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Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?

TESTIMONY

Before the Senate Judiciary Committee
Subcommittee on Crime and Drugs

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Chairman Specter, Ranking Member Graham, and distinguished members of the Subcommittee, thank you for the invitation to testify today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School and a Senior Scholar with the Mercatus Center at George Mason University, where I am a member of the Financial Markets Working Group.

I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

Considering new legislation requires that we compare the costs of the new law against its benefits. This is typically a complicated process. For today's proposal, however, the exercise is fairly simple. A criminal fiduciary duty standard for securities brokers would impose inordinate costs on the securities markets that would be passed through to investors while doing little to stop future financial crises.

I will also note that comparing today's topic to the Goldman Sachs controversy is entirely inappropriate. That case is complex and awaits a final verdict. I certainly don't need to remind the Senate Committee on the Judiciary that it would be foolhardy to make new legislation under the assumption that wrongdoing occurred without a full trial on the issue.

If it is ultimately determined that Goldman Sachs did engage in wrongdoing the Department of Justice already has the necessary tools to prosecute securities fraud under Section 10b of the Securities Exchange Act of 1934. The legislation under consideration today, then, would not assist in prosecuting fraud of the sort alleged in the Goldman Sachs case, if indeed fraud occurred in that case at all.

My work focuses on fiduciary duties in state corporation law. I was privileged to clerk for the Delaware Court of Chancery, one of the sources of American corporate law. The

concept of fiduciary duties we are discussing today emerged from that Court in many ways.

The challenge for judges reviewing business investments, under a fiduciary duty standard and after the fact, is that it is tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs. Business decisions, like purchases of investment products, are highly risky. That is why they can be so profitable. But in administering fiduciary duty laws it is nearly impossible to avoid being influenced by the benefit of hindsight.

Such Monday morning quarterbacking would however chill transactions in the securities markets at a time when they are already under severe strain.

Getting fiduciary duties right in the civil liability sphere is difficult enough. Making fiduciary duty violations into criminal violations would pose an even greater challenge.

There are a wide variety of different relationships between securities brokers and their clients. Some securities brokers act as counselors, some merely facilitate transactions at the client's direction. Some brokers cater to large institutional investor clients, others cater to individual retail clients. The contracts governing these relationships are equally diverse. A global fiduciary standard for all of these relationships would limit investors' flexibility to design contracts appropriate for their particular needs.

By way of analogy, consider the market for foreclosed housing. Foreclosed homes are more likely to need significant refurbishment and have high maintenance costs. Banks foreclosing homes do not have the resources to inspect them all. So, foreclosed homes sell "as is" at a deep discount. Buyers with the skills to gauge the risk are willing to buy the foreclosed homes, without requiring absolute guarantees from the seller.

If we were to mandate that banks selling foreclosed homes issue an absolute guarantee on the homes they sell, there would no longer be a market for those homes and a recovery in the housing market would be all but impossible.

The same thing would happen in the securities markets if we made brokers, through an unprecedented criminal fiduciary duty standard, absorb all of the risk of the financial products they sell. The securities markets would freeze up. Brokers would operate under the specter of prosecutions that, through hindsight bias, targeted them for selling products that lost money despite being fair risks at the time they were sold.

A criminal fiduciary duty standard for securities brokers is a misguided idea. A civil fiduciary duty standard also poses risks. Should this Committee decide to institute a civil fiduciary duty standard for securities brokers, I would urge an exemption permitting brokers and their clients to opt-out of fiduciary liability to permit transactions for which the parties feel fiduciary duties are not appropriate.

I thank you for the opportunity to testify, and I look forward to answering your questions.