrimonial relations).

107 Gary A. Munneke & Theresa E. Loscalzo, *The Lawyer's Duty to Keep Clients Informed: Establishing a Standard of Care in Professional Liability Actions*, 9 PACE L. REV. 391, 398 (1989). For a discussion of the fiduciary role of lawyers, see Andrew L. Willms *Lawyers as Fiduciaries*, WIS. B. BULL., Dec. 1987, at 15.

Little has been written about the origin of the fiduciary duties of lawyers. *See* Lester Brickman & Lawrence A. Cunningham, *Nonrefundable Retainers: Impermissible Under Fiduciary Statutory and Contract Law*, 57 FORDHAM L. REV. 149, 154 n.19 (1988).

108 Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991).

109 *See generally* BEVIS LONGSTRETH & H. DAVID ROSENBLOOM, CORPORATE SOCIAL RESPONSIBILITY AND THE INSTITUTIONAL INVESTOR (1973). Fiduciary duties are the subject of an article on their role in strategic delays in various commercial situations. Saul Levmore, *Strategic Delays and Fiduciary Duties*, 74 VA. L. REV. 863 (1988).

One author stated that fiduciary relations form "the most rudimentary instance of association. More complex associations are built upon the fiduciary relation by successive modifications of its elemental structure. The structure of the fiduciary relation may be described as shifting judgment from one person to another." Arthur J. Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law*, 29 BUFF. L. REV. 599, 615 (1980)

110 Curtis, *supra* note 47.

Banks already have fiduciary duties in other aspects of their operations. *See generally* Walter Wyatt, *Fiduciary Powers of National Banks*, 6 VA. L. REV. 301 (1920). Credit union officials may also have fiduciary duties. Sharyn G. Campbell & Kathryn A. Black, *Emerging Doctrines of Fiduciary Responsibility of Credit Union Officials*, 40 BUS. LAW. 957 (1985).

111 *See generally* John C. Coffee, Jr., *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117, 142-48 (1981) (discussing prosecution of Governors Otto Kerner,

The fiduciary concept also became "a critical building block" in the law of agency, partnerships, and business organizations.[112] The making of agents into fiduciaries for the benefit of their principals seems to have appeared at the end of the eighteenth century.[113] Partners were also deemed to be fiduciaries. Oddly, a partner is both a trustee and a *cestui que trust.* As a trustee, each partner must protect the interests of the partnership for the other partners. As a beneficiary, each partner is protected by the concomitant fiduciary duties of other partners.[114] Fiduciary duties have also been applied to corporate officers and directors.[115]

D. *Corporations and Fiduciary Duties*

The application of fiduciary duties to corporations originated in the Anglo-American business sector in the seventeenth century.[116] In England, in 1742, Lord Hardwicke concluded that the committeemen forming the management of a corporation were acting as agents "to those who employ them in this trust."[117] It was not until this century, however, that those duties were extended to majority shareholders in the United States.[118]

The fiduciary concept was applied to corporations to fill a perceived gap in the law.[119] The separation of ownership from

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Marvin Mandell and others).

112 Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decision Making—Some Theoretical Perspectives,* 80 NW. U. L. REV. 1 (1985).

113 Frankel, *supra* note 50. Where an individual has been entrusted to perform a particular job, he must act consistently with that undertaking. Sealy, *supra* note 91, at 76.

114 Sealy, *supra* note 91, at 76; *see also* BOGERT & BOGERT, *supra* note 67, § 36. For a general discussion of fiduciary duties of partners *inter se,* see Day v. Sidley & Austin, 394 F. Supp. 986 (D.C. Cir. 1975), *aff'd,* 548 F.2d 1018 (D.C. Cir. 1976), *cert. denied,* 431 U.S. 908 (1977).

Section 21 of the Uniform Partnership Act makes every partner a trustee of profits of the firm for other partners. MELVIN A. EISENBERG, CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES AND FORMS § 21 (1991 ed.). The Revised Uniform Partnership Act contains an "integrated and exclusive statement of the fiduciary duties of partners." *Id.* It requires a duty of good faith, fair dealing, and loyalty. Weidner, *supra* note 47, at 457-58.

115 Scott, *supra* note 48.

116 Frankel, *supra* note 50, at 795 n.3.

117 Charitable Corp. v. Sutton, 2 Atk. 400, 405 (1742), *noted in* Sealy, *supra* note 91, at 70.

118 Frankel, *supra* note 50, at 795-906. In Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919), the Supreme Court concluded that fiduciary obligations exist between majority and minority shareholders. For a discussion of the fiduciary duties of a majority shareholder, see William W. Yerrall, *The Extent to Which a Stockholder, as Such, is a Fiduciary in Massachusetts,* 16 MASS. L.Q. 57 (1931). *See generally* L. Clark Hicks, Jr., Comment, *Recent Decisions* 60 MISS. L.J. 425, 426-28 (1990).

119 Kansas held as early as 1879 that directors of corporations act like trustees. Ed-

control created a need for the protection of shareholders from overreaching by management.[120] As one author notes, managers were naturally inclined to maximize their own wealth rather than shareholders.[121]

There was, therefore, a perceived need for shareholder protection from the vagaries of management. "Courts and legislatures have met this need by treating management, directors, and controlling shareholders as 'fiduciaries' who owe certain legally enforcible duties to the firm."[122] "The corporation is a human

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ward J. Nazar, Comment, *Corporations: A Strict Fiduciary Standard for Officers and Directors*, 16 WASHBURN L.J. 755 (1963). As trustees, directors were sometimes held liable for taking corporate opportunities or for engaging in a competing business. *See generally* Note, *Liability of Directors for Taking Corporate Opportunities, Using Corporate Facilities, or Engaging in a Competing Business*, 39 COLUM. L. REV. 219 (1939).

The introduction of trust concepts into corporate law may have been accelerated by the introduction of so-called business trusts, such as the one organized by Standard Oil Company in the previous century. These were simply business combinations of separate corporate shareholders who transferred their stocks to trustees, allowing them, in effect, to merge their operations into a single combine. S.C.T. Dodd, *The Present Legal Status of Trusts*, 7 HARV. L. REV. 157 (1893). These trusts became the subject of abuse and were met with the antitrust laws. DANIEL YERGIN, THE PRIZE (1990). For a discussion of business trusts and the application of fiduciary principles to their operations, see Robert S. Stevens, *Limited Liability in Business Trusts*, 7 CORNELL L.Q. 116 (1922); Wilgus, *supra* note 47.

The device known as a "Massachusetts Trust" also grew rapidly in popularity earlier in this century. Scott, *supra* note 52. This device later became less popular as state corporate securities laws became more flexible in their operation. *See generally* LARRY SODERQUIST & A.A. SOMMER, JR., CORPORATIONS 23-24 (3d ed. 1986).

120 In 1905, the President of the New York Stock Exchange stated that:

> "The extension of the principle of incorporation has enabled leaders in business to set up two standards of morality, to maintain a Jekyll and Hyde duality, and to do as members of an impersonal and non-moral corporate body acts which they would shrink from as individuals. In private life they are stainless, but in the interests of corporations . . . they will have recourse to every villainy damned in the decalogue."

Wilgus, *supra* note 47, at 72 (quoting Chandler, *Express Trusts*, N.Y. DAILY TRIB., Oct. 7, 1905, at 20).

121 David M. Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUTGERS L. REV. 184, 235 (1979).

122 Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983). Under state corporate law, the business and affairs of corporations are managed by the boards of directors. A limitation on their authority is a fiduciary duty to the corporation and the shareholders. *See* Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance*, 66 WASH. L. REV. 413, 442-443 (1991); *see also* Christu K.M. Dela Garza, *Conflict of Interest Transactions: Fiduciary Duties of Corporate Directors Who Are Also Controlling Shareholders*, 57 DENV. L. J. 609, 610 (1980) ("[T]he Uniform Fiduciaries Act defines a fiduciary as both a trustee of an express trust and a director or officer of a corporation.").

enterprise, subject to human failings, and the goal of the law has been to prevent, correct, or rectify those failings when necessary. The bulk of these adjudicative mechanisms come under the general heading of fiduciary duty."[123] The law thus chose a middle course to deal with the inherent conflict between management and shareholders, using the flexibility of the fiduciary duty doctrine to steer around the shoals.[124]

A critical benchmark in the application of fiduciary duties in the context of commercial operations came in the New York case of *Meinhard v. Salmon*.[125] There, Judge Cardozo, speaking for the court, held that a breach of fiduciary duty occurs where a joint venturer renewed and expanded an expiring lease without including his co-venturer.[126] That decision, however, was rendered by a sharply divided court (4-3), and leading commentators suggested that the rule would not be followed for corporate directors be-

123 Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1675 (1990).

124 Phillips, *supra* note 121, at 255.

125 164 N.E. 545 (N.Y. 1928).

126 In words that have frequently been quoted by courts in applying fiduciary duties to corporations and other business entities, Judge Cordozo stated:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgement of this court.

Id. at 546 (citation omitted). Earlier, the New York courts had held that a corporate agent may not compete with his principal. Beatty v. Guggenheim Exploration Co., 122 N.E. 378 (N.Y. 1919) (employee who had been sent to investigate property in which the corporation held an option breached a fiduciary duty by acquiring claims on adjoining property).

In Wendt v. Fisher, 154 N.E. 303 (Ct. App. N.Y. 1926), Judge Cardozo had also held that the duty of loyalty of fiduciaries in a commercial context is uncompromising. He stated that where the duty of loyalty was breached the law would not look to determine whether the contract was fair or unfair. If there are dual interests to be served, full disclosure must be made. If not, the party being represented by the fiduciary may have the transaction set aside without any inquiry as to whether the transaction was fair or unfair. "Only by this uncompromising rigidity has the rule of undivided loyalty been maintained against disintegrating erosion." *Id.* at 304. In Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. 1918), Judge Cardozo further stated that the fiduciary duty concept holds a director "to the duty of constant and unqualified fidelity." *Id.* at 379.

cause "the policy of facilitating business has prevailed over the older policy of removal of temptation."[127] Consequently, a lesser standard of care may be applied to the fiduciary duties of a board of directors under corporate law than activities under general trust law.[128]

Nevertheless, the *Meinhard* decision signaled a continued effort to extend the fiduciary concept into corporate law.[129] For example, in *Pepper v. Litton*,[130] the Supreme Court stated that directors and controlling shareholders are fiduciaries, and that their "dealings with the corporation are subject to rigorous scrutiny . . . ." Moreover, "[t]heir powers are powers in trust. . . . [the] fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as shareholders."[131]

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127 Scott, *supra* note 48, at 555 n.30.

128 Antonia M. Graumbach & W.B. McKeown, *Fiduciary Responsibilities of Private Foundation Boards*, 125 TR. & EST. 37 (1986). *See infra* note 139 and accompanying text. The concept of fiduciary duties for corporate officers and directors had begun to loosen before the decision in *Meinhard*. At an early point, there was a principle that absolutely precluded contracts between a corporation and its directors. This appeared to be the law in 1880. "Thirty years later this principle was dead." Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35, 39 (1966).

In the 1930s, after *Meinhard*, a famous academic debate began on the role of corporate management and their obligations to shareholders. It was then observed that the dispersal of stock holdings in publicly held corporations was separating management control from ownership. *See generally* A.A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); A.A. Berle, Jr., *Corporate Powers As Powers in Trust*, 31 HARV. L. REV. 1049 (1931); A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Joseph Biancalana, *Defining the Proper Corporate Constituency: Asking the Wrong Question*, 59 U. CIN. L. REV. 425 (1990); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?* 2 U. CHI. L. REV. 194 (1935). This debate has yet to end. In 1966, for example, Professor Brudney observed there is a lack of identity between the economic interests of those who control corporations while owning only a portion, or none, of the equity and the economic interests of the owners of the equity. Victor Brudney, *Fiduciary Idealogy in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 260 (1966). More recently, this debate has centered on whether independent directors should be added to the board of directors. *See generally* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 283-84 (1991).

129 The expansion of fiduciary duties into commercial realms has also been occurring in other countries. Dennis R. Klinck, *The Rise of the "Remedial" Fiduciary Relationship: A Comment on* International Corna Resources, Ltd. v. Lac Minerals, Ltd., 33 MCGILL L.J. 599, 601 (1988).

130 308 U.S. 295, 306 (1939).

131 *Id.* at 306-07. The scope of fiduciary duties owed by directors to creditors is today quite limited. *See infra* note 142. *See generally* David M.W. Harvey, *Bondholders Rights and*

By 1980, as Professor Coffee points out,[132] the courts had held that fiduciary duties of stockholders/directors under state law prohibited them from using their offices for personal benefit at the expense of other shareholders;[133] that majority shareholders who attempted to "freezeout" minority shareholders were subject to fiduciary duties;[134] that shareholders of a close corporation owed fiduciary duties to other shareholders;[135] and that fiduciary duties of corporate officers prohibited them from using inside information to profit in their own personal trading activities.[136]

In addition, directors and officers were precluded by reason of their fiduciary role from appropriating an opportunity that rightfully belonged to the corporation.[137] Fiduciary standards

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the Case For a Fiduciary Duty, 65 ST. JOHN'S L. REV. 1023 (1991); William Klein, *Equity v. Debt: Trying to Level The Corporate Money Field*, N.Y.L.J., Mar. 19, 1992, at 1.

132 Coffee, *supra* note 111, at 117 n.2.

133 "The obligations of a corporate director fall into two broad categories: a duty of loyalty and a duty of care." Jonathon W. Groessl, Note, *Delaware's New Section 102(b)(7): Boon or Bane for Corporate Directors?* 37 DEPAUL L. REV. 411, 441 (1988); Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care: Riddles Wisely Expounded*, 24 SUFFOLK U. L. REV. 923 (1990). *See generally* Zahn v. TransAmerica Corp., 162 F.2d 36, 45 (3d Cir. 1947).

134 Singer v. Magnavox Co., 380 A.2d 969, 976-78 (Del. 1977). For a discussion of the duties of majority shareholders to minority interests, see Gerald Gillerman, *The Corporate Fiduciary Under State Law*, 3 CORP. L. REV. 299 (1980). For a discussion of shareholder voting trusts and whether they implicate trust law principles, see generally Turner V. Adams, Note, *Corporations—Voting Trust—Should Trust Principles Apply to Close Corporations?*, 48 N.C. L. REV. 336, 342 (1970).

The Supreme Court has also held that a stockholder bringing a derivative action on behalf of a corporation is a fiduciary representing the interests of other shareholders. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949).

135 A Massachusetts court held that the members of a close corporation owed fiduciary duties essentially equal to that of partners in a partnership. The court stated that this strict good faith standard is more stringent than the standard of fiduciary duty to which directors and stockholders of other corporations must adhere. Donahue v. Rodd Electrotype Co. 328 N.E.2d 505, 515-16 (Mass. 1975). *See generally* Meiselman v. Meiselman, 307 S.E.2d 551 (N.C. 1983); Comment, *The Standard of Fiduciary Duty in a Close Corporation:* Donahue v. Rodd Electrotype, 61 IOWA L. REV. 876 (1976).

136 Diamond v. Oreamuno, 248 N.E.2d 910, 910-12 (N.Y. 1969). The decision in *Diamond v. Oreamuno* was, however, later rejected by at least two other courts. In Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), *vacated sub nom*, Leahman Bros. v. Schein, 416 U.S. 386 (1974), *petition for cert. filed*, 313 So. 2d 739 (Fla. 1975), the Second Circuit had concluded that the Florida courts would adopt the *Diamond v. Oreamuno* standard. The Supreme Court, however, vacated that decision and directed that the issue be certified to the Florida Supreme Court for decision. The Florida court rejected the *Diamond* standard. The Florida court's decision was followed in Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (diversity action applying Indiana law).

137 Jodi L. Popofsky, Note, *Corporate Opportunity and Corporate Competition: A Double-Barreled Theory of Fiduciary Liability*, 10 HOFSTRA L. REV. 1193 (1982). This theory is best exemplified by Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939). There the president and di-

were also often codified in state business corporation laws.[138] The Revised Model Business Corporation Act ("RMBCA"), however, did not use the term fiduciary duty because the draftsmen were concerned that the concept was being confused with the law of trusts. It was thought that some of the duties imposed on trustees are not appropriate for directors.[139] Instead, the RMBCA establishes a duty of good faith and requires the care that an ordinarily prudent person in a like position would exercise under similar circumstances. This in essence is designed to define the fiduciary duties of a director without labeling them as such.

The approach taken by the RMBCA was a reflection of the erosion and resistance to the expansion of these fiduciary duties.[140] In the 1960s, prior to the approval of the RMBCA, Professor William Cary charged that the Delaware courts had "contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights."[141] Delaware and other states also began allowing corporations to limit the liability of corporate directors for fiduciary violations.[142]

The application of fiduciary duties in a corporate context has not been abandoned in Delaware. Before and after Professor Cary's criticisms, the Delaware courts held that a basic principle of

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rector of Loft, Inc. was found to have used his position and assets of the company to revitalize the failing Pepsi-Cola Company for his own personal benefit. Thereafter, however, the legislatures began a process of allowing corporate opportunities to be acquired where there is full disclosure and independent director approval. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (1974); REVISED MODEL BUSINESS CORPORATION ACT § 8.62 (1985).

138 J. Kenneth Moritz, Note, *Toward Standards for Managers Subject to Hostile Bids: The Tri-Level Model*, 50 U. PITT. L. REV. 269, 273 (1988).

139 REVISED MODEL BUSINESS CORPORATION ACT § 8.30 commentary at 222 (1985).

140 One author has stated that:

> The original analogy between a trustee and those who control a corporation was a close one. But as corporations began to play a role of increasing importance in an increasingly complex commercial world, the strictures imposed by the law on a true trustee gradually eroded. Today little is left but the basic notion that officers, directors, and controlling shareholders owe some sort of duty, one that will be enforced by the court, to the corporation, and through it to the shareholders.

LEWIS D. SOLOMON ET AL., CORPORATIONS 545 (1982).

141 William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974), *noted in* Bartley A. Brennan, *Current Developments Surrounding the Business Judgment Rule: A "Race to the Bottom" Theory of Corporate Law Revived*, 12 WHITTIER L. REV. 299, 303 (1991).

142 Douglas M. Branson, *Assault On Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 380-81 (1988).

Delaware corporate law is that directors have a fiduciary duty to act in the best interests of the corporation's shareholders.[143] Its scope and application, however, seem to depend on the prevailing winds of a judiciary that often and unpredictably changes course as new issues arise. This became most apparent during the takeover mania of the 1980s.[144] The fiduciary duty principle allowed the Delaware courts effectively to superimpose themselves over the board of directors of Delaware corporations during the many takeovers that occurred during this period. In that role, the Delaware courts reviewed acquisitions for such things as fairness to minority stockholders,[145]and they sought to impose judicial due process type decisionmaking procedures on boards of directors in considering proposals to buy out companies and in reacting to such proposals.[146] Those efforts were often conflicting,[147] and they

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143 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc. 5 A.2d 503, 510 (Del. 1939).

144 For a discussion of the problem raised by fiduciary duties analysis in the context of mergers and acquisitions, see e.g., Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); John C. Coffee, Jr., *Shareholders v. Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Harvey L. Pitt, *On the Precipice: A Reexamination of Director's Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811 (1990); Felicia Smith, *Recognition of the Fiduciary Duties of Corporate Directors and Officers Defending Against Change of Control by Tender Offer*, 7 MISS. C. L. REV. 117 (1987); Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238 (1979). *See also* Robert L. Bevan, *Fiduciaries Face Complex Demands when Corporate Takeovers Occur*, 125 TR. & EST. 42 (1986) (discussion of how a bank trust department should handle tender offers); Daniel M. Snow, Note, *Bank Financing of Involuntary Take-Overs of Corporate Customers: A Breach of a Fiduciary Duty?*, 53 NOTRE DAME LAW. 827 (1978) (discussion of claims that banks have fiduciary duties in financing competing interests in tender offers); Comment, *Disclosure of Confidential Information—A Commercial Bank Has No Fiduciary Duty to Refrain from Financing a Takeover of a Borrower Nor Is It Precluded from Using Such Information from One Borrower to Evaluate a Loan to Another*—Washington Steel Corp. v. T.W. Corp., 14 GA. L. REV. 116 (1979).

Duties of pension funds trustees under ERISA may also come into conflict with the interest of companies to have their pension funds serve as a foil for tender offers. *See infra* notes 149-55 and accompanying text; Ann Myre, Note, *Fiduciary Duties of Pension Fund Managers In Corporate Take-overs*, 11 N. KY. L. REV. 553 (1984).

Fiduciary duty issues have also been raised in connection with going private transactions. Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freeze-Outs*, 87 YALE L.J. 1354, 1365-70 (1978). *See generally* Ronald A. Brown, Jr., Note, *Claims of Aiding and Abetting a Director's Breach of Fiduciary Duty—Does Everyone Who Deals with a Delaware Director Owe Fiduciary Duties to that Director's Shareholders*, 15 DEL. J. CORP. L. 943 (1990).

145 For a discussion of the evolution of fiduciary duties in the Delaware courts, see Charles W. Murdock, *Delaware: The Race to the Bottom—Is an End in Sight?*, 9 LOY. U. CHI. L.J. 643 (1978).

146 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *See generally* William F. Johnson,

"triggered a sharp debate."[148] The result was confusion and a less than complete understanding of what is expected of corporate managers.

E. *Federal Laws and Fiduciary Duties*

1. ERISA

Fiduciary duties have also found their way into federal law. The most visible of those incursions is found in ERISA, which imposes broad fiduciary duties on the administrators of retirement plans[149] that now hold trillions of dollars in assets.[150] The intent of ERISA was "to incorporate and federalize the common law of trusts as appropriate in view of the special nature and purposes of employee benefit plans."[151] The standards for administrators established by the federal government under ERISA have often

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Note, Mills Acquisition Co. v. MacMillan, Inc.: *Corporate Auctions Now Require Sharper Supervision by Directors*, 39 AM. U. L. REV. 721 (1990).

The Delaware courts and others also strongly suggested that the use of outside directors may better assure that corporate management is meeting its fiduciary duties. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir. 1981); Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Solash v. Telex Corp. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. 1988); *supra* note 145. For a discussion of the increased role of outside directors in management, see generally Arthur W. Hahn & Carol B. Manzoni, *The Monitoring Committee and Outside Directors' Evolving Duty of Care*, 9 LOY. U. CHI. L.J. 587 (1978).

147 *Compare Smith*, 488 A.2d at 858 *and Revlon*, 506 A.2d at 173 *with* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

148 Tamar Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 705 (1984); A.A. Sommer, Jr., *The Duty of Loyalty in the ALI's Corporate Governance Project*, 52 GEO. WASH. L. REV. 719 (1984); *see also* Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497 (1992) (discussion of need to apply fiduciary duties to investment bankers in merger transactions).

149 Under ERISA a party is considered a fiduciary if it uses discretion in administering a benefits plan, controlling its assets, or providing investment advice to the plan. William L. Scogland, *Fiduciary Duty: What Does it Mean?*, 24 TORT & INS. L.J. 803 (1988-89); *see also* Scott A. Cammar, Note, *Interpreting ERISA: Corporate Officer Liability for Delinquent Contributions*, 1986 DUKE L.J. 710, 724-25 (the definition of a fiduciary under ERISA is very broad and may include any corporate officer who exercises authority or discretionary control over a plan's management, assets or administration).

150 O'BARR & CONLEY, *supra* note 62, at 25-39.

ERISA was adopted by Congress in recognition of the fact that pension plans were holding substantial wealth and that many members of the public were dependent on their pension schemes for retirement. Myre, *supra* note 144.

151 Monica Gallagher, *Recent Developments and Concepts Relating to Fiduciary Liability*, 16 FORUM 753 (1964).

been confusing, but they have also sometimes been more flexible than traditional trust standards.[152] For example, the Department of Labor has adopted prudential investment standards that recognize modern portfolio investment theory.[153] The ERISA concept of fiduciary duties, however, continues to raise the following, difficult issues for benefit plan administrators: Should administrators participate in the management of companies in which the plan holds stock?[154] Should they seek to have their companies act in a socially responsible manner?[155]

152 For a discussion of fiduciary standards under ERISA, see generally Daniel C. Knickerbockers, Jr., *Trust Law with a Difference: An Overview of ERISA Fiduciary Responsibility,* 23 REAL PROP. PROBS. & TR. J. 633 (1988); Scogland, *supra* note 149; Bill Shaw et al., *Investment Prudence and Fiduciary Responsibility in Managing Defined Benefit Pension Funds Under ERISA,* 22 SUFFOLK U. L. REV. 83 (1988); Leslie L. Wellman & Shari J. Clark, *An Overview of Pension Benefit and Fiduciary Litigation Under ERISA,* 26 WILLAMETTE L. REV. 665 (1990); Bradley R. Duncan, Note, *Judicial Review of Fiduciary Claim Denials Under ERISA: An Alternative to the Arbitrary and Capricious Test,* 71 CORNELL L. REV. 986 (1986); Note, *Fiduciary Standards and the Prudent Man Rule Under the Employment Retirement Income Security Act of 1974,* 88 HARV. L. REV. 960 (1975); Deborah A. Geier, Note, *ERISA: Punitive Damages for a Breach of Fiduciary Duty,* 35 CASE W. RES. L. REV. 743 (1985); Judy B. Shepura, Note, *Fiduciary Duties Under ERISA: Interpretations Within the Eleventh Circuit,* 19 CUMB. L. REV. 131 (1988); Donald J. Weiss, Note, *Conflicts of Interest Arising Under ERISA's Fiduciary Standards: Can the Trustee Ever Be Prudent As Long As He Faces Dual Loyalties?,* 9 NOVA L.J. 413 (1985).

153 For a discussion of the prudent-person rule under ERISA, see James D. Hutchinson, *The Federal Prudent-Man Rule Under ERISA,* 22 VILL. L. REV. 15 (1976-77); Morton Klevan, *Fiduciary Responsibility Under ERISA's Prudent-Man Rule: What are the Guide Posts?,* 44 J. TAX'N. 152 (1976); H. Stenris Little & Larry T. Thrailkill, *Fiduciaries Under ERISA: A Narrow Path to Tread,* 30 VAND. L. REV. 1 (1977); Timothy R. Garmager, Note, *Economic Analysis and the Prudent-Man Rule Under ERISA: Efficiency Versus the Public Interest,* 7 LOY. U. CHI. L.J. 683 (1976).

The Department of Labor's regulations under ERISA "reflect most dramatically the influence of portfolio theory because they specifically state that the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall portfolio." Bevis Longstreth, *Fiduciaries, Capital Markets and Regulation: The Current Challenge,* 7 ANN. REV. BANKING L. 237, 239-40 (1988).

154 *See generally* Jayne W. Barnard, *Institutional Investors and the New Corporate Governance,* 69 N.C. L. REV. 1135 (1991); Richard W. Stevenson, *Large Foot in Board-Room Door,* N.Y. TIMES, June 6, 1991, at D1; James A. White, *Giant California Pension Fund Softens Approach to Influencing Corporations,* WALL ST. J., Oct. 7, 1991, at C9; James A. White, *New York's Regan to Pensions: Hands Off,* WALL ST. J., Sept. 13, 1991, at C1.

The role to be played by plan administrators is not a mere academic issue. By 1988, it was "statistically apparent that institutional trustee shareholders control corporate America." Robert A.G. Monks, *Introduction To Pension and Trust Fiduciaries: Risks and Duties as Corporate Shareholders,* 7 ANN. REV. BANKING L. 223 (1988). In fact, benefit schemes regulated by ERISA are the dominant owners of American industrial firms. *Id.* at 227. *See generally* O'BARR & CONLEY, *supra* note 62.

155 *See generally* Eugene Maloney, *Proxy Voting Responsibility Under ERISA,* 7 ANN. REV. BANKING L. 259, 262-63 (1988).

2. The Federal Securities Laws

The federal securities laws have also raised the specter of fiduciary duties. A House committee report published in connection with the adoption of the Securities Exchange Act of 1934 equated fiduciary duties of market participants with a "guarantee of 'straight shooting.'"[156] The courts also seemed willing to find such duties to be implicit in those acts. For example, in *Securities and Exchange Commission v. Chenery Corp.*,[157] Justice Frankfurter stated that officers and directors of holding companies undergoing reorganization under the Public Utility Holding Company Act of 1935[158] "occupy positions of trust."[159] The Court rejected "a lax view of fiduciary obligations," but it noted that identifying the scope and nature of fiduciary duties raised a number of questions:

> [T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[160]

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156 H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5 (1934).

157 318 U.S. 80, 85-86 (1943).

158 15 U.S.C. § 79 (1988).

159 *Chenery*, 318 U.S. at 85.

160 *Id.* at 85-86. An early problem raising fiduciary duty issues in the securities markets involved agreements under which an indenture trustee, such as a bank or other financial institution, was named as a party for enforcing bond holder rights under the indenture agreement. For a discussion of the trust indenture, see generally Louis S. Posner, *Liability of the Trustee Under the Corporate Indenture*, 42 HARV. L. REV. 198 (1928); Louis S. Posner, *The Trustee and the Trust Indenture: A Further Study*, 46 YALE L.J. 737 (1937). *See also* Richard B. Smith et al., *The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision*, 35 BUS. LAW. 161, 163-64 (1979) (description of the history of corporate indenture agreements). Such indenture transactions date back to at least 1830, but they did not receive notoriety until the stock market crash in 1929, which resulted in numerous corporate reorganizations where the rights of bond holders were often abused or left unprotected by indenture trustees. Those "trustees" were often affiliated with management in the company being reorganized, and they expressed the view that their duties where chiefly ministerial. *See generally* SECURITIES & EXCH. COMM'N, REPORT OF THE STUDY AND INVESTIGATION OF THE WORK ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-40); Albert R. Jones, *The Corporate Trustee Problem*, 26 KY. L.J. 3 (1937).

Initially, the courts took different views on the scope of indenture trustees' fiduciary duties. Smith, *supra*, at 164. But concerns with conflicts increased as a result of the stock market crash of 1929 and because of the massive growth of debentures. Indeed, by 1931, over 10 billion dollars in bond issues were being handled by bank trustees under bond indentures. Shinn, *supra* note 58, at 359 n.1. A massive study conducted by the SEC also revealed abuses. SECURITIES & EXCH.COMM'N, *supra*. That study resulted in the enactment

The creation of private rights of action under rule 10b-5[161] and its expansive application also "helped fill the gap in the law left by the erosion of state law [of fiduciary] duties."[162] In addition, the SEC asserted that the securities laws created a new federal corporation law with fiduciary duties greater than those imposed by state law.[163] The SEC sought an expansive application of such duties, and it was aided in that effort by the courts.[164] For example, in *Rosenfeld v. Black*,[165] the Second Circuit held that fiduciary principles precluded an investment adviser to a mutual fund from selling its position to another adviser.[166]

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of the Trust Indenture Act of 1939, which imposed limited fiduciary duties on indenture trustees. For a discussion of the history and background of that act, see John P. Campbell & Robert Zack, *Put a Bullet in the Poor Beast. His Leg is Broken and His Use has Passed. Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: a Proposal to End it in the Public Interest*, 32 BUS. LAW. 1705 (1977); Michael V. Campbell, *Implications of the Trust Indenture Reform Act of 1990: Breathing New life into the Trust Indenture Act of 1939*, 11 ANN. REV. BANKING L. 181 (1992); Henry F. Johnson, *The 'Forgotten' Securities Statute: Problems in the Trust Indenture Act*, 13 U. TOL. L. REV. 92 (1981); William A. Johnson, *Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default*, 15 ST. LOUIS U. L.J. 203 (1970); Wilker G. Katz, *Responsibility of Trustees Under the Federal Trust Indenture Act of 1939*, 26 A.B.A. J. 290 (1940); H.C. McCollom, *The Securities and Exchange Commission and Corporate Trustees*, 36 COL. L. REV. 1197 (1936); Robert G. Miller, *Legislation: The Trust Indenture Act of 1939*, 25 CORNELL L.Q. 105 (1939-40); Stewart M. Robertson, *The Venture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL'Y 461, 472-77 (1988); Frederica R. Olorzut, Note, *The Trust Indenture Act of 1939: The Corporate Trustee as Creditor*, 24 UCLA L. REV. 131 (1976).

161 17 C.F.R. § 240.10b-5 (1992).

162 Robert S. Schwartz, Note, *SEC Rule 10b-5: Constructive Fraud in the Liabilities of Fiduciaries*, 35 OHIO ST. L.J. 934 (1974).

163 *Id.* (citing Cady Roberts & Co., 40 S.E.C. 907 (1961)).

164 The SEC has also broadened the fiduciary duties applied to broker/dealers under the federal securities laws by establishing the so-called "shingle" theory. This theory suggests that a broker is a professional who hangs out his or her shingle and makes an implied representation to the public that they will be dealt with fairly by the professional. Carl Wartman, Note, *Broker Dealers, Market Makers and Fiduciary Duties*, 9 LOY. U. CHI. L.J. 746, 747 (1978).

165 445 F.2d 1337 (2d Cir. 1971), *cert. denied*, 409 U.S. 802 (1972).

166 The Second Circuit was not creating new law, as evidenced by an old English opinion:

> This is a very extraordinary case . . . . I do not remember a case where the office of a trustee has been purchased for money . . . . [I]t is a well-settled principle that, if a trustee makes a profit of his trusteeship, it shall inure to the benefit of his *cestui qui trusts*. Though there is some peculiarity in the case, there does not seem to be any difference in principle whether the trustee derived the profit by means of the trust property, or from the office itself. I shall therefore direct that the £75 be repaid . . . and further declare the deed to be void.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[167] the Supreme Court seemed to lend further credence to the SEC's views. The Court stated that a "controlling stockholder owes the corporation a fiduciary obligation—one 'designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.'"[168] In that opinion, Justice Douglas quoted from the legislative history of the Securities Exchange Act of 1934: "'[D]isregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like."[169] He also stated, however, that Congress did not intend section 10(b) of the Securities Exchange Act of 1934[170] to serve

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Sugden v. Crossland, 3 Sm. & Giss. 192, 193-94, 65 Eng. Rep. 620, 621 (1856). *But see* SEC v. Insurance Sec., Inc., 254 F.2d 642 (9th Cir.) (permitting sale of advisory relationship), *cert. denied*, 358 U.S. 823 (1958); Krieger v. Anderson, 182 A.2d 907 (Del. 1962) (allowing sale of advisory relationship). *See generally* Note, *Advisory Succession in the Mutual Fund Industry*, 67 NW. U. L. REV. 278 (1972); Harold Schiffman, Note, *The Relationship Between the Investment Advisor and the Mutual Fund: Too Close for Comfort*, 45 FORDHAM L. REV. 184 (1976); A. Ross Wollen, Note, *Mutual Fund Control-Transfer Profits: Congress, the SEC, and* Rosenfeld v. Black, 58 VA. L. REV. 371 (1972). For a discussion of the fiduciary duties of investment advisers, see Allan M. Ahart, *Advising the Individual Investor: Comparing the Federal Regulation of Investment Advisers, Banks, and Broker-Dealers*, 6 PEPP. L. REV. 31 (1978).

Mutual fund managers may also be viewed to have fiduciary duties under the Investment Company Act of 1940, 15 U.S.C. § 80(a) (1988). *See* Clarke Randall, *Fiduciary Duties of Investment Company Directors and Management Companies Under the Investment Company Act of 1940*, 31 OKLA. L. REV. 635 (1978). Shareholders may also enforce fiduciary duties under that Act. Kamen v. Kemper Fin. Serv., 111 S. Ct. 1711 (1991). The Investment Company Act of 1940, however, is probably a case where defining specific standards to enforce a fiduciary role has run riot. *See generally* John P. Freeman, *The Use of Mutual Funds Assets to Pay Marketing Cost*, 9 LOY. U. CHI. L.J. 533 (1978) (discussing some of the complexities of the Investment Company Act of 1940); Joel H. Goldberg, *Disinterested Directors, Independent Directors and the Investment Act of 1940*, 9 LOY. U. CHI. L.J. 565 (1978).

167 404 U.S. 6 (1971)

168 *Id.* at 12 (quoting Pepper v. Litton, 308 U.S. 295, 307 (1939)).

In a very early case, Justice Story stated that shareholders' equity in a corporation is in the nature of a trust fund for creditors. Wood v. Dummer, 30 Fed. Cas. 435 (C.C.D. Me. 1824). But in 1892 the Supreme Court of Minnesota stated that the trust fund theory was in a shambles. *See* BAYLES MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 46 (2d ed. 1981). The scope of fiduciary duties owed by directors to creditors is today quite limited. *See supra* note 142; George S. Corey et al., *Are Bond-Holders Owed a Fiduciary Duty?*, 18 FLA. ST. U. L. REV. 971 (1991).

169 *Bankers Life*, 404 U.S. at 11-12 (quoting from H.R. REP. NO. 1383, 73d Cong., 2d Sess. 6 (1934)).

170 15 U.S.C. § 78j(b) (1988).

as a means "to regulate transactions which constitute no more than internal corporate mismanagement."[171]

These events seemed to herald an era of expanded fiduciary duties in the federal securities laws. That hope, or fear, was cut short by the Supreme Court's decision in *Santa Fe Industries v. Green.*[172] The Supreme Court would not read a broad fiduciary concept into rule 10b-5,[173] the most frequently litigated provision of the federal securities laws.[174] The Supreme Court, however, has since sown much confusion because it has held that a person utilizing "inside" information does not violate rule 10b-5 unless that person has breached some fiduciary or other duty in obtaining such information.[175] The Supreme Court also continues seemingly to recognize fiduciary duties under the federal securities laws even as it acts to limit their scope. In *Virginia Bankshares, Inc. v. Sandberg,*[176] for example, the Supreme Court recognized that directors of corporations have fiduciary duties to shareholders, and that statements made by a board of directors may be given special importance by shareholders. Nevertheless, the Court found no liability for misleading statements in a proxy statement because the shareholders were not required by law to have voted on the action

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171 *Bankers Life,* 404 U.S. at 12.

172 430 U.S. 462 (1977).

173 17 C.F.R. § 240.10b-5 (1992).

174 *See generally* Thomas L. Hazen, *Corporate Mismanagement and the Federal Securities Act's Anti-Fraud Provisions: A Familiar Path With Some New Detours,* 20 B.C. L. REV. 819 (1979).

The decision in *Santa Fe* contrasts with the trend in recent years of treating breach of fiduciary duties by corporate officers as criminal offenses under federal law. *See generally* John C. Coffee, Jr., *Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics,* 19 AM. CRIM. L. REV. 117 (1981); Peter R. Ezersky, Note, *Intra-Corporate Mail and Wire Fraud: Criminal Liability for Fiduciary Breach,* 94 YALE L.J. 1427 (1985).

175 In Chiarella v. United States, 445 U.S. 222 (1980), the Supreme Court held that a printer who purloined confidential financial information from his job materials was not criminally liable under the federal securities laws for trading on inside information where there was no fiduciary obligation on his part to disclose that information. *See also* Dirks v. SEC, 463 U.S. 646 (1983) (investment adviser could tip his clients on information received from a corporate insider). *Compare* Carpenter v. United States, 484 U.S. 19 (1987) (Wall Street Journal reporter liable under rule 10b-5 for "misappropriating" market moving information from the Journal prior to publication. However, this decision was a 4-4 affirmance of the decision of the Second Circuit).

In United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), the Second Circuit held that family members and their "tippees" were not under a fiduciary duty to refrain from trading on confidential information imparted by another family member. *See also* Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991) (attorney did not owe fiduciary duty of disclosure to third parties).

176 111 S. Ct. 2749 (1991).

in question.[177] In contrast, the Court of Appeals for the District of Columbia recently held that a securities broker breached fiduciary duties when it failed to advise customers that they had the right to disavow unauthorized trades that were placed in their account.[178] The result of all this is that the federal securities laws

177 Even before the *Santa Fe* decision, a district court had held in Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd,* 453 F.2d 417 (5th Cir. 1972), that a securities broker did not owe a fiduciary duty to its customers unless there was an express investment advisory contract or unless the customer was "infirm or ignorant of business affairs." *Id.* at 113. *Compare* Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981) (broker liable under section 10(b) if trading was excessive in light of investment objectives, broker exercised control over the trading, and broker acted with intent to defraud with willful and reckless disregard for investor's interests) *and* Mihara v. Dean Whitter & Co., 619 F.2d 814, 821-22 (9th Cir. 1980) (account executive has duty not to place his interests over clients by excessive, unwarranted trading). The Second Circuit has also held that the New York Stock Exchange is not a fiduciary to investors who deal with its members. Baird v. Franklin, 141 F.2d 238 (2d Cir.) (or without willful and reckless disregard for investor's interests), *cert. denied,* 323 U.S. 737 (1944). *See generally* McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254, 1258 (8th Cir. 1984) (expressing need to show more than a simple broker-customer contract).

178 Merrill Lynch, Pierce, Fenner Smith, Inc. v. Chong, 901 F.2d 1124 (D.C. Cir. 1990). In Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd,* 647 F.2d 165 (6th Cir. 1981), the district court held that the fiduciary duties of a broker would vary, depending on the nature of the account at issue. Those duties would be more narrow for a "nondiscretionary" account, as opposed to a "discretionary" account in which the broker controls the trading rather than the customer. *Id.* at 952-53. The duties associated with a "nondiscretionary" account may include the duty to recommend a stock only after studying it sufficiently and finding a reasonable basis for doing so; to execute the customer orders promptly; to inform the customer of the risks of the transaction; to refrain from self-dealing; to not misrepresent material facts; and to conduct transactions for the customer only upon the customer's authorization. *Id.* at 953. The court also stated that the methods for accomplishing these duties might vary, depending on the sophistication of the customer. *Id.* In no event would these duties include a duty either to keep abreast of financial information that would affect the value of a customer's investment, or to prevent the customer from engaging in a risky transaction, provided that the broker meets the fiduciary duties listed by the court. *Id.*

In a discretionary account, the *Leib* court would find enhanced fiduciary duties. These duties would include a fiduciary duty to manage the account in accordance with the needs and objectives of the customer; to keep informed regarding changes in the market which would affect the customers investment; to keep the customer advised of transactions in the account; and to advise the customer of potential risks for the course of trading that the broker is engaged in on behalf of the customer. *Id. See also* Caravan Mobile Home Sales v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985) (stockbroker assumes no obligation to advise customers of information that may affect their investment where the account is a non-discretionary account); Thompson McKinnon Sec., Inc. v. Moore's Farm Supply, 557 F. Supp. 1004, 1011-12 (W.D. Tenn. 1983) (securities broker breached its fiduciary duty when it failed to liquidate a customer account as directed).

At least one arbitration panel has held, however, that even discount brokers, who seek to act only in the role as an order taker, must supervise customer trading strategies are as muddled as state corporate laws in their application of fiduciary duties.[179]

F. Law, Economics and Academics

In recent years, scholars have begun to question whether fiduciary principles may be counterproductive because it is thought that they reduce the efficiency of business.[180] Indeed, the so-called Chicago school of law and economics has launched what sometimes appears to be a frontal assault on the fiduciary concept.[181] This school argues that contract law should control commercial relationships,[182] and that commercial relationships should be viewed as being composed of a series of agency costs and responsibilities.[183] That approach has met with

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to prevent huge losses. *See* Milo Geyelin, *Discount Broker is Held Liable for Losses*, WALL ST. J., June 18, 1991, at C1. The New York Stock Exchange has also said that discount brokers have a duty to prevent customers from ruining themselves. *See* Michael Siconolfi, *Discounters Must Watch Out for Customers, Big Board Says*, WALL ST. J., July 19, 1991, at C1; Michael Siconolfi, *Bear Stearns Fined in Case Involving Savvy*, WALL ST. J., June 12, 1992, at C1.

179 The application of fiduciary duties under the federal securities laws has raised other problems. The concept of fiduciary duties led to the belief that brokers, as agents, have a duty to obtain the best execution price for customer orders. This has raised serious and delicate questions in SEC and congressional efforts to establish a central market system. 15 U.S.C. § 78k-1 (1988). *See generally* Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981), *revised by and reprinted in* I AMERICAN BAR ASSOCIATION, GLOBAL CAPITAL MARKETS AND THE DISTRIBUTION OF SECURITIES 10, 28-29 (1991) (discussion of "best execution" fiduciary concerns in the development of a central securities market system).

180 Hu, *supra* note 86.

181 One author has stated that the fiduciary concept is "the principal device" used "to restrict the otherwise unfettered powers of persons who are entrusted with control over the assets and affairs of others." Davis, *supra* note 112. He notes that economists have studied the implications of the divergence of interests between fiduciaries and principals. *Id.* at 2. As a result of their work, lawyers have begun to question whether the fiduciary duty mechanism was "short-sighted" and whether "contract and market mechanisms are available to protect the underlying interests of the shareholders more efficiently." *Id.*

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> Fiduciary law is stricter on fiduciaries than contract law is on ordinary contracting parties in at least four fundamental respects. There are stricter rules about disclosure, more open-ended duties to act, tighter delineations of rights to compensation and to benefits that could flow from one's position, and more intrusive normative rhetoric. These elements of strictness do not arise from actual contracts but have been created by judges in the common law tradition.

Robert C. Clark, *Insider Trading as an Agency Problem*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 76, 76 (John W. Pratt and Richard J. Zeckahuser eds. 1984). These duties are designed to deter managerial abuse of discretion. *Id.* at 77.

183 Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate*

opposition.[184] Nevertheless, the courts and the SEC have begun to consider some aspects of this contractual rights viewpoint and have begun to limit the role that fiduciary duty may play in corporate law.[185]

Another academic view would make fiduciary duties uniform in all fields of the law. Professor Frankel has argued that fiduciaries be treated as a group that is subject to a distinct body of

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Control, 65 CHI.-KENT L. REV. 681 (1989). Law and economic scholars are suspicious of using fiduciary duties to regulate corporations. They view "the corporation as a nexus of contracts, [and] treat common law and state statutory provisions as implied terms of a contract by which both managers and shareholders seek to reduce the agency costs associated with centralized management." *Id.* at 687. This contract model "does not treat fiduciary rules as the primary tool for reducing agency costs because they require costly judicial intervention." *Id.* at 687; *see also* J.A.L. Hetherington, *Defining the Scope of Controlling Shareholder's Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9 (1987) (advocating a contractual rights model as opposed to a fiduciary duty model for corporations). Even some of the more ardent free market advocates in this school, however, grant the need for at least restraining fraud. *See generally* United States v. Dial, 757 F.2d 163 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985); Frank H. Easterbrook, *Monopoly, Manipulation, and the Regulation of Futures Markets*, 59 J. BUS. 103 (1986); Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in the Financial Markets?* 105 HARV. L. REV. 503 (1991).

One author has posited that officers and directors are fiduciaries because they are agents of shareholders, and agents have fiduciary responsibilities. Thomas J. Kelly, *Economic Institutions and Values: Fiduciary Responsibility of Corporate Officers and Directors*, 36 NOTRE DAME LAW. 343 (1960-61). *But see* Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85 (1880) (directors have independent judgement); Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991) (application of law and economics to define appropriate role of fiduciary duties).

184 "Because directors manage the shareholders' investment, they should be held accountable for their misdeeds. The age-old analogy of corporate directors to trustees is not misplaced." Thomas L. Hazen, *Corporate Directors' Accountability: The Race to the Bottom-The Second Lap*, 66 N.C. L. REV. 171, 179 (1987). *See generally* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness: Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders*, 60 TEMP. L.Q. 47 (1987); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273 (1991); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

185 In Jordan v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988), a judge from the so-called school of law and economics stated that:

> Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements. It is a violation of duty to steal from the corporate treasury; it is not a violation to write oneself a check that the board has approved as a bonus.

Id. at 436.

policies, principles, and rules. This is in contrast to the present law which treats fiduciaries as being of varying types with varying duties.[186] Until Professor Frankel's position is adopted, however, the present law will continue to recognize that some fiduciary relationships are more intense than others. In other words, "[t]he greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty."[187] For example, agents, trustees, and corporate managers are all fiduciaries and are subject to the fiduciary principle of loyalty, although not to the same extent.[188]

IV. FIDUCIARY DUTIES UNDER THE COMMODITY EXCHANGE ACT

A. *Legislation*

Until this century, commodity brokers were regulated almost entirely by state law. Under state law, "[t]he agency of a stock or commodity broker, contemplating as it does the dealing in the money and other property of his principal, is fiduciary in nature."[189] As such, the broker was viewed as a "quasi-trustee"[190] who had to act with the "utmost good faith and integrity."[191]

In 1922, the federal government began to regulate the futures markets.[192] That legislation, however, proved to be ineffective, as

186 Frankel, *supra* note 50; *see also* J.C. Shepherd, Note, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51 (1981) (discussion of unifying fiduciary principles).

187 Scott, *supra* note 48, at 541.

188 *Id.* For a discussion of the duty of loyalty owed by corporate officials, see David S. Ruder, *Duty of Loyalty-A Law Professor's Status Report*, 40 BUS. LAW. 1383 (1985).

189 CHARLES MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES 251 (1931). *But see* DeSciose v. Chiles, Heider & Co., 476 N.W.2d 200 (Neb. 1991); Vogelaar v. H.L. Robbins & Co., 204 N.E.2d 461 (Mass. 1965).

190 MEYER, *supra* note 189, at 252.

191 *Id.* at 253, 265-66.

192 Initially, Congress adopted the Future Trading Act, ch. 86, 42 Stat. 187 (1921). The Supreme Court, however, declared that statute to be an unconstitutional exercise of congressional taxing power. Hill v. Wallace, 259 U.S. 44 (1922). Undaunted, Congress reenacted the legislation under its commerce power, and named it the Grain Futures Act of 1922, 42 Stat. 998 (1922). The legislation was then held to be constitutional. Chicago Bd. of Trade v. Olsen, 262 U.S. 839 (1923). The Grain Futures Act established a licensing system that designated commodity exchanges as "contract markets." The Act required all futures trading to be conducted on such contract markets, and required contract markets to police their members and prevent them from engaging in price manipulations.

There were very few other protections in the statute that were designed to protect the public specifically or to establish fiduciary duties. Even before the adoption of this evidenced by the effects of the stock market crash of 1929 on the futures markets.[193] President Roosevelt then called for legislation to regulate both the securities and futures markets.[194] Legislation was not adopted in the commodity futures area, however, until 1936. That legislation, the Commodity Exchange Act,[195] carried forward the licensing system that had been utilized in the 1922 legislation for exchanges. In addition, it effectively regulated the activities of brokerage firms for the first time. These brokerage firms, called "futures commission merchants," had to be licensed in order to solicit and execute customer orders on the exchanges.[196] Additionally, the Act required brokers to segregate their customer margin funds from the brokerage firm's own monies.[197] This was a recognition that these funds were held in what amounted to a trust for customers. Congress thought that such a segregation would prevent customer funds from being improperly used to margin the accounts of other customers or for the proprietary trading of the futures commission merchant.[198] This trust fund theory remains in the present legislation.[199]

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legislation, however, the Federal Trade Commission had suggested in a massive study of the commodity markets that brokers owed fiduciary duties to customers. It did not specify what those duties were. FEDERAL TRADE COMM'N, REPORT ON THE GRAIN TRADE, 5 FUTURES TRADING OPERATIONS IN GRAIN 318-19 (1920).

At least some futures traders could have benefitted from an expansive application of fiduciary duties. For example, John Anderson Truman lost about $40,000 in futures trading in 1901, causing his son to forsake a college education and to give up his piano lessons. The son's sense of loss from those deprivations was plain even after he became the President of the United States. RICHARD L. MILLER, TRUMAN: THE RISE TO POWER 41, 47 (1985). Lyndon Johnson's father also thrust his family into poverty as a result of his cotton futures speculations. ROBERT DALLEK, LONE STAR RISING: LYNDON JOHNSON AND HIS TIMES 1908-1960 24 (1991). The richest man in the world at that time, H.L. Hunt, lost everything in the futures markets before he acquired his oil fortune. Two of his sons, Nelson Bunker and Herbert, have not been so lucky. HARRY HURT, TEXAS RICH: THE HUNT DYNASTY FROM THE EARLY DAYS THROUGH THE SILVER CRASH 28, 47-48 (1981).

193 WILLIAM R. KLINGAMAN, 1929: THE YEAR OF THE GREAT CRASH 338 (1989); *Wheat's Plunge to a 300 Year Low*, LITERARY DIG., Nov. 12, 1932, at 6.

194 H.R. REP. NO. 421, 74th Cong., 1st Sess. 2 (1935). President Roosevelt had stated that federal regulation was necessary "for the protection of investors." *Id.*

195 Commodity Exchange Act, ch. 545, § 1, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. §§ 1-26 (1988)).

196 7 U.S.C. § 6d.

197 *See id.*

198 Note, *Legislation, The Commodity Exchange Act of 1936*, U. PA. L. REV. 614, 618 (1937); *see also Grain Futures Act Amendment: Hearings on H.R. 11952 Before the House Comm. on Agriculture*, 70th Cong., 1st Sess. 2, at 11-12 (1928) ("these provisions seem entirely clear and should prevent losses which frequently occur to customers through the financial failures of commission houses resulting from the use of margin monies for their own speculative purposes.").

199 Customers funds enjoy special trust fund status in bankruptcy proceedings so that

The Commodity Exchange Act imposed other standards that seem to be based on concepts of fiduciary duties. Indeed, a "fundamental purpose" of the Commodity Exchange Act was "to ensure fair practice and honest dealing on the commodity exchanges . . . ."[200] Among other things, futures commission merchants and other contract market members were prohibited from conduct considered to be fraudulent. This included making false statements, cheating or defrauding customers, and similar activities.[201] In addition, following fiduciary principles, the Act prohibited floor brokers[202] from taking the opposite side of a customer's order without the customer's permission.[203] The Act also prohibited certain trading practices on the floors of exchange such as "wash" trades, "fictitious" trades, and "accommodation" trades.[204]

The Commodity Exchange Act made principals, such as futures commission merchants, liable for the activities of their agents.[205] There was also a recognition that large traders owed duties to other participants in the market. For example, the Act sought to prohibit manipulation of market prices,[206] and it sought to avoid the effects of "excessive" speculation by imposing

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customers have preference over other creditors. Bankruptcy Act of 1978, 11 U.S.C. § 556 (1988). Regulations under the Commodity Exchange Act also establish a "legal" list of permitted investments for customer funds. 17 C.F.R. § 1.25 (1992). *See generally* CFTC Interpretative Letter No. 86-21, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,266 (1986); CFTC Interpretative Letter No. 84-24, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,449 (1984); Andrea M. Corcoran & Susan C. Ervin, *Maintenance of Market Strategies in Futures Brokers Insolvencies: Futures Position Transfers From Troubled Firms,* 44 WASH. & LEE L. REV. 849 (1987); Frederick L. White, *The Commodity Related Provisions of the Bankruptcy Act of 1978,* 34 REC. ASS'N B. N.Y. 262 (Apr. 1979).

200 H.R. REP. NO. 421, 74th Cong., 1st Sess. 1 (1935). The Act "simply provides for honesty in the conduct of what are important public markets." *Id.* at 2-3.

201 7 U.S.C. § 6b (1936).

202 A floor broker executes customer orders on the floors of the exchange. 7 U.S.C. § 6e. Traders on the floor of an exchange who simply trade for their own account are not required to register; although recent legislation now requires such registration. Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992); *see* H.R. REP. NO. 978, 102d Cong., 2d Sess. § 16 (1992); H.R. 2869, 101st Cong., 1st Sess. § 205 (1989); H.R. REP. NO. 236, 101st Cong., 1st Sess. § 205 (1989).

203 7 U.S.C. § 6(b). This provision also prohibited futures commission merchants from taking customer orders into their own account, rather than executing the orders on an exchange. *Id.*

204 7 U.S.C. § 6(c).

205 7 U.S.C. § 4. As discussed above, agency liability is premised around fiduciary duties. *See supra* note 192 and accompanying text. Markham v. Joudan, 41 N.Y. 235, 244-45 (1869), the leading case in the area, established that a broker executing customer orders was an agent of the customer. This meant applying fiduciary principles rather than the law of vendor-vendee. MEYER, *supra* note 189, at 245-50.

206 7 U.S.C. § 13(b) (1936).

limits on the size of positions that could be held by speculators.[207]

Unfortunately, the Commodity Exchange Act of 1936 did not prove effective in dealing with market abuses, and it could not accommodate the explosive growth that occurred in futures trading in the 1970s.[208] Therefore, the statute was expanded in 1974 to include every commodity involved in futures trading; before 1974, the Act had been amended in a piecemeal fashion as new commodities became the subject of futures trading.[209] In addition, Congress created the Commodity Futures Trading Commission ("CFTC"), a new independent federal agency, to administer the statute.[210] Previously, the Act had been administered by the Commodity Exchange Authority, a small agency within the Department of Agriculture.[211] Congress extended vast powers to the CFTC, including the authority to seek injunctive relief against violators of the statute,[212] and the authority to impose civil penalties of up to $100,000 per violation.[213]

Interestingly, the new amendments did little to expand the duties of market participants or to impose higher standards. For the most part, the amendments simply brought an increased number of market participants under the registration requirements of the statute and expanded the range of sanctions for violating existing requirements. The new registrants included commodity trading advisers,[214] the analogue of which has been held to bear

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207 7 U.S.C. § 6a.

208 *See supra* note 28 and accompanying text.

209 These amendments were contained in the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974). For a history of the piecemeal amendments that had been previously made to the Commodity Exchange Act to include new commodities that became subject to commodity futures trading, see H.R. REP. No. 975, 93d Cong., 2d Sess. 35 (1974).

210 7 U.S.C. § 4a (1974).

211 The Commodity Exchange Authority was subject to oversight by the Commodity Exchange Commission, which was composed of the Secretaries for Agriculture and Commerce and the Attorney General of the United States. H.R. REP. NO. 975, 93d Cong., 2d Sess. 36 (1974).

The Commodity Exchange Authority had held that the breach of a fiduciary duty by a broker or other agent of a commodity futures customer is fraudulent. Agency requires good faith and any breach of good faith was deemed to be fraudulent. *In re* Steen, 21 Agri. Dec. 1076, 1089 (1962). *See generally In re* Sicinski, 25 Agric. Dec. 302, 307 (1966); *In re* Marks, 22 Agric. Dec. 761, 773 (1963).

212 7 U.S.C. § 13a-1 (1974).

213 7 U.S.C. § 9 (1974).

214 7 U.S.C. § 6n (1974). The term commodity trading adviser is defined in the Commodity Exchange Act, 7 U.S.C.A. § 2 (West Supp. 1992). *See generally* CFTC v. Sav-

fiduciary responsibilities in the securities area.[215] Another new registrant was the commodity pool operator,[216] which is similar in its activities to mutual funds that have been heavily regulated with fiduciary duties in mind.[217] The amended statute also required the registration of brokerage firm agents, the employees of commodity trading advisers, and commodity pool operators.[218]

B. The CFTC Grapples with Fiduciary Duties

1. Customer Protection Proposals

Early in its history, the CFTC proposed a package of customer protection rules that were allegedly based on a "congressional recognition of the fiduciary nature of the commodity professional's relationship with his customer."[219] The proposed rules included a requirement that futures commission merchants (commodity brokers) not recommend futures transactions that were unsuitable for their customers.[220] Another proposal required that brokerage firms supervise their employees diligently in order to protect customers from undisciplined and untrained employees.[221] The CFTC proposed prohibiting "churning," the excessive trading of an account controlled by a broker.[222] The CFTC additionally pro-

age, 611 F.2d 270 (9th Cir. 1979) (describing role of commodity trading adviser).

215 *Supra* note 189.

216 7 U.S.C. § 6n (1974).

217 Lopez v. Dean Witter Reynolds, Inc., 805 F.2d 880 (9th Cir. 1986) (describing commodity pool operator); Rosenthal & Co. v. CFTC, 802 F.2d 963, 965 (7th Cir. 1986) (same).

218 7 U.S.C. § 6k (1974).

219 *Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers,* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,474, at 21,926 (Sept. 6, 1977) (the author was involved in the formulation of these proposals while employed at the CFTC) [hereinafter *Proposed Standards*]. The CFTC cited as authority for this proposition certain antifraud provisions in the Commodity Exchange Act and a provision stating that the activities of commodity trading advisers and commodity pool operators are affected with a national public interest. 7 U.S.C. §§ 6b, 6l-6o (1974). These proposals were also based in part on the recommendations of an industry advisory committee that concluded that increased standards for commodity professionals were needed to increase public confidence in the futures markets. ADVISORY COMMITTEE, COMMODITY FUTURES TRADING COMM'N, REPORT ON COMMODITY FUTURES TRADING PROFESSIONALS (1976).

220 This doctrine was borrowed from the SEC and is intertwined with the SEC's so-called "shingle" theory. *See supra* note 164; THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 424 (2d ed. 1990).

221 This concept was also borrowed from the SEC. *See* NICHOLAS WOLFSON ET AL., REGULATION OF BROKER DEALERS IN THE SECURITIES MARKETS (1977).

222 Churning had long been held to be a violation of the federal securities laws. *See, e.g.*, WOLFSON, *supra* note 221, § 2.11. Such conduct was also previously held to be a vio-

posed that brokers be required to supply customers with a prescribed, short, plain language statement of the risks of commodity futures trading.[223] Other proposals included a requirement that brokers handling discretionary accounts obtain from the account holder written authorization to initiate trades instead of doing so without first seeking permission.[224] The CFTC proposals also would have required that brokers use "due diligence" in executing customer orders.

This rather full package of customer protection proposals met with a storm of industry opposition, especially the suitability proposal. As a result, the rules that were eventually adopted were a slimmed-down version of the original proposals. The adopted rules included the supervisory requirement, the written trading authorization for discretionary accounts, and the short form risk disclosure statement.[225] The CFTC sought to justify its failure to adopt the remaining proposals, including due diligence, churning, and suitability, on the grounds that these requirements were already inherent in the Commodity Exchange Act. The CFTC stated that it did not want to narrow those requirements by adopting rules that could be too restrictive.[226]

The CFTC later ruled in an adjudicative proceeding that churning was indeed an inherent prohibition in the antifraud provisions of the Commodity Exchange Act.[227] The CFTC later

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lation of the Commodity Exchange Act. Follansbee v. Davis, Kaggs & Co., 681 F.2d 673, 676-77 (9th Cir. 1982); Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 133-34 (8th Cir. 1970); Hecht v. Harris Upham & Co., 283 F. Supp. 417, 432-35 (N.D. Cal. 1968), *aff'd*, 430 F.2d 1202 (9th Cir. 1970).

223 This concise risk disclosure statement is in stark contrast to the long, complex prospectuses required for investor protection under the federal securities laws that seek disclosure of all "material" facts. *See generally* HAZEN, *supra* note 220, at 93-96.

224 Discretionary accounts are particularly susceptible to abuse. CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979); 113 CONG. REC. 23,652 (Aug. 22, 1967); COMMODITY EXCHANGE AUTHORITY, U.S. DEP'T OF AGRIC., CIRCULAR NO. 539 (1939); REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMIN. 37 (1939). Commodity exchanges have stringent rules for discretionary accounts. For example, most exchanges prohibit discretionary accounts unless they maintain a minimum level of funds. The apparent thrust of these exchange rules is to prevent small customers from participating in discretionary accounts and to limit their losses. *See generally In re* Paragon Futures Ass'n, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,266 (C.F.T.C. Apr. 1, 1992). The CFTC declined to follow such an approach in its customer protection proposals. *Adoption of Customer Protection Rules*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,642 (July 24, 1978) [hereinafter *Protection Rules*].

225 17 C.F.R. §§ 166.2-.3 (1992). The CFTC risk disclosure requirement is set forth at 17 C.F.R. § 1.55 (1992).

226 *Protection Rules*, *supra* note 224, at 22,625.

227 *See, e.g.*, Gilbert v. Refco, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,081 (C.F.T.C.

held, however, that there was no suitability requirement inherent in that Act.[228]

2. The Scienter Issue

As another part of its initial regulatory efforts, the CFTC held in *Gordon v. Shearson Hayden Stone, Inc.*,[229] that the antifraud provisions of the Commodity Exchange Act did not contain a scienter requirement because the principal-agent relationship between customers and commodity professionals "necessarily" meant that commodity professionals "stand in a fiduciary relationship" to customers.[230] Citing securities law cases, the CFTC stated that, as

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June 27, 1991); Halterman v. Eastern Capital Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,222 (C.F.T.C. Apr. 15, 1988); Stahl v. Woodstock Commodities, Int'l, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,203 (C.F.T.C. Aug. 14, 1986); *In re* Cayman Assocs. [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,033 (C.F.T.C. Apr. 21, 1986); Dunn v. Contemporary Fin. Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,955 (C.F.T.C. Feb. 25, 1986); Meridan Brick, Inc. v. Murlas Commodities, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,608 (C.F.T.C. Mar. 29, 1985); Fields v. Cayman Assocs., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,688 (C.F.T.C. Jan. 2, 1985); Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417 (C.F.T.C. Nov. 13, 1984); *In re* Lincoln Wood Commodities, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 (C.F.T.C. Jan. 31, 1984).

228 Phacelli v. Conticommodity Servs., [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250 (C.F.T.C. Sept. 5, 1986). Prior to the *Phacelli* decision, the CFTC had begun a decisive retreat from its assertion that suitability was inherent in the Commodity Exchange Act. Avis v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,379 at 25,830 n.4 (C.F.T.C. Apr. 13, 1982); Jensen v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,324, at 21,324 n.1 (C.F.T.C. Oct. 9, 1981).

In rejecting a suitability rule as implicit, the CFTC relied on its disclosure requirements to assure that the customer was making a "knowing and meaningful election to undertake the risks of commodity futures trading . . . ." *Phacelli* [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250 at 32,674. In proposing the suitability rule, however, the CFTC stated that:

> Suitability and disclosure are separate concepts . . . . The Commission is considering the adoption of a suitability rule precisely because disclosure alone does not sufficiently protect some customers from high-pressure sales tactics . . . . In addition, the proposed rule is predicated in substantial measure on the principle that . . . a market professional . . . has the special skill and background to asses the degree of risk involved in the trade.

Proposed Standards, *supra* note 219 at 21,929.

229 [1980-1982 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,016 (C.F.T.C. Apr. 10, 1980), *aff'd sub nom.*, Shearson Loeb Rhodes, Inc. v. CFTC, Civ. No. 80-7212 (9th Cir. Feb. 12, 1982).

230 *Id.* at 23,981-82. The CFTC drew a distinction between common law fraud and constructive fraud. *Id.* at 23,976. Intent and falsehood are needed to establish common law fraud but those elements are not required for constructive fraud. 3 JOHN N.

a fiduciary, a commodity professional who provides commodity advice has a duty to know all material market facts and to disclose those facts to the customer. In addition, commodity professionals have a fiduciary duty to have an adequate and reasonable basis for any trading advice rendered to customers.[231]

3. Proposed Disclosure Requirement

Following the expansive approach taken in the *Gordon* decision, the CFTC later sought to strengthen the role of the disclosure statement required to be given to customers under its customer rules. The proposal stated that the delivery of the risk disclosure statement would not relieve a futures commission merchant of the obligation to disclose "all material facts" to customers. The CFTC premised the proposal on what it believed were the fiduciary duties owed by futures commission merchants to their customers.[232]

The CFTC proposal met with strong industry criticism. The CFTC, therefore, modified its proposal to state more ambiguously that the risk disclosure statement did not relieve a futures commission merchant from any other disclosure obligations it might have under applicable law.[233] The amendment did not state what those obligations might be, leaving open the question that had apparently been resolved in *Gordon*—that all material risks must be disclosed.

POMEROY, EQUITY JURISPRUDENCE § 922 (5th ed. 1941). *See generally* Henry B. Borders, Note, Ernst & Ernst v. Hochfelder *as Applied to Commodities Fraud: No Intent Required*, 79 KY. L.J. 369 (1990-91).

The CFTC also stated in *Gordon* that the scope of the fiduciary duties of commodity professionals may vary, depending on whether they are simply a conduit for orders or whether they act as advisers. *Gordon*, [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,016, at 23,981-82.

231 *Supra* note 189. *See generally In re* Haltmier, [1975-1977 Transfer Binder] Comm. Fut L. Rep. (CCH) ¶ 20,160 (C.F.T.C. May 5, 1976), *aff'd*, 554 F.2d 556 (2d Cir. 1977) (customers repose a high degree of trust in their brokers). In Wattay v. Shearson Hayden Stone, Inc., CFTC Doc. No. R 76-22 (C.F.T.C. Apr. 20, 1981), the CFTC again stated a fiduciary duty was breached when a broker failed to properly record a trade. It noted, however, that the relationship may be flexible and may impose different duties depending on whether the broker has substantial discretion or is simply an order taker.

232 [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,620 at 23,360-61 (Nov. 23, 1982).

233 *Protection of Commodity Customers: Risk Disclosure by Futures Commission Merchants and Introducing Brokers to Customers* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,482, at 30,138 (C.F.T.C. Feb. 8, 1985).

The CFTC release announcing the adoption of this more ambiguous language did state, as did the *Gordon* decision, that the nature and extent of disclosures that must be made would depend on the facts and circumstances of the particular transaction.[234] The CFTC release also set forth its view that a breach of fiduciary duty owed to a customer by a commodity professional was sufficient to establish a violation of the antifraud provisions of the Commodity Exchange Act. It indicated that this fiduciary duty might establish duties beyond what normally would apply under those antifraud provisions.[235] The CFTC stated, however, that its proposed amendment was not intended to impose a uniform duty of disclosure on brokers or require that customers be furnished with a long prospectus or that lengthy verbal disclosures be made. Moreover, the CFTC was of the view that there might be a sliding scale of fiduciary duties. For example, the duty of a futures commission merchant to disclose information to a customer with a discretionary account is broader than the duty of a broker who is simply executing customer orders.[236]

4. *Gordon* is Overruled

The disclosure amendment seemed to signal a retreat from the expansive view of fiduciary duties that was set forth in the CFTC's decision in *Gordon,* and it introduced some uncertainty as to the scope of fiduciary duties under the Commodity Exchange Act. This was compounded when the CFTC began to retreat from the *Gordon* decision.[237] That somewhat disorderly withdrawal was occasioned by the fact that many courts had rejected the CFTC's conclusion that scienter was not required under section 4b.[238] Some ten years after *Gordon,* the CFTC finally recognized that the courts would not accept its views on scienter, and the CFTC overruled *Gordon.*[239] In the meantime, however, the CFTC handed

234 *Id.*

235 *Id.*

236 *Id.* at 30,139-40.

237 *See generally* Munnell v. PaineWebber, Jackson & Curtis, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,313, at 32,862 n.5 (C.F.T.C. Oct. 8, 1986); Wills v. First Fin. Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,605 (C.F.T.C. May 31, 1985).

238 *See, e.g.,* Drexel Burnham Lambert, Inc. v. CFTC, 850 F.2d 742 (D.C. Cir. 1988); Tamari v. Bache & Co. (Lebanon) S.A.L., 838 F.2d 904 (7th Cir. 1988); Hill v. Bache Halsey Stuart Shields, Inc., 790 F.2d 817 (10th Cir. 1986); Greenwood v. Dittmer, 776 F.2d 785 (8th Cir. 1985); Masters Commodities, Inc. v. Texas Cattle Management Co., 586 F.2d 1352, 1356 (10th Cir. 1978).

239 Hammond v. Smith Barney, Harris, Upham & Co., [1987-1990 Transfer Binder]

down other decisions that were based either in whole or in part on findings of a breach of fiduciary duties. For example, in *In re Murphy*,[240] the CFTC held that a floor broker was a fiduciary in executing customer orders. The CFTC further held in several cases that a fiduciary duty was breached where full disclosures of risks were not made or where there were misrepresentations.[241] A re-

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Comm. Fut. L. Rep. (CCH) ¶ 24,617 (C.F.T.C. Mar. 1, 1990). *Compare* Ruddy v. First Commodity Corp., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,435 (C.F.T.C. Mar. 31, 1981) *with In re* Conticommodity Servs., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,038 (C.F.T.C. Apr. 17, 1991) (scienter not required under antifraud rule for foreign futures contracts traded in United States even though rule had been adopted to eliminate such a requirement).

240 [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,798 (C.F.T.C. Sept. 25, 1985).

241 Tysdal v. Jack Carl/312 Futures, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,242 (C.F.T.C. Feb. 27, 1992); Schneider v. Rouse Woodstock, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,196 (C.F.T.C. July 31, 1986) (a broker has a fiduciary duty to disclose the risks of commodity futures trading); Riebold v. First Commodity Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,080 (C.F.T.C. May 20, 1986) (broker's fiduciary duties require a full disclosure of all material facts). *See generally* Grift v. Shearson Lehman Bros., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,962 (C.F.T.C. Nov. 27, 1990); Swickard v. A.G. Edwards & Sons, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,522, at 30,275 (C.F.T.C. Mar. 7, 1985); Arnow v. First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,282, at 29,429 n.4 (C.F.T.C. July 13, 1984); Avis v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,379, at 25,831 n.8 (C.F.T.C. Apr. 13, 1982); Ruddy v. First Commodity Corp., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,435, at 26,085 (C.F.T.C. Mar. 31, 1981); Yameen v. Madda Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,125, at 24,558 (C.F.T.C. Oct. 8, 1980).

Judgment officers and administrative law judges employed by the CFTC have also issued numerous opinions on the scope and application of fiduciary duties. *See, e.g.*, Hill v. Merrill Lynch Futures, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,459 (C.F.T.C. May 17, 1989) (degree of fiduciary duty varies with the knowledge and sophistication of the customer); Lang v. Shearson Lehman Bros., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,256 (C.F.T.C. May 31, 1988) (a "full-service broker" did not owe a customer a duty to monitor a nondiscretionary account); Gropper v. Heinhold Commodities, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,185 (C.F.T.C. May 7, 1988) (breach of fiduciary duty found where broker did not provide oral confirmation of a trade as was customary); Schindel Agri-Sales v. PaineWebber, Jackson & Curtis, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,094 (C.F.T.C. Jan. 5, 1988) (broker has a fiduciary duty to seek clarification of any ambiguous or any incomplete orders); Sane v. Prudential-Bache Secs., Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,088 (C.F.T.C. Dec. 29, 1987) (breach of fiduciary duty found where discretionary account was not traded as agreed with customer); Walkington v. First Commodity Corp., Comm. Fut. L. Rep. (CCH) ¶ 24,033 (C.F.T.C. Nov. 30, 1987) (breach of fiduciary duty occurred where risks of trading were minimized), *dismissed on other grounds*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,335 (C.F.T.C. Sept. 13, 1988); Mancik v. Apache Trading Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,032 (C.F.T.C. Nov. 30, 1987) (breach of fiduciary duty found where customer was not advised that his account executive had left the brokerage firm); Moravec v. Stanford Management Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,757 (C.F.T.C. June 29, 1987) (fiduciary duty breached by a misrepresentation of risks); Merwin v. Heinold Commodities, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,756 (C.F.T.C. June 26, 1987) (section 4b of the Commodity Exchange Act imposes fiduciary duties intended prohibit constructive fraud); Secrest v. Madda Trading Co., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,593 (C.F.T.C. Apr. 24, 1987) (breach of fiduciary duty found where misrepresentations were made and a customer account was churned); Koprowski v. Gannon, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,151, at 32,375 (C.F.T.C. July 15, 1986) (the fiduciary duty of a broker "broadens concomitantly with any expansion of the degree of trust reposed in the professional;" breach of fiduciary duty occurs when a broker downplays the risks of trading and the importance of risk disclosure statements); Wolken v. Refco, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,152 (C.F.T.C. July 14, 1986), *vacated and remanded*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,779 (C.F.T.C. Aug. 27, 1987), *appeal dismissed*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,509 (C.F.T.C. July 18, 1989); Kightlinger v. Performance Inv. Co., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,021 (C.F.T.C. Apr. 30, 1986) (breach of fiduciary duty found where customer was told to continue and await corrective action); Myhre v. First Commodity Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,001 (C.F.T.C. Apr. 16, 1986) (breach of fiduciary duty where customer not informed that broker handling his discretionary account would no longer be handing the account), *aff'd on other grounds*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,487 (C.F.T.C. Feb, 12, 1987); Bey v. Feeney, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,998 (C.F.T.C. Apr. 11, 1986) (breach of fiduciary duty found where customer not informed of the financial problems of the broker nor kept informed of the status of his account); Yi v. International Trading Group, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,958 (C.F.T.C. Mar. 13, 1986) (fiduciary duties will vary depending on the sophistication of the customer); Hickle v. Commodity Fluctuation Sys., Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,956 (C.F.T.C. Feb. 28, 1986) (broker has fiduciary duty to disclose all material facts and risks); Chabala v. First Commodity Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,922 (C.F.T.C. Jan. 31, 1986) (fiduciary duty of a broker requires disclosure of risk); Dow v. Appleman, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,852 (C.F.T.C. Dec. 26, 1985) (broker had fiduciary duty to inform customers of fraudulent dealings that the broker learned of following the establishment of the customer accounts questioned); Jones v. First Fin. Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,779, at 31,133-234 (C.F.T.C. Oct. 30, 1985) (fiduciary duty required disclosure of all material facts and clear representations of risks); Kahn v. First Commodity Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,668, at 30,844 (C.F.T.C. July 31, 1985) (high pressure sales pitches violated fiduciary duty), *aff'd in part, rev'd in part*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,306 (C.F.T.C. Sept. 30, 1986); Katz v. Newcomb Commodities Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,607 at 30,603 (C.F.T.C. May 3, 1985) (fiduciary duty breached by trading practices); Syndicate Sys., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,451, at 29,994-96 (C.F.T.C. Dec. 19, 1984) (no breach of fiduciary duty found), *aff'd*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,289 (C.F.T.C. Sept. 30, 1986); Milano v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,416, at 29,864-65 (C.F.T.C. Oct. 31, 1984) (breach of fiduciary duty results in violation of antifraud provision even if breach was negligent or unintentional); Oblon v. Yorkstone Research Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,425, at 29,897 (C.F.T.C. Oct. 30, 1984) (failure to disclose commission payments and overcharge was a breach of fiduciary duty); Holmes v. Murlas Commodities, Inc., [1984-1986 Transfer cent CFTC decision also stated that a broker has an ongoing duty to disclose material information to customers, even if the customer does not ask for that information.[242] In another decision, however, the CFTC held that a broker has no fiduciary duty to disclose information to customers about day-to-day market moves.[243] More

Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,669, at 30,847 (C.F.T.C. Aug. 31, 1984) (Commission Merchant has fiduciary duty to disclose material facts), *aff'd mem.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,103 (C.F.T.C. June 13, 1986); Keyser v. Green, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,320, at 29,553 (C.F.T.C. Aug. 17, 1984) (account executive has a fiduciary duty to inform himself as to the actual state of customer's account and to make recommendations and take actions based upon this knowledge); Sudol v. Shearson Loeb Rhodes, Inc., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,112, at 28,894 (C.F.T.C. Apr. 27, 1984) (broker has a fiduciary duty to know all material facts reasonably ascertainable in connection with customer's trading decision), *rev'd on other grounds*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,748 (C.F.T.C. Sept. 30, 1985); Zadik v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,036, at 28,630 (C.F.T.C. Feb. 16, 1984) (no breach of fiduciary duty where customer controlled his own account); Ettinghaus v. Chartered Sys. Corp., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,897, at 23,641 (C.F.T.C. Sept. 19, 1979) (full and fair disclosure of all material facts is required); Klatt v. International Trading Group, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,636, at 22,598 (C.F.T.C. June 21, 1978) (commodity professional is necessarily in a fiduciary relationship with a customer or prospective customer); Wilke v. Winchester-Hardin-Oppenheimer Trading Co., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,605, at 22,502 (C.F.T.C. Dec. 29, 1977) ("It is, by now, axiomatic that a breach of fiduciary duty is fraud within the meaning of Section 4b of the Act."); *see also* Jerry W. Markham & Kyra H. Bergin, *Customer Rights Under the Commodity Exchange Act*, 37 VAND. L. REV. 1299, 1344 n.231 (1984) (case citing same proposition).

242 The CFTC has not backed off its conclusion that brokers should have a reasonable basis for making recommendations to customers. *See supra* note 231 and accompanying text. The basis for these decisions seems to be the belief that a commodity professional is making an implied representation that there is a reasonable basis for that recommendation. Hanay v. First Commodity Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,936, at 34,282, n.3 (C.F.T.C. Sept. 21, 1987); Fox v. First Nat'l Monetary Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,690, at 33,784 n.12 (C.F.T.C. June 25, 1987); Syndicate Sys., Inc. v. Merrill Lynch Pierce, Fenner & Smith, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,289, at 32,788 (C.F.T.C. Sept. 30, 1986).

243 Grist v. Shearson Lehman Bros., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,962 (C.F.T.C. Nov. 27, 1990); *see also* Holmes v. Wheat Inv. Advisors Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,653 (C.F.T.C. June 8, 1987) (the degree of fiduciary duty will vary among discretionary and nondiscretionary accounts).

In Diaz v. First Commodity Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,164 (C.F.T.C. Feb. 17, 1988) an administrative law judge found that a broker breached a fiduciary duty where he had charged a customer a management fee that was so excessive as to preclude any possibility of profit. *See also* Chabala v. First Commodity Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,922 (C.F.T.C. Jan. 31, 1986). The CFTC, however, subsequently concluded that it did not regulate the amount of fees charged by brokers. The CFTC stated that it would not pass on the issue of a customer's agreement to pay fees even if the fees are so high as to be "unconsciorecently, a series of CFTC decisions that seem to be creating a "buyer-beware" standard in the futures industry has led to congressional hearings on whether greater customer protection is needed.[244]

The regulation of commodity pool operators and commodity trading advisers by the CFTC raises another area of concern. CFTC regulations required such entities to give broad disclosures to their customers. This is one of the few areas where the CFTC had sought specific disclosures in other than a very summary form. The required disclosures included possible conflicts of interest, prior trading losses and successes (track records), disclosure of all fees, commissions, and other information pertinent to the decision on whether to invest in a commodity pool or to retain the services of a commodity trading adviser. These regulations seemed to recognize that commodity trading advisers and commodity pool operators owe greater duties to their customers and that their customers need special protection.[245] This conceptual approach

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nable" or "per se" fraudulent. Johnson v. Fleck, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,957 (C.F.T.C. Nov. 20, 1990); *see also* Tysdal v. Jack Carl/312 Futures, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,242 (C.F.T.C. Feb. 27, 1992) (the mere existence of a fiduciary relationship would not transform a breach of contract into a violation of the antifraud provisions of the Commodity Exchange Act).

244 Kevin G. Salwen & Sandra Block, *CFTC Gets in the Habit of Rejecting Advise of Its Own Judges in Disciplinary Cases*, WALL ST. J., May 12, 1992, at C1; Kevin G. Salwen, *CFTC's Policies on Enforcement Are Under Study*, WALL ST. J., May 14, 1992, at C13; Kevin G. Salwen, *CFTC Rulings Draw Criticism From Dissident*, WALL ST. J., May 19, 1992, at C1; Kevin G. Salwen, *Two Congressmen to Seek to Revive CFTC Decisions*, WALL ST. J., May 20, 1992, at C19.

Commissioner Fowler C. West has repeatedly pointed out in several dissenting and concurring opinions efforts to cut back on consumer protection. *See, e.g., In re* Paragon Futures Ass'n, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,266 (C.F.T.C. Apr. 1, 1992) (dissent); Van Arsdale v. Nationwide Futures Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,246 (C.F.T.C. Mar. 6, 1992); Steen v. Monex Int'l Ltd., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,245 (C.F.T.C. Mar. 3, 1992) (Commissioner West dissenting and concurring); Tysdal v. Jack Carl/312 Futures, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,242 (C.F.T.C. Feb. 27, 1992); Muniz v Lassila, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,225 (C.F.T.C. Jan. 17, 1992); Gilbert v. Refco, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,081 (C.F.T.C. June 27, 1991) (dissent); *In re* Conticommodity Servs. Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,038 (C.F.T.C. Apr. 27, 1991) (dissent); Morris v. Stotler & Co., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,080 (C.F.T.C. Apr. 1, 1991) (dissent). The CFTC's opinions causing this concern have been based principally on an expanded application of a requirement to show that fraud or other misbehavior actually caused the customer loss. *Id.* This has resulted in a higher burden of proof for sophisticated and experienced customers. *Id.* For a discussion of causation principles under the federal securities laws, see 2 THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION §§ 13.5-.6 (2d ed. 1990).

245 Apparently scienter requirements for commodity pool operators and commodity trading advisers are lower under a special antifraud provision for such persons than under section 4b. *Compare* 7 U.S.C. § 6b (1988) (requiring that a person act "willfully") *with*

seemed to parallel, albeit on a much smaller scale, some of the regulations imposed under the federal securities law for trading advisers and investment companies.[246] The CFTC's tougher approach for advisers and pool operators was also consistent with the sliding scale approach expressed in the *Gordon* decision and in its release on risk disclosures.[247] Recently, however, the CFTC announced that it would be reducing the amount of disclosures required for commodity pool operators and that more detailed disclosures would be available only on request.[248]

The role of fiduciary duties under the Commodity Exchange Act raises other issues. For example, as noted above[249] section 4d of the Commodity Exchange Act[250] requires customer margin funds to be maintained in segregated trust accounts. It appears that section 4d was designed to impose a fiduciary duty upon futures commission merchants to protect customer funds.[251] If so,

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7 U.S.C. § 6o (1988) (failing to use "willfully"). *See generally* Messer v. E. F. Hutton & Co., 833 F.2d 909 (11th Cir. 1987), *amended on reh'g*, 847 F.2d 673 (11th Cir. 1988); First Monetary Corp. v. Weinberger, 819 F.2d 1334 (6th Cir. 1987); CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979); Taylor v. Peabody Trading Co., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,926 (C.F.T.C. Nov. 19, 1983).

246 SEC regulations are considerably more intrusive than the CFTC. *Compare* 17 C.F.R. §§ 4.1-4.41 (1988) (setting out rules for commodity pool operations and commodity trading regulators) *with* 17 C.F.R. §§ 275.020 to 206(9)-4 (1992) (outlining rules and regulations for investment advisers) *and* 15 U.S.C. §§ 80a-1 to 80a-64 (1988 & Supp. II 1990) (establishing rules for investment companies). The SEC, however, seems to be borrowing a page from the CFTC's book by requiring penny stock dealers to provide their customers summary disclosure documents before trading. 57 Fed. Reg. 18,033 (1992) (to be codified at 17 C.F.R. § 240.15g-2).

247 *See supra* notes 229-30 and accompanying text.

248 *Exemption for Commodity Poll Operators and Commodity Trading Advisers for Offerings to Qualified Eligible Participants*, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,215 (Jan. 28, 1992); Kevin G. Salwen, *SEC, CFTC Unveil About 100 Moves to Trim Red Tape*, WALL ST. J., Apr. 29, 1992, at C19.

249 *See supra* note 198 and accompanying text.

250 7 U.S.C. § 6d (1988).

251 Section 4d of the Commodity Exchange Act has as its "aim only to impose the duties of a fiduciary upon a class of men who, under accepted legal theory as well as by every consideration of policy, ought to bear such obligations." Comment, *Legislation, The Commodity Exchange Act of 1936*, 85 U. PA. L. REV. 614, 618 (1937). Its terms were a recognition that the use of customer funds to finance the operations of futures commission merchants or favored customers could result in losses to innocent customers. H.R. REP. NO. 975, 93d Cong., 2d Sess. 34 (1974). This provision was adopted over industry objections that trust fund treatment of customers was not realistic because of the flexibility needed by futures commission merchants to deal with customer margin funds. *Regulation of Grain Exchanges: Hearing on H.R. 8829 Before the House Comm. on Agric.*, 73d Cong., 2d Sess. 149 (1934) ("a system devised to extend legal trust fund treatment to customers' margin deposits could not operate with the required flexible attitude and would be most cumbersome and difficult to operate if indeed not impossible").

the fiduciary relationship is a somewhat odd one.[252] Under an ordinary trust, a trustee cannot retain the profits from investments of the corpus of the trust. This is a strict rule.[253] A regulation under the Commodity Exchange Act, however, permits a futures commission merchant to retain the interest from investment of customer funds held in the segregated accounts required by section 4d.[254] To date, the courts have upheld this regulation.[255]

Still another area of ambivalence and ambiguity in the application of fiduciary duties under the Commodity Exchange Act involves a practice known as "dual" trading, which involves traders on the floors of the exchanges. Under existing law, a trader can both execute customer orders on the floor of the exchange and trade for his or her own account at the same time. This creates an inherent conflict. On the one hand, floor brokers act as agents of a customer in executing the order. On the other, in trading for their own accounts, floor traders act as principals seeking to further their own interests.[256]

This dual trading role has long been a concern of Congress. In the hearings that led to the adoption of the Commodity Exchange Act, there was a recognition that the "highest of good faith" was required of floor brokers.[257] "It is a peculiar trust, a relationship that requires as high a degree of integrity as that required of the attorney or the doctor or anyone else."[258] Congress, however, chose not to ban this practice in the Commodity Exchange Act of 1936. Instead, it placed various probations on

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252 At common law, however, a broker was viewed to be acting in the role of a debtor with respect to customer funds held in a margin account or which were held as collateral to secure a margin account. A broker could commingle such funds with her own. MEYER, *supra* note 189. Commodity futures accounts are margin accounts. This anomaly was what apparently necessitated the adoption of section 4d.

253 *See supra* notes 65-70 and accompanying text.

254 17 C.F.R. § 1.29 (1992).

255 *See* Craig v. Refco, Inc., 816 F.2d 347 (7th Cir. 1987), *aff'd*, 822 F.2d 1876 (9th Cir. 1987); Marchese v. Shearson Hayden Stone, Inc., 734 F.2d 414 (9th Cir. 1984); Crabtree Investments, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 577 F. Supp. 1466 (M.D. La.), *aff'd*, 738 F.2d 434 (5th Cir. 1984).

256 *See generally* Jerry W. Markham, *Prohibited Floor Trading Activities Under the Commodity Exchange Act*, 58 FORDHAM L. REV. 1, 17-22 (1989).

257 *Regulation of Commodity Exchanges: Hearing on H.R. 3009 Before the House Comm. on Agric.*, 74th Cong., 1st Sess. 24 (1935).

258 *Id.* The floor broker is in a "position of trust." *Id.* at 25. The profession of floor brokers "requires an extreme order of good faith." *Id.* at 26. A floor broker should not execute customer orders when he is riding "a horse going in the other direction." *Id.* at 24.

floor brokers to reduce abuses that had previously gone unpunished.[259]

The dual trading problem also concerned Congress during the hearings that led to the creation of the CFTC. Some argued that eliminating the dual role would prevent conflicts of interest. Industry representatives contended, however, that prohibiting dual trading would lead to a loss of liquidity because floor brokers trading for their own accounts added volume and liquidity to the marketplace.[260]

Congress's decision on this issue in 1974 was basically a compromise. Congress concluded that the CFTC should determine whether the floor broker should be allowed to engage in dual trading and to specify the terms under which such trading should be permitted. The CFTC was specifically ordered to determine the effect of market liquidity on any restrictions on dual trading.[261]

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259 In Secretary v. Massey, GFA Dkts. 2 & 3 (Nov. 9, 1933), the Commodity Exchange Commission held that the Grain Futures Act did not prohibit abusive practices by floor brokers. *To Amend the Grain Futures Act:, Hearings on H.R. 6772 Before the Senate Comm. on Agric. and Forestry,* 74th Cong., 1st Sess. 20 (1936); *Regulation of Commodity Exchanges: Hearing on H.R. 3009 Before the House Comm. on Agric.,* 74th Cong., 1st Sess. 68-71, 119 (1935). The Commodity Exchange Act sought to fill that gap by specifically prohibiting those practices. 7 U.S.C. §§ 6b-6c (1988).

260 *See generally Hearings Before the Senate Comm. on Agric. and Forestry,* 93d Cong., 2d Sess., pt. 3, 672, 686, 696, 702-15, 721, 738, 741, 747, 756, 761-62, 765, 768, 781, 812, 823, 848, 861, 863-64, (1974); *Hearings Before the Senate Committee on Agriculture and Forestry,* 93d Cong., 2d Sess. 195, 198, 203-05, 213-14, 216, 230, 233, 248, 253, 254, 266, 270-71, 273, 275-76, 283-84, 287, 313, 319, 331, 332-33, 341, 342, 368, 370, 374, 376, 383-84, 386-87, 396-99, 404, 411-12, 426, 432, 435-37, and 439 (1974); *Hearings Before the Senate Committee on Agriculture and Forestry,* 93d Cong:, 2d Sess., pt. 2, 445, 450-54, 453, 455, 467, 473, 475, 498, 506-07, 513, 521-23, 525, 527-32, 550-54, 561-63, 580-81, 611-12, 617, 639 (1974).

A representative from one brokerage firm stated that it did not permit its employees to trade for their own account where they serviced customers. This witness testified:

> We feel that the man involved should be concentrating on the customer's matters and not on his own trading. Commodities are volatile, there's always substantial risk of economical involvement that would distract the man or perhaps even get him in over his head. And, we just think we live in a fish bowl. It is like Caesar's wife, we would rather lean to the extreme of showing the customer that we give you an opinion or some advice we hope it is objective, because we have no ax to grind.

Hearings Before the Senate Comm. on Agric. and Forestry, 93d Cong., 2d Sess., pt. 2, at 513 (1974). This witness, however, stated that dual trading by individuals on the floor of the exchanges raised more complex problems. *Id.*

One government official also argued that floor brokers should be prohibited from trading for their accounts while they are executing customer orders because of the conflict of interests presented by dual trading. H.R. REP. NO. 975, 93d Cong., 2d Sess. 50-51 (1974).

261 Commodity Exchange Act, Pub. L. No. 93-463, 88 Stat. 1396 (codified as

The CFTC responded by adopting regulations that required the exchanges to establish minimum standards for dual trading floor brokers. These regulations were designed to preclude floor brokers from acting to the detriment of their customers and trading for their own accounts.[262] The CFTC coupled this regulatory approach with an effort to require time stamping of orders at or about the time of their execution on the floor of the exchanges. This was designed to allow abuses to be more easily detected. The CFTC was thus seeking an "audit trail" so that it could determine whether floor brokers were abusing customer orders while they were trading for their own account. That effort, however, was largely unsuccessful. Only recently, after some highly publicized scandals, has the CFTC acted to impose more effective audit trails in the pits.[263] Congress has also recently enacted legislation to curb this practice.[264]

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amended at 7 U.S.C. § 6j (1988)).

262 17 C.F.R. § 155.2 (1992). Among other things, this regulation prevented a broker from trading in front of a customer to obtain a more advantageous price for his own account to the exclusion of the customer. *Id.*

This approach is in stark contrast to that undertaken by the SEC which prohibits members of national securities exchanges from initiating orders for their own accounts while they are on the floor of the exchange except under tightly controlled conditions. 17 C.F.R. 240.11a-1 (1992). *See generally* 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2531-44 (1990).

263 In 1989, the government announced that it had conducted two massive "sting" operations on the Chicago Board of Trade and the Chicago Mercantile Exchange. About 48 floor brokers and floor traders were later indicted. Although subsequent trials of some of the indicted traders were not a complete success, many others were convicted or pled guilty. *See generally* DAVID GREISING & LAURIE MORSE, BROKERS, BAGMEN AND MOLES—FRAUD AND CORRUPTION IN THE CHICAGO FUTURES MARKETS (1991); Jerry W. Markham, *The Commodity Exchange Monopoly—Reform is Needed,* 48 WASH. & LEE L. REV. 977 (1991); Markham, *supra* note 256. The exchanges are now experimenting with handheld computers as a method for assuring a more effective audit trail. Seth Faison, Jr., *Computers Spell Change in the Pits,* N.Y. TIMES, Feb. 27, 1992, at C1. In the meantime, abuses continue.

264 This legislation substantially restricts this practice, particularly in trading pits with sufficient liquidity to obviate the need for dual trading or where exchange monitoring systems are sufficient to guard against abuse. H.R. REP. NO. 236, 101st Cong., 1st Sess. 2 (1989); Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992); *see* H.R. REP. NO. 978, 102d Cong., 2d Sess. 3-6 (1992). *See generally* S. REP. NO. 191, 101st Cong., 1st Sess. 90 (1989). Meanwhile, abuses continue on the futures markets. Elyse Tanouye, *'Gunning' Plays Can Claim Victims in the Futures Pit,* WALL ST. J., June 17, 1992, at C1.

C. The Federal Courts

The federal courts have been even less receptive to the imposition of fiduciary duties than the CFTC. Several federal courts have imposed a scienter requirement under the Act, thereby explicitly or implicitly rejecting the CFTC's initial conclusion that fiduciary duties under the Commodity Exchange Act obviated the necessity for such a showing.[265] The federal courts, however, have been less consistent in other areas in defining the scope of fiduciary duties under the Act.

In *Hlavinka v. CFTC*,[266] the Seventh Circuit stated that the application of fiduciary duties to a broker would depend on whether the customer was relying on the broker's expertise and judgment.[267] Earlier, the Seventh Circuit had concluded in *CFTC v. Heritage Capital Advisory Services, Ltd.*,[268] that only brokers operating discretionary accounts would be viewed as fiduciaries. In *United States v. Dial*,[269] however, the Seventh Circuit stated that a broker is a fiduciary to his customers and this requires disclosure of conflicts of interest in the broker's trading.[270] The Seventh Circuit also held in *Anspacher & Associates v. Henderson*[271] that a broker owes a fiduciary duty to execute orders faithfully. The court was of the view that this was a duty that was in addition to obligations arising under the Commodity Exchange Act, citing *United States v. Dial*.[272]

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265 See *supra* note 238.

266 867 F.2d 1029 (7th Cir. 1989).

267 In *Hlavinka*, the customer argued that, because the broker there was not a discount broker, the broker had a fiduciary duty to advise the customer fully on market changes and risks. The CFTC rejected that claim and the Seventh Circuit affirmed. *Id.* at 1033.

268 823 F.2d 171, 173 (7th Cir. 1987).

269 757 F.2d 163 (7th Cir.), *cert. denied*, 474 U.S. 838 (1985).

270 In *Dial*, the broker solicited customers to engage in transactions that were large enough that they could affect market prices. The broker would then trade before the transactions were entered in order to profit. The Seventh Circuit stated that a fiduciary is acting as an alter ego to the principal and the principal "trusts the fiduciary to deal with him as frankly as he would deal with himself—he has bought candor." *Id.* at 168.

The decision in *Dial* involved a criminal prosecution under the mail and wire fraud statutes. 18 U.S.C. §§ 1341, 1343 (1988). In another commodity futures prosecution, the defendant contended that he did not stand in a fiduciary relationship with prospective customers and did not owe them a duty of disclosure. The Seventh Circuit responded that mail fraud charges could be sustained without establishing a duty to disclose. United States v. Biesiadecki, 933 F.2d 539 (7th Cir. 1991).

271 854 F.2d 941, 945 (7th Cir. 1988).

272 An interesting question is whether the Seventh Circuit was suggesting in *Anspacher*

The *Dial* court relied on the Ninth Circuit's decision in *Marchese v. Shearson Hayden Stone, Inc.*,[273] as the basis for its conclusion that a broker is a fiduciary to his customers. The *Marchese* decision was in turn based on a Supreme Court decision under the Investment Advisor's Act of 1940, a statute involving a position of special trust and confidence and of doubtful application to the duties of brokers.[274] Indeed, in other decisions, the Ninth Circuit seems to have taken the sliding scale approach to fiduciary duties—applying greater duties as the broker's control over the customer's account increases.[275] The sliding scale approach also seems to have been followed by other courts, at least in practice. For example, the Fifth Circuit stated in *Romano v. Merrill Lynch, Pierce, Fenner & Smith*,[276] that a broker owes fiduciary duties to customers that vary according to the relationship between the broker and the customer. This would involve a determination of whether the customer or the broker controlled the account.[277]

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that the fiduciary duty found in *Dial* created a private right of action for the customer in *Anspacher*. Most courts have rejected implied private rights of action under the mail and wire fraud statutes. *See, e.g.*, Ryan v. Ohio Edison Co., 611 F.2d 1170 (6th Cir. 1979); Bell v. Health-Mor, Inc., 549 F.2d 342 (5th Cir. 1977).

273 734 F.2d 414, 418 (9th Cir. 1984).

274 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963). In Santa Fe Indus. v. Green, 430 U.S. 462 (1977), the Supreme Court rejected the decision in *Capital Gains* as a basis for finding fiduciary duties under SEC rule 10b-5 because it was of special application to investment advisers. *Id.* at 471 n.11.

275 In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Trabulsi, Civ. No. 83-5987 (9th Cir. Sept. 27, 1984), the Ninth Circuit, in an unpublished memorandum decision, stated that a brokerage firm has no fiduciary duty to a customer beyond the execution of orders when it is acting simply as an agent of the customer. In another decision, the Ninth Circuit concluded that section 4b of the Commodity Exchange Act applied to a breach of fiduciary duty by a broker. There, the practice at issue was churning (*i.e.*, excessive trading of a customer account controlled by a broker). Yopp v. Siegel Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,708, at 31,001 (9th Cir.), *withdrawn pending petition for reh'g*, 770 F.2d 1462 (9th Cir. 1985), *withdrawn by stipulation*, No. 83-6250 (9th Cir. Jan. 30, 1986).

These two cases suggest that the Ninth Circuit is, in practice, applying a sliding scale approach to fiduciary duties—imposing such duties more broadly where the broker controls the customer's account. The court in *Yopp*, however, relied on the *Gordon* decision by the CFTC, so the court may have had something broader in mind. If so, it may wish to reconsider its position in view of the CFTC's overruling of the *Gordon* decision. *See supra* note 239 and accompanying text.

276 834 F.2d 523 (5th Cir. 1987), *cert. denied*, 487 U.S. 1205 (1988).

277 The decision in *Romano*, must be considered in light of a subsequent Fifth Circuit decision that relied on state law to conclude that a customer was not owed fiduciary duties by a commodity broker. *See infra* notes 293-95 and accompanying text.

The First Circuit was more enthusiastic in *Schofield v. First Commodity Corp.*[278] There the court cited the CFTC's decision in *Gordon* for the proposition that the failure to inform an investor of the risks of commodity futures trading is a breach of fiduciary duty that violates section 4b of the Commodity Exchange Act.[279] Since *Gordon* has been overruled by the CFTC, that view is placed in some doubt.[280]

In *Hill v. Bache Halsey Stuart Shields, Inc.*,[281] the Tenth Circuit took a more restrictive approach, holding that section 4b of the Commodity Exchange Act does not impose fiduciary duties. The court noted that section 4b is a fraud standard. In contrast, application of fiduciary duties is designed to eliminate the need to meet the requirements for establishing fraud. For example, fiduciary duties impose per se liability on a trustee for self-dealing, while section 4b imposes fraud standards such as scienter that fiduciary duties sought to avoid by utilizing such concepts as constructive fraud.[282]

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278 793 F.2d 28, 34 (1st Cir. 1986).

279 7 U.S.C. § 6b (1988).

280 *See supra* note 239-41 and accompanying text.

281 790 F.2d 817 (10th Cir. 1986).

282 Federal district courts have also considered fiduciary duties in the context of the Commodity Exchange Act. For example, in Wilkinson v. Rosenthal & Co., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,328 (E.D. Pa. July 27, 1988), the district court held that brokers owe fiduciary duties to customers even in nondiscretionary accounts. *See also In re* Conticommodity Servs., Inc., 733 F. Supp. 1555 (N.D. Ill. 1990) (claim of breach of fiduciary duty could be made under Commodity Exchange Act); McBlaine v. Jack Carl Assocs., 705 F. Supp. 1340 (N.D. Ill. 1989) (failure to comply with customer's trading instructions was reckless and was a violation of fiduciary duty); Kearney v. Prudential-Bache Sec., 701 F. Supp. 416 (S.D.N.Y. 1988) (negligent breach of fiduciary duties does not establish a violation of section 4b of the Commodity Exchange Act); Richardson Greenshields Sec., Inc. v. Lau, 693 F. Supp. 1445 (S.D.N.Y. 1988) (discretionary account authority imposes fiduciary duties); Nanlawala v. Jack Carl Assocs., 669 F. Supp. 204 (N.D. Ill. 1987) (fiduciary duty claimed in trading of discretionary account); Michael Assocs. v. Conticommodity Servs., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,626 (S.D.N.Y. Mar. 3, 1987) (broad fiduciary duties do not apply to nondiscretionary commodity accounts); Howell v. Friefeld, 631 F. Supp. 1222, 1224 (S.D.N.Y. 1986) (broad fiduciary duties apply to a discretionary account but lesser duties apply to nondiscretionary account); Woods v. Reno Commodities, Inc., 600 F. Supp. 574, 578 (D. Nev. 1984) (broker stands in a fiduciary relationship to customers and this requires full disclosures of all material facts); Hagstrom v. Breutman, 572 F. Supp. 692, 697 (N.D. Ill. 1983) (fraudulent conduct is required to establish violation of section 4b rather than breach of fiduciary duty); Peavey Co. v. Mitchell, [1982-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,593 (W.D. Okla. Dec. 30, 1983) (fiduciary duties did not negate the need for showing scienter under antifraud provisions of Commodity Exchange Act).

Several federal courts have found the scope of fiduciary duties for brokerage firms to be grounded on state law requirements. In *Horn v. Ray E. Friedman & Co.*,[283] the Eighth Circuit held that the issue of whether fiduciary duties attached to commodity futures trading is a question of state law. It held that where an account was nondiscretionary there were no fiduciary duties.[284] In *Irvine v. Cargill Investor Services, Inc.*,[285] the Eleventh Circuit stated that commodity futures brokers would be held to a high level of fiduciary duty under Florida law.[286] The Sixth Circuit also concluded in *Street v. J.C. Bradford & Co.*,[287] that a commodities broker is the agent of the customer and, therefore, a fiduciary relationship exists.[288] The Second Circuit has stated that, even though a broker is not acting as a technical trustee, a breach of fiduciary duty occurs under New York law where a broker misinforms a customer as to the status of the customer's account.[289]

In *Wasnick v. Refco, Inc.*,[290] a district court in the Ninth Circuit found a breach of fiduciary duty under state law where a customer was determined not to be suitable for trading in commodity futures. That decision, however, was reversed on appeal because the laws of the state of Washington were found not to

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283 776 F.2d 777 (8th Cir. 1985).

284 *Id.* at 799-80. In Framland Indus. v. Frazier-Parrott Commodities, Inc., 871 F.2d 1402 (8th Cir. 1989), the Eighth Circuit stated that any state law fiduciary duty owed to a customer must arise from the agency relationship with the broker. Similarly, in Ray E. Friedman & Co. v. Jenkins, 738 F.2d 251 (8th Cir. 1984), the Eighth Circuit held that Minnesota state law did not apply fiduciary duties to a nondiscretionary futures account. The court noted that the trader here was sophisticated and reckless and that he "gambled big and lost." *Id.* at 254; *see also* Osborn v. E.F. Hutton & Co., 853 F.2d 616 (8th Cir. 1988) (state fiduciary duty claims were not established); Greenwood v. Dittmer, 776 F.2d 785 (8th Cir. 1985) (under Arkansas law there is no fiduciary duty for a nondiscretionary commodity account).

285 799 F.2d 1461 (11th Cir. 1986).

286 A Florida court held that claims of fiduciary duty under state law are not preempted by the Commodity Exchange Act. Poncy v. Shearson Lehman Bros., Inc., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,530 (Fla. Dist. Ct. App. Sept. 27, 1989).

287 886 F.2d 1472 (6th Cir. 1989).

288 The court made this observation in the context of assessing the validity of a release of claims against a broker. *Id.* at 1481.

289 Modern Settings, Inc. v. Prudential-Bache Sec., Inc., 936 F.2d 640, 648 (2d Cir. 1991).

290 [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).

establish a suitability requirement.[291] The Ninth Circuit's decision tracks the CFTC's present views on suitability.[292]

In *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*,[293] a federal district court found that a commodity broker owed fiduciary duties to a customer. On appeal, however, the Fifth Circuit certified to the Mississippi Supreme Court questions that sought to determine what, if any, fiduciary duties commodity brokers owe to their customers.[294] The Mississippi Supreme Court responded that a customer seeking speculative profits was owed no duty by the broker to prevent the customer from committing financial suicide. The court stated that the fiduciary duties of a broker end with the duty to carry out a customer's instructions.[295]

State courts have also considered the imposition of fiduciary duties on commodity brokers. For example, a Colorado court held in *Rupert v. Clayton Brokerage Co.*[296] that a broad range of fiduciary duties would apply to discretionary accounts. It also stated that negligence could impose liability for fiduciary duty breaches.[297] In *Martin v. Heinold Commodities, Inc.*,[298] however, the Illinois state court held that a broker's fiduciary duty generally is limited to its role as an agent of the customer.

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*,[299] a Wisconsin court rejected the then existing CFTC decisions finding

291 911 F.2d 345 (9th Cir. 1990).

292 *See supra* note 228 and accompanying text.

293 2 Comm. Fut. L. Rep. (CCH) ¶ 24,520 (S.D. Miss. May 31, 1989).

294 Puckett v. Rufenacht, Bromagen & Hertz, Inc., 903 F.2d 1014 (5th Cir. 1990). The questions certified by the Fifth Circuit are set forth at Puckett v. Rufenacht, Bromagen & Hertz, Inc., 919 F.2d 992 (5th Cir. 1990).

295 Puckett v. Rufenacht, Bromagen & Hertz, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,144 (Miss. 1991).

Federal district courts have also considered fiduciary duties in the context of state law. *See, e.g.*, Crook v. Shearson Loeb Rhodes, Inc., 591 F. Supp. 40, 50 (N.D. Ind. 1983) (fiduciary duties imposed by state common law fraud requirements; but the district court relied upon the *Gordon* decision of the CFTC). *See generally* Foote v. Blumenthal, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,437 (N.D. Ill. Apr. 12, 1989) (fiduciary duty is established under state law where a discretionary account is present); Refco, Inc. v. Troika Inv., Ltd., 702 F. Supp. 684 (N.D. Ill. 1988) (under Illinois law, a broker is a fiduciary if he controls a discretionary account, but fiduciary duties of agency still attach to nondiscretionary accounts in the execution of orders).

296 737 P.2d 1106 (Colo. 1987).

297 *Cf.* Hudson v. Wilhelm, 651 F. Supp. 1062, 1064 (D. Colo. 1987) (under Colorado law there is no per se rule as to the scope of fiduciary duties owed by a broker to its customers).

298 510 N.E.2d 840 (Ill. 1987).

299 377 N.W.2d 605 (Wis. 1985).

fiduciary duties. The court held that fiduciary duties did not attach to nondiscretionary accounts unless there was an express agreement providing otherwise. Simply because a customer reposed trust and confidence in a broker did not establish a fiduciary relationship. The court found adequate protection in prohibitions against misrepresentations.[300] In *DeRance, Inc. v. PaineWebber, Inc.*,[301] however, the Seventh Circuit held that Wisconsin state law would find a fiduciary relationship where confidence is reposed by a customer in the superiority and influence of the broker.[302]

VI. A New Approach is Needed

The popularity of the fiduciary concept is undoubtedly due to its flexibility. A court or agency faced with an ethical breach, or a sharp practice or lapse in judgement that falls short of violating statutory or common law standards can use the fiduciary concept to fill the gap in the law and protect those who are disadvantaged by the activity. The concept also allows the courts and administrative agencies to proscribe socially undesirable activities that were not anticipated by the legislature or which are too novel for application of the strict confines of the common law. It assures that those who may engage in sharp practices and prey on the unwary do not escape retribution through legal loopholes.[303] The fiduciary concept assures protection to those who are not in a position to protect themselves and who are dependent on government regulation for their safety.

The negative side to the fiduciary duty approach is that the uncertain scope of the concept may discourage socially desirable activities. The fiduciary duty concept allows an after-the-fact assessment of the conduct of a regulated entity. The decision maker, with the benefit of hindsight, can assess whether the conduct measured up to what it believes should have been the proper level

300 *Cf.* Jacobson v. Western Montana Prod. Credit Ass'n, 643 F. Supp. 391 (D. Mont. 1986) (a defendant establishing a hedging program for livestock producers owed them a fiduciary duty and had to use reasonable care in providing advice on hedging).

301 872 F.2d 1312 (7th Cir. 1989).

302 *See also* Vogel v. A.G. Edwards & Sons, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,996 (Mo. Ct. App. Dec. 31, 1990) (state law imposes fiduciary duties that vary according to whether the account is discretionary).

303 The downside to articulating specific standards for someone who is considered to be in a fiduciary role is that, as expressed by one SEC official, this may provide a wrongdoer with a "road map for fraud." Sommer, *supra* note 93, at 531.

of care. This is disadvantageous to the regulated entity because of the uncertainty of how its conduct will look in the piercing light of twenty-twenty hindsight. The very ambiguity of the concept serves to induce the entity to curb its conduct well beyond the strict legal bounds of a statute or an agency's written rules.[304] This may be desirable in achieving high standards of conduct, but it carries with it the penalty of discouraging aggressive entrepreneurial activities. It makes society less competitive.

The fluidity of the fiduciary concept also allows it to be bent to the will of the decision maker. An active decision maker can expansively apply the doctrine or a noninterventionist can equally contract it. The nebulous nature of the doctrine may then be disadvantageous to the regulated entity or those being protected if the regulator changes its regulatory philosophy to benefit one or the other. Rights and remedies become even more uncertain. Alternatively, as may be the case with the CFTC, the decision maker may opt for disengagement, leaving it to the market to winnow out improper practices, while unknowing and unsophisticated customers suffer the consequences.

Another negative feature of the fiduciary duty concept is exemplified by what has occurred in Delaware—the concept may be used as a guise to second guess business judgments or to otherwise interfere with the conduct of legitimate business. For that reason, the fiduciary concept is particularly alluring to an activist decision maker that wants to thrust itself into the operations of the entities it regulates.

There is a solution to the issues that arises from the conflicting advantages and disadvantages of the fiduciary concept. That solution is one that reflects the realities of the marketplace. The changing nature of the futures markets has reduced the need for a broad application of fiduciary duties. As shown above,[305] futures markets are becoming increasingly dominated by large institutional investors. Such investors do not need a trustee to look after their interests. Once this is acknowledged, the problem becomes manageable. Special protections are needed only for a

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304 One author has suggested that the courts deliberately keep fiduciary doctrine ambiguous. The courts are trying to keep actors away from marginal behavior. J.A.C. Hetherington, *Defining the Scope of Controlling Shareholder's Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9 (1987); *see also* Ragsdale v. Kennedy, 209 S.E.2d 494, 500 (N.C. 1974) (fraud "is better left undefined lest crafty men find a way of committing fraud which avoids the definition").

305 *Supra* note 40 and accompanying text.

small class of customers. Most market participants would not be affected by those protections. The range of protections that are needed for this small class of customers is also finite and can be identified by simple rules adopted by the CFTC which, when coupled with existing antifraud prohibitions, would offer a more ideal level of certainty and protection.[306]

A. *Identifying the Customers Who Need Fiduciary Protection*

The first step in this new approach is to identify the classes of customers who are in need of special protections. Certainly, large institutions are not in need of such protections.[307] Indeed, they are themselves often acting as trustees for their owners (*e.g.*, pension funds). It is their business to know market risks and to monitor their investments. Institutional investors also have the resources to, and do, monitor the market to assure that they are receiving the best execution and to otherwise look out for their own interests.[308]

Moreover, institutions have the bargaining power to deal as equals with their broker. This is reflected by the fact that institutions can, and almost always will, insist on receiving interest on

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306 These protections would extend beyond common law requirements. *See generally* Arthur L. Shipe, *Salesmen as Fiduciaries Under the Commodity Exchange Act*, 25 SEC. & COMM. REG. 1 (1992).

307 In Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989), a district court took note of Judge Cardozo's admonitions in *Meinhard v. Salmon*, *supra* note 125 and accompanying text. The district court stated that, before such fiduciary duties are applied, the court must determine whether the plaintiff "is entitled to more than the 'morals of the market place' and the protections offered by actions based on fraud, state statutes or the panoply of available federal securities laws." *Metropolitan Life*, 715 F. Supp. at 1525. The court held that the plaintiffs before it, sophisticated insurance companies, were not entitled to the protections of fiduciary duties. *Id.*

308 Nevertheless, the lack of sophistication in an institution can sometimes be appalling. They seem, however, to be able to take care of themselves when disaster strikes. For example, a marketing and trading arm of the government of Peru was allowed to recover hundreds of millions of dollars through actions brought in United States courts even though the losses stemmed from speculative investments of its own employees. Minpeco S.A. v. Hunt, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,462 (S.D.N.Y. May 24, 1989); *see also* Drexel Burnham Lambert, Inc. v. CFTC, 850 F.2d 742, 744-45 (D.C. Cir. 1988) (company allowed to recover large losses caused by the trading of an employee that the company knew was a compulsive gambler and a felon); Katra v. D.E. Jones Commodities, Inc., 652 F. Supp. 907 (S.D.N.Y. 1986), *rev'd*, 835 F.2d 966 (2d Cir. 1987) (pension fund investments in futures likened to "lotto"); Evanston Bank v. Conticommodity Servs., Inc., 623 F. Supp. 1014 (N.D. Ill. 1985) (discretionary account mishandled by broker but with bank's alleged knowledge); Siconolfi, *Bear Stearns Fined in Case Involving Savvy*, *supra* note 178, at C1 (punitive and other damages entered by arbitration panel for churning of a sophisticated trader's account).

their funds that are held in segregated accounts by the futures commission merchant.[309] Institutions also aggressively negotiate commissions with their brokers, which is another reflection of their bargaining power.[310] Further, there are several hundred futures commission merchants competing for this institutional business.[311] Such competition provides alternative avenues for institutions that do not receive the service they believe themselves entitled. Much of the same is true for wealthy and sophisticated customers. They have the ability to follow the market and to benefit from broker competition for their accounts.[312] The level of regulatory protection needed by these traders is, for the most part, already in place. This includes antifraud protections and protection of their funds under the provisions of the Commodity Exchange Act.[313]

The exclusion of institutions and wealthy, sophisticated traders from special protections will cover the vast majority of market participants. As shown above, however, a small class of customers in the futures market lack the sophistication or resources required to trade in the highly leveraged, often volatile futures markets.[314] These small traders are often either not well-educated or do not have the financial sophistication or wealth to hire advisers or other fiduciaries to guide them. Consequently, they depend on brokers or other commodity professionals for advice and guidance.

That reliance may be misplaced. Neither competition among brokerage firms for their business nor the feeble bargaining power of the small customer provide the same measure of protection

309 As noted *supra* note 254 and accompanying text, CFTC regulations allow futures commission merchants to retain interest on segregated funds. Those regulations, however, do not require such retention, and sophisticated investors with bargaining power will insist on the interest.

310 Angrist, *supra* note 43, at C1.

311 ELECTRONIC BULLS AND BEARS, *supra* note 11, at 32.

312 Still, wealthy individuals seem frequently to lose money in the futures markets. *See, e.g.*, Todd Mason, *Momma, Don't Let Your Babies Grow Up to Work for the Tax Boys*, WALL ST. J., Jan. 29, 1991, at C1 (singer Willie Nelson loses most of his assets as a result of phony futures transactions that were done for tax purposes); Louvdes L. Valeriano & Amy Stevens, *Tisch Brothers Sue Asher Edelman Over Alleged Tax Fraud Scheme*, WALL ST. J., July 23, 1991, at B3 (wealthy executives experience huge losses from similar transactions); *Mercedes McCambridge's Son's Note Exonerated Her*, L.A. TIMES, Apr. 17, 1989, at 2 (account of academy award winning actress used by her son to defraud an investment banking firm through futures trading); *see also* Stephens, Inc. v. Geldermann Inc., 962 F.2d 808 (8th Cir. 1992) (investment banker allowed to recover from broker for this trading).

313 7 U.S.C. §§ 4a, 6d (1988).

314 *See supra* note 35-36 and accompanying text.

afforded to large institutions or sophisticated customers. Most of the larger, more reputable brokerage firms do not compete for the business of small customers. Indeed, they impose substantial net worth or other requirements in order to discourage the unsophisticated and unsuitable. Further, most small speculators lose money in the markets.[315] This means that even the firms accepting small accounts have little incentive to provide a high level of service that would result in repeat business.[316] To the contrary, there is an incentive to trade small accounts as rapidly as possible to generate a high level of commissions before losses drive the customer away.

Brokerage firms also have an incentive to lure unsuitable customers into the market. To cite one flagrant example, in *Dwyer v. Murlas Bros. Commodities*,[317] an administrative law judge of the CFTC found a widow unsuitable for trading in commodity futures. She had met her broker at her husband's funeral and was persuaded to invest the proceeds of his life insurance policy in futures even though her income could not support her. Needless to say, she lost all of the insurance proceeds in the futures trading. Surely, some rule should exist to prohibit such conduct. Nevertheless, as previously noted, the CFTC has rejected a suitability concept under the Commodity Exchange Act.[318]

Small, unsophisticated customers are in need of special protections that can only be implemented through government regulations. Identification of those customers would involve establishing net worth or other financial tests to exclude institutions or alternative trading experience requirements for individuals. For example, a customer with one or more years (or even less) of

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315 About 90% of customers lose money in their trading. Marvin v. First Nat'l Monetary Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,190 (C.F.T.C. Mar. 11, 1988); Elderd v. First Commodity Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,655 (C.F.T.C. June 8, 1987). *See generally* 120 CONG. REC. 2932 (1974); U.S. DEP'T AGR., TECHNICAL BULL. NO. 1001, AN ANALYSIS OF SPECULATIVE TRADING IN GRAIN FUTURES (1949); MARKHAM *supra* note 5, at 41; HIERONYMUS, *supra* note 7, at 258-63; POWERS *supra* note 25, at 18-19; Shipe, *supra* note 306.

316 *See generally* Shipe, *supra* note 306, at 59-60.

317 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,520 (C.F.T.C. Nov. 21, 1977), *dismissed*, No. R 77-98, 1979 C.F.T.C. LEXIS (C.F.T.C. Jan. 24, 1979).

318 *See supra* note 228 and accompanying text. In the case in which it rejected the suitability concept, the CFTC was unmoved by the fact that the customer was disabled, unsophisticated, and unable to afford losses in operations as speculative as futures trading. Phacelli v. Conticommodity Servs., Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,345 (C.F.T.C. Sept. 12, 1984), *rev'd*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250 (C.F.T.C. Sept. 5, 1986).

active trading experience in the futures markets would not need the guiding hand of a fiduciary, even if that customer is not wealthy or well-educated.

Such a regulatory approach is not novel. The SEC already exempts institutional and sophisticated investors from many of the disclosure provisions of the federal securities laws. For example, SEC rule 506 allows offerings of securities to be made to "accredited" investors without registering those securities with the SEC.[319] The Securities Act of 1933 states that accredited investors may include large institutions as well as "any person who on the basis of such factors as financial sophistication, net worth knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor" under such standards as may be set by the SEC.[320] The SEC has, pursuant to this authority, defined accredited investors to include, among others, financial institutions, business associations with assets in excess of five million dollars, and individuals with net worth exceeding one million dollars.[321] Similar tests, as well as trading experience exemptions for knowledgeable investors, could be employed under the Commodity Exchange Act.[322]

The CFTC is already loosening existing regulatory requirements for institutions. It has adopted a rule that will relieve commodity pools and commodity trading advisers from CFTC disclosure requirements for customers who qualify as "accredited" investors.[323] This rule is "based upon the premise that accredited investors are 'sophisticated investors' who are 'capable of protecting their own financial interests and would benefit from reduction of the unnecessary costs currently associated with providing them with such investment opportunities.'"[324]

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319 17 C.F.R. § 230.506 (1992).

320 15 U.S.C. § 77b(15) (1988).

321 17 C.F.R. § 203.501(a) (1992). The SEC has also acted to facilitate the development of markets where institutions can trade securities. Harold S. Bloomenthal, *PORTAL—A NASDAQ for Restricted Securities*, SEC. FED. CORP. L. REP., Jan. 1990, at 89.

322 A novice customer could also be removed from the category of those needing special protection after he has acquired experience in actively trading his account for a specified period of time.

323 17 C.F.R. § 4.7 (1992). The CFTC rule imposes standards for accredited investors even more stringent than those imposed by the SEC. Barbara Durr, *Managed Futures Industry Given First Break*, FIN. TIMES, May 8, 1992, at 26.

324 *CFTC Proposed Rule on Accredited Investors*, SEC. REG. & L. REP. (BNA), Jan. 24, 1992, at 117-19 (citation and footnote omitted). The CFTC is also simplifying account opening procedures for large institutions and sophisticated customers. CFTC Interpretive

The specially protected class of customers should also include those with discretionary or controlled accounts unless they are exceptionally sophisticated. Historically, such accounts have been of particular regulatory concern,[325] and the CFTC has already accepted the necessity of imposing greater fiduciary duties on brokers controlling a customer's trading.[326] This approach is also reflected in the CFTC's regulations governing commodity trading advisers and commodity pool operators. For instance, because of the control and influence they exercise over customer trading, current CFTC regulations for brokerage firms that control customers' trading have been more comprehensive than for other registrants.[327]

One area of concern will be the establishment of a methodology for determining what constitutes a discretionary account. Generally, a discretionary account would include those accounts where the broker has been given express authority to trade without first consulting the customer. A discretionary account may also be found in the absence of actual written discretionary authority, as where the broker exercises de facto control as a result of the ignorance or trust and confidence placed in the broker by the customer. The broker may also operate under de facto authority where the trading limits or instructions of the customer are so broad or vague as to give the broker effective control.

Fortunately, the CFTC has regulations and case law already in place to deal with the identification of discretionary accounts. One customer protection rule that the CFTC did adopt requires brokers to have a written authorization from the customer before

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Letter No. 92-4 (C.F.T.C. Apr. 17, 1992). Congress also recently granted authority to the CFTC that allows it to exempt from the Act institutions trading swaps and other hybrid instruments. Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992); *see* H.R. REP. NO. 978, 102d Cong. 42-44 (1992).

325 In 1938, the Commodity Exchange Authority conducted an investigation of managed accounts. It discovered that these accounts were often solicited through false and misleading statements. Account controllers commonly allocated profitable trades after the fact to their own or favored accounts at the expense of other customers. U.S. DEP'T AGRIC., REPORT OF THE CHIEF OF THE COMMODITY EXCHANGE ADMINISTRATION 36-37 (1939); U.S. DEP'T AGRIC., CIRCULAR NO. 539, COMMODITY EXCHANGE ADMINISTRATION, TRADING FOR OTHERS IN COMMODITY FUTURES (Oct. 1939). In 1968, the Commodity Exchange Act was amended to apply its antifraud provisions to such schemes. 113 CONG. REC. 23,652 (1967); S. REP. NO. 947, 90th Cong., 2d Sess. 6 (1968). Nevertheless, such abuses have continued. *See, e.g.*, Bosco v. Serhant, 836 F.2d 271 (7th Cir. 1987); CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979).

326 *See supra* note 236 and accompanying text.

327 *See* 17 C.F.R. 4.1-.32 (1992). The CFTC is, however, now in the process of loosening those restrictions. *See supra* note 248 and accompanying text.

exercising discretionary trading in the customer's account.[328] The CFTC rule does not require a writing where the broker is merely exercising time and price discretion in executing a customer order.[329] This allows the customer to rely on the broker's time and place advantage in determining when an order should be executed, but requires the customer to specifically authorize the quantity and commodity interest to be traded.[330] CFTC cases on churning claims have also established a body of law on whether a customer's account was under the de facto control of a broker (*i.e.*, one element of a churning claim requires proof that the broker exercised discretionary control over the customer's account).[331]

B. *Fiduciary Duties for "Protected Customers"*

The next step in the process of protecting unsophisticated customers (the "Protected Customers") is to identify and define the protections they need. This may be accomplished by regulations that are simple and few.[332] The broker, for example,

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328 17 C.F.R. § 166.2 (1992).

329 *Id.*

330 *Id.* *See generally* Morris v. Stotler & Co., 2 Comm. Fut. L. Rep. (CCH) ¶ 25,080, at 38,046 n.18 (C.F.T.C. June 27, 1991); Wolkon v. Refco, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,509 (C.F.T.C. July 14, 1989).

331 For example, in Secrest v. Madda Trading Co., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,627 (C.F.T.C. Sept. 14, 1989), the CFTC held that the existence of an express grant of discretionary control will give rise to a *rebuttable* presumption of control. CFTC cases further establish a methodology for ascertaining the existence of de facto control in the absence of an express grant of such authority. In Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 at 24,454 (C.F.T.C. Sept. 3, 1980), the CFTC identified the following non-exclusive list of factors as demonstrative of broker control over a customer's account:

> 1) a lack of customer sophistication 2) a lack of prior commodity trading experience on the part of the customer and a minimum of time devoted by him to his account 3) a high degree of trust and confidence reposed in the associated person [*i.e.*, the broker] by the customer 4) a large percentage of transactions entered into by the customer based upon the recommendations of the associated person 5) the absence of prior customer approval for transactions entered into on his behalf 6) customer approval of recommended transactions where the approval is not based upon full, truthful and accurate information supplied by the associated person.

(citations and footnote omitted). *Accord* Ball v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,184, at 24,874 (C.F.T.C. Apr. 2, 1981).

332 Caution is in order. Regulations to protect the weak should be clear, but they should be narrowly focused. As the Supreme Court stated long ago with respect to the regulation of commodity futures:

should be required to fully explain the nature of futures trading, any trading program planned for the customer, the risks involved and the extent of losses that may reasonably be expected if the trading program does not work.[333] The broker should also be required to advise the customer of any change in trading strategies. Further, customers should be given a special short form notice whenever the open or closed commodity futures trading in their account reflects a specified percentage loss of account equity (*e.g.*, ten percent) or some dollar figure (*e.g.*, five thousand dollars). This assures that customers are on actual notice of losses in their accounts. Even though present account statements contain such information, they are often overloaded with information and confusing in presentation.[334] Further, while it might be thought that margin calls would put a customer on notice of losses, they are often explained away by brokers or their effect is concealed where margin is paid from funds already in the customer's account. A special notice would assure that Protected Customers are on actual notice of losses in their account.

Brokers handling the accounts of Protected Customers should further be required to keep themselves apprised of market conditions that may have a material effect on the accounts they control,[335] and they should be barred from trading for their own account.[336] Brokers should also be required to disclose not only

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> Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain.

Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 247-48 (1905).

333 Of course, many commodity futures transactions involve the potential of virtually unlimited trading losses. Further, while many trading strategies may seek to limit those losses, they are not fail proof. This should be explained to the customer.

334 17 C.F.R. § 1.33(a) (1992). The SEC is now requiring brokers selling speculative penny stocks to provide a monthly status report to customers holding such securities. 57 Fed. Reg. 18,034 (1992) (to be codified at 17 C.F.R. 240.15g-6).

335 This is not to suggest that brokers must become human ticker tapes or infallible in their trading. Vetrono v. Manglapus [1984-1986 Transfer Binder] Comm. Fut. L. Rep. ¶ 22,702, at 30,985 (C.F.T.C. Aug. 6, 1985); Flynn v. First National Monetary Corp. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,396 (C.F.T.C. Mar. 9, 1982).

336 This will lessen the temptation to allocate favorable trades for the broker's benefit

the amount of any management or brokers fees, but also the effect of such fees on the profitability of the customer's account.[337]

Some standards previously rejected by the CFTC should now be reconsidered. The suitability concept is the most controversial of those proposals. In fact, however, this issue is more apparent than real. Suitability has long been a part of the regulatory requirements for broker-dealers in the securities industry.[338] The number of actions brought for violation of that requirement are few in number, but the concept is accepted and respected and has not been shown to have affected market liquidity or desirable market activity.[339] There is an even greater need for a suitability requirement in the futures industry. Futures contracts are complicated, highly leveraged, short-term instruments that are traded on commodities selected for their price volatility.[340]

Surely, no respectable professional licensed by the federal government should be authorized to recommend such instruments

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at the expense of the customer. *See supra* note 222 and accompanying text. The problem of "dual" trading by *floor* brokers in executing orders for Protected Customers can best be met by adopting automated small order execution systems such as those used in the securities industry. Markham, *supra* note 256, at 1016-20.

337 Several decisions by CFTC administrative law judges and judgment officers have held that it is fraud not to disclose the effects of a large commission on the ability of a customer to make a profit. *See, e.g.*, Diaz v. First Commodity Corp., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,164 (C.F.T.C. Feb. 17, 1988) (finding violations where management fees were so large as to preclude any potential for profit); *see also* Morlais v. Murlas Commodities, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,942 (C.F.T.C. Oct. 18, 1990); Hanly v. Commodity Options Specialists, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 24,912 (C.F.T.C. Oct. 18, 1990). The CFTC, however, has rejected those decisions, concluding that it has no power to regulate commissions or fees. Macurdy v. Byrne, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,083 (C.F.T.C. July 11, 1991); Johnson v. Fleck, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,957 (C.F.T.C. Nov. 20, 1990).

338 WOLFSON, *supra* note 221, ¶ 2.08.

339 1 HAZEN, *supra* note 220, § 10.7.

340 In proposing a suitability rule in 1977, the CFTC stated that:

> Commodity customers are often unaware of, or inattentive to, the substantial risk of loss in commodity trading. Since futures contracts can be purchased on relatively small margins (thus giving customers a high degree of leverage) and the market prices of futures contracts are subject to large and rapid fluctuations, futures traders can lose substantially more than the amount of funds deposited as original margin . . . . There is a need for a rule that will prohibit commodity professionals from encouraging or causing their customers to take risks in the commodities market that are beyond their capacity to bear. Futures trading may be unsuitable for customers who do not possess risk capital or who are seeking production of income or preservation of capital.

Proposed Standards, *supra* note 219, at 21,928.

to customers whose finances or business acumen make them unsuitable for such trading. This is not just a theoretical concern. There remains in the futures industry a class of customers, albeit decreasing in number, whose suitability for futures trading is doubtful.[341] Claims made by unsophisticated and unknowing commodity futures customers continue to fill the reporters.[342] Still, the commodity futures industry neither accepts nor respects the application of the suitability concept to futures trading, and the CFTC has declined to adopt a suitability rule in the face of heavy industry opposition.[343] However, CFTC rulings have resolved some of the concerns associated with suitability. For example, the CFTC has adopted part of the SEC's so-called "shingle" theory that requires brokers to have a reasonable basis in fact for the recommendations they make to customers.[344]

The CFTC has also caused the National Futures Association ("NFA"), the industry's largest self-regulatory body, to adopt a rule that the CFTC viewed to be the equivalent of a suitability rule.[345] The self-regulatory bodies are also the chief means by which the suitability rule is applied to the securities industry.[346] Extension of the NFA rule to the other self-regulatory bodies in the futures industry would seem to be in order to assure uniformity of regulation among the self-regulatory bodies in the futures industry. This would also assure more uniformity within the securities industry, which is becoming increasingly integrated with the futures markets. This extension of the suitability concept would also do much to alleviate criticism of customer protection in the futures industry.[347]

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341 *See supra* note 36 and accompanying text.

342 The *Commodity Futures Law Reporter* published by the Commerce Clearing House is an apt chronicle of the claims made by such customers. *See also* 13 & 13A JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD MANIPULATION & OTHER CLAIMS (1990).

343 *See supra* note 228 and accompanying text.

344 *See* Hannay v. First Commodity Corp. of Boston, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,936, at 34,282 (C.F.T.C. Sept. 21, 1987); Syndicate Sys., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,289, at 32,788 (C.F.T.C. Sept. 30, 1986); 1 HAZEN, *supra* note 220, § 10.6.

345 Phacelli v. Conticommodity Servs., Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,675 (C.F.T.C. Sept. 5, 1986). Actually, it only requires supplemental risk disclosure to those who may be unsuitable. Walter C. Greenough, *The Limits of the Suitability Doctrine in Commodity Futures Trading*, 47 BUS. LAW. 991, 997 (1992).

346 1 HAZEN, *supra* note 220, § 10.7.

347 A more novel approach may simply be to adopt objective standards that make customers with net worths or incomes of less than a specified amount per se unsuitable. This may sound draconian, but most responsible brokerage firms already impose such

The CFTC's reversal of its *Gordon* decision also leaves a gap in the level of protection from negligent acts by a commodity professional. Some protection, however, is present in the form of a separate antifraud provision applicable to account controllers acting as commodity trading advisers or as commodity pool operators. That statute imposes a negligence standard for liability.[348] Another CFTC rule has also reduced concern here by prohibiting some of the more egregious abuses in the handling of customer orders.[349]

Still, there are gaps, and more protection may be needed in the form of a due diligence requirement such as that previously proposed by the CFTC.[350] Presently, there is no CFTC rule to govern the failure to use due diligence in the absence of fraud.[351] The adoption of such a rule would establish, among

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requirements so that they may avoid the inevitable lawsuits that arise when unsuitable customers lose money from trading high risk instruments.

In proposing a suitability rule, the CFTC asked for comments on using such objective standards. The CFTC stated, however, that:

> While specific standards would no doubt be easier to administer and enforce . . . they do not seem to take into account the varying circumstances of individual customers and the many other factors that affect suitability. An individual with a relatively large net worth might have little capacity for risk taking if he has many dependents and large financial commitments. Conversely, an individual with a relatively small net worth may be in a position to take comparatively large risks—for example, a person with no dependents and a steadily rising income.

Proposed Standards, *supra* note 219, at 21,930.

348 7 U.S.C. § 6o (1988). *See* Messer v. E. F. Hutton & Co., 833 F.2d 909 (11th Cir. 1987), *amended in part on reh'g*, 847 F.2d 673 (11th Cir. 1988); First Nat'l Monetary Corp. v. Weinberger, 819 F.2d 1334 (6th Cir. 1987); CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979) (no scienter requirement for this antifraud provision); Taylor v. Peabody, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,926 at 27,995 n.1 (C.F.T.C. Nov. 17, 1983) (same); First Commodity Corp. v. CFTC, 676 F.2d 1, 6 (1st Cir. 1982) (same).

349 17 C.F.R. § 155.3 (1992).

350 For example, this antifraud provision still leaves a gap for brokers who are not subject to that provision. 7 U.S.C. § 6o. The CFTC also stated in its release proposing its customer protection rules that brokers "should exercise care in the choice of floor brokers and associated persons who handle orders should be properly trained." *Proposed Standards*, *supra* note 219, at 21,936. There was some doubt whether brokers are liable for the conduct of floor brokers they select to execute their customers orders. S. REP. NO. 101, 101st Cong., 1st Sess. 15 (1989). *Compare* Buran v. Lerman, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,874 (C.F.T.C. July 6, 1990) *with* Sherman v. Sokoloff, 570 F. Supp. 1266 (S.D.N.Y. 1983) *and* Balfour MacLaine, Inc. v. National Coin Exch., 697 F. Supp. 835 (E.D. Pa. 1988). New legislation now makes brokerage firms liable for the conduct of floor brokers, Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992); *see* H.R. REP. NO. 978, 102d Cong., 2d Sess. (1992).

351 Drexel Burnham Lambert, Inc. v. CFTC, 850 F.2d 742 (D.C. Cir. 1988). At least

other things, that brokers must use special care in executing orders of Protected Customers who are not in a position to monitor their own orders to assure their proper execution.[352] Again, this rule could be limited in scope to Protected Customers to reduce any undue regulatory burden.[353]

A last measure of protection needed for Protected Customers involves supervisory requirements. The CFTC currently has a broad, though somewhat vague, rule governing supervision. Specifically, the CFTC rule states that brokers and other registrants must "diligently supervise the handling" of customer accounts.[354] This rule was also a part of the CFTC's original customer protection proposals. In its proposed form, the CFTC had specified in some detail what types of supervision were to be required, particularly for discretionary accounts.[355] In adopting a more generic rule, the CFTC stated that the proposals were guidelines for supervisors to follow in meeting the requirements of the rule.[356] More is needed for Protected Customers. Indeed, the CFTC has already recognized the special supervisory needs for at least one set of customers—those trading in commodity options.[357] Protected

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one court, however, has found an implied duty of due diligence. Thomson McKinnon Sec., Inc. v. Moore's Farm Supply, 557 F. Supp. 1004 (W.D. Tenn. 1983).

The CFTC's proposed due diligence rule stated that due diligence includes the principle of "customer first," (*i.e.*, that the broker not trade in front of the customer in order to obtain a more advantageous price for the broker). *Proposed Standards*, *supra* note 219, at 21,936. Subsequently, the CFTC adopted a rule that required the exchanges to prohibit such practices. 17 C.F.R. § 155.3 (1992).

352 *Proposed Standards*, *supra* note 219, at 21, 936. The CFTC rule proposal stated that, "Due diligence also means the careful and efficient handling of customers' orders. For example, orders should be transmitted in a timely fashion to the trading floor." *Id.*

353 Institutional customers or experienced traders are not in the same need of protection as Protected Customers are for a due diligence rule. The former can follow exchange prices and determine whether they received a good execution. If not, they can complain or move their business elsewhere, a threat that will insure that their brokers act diligently.

354 17 C.F.R. § 166.3 (1992).

355 *Proposed Standards*, *supra* note 219, at 21,934. For example, the rule proposal would have required a supervisor to review and approve each transaction entered by a broker for a customer's account over which the broker had discretion. *Id.*

356 *Protection Rules*, *supra* note 224, at 22,624-625.

357 Historically, commodity options have been the subject of serious abuses in the commodities industry. Robert C. Lower, *The Regulation of Commodity Options*, 1978 DUKE L.J. 1095 (1978); Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741 (1983); John Schobel & Jerry Markham, *Commodity Options—A New Industry or Another Debacle*, Sec. Reg. & L. Rep. (BNA) No. 347, Special Supp. (Apr. 7, 1976). After a series of scandals arising shortly after its creation, the CFTC was forced to suspend virtually all commodity options trading. 17 C.F.R. § 32.11 (1978). *See generally Extend Commodity Exchange Act: Hearings on H.R.*

Customers should have the benefit of those protections in commodity futures as well.

VII. CONCLUSION

This country received the fiduciary concept from England with a great deal of enthusiasm. It was expansively applied to an ever increasing number of relationships far beyond the field of trusts where it seems to have sprouted. The results have often been ambiguity, confusion, uncertainty, and backtracking as legal philosophies change. This has been most visibly reflected in the fields of corporate and securities law. The application of fiduciary duties to the commodity futures industry is also engendering that same ambivalence.

The CFTC's switch in position on scienter has heightened the need to consider whether at least some futures customers are in need of a greater level of regulatory protection. Their only protection now is an antifraud provision that may offer no greater protection than a common law fraud standard.[358] More is needed. First, a class of Protected Customers should be identified. They should include the unsophisticated, the inexperienced, and those whose accounts are traded pursuant to discretionary authority. They would not include institutions, the wealthy, or the financially sophisticated. Second, a limited number of protections should be adopted for these Protected Customers. Those protections should be set forth in a limited number of specific rules that would replace the uncertainty of the vague protections of fiduciary duties that may not even exist in this important part of the financial services industry. These protections would include special alert notices of trading losses, a modest number of other disclosures, an extension of existing supervisory requirements and self-regulatory rules on suitability, and the adoption of a "due diligence" rule that would be limited in application to this small class of Protect-

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10285 *Before the House Subcomm. on Conservation and Credit of the Comm. on Agric.*, 95th Cong., 2d Sess. 39 (1978). Excluded from the suspension were commercial traders of commodity options—they were able to fend for themselves. 17 C.F.R. § 32.4 (1978). The CFTC later allowed options trading to go forward on the exchanges under a set of rules that imposed special safeguards for customers trading these instruments, including additional supervisory requirements. 17 C.F.R. § 33.1-.29 (1978). The CFTC required the exchanges to impose these special supervisory requirements. 17 C.F.R. § 33.4 (1978).

358 Puckett v. Rufenacht, Bromagen & Hertz, Inc., 903 F.2d 1014 (5th Cir. 1990); Greenwood v. Dittmer, 776 F.2d 785, 789 (8th Cir. 1985); Nanlawala v. Jack Carl Assocs., Inc., 669 F. Supp. 204 (N.D. Ill. 1987).

ed Customers. In this way, Protected Customers will receive protection without creating the ambiguity, confusion, and uncertainty characteristic of fiduciary principles.