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The Failure of Investor Protection by Disclosure

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THE FAILURE OF INVESTOR PROTECTION BY DISCLOSURE

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This Article deals with the issue of investor protection by disclosure. It discusses the evolution of disclosure in the financial area during the past thirty years, the role of disclosure in the regulation of intermediaries, and the current strong disagreements concerning the Dodd–Frank Act's mandate applicable to market brokers. The Article notes the role of disclosure in the restructured financial intermediation system, its failure to protect investors, and concludes with suggestions to partially correct the failure and restore the rationale for effective disclosure. Disclosure should apply to the risks posed by the intermediaries rather than to the dangers and risks posed by the investments that the intermediaries offer.

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I. INTRODUCTION

This Article deals with an old issue in the context of a new environment, that is, disclosure to investors in the context of the evolving financial system. The new environment relates to trading in securities and other innovative and novel financial instruments.

Financial instruments involve promises. One party, a saver, offers money to another, a borrower. The borrower promises to repay the saver and an additional amount to cover the saver's risks and loss of alternative financial gains from the lent amount. The more complex the conditions of the arrangement become, the more complex the promising party is (e.g., a large pool of various borrowers providing various mortgages), the more reliance and trust the transaction involves on the part of the saver. Trust and reliance are required of any dealings between two parties. Yet, promises of future payments by unknown and unknowable borrowers may involve a higher level of trust. Even if known, borrowers pose a risk whether they are individuals, who may lose their assets or their jobs, or corporations and other entities that may lose their business or legitimacy.

This Article addresses the legal requirements of disclosure aimed at informing investors (savers) about the investments they are offered and designed to help them determine whether to buy or sell the borrowers' promises. In the 1930s, Congress established a legal requirement to inform investors about the borrowers' promises. During the past thirty years, this requirement has undergone significant changes. The recent legislation of the Dodd–Frank Act addressed disclosures once more. After the Act was passed, the implementation of some of the disclosure requirements has currently been subject to strong and sometimes passionate disagreements. On a very fundamental level—and some would say the highest level—is this question: when and under what circumstances must one party to a negotiation or a relationship disclose to another particular facts, and who and how are these facts to be disclosed? This question is discussed in Part II of this Article.

Part III of the Article examines the role of disclosure in the context of two main forms of intermediation in our financial systems. One form is institutional intermediation, such as the intermediation by banks and insurance companies. The other form is market intermediation by underwriters, brokers, and dealers. This Part addresses the different regulatory regimes regulating the intermediaries and the process. In addition, this Part follows the slow merger of the two structures, and the role disclosure played in each of these structures.

We note that in the United States market intermediation was, and continues to be, grounded in disclosure; institutional intermediation was based on substantive regulation and substantive fiduciary law. This type of regulation has increasingly been watered down and substituted by disclosure. In part, this process was caused by the merger of the two intermediation forms and brought about a heightened emphasis on disclosure.

Part IV discusses the legal roots and rationale, advantages and flaws of the disclosure requirement for investors–savers about the terms of the borrowers' promises. In this Part, we note the failure of disclosure to achieve its objective and the reasons for the failure such as (1) the complexity of the financial promises for which investors–savers pay, (2) the copious disclaimers of the issuers as protection from prosecution, and (3) the drive of the issuers and salespersons to emphasize the promised gain and de-emphasize the risk of loss posed by these financial promises. We note the disastrous failure of disclosure to produce the anticipated results, regardless of the type of intermediaries that were required to apply it. After all, communications among humans are complicated.[1]

Part V concludes by suggesting a partial correction for the failure of disclosure. In the current environment, there is an overwhelming drive for innovations and the adoption of innovation by the financial intermediaries. Explaining the promises for which investors–savers pay cash in the hope of gaining more has become ineffective. Even the purchase of such promises is no longer simple. There developed an entire community that invents and models new promises that must explain its own innovations. In short, understanding the promises and their effect on the savers who buy these promises has become a profession. Teaching buyers and sellers whose expertise lies elsewhere to become "educated" in this science is tremendously wasteful for society.

Therefore, in this day and age, disclosure about securities and transactions in securities must relate not to the nature of the securities, but to the reliability of the intermediaries and the innovators that produce these securities—whoever produces them. These experts know—or should know—what they are innovating, offering, or benefitting from.

The time when this country and any other country had "sophisticated investors" is over. Because the interests of intermediaries may compete with the interests of the investors–savers, these investors–savers must understand what disclosure they need and what disclosures they can understand.

Because conflicting interests are far easier to understand than the

1. *See* LUDWIG WITTGENSTEIN, TRACTATUS LOGICO-PHILOSOPHICUS (D.F. Pears & B.F. McGuinness trans., 1974); LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS (G.E.M. Anscombe trans., 3d ed. 1967).

complex instruments which are being offered, the information about conflicts of interests can help investors determine which innovation is reliable. Disclosure must move from what is being sold to who is selling it.

II. WHEN AND UNDER WHAT CIRCUMSTANCES MUST A PARTY TO A RELATIONSHIP DISCLOSE TO THE OTHER PARTY CERTAIN FACTS?

Law deals extensively with the role of disclosure by the parties to a variety of interactions both personal and public. This Part will first address disclosure between parties in a contractual relationship. Second, this Part will discuss disclosure within a fiduciary relationship. Finally, this Part will discuss disclosure in the markets.

A. Disclosure: The Contract Model

The base line of contract duty of disclosure is that no party is required to disclose any facts to the other. Each party may, however, demand information from the other. And once the other agrees to provide the information, the other party must tell the truth. If it does not tell the truth, the law provides the other party, and sometimes the society, with remedies and punishments.

This model is based on the assumption that both parties are more or less equally able to seek the necessary information for making its decisions. In addition, the model is based on the assumption that each party understands that the other's interests may conflict on some particulars with its own (e.g., price) as well as that the parties have shared interest to interact (to trade).

B. Disclosure: The Fiduciary Model

Intermediaries may be contract parties, exchanging securities with their customers. However, intermediaries may play various roles for investors–savers. Intermediaries may serve as trustees who manage the investors–savers money and finances, or as brokers who sell and advise investors–savers, or as advisers to investors–savers. To perform these services, intermediaries must be entrusted with discretion or money, or both.

In most of these cases the roles of the parties change, regardless of how educated the investors–savers are. In all these cases the investors–savers must entrust to the intermediaries either their securities, other property, cash, or the power to determine whether to buy, sell, or hold obligors' promises.

The more control intermediaries have over the investors' money and the greater the intermediaries' power to determine the investments, the higher the investors' risk is that the intermediaries will be tempted to use the money, securities, or power for other than the investors–savers' sole interest. The more the investors control either the entrusted money or power, the lower their risk would be. However, in situations in which control is impossible or for other reasons reliance by investors on intermediaries is necessary, the possibility of control is reduced. If control can and is exercised, however, the relationship becomes far less efficient.[2]

Therefore, depending on the nature and level of the entrustors' risks from misappropriation by intermediaries and on the ability and rationality of entrustors' control to prevent such misappropriation, fiduciary law imposes substantive prohibitions on the entrusted party (the fiduciaries). Yet, even in this case, fiduciaries may engage in prohibited activities if, and only if, they receive the consent of the entrustors, after full disclosure. This exception converts the relationship from a fiduciary to a contract relationship with respect to the transaction that received the investor–saver's consent.

With respect to the ownership of the money and third party promises, intermediaries have ownership only to the extent necessary to perform their services.[3] If intermediaries use entrusted money and power for the benefit of anyone (including their own) without the express permission of the true beneficial owners, these intermediaries breach their duties. In fact, they are embezzlers, regardless of the interpretation of the law. In reality, they took what did not belong to them and broke the trust that was placed in them.

Intermediaries are controlled by law to prevent embezzling entrusted property and misusing entrusted power. The law is designed to induce intermediaries to perform their services according to the reasonable expectations and the needs of the investors and society.[4]

C. Disclosure: The Market Model

The same duality of contract on the one hand and imposed rules of behavior on the other hand, appears in non-personal market relationships

2. *See* TAMAR FRANKEL, FIDUCIARY LAW Ch. 2 (2011).

3. *See id.* at 19; *see also* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 809 (1983) ("The power that the fiduciary obtains is originally vested in someone else, and is delegated to the fiduciary not for his own use, but solely for the purpose of facilitating the performance of his functions.").

4. To be sure, such control depends among other things on (1) the nature of the services and degree of entrustment, (2) the entrustors' ability to exercise control, and (3) the alternative controlling mechanisms such as public mores and pressures.

as well. However, law changes the model of contract relationship. Instead of leaving each party to seek information from the other, the law imposes on the parties a duty to truthfully disclose relevant information.[5]

Government agencies may act as the counter parties and surrogates of the investors for this purpose.[6] And when a transaction involves products that require expertise, such as pharmaceutical products, the government imposes testing and substantive duties on the producers before they can offer the products in the markets. For experiments, however, law reverts to a fiduciary model of full disclosure—contract.[7] That is, so long as the information provided to the other party is accessible and intelligible.[8] When the subject matter of the relationship is financial, a number of issues arise. At the outset, however, let us define what is usually called "financial assets." I maintain that the name is misleading. Financial assets are a *party's promises* to pay *in the future* a sum of money for cash, such as the purchase of bonds, or for a promise to pay more or less money *in the future*, depending on currently unknown circumstances, such as the relationship underlying "swaps." In both cases, at least one of the subject matters of the relationship is promises to pay. Arguably, this is a very usual subject matter of many transactions in assets. The difference between the sale or purchase of real assets and financial assets, however, is that the subject matter of the purchase or sale in the financial area is a promise to pay in the future. It is for this promise that the buyer pays.

Disclosure has become the main regulatory mechanism for the securities markets. Disclosure offers two main benefits. First, it enables investors to make their decisions on whether and how to trade in securities (third party promises). Second, disclosure can deter issuers and brokers from misleading investors.[9] Publicity can deter fraud. The

5. Goodwin v. Aggasiz, 186 N.E. 659, 660–61 (Mass. 1933).

6. *See* 15 U.S.C. § 77e(a) (2006) (prohibiting sale of unregistered securities); *id.* § 77e(b) (prohibiting prospectus not meeting requirements of Securities Act with regard to registered securities); *id.* § 77e(c) (prohibiting offer of securities unless registration statement has been filed).

7. *See* Grimes v. Kennedy Krieger Inst., Inc., 782 A.2d 807, 843–44 (Md. 2001) (finding provisions of consent agreement "created contractual relationships imposing duties by reason of the consent agreement themselves").

8. *Id.* at 823–37, 848 (requiring clear disclosure).

9. *See, e.g.*, LOUIS LOSS ET AL., 1 SECURITIES REGULATION 580 (4th ed. 2006) (stating that "announced aim" of the 1933 Act "was to inform the investor of the facts concerning securities offered for sale and to protect him against fraud and misrepresentation"); Basic, Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("The 1934 Act was designed to protect investors against manipulation of stock prices.") (citing legislative history); *id.* ("There cannot be honest markets without honest publicity.") (quoting legislative history); *id.* (noting "fundamental purpose" of 1934 Act as "implementing a philosophy of full disclosure") (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963))).

light of day (and perhaps the warmth of the sun) can be the effective regulators.[10] To be sure, this description is very general. However, for the purpose of this Article, these high-level models may suffice.

III. THE TWO MAIN FORMS OF INTERMEDIATION, THEIR EVOLUTION AND SUBSEQUENT MERGER

A. The Two Forms of Financial Intermediation

Developed societies have established financial intermediation systems, that is, mechanisms that facilitate the transfer of money from savers to borrowers. These mechanisms are financial intermediaries. A history of financial intermediation demonstrates the emergence of two fundamental forms: institutions and markets. Financial promises—I do not call them assets, and instead describe them by what I consider a more accurate description—are traded in markets. Markets in physical products and necessities developed early on where sellers and buyers would meet, sometimes periodically, such as in the establishment of fairs.[11] The fairs in financial promises were and are called today as well, exchanges. But buyers and sellers rarely enter them. Rather, these fairs are populated by intermediaries, who can connect buyers with sellers of third party promises. Markets, however, require a number of conditions. The third party promises must be standardized and in sufficient number and appropriate amounts to attract an adequate number of brokers to take on the intermediation task. In addition, markets must float sufficient information about the third party promises to allay the fears of the buyers of these *promises* that the promises will not be kept—the buyers' risks. For these risks, buyers receive rewards linked in part to the levels of these risks.

10. *See* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914) ("Sunlight is said to be the best of disinfectants; electric light the most effective policeman."), *quoted in* LOUIS LOSS ET AL., 1 SECURITIES REGULATION 261 (4th ed. 2006). *See also* James R. Barth & Joseph J. Cordes, *Optimal Financial Disclosure with and Without SEC Regulation*, 20 Q. REV. ECON. & BUS. 30 (1980). Professors Barth and Cordes calculate the cost benefit of disclosure with or without SEC regulation and conclude that "court costs" would render incentives to zero information. It is not clear whether the writers considered possible misinformation. They view information as an asset for which investors might pay more or less. The article contains nice charts.

11. *See, e.g.*, *Barnstaple*, DEVON CNTY. COUNCIL, http://www.devon.gov.uk/historicbarnstaple (last visited Feb. 16, 2013) (citing H.G. HOSKINS, DEVON (1954)) (noting Barnstaple's economic importance in medieval times; and that one weekly market was held for "vegetables and other farm produce" and another was limited to "corn and cattle").

B. The Gold Merchants—Ancient Bank Model

In the past, market in gold, and perhaps other expensive assets, tended to take the form of institutions. Perhaps the reason was linked to physical security requirements, which were too costly to establish in a market, and which would have involved more persons than those who wished and could afford to buy.

Therefore, early on, goldsmiths received custody of clients' gold, other precious metals and precious stones. The purpose of the custody was to create ornaments from these materials. Goldsmiths held their clients' gold and handed over receipts for the amounts they held. With time, these clients paid other parties not with gold, but with the goldsmiths' receipts. Both parties preferred to deal with receipts rather than with the metals. Thus, gold became a form of money through institutional intermediaries—the goldsmiths. When goldsmiths found that the clients did not demand all the gold their gold in species, the goldsmiths began to sell more receipts for gold than the amount they held, so long as they had a sufficient amount of gold to meet demand for the species.[12] Like today's banks, the goldsmiths' liabilities exceeded their assets but matched the demand. Similarly, to meet the needs of travelling merchants to foreign countries, the Lombards introduced in England bills of exchange in the thirteenth and fourteenth centuries.[13] In time banks developed as an intermediation form. Banks borrowed money and issued their own obligations (banknotes); then turned and lent the money they borrowed to borrowers at a higher interest rate.

C. Markets

As noted, markets in third party promises cannot develop unless certain conditions exist. First, the traded financial instruments must be standardized. Second, there must be a sufficient number of such financial instruments in denominations to attract a sufficient number of traders. Third, there must be interested intermediaries—underwriters, brokers, and dealers, and perhaps, with the growth of complex and number of financial instruments, advisers.

If the conditions for markets do not exist, intermediation is carried on by institutions. Institutions borrow from lenders on the lenders' terms, and then turn around and lend the proceeds of the lenders' money to borrowers on their own terms. Intermediaries in the markets usually live

12. *See* J. MILNES HOLDEN, THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW 206–07 (1955) (noting role of goldsmiths in development of check system); *id.* at 70–73 (generally describing goldsmiths' notes).

13. *Id.* at 1–2.

off a percentage of the amounts they trade, even though they currently charge a fixed fee for the number of promises that they sell or buy at different prices. In contrast, institutions live off the different risk level of the promises they issue and the third party promises of the borrowers to whom they lend. Thus, by definition, the risk levels of institutional borrowing are lower than the risk level of the borrowers to whom they transfer the promises.

D. The Changed Intermediation Scene in the United States

In 1933 Congress separated market and institutional intermediation by the Glass–Steagall Act. Congress imposed tight controls on institutional intermediaries, such as banks[14] and mutual funds,[15] and the states have imposed similar controls on insurance companies.[16] Historically, Congress treated market regulation by required disclosure. State laws, which imposed government pricing on the first issuance of securities, for example, have disappeared.[17]

During that period, the banks and the insurance companies were the main intermediaries.[18] Both institutions were not focused on market intermediation. Insurance companies in the 1940s were usually owned by the policy holders and received their funding from the policyholders. It was only later, in the late 1950s, that insurance companies became interested in both raising funds in the markets and offering securities trading in the markets, that is variable annuities and variable insurance financial intermediation.[19]

It was only in the 1980s that banks began to recognize the extent to which markets have risen as intermediaries. It was in the 1980s that bank regulators began to advocate for their banks to expand the banks' functions to market activities. In both cases the markets began to "bite" into the monopoly of the banks and insurance companies. In the case of banks, the regulators began to strongly advocate opening the doors of bank institutional intermediation to market intermediation. The courts

14. *See* 12 U.S.C. §§ 21–216d (2006) (governing national banks); *id*. §§ 221–522 (Federal Reserve System).

15. *See* Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to a-64 (2006); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to b-21 (2006).

16. *See* McCarran–Ferguson Act, 15 U.S.C. § 1011 (2006) (stating policy that state regulation of insurance business is in public interest); MASS. GEN. LAWS chs. 175–175K (2011) (Massachusetts insurance statutes).

17. *See, e.g.*, Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 471 (1993) (noting that "[m]ajor states have abandoned their commitment to merit regulation").

18. *See supra* Part II.

19. *See* Tamar Frankel, *Variable Annuities,Variable Insurance and Separate Accounts*, 51 BYU L. REV. 177 (1971).

of the 1960s denied the roundabout ways of such door-opening. The courts of the 1980s and the regulators pressed hard for the doors to be opened. In 1996, the pressure gave way, and Congress eliminated the separation of market and institutional intermediation altogether.[20] Therefore thereafter, disclosure took second seat to substantive regulation. The focus on disclosure has risen with the rise of markets.

The financial markets changed after the 1929 crash. Markets were no longer the main intermediation channels. Rather the main intermediaries were banks, insurance companies, and later in the 1970s, investment companies. This hegemony, however, began to weaken. In the 1950s, the market segment of intermediation began to encroach on institutional intermediation and occupy an increasingly larger part of the intermediation business.

As this market pressure developed, banks and their regulators, as well as some insurance companies, began to press for a greater role in market intermediation. This pressure culminated in the effective overturning of the Glass–Steagall Act by Congress in 1996. Thus, today, there are large financial intermediaries that function as banks, brokers, dealers and mutual funds.

Today their intermediation functions are performed by financial intermediaries that serve not only intermediation, but the creation of new types of financial promises. One type of such promises converts individual promises, such as loans, into marketable promises such as securities. Another type separates promises of borrowers from the risk that they pose and offers a market in risks from promises. In addition, there are pools of such promises that promise payments depending on the performance of the underlying promises.

IV. THE ROLE OF DISCLOSURE IN THE TWO MAIN FORMS OF INTERMEDIATION IN OUR FINANCIAL SYSTEMS

A. Disclosure in Traditional Institutional and Market Intermediation

The role of disclosure in traditional institutional intermediation and market intermediation differs significantly. It was recognized that the possible failure and problems that arise in institutional intermediation cannot be resolved by disclosure to the lenders, such as bank depositors. Institutional intermediaries may fail if the demand for the money they borrowed exceeds the amount of liquid assets they carry. Their managements may consume current assets in the hope of making up the

20. Gramm–Leach–Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 § 101(a) (1999) (repealing 12 U.S.C. § 377 (1935)).

difference to cover long term assets. The disparity between their assets and liabilities creates both risk and incentives for managers to take greater risks with long-term assets.

Two solutions were employed to address these problems. One was substantive regulation and the other—government backup to avoid "runs." This was the solution for banks and credit unions and alike, as well as for insurance companies. The other solution was to substantively regulate banks and insurance companies' operations, and impose fiduciary duties and disclosure requirements on investment companies. In addition, the most successful investment companies of the "open end" species are required to offer investors an escape by redemption—receiving their money after a fairly short notice and a system of evaluation. In that sense, open end companies are very similar to banks' offering of demand deposits.

B. Disclosure in Market Intermediation

Disclosure in market intermediation is fundamentally different from controls of institutional intermediation. This disclosure is grounded in the image of a contract offered to the public. The regulator, the Securities and Exchange Commission, represents the public by requiring the issuer of financial securities to make not only substantive disclosure, but also asking the issuer to revise such disclosure for clarification accompanied by criminal and civil sanctions on misinformation.[21]

We noted that bank regulation is based on substantive regulation both in terms of how to manage the borrowing and investments of the public's money, and investment company regulation is based on disclosure and fiduciary duties imposed on money managers. The merger of the two forms—institutions and markets intermediation—brought about the heightened emphasis on disclosure in all forms of intermediation in our financial system. It brought together the different regulatory regimes to which the institutions are subject, and the incompatible role of disclosure in each of these institutions. Their culture, which was governed by directives or fiduciary law on how to

21. *See* 15 U.S.C. § 77e(a) (2006) (prohibiting sale of unregistered securities); *id.* § 77e(b) (prohibiting prospectus not meeting requirements of Securities Act with regard to registered securities); *id.* § 77e(c) (prohibiting offer of securities unless registration statement has been filed); LOUIS LOSS ET AL., 1 SECURITIES REGULATION 813–19 (4th ed. 2006) (if a registration statement is not acceptable, the staff generally drafts a comment letter, and the registrant generally drafts an appropriate amendment); 15 U.S.C. § 77x (2006) (providing for penalties for violations of 1933 Act); *id.* § 78ff (2006) (providing for penalties for violations of 1934 Act).

manage other people's money, has been watered down to disclosure.[22]

C. Disclosure is Less Specific than Rules

There is an extensive discussion among academics with respect to the value and consequences of required disclosure including the history of the requirement. Cost is a big issue. Cost focuses on the cost to the institutions rather than the cost to the investors. There are arguments that those who are adversely affected by disclosure may find ways around it. Some predictions suggest that disclosure may bring about results that are worse than mere silence. Market enforcement, including the information contained in the price, may be far better than disclosure by regulation and may be weakened by government action. Thus, disclosure may impair information that the law required to disseminate to the public.[23] There is copious literature, especially in behavioral economics, on the usefulness and effect of disclosure to investors. It has been shown that investors do not read the disclosed information,[24] and that often they do not make rational investment decisions.[25] Therefore, information is hardly effective and sometimes defective.

Disclosure is also emasculated with the speed of trading. As huge amounts of money are transferred at a blink of an eye disclosure loses much of its regulatory power. It is a promise to behave in a certain way, but may be harder to verify the true behavior.

We have gone a long way in trading in promises. On the way, we lost the identity of *who* promises, and sometimes also *what is the underlying-pooled-promise*. Effective diversification has made it hard and often impossible to retrieve the underlying information about the first, second, and other tiers of promisors and the promisors who supported these promises.

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22. *See* Jeffrey D. Bauman, *Loss and Seligman on Securities Regulation: An Essay for Don Schwartz*, 78 GEO. L.J. 1753 (1990) (reviewing LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3rd ed. 1969)).

23. *See* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473 (2007); *see also* Allison M. Snyder, *Survey: Holding Multinational Corporations Accountable: Is Non-Financial Disclosure the Answer?*, COLUM. BUS. L. REV, 2007, at. 565 (describing the policy arguments on mandatory disclosures).

24. *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 682 (1996) ("[A]necdotal evidence, supported by many people's assumptions about investment practices, indicates that most nonprofessional investors do not read the prospectuses and other legal disclosure documents they are given.") (citing Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973)).

25. *See, e.g.*, ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 148–56 (2d ed. 2005) (suggesting that investors have "limited abilities and certain natural modes of behavior"); *id.* at 157–75 (suggesting social influence on judgment).

Disclosure of the creative promises of both institutional and market intermediaries emasculated disclosure and made their method of these promises to the investors ineffective. Investors trusted the intermediaries, were fired up by the sales talk of intermediaries, and were stumped by the enormous and detailed disclosure as well as the "bespeaks caution" detractions of the promises.

Disclosure is a waiting method. It is difficult to check whether the disclosed promise has been performed. Saying, "I will do such and such tomorrow" does not mean, "I have done it yesterday." In the meantime a violation of the promise can mature into a profitable habit, "This is the way we do things, and look how successful we have become." A habit of a wrongful act becomes a habit of a justifiable act, especially if it is profitable. Thus, when the fraud or harmful behavior has been discovered after a few years, not only are there justifications for the habit, but also strong resistance. The resistance to the disclosure of conflict of interests demonstrated by broker dealers serves as an example.

It is unclear whether habits that developed during the rise of "subprime" mortgage backed securities can be uprooted easily, even if the perpetrating entities are required to pay millions in retribution.[26] First, entities are not people. The real perpetrators may have filled their pockets and left. Second, the culture of the entity remains and is hard to change. Someone might sigh remembering the good old days and newcomers may sigh, hoping for the return of those days. One fact does loom large. In the past two to three years, most of the managers of the large financial intermediaries have left and been replaced by a new generation. This generation has inherited problems, and it is not clear how it views both itself and its mission. [27] In addition, the threat of strict enforcement and punishment in the case of untrue disclosure might lead to "protective disclosure." An example of such a disclosure by Bank of America in the third quarter of 2011 follows and speaks for itself: With the disclosure of future evaluations by financial institutions came disclaimers by the yards.[28] One such disclaimer is attached in Appendix A to this Article.

26. Jean Eaglesham, *Mortgage-Bond Deal Draws a Fine*, WALL ST. J., Feb. 29. 2012, at C2. Note the cases against insider traders after years of quiet on this front. *See* Jenny Strasburg & Reed Albergotti, *Insider Targets Expanding*, WALL ST. J., Feb. 28, 2012, at A1, A2.

27. *See* Francesco Guerrera, *Wall Street Chiefs Set a New Agenda*, WALL ST. J., Feb. 28, 2012, at C1.

28. *See supra* Part II.

D. Disclosure in Fiduciary Law

The situation both before the 1929 crash and thereafter led to a quest for professional advice. It appeared in the form of newspapers, advisory news, and advice in more personal contact. Advisers are fiduciaries in the sense that their advice must be entirely focused on the benefit for the advisees, and any conflict of interest that taints their advice must be disclosed. After such disclosure, the advisee can determine whether to rely on the adviser or seek another one.

In the 1940s the regulation of advisers–fiduciaries was not strict, and the Advisers Act of 1940 had little "bite" in it.[29] Therefore, disclosure of fiduciaries regarding their conflicts of interests was not the focus of financial system regulation. And, as noted, the markets were not the main financial intermediaries of the 1940s.

An additional reason for the relaxed treatment by intermediaries applies particularly to banks and their regulators. For example, a golden rule of trust law is that trustees may not mingle their own money with the beneficiaries' money. Trustees may sometimes mingle beneficiaries' money but never the beneficiaries' money with their own. It turns out that the banking regulators allowed banks to insert banks' assets into customers' accounts. When MF Global Holdings became bankrupt, approximately $1.6 billion was found missing. In an attempt to find where the money was, employees and investigators found that $165 million of customers' money had been transferred from customers' accounts to the company's account, in a moment's notice and a few moments-transfer. It may have been a mistake, but that mistake could not have happened had not the banking regulation allowed the company to mix its money together with the customers' money in the customers' account. The explanation for this regulatory permission was "in part to provide ease of trading for those customers."[30] Regulators who are more concerned about the "efficient operation" of the companies and have no concern about the customers' money are in fact at the service of the financial intermediaries. Most interesting was the reaction of the regulators to this debacle: "Regulators and industry groups are working on possible changes to rules aimed at preventing a shortfall in client money. On Wednesday the Futures Industry Association called for more disclosure on handling of customer money."[31] More

29. TAMAR FRANKEL & ANN TAYLOR SCHWING, 1 THE REGULATION OF MONEY MANAGERS § 1.02[A][1], at 1–37 (2001 & Supp. 2002) (citing Note, *The Regulation of Investment Advisers*, 14 STAN. L. REV. 827 (1962)).

30. Julie Steinberg et al., *Fast, Furious at MF Global*, WALL ST. J., Mar. 1, 2012, at C1.

31. *Id.*

disclosure indeed! Let no investors rely on protection from them.

V. THE FAILURE OF DISCLOSURE AND CORRECTIVE ACTION: ASK NOT *WHAT* YOU BUY BUT *WHO* IS SELLING TO YOU

The last thirty years have seen not only a movement from institutions to markets; they have also seen two accompanying developments: the movement from substantive regulation to disclosure, and the rise of market advisory services based on disclosure rather than on fiduciary rules. These trends denote reduced substantive regulation and increased reliance on disclosure—the contract model.

However, disclosure presents an increasingly serious problem. The roots of the problem are embedded in two other developments. As promises and institutional structures have become increasingly complex, so did disclosure about the promises that the institutions design or offer.

Most humans have great difficulty in calculating complexity. They simplify complex materials in order to absorb and understand their meaning and make decisions. Sheena Iyengar is the psychologist responsible for the famous jam experiment:

> At a luxury food store in Menlo Park, [CA] researchers set up a table offering samples of jam. Sometimes, there were six different flavors to choose from. At other times, there were 24. (In both cases, popular flavors like strawberry were left out.) Shoppers were more likely to stop by the table with more flavors. But after the taste test, those who chose from the smaller number were 10 times more likely to actually buy jam: 30 percent versus 3 percent. Having too many options, it seems, made it harder to settle on a single selection.[32]

Judicial approach of "bespeaks caution" adds to dilute the value of disclosure. It has undermined the substance of promises, which by definition relate to the future performance and the disclosure of these promises as well. Most importantly, disclosure documents have become bulky and unreadable to the untutored eye, as seen in the Bank of America statement.[33]

The reason for this type of disclosure is not hard to find. Disclosure pursuant to regulation carries with it penalties for misleading statements. Factual statements are more vulnerable than future and less factual statements. Consequently, many investors do not read the disclosure documents; many others who do read do not understand their meaning. The main issue is efficiency. The longer it takes to research and read the documents, the harder it is to understand them, the more inclined

32. Virginia Postrel, *Indecision-Making*, N.Y. TIMES, Apr. 18, 2010, at BR.

33. *See infra* Appendix A.

investors are to rely on others for a shorter, simpler, and more understandable message.

It is therefore not surprising that investors seek experts for directions on what to buy, sell, or hold. They follow advisory letters, advisers, and brokers. It is not surprising that broker–dealers seek to offer investors advice about investment choices.[34] Even though the Advisers Act of 1940 has become more robust and specific, the status of broker–dealers as fiduciaries is being argued now and diluted.[35]

Since 1934, brokers were subject to a number of regulations. They were required to offer investors prospectuses or other documents relating to the securities (financial promises) that the investors would buy;[36] and provide their investors with the "best execution" of the investors' orders.[37] In addition brokers may advise their clients on the choice of their investments, provided their advice was "suitable" to the clients' situation. However, "suitability" and their other brokers' regulation skirt around the brokers' duties as fiduciaries.

Brokers are not required to avoid conflicts of interests while they advise investors. They are not required to disclose to investors any

34. Certain Broker–Dealers Deemed Not to Be Investment Advisers, 70 Fed. Reg. 20,424, 20,425 (Apr. 19, 2005).

35. The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) empowered the SEC to require broker–dealers and investment advisers, when providing personalized investment advice about securities to retail customers, "to act in the best interest of the customer" without regard to the interest of the broker–dealer or adviser, and such standard must generally be as stringent as that applicable to investment advisers under sections 206(1)-(2) of the Advisers Act. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g)(2), 124 Stat. 1376 (codified at 15 U.S.C. § 80b-11(g) (2010)); 15 U.S.C. § 80b-6(1), (2) (2006). The Dodd–Frank Act also empowered the SEC to provide a standard of conduct for broker–dealers, when providing personalized investment advice about securities to retail customers, that is the same as that applicable to an investment adviser under section 211 of the Advisers Act. Pub. L. No. 111-203, § 913(g)(1), 124 Stat. 1376 (codified at 15 U.S.C. § 78o(k)(1) (2010)); 15 U.S.C. § 80b-11 (2006). The Dodd–Frank Act also required the SEC to conduct a study to evaluate the effectiveness of existing standards of care for broker–dealers and investment advisers regarding personalized investment advice and recommendations about securities to retail customers. Pub. L. No. 111-203, § 913(b)(1), 124 Stat. 1376 (codified at 15 U.S.C. § 78o (2010)). The study must also evaluate whether there are "gaps, shortcomings, or overlaps" in such standards that should be addressed. *Id.* § 913(b)(2), 124 Stat. 1376 (codified at 15 U.S.C. § 78o (2010)). The SEC must also consider other issues including (1) whether retail customers understand the different standards of care applicable to broker–dealers and investment advisers; (2) the impact on retail customers of imposing on broker–dealers the standard of care of investment advisers and/or other Advisers Act requirements; and (3) the impact on retail customers of eliminating the broker–dealer exclusion from the Advisers Act. *Id.* § 913(c), 124 Stat. 1376 (codified at 15 U.S.C. § 78o (2010)). In the study, the staff noted retail investor confusion between broker–dealers and advisers and their standards of care, and prepared recommendations including a uniform fiduciary standard for advisers and broker–dealers for personalized investment advice about securities to retail customers. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER–DEALERS v–viii (2011), *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf.

36. 15 U.S.C. § 77e (2006) (amended 2010).

37. *Id.* at Rule 5310, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455.

conflicting interests that the brokers might have in connection with their advice-sales talk. Therefore, disclosure is required with respect to *what is being sold*. Disclosure is not required with respect to who is the person who gives the advice, what are the adviser–broker's interests in the transaction, and whether these interests conflict with the interests of the investors.

For example, brokers need not disclose to their customers that they are recommending more expensive third party promises involving more expensive management fees, or limiting the investors' choices to those that the brokers are required by their organization's management to sell. Brokers are not required, and sometimes cannot explain to investors what the third party promises that they offer mean and what the possible consequences of buying these promises could be. In short, no risk must be disclosed. The "suitability" of the investment for the customer is determined by the broker, but there is no need to disclose to the customer the considerations that lead to the finding of "suitability."

Therefore, the first type of disclosure—relating to what is being sold—must be disclosed. The second type of disclosure—regarding who the seller is, and any conflicts of interests that the seller might have with respect to the seller's advice—need not be disclosed. Sales talk, even though it contains phrases such as "trust me" and "I have experienced the same and bought the same" or "my entire family invested in this stock" or "we know the price will rise very soon" or "look at all the millions that other investors in the stock have collected" can be taken as advice. It should be emphasized that investors do not easily quantify their transaction costs, including the costs that their brokers might impose on them. These costs, however, may be quite high with the longevity of the investments.

I conclude that investors today are as vulnerable as they were in the 1920s. Their banks are no longer banks, but market traders. Their market traders are no longer mere brokers, but also advisers. Investors hand over their money and rely on the banks and their brokers, both of whom are not fiduciaries. Moreover, banks and brokers are regulated mostly as sales intermediaries. They are only required to disclose to investors the promises that they sell them. The salespersons and sales institutions may bask in the warmth of the conflicts of interests that investors are not aware of. Therefore, investors are unable to determine whether to engage such intermediaries and whether to rely on their advice.

The financial intermediation system is broken. That is because investors do not trust it, and quite rightly so. Regulation might not be effective so long as the brokerage and other intermediation organizations are fighting their fiduciary duties concerning other peoples' money. A law which they strongly resist will not work well, even if passed. The drive to repeal it is likely to continue.

The financial system will not mend until a new type of rule enforcement is introduced and unless investors change their focus and attitude. Instead of asking or listening to the marvelous investments that they are offered, investors should focus on the market intermediaries, including: the banks, the registered brokers, the unregistered brokers, and anyone else who offers "promises" for sale.

Before investors meet potential intermediaries face to face, investors should inquire and receive from intermediaries a simple signed informational form.[38] This form should provide investors with information about the intermediaries: who are the intermediaries, what their background and expertise are, whether the intermediaries' interests might conflict with those of the potential clients, and similar information that would help investors determine the level of the intermediaries' trustworthiness. Investors should focus first on the intermediaries' reliability as advisers, and only then on what the intermediaries offer. To the extent that Congress and the regulators do not protect (or perhaps cannot protect) investors, the investors should take steps to protect themselves and in many cases they can.

APPENDIX

A. BofA Third-Quarter 2011 Disclaimer:

Bank of America and its management may make certain statements that constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements can be identified by the fact that they do not relate strictly to historical or current facts. Forward-looking statements often use words such as "anticipates," "targets," "expects," "estimates," "intends," "plans," "goals," "believes" and other similar expressions or future or conditional verbs such as "will," "should," "would" and "could." The forward-looking statements made represent Bank of America's current expectations, plans or forecasts of its future results and revenues, the company's building of a fortress balance sheet; the implementation and completion of, and expected impact from, Project New BAC, including estimated expense reductions; the pending sale of the company's Canadian credit card business; the nationwide launch of Customer Solutions; plans to hire more than 1,000 small business bankers by early

38. *E.g.*, SEC, FORM ADV (2011), *available at* http://www.sec.gov/divisions/investment/iard/iastuff.shtml (under the investment Advisers Act of 1940).

2012; implementation of a customer-focused strategy to position the company for long-term growth; plans to exit the Home Loans correspondent mortgage lending channel and focus on retail distribution of mortgage products and services; the estimated range of possible loss for non-GSE representations and warranties exposure; representations and warranties reserves, expenses and repurchase activity; and other similar matters. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict and are often beyond Bank of America's control. Actual outcomes and results may differ materially from those expressed in, or implied by, any of these forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider all of the following uncertainties and risks, as well as those more fully discussed under Item 1A. "Risk Factors" of Bank of America's 2010 Annual Report on Form 10-K and Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2011 and in any of Bank of America's subsequent SEC filings: the company's ability to implement, manage and realize the anticipated benefits and expense savings from Project New BAC; the company's timing and determinations regarding any potential revised comprehensive capital plan submission and the Federal Reserve Board's response; the company's intent to build capital through retaining earnings, reducing legacy asset portfolios and implementing other non-dilutive capital related initiatives; the accuracy and variability of estimates and assumptions in determining the expected total cost to Bank of America of the recent private label securitization settlement (the settlement) with The Bank of New York Mellon (BNY Mellon); the accuracy and variability of estimates and assumptions in determining the estimated liability and/or estimated range of possible loss for representation and warranties exposures to the GSEs, monolines and private label and other investors; the accuracy and variability of estimates and assumptions in determining the portion of Bank of America's repurchase obligations for residential mortgage obligations sold by Bank of America and its affiliates to investors that has been paid or reserved after giving effect to the settlement agreement with BNY Mellon (the settlement agreement) and the charges in the quarter ended June 30, 2011; the possibility that objections to the settlement, including substantial objections already filed, will delay or prevent receipt of final court approval; whether the conditions to the settlement will be satisfied, including the receipt of final court approval and private letter rulings from the IRS and other tax rulings and opinions; whether conditions in the settlement agreement that would *permit Bank of America and legacy Countrywide to withdraw from the settlement will occur and whether Bank of America and legacy Countrywide will determine to withdraw from the settlement pursuant to the terms of the settlement agreement; the impact of performance and enforcement of obligations under, and provisions contained in, the settlement agreement and the institutional investor agreement, including performance of obligations under the settlement agreement by Bank of America (and certain of its affiliates) and the trustee and the performance of obligations under the institutional investor agreement by Bank of America (and certain of its affiliates) and the investor group; Bank of America's and certain of its affiliates' ability to comply with the servicing and documentation obligations under the settlement agreement; the potential assertion and impact of additional claims not addressed by the settlement agreement or any of the prior agreements entered into between Bank of America (and/or certain of its affiliates) and the GSEs, monoline insurers and other investors;the company's resolution of certain representations and warranties obligations with the GSEs and ability to resolve any remaining claims; the company's ability to resolve any representations and warranties obligations with monolines and private investors; increased repurchase claims and repurchases due to mortgage insurance cancellations, rescissions and denials; the company's failure to satisfy its obligations as servicer in the residential mortgage securitization process; the foreclosure review and assessment process, the effectiveness of the company's response to such process and any governmental or private third-party claims asserted in connection with these foreclosure matters; the risk of a credit rating downgrade of the U.S. government by one of the other major credit rating agencies in addition to the downgrade from Standard & Poor's in August 2011; the risk that Standard & Poor's will further downgrade the U.S. government's credit rating; negative economic conditions generally including continued weakness in the U.S. housing market, high unemployment in the U.S., as well as economic challenges in many non-U.S. countries in which we operate; the impact resulting from international and domestic sovereign credit uncertainties, including the current challenges facing European economies; the company's credit ratings and the credit ratings of its securitizations, including the risk that the company or its securities will be the subject of additional or further credit rating downgrades in addition to the downgrade by Moody's in the third quarter of 2011; the company's mortgage modification policies, loss mitigation strategies and related results; and any measures or steps taken by federal regulators or other governmental authorities with regard to mortgage loans, servicing agreements and standards, or other matters; the level and volatility of* *the capital markets, interest rates, currency values and other market indices; changes in consumer, investor and counterparty confidence in, and the related impact on, financial markets and institutions, including the company as well as its business partners; the accuracy and variability of estimates of the fair value of certain of the company's assets and liabilities; legislative and regulatory actions in the U.S. (including the impact of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Financial Reform Act), the Electronic Fund Transfer Act, the Credit Card Accountability Responsibility and Disclosure Act and related regulations and interpretations) and internationally; the identification and effectiveness of any initiatives to mitigate the negative impact of the Financial Reform Act; the impact of litigation and regulatory investigations, including costs, expenses, settlements and judgments as well as any collateral effects on its ability to do business and access the capital markets; the ability to achieve resolution in negotiations with law enforcement authorities and federal agencies, including the U.S. Department of Justice and the U.S. Department of Housing and Urban Development, involving mortgage servicing practices, including the timing and any settlement terms; various monetary, tax and fiscal policies and regulations of the U.S. and non-U.S. governments; changes in accounting standards, rules and interpretations (including new consolidation guidance), inaccurate estimates or assumptions in the application of accounting policies, including in determining reserves, applicable guidance regarding goodwill accounting and the impact on the Company's financial statements.*

Forward-looking statements speak only as of the date they are made, and Bank of America undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

B. Bank of America First Quarter 2011 Disclaimer

Forward-Looking Statements

Bank of America and its management may make certain statements that constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not historical facts, but instead represent Bank of America's current expectations, plans or forecasts of its future results and revenues, including net interest income, credit trends, including credit losses, credit reserves, charge-offs and nonperforming asset levels, consumer and commercial service charges, including the impact of changes in the *company's overdraft policy liquidity, regulatory and GAAP capital levels, revenue impact of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act), the closing of the First Republic Bank and Columbia Management sales, the impact of higher interest rates on the balance sheet and other similar matters. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict and are often beyond Bank of America's control. Actual outcomes and results may differ materially from those expressed in, or implied by, any of these forward-looking statements.*

You should not place undue reliance on any forward-looking statement and should consider all of the following uncertainties and risks, as well as those more fully discussed under Item 1A. "Risk Factors" of Bank of America's 2009 Annual Report on Form 10-K and in any of Bank of America's subsequent SEC filings: negative economic conditions that adversely affect the general economy, housing prices, the job market, consumer confidence and spending habits; Bank of America's modification policies and related results; the level and volatility of the capital markets, interest rates, currency values and other market indices; changes in consumer, investor and counterparty confidence in, and the related impact on, financial markets and institutions; Bank of America's credit ratings and the credit ratings of its securitizations; estimates of fair value of certain Bank of America assets and liabilities; legislative and regulatory actions in the United States (including the impact of the Electronic Fund Transfer Act, the CARD Act of 2009 and related regulations) and internationally; the impact of litigation and regulatory investigations, including costs, expenses, settlements and judgments; various monetary and fiscal policies and regulations of the U.S. and non-U.S. governments; changes in accounting standards, rules and interpretations (including the new accounting guidance on consolidation) and the impact on Bank of America's financial statements; increased globalization of the financial services industry and competition with other U.S. and international financial institutions; Bank of America's ability to attract new employees and retain and motivate existing employees; mergers and acquisitions and their integration into Bank of America; Bank of America's reputation; and decisions to downsize, sell or close units or otherwise change the business mix of Bank of America. Forward-looking statements speak only as of the date they are made, and Bank of America undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.