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**Articles**

***829** TRUST AND THE REFORM OF SECURITIES REGULATION

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Abstract

Trust is a critically important ingredient in the recipes for a successful economy and a well-functioning securities market. Due to scandals, ranging in nature from massive incompetence to massive irresponsibility to massive fraud, investor trust is in shorter supply today than in years past. This is troubling, and commentators, policy makers, and industry leaders have all recognized the need for trust's restoration.

As in times of similar crises, many have turned to law and regulation for the answers to our problems. The imposition of additional regulatory oversight, safeguards, and remedies, some advocate, can help resuscitate investor trust. These advocates have it half right.

For trust is complicated, and exists in a variety of forms. Some forms, predicated primarily upon reasoned calculation, respond well to law and regulation. But other forms, predicated primarily upon relationship and emotion, respond poorly to law and regulation. In fact, these latter forms of trust can be seriously harmed by legal intervention. Wise policymakers would carefully assess the nature of whatever particular trust relationship they wish to strengthen before taking action to ostensibly strengthen the trust in that relationship.

Unfortunately, such an assessment has not been part of the significant securities law reforms recently proposed. As such, some of these reforms threaten to undermine, rather than enhance, the remaining supply of trust.

***830** Introduction

Trust is a critical, if not the critical, ingredient to the success of the capital markets (and of the free market economy in general). As Alan Greenspan once remarked: "[O]ur market system depends critically on trust-trust in the word of our colleagues and trust in the word of those with whom we do business." [FN1] From the inception of federal securities legislation in the 1930s, to the Sarbanes-Oxley Act of 2002, to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, it has long been understood that in the face of economic calamity, the restoration and/or preservation of trust-especially investor trust-is paramount in our financial institutions and markets. [FN2]

And if further proof of the indispensability of trust was needed, it has been forcefully provided by the financial services industry crisis and the unusually strong recession that afflicted much of the globe throughout 2008 and 2009. By most accounts, a breach of trust-in the form of fairly reckless risk-taking by some, and in the form of dereliction of duty by others-has ***831** precipitated the crisis and, indirectly, the recession. [FN3] The lack of trust that these breaches engendered has figured prominently in the persistence of our economic woes, from banks fearful of lending to investors fleeing the capital markets. [FN4]

Adding to this is an uptick in fraud reminiscent of the Enron-WorldCom-Global Crossing era of approximately a decade ago. From Bernie Madoff to Marc Dreier to Allen Stanford (among, sadly, many others), securit-

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ies fraud (and Ponzi schemes in particular) appears to be en vogue once again. [FN5] Much of this fraud (as is usually the case with fraud in general) was made possible by trust and its breach. Understandably and predictably, this uptick in fraud-remarkable in both frequency and severity-has further contributed to the erosion of investor trust and confidence. [FN6]

Consistent with the historical pattern of U.S. securities regulation, the current economic crisis, coupled with a spate of corporate scandals, has given rise to calls for a re-examination of our current regulatory regime and the enactment of a host of reforms.. [FN7] The reforms suggested and enacted are typical of past reform efforts: they generally entail the imposition of greater, rather than lesser, regulatory oversight, and involve the promulgation of ***832** more, rather than fewer, rules and regulations upon the world of finance and business. [FN8]

A critical assumption undergirding much of this reform is that regulation can restore investor trust and confidence. Or, if such a restoration cannot be effected, the assumption is that regulation can at least serve to bridge the chasms created by the deterioration of trust and confidence, thereby providing a means for marketplace participants to once again safely connect and transact with one another.

But do these assumptions hold? A critical set of questions should be considered. Can regulation serve to bolster and repair relationships dependent upon trust? And in the absence of trust, can regulation serve as an effective substitute to trust? In short, are there limits to the ability of regulation to resuscitate an economy that has suffocated due to lack of trust?

Conversely, can regulation work to "crowd out" trust, effectively transforming relationships that once were close and trustworthy to arm's length and legalistic? Could regulation serve to displace relationships of trust with transactions subject merely to the "morals of the marketplace"?

Although additional research (especially multidisciplinary, empirical research) is needed to resolve many of the preceding questions, the last couple of decades have, fortuitously, witnessed an explosion of excellent scholarship exploring the phenomenon of trust. [FN9]The present world situation invites, if not demands, a review of this scholarship at this time. Indeed, this scholarship is more timely and relevant today than when it was originally authored.

This article hopes to employ the literature on trust to evaluate our traditional regime of securities regulation-along with recently enacted reforms thereto. Although the literature on trust has been applied to corporate law, [FN10] contract law, [FN11] partnership law, [FN12] and even health law, [FN13] it has ***833** not been applied to the law of financial regulation-at least not to any sustained degree, and certainly not since the recent crisis which has, arguably, exposed significant shortcomings in the U.S. securities regulatory regime. [FN14]

This article will proceed in three parts. Part I will set forth a summary of the existing research on trust. It will address what trust is, how trust is earned, and how trust is destroyed. It will also address the interplay of law and trust, and why trust is indispensible to the capital markets.

Part II will examine three specific areas within the field of securities regulation that have received most of the attention of reformers: broker-dealer regulation, investment adviser regulation, and hedge fund regulation. This section will first assess whether the law's traditional approach to each of these areas served to support, versus undermine, trust. Part II will thereafter examine whether the reforms brought about by the Dodd-Frank Act in each of these areas are likely to enhance, versus enervate, trust.

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Part III will briefly consider the dark side of trust: its breach. Moreover, Part III will address the challenge of attempting to simultaneously increase trust while, at the same time, protecting those individuals who might misplace their trust.

In concluding, this article joins the chorus of those who sing of the indispensability of trust to well-functioning free markets. Unfortunately, trust is a fragile commodity. Breaches of trust, especially repeated, frequent, severe, and widespread breaches-such as those abounding in our era-do great damage to it. Fortunately, in some contexts, law and regulation can serve to increase and safeguard trust. Unfortunately, in other contexts, law and regulation can serve to undermine trust. The key for policymakers is to distinguish between the two contexts, and proceed accordingly.

For the most part, our traditional regime of securities regulation generally proceeds appropriately. That is, relatively speaking, greater regulation has been traditionally imposed upon those areas in the securities industry where such regulation is trust enhancing, and lesser regulation is imposed upon those sectors where such regulation is trust defeating.

Regrettably, the same cannot be said, generally speaking, of the reform proposals considered by this article. Efforts to indiscriminately ratchet up the overall level of regulation on financial services professionals ***834** ignores the lessons taught by trust scholarship, and risks undermining the very trust that is hoped to be restored.

## I. Trust

Before examining how financial regulation negotiates the phenomenon of trust, this article shall first summarize and review the literature on trust per se. The first half of this undertaking shall concern itself with trust generally: how it is created, destroyed, and rehabilitated. The second half of this undertaking shall address the importance of trust to the free market.

### A. Trust Defined

As a preliminary matter, what exactly is "trust"? Different scholars define the phenomenon of trust in different ways, [FN15] and it is critical to nail down the meaning of the term for purposes of this article before proceeding.

At its simplest level, trust can be defined (as per Tamar Frankel) as "believing that others tell the truth and will keep their promises." [FN16] More detailed is the definition proposed by Margaret Blair and Lynn Stout: "a willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability." [FN17] This definition lines up well with Jay Barney and Mark Hansen's "strong form" of trust, [FN18] which served as the basis of Larry Ribstein's scholarship on trust. [FN19] As Ribstein formulated it:

> Strong form, or "principled," trust arises . . . where the trustor is technically free to breach but "opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an exchange." Trust in this form ***835** . . . arises only when the trustee is not bound by external constraints to honor his promise. [FN20]

Indeed, a consensus among those who have studied the issue of trust seems to have formed around this definition-the root of which is "vulnerability":

> Trust experts all seem to agree that trust is a state of mind that enables its possessor to be willing to make herself vulnerable to another-that is, to rely on another despite a positive risk that the other will act in a way that can harm the truster. [FN21]

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Thus, this is the definition that I shall employ in this article. The greater the extent to which a person can renege his or her promise(s) and get away with it, the greater the extent to which a person can disappoint another without legal, economic, or reputational sanction, the greater degree of trust it takes to rely on (or make one's self vulnerable to) that person.

But even greater definitional complexity can (and must) be introduced. For the willingness to make one's self vulnerable to another can be grounded primarily in emotion, or primarily in reason. [FN22]

When grounded primarily in emotion, such trust is referred to as "affective trust," and constitutes a general, optimistic disposition that the subject of one's trust will behave honorably and appropriately. [FN23] Oliver Williamson speaks of this form of trust when he describes "noncalculative" (or, more accurately, "nearly noncalculative") trust, or "personal trust." [FN24] Such trust is a "passion," [FN25] Williamson explains, and "is reserved for very special relations between family, friends, and lovers. Such trust is also the stuff of which tragedy is made. It goes to the essence of the human condition." [FN26] This form of trust is fairly consistent with Claire Hill and Erin Ann O'Hara's concept of "trust in"-"an attribute-based trust." [FN27]

***836** In contrast to affective trust stands "cognitive trust." [FN28] Grounded primarily in reason, "cognitive trust, is more of an economic or strategic concept than affective trust." [FN29] Reliance and voluntary exposure to vulnerability stemming from cognitive trust is not based upon emotions or norms, but rather "upon a cost-benefit analysis of the act of trusting someone." [FN30] For this reason, Williamson rejects even calling such reliance "trust." [FN31] To him, such reliance is a form of calculativeness, which serves to economize on the scarcity of one's mental energies and time. [FN32] The potential vulnerabilities accepted are not due to "trust," but to rational risk management-to the fact that "the expected gain from placing oneself at risk to another is positive." [FN33] This really has very little to do with "trust" as commonly understood, leading Williamson to remark that "[c]alculative trust is a contradiction in terms." [FN34] Similarly, Frank Cross has observed that for those wedded to an understanding of trust as affective trust, President Ronald Reagan's famous standard of "trust but verify" is "virtually incoherent." [FN35]

"Cognitive trust" lines up well with Hill and O'Hara's depiction of "trust that." [FN36] "Trust that" trust, according to Hill and O'Hara, is essentially predictive: it reflects a reasoned assessment that the person in whom trust is placed "will behave in a way that is not harmful regardless of his character type." [FN37]

Interestingly, the fundamental differences between affective and cognitive trust are on display in their breach:

> Trust theorists explain that moral outrage and indignation flowing from a profound sense of betrayal is a hallmark of ***837** highly trusting relationships that have strong emotional content. In contrast, violation of the more moderated type of trust known as confidence, which has a more calculative basis, tends to produce only disappointment in not achieving expected results. The moral and emotional tenor of betrayal arises from the assumptions made, and sometimes disapproved, about . . . motivations and intentions-not only about . . . skills and performance. [FN38]

Importantly, affective trust and cognitive trust differ in how each of them interacts with vulnerability-the key to trust generally. The degree of risk and vulnerability posed by a given transaction or situation is an important factor in assessing cognitive trust, but not necessarily so when assessing affective trust.

Affective trust ordinarily precedes a given transaction or situation. Thus, when a party who trusts another (affectively) is confronted with a potentially risky transaction, [FN39] the critical question is whether the

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amount of affective trust already in existence between the parties is enough to enable the transaction to proceed, given the risks associated with it. If affective trust is in sufficient supply, the transaction will be undertaken; if not, the transaction will be passed upon. The primary impact that risk and vulnerability have upon affective trust is akin to the impact of exercise upon a muscle [FN40]: the more that affective trust is put to use via exposure to risk and vulnerability, the greater it grows in response. [FN41]

Vulnerability challenges cognitive trust in quite a different way. [FN42] Increased vulnerability drives up the cost of this form of trusting. By driving up the cost of trusting, vulnerability immediately alters the cognitive trust equation. Additional safeguards may be needed in order for a relationship predicated upon cognitive trust to withstand a period of increased risk and vulnerability. [FN43] This exemplifies the dynamic, situational nature of cognitive trust, which adjusts from context to context, versus the relatively static nature of affective trust- which may indeed increase or decrease over time, ***838** not in immediate reaction to greater risk and vulnerability, but rather in reaction to the fulfillment or dashing of trust's expectations after the fact. [FN44]

Although in theory it is possible to isolate these two versions of trust, it is exceedingly difficult to do so in practice. [FN45] At the extremes, perhaps, we might encounter cases of "affective trust" on one hand (such as a transaction between a son and his mother), and "cognitive trust" on the other hand (such as a transaction on eBay involving total strangers). But in the vast majority of situations, both forms of trust are likely to be implicated, and it is probably better to conceptualize "affective trust" and "cognitive trust" as marking two poles of a spectrum of trust relationships. [FN46] As Hill and O'Hara have confidently declared:

> It is now understood that the distinctions between calculative and noncalculative decision-making and between instrumental and noninstrumental behaviors are by no means clear. Because trustworthy behavior is very often a result of both internalized noninstrumental values and instrumental motives, it becomes in practice quite difficult to separate out calculative from noncalculative trust-relevant behaviors. [FN47]

There is yet another dimension to the definition of trust that must also be discussed before proceeding. Namely, the distinction between generalized trust on the one hand, and confidence in one's competency, ability, or reliability in a specific area of expertise on the other. [FN48] What I am defining as "generalized" trust refers to trust of a moral nature: trust in the character, integrity, and honesty of the subject in question. What I am ***839** defining as "specific" trust refers to trust of a technical nature: trust in the capability of the subject in question to satisfactorily deliver upon a specific promise, good, or service.

To some extent, the distinction between "generalized trust" and "specific trust" parallels the distinction between "affective" and "cognitive" trust, discussed previously. [FN49] The principal difference between these two dichotomies is that the affective/cognitive dichotomy is grounded primarily in the source or cause of the trust in question, whereas the generalized trust/confidence dichotomy is grounded primarily in the target or subject of the trust in question. In other words, whether one's trust in another is affective versus cognitive is largely a function of the nature of the trusting individual (coupled with context and circumstances); [FN50] whether one's trust is a generalized trust or specific is more a function of the individual or entity in whom trust is being placed (again, coupled with context and circumstances). [FN51]

In the securities industry, both forms of trust are implicated, sometimes simultaneously. For example, most investors have confidence (hopefully) in the fact that their brokers will properly execute a trade on their behalf- an example of specific trust. This confidence in the broker's skill and professionalism probably exists apart from any judgment formed about the broker's integrity and/or moral character. [FN52] That said, most investors probably also have a certain degree of generalized trust in their broker as well, and assume that their brokers, in addi-

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tion to executing trades properly, will not decide to abscond with their funds one day.

As with the distinction between affective and cognitive trust, the generalized/specific distinction is particularly important because, as we shall see, law and regulation appears to impact them in different ways. [FN53]

In sum, "trust" can be exhibited in forms primarily affective or primarily cognitive. Additionally, trust can be generalized or specific. Because of similarities in their natures, and the contexts in which they arise, affective trust is likely to be coupled with generalized trust, and cognitive trust is likely to be coupled with specific trust. [FN54]

***840** B. The Psychology of Trust

Thanks to an outpouring of research on trust over the last couple of decades, we now know quite a bit about how trust is developed, nurtured, maintained, destroyed, and rebuilt. This section will introduce that literature on trust, and the following section will focus on the interplay of law and trust.

Sociologist L.G. Zucker has identified three paths to the development of trust: characteristic-based, process-based, and institution-based. [FN55] Characteristic-based trust "rests on social similarity and assumes cultural congruence." [FN56] It arises from shared heritage, background, and values, and as such is not something that can be "deliberately created." [FN57] Indeed, given the increasing amount of diversity that marks modern nations and modern society in general, trust based upon common characteristics "is becoming a scarce commodity." [FN58]

Process-based trust is trust tied to interpersonal experiences between the parties to the trust relationship. [FN59] It is built up over time, incrementally, via repeated (positive) exchanges and dealings in which trust is honored and rewarded. [FN60] Thus, unlike characteristic-based trust, process-based trust can be intentionally and strategically developed. [FN61] That said, the mobility which characterizes modern society significantly undermines the development of process-based trust (which requires time and stability). [FN62]

Based neither on a shared cultural background, nor actual interpersonal relations, institution-based trust "is tied to formal social structures" which "protect the interests of all parties to the exchange." [FN63] Examples of this would be "professional credential or membership . . . ***841** association [s]," "insurance," and "legal/statutory rules." [FN64] Thus, as with process-based trust, institution-based trust "can be deliberately produced by individuals, firms, and entire industries." [FN65] Given the complexity of modern society, "where common histories can no longer be assumed," and coupled with proliferation of international trade, the possibility of institutionally based trust is a critically important one. [FN66]

Zucker's characteristic-based trust lines up well with affective (and generalized) trust, and helps to explain its ordinary path of development. Zucker's institutionally-based trust lines up well with cognitive (and specific) trust, and helps to explain its ordinary path of development. [FN67] Finally, Zucker's process-based trust would appear to be a route under which both affective and cognitive trust could readily develop, given that it exhibits features important to the development of both.

In many instances, trust may arise from a combination of sources. A typical business relationship might, for example, begin between two former college classmates who share a similar social and cultural background-thus starting with a degree of characteristic-based trust. It might be further enhanced by the credentials earned by the two former classmates since their graduation from college-thus adding a degree of institutionally based trust. Finally, the business relationship is likely to start off modestly, with a series of relatively minor transactions be-

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fore something more substantive and ambitious is embarked upon in common-an example of process-based trust. As sociologist Jorg Sydow explains:

> Kinship and friendship ties as well as other reliable sources of interorganizational trust aside, a cycle of trust almost always begins with what might be called a policy of small steps, which is characterized, above all, by a sparse use of resources and a careful reference to the prevailing rules of signification and ***842** legitimization. This policy may first lead to what has been called "tentative trust," before this kind of trust changes into more persuasive, resilient, and durable forms. [FN68]

All trust, whatever its originating wellspring, "grows with use." [FN69] Trust is maintained and nurtured via "continual positive experiences" coupled with periodic personal interaction between the trustor and the trustee (or a human representative of the trustee if the trustee is an institution). [FN70] Not surprisingly, research suggests that trust is far easier to maintain than to develop out of whole cloth. [FN71]

But as with so many things in life, what might take years to build and maintain can take mere moments to destroy. For trust is often quite fragile, and even an isolated negative experience "may be reacted to with great emotional intensity and upset trust for ever [sic]." [FN72] For, once broken, trust is "hard to regain." [FN73]

Trust has a resilient side too, however. For "not all negative feedback information about the trustee threatens or disrupts trust." [FN74] "Depending on the circumstances and the object of trust, certain symbolic thresholds are erected to determine when trust is considered broken." [FN75]

Of the two forms of trust, affective trust "is often stronger and more resilient" than cognitive trust. [FN76] This is not particularly surprising, since affective trust is predicated on emotions and values usually formed over a lifetime; cognitive trust can be generated more rapidly, after a fairly straightforward examination or study of one's counterparty. And as additional information is learned about the object of one's cognitive trust, that trust can just as rapidly be increased or decreased.

Additionally, according to Sitkin and Roth, the resilience of trust is linked to the type of violation in question. For "[c]ontext-specific ***843** violations" that go to technical competency and related matters "can be viewed as isolated exceptions." [FN77] Indeed, "[e]ven repeated violations of trust can be excused as personal quirks as long as the violations are confined to a particular domain and are not interpreted as threatening to 'spill over' into other domains." [FN78] Hence, while such violations could very well undermine what I have referred to as "specific trust" (one's confidence in a person to accomplish an assigned task competently and satisfactorily), [FN79] they are unlikely to dislodge "generalized trust" if it already exists. [FN80]

Much more serious-and potentially unforgivable-is a violation of trust that goes to a question of values. [FN81] For such violations are ordinarily not viewed in isolation, but rather interpreted in a generalized fashion-infecting the entirety of the violator's character, and poisoning the entirety of the trustor/trustee relationship. [FN82] Such violations serve to reduce, if not destroy, the generalized trust that had previously existed. [FN83]

### C. The Importance of Trust

Over the past decade or so, a flurry of important works have been authored touting the importance of trust-especially within the context of commercial relations and the economy as a whole. [FN84] As Nobel laureate Kenneth Arrow explained: "'Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by a lack of mutual confidence."' [FN85]

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This is because the transaction costs of bullet-proofing every deal and relationship would simply be too high. [FN86] Without a modicum of trust, the ***844** expense of protecting one's self in a transaction by monitoring the other party and other such measures could very well exceed the value of the transaction itself-thereby chilling commerce. [FN87]

Thus, it can be fairly said that "[t]rustworthiness lubricates social [and business] life." [FN88] As Robert Putnam explained: "Where people are trusting and trustworthy . . . everyday business and social transactions are less costly. There is no need to spend time and money making sure that others will uphold their end of the arrangement or penalizing them if they don't." [FN89] This frees up time and resources for more productive, beneficial use.

Additionally, relationships imbued with trust enable the parties thereto to achieve higher levels of mutual satisfaction. [FN90] As Christel Lane explained:

> A high level of trust between exchange partners is said to incline them towards expanding the amount of knowledge they make available to each other. In a relationship of trust, information exchanged may be more accurate, comprehensive, and timely, and under conditions of high trust, developed in a long-standing relationship, both implicit and proprietary knowledge considered confidential is made available to the exchange partner. Such easy exchange of information, in turn, makes exchange partners more open to each other and thus inclines them to explore new opportunities of collaboration, such as the enhancement of product quality and the joint exploitation of a new technology. [FN91]

Thus, trust not only reduces the costs of transacting, it also creates opportunities for a greater number of qualitatively richer commercial exchanges.

Trust is especially critical to the financial services industry, as "[f]inancial services are excellent examples of highly intangible and complex service-based offerings." [FN92] As a result, clients and customers are particularly ***845** reliant upon the advice and representations of financial service professionals-and this reliance requires a certain amount of trust. [FN93] This situation is captured well by the title of Lynn Stout's article: "Trust Behavior: The Essential Foundation of Securities Markets." [FN94] As Stout concludes:

> The American securities market is one of the largest and most important institutions in our economy. By 2007, more than 91 million individual investors held a total of more than $15 trillion in corporate bonds and equities, either directly or through pension and mutual funds. This is only possible because many investors trust. They may not necessarily trust individual securities professionals and corporate insiders to be honest and dependable (although I would like to believe most are honest and dependable, recent events do raise doubts), but at least they trust "the system." And because they trust, they are willing to buy trillions of dollars of securities, even when they are not quite sure what they are buying or whom they are buying it from. [FN95]

Additionally, there are positive externalities to trust. [FN96] Although these days, one does not often hear the old phrase "[w]hat's good for business is good for America," [FN97] bandied about, most would probably agree that greater trust in the world of business and financial services is likely to have certain beneficial spillover effects. And indeed, such trust can "be simultaneously a 'private good' and a 'public good."' [FN98] For many, if not all of us, benefit when ***846** businesses and consumers can spend less time and money guarding themselves from fraud and other wrongdoing, and more time and money on productive pursuits (such as research and development), or simply leisure. This is perhaps why societies marked by greater trust enjoy more than simply enhanced business profits, but rather an increase in flourishing across the board. [FN99]

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Finally, it is critically important to recognize that not all trust is of equal quality and value. Distinctly superior are affective and generalized trust (over cognitive and specific trust), which tolerate the least amount of suspicion, inspire the greatest amount of honesty and sacrifice, and exhibit the greatest resiliency in challenging and unfortunate situations. [FN100] Indeed, recall that some commentators dispute whether "cognitive trust" is trust at all. [FN101]

This qualitative divide is what has fueled commentators, such as Marc Galanter, to denigrate the role of law and lawyers in our society (purveyors of cognitive and specific trust) as providers of artificial trust: "[l]ike the provider of artificial hormones that supplement the diminished supply coursing through the body, the lawyer contrives enforceability to supplement the failing supply of reciprocity, moral obligation, and fellow-feeling . . . . Lawyers contrive to provide 'artificial trust."' [FN102]

Francis Fukuyama has shed light on how societies characterized by these different forms of trust operate. Fukuyama concluded that by almost every conceivable economic measure, societies lacking in affective and generalized trust fare poorly when compared to societies possessing such trust. [FN103] This is what leads Fukuyama to assert that "[w]idespread distrust . . . ***847** imposes a kind of tax on all forms of economic activity, a tax that high-trust societies do not have to pay." [FN104] In other words, what societies lack in affective and generalized trust, they need to purchase via mechanisms that generate cognitive and specific trust. And in so doing, "trust in the system of law replaces interpersonal trust in individuals." [FN105]

Where law and cognitive trust serve as a substitute to affective trust, "parties [interact] with a high degree of wariness, [as] this form of synthetic or rational trust extends only as far as the law's realistic protections." [FN106] As a result, such societies become simply qualitatively "unpleasant" when compared to those where affective and generalized trust, rather than cognitive and specific trust (generated via force and/or law) regulate everyday life. [FN107] As Fukuyama observed:

> It is perhaps easier to appreciate the economic value of [affective and generalized] trust if we consider what a world devoid of trust would look like. If we had to approach every contract with the assumption that our partners would try to cheat us if they could, then we would have to spend a considerable amount of time bulletproofing the document to make sure that there were no legal loopholes by which we could be taken advantage of. Contracts would be endlessly long and detailed, spelling out every possible contingency and defining every conceivable obligation. We would never offer to do more than we were legally obligated to in a joint venture, for fear of being exploited, and we would regard new and possibly innovative proposals from our partners as tricks designed to get the better of us. Moreover, we would expect that, despite our best efforts in the negotiations, a certain number of people would succeed in cheating us or defaulting on their obligations. We would not be able to resort to arbitration, because we would not trust third-party arbitrators sufficiently. Everything would have to be referred to the legal ***848** system for resolution, with all of its cumbersome rules and methods, or potentially even to the criminal courts. [FN108]

D. Law and Trust

Recognition of trust's importance to our economy has caused commentators to scrutinize the ways that trust can and is impacted by law. Scholars are at odds over law's effect on trust, with some arguing that law enhances trust, and others arguing that law undermines trust. [FN109]

Common ground appears to exist over the fundamental proposition that "the rule of law is associated with significantly higher levels of trust." [FN110] Indeed, this notion was introduced previously in our discussion of institutionally based trust. [FN111] And this comes as no surprise, since little good has come out of societies

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marked by anarchy and chaos (especially while they are anarchic and chaotic). [FN112] Indeed, in words particularly relevant to this article, Francis Fukuyama wrote, "[t]here is no question that institutions like contract and commercial law are necessary preconditions for the emergence of a modern industrial economy. No one would argue that trust or moral obligation alone can take their place." [FN113]

A more difficult question is the effect of additional law and regulation on trust once a sufficient legal framework is already in place. In other words, what is the impact of additional law and regulation in a society already characterized by law and order?

In approaching this question, we must keep in mind the different varieties of trust discussed previously: affective, cognitive, generalized, and specific. [FN114] For as we shall see, law appears to operate on different varieties of trust in different ways.

***849** For starters, recall that the essence of trust, as commonly understood, is the decision to intentionally expose one's self to vulnerability in a given situation or relationship. [FN115] Consider also that one of the primary purposes of law [FN116] is to reduce one's vulnerability. [FN117] Indeed, within the context of financial regulation, this purpose can be readily gleaned from the one-sentence preamble to the 1933 Securities Act: "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." [FN118] A tension immediately presents itself: how can law serve to further trust by reducing that feature which most characterizes the trust relationship: vulnerability? [FN119]

To address this tension, we must identify the kind, or aspect, of trust in question. Starting with the affective-cognitive spectrum, let us first consider trust that is primarily affective in nature.

Recall that affective trust is fundamentally emotional, triggered by a recognition of certain moral attributes, and grounded upon shared social norms. [FN120] As such, it is not difficult to see why affective trust is unlikely to be enhanced by the promulgation of protective law or regulation. [FN121] For, unlike cognitive trust, affective trust is not the result of a "cost-benefit" analysis on the part of the trusting party. [FN122] Thus, efforts to reduce the cost of trusting in the context of affective trust (by lowering the risks associated with the vulnerability to which the trustor is exposed), do little to enhance the overall level of affective trust. [FN123]

***850** Moreover, for a number of reasons, law and regulation can theoretically diminish affective trust and its development. [FN124] As previously observed, "regulation decreases the sense of vulnerability that is critical to [affective] trust," thus forestalling the development of affective trust by depriving the regulated parties of this critical ingredient. [FN125] Trust is earned by those who fail to take advantage of others when in a position to do so. By limiting the opportunities to take advantage of another (via rules or regulations that prevent misconduct, make misconduct unlawful, or otherwise subject misconduct to sanctions), law and regulation limit the ability of individuals and institutions to demonstrate their trustworthiness. [FN126]

Law and regulation can also transform a relationship that was initially informal and based upon trust to something formalized, strictly circumscribed, and explicitly based upon law (such as a detailed contract). [FN127] Consider for example, the popular view of prenuptial agreements which are "'often regarded with distrust and hostility."' [FN128]

Similarly, evidence suggests that law and regulation can "crowd out" trust-a phenomenon whereby legal mechanisms and adherence to regulatory standards supplant social norms and the binds of trust. [FN129] As

Mark Hall explains: "a heavily regulatory legal regime tends to crowd out intrinsic motivation by replacing it with extrinsic penalties. This can undermine both the perception and the reality of trustworthiness." [FN130]

Further, sociologists have commented upon a "spiral of distrust" that can emerge as relationships that once might have been based upon trust morph into highly structured legal forms. [FN131] As layer upon layer of monitoring agents and mechanisms are superimposed upon a given relationship, distrust is institutionalized. [FN132]

***851** Law and regulation appear to have a negative effect on "generalized trust" as well (trust in a counterparty's integrity and character, as opposed to mere confidence in his or her technical capabilities). [FN133] In an important study, Sim Sitkin and Nancy Roth concluded that:

> The literature also suggests that attempts to "remedy" trust violations legalistically frequently fail because they paradoxically reduce the level of trust rather than reproducing trust. The adoption of legalistic "remedies" (i.e., institutionalized mechanisms that mimic legal forms and exceed legal/regulatory requirements) imposes a psychological and/or an interactional barrier between the two parties that stimulates an escalating spiral of formality and distance and leads to a need for more rules. And so the process is perpetuated. [FN134]

Another way of looking at the problems posed by law and regulation to affective trust is through the lens of "rights talk." [FN135] For much of securities regulation is oriented toward investor protection, bringing with it a set of investor rights (e.g., the right to certain disclosures). But "[t]he language of rights and the language of trust move in opposite directions from one another," [FN136] and thus recognition of these investor "rights" comes at the expense of affective trust. For "[t]he scrupulous insistence on observance of one's rights is an admission that one does not trust . . . ." [FN137] Put differently, "the law's regulatory functions sometimes compete with its expressive functions, which can be complex, unpredictable, and multidimensional." [FN138]

In light of the foregoing, should law and regulation be pared back to a bare minimum? Not necessarily. For law and regulation may serve to enhance trust that is primarily cognitive in nature. [FN139]

***852** Law and regulation's potential salutary effect upon cognitive trust is not particularly surprising, given that cognitive trust is, by definition, a decision to make one's self vulnerable based upon a weighing of the costs and benefits associated with such vulnerability under the circumstances. [FN140] To the extent that law can lessen the cost of vulnerability (by reducing either the probability or magnitude of its attendant risks), law naturally makes trusting another (in a cognitive sense) a more attractive option. [FN141]

Law also can positively affect "specific trust." [FN142] Again, this result is not particularly surprising because "specific trust" is rather narrow in character, defined as "belief in a person's competence to perform a specific task under specific circumstances." [FN143] It does not take much to see why and how state-circumscribed standards and rules of liability can serve to increase confidence in someone who is subject to them. [FN144] Simply put, it is easier to have confidence (specific trust) in a person or institution that is bound by law to perform a service, or produce a product, that meets certain government-mandated standards than, ceteris paribus, in a person (or institution) who is not so bound by any such standards. As with cognitive trust, the driving force behind the trusting party's decision-making within the context of specific trust is not one of emotion or character. Instead, the trustor is taking a simple calculated risk: hoping that the price he or she is paying for a particular good or service is appropriate given the possibility that the transaction might ultimately prove unsatisfactory. Law helps reduce the cost of an unsatisfactory transaction, by reducing the chance of its occurrence and/or

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providing a remedy if it presents itself.

So, law appears to have deleterious effects upon trust that is affective and generalized, and positive effects upon trust that is cognitive and specific. But what about trust that is affective and specific? Or cognitive and generalized?

There is little shame, I believe, in admitting that existing scholarship and research is inconclusive here. Especially because the joining of these two forms of trust is probably quite rare: how often does one assume a certain technical competency on the part of another (specific trust) out of an assessment of that person's moral character? Similarly, how often does one ***853** assume that an individual is all-around upright and trustworthy simply because of his or her technical proficiency in a specific craft? In other words, given the similarity of their natures, cognitive trust is, I firmly suspect, more often coupled with specific trust (rather than generalized trust), and affective trust more often coupled with generalized trust (rather than specific trust). [FN145]

Finally, before proceeding, we would do well to consider the critiques of the argument that law can inhibit or harm trust (affective and generalized trust). One critique posits that since "law never provides total protection for the trusting party," law cannot truly displace trust. [FN146] Courts are imperfect. Litigation is expensive, and worse yet, uncertain. The efforts of regulators do not always meet with success. Thus, the argument goes, every transaction contains a degree of vulnerability-and with that the seeds of affective trust. [FN147]

This argument is certainly not without merit. It cannot be said that even the most heavily regulated transactions are riskless. So, certainly, opportunities to prove one's trustworthiness will always exist-regardless of the regulatory regime in place. But the question is not one of whether any opportunities to build trust persist under a regime of heightened regulation, but rather whether the effect of additional law and regulation upon relationships and transactions reduce such opportunities.

Although opportunities to earn trust admittedly still exist even after the imposition of additional regulation, such opportunities are reduced in number and quality. Few individuals trust each other, for example, as much ***854** as those who have served together in the armed forces. [FN148] Of course, it's not practical, nor necessarily desirable, to put future business partners or relations together in a foxhole before embarking upon a relationship. But the further we move away from such a scenario, the more difficult it becomes to build affective and generalized trust. Thus, to the extent that our laws construct a thicker, and more ubiquitous safety net under commercial transactions, the more difficult and slower it becomes to form deep, lasting bonds of trust.

Frank Cross raises an interesting critique in his compelling article on trust, which takes aim at the "crowding out" theory. [FN149] According to Cross, "[t]he mere existence of the law does not produce some sociological imperative to use it." [FN150] Cross argues that if individuals preferred to predicate their transactions on trust, they would eschew formal contracts and other legal protections yet, by in large, people do not opt for that route. [FN151] What this argument overlooks is a phenomenon common to human nature-and, perhaps, especially so to every parent who has ever attempted to raise a disciplined child. There is a tremendous temptation to adopt quick and easy fixes over more burdensome, tedious solutions despite the fact that the latter may very well be better in the long run. A toddler crying for his parent's cell phone can be placated by giving him the cell phone-thereby garnering the parent a respite of peace and quiet. Or the child may instead be told that he simply cannot have the cell phone-which may very well trigger an emotional torrent for quite some time. The former policy brings short term results, the latter policy is conducive to long term results.

I suggest that the same phenomenon is at work in Cross's observation that people generally opt for the pro-

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tections of law over the greater risks of relying on trust alone. Building and developing trust is hard, and sometimes stressful work. It also takes time and commitment. Although, by most accounts, the end product is well worth the effort, many people and businesses would rather not commit their time and energy to such a processor are simply short-sighted. This does not evidence a rejection of the proposition that "trust is preferable to law." [FN152] For it is not trust per se that is being eschewed, but rather the trust-development process.

***855** Yet another critique is that "by reducing the risk of relying on others, regulation starts relationships in which trust can eventually develop." [FN153] This critique has intuitive appeal. After all, as previously indicated, rare is the trust that is entirely affective or entirely cognitive-most trust relationships sit somewhere along a spectrum between those two poles. [FN154] It would seem that law-especially law with a light touch-could help an individual overcome his or her cognitive trust concerns and enter into a business relationship with another that is primarily affective.

Although Larry Ribstein rejects this critique, [FN155] I see little problem in conceding its merit. The protections of regulation may certainly tip the scales for some individuals, prompting them into trust relationships by making the vulnerability associated therewith more acceptable. By the same token, Ribstein is correct in observing that these same protections will also affect relationships that did not otherwise need them-and for those particular relationships "[t]he existence of legal coercion means that one no longer can clearly demonstrate that he respects his promise regardless of self-interest, but rather can show only that he can be legally coerced into performing." [FN156] Thus, for these relationships, the law will work to inhibit the development of trust. Ultimately, it would seem as though the strength of this critique would lie in the existence of empirical evidence that does not yet exist: to what extent does law kick-start some trust relationships, versus smother other potential trust relationships? I surmise that the answer is dependent upon a number of variables. That said, I read the existing literature to suggest that the affective trust relationships that are harmed by such regulation outnumber those that are helped. [FN157]

Lastly, Simon Deakin and Frank Wilkinson have asserted that the complexity of law's operation casts doubts upon whether law can be said to undermine trust. [FN158] More specifically, Deakin and Wilkinson point out that law and regulation serve to influence social norms, which are in turn part of the mix of factors affecting affective (and generalized) trust. [FN159] N. Luhmann also asserted that law could operate in the background to help foster trust in society, by "deterring cheating" and providing assurance. [FN160] However, ***856** Luhmann added the important caveat (omitted from Deakin and Wilkinson's discussion) that law ceases to function in this regard once "activated." [FN161] "The actual use of legal sanctions, for Luhmann as for most other social scientists, is incompatible with a trust relationship." [FN162]

The interplay between law and social norms is a controversial, and imperfectly understood phenomenon. [FN163] The degree to which a particular financial regulation might possibly affect norms in such a way as to engender affective or generalized trust seems quite uncertain. Although Deakin and Wilkinson's argument is an interesting one, I find this particular critique too speculative to credit in light of the countervailing evidence and arguments.

Finally, even if law and regulation do in fact destroy or diminish affective and generalized trust, it generally does so while building up cognitive and specific trust. This certainly diminishes the severity of the problems posed by the imposition of law and regulation upon relationships of trust (or of potential trust), but it does not entirely overcome them. Although cognitive and specific trust are important and helpful forms of trust, it is critically important to bear in mind that not all trust is created equal. Cognitive and specific trust are distinctly

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"lower quality" versions of trust, of less value to individuals and society than the "higher quality" varieties of affective and generalized trust. [FN164] For, as mentioned, certain particular benefits inure to relationships based upon affective and generalized trust that simply cannot be satisfactorily replicated by cognitive and specific trust. [FN165] This suggests that we accept the trade off of cognitive/specific trust in place of affective/generalized trust only when compelled to do so.

## II. Securities Regulation and Trust

In 2008 and 2009, the United States underwent an economic crisis of historic proportions, a change in presidential administrations, and gave the Democratic party its largest Congressional majority in over a decade. Not surprisingly, the confluence of these events has given rise to a variety of economic reforms and reform proposals-many directed at the regulation of the securities markets.

***857** The proposals were initially set forth by the Obama Administration in June 2009 via the Department of Treasury's "White Paper" on financial reform: "Financial Regulatory Reform-A New Foundation: Rebuilding Financial Supervision and Regulation." [FN166] These proposals included: (1) elimination of the "private adviser" exemption of the 1940 Investment Advisers Act; [FN167] (2) greater regulation of hedge funds, [FN168] and (3) the imposition of fiduciary obligations upon brokers. [FN169] Additional detail was added in July 2009 via the Treasury's delivery to Congress of two pieces of draft legislation: (1) the "Private Fund Investment Advisers Registration Act of 2009", [FN170] and (2) the "Investor Protection Act of 2009." [FN171] These proposals, in one form or another, have been included in a variety of U.S. House and Senate bills, [FN172] which have essentially culminated in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 [FN173].

In this part, I shall first proceed to examine the traditional regulatory regime as it applies to brokers, investment advisers, and hedge finds (the subjects of the aforementioned proposals). [FN174] Following each examination, I shall immediately analyze the merits of the reforms to the traditional regime brought about by the Dodd-Frank Wall Street Reform and Investor ***858** Protection Act of 2010. My goal shall be to identify whether the traditional regulation, versus the regulation as reformed, best serves to foster trust.

### A. Broker Regulation

#### 1. Traditional Regulation

Brokers play a critically important role in secondary market trading. [FN175] Although a large number of investors are taking advantage of discount brokerages of late (which offer low-cost, execution-only services online), [FN176] as of 2008 "43 per cent of individual investors were [still] with full-service brokers." [FN177]

Full-service brokers not only execute customer trades, but also "provide customers with research analysis and investment advice." [FN178] As such, the relationship between an investor and his or her (full-service) broker can be, and often is, a personal one. [FN179] Indeed, "[f]ull-service broker-dealers have always sought to develop long-term relationships with their customers who often come to rely on them for expert investment advice." [FN180]

"Broker-dealers are heavily regulated." [FN181] They are subject to a panoply of rules and requirements, hailing from the Securities Exchange Act of 1934, FINRA (the Financial Industry Regulatory Authority-a self regulatory organization that oversees thousands of brokerage firms), and state law as well. [FN182]

The "keystone of the entire system of broker-dealer regulation" is the requirement that anyone acting as a broker must register with the SEC. [FN183] ***859** The SEC has explained the importance of the registration requirement, and the explanation merits being set forth in full:

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> Registration of market professionals is a key element in the federal statutory scheme and plays a significant role in protecting investors. It promotes baseline levels of integrity among broker-dealers and their personal dealing with investors, through statutory disqualification provisions and the Commission's [SEC's] disciplinary authority; retention of sufficient capital to operate safely, through Commission net capital requirements; and maintenance of adequate competency levels, through self-regulatory organization ("SRO") qualification requirements. In addition, registration brings broker-dealer firms under extensive recordkeeping and reporting obligations, special antifraud rules, and the Commission's broad enforcement authority over broker-dealers. That authority, in turn, helps assure that investors in the U.S. securities markets are protected by the statutory and regulatory provisions governing the U.S. securities industry. Moreover, the Commission's financial supervision of all entities participating in the interdependent network of securities professionals contributes to the financial soundness of this nation's securities markets. [FN184]

In addition to the registration requirement and all that it entails, as set forth above, [FN185] the "suitability doctrine" constitutes a second major component governing the broker-client relationship. [FN186] Explicitly set forth as a rule by FINRA, and recognized by the SEC as a "fundamental duty of brokers" enforceable under the securities laws' general antifraud rule (Rule 10b-5), [FN187] the suitability doctrine demands that a broker/brokerage firm "will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer." [FN188]

***860** Thus, to summarize, brokers who execute trades and/or provide investment advice to clients are subject to the following regulations (among others):

. Mandatory registration
. Qualification requirements
. Net capital requirements
. Recordkeeping requirements
. Antifraud rules
. The Suitability Doctrine

As the broker-client relationship can be (and often is) a personal one (outside of the context of discount brokers), [FN189] the ground is fertile for the development of affective and generalized trust. The thicket of regulations governing this relationship, however, would seem to choke off the air and space needed for such trust to grow. The broker has little room in which to demonstrate his or her trustworthiness, qualifications, or other like characteristics that could possibly give rise to the type of bonding, and the type of feelings, that form the basis of affective and generalized trust. [FN190]

Instead, the broker is left, it would seem, with only enough space to demonstrate his or her technical abilities via superior customer service and superior securities recommendations. This, of course, represents an opportunity to develop cognitive and specific trust. [FN191] And in this respect, the regulatory thicket supports, rather than undermines, the development of such trust.

Whether, from a trust perspective, broker regulation hits the mark depends upon one's view of the role of brokers in the securities marketplace. If viewed as a mere functionary-a simple agent beholden to his/her principal's commands [FN192]-then, perhaps, the richness of affective and/or ***861** generalized trust may be an unnecessary luxury. Pursuant to this perspective, an investor's decision to open a brokerage account at a particular brokerage firm does not represent a leap of faith in the judgment and morals of that firm's brokers. Rather, it represents simply a convenient means by which to purchase and sell securities. The investor's trust in this scen-

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ario is limited to confidence in the brokerage firm's ability to execute trades in a timely fashion, to maintain accurate records of his or her account, and to refrain from defrauding him or her. Indeed, if the investor is trading exclusively through an online account, it is possible that he or she may never even make personal contact with anyone at the brokerage firm-let alone a real, live broker. By heavily regulating brokers and brokerage firms, the securities laws arguably instill trust in them (cognitive and specific) and thereby encourage investors to open and utilize brokerage accounts.

And such a perspective may very well be the appropriate one, given trends within the industry. [FN193] As Charles Schwab, founder and chairman of the Charles Schwab Corporation explained:

> My company . . . was founded 35 years ago as a reaction to the high cost and inherent exclusivity of traditional Wall Street investing. Today we serve almost 10 million accounts. The majority are what we refer to as self-directed: They make their own decisions about what to buy, sell or hold. We provide them with an efficient platform, tools, assistance, education and, of course, low costs. . . . To be sure, we are happy to manage money for our clients. But millions of investors have decided that their needs are best served when they direct their own finances. [FN194]

However, another sound perspective is also possible. Under this alternative perspective, the full-service broker, not the discount broker, is the model. Pursuant to this perspective, a broker does not simply execute orders at a client's command, but rather renders investment advice to the client, and may even manage the client's account (which may include "authorization to trade without the [client's] prior consent"). [FN195] Such brokers are not simply functionaries, but rather "are clearly fiduciaries in the broadest sense." [FN196] ***862** Under this perspective, one would like to see the development of affective and generalized trust, for all the reasons referred to earlier. [FN197] For here, the broker necessarily exercises quite a bit of discretion-discretion which is difficult to efficiently regulate via law. [FN198] This same discretion also gives rise to a myriad of ways in which a client can be harmed by his or her broker, ranging from simple fraud, to unsuitable recommendations, to churning. [FN199] It is precisely in such circumstances that affective and generalized trust becomes so valuable. [FN200] For investors recognize their irreducible quantum of vulnerability here, and trust-especially affective and generalized trust, which goes not merely to competence but to overall honesty-serves best to assuage their legitimate concerns.

From this second perspective, the law regulating brokers may, in fact, be problematic. For, as discussed, the heavy hand of regulation can crowd out trust in a relationship, converting expectations and behavior based upon honor and integrity to those based upon the letter of the law. [FN201] This suggests that the law tread lightly upon the broker-client relationship, regulating only to the degree absolutely necessary, and leaving the greatest amount of latitude for affective and generalized trust to develop. As presently constructed, this is not how most would characterize the regulation of broker-dealers. [FN202]

Both perspectives are justifiable, as both types of broker-client relationships exist. From what we know about trust however, the law operates to decisively favor one such paradigm here over the other (namely, that of the discount-broker). Whether such operation is sensible, given industry trends, or whether such operation is in fact responsible for industry trends, remains an interesting and open question.

2. Reforms

The White Paper proposed that Congress enable the SEC to "[e]stablish a fiduciary duty for broker-dealers offering investment advice ***863** and harmonize the regulation of investment advisers and broker-dealers." [FN203] As the White Paper accurately noted: "investment advisers and broker-dealers are regulated under dif-

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ferent statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective." [FN204] Although each set of professionals may give investment advice to their clients, investment advisers are subject to a fiduciary duty when giving such advice, but broker-dealers are not. [FN205] Instead, broker-dealers are subject to the lower standard of "suitability," pursuant to which a broker-dealer "will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer." [FN206]

The White Paper basically argued that investment advice is investment advice, regardless of its source. [FN207] It also asserts (probably accurately) that "[r]etail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same." [FN208] This argues strongly in favor of a consistent legal standard, and the standard advanced is the one currently governing investment advisers. [FN209]

The proposed Investor Protection Act of 2009 set forth the language that would bring about this harmonization of standards. [FN210] Specifically, in the words of the proposed act:

> [T]he standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice. [FN211]

***864** Additionally, as mentioned, the proposed Act would have required the SEC to promulgate certain disclosures on the part of brokers to investors regarding "the terms of their relationships," and even, "where appropriate . . . promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes . . . contrary to the public interest and the interests of investors." [FN212]The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, [FN213] which President Obama signed into law on July 21 2010, [FN214] does not go as far as its predecessor proposals. Instead, the Dodd-Frank Act merely requires the SEC to undertake a study as to the merits of imposing a fiduciary duty upon brokers, and authorizes the SEC to impose such a duty via regulatory rulemaking should it deem it appropriate to do so. [FN215]

The call to harmonize the standards governing broker and investment-adviser client relationships has much merit. So does the call for greater regulation of sales practices, conflicts, and compensation. But, from the narrow perspective of trust enhancement, would such harmonization be a wise move?

As previously discussed, broker-dealers are already heavily regulated. [FN216] Regardless of the wisdom of such a regime from a trust perspective, its existence is a matter of fact, and leaves little room in which the higher quality forms of trust could develop. In light of this, it is difficult to see the harm of the additional regulatory impositions. Indeed, in light of such an inhospitable environment for affective and generalized trust, it would be wise to maximize cognitive/specific trust. Fortunately, such are the precise effects that the proposed reforms would be predicted to have. [FN217] For the reforms in question serve to reduce the risk of entering into a financial relationship with a broker (by imposing a heightened standard of conduct, and other regulatory strictures aimed at protecting the investor). ***865** This reduces the cost component of the cost-benefit equation at the heart of cognitive/specific trust.

B. Regulation of Investment Advisers

1. Traditional Regulation

The Investment Advisers Act of 1940 [FN218] defines "[i]nvestment adviser" as "any person who, for com-

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pensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing, or selling securities." [FN219] The Act excludes from the definition those whose investment advice is only "incidental" to their main line of business, [FN220] and it is pursuant to this exemption that brokers (among others) escape the Act's strictures.

Also exempt from some of the Act's requirements (namely, its registration requirement, but not from the definition of an "investment adviser") is "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company. . . ." [FN221] (the "private adviser" exemption) [FN222] Among other things, this exemption serves to exempt advisers to a limited number of hedge funds, family members, venture capital, and private equity funds from the Act's registration requirements. [FN223]

As with broker-dealers, investment advisers are "heavily regulated." [FN224] As mentioned, non-exempt advisers must register with the SEC, [FN225] which requires the submission of a Form ADV. [FN226] Additionally, advisers subject to the registration requirement must, among other things, maintain detailed books and records, [FN227] provide certain written disclosures to their clients, [FN228] ***866** "establish, maintain and enforce a written code of ethics." [FN229] Finally, all advisers are held to a fiduciary duty standard, and as such possess "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' [their] clients." [FN230]

Analysis of the law's traditional approach to investment advisers largely replicates the analysis undertaken with regard to brokers. [FN231] Both sets of investment professionals are heavily regulated, leaving little room for affective and generalized trust to develop in the first place. Yet one could foresee the natural development of affective and generalized trust in relationships between both sets of investment professionals and their clients were some of this regulation pared back-for all the building blocks of such a relationship appear to be in place. [FN232]

I expressed a degree of ambivalence concerning the heavy regulation of brokers because of the apparently shifting business model of the industry from full-service brokers to discount brokers. [FN233] For with this shift comes a reduced ability to form bonds of affective and generalized trust, thereby justifying a regulatory approach that substantially skews in favor of cognitive and specific trust. But within the context of investment advisers, no such dichotomy exists; there is no movement toward a "discount" investment adviser model. As such, from a trust perspective, my view of the regulatory approach toward investment advisers is less ambiguous and more critical. For it would seem as though law and regulation are promoting cognitive/specific trust at the expense of affective/generalized trust in the absence of a compelling reason to do so.

Within the investment adviser industry, the possibility of affective and generalized trust would appear to be at its greatest among those investment advisers who have the smallest number of clients. One would expect such advisers, ceteris paribus, to have closer, more personal, and more lasting relationships with their small number of clients than those advisers with a much larger client base. Interestingly, here the law somewhat facilitates the development of this trust by recognizing the aforementioned exemption from ***867** the registration (and certain other) requirements of the 1940 Investment Advisers for advisers with fewer than 15 clients. [FN234] From a trust perspective, this is a laudable carve-out. It enables the greatest degree of investor vulnerability in that space where such vulnerability is most likely to fuel the development of trust.

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2. Reforms

Arguing that "there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisors [sic] and the funds that they manage," [FN235] the White Paper proposed "[r]equiring the SEC registration of investment advisers to hedge funds and other private pools of capital." [FN236] The proposed Private Funds Investment Registration Act would accomplish this by eliminating the aforementioned "private adviser" exemption contained in § 203(b) of the 1940 Investment Advisers Act. [FN237] The effect of this proposed legislation would be to require all investment advisers "to private funds with at least $30 million in assets under management to register with the SEC," [FN238] regardless of the adviser's number of clients. Less significantly, but potentially quite significant nonetheless, the Act would also require the SEC to:

> (1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals; and (2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors. [FN239]

Recall that an adviser's obligation to register with the SEC triggers a trio of other regulatory requirements:

***868** . the maintenance of detailed books and records; [FN240]

. the provision of certain written client disclosures; [FN241]and

. the establishment of a written code of ethics. [FN242]

Additionally, all advisers, whether exempt from registration (and its associated requirements) or not, are held to a fiduciary duty standard vis-a-vis their client interactions. [FN243]

These proposals were enacted into law under the Dodd-Frank Act. [FN244] The Dodd-Frank Act eliminates the aforementioned "private advisor" exception [FN245] (but replaces it with some narrower exceptions of its own). [FN246] The Act also requires the SEC to facilitate enhanced disclosures, and to prohibit certain sales practices "contrary to the public interest" as per the proposed Private Funds Investment Registration Act quoted above. [FN247]

In assessing the current regulatory approach to investment advisers, I observed that law was probably hampering the development of affective and generalized trust in an area where such trust could most likely develop. [FN248] I also observed, however, that the exemption for private advisers serves to carve out a small space-and, fortuitously, the most appropriate space-for such trust to grow. [FN249] Elimination of this exemption reduces this opportunity. Imposition of disclosures setting forth the terms of investment adviser-client relationships, along with regulation of sales practices, conflicts, and compensation, further eliminates this opportunity. Thus, the proposed reform is a deleterious move if one favors increased affective and generalized trust in the financial adviser industry.

***869** C. Hedge Fund Regulation

1. Traditional Regulation

Perhaps the entities least regulated in the world of financial services are hedge funds. Originally created decades ago "as a speculative tool used for conservative purposes," [FN250] the hedge fund has reached "near-mythical status in the securities industry, inspiring feelings of admiration and fascination but also envy and fear in many people." [FN251] Although, in the words of its creator, the hedge fund was devised to "hedge against the vagaries of the market" [FN252] (hence its name), hedge funds today employ a variety of strategies in pursuit of robust returns, usually characterized by "[h]igh leverage, management expertise, performance fees, and

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absolute return strategies." [FN253]

There is no single definition of a "hedge fund," and the term is not defined by U.S. securities laws. [FN254] That said, a common definition is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." [FN255]

What has made hedge funds the subject of fascination and controversy is, in large part, their "secrecy" [FN256] and relative lack of regulatory oversight. [FN257] For, aside from the imposition of basic antifraud liability, hedge funds have traditionally been largely unregulated. [FN258] This lack of regulatory oversight comports well with the original legislative intent of U.S. securities law. [FN259] Congress acted with "the specific purpose of protecting the common layperson investor, unfamiliar with the complexities of the financial markets," whereas more sophisticated investors were expected to fend for ***870** themselves. [FN260] For the most part, investors in hedge funds are sophisticated, and if not, certainly have access to sophisticated investment advice: traditional hedge funds "have steep investment minimums, from $1 million to as high as $50 million per investor." [FN261]

From a trust perspective, the lack of hedge fund regulation seems sensible. As with the world of investment advisers, the hedge fund industry is marked by repeat players, generally drawn from a similar social milieu. [FN262] The frequent and historical interactions among these players lays the foundation for affective and generalized trust to develop. [FN263] Given the superiority of affective and generalized trust, legislators and regulators have been wise in leaving the hedge fund industry alone.

2. Reforms

In connection with its argument that "there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisors and the funds that they manage," [FN264] the White Paper proposed "that all investment funds advised by an SEC-registered investment adviser should be subject to recordkeeping requirements; requirements with respect to ***871** disclosures to investors, creditors, and counterparties; and regulatory reporting requirements." [FN265]

Although nothing replicating the White Paper's approach made it very far in Congress, the Private Funds Investment Registration Act proposed to accomplish much of the same objectives (concerning hedge fund regulation) indirectly, by requiring that investment advisers to hedge funds "maintain such records of and file with the Commission such reports regarding private funds advised by the investment adviser as are necessary or appropriate in the public interest and for the . . . assessment of systemic risk. . . . " [FN266] This is precisely the approach adopted by the Dodd-Frank Act. [FN267]

The regulation of hedge funds has been a subject of debate and controversy even before the current economic crisis. [FN268] It is not the purpose of this article to rehash or take sides in that debate. But, in terms of assessing whether such regulation is trust-enhancing or trust-diminishing, for reasons previously expressed, the latter would seem to be the case. [FN269]

Indeed, under the traditional regime, although not heavily regulated, "hedge funds are permitted to voluntarily subject themselves to SEC regulation." [FN270] Such a voluntary approach, especially within the context of the hedge fund industry, seems optimal from a trust-enhancing perspective. It enables those funds that have managed to develop a critical mass of affective and generalized trust to continue operating on the basis of such trust-without interference from law and regulation. It also enables those funds which, for whatever reason, have been unable to gain traction in the development of affective and generalized trust, to avail themselves of the next

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best thing: cognitive and specific trust via voluntary subjection to SEC regulation. Removal of this choice, by effectively mandating the regulation of all hedge funds, risks sacrificing the affective/generalized trust relationships forged by the former group of hedge funds-a trust that their current particular context enables them to nurture and maintain.

***872** III. Problems With Trust

This article's premise has been the indispensability of trust to our economy as a whole, and to capital markets in particular. Without retreating from that premise, it is important to nevertheless acknowledge that trust is not an unmixed blessing. [FN271] For in addition to the beneficial opportunities and efficiencies that trust engenders, there is an accompanying set of nefarious opportunities and exploitations that it enables as well. [FN272] Trust can be honored, or breached; rewarded, or abused. This is largely inescapable, and arises from the fact that, as discussed, vulnerability is at trust's core. [FN273]

Additionally, trust can also play a role in undermining regulatory oversight, as was made clear by the SEC's internal investigation into its handling of the Madoff scandal. [FN274] The SEC's investigation revealed that an important factor in explaining why SEC staff failed to uncover the Madoff scheme was Madoff's reputation. [FN275] This led to an unfortunate degree of trust in Madoff on the part of the SEC's staff, causing them to credit his unsubstantiated representations. [FN276]

Thus, a public policy approach that encourages and promotes trust-especially affective and generalized trust-will also, simultaneously, and inevitably, be opening up greater numbers of people to victimization. This presents a very real dilemma. Moreover, in the financial services industry, this problem is compounded by the fact that an investor suffers not only if he or she places trust in the wrong person or institution, but also (quite often) if that person or institution misplaces its trust in another person or institution. That is, not only must an investor hope that his or her broker (for example) is genuinely trustworthy, but also that the broker's choices of whom to trust with the investor's money are also correct.

This dilemma is not unique to trust, but appears in a variety of contexts. A vaccine that will save millions of lives may also cause the death of hundreds who suffer from serious side effects. Trains, planes, and automobiles all make possible life as we know it, yet all are subject to ***873** accidents and mishaps that will claim life from time to time. Society's solution to these dilemmas is regulation. Regulation attempts to maximize the benefit of a good, while minimizing its potential harms. Thus, we permit (and indeed, encourage) inoculation by vaccine, but only after testing for side effects, and warning those most at risk of the side effects. We allow the use of automobiles, but demand that automobiles meet certain crash-test and safety requirements, be driven subject to posted speed limits, etc.

What is unique about trust, however, is that the imposition of a regulatory solution, as discussed, can be particularly counterproductive. [FN277] Requiring front-row automobile passengers to wear seat belts improves automobile safety-at the cost of only a minor inconvenience and few additional dollars per car. [FN278] Imposing additional regulatory requirements upon investment advisers in order to protect against breaches of trust will not only probably cost a bit of time and money, but might also very well reduce trust itself. [FN279] For as explained throughout this article, regulation generally has the effect of increasing one form of trust (cognitive and specific trust) at the expense of another, more beneficial form of trust (affective and generalized). [FN280] This makes a regulatory solution to misplaced trust problematic.

Many argue in favor of market-based solutions to problems such as these, in lieu of regulation. [FN281]

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Whatever the merits of these arguments may be, the superiority of such solutions is difficult to imagine in this particular context. For so long as someone or something intervenes between a financial professional and his or her client, affective/generalized trust will be undermined. It matters little whether the actor intervening is a government regulator, or an independent third party professional. Indeed, as previously mentioned, even privately negotiated contracts between two parties can serve to reduce the amount of (affective/generalized) trust in their relationship. [FN282] ***874** Thus, a market-based solution to this particular problem involves similar deleterious trade-offs as does a regulatory solution. [FN283]

In light of this, there is indeed little we can do to protect against the abuse of trust if we wish to maximize the benefits of trust in our society. Bernie Madoff is the price we pay for the benefits of trust. Although that price is indeed a steep one, it is dwarfed in comparison to the rewards reaped in countless relationships where trust is kept instead of broken. [FN284] We could certainly do more to prevent future Madoffs, but our efforts would come at the cost of weakening trust in those tremendously beneficial relationships that are flourishing now-and which will develop and flourish in the future.

Of course, it should be noted that efforts to maximize the benefits of trust do not counsel in favor of an extremely deregulatory position. For it would do well to recall at this point the fact that trust is unlikely to exist in an extreme, pure form. [FN285] Thus, even a relationship characterized by a high degree of affective/generalized trust likely has a component of cognitive/specific trust as well. [FN286] One could draw from this an inference (not a necessary inference, but a fair one), that, in the complete absence of any cognitive/specific trust, even a relationship that would ordinarily be highly trusting (on affective/generalized grounds) would not long endure as such. Indeed, as previously mentioned, "[t]here is no question that institutions like contract and commercial law are necessary preconditions for the emergence of a modern industrial economy. No one would argue that trust or moral obligation alone can take their place." [FN287] This suggests the wisdom of public policy doing what it can to ensure at least a modicum of cognitive/specific trust in the financial services industry-whether this is provided by market forces, or in their absence, via law and/or regulation.

But these considerations are moot because we already have more than a sufficient foundation to support cognitive and specific trust in the financial services industry. It seems quite implausible to suggest that the industry is so completely devoid of cognitive/specific trust that affective/generalized trust cannot exist. [FN288] Wall Street, for all its recent excesses, is a far cry from the Wild West. Financial professionals are generally well educated, selectively hired, and subject to a host of both private and public ***875** credentialing organizations. [FN289] Thus, we are not operating in an environment in which law and regulation are needed to make possible affective/generalized trust; the predicate for such trust already exists.

## IV. Conclusion

Trust is a critically important ingredient in the recipes for a successful economy and a well-functioning financial services industry. Due to scandals ranging in nature from massive incompetence to massive irresponsibility to massive fraud; investor trust is in shorter supply today than just a couple of years ago. [FN290] This is troubling, and commentators, policymakers, and industry leaders have all recognized the need for trust's restoration.

As in times of similar crises, many have turned to law and regulation for the answers to our problems. The imposition of additional regulatory oversight, safeguards, and remedies, some advocate, can help resuscitate investor trust. These advocates have it half right.

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Trust is complicated, existing in a variety of forms. [FN291] Some forms, predicated primarily upon reasoned calculation (cognitive and specific trust), respond well to law and regulation. [FN292] But other forms, predicated primarily upon relationship and emotion (affective and generalized trust), respond poorly to law and regulation. [FN293] In fact, these latter forms of trust can be seriously harmed by legal intervention. Unfortunately, these latter forms of trust also happen to be the most valuable and most beneficial forms-giving rise to the greatest efficiencies, and inspiring the greatest degrees of cooperation and sacrifice among those in relationships characterized by their existence.

Wise policymakers would exhibit a preference for the higher quality versions of trust. This would generally counsel in favor of a deregulatory approach to the financial services industry-one in which law and regulation got out of the way, and enabled relationships between clients and industry professionals to flourish.

***876** But not always. For when high quality trust is unlikely to exist or persist, it is essential that the only other game in town-cognitive and specific trust-be in ready supply. Here, happily, law and regulation can play a salutary role. [FN294]

Thus, the wisest policymakers would carefully assess the nature of whatever particular trust relationship he or she wishes to strengthen. If the nature is that of affective or generalized trust, the urge to impose additional regulation to bolster trust ought to be resisted (indeed, perhaps some regulatory pruning might actually be called for). If, on the other hand, the relationship is better characterized as one of cognitive or specific trust, additional (or more accurately better) regulation could indeed be beneficial.

In light of this, proposals and enactments to reform securities regulation present a mixed bag. Increased regulation of broker-dealers is likely to do little harm, as it is unclear whether sufficient room for high-quality, affective/generalized trust exists here in the first place. And if, in the twenty-first century, the brokerage industry relies upon primarily cognitive and specific trust (due to increased movement toward the discount-broker business model), such increased regulation could be beneficial.

As for increased regulation of investment advisers and hedge funds, this would seem unwise. [FN295] For here we have the greatest possibility (and most likely actuality) of high quality trust-trust which the imposition of additional regulation threatens to enervate.

Lastly, it is important to bear in mind that the existence of trust is itself not an entirely unmixed blessing. By definition, trusting investors are vulnerable investors. And since vulnerability entails costs, trust entails costs. Misplaced trust can lead to victimization and serious harm. Unfortunately, this places us within the horns of a dilemma: our only way to reduce these costs is to increase regulation, thereby displacing high quality trust with lower quality trust. That would cause us to forgo the full extent of benefits that trust (high quality trust) offers to us and to society.

Sadly, for a variety of reasons this trade-off may be, ultimately, inevitable. For quite some time, those characteristics that most readily give rise to high quality trust have been diminishing in our society. [FN296] Coupled ***877** with the recent spate of scandals and economic calamity-a mere decade after the last spate of scandals and economic calamity-perhaps all that realistically remains in the financial services industry generally, and in the securities industry in particular, is the lower quality varieties of trust. Fortunately, that will suffice, and the capital markets, as well as the economy as a whole, will be operable. Unfortunately, that settles us into a place far inferior to that which could have been possible.

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[FN1]. R. William Ide III & Douglas H. Yarn, Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust, 56 Vand. L. Rev. 1113, 1114 (2003) (quoting Federal Reserve's Second Monetary Policy Report for 2002: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 11 (2002) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System)); see also Elizabeth Warren, Wall Street's Race to the Bottom, Wall St. J., Feb. 9, 2010, at A19 ("Banking is based on trust.").

[FN2]. See Susanna Kim Ripken, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, 58 Baylor L. Rev. 139, 140-41 (2006).

[FN3]. See generally Peter Gakunu, The 2007-2008 crisis - a breakdown of trust?, New Europe, Nov. 10, 2008, http://www.neurope.eu/articles/90474.php (discussing the role of trust in relation to the sub-prime mortgage and financial sector crisis).

[FN4]. See Jamie Dimon, A Unified Bank Regulator Is a Good Start, Wall St. J., June 27, 2009, at A13 (". . . no discussion of the future of the financial system can be complete without an acknowledgment of the industry's responsibility to re-earn the trust of the American people."); see also Paul Hannon, Foreign Investing Falls 39%, Wall St. J., Jan. 20, 2010, at A13 (discussing the reduction in overseas investment); John D. Morley & Roberta Romano, The Future of Financial Regulation, 57-58 (John M. Olin Center for Studies in Law, Econ., and Pub. Policy Research Paper No. 386, 2009), available at http://ssrn.com/abstract=1415144 (setting forth President Obama's numerous references to "trust" in his speeches regarding the financial crisis). Some scholars suggest that mistrust of such a degree threatens the legitimacy of corporations themselves. See Ide III & Yarn, supra note 1, at 1114-15.

[FN5]. See, e.g., Tina Brown, Did We All Go Mad?, Daily Beast, http:// www.thedailybeast.com/blogs-and-stories/2008-12-15/did-we-all-go-mad/ (Dec. 15, 2008, 7:30 EST); Frank Pasquale, A Total Breakdown in Trust, Concurring Opinions, http://www.concurringopinions.com (Dec. 13, 2008, 15:40 EST).

[FN6]. Cf. Daniel Henninger, In Government We Trust?, Wall St. J., Aug. 20, 2009, at A11 ("I believe Madoff's massive and destructive breach of trust had an effect on the public mind that carried beyond the tragedy of its immediate victims. After Madoff, John Q. Public set the bar really high for anyone seeking a big commitment of trust with money.").

[FN7]. See generally John H. Walsh, A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry, 29 Hofstra L. Rev. 1015, 1035-37 (2001) (Discussing the motivations of the Roosevelt administration in regulating the securities industry).

[FN8]. See Ripken, supra note 2, at 140-41(describing the background to the passage of the Sarbanes Oxley Act).

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[FN9]. Especially significant, and foundational, within the field of corporate and commercial law are Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad (2006); Lawrence E. Mitchell, Trust and Team Production in Post-Capitalist Society, 24 J. Corp. L. 869 (1999); Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735 (2001); Frank B. Cross, Law and Trust, 93 Geo. L. J. 1457 (2005). Two other important works addressing trust, but within the larger context of social capital, are Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity (1995) and Robert D. Putnam, Bowling Alone: The Collapse and Revival of American Community (2000).

[FN10]. E.g., Blair & Stout, supra note 9.

[FN11]. Simon Deakin & Frank Wilkinson, Contract Law and the Economics of Interorganizational Trust, in Trust Within and Between Organizations 146, 146- 47 (Christel Lane & Reinhard Bachmann eds., 1998).

[FN12]. Reza Dibadj, The Misguided Transformation of Loyalty into Contract, 41 Tulsa L. Rev. 451 (2006).

[FN13]. Mark A. Hall, Law, Medicine, and Trust, 55 Stan. L. Rev. 463 (2002).

[FN14]. The exception to this is an earlier piece of mine, in which I addressed the role of trust with regard to financial services regulation generally. See Ronald J. Colombo, The Role of Trust in Financial Regulation, 55 Vill. L. Rev. (forthcoming 2010).

[FN15]. Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 36 J.L. & Econ. 453, 453 (1993) ("As the literature on trust reveals, and as developed here, 'trust' is a term with many meanings.").

[FN16]. Frankel, supra note 9, at 49.

[FN17]. Blair & Stout, supra note 9, at 1739-40.

[FN18]. See Jay B. Barney & Mark H. Hansen, Trustworthiness As a Source of Competitive Advantage, 15 Strategic Mgmt. J. 175, 175 (1994).

[FN19]. See Larry E. Ribstein, Law v. Trust, 81 B.U. L. Rev. 553, 557 (2001).

[FN20]. Id. (quoting Barney & Hansen, supra note 18, at 179).

[FN21]. Claire A. Hill & Erin Ann O'Hara, A Cognitive Theory of Trust, 84 Wash. U. L. R. 1717, 1724 (2006).

[FN22]. See Cross, supra note 9, at 1464-68.

[FN23]. Id. at 1464.

[FN24]. Williamson, supra note 15, at 479.

[FN25]. Id. at 482.

[FN26]. Id. at 484.

[FN27]. See Hill & O'Hara, supra note 21, at 1725-26.

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[FN28]. See Cross, supra note 9, at 1465.

[FN29]. Id.

[FN30]. Id.

[FN31]. Williamson, supra note 15, at 463.

[FN32]. Id. at 458.

[FN33]. Id. at 463.

[FN34]. Id.

[FN35]. See Cross, supra note 9, at 1465.

[FN36]. See Hill & O'Hara, supra note 21, at 1724-25.

[FN37]. Id. at 1725. A term often accompanying or used interchangeably with trust is "confidence." E.g., Confidence, Webster's Third New international Dictionary of the English Language Unabridged 475 (1993) ("the state of one that confides: TRUST, RELIANCE, BELIEF"). The form of trust implicated by confidence appears to be cognitive trust-trust that a particular person or institution will execute a promised performance satisfactorily. For affective trust entails trusting in a particular person or institution generally, and as such includes "motivations and intentions," not merely "results." Hall, supra note 13, at 474. See also Ribstein, supra note 19, at 555 ("'Trust' differs from the decision to rely.").

[FN38]. Hall, supra note 13, at 494 (citations omitted).

[FN39]. Risky in the sense that the transaction exposes the party's vulnerability to the other.

[FN40]. See Arnold Schwarzenegger, Encyclopedia of Modern Bodybuilding 70- 71 (1985).

[FN41]. Assuming, of course, a satisfactory experience on the part of the trusting party. See infra text accompanying notes 69-70.

[FN42]. Cross, supra note 9, at 1469 ("While all trust is necessarily a 'leap of faith,' the breadth of that leap is much narrower with cognitive trust.").

[FN43]. See Hill & O'Hara, supra note 21, at 1752-53.

[FN44]. Cross, supra note 9, at 1471 ("When primarily cognitive, a person's trust will vary much more and be more dependent upon particularized circumstances."). It should be noted that cognitive trust also increases or decreases in response to experiences between parties, for such experiences serve as evidence, either favorable or unfavorable, upon which to calculate trustworthiness in future situations. See infra text accompanying notes 69-70.

[FN45]. Hill & O'Hara, supra note 21, at 1727.

[FN46]. See Cross, supra note 9, at 1469 ("any individual instance of trust probably contains both affective and

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cognitive components").

[FN47]. Hill & O'Hara, supra note 21, at 1727. This comports well with Carol Rose's view of trust as "semi-rational." See Carol M. Rose, Trust in the Mirror of Betrayal, 75 B.U. L. Rev. 531, 534-35 (1995).

[FN48]. See Sim B. Sitkin & Nancy L. Roth, Explaining the Limited Effectiveness of Legalistic "Remedies" For Trust/Distrust, 4 J. Org. Sci. 367, 371-73 (1993). Sitkin and Roth identified the important differences between "generalized trust" and "specific trust," albeit under a different nomenclature (identifying matters relating to what I have labeled "generalized trust" as impacting "distrust," and identifying matters relating to what I have labeled "specific trust" as impacting simply "trust"). Id.

[FN49]. See supra text accompanying notes 23-37.

[FN50]. See Cross, supra note 9, at 1464-67.

[FN51]. See Sitkin & Roth, supra note 48, at 371-72.

[FN52]. Cf. Hill & O'Hara, supra note 21, at 1730 (observing that "trust and distrust can, and often do, coexist").

[FN53]. See Sitkin & Roth, supra note 48, at 373-77; see also infra Part I.D (discussing the relationship between law and trust).

[FN54]. See Hill & O'Hara, supra note 21, at 1744 (equating "specific trust" with "trust that" [cognitive trust], and "general trust" with "trust in" [affective trust]); see also id. at 1723-27 (defining the "trust in" and "trust that" forms of trust); see also infra Part I.B. (discussing how trust is developed).

[FN55]. Christel Lane, Introduction: Theories and Issues in the Study of Trust, in Trust Within and Between Organizations 1, 11 (Christel Lane & Reinhard Bachmann eds., 1998) (citing Lynne G.. Zucker, Production of Trust: Institutional Sources of Economic Structure, 1840-1920, 8 Res. Org. Behav. 53, 60 (1986)).

[FN56]. Id. at 12.

[FN57]. Id.

[FN58]. Id. See also Fukuyama, supra note 9, at 314 (identifying the "vast expansion in the number and scope of rights to which Americans believe they are entitled" as a threat to community and, a fortiori, to trust); see also Cross, supra note 9, at 1492-94 (citing critiques similar to Fukuyama by Mary Ann Glendon, Philip Howard, Robert Kagan, Amitai Etzioni, and others).

[FN59]. See Lane, supra note 55, at 11.

[FN60]. Id.

[FN61]. Id.

[FN62]. Lane, supra note 55, at 11, 21-22.

[FN63]. Id. at 12.

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[FN64]. Id.

[FN65]. Id.

[FN66]. Lane, supra note 55, at 15; see also Tom Hayes & Michael S. Malone, The Ten-Year Century, Wall St. J., Aug. 11, 2009, at A17

> So how do we control this increasingly out-of-control, interlinked world? . . . . Most importantly, trust will become the critical factor. Without the luxury of time, trust will be the new currency of our times, whether in news sources, economic systems, political figures, even spiritual leaders. As change accelerates, it will remain one true constant.

[FN67]. See Williamson, supra note 15, at 486 (asserting that "[c]alculativeness . . . always reappears" in settings of institutional trust); but see Lawrence E. Mitchell, The Importance of Being Trusted, 81 B.U.L. Rev. 591, 609-11 (2001) (asserting that affective trust can be institutionally-based).

[FN68]. Jorg Sydow, Understanding the Constitution of Interorganizational Trust, in Trust Within and Between Organizations 31, 39 (Christel Lane & Reinhard Bachmann eds., 1998); see also Hill & O'Hara, supra note 21, at 1743 (noting that the initial development of trust occurs in small steps for most people).

[FN69]. Mitchell, supra note 67, at 600.

[FN70]. See Sydow, supra note 68, at 46-49.

[FN71]. See id. at 53-54 (discussing the difficulties of trust creation as opposed to trust management).

[FN72]. See Lane, supra note 55, at 23.

[FN73]. Lawrence E. Mitchell, Trust and Team Production in Post-Capitalist Society, 24 J. Corp. L. 869, 870 (1999).

[FN74]. Lane, supra note 55, at 23.

[FN75]. Id.

[FN76]. Hill & O'Hara, supra note 21, at 1469.

[FN77]. Sitkin & Roth, supra note 48, at 372.

[FN78]. Id.

[FN79]. See supra text accompanying notes 48-50.

[FN80]. See Sitkin & Roth, supra note 48, at 372.

[FN81]. Id. at 371.

[FN82]. Id.

[FN83]. Id.; see also Lane, supra note 55, at 23 (stating that even one falsehood has the potential to forever upset trust).

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[FN84]. See supra note 9. Of course, certain philosophers have understood and articulated the importance of trust long before our present generation. See, e.g., Alison Hills, Kantian Trust, The Philosophy of Trust (2002) www.open2.net/trust/downloads/docs/kantiantrust.pdf.

[FN85]. Putnam, supra note 9, at 288 (quoting Kenneth J. Arrow, Gifts and Exchanges, 1 Phil. Pub. Aff. 353, 357 (1972)) (alteration in original).

[FN86]. Oliver R. Goodenough, Values, Mechanism Design, and Fairness, in, Moral Markets: The Critical Role of Values in the Economy 228, 239 (Paul J. Zak ed., 2008). I have addressed the issue of transaction costs, and the need for virtue generally (not simply trust) in Ronald J. Colombo, Exposing The Myth of Homo Economicus, 32 Harv. J.L. & Pub. Pol'y 737, 747, 752-53 (2009) (Book Review).

[FN87]. See Tamar Frankel, Trust and Non-Trusting on the Internet, 81 B.U. L. Rev. 457, 460-63 (2001); see also Goodenough, supra note 86, at 239 (noting how values such as trustworthiness lower transaction costs).

[FN88]. Putnam, supra note 9, at 21.

[FN89]. Id. at 288.

[FN90]. See Lane, supra note 55, at 20.

[FN91]. Id. (citations omitted).

[FN92]. Deirdre O'Loughlin et al., From Relationships to Experiences in Retail Financial Services, 22 Int'l J. Bank Marketing, 522, 523 (2004); see also Sydow, supra note 68, at 33 (discussing the role of trust in the financial services industry).

[FN93]. See Cross, supra note 9, at 1516 ("Financial contracts may be considered 'trust intensive contracts par excellence,' so 'trust . . . should matter most for the development of financial markets."'(quoting Luigi Guiso et al., The Role of Social Capital in Financial Development 1 (Ctr for Research in Sec. Prices, Working Paper No. 511, 2001), available at http:// papers.ssrn.com/paper.taf?abstract_id=209610)).

[FN94]. Lynn A Stout, Trust Behavior: The Essential Foundation of Securities Markets, UCLA Sch. of Law, Law & Econ. Research Paper No. 09-15 (2009), available at ssrn.com/abstract=1442023.

[FN95]. Id. at 14.

[FN96]. Putnam, supra note 9, at 18-20 (referring specifically to "social capital," a phenomenon itself built on trust).

[FN97]. See Lorraine A. Schmall, Women And Children First, But Only If The Men Are Union Members: Hiring Halls And Delinquent Child-Supporters, 6 Notre Dame J.L. Ethics & Pub. Pol'y 449, 461 (1992). See also Speech by Calvin Coolidge to the American Society of Newspaper Editors (Jan. 17, 1925), in John Bartlett, Familiar Quotations 736 (15th ed. 1980) ("The chief business of the American people is business."); see also, Speech by Charles Erwin Wilson to the Senate Armed Forces Committee (1952) ("What is good for the country is good for General Motors, and what's good for General Motors is good for the country."). Id. at 817.

[FN98]. Putnam, supra note 9, at 20 (referring to "social capital," which is built on trust).

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[FN99]. Id. at 135-36. "A growing body of research suggests that when trust and social networks flourish, individuals, firms, neighborhoods, and even nations prosper." Id. at 318. But see Cross, supra note 9, at 1527-43 (discussing the negative consequences of trust).

[FN100]. See supra text accompanying notes 74-80; Hill & O'Hara, supra note 21, at 1725-26; Cross, supra note 19, at 1464-68. See also Blair & Stout, supra note 9, at 1750-51, 56-59 (extolling the benefits of "trust," which the authors have defined as "internalized [affective] trust and not calculative behavior [cognitive trust]").

[FN101]. See supra text accompanying notes 29-34.

[FN102]. Marc Galanter, The Faces of Mistrust: The Image of Lawyers in Public Opinion, Jokes, and Political Discourse, 66 U. Cin. L. Rev. 805, 806-07 (1998). More colorful still is Grant Gilmore's well-known comment on the subject:

> Law reflects but in no sense determines the moral worth of a society. . . . The better the society, the less law there will be. In Heaven there will be no law, and the lion will lie down with the lamb. . . . The worse the society, the more law there will be. In Hell there will be nothing but law, and due process will be meticulously observed.

Grant Gilmore, The Ages of American Law 110-11 (1977).

[FN103]. See Fukuyama, supra note 9, at 150-51. Fukuyama does not refer to "affective," "generalized," "cognitive," or "specific" trust in those terms, but instead distinguishes between "high-trust" and "low-trust" societies. Id. at 10-12. A careful reading of his book Trust reveals that by "high-trust" societies, he is referring to societies rich in affective and generalized trust, and that by "low-trust" societies, he refers to societies lacking in such trust, and which have instead substituted for its lack with cognitive and specific trust supplied via force, law, and regulation. Id.

[FN104]. Fukuyama, supra note 9, at 27-28.

[FN105]. Hall, supra note 13, at 514.

[FN106]. Id.

[FN107]. Putnam, supra note 9, at 136 (quoting Diego Gambetta, Can We Trust Trust? In Trust: Making and Breaking Cooperative Relations 220, 221 (Diego Gambetta ed., 1988).

[FN108]. Fukuyama, supra note 9, at 152-53.

[FN109]. Hill & O'Hara, supra note 21, at 1751-52; Raymond H. Brescia, Trust in the Shadows: Law, Behavior, and Financial Re-Regulation, 57 Buff. L. Rev. 1361, 1400-02 (2009). See also Sergio G. Lazzarini et al., Order with Some Law: Complementarity Versus Substitution of Formal and Informal Arrangements, 20 J.L. Econ. & Org. 261, 261-63 (2004) (discussing the benefits and drawbacks of formal rules compared to informal arrangements).

[FN110]. Cross, supra note 9, at 1525; see also Martin Raiser et al., Trust in Transition: Cross-Country and Firm Evidence, 24 J.L. Econ. & Org. 407, 426 (2008) ("trust among businesses is higher where confidence in third party enforcement through the legal system is higher").

[FN111]. See supra text accompanying notes 63-66.

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[FN112]. Cf. The Declaration of Independence para. 2 (U.S. 1776) (asserting the necessity and purpose of government); Edmund Burke, Reflections on the Revolution in France 19 (Dolphin Books 1961) (1790).

[FN113]. See Fukuyama, supra note 9, at 151.

[FN114]. See supra Part I.A.

[FN115]. See supra Part I.A.

[FN116]. For the purpose of this article, "law" refers to any external, state-backed (i.e., legally enforceable) constraints upon a party's conduct, including criminal law, contract law, securities law, commercial law, and associated regulation. Law does not include influences upon a party's conduct that are solely market-based or morality-based.

[FN117]. See Shelly George, Slipping Through the Cracks and Into Schools: The Need For a Uniform Sexual-Predator Tracking System, 10 Scholar 117, 133 (2008) ("'A central purpose of law is to protect the weak from the strong and to compensate victims for injuries caused by carelessness and neglect.'") (quoting Todd A. DeMitchell, The Inadequacy of Legal Protections for the Sexual Abuse of Students: A Two-Track System, 215 Educ. L. Rep. 505, 505 (2007)). Cf. P.S. Atiyah, Essays on Contract 4 (1986) (discussing whether all contracts or promises should create moral and legal obligations).

[FN118]. Securities Act of 1933, ch. 38, 48 Stat. 74 (preamble) (codified as amended at 15 U.S.C. §§77a-77aa (2006).

[FN119]. See Cross, supra note 9, at 1482; Hall, supra note 13, at 520-21.

[FN120]. See supra text accompanying notes 23-27.

[FN121]. See Hill & O'Hara, supra note 21, at 1725-26; see also Ribstein, supra note 19, at 563-65 (noting that regulation cannot create personal trust).

[FN122]. See Cross, supra note 9, at 1465.

[FN123]. See Hill & O'Hara, supra note 21, at 1725-26; Cross, supra note 9, at 1482-83.

[FN124]. See Hill & O'Hara, supra note 21, at 1725-26.

[FN125]. Ribstein, supra note 19, at 580-81.

[FN126]. See Cross, supra note 9, at 1491-92.

[FN127]. Ribstein, supra note 19, at 581; accord George Dent, Lawyers and Trust in Business Alliances, 58 Bus. Law. 45, 53-54 (2002).

[FN128]. Cross, supra note 9, at 1482 (quoting Allison A. Marston, Planning for Love: The Politics of Prenuptial Agreements, 49 Stan. L. Rev. 887, 888 (1997)).

[FN129]. See Hill & O'Hara, supra note 21, at 1725-26; Ribstein, supra note 19, at 580-81; but see Cross, supra note 9, at 1498 (criticizing "crowding out" theories as not "logical"). Cf. Paul J. Zak, Values and Value: Moral

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Economics, in Moral Markets: The Critical Role of Values in the Economy 259, 265 (Paul J. Zak ed., 2008) (discussing how rules and policies can crowd out good behavior that people follow most of the time).

[FN130]. Hall, supra note 13, at 510.

[FN131]. See Lane, supra note 55, at 15-16.

[FN132]. See id.

[FN133]. See Sitkin & Roth, supra note 48, at 370.

[FN134]. Id. at 369 (citations omitted); see also id. at 376; Mari Sako, Does Trust Improve Business Performance?, in Trust Within and Between Organizations 88, 99-100, (Christel Lane & Reinhard Bachmann eds., 1998); but see Lazzarini, supra note 109, at 263-264 (rejecting Sitkin & Roth's conclusion).

[FN135]. See Cross, supra note 9, at 1492-94.

[FN136]. Hall, supra note 13, at 469 (quoting Richard Sherlock, Reasonable Men and Sick Human Beings, 80 Am. J. Med. 2, 3 (1986)).

[FN137]. Id.

[FN138]. Id. at 509.

[FN139]. Despite the preceding, it should be noted that law and regulation could conceivably promote affective trust. Instead of law and regulation as typically envisioned (as a set of mandates and prohibitions), law and regulation with a softer touch could seed affective trust by facilitating interaction and communication. See Cross, supra note 9, at 1500-01, 1508-12; see also Hall, supra note 13, at 498-507 (discussing trust and law in the context of healthcare). This is not, however, the nature of the law and regulation reviewed in this article, and thus shall not be contemplated when reference is made to law and regulation.

[FN140]. See supra text accompanying notes 28-35.

[FN141]. See Cross, supra note 9, at 1483; Williamson, supra note 15, at 477-78.

[FN142]. See Sitkin & Roth, supra note 48, at 370.

[FN143]. Id. at 373.

[FN144]. Id.

[FN145]. See supra text accompanying notes 49-54. That said, if required to resolve the question, it seems as though law's effect on such relationships would be governed predominantly by whether the trust in question was affective versus cognitive (and not by whether the trust was generalized or specific). For the affective-cognitive spectrum goes more to the reason for or cause of the trust, whereas the generalized-specific spectrum goes more to the object of the trust. In other words, affective (or cognitive) trust tells us something about why a person has chosen to trust another; generalized (or specific) trust tells us something about the content or depth of a person's trust in another. Law would seem to have a greater effect (positive or negative) on that which causes one person to trust another-than on the specific manifestations of such trust once it comes into play. Thus, even though I

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might hold a sense of generalized trust toward a person, if that trust is cognitively based (meaning: I trust in that person's values and integrity not because of an emotional or moral instinct, but rather through a calculative assessment of his or her credentials, references, etc.), legal rules that would help protect me in a transaction with such an individual are likely to increase my trust in that individual. Conversely, if my trust were affectively based yet specific in content (meaning: I trust in that person's technical expertise primarily due to instinctual, emotional reasons), the imposition of legal rules upon our relationship is likely to undermine my trust in that person-by putting distance between us and transforming the nature of our relationship (thereby interfering with the instinctual, emotional connection that generated our trust).

[FN146]. Cross, supra note 9, at 1498-99.

[FN147]. See Hill & O'Hara, supra note 21, at 1756.

[FN148]. Cf. Irene E. Van Der Kloet et al., Development of Trust among Soldiers on a Deployment Mission, 15 Small Wars & Insurgencies 131, 137-55 (2004) (discussing the results of a study relating to the development of trust among soldiers at various stages in their deployment).

[FN149]. Cross, supra note 9, at 1499.

[FN150]. Id.

[FN151]. Id.

[FN152]. Id.

[FN153]. Ribstein, supra note 19, at 563.

[FN154]. See supra Part I.A.

[FN155]. See Ribstein, supra note 19, at 563, 582-83.

[FN156]. Ribstein, supra note 19, at 582.

[FN157]. See supra text accompanying notes 133-134.

[FN158]. Deakin & Wilkinson, supra note 11, at 147.

[FN159]. Id. at 154.

[FN160]. See Lane, supra note 55, at 13 (citing Niklas Luhmann, Trust and Power 34-36 (Tom Burns & Gianfranco Poggi eds., Howard Davis et al. trans., John Wiley & Sons Ltd. 1979) (1973)).

[FN161]. Id.

[FN162]. Id.

[FN163]. Robert E. Scott, The Limits of Behavioral Theories of Law and Social Norms, 86 Va. L. Rev. 1603, 1603-04 (2000).

[FN164]. See supra Part I.B.

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[FN165]. See supra Part I.B.

[FN166]. See generally U.S. Treasury Dep't., Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (2009) available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter "White Paper"].

[FN167]. See id. at 12, 37-38.

[FN168]. See id. at 5.

[FN169]. See id. at 68, 71.

[FN170]. U.S. Treasury Dep't, Private Fund Investment Advisers Registration Act of 2009 (proposed), available at http://www.treas.gov./ initiatives/regulatoryreform/ (follow hyperlink for "Title IV-Registration of Advisers to Private Funds") [hereinafter Private Fund Investment Advisers Registration Act of 2009 (proposed)].

[FN171]. U.S. Treasury Dep't, Investor Protection Act of 2009 (proposed), available at http://www.treas.gov/press/releases/docs/tg205071009.pdf [hereinafter Investor Protection Act of 2009 (proposed)].

[FN172]. Private Fund Investors Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009); Investor Protection Act of 2009, H.R. 3817, 111th Cong. (2009); The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (On Dec. 11, 2009, the House passed this Act; on Jan. 20, 2010, this legislation was referred to the Senate Committee on Banking, Housing, and Urban Affairs). Related pending legislation includes Return to Prudent Banking Act of 2009, H.R. 4377, 111th Cong. (2009); Investors Rights and Corporate Accountability Act of 2009, S. 2813, 111th Cong. (2009); Mutual Fund Transparency Act of 2009, S. 1964, 111th Cong. (2009); Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009).

[FN173]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[FN174]. The general U.S. approach to securities regulation is reviewed, from a trust perspective, in a predecessor article to this one: Ronald J. Colombo, The Role of Trust in Financial Regulation, 55 Vill. L. Rev. (forthcoming 2010).

[FN175]. See Richard Roberts, Wall Street 122 (2002).

[FN176]. See id.

[FN177]. Rachel Chang, Self Serve Investors Ditching Brokers: Credit Crunch May Have Been Lethal for Big Banks but it Has Been a Bonus for Small Online Outfits, Toronto Star, July 25, 2009, at B02.

[FN178]. Roberts, supra note 175, at 122.

[FN179]. See Laura S. Unger, On-Line Brokerage: Keeping Apace Of Cyberspace, in Securities Law & the Internet: Doing Business in a Rapidly Changing Environment 2000, at 237, 285 (PLI Corp. Law & Practice, Course Handbook Series No. B-1189, 2000) ("In a traditional full-service brokerage relationship, a customer interested in a security visits or calls his or her registered representative . . . . ").

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[FN180]. Certain Broker-Dealers not to be Investment Advisers, Advisers Act Release Nos. 34-51523; IA-2376, Fed. Reg. 20424, 20432 (proposed Apr. 19, 2005), vacated by Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

[FN181]. Clifford E. Kirsch, Broker-Dealer Regulation § 1:2 (2008) WL PLIREF-BDR s 1:2.

[FN182]. See id.

[FN183]. 1 Norman S. Poser & James A. Fanto, Broker-Dealer Law and Regulation § 5.01 (4th ed. 2010) (quoting Roth v. SEC, 22 F.3d 1108, 1109 (D.C. Cir. 1994)).

[FN184]. Id. (quoting Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 25,801 [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,244, at 89,192 (June 14, 1988) 1988 WL 1000013).

[FN185]. See supra text accompanying note 184.

[FN186]. See Kirsch, supra note 181, § 6:1.1.

[FN187]. See 17 C.F.R. § 240.10b-5 (2006).

[FN188]. Kirsch, supra note 181, § 6:1.1; see also id. § 6:1.2 (discussing the factors that go into determining the suitability of an investment for a customer).

[FN189]. See supra text accompanying notes 178-180.

[FN190]. See supra text accompanying notes 23-27, 48-51.

[FN191]. See supra text accompanying notes 28-37, 48-52.

[FN192]. E.g., Douglas Campbell, The Law of Stockbrokers 13 (2nd ed.1927):

> A stockbroker is one who is employed to buy or sell stocks, bonds, and other securities, receiving a commission as compensation for his services. In making the purchase, or sale, he acts as the agent of the person for whom it is made, and in that capacity he has an interest in the transaction only to the extent of his commission.

[FN193]. See supra text accompanying notes 176-77.

[FN194]. E.g., Charles R. Schwab, Brokers Aren't Responsible for Bad Bets, Wall St. J., Aug. 19, 2009, at A15.

[FN195]. Joseph L. Hood Jr., Arbitration and Litigation of Public Customers' Claims Against Broker-Dealers After McMahon, 19 St. Mary's L.J. 541, 561 (1988).

[FN196]. Id.

[FN197]. See supra Part I.C.

[FN198]. See Colombo, supra note 86, at 760-64 (setting forth the limits of law's ability to effectively regulate misconduct and wrongdoing).

[FN199]. E.g., Seth E. Lipner, The Law of Churning, in Securities Arbitration 1999, at 309, 313 (PLI Corp. Law

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& Practice Course, Handbook Series No. B0-0092, 1999), WL 1131 PLI/Corp 309 (describing the practice of churning in which the broker initiates excessive transactions for the customer for his own benefit).

[FN200]. See supra Part I.C.

[FN201]. See supra note 129 and accompanying text.

[FN202]. See Kirsch, supra note 181, at § 1:2.

[FN203]. White Paper, supra note 166, at 71.

[FN204]. Id.

[FN205]. See id.

[FN206]. Kirsch, supra note 181, § 6:1.1.

[FN207]. See White Paper, supra note 166, at 71.

[FN208]. Id.

[FN209]. See id. at 72.

[FN210]. See Investor Protection Act of 2009 (proposed), supra note 171, at 4-5.

[FN211]. Id. at 4. See also Jane J. Kim, Fiduciary Duty Hits the Street-Sort of, Wall St. J., Aug. 29, 2009, at B1 (noting the disagreement between those advocating for a uniform federal standard of fiduciary duty and those favoring existing standards).

[FN212]. Investor Protection Act of 2009 (proposed), supra note 171, at 4-5; see also infra text accompanying note 235-39 (outlining how the SEC would regulate investment advisers to protect investors).

[FN213]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[FN214]. See Jesse Lee, President Obama Signs Wall Street Reform: "No Easy Task," The White House Blog (July 21, 2010, 2:22 PM), http:// www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task.

[FN215]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, § 913(f), (g) (2010).

[FN216]. See supra Part II.A.

[FN217]. Additionally, some scholars have argued that fiduciary duties can enhance affective trust as well, for "[t]here is less for a principal to inquire about" and thus there are "fewer (potentially trust-eroding) inquiries [that] need be made." Hill & O'Hara, supra note 21, at 1760; see also Blair & Stout, supra note 9, at 1785-86 (discussing the situations in which fiduciary relationships created by law can encourage trust).

[FN218]. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to - 21 (2006).

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[FN219]. Id. § 80b-2(a)(11).

[FN220]. Id.

[FN221]. Id. § 80b-3(b)(3).

[FN222]. See Matthew Goldstein, A Secret Society: Hedge Funds And Their Mysterious Success, 6 J. Int'l Bus. & L. 111, 120-25 (2007).

[FN223]. Shearman & Sterling LLP, Obama Administration Proposes Investment Adviser Legislation to U.S. Congress, 2-3 July 22, 2009, http:// www.shearman.com/obama-administration-proposes-investment-adviser-legislation-to-us-congress/ (then follow the "click here to view the full memo, Obama administration proposes Investment Adviser Legislation to U.S. Congress" hyperlink).

[FN224]. William A. Birdthistle, Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry, 80 Tul. L. Rev. 1401, 1408 (2006).

[FN225]. 15 U.S.C. § 80b-3(a).

[FN226]. 17 C.F.R. §275.203-1(a)

[FN227]. 17 C.F.R. §275.204-2

[FN228]. 17 C.F.R. §275.204-3.

[FN229]. 17 C.F.R. §275.204A-1.

[FN230]. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-95 (1963) (quoting William L. Prosser, Handbook of the Law of Torts 535 (2d ed. 1955) and 1 Harper and James, The Law of Torts 541 (1956)); see also Hristiyaniya Atanasova, The Scope of Investment Advisers' Fiduciary Duties When They Merge, 27 Rev. Banking & Fin. L. 509, 512-14 (2008).

[FN231]. See supra Part II.A.

[FN232]. Namely, repeated interpersonal interactions over long periods of time, coupled with the client's vulnerability and dependence upon the adviser/broker.

[FN233]. See supra Part II.A.

[FN234]. See supra text accompanying notes 221-223.

[FN235]. See White Paper, supra note 166, at 37.

[FN236]. Id.

[FN237]. See Private Fund Investment Advisers Registration Act of 2009 (proposed), supra note 170, at 2; see also supra text accompanying notes 222- 223.

[FN238]. See Shearman & Sterling LLP, supra note 223, at 2. An exception would also be recognized for certain

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non-U.S. investment advisers. See id. at 3.

[FN239]. Investor Protection Act of 2009 (proposed), supra note 171, at 4-5,

[FN240]. 17 C.F.R. §275.204-2.

[FN241]. 17 C.F.R. §275.204-3.

[FN242]. 17 C.F.R. §275.204A-1.

[FN243]. See Atanasova, supra note 230, at 512-13; see also SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-95 (1963).

[FN244]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, §§ 1053(c)(3)(A), 403 (2010).

[FN245]. See supra text accompanying notes 221-222.

[FN246]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[FN247]. Id. § 743; see supra text accompanying note 239.

[FN248]. See supra text accompanying notes 233-34.

[FN249]. See id.

[FN250]. Evan M. Gilbert, Unnecessary Reform: The Fallacies with and Alternatives to SEC Regulation of Hedge Funds, 2 J. Bus. Entrepreneurship & L. 319, 319-20 (2009).

[FN251]. Thierry Olivier Desmet, Understanding Hedge Fund Adviser Regulation, 4 Hastings Bus. L.J. 1, 1 (2008).

[FN252]. Peter Landau, Alfred Winslow Jones: The Long and Short of the Founding Father, Institutional Investor, (Aug. 1968).

[FN253]. J.W. Verret, Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal, 32 Del. J. Corp. L. 799, 803 (2007).

[FN254]. See Gilbert, supra note 250, at 321.

[FN255]. Id. (quoting Alfred C. Tierney, The SEC's Rule 206(4)-8: Two Steps Back and One Step Forward, 44 Cal. W. L. Rev. 589, 593-94 (2008)).

[FN256]. Desmet, supra note 251, at 1-2.

[FN257]. See id. at 13.

[FN258]. Id. at 13-15. In 2004, the SEC promulgated a rule requiring hedge fund registration, but that rule was subsequently quashed by the U.S. Court of Appeals for the D.C. Circuit. See id. at 15-24.

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[FN259]. See Gilbert, supra note 250, at 322-23.

[FN260]. Id.

[FN261]. Desmet, supra note 251, at 4, 8-9. That said, the "retailization of hedge funds," pursuant to which an investor can buy into a "funds of funds" for as low as $25,000, has "created [additional] serious concerns that the hedge fund industry is too lightly regulated." Id. at 4, 9-10. But see Gilbert, supra note 250, at 338-40 (setting forth reasons why "retailization is not a valid concern" supportive of additional hedge fund regulation).

[FN262]. Desmet, supra note 251, at 8. See also Hill & O'Hara, supra note 21, at 1786-87 (discussing how corporate directors and CEOs "often belong to the same clubs, associations, and charities"); see also Steve Cocheo, The glass corner office: While no longer exclusively a man's world, is banking an equally woman-friendly business yet?, ABA Banking J., (Oct. 2001) (discussing the role of women in the banking industry), available at http:// www.allbusiness.com/finance/826351-1.html; see also Patricia H. Thornton, The Sociology of Entrepreneurship, 25 Ann. Rev. Soc. 19, 31-33 (1999) (noting the relationship between funding of new business ventures and the sociological attributes of the regions in which they occur). Cf. Ranjay Gulati & Monica C. Higgins, Which Ties Matter When? The Contingent Effects of Interorganizational Partnerships on IPO Success, 24 Strategic Mgmt. J. 127, 129-32 (2003) (discussing the benefits of interorganizational endorsement relationships and alliances between firms). See generally Mark S. Mizruchi & Linda Brewster Stearns, Getting Deals Done: The Use of Social Networks in Bank Decision-Making, 66 Am. Soc. Rev. 647, 648-51 (2001) (examining how commercial banks close transactions using social networks).

[FN263]. Cf. Alan Fish & Daniel New, Investment Performance Reporting: From Obligation to Differentiator, HedgeWorld Daily News, Sep. 11, 2008, available at 2008 WLNR 17284494 (noting how firms in the investment management industry can benefit from the adoption of uniform standards relating to the presentation of investment results).

[FN264]. See White Paper, supra note 166, at 37.

[FN265]. Id.

[FN266]. Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. §4(b)1 (2009).

[FN267]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, § 619 (2010).

[FN268]. E.g., Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 Temp. L. Rev. 681, 681-82 (2000).

[FN269]. See supra Part.I.C.

[FN270]. Gilbert, supra note 250, at 343.

[FN271]. Among other potential ills, societies and communities high in trust can also exhibit xenophobic tendencies regarding those outside their circles of trust. See Cross, supra note 9, at 1528-34.

[FN272]. See Stout, supra note 94, at 8, 12; Hill & O'Hara, supra note 21, at 1719-20.

[FN273]. See supra text accompanying notes 17-21.

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[FN274]. SEC Office of Investigations, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme 372-89 (2009).

[FN275]. See id. at 389.

[FN276]. See id. at 372-73. A similar phenomenon has apparently been at work in the boardrooms of U.S. corporations in which "directors failed to look hard and well enough because they trusted too much in the officers." Hill & O'Hara, supra note 21, at 1786.

[FN277]. See supra Part I.D.

[FN278]. See Jason Eberhart-Phillips, What I Learned First-Hand About Seat Belts, Kansas Health Institute, Feb. 23, 2010, http:// www.khi.org/news/2010/feb/23/what-i-learned-first-hand-about-seat-belts/.

[FN279]. See supra Part II.B.

[FN280]. See supra Part I.D.

[FN281]. E.g., Ian Vasquez, The Brady Plan and Market-Based Solutions to Debt Crises, The Cato Journal, http://www.cato.org/pubs/journal/cj16n2.html (follow "The Brady Plan and Market-Based Solutions to Debt Crises" hyperlink) (discussing the use of a free market approach to resolve the debt crises that resulted from the inability of Mexico to honor its debt obligations); cf. Frankel, supra note 87, at 472 (discussing "private sector professionals and organizations with significant reputations, which act as reliable verifiers of others' assertions of facts and promises").

[FN282]. See supra notes 127-28.

[FN283]. See Hall, supra note 13, at 510; but see Ribstein, supra note 19, at 570 (arguing that private constraints may not be as deleterious to trust as legal regulation).

[FN284]. See Cross, supra note 9, at 1474-75, 1477-79; Hill & O'Hara, supra note 21, at 1719.

[FN285]. See supra notes 45-46.

[FN286]. See id.

[FN287]. See Fukuyama, supra note 9, at 151.

[FN288]. See Stout, supra note 94, at 9 ("One of the most remarkable things we can [say] about trust . . . is just how much trust is out there").

[FN289]. Karen Chan & Kathy Sweedler, A Guide to Financial Credentials, University of Illinois Extension (2007), http:// www.ace.illinois.edu/cfe/cfp/CredentialsNov07.pdf.

[FN290]. See Stout, supra note 94, at 13 ("Unfortunately, over the past decade, American investors have witnessed innumerable financial scandals of the Enron/Worldcom/Madoff sort. . . . If trust is indeed influence by history, as the evidence suggests, investor trust can only be expected to decline.").

[FN291]. See Hall, supra note 13, at 525.

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[FN292]. See id.

[FN293]. See id.

[FN294]. See Hall, supra note 13, at 523 (observing the bias toward cognitive trust approaches in business law, which is sensible given that trust in this context generally "arises more from calculation than emotion").

[FN295]. It is important to recognize, as one must throughout this article, that the perspective here is one limited to the enhancement of trust. Certainly other objectives and policy concerns are being addressed by all the regulations, both current and proposed, that have been discussed-some of which might very well outweigh the issue of trust and, on balance, militate in the regulation's favor.

[FN296]. See supra text accompanying notes 55-66.

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