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# Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer a Better Approach?

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# CURBING BROKER-DEALERS' ABUSIVE SALES PRACTICES: DOES PROFESSOR JENSEN'S INTEGRITY FRAMEWORK OFFER A BETTER APPROACH?

*Barbara Black**

Retail investors, particularly senior citizens, need competent and careful investment advice more than ever before. With the decline of fixed-benefit pensions,[1] U.S. workers must substantially fund their own retirements, yet many enter or near retirement with inadequate savings.[2] In addition, the current environment of low interest rates exacerbates the problems of those living on fixed incomes.[3] Many investors are not qualified to deal with these challenges; surveys show that retail investors as a whole lack basic financial literacy.[4] Consequently, many must rely on the services provided by investment advice providers, including broker-dealers.[5] Regulators have sounded the alarm about sales of risky, complex products to retail customers in search of better returns ("chasing

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* Charles Hartsock Professor of Law and Director, Corporate Law Center. I thank Alan Palmiter and the editors of the Law Review for inviting me to participate in this symposium.

1. *Managing Lifetime Income*, U.S. SEC. & EXCHANGE COMMISSION, http://investor.gov/employment-retirement/retirement/managing-lifetime-income (last visited Apr. 3, 2013) (reporting trend away from defined benefit plans and toward defined contribution plans).

2. *See* Mark Twigg, *The Future of Retirement—A New Reality*, HSBC 5, 8 (2013), http://www.hsbc.com/about-hsbc/structure-and-network/retail-banking/retirement/the-future-of-retirement-a-new-reality-flipbook#/8/ (noting key findings, including: (1) fifty-six percent of U.S. respondents think their retirement preparations are inadequate; (2) on average, U.S. respondents expect their retirement to last eighteen years, but their retirement savings to last for only ten years; and (3) there is an overreliance on dwindling state benefits).

3. *See* Shefali Anand, *Low Interest Rates Force Creative Choices*, WALL ST. J., Mar. 4, 2013, at R12 (discussing the impact of low interest rates on bond investments).

4. *See* U.S. SEC. & EXCH. COMM'N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS, at vii–viii (2012), *available at* http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf (discussing the findings of a report from the Library of Congress regarding the financial literacy of retail investors).

5. This Essay focuses on broker-dealers' sales practices and does not address the sales practices of investment advisers.

yield"), especially senior citizens and retirees.[6] Both the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") have identified abusive broker-dealer sales practices as priorities in their examinations of broker-dealers[7] and have brought numerous enforcement actions against broker-dealers for sales practices that harm retail investors.[8] These enforcement actions frequently allege both failures of the firms' due diligence processes to assure the suitability of recommended investments and failures of the supervisory and compliance systems that are supposed to detect and deter impermissible sales practices. In this Essay, I explore whether Michael Jensen's integrity framework[9] could provide an effective alternative for improving broker-dealers' sales practices.

## I. IDENTIFYING THE PROBLEM

The relationship between the retail customer, on the one hand, and her registered representative and the broker-dealer with whom the registered representative is associated, on the other, is a paradigm of the agency relationship described by Professors Jensen and Meckling in their classic 1976 article.[10] They identify three types of costs inherent in the agency relationship: monitoring expenditures by the principal, bonding expenditures by the agent, and residual loss—or the divergence between the agent's decisions and those that maximize the principal's welfare.[11]

The ability of the retail customer (the principal) to monitor the performance of her registered representative, to assure that he is making decisions consistent with her investment objectives, is minimal. Because of investors' general low level of financial literacy and the complexity of investment products, it is difficult for most retail customers to assess the investment choices recommended by the registered representatives who service their accounts, with the

6. *See* Nathaniel Popper, *Complex Investments Prove Risky as Savers Chase Bigger Payoff*, N.Y. TIMES, Feb. 11, 2013, at A1 (quoting a Federal Reserve governor's concerns that "investors desperate for yield could be creating a bubble in widely available investments like junk bonds").

7. *See infra* notes 17–20 and accompanying text.

8. *See infra* Part II.

9. *See generally* Werner Erhard & Michael C. Jensen, *Putting Integrity into Finance: A Purely Positive Approach* (Harvard Bus. Sch. Negotiation, Orgs. & Mkts., Research Paper No. 12-074, 2013), *available at* http://ssrn.com/abstract=1985594 (asserting that inserting integrity into the theory and practice of finance could increase workability, value, and quality of life).

10. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976) (stating that a stockholder's relationship with the manager of a corporation "fit[s] the definition of a pure agency relationship").

11. *Id.* at 308.

possible exception of gross forms of fraud, like churning or unauthorized transactions, that customers might detect from a review of their account statements. Accordingly, whenever broker-dealers or their registered representatives recommend securities transactions or investment strategies to a retail customer, FINRA requires them to have a reasonable basis to believe that the recommendations are suitable for the customer based on the customer's investment profile.[12] This requires understanding both the customer's investment objectives and the key features of the recommended investment. Because of the complexity of many investments, however, the registered representatives who are selling the products may have an imperfect understanding of their key features.

Registered broker-dealers must incur significant bonding expenditures in recognition of customers' dependence on them. Broker-dealers are required to have in place an extensive system of supervisory procedures and controls to detect and deter violative conduct on the part of their registered representatives.[13] Compliance officers are responsible for ensuring compliance with numerous laws and regulations that regulate every aspect of the firm's business, including the sales practices of the registered representatives.[14] Because compliance systems are expensive and interfere with selling activities, however, some firms do not implement adequate systems, and even firms with adequate regulatory controls cannot be completely effective in preventing abuses.

Finally, conflicts of interest are "endemic" to the securities industry.[15] Broker-dealers typically sell products on a commission basis, so there is a direct connection between the product sold and the compensation received by the registered representative, which serves as an incentive to select more expensive products for the

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12. *2111. Suitability*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=14960&element_id=9859&highlight=2111#r14960 (last visited Sept. 28, 2013).

13. *3010. Supervision*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717 (last visited Sept. 28, 2013); *3012. Supervisory Control System*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3722 (last visited Sept. 28, 2013); *3130. Annual Certification of Compliance and Supervisory Processes*, FINRA, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286 (last visited Sept. 28, 2013).

14. For a description of this external "panopticon" approach, see James A. Fanto, Surveillant *and* Counselor: A Reorientation in Compliance for Financial Firms 19–23 (Sept. 5, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2321317.

15. NORMAN S. POSER & JAMES A. FANTO, 1 BROKER-DEALER LAW AND REGULATION § 1.08 (4th ed. 2007).

customer.[16] The losses suffered by retail customers because of the broker-dealer's fraud, bias, or incompetence are substantial and can have devastating effects on the financial well-being of retail customers and their families.

In recent years, regulators have expressed growing concern about aggressive sales pitches aimed at retail investors. The SEC has identified fraud in connection with sales practices aimed at retail investors as a priority in its examination of broker-dealers.[17] These practices include "unsuitable recommendations of higher yield products (e.g., unsuitable recommendations of municipal or corporate bonds), as well as improper supervision and due diligence processes regarding those recommendations or those products" and "conflicts of interest that are not appropriately mitigated, and are not clearly disclosed in an understandable and timely manner."[18] Similarly, in identifying its 2013 regulatory and examination priorities, FINRA "recognizes that retail investors have been challenged to find attractive returns within their risk tolerance" and has identified as a key concern "sales practice abuses, yield-chasing behaviors and the potential impact of any market correction, external stress event or market dislocation on market prices."[19] In particular, FINRA notes that,

> [g]iven the market conditions discussed above, we are particularly concerned about firms' and registered representatives' full understanding of complex or high-yield products, potential failures to adequately explain the risk-versus-return profile of certain products, as well as a disconnect between customer expectations and risk tolerances.[20]

## II. EXAMPLES OF ABUSIVE SALES PRACTICES

The broker-dealer's suitability obligation is paramount in retail investor protection.[21] Whenever the firm and its salespersons

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16. *But see* Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 45–46 (2005) (noting that some brokerage firms promoted fee-based accounts so that brokers are not financially motivated to give advice to generate sales commissions, but these accounts generated their own problems).

17. *OCIE National Exam Program: Examination Priorities for 2013*, U.S. SEC. & EXCHANGE COMMISSION 7 (Feb. 21, 2013), http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

18. *Id.*

19. *2013 Regulatory and Examination Priorities Letter*, FINRA 1 (Jan. 11, 2013), http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

20. *Id.*

21. *See 2111. Suitability*, FINRA, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1 (last visited Sept.

recommend a security or an investment strategy, they must perform due diligence to ascertain that the security or strategy is suitable for the customer.[22] To do this, the salesperson making the recommendation must be knowledgeable about the features of the security or strategy he is recommending and the financial circumstances and investment objectives of the customer in order to ascertain that they correspond.[23] This requires the firm to research the products it sells and to educate the salespersons about them. In addition, the broker-dealer must have in place adequate supervisory systems to guard against the registered representative's failures.[24] Unsuitable recommendations may be the product of fraud if, for example, the firm is knowingly peddling interests in a Ponzi scheme, in which case the customer will have a federal securities fraud claim.[25] Frequently, however, unsuitable recommendations may be the product of incompetence, carelessness, or biased judgment if, for example, the firm's due diligence about the product was inadequate or the registered representative did not understand the information about the product communicated to him by the research department. In those instances, the customer has no federal remedy.[26] Whatever the cause of the unsuitable recommendation, the resulting financial loss can be devastating to the investor.

To illustrate abusive sales practices, I briefly describe five types of investments sold by broker-dealers that have recently been the subject of regulatory action: auction rate securities ("ARSs"), private placements, non-traded real estate investment trusts ("REITs"), proprietary mutual funds, and variable annuities.

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28, 2013) ("The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.").

22. *See 2111. Suitability*, *supra* note 12 ("A member or associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.").

23. *See id.* (defining a customer's investment profile); *see also 2111. Suitability*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=14960&element_id=9859&highlight=2111#r14960 (last visited Sept. 28, 2013) (refer to Rule 2111(a)).

24. *See generally Additional Guidance on FINRA's New Suitability Rule*, FINRA (May 2012), http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf (addressing issues faced by the securities industry as firms revise compliance strategies).

25. *See* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012) (antifraud provision); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2012) (creating liability for any misstatement or omission of a material fact).

26. *See generally* Barbara Black, *Transforming Rhetoric into Reality: A Federal Remedy for Negligent Brokerage Advice*, 8 TRANSACTIONS: TENN. J. BUS. L. 101 (2006) (arguing that a fundamental deficiency in federal securities regulation is that customers have no federal remedy for incompetent or careless investment advice).

### A. Auction Rate Securities

ARSs are debt instruments or preferred shares whose interest rates or dividends are reset at frequent intervals through auctions that also provide liquidity for investors wishing to sell.[27] During the financial crisis many ARSsauctions failed, leaving investors with illiquid investments.[28] In 2008 and 2009, the SEC and other regulators entered into settlements with a number of securities firms involving charges that the firms' salespersons misrepresented that ARSs were safe, liquid investments that were the equivalent of cash or money market funds.[29] As a result of these misrepresentations, many retail investors invested funds they needed to have available on a short-term basis and lost the ability to access those funds when the credit markets froze.[30] Because these actions were settled without any findings or admissions, we do not know whether the SEC could have established that the misrepresentations constituted securities fraud. It is likely, however, that the agency could have established that the firms and their salespersons made negligent misrepresentations about the nature and risks of ARSs that misled customers and caused them serious injury.

### B. Private Placements

Securities that are offered for sale in private placements are not subject to the registration requirements of the Securities Act of 1933.[31] As a result, the Securities Act limits these offerings to sophisticated investors or others who "do not need the protections of the Act."[32] In addition, because these investments are illiquid and frequently involve high risk, purchasers bear the significant risk that they will not recoup their investment. Unfortunately, some broker-dealers have aggressively marketed private placements in speculative, even fraudulent, ventures to unsophisticated retail

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27. Linda Chatman Thomsen, *Testimony Concerning the SEC's Recent Actions with Respect to Auction Rate Securities*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 18, 2008), http://www.sec.gov/news/testimony/2008/ts091808lct.htm.

28. *Auction Rate Securities: What Happens When Auctions Fail*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P038207 (last updated Nov. 18, 2008).

29. The SEC posted the settlements and other documents on its website. *See Auction Rate Securities*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/investor/ars.htm (last modified July 5, 2011).

30. *See* Thomsen, *supra* note 27 (noting that investors could not access their funds for important short term needs after brokers had led them to believe their investments were safe and liquid).

31. *See* Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(2) (2012).

32. Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 119, 124–25 (1953); *see also* 17 C.F.R. § 230.506 (2012) (providing an exemption from registration).

investors.[33] In 2011, the Massachusetts Securities Division and Securities America ("SA"), a subsidiary of Ameriprise Financial, Inc., settled an administrative proceeding involving SA's actions as placement agent for the sale of Medical Capital promissory notes in private placements from 2003 to 2007.[34] As alleged in the complaint, SA aggressively marketed the notes to unsophisticated investors and represented that it had "reasonable grounds to believe" that the investments were suitable for them, without informing the investors of material risks that the firm's own due diligence analyst specifically requested the firm to disclose.[35] Medical Capital was almost certainly a Ponzi scheme,[36] and if the salespersons understood this, they committed securities fraud.[37] Yet apparently some of the SA brokers invested their personal funds in Medical Capital, suggesting that they did not understand the investments they were recommending.[38] Perhaps for this reason, the consent order charges the firm with "unethical or dishonest conduct or practices"[39] and not with fraud.

As another example, in 2011, FINRA sanctioned ten firms and seventeen individuals for selling interests in private placements without having a reasonable basis for recommending the investments.[40] Specifically, FINRA found that

> the broker-dealers did not have adequate supervisory systems in place to identify and understand the inherent risks of these offerings and, as a result, many of the firms failed to conduct adequate due diligence of these offerings. In addition, some of the firms did not have reasonable grounds to believe that the

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33. *See, e.g.*, Jennifer J. Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993 (2012) (describing sales of promissory notes at Medical Capital).

34. Consent Order at 2, Securities America, No. 2009-0085 (Mass. Sec. Div. May 23, 2011), *available at* http://www.sec.state.ma.us/sct/archived/sctsa/sa_order.pdf.

35. Administrative Complaint at 3–4, Securities America, No. 2009-0085 (Mass. Sec. Div. Jan. 26, 2010), *available at* http://www.sec.state.ma.us/sct/archived/sctsa/sa_complaint.pdf.

36. Johnson, *supra* note 33, at 999.

37. *See* 15 U.S.C. § 78j(b) (2012) (stating grounds for securities fraud violations); 17 C.F.R. § 240.10b–5 (2012) (stating grounds for securities fraud violations).

38. Johnson, *supra* note 33, at 1007.

39. Consent Order, *supra* note 34, at 18.

40. *FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation*, FINRA (Nov. 29, 2011), http://www.finra.org/newsroom/newsreleases/2011/p125193 [hereinafter *FINRA Sanctions Eight Firms and 10 Individuals*]; *FINRA Sanctions Two Firms and Seven Individuals for Selling Private Placements Without Conducting a Reasonable Investigation*, FINRA (Apr. 7, 2011), http://www.finra.org/Newsroom/NewsReleases/2011/P123441.

private placements were suitable for any of their customers. Additionally, the sanctioned principals did not have reasonable grounds to allow the firms' registered representatives to continue selling the offerings, despite the numerous "red flags" that existed regarding the private placements.[41]

### C. *Non-traded Real Estate Investment Trusts*

Non-exchange traded real estate investment trusts, or non-traded REITs, pool the capital of investors to purchase a portfolio of income-producing real estate.[42] Because REITs must distribute at least ninety percent of their taxable income to their investors, they are attractive to investors who seek periodic distributions.[43] Frequently, however, the distributions are financed by borrowings or are even a return of the investors' principal.[44] Non-traded REITs are generally illiquid, and since many REITs are offered as private placements, they present the same risks as described above. The fees charged to the customers are high.[45]

Both FINRA and State Attorneys General have brought enforcement actions against broker-dealers for abusive practices in the sale of non-traded REITs to unsophisticated investors. For example, in October 2012, FINRA sanctioned David Lerner Associates, its founder and CEO, and its head trader for targeting unsophisticated and elderly investors in sales of a non-traded REIT.[46] The charges included excessive markups, inadequate due diligence in determining the suitability of the investments, and misleading marketing materials.[47] In announcing the settlement, FINRA's Chief of Enforcement cautioned that "[f]irms must conduct a thorough suitability analysis before selling products, and make accurate disclosure of risks and features at the point of sale, especially with alternative investments such as non-traded REITs."[48]

Similarly, the Massachusetts Securities Division recently settled charges with LPL Financial LLC involving its sales of non-

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41. *FINRA Sanctions Eight Firms and 10 Individuals*, *supra* note 40.

42. *Public Non-Traded REITs—Perform a Careful Review Before Investing*, FINRA, http://www.finra.org/investors/protectyourself/investoralerts/reits/p124232 (last updated Aug. 15, 2012) [hereinafter *Public not Traded REITs*].

43. Popper, *supra* note 6.

44. *Public Non-Traded REITs*, *supra* note 42.

45. *Id.*

46. *FINRA Sanctions David Lerner Associates $14 Million for Unfair Practices in Sale of Apple REIT Ten and for Charging Excessive Markups on Municipal Bonds and CMOs*, FINRA (Oct. 22, 2012), http://www.finra.org/newsroom/newsreleases/2012/p191729.

47. *Id.*

48. *Id.*

traded REITs.[49] According to the state, LPL brokers regularly sold non-traded REITS to customers who did not meet the net worth and annual income suitability standards set forth in the prospectuses or in amounts that exceeded the state's ten percent concentration limit for non-traded REITs.[50] Supervisors of salespersons failed to follow the due diligence and oversight procedures set forth in the firm's own compliance manual and written supervisory procedures.[51]

### D. *Proprietary Mutual Funds*

Some brokerage firms have affiliates that sponsor their own mutual funds, known as proprietary mutual funds, which are marketed to retail investors. These funds generally have higher costs than comparable funds.[52] The promotion by brokerage firms of their proprietary funds presents an obvious conflict of interest.[53] In 2012, for example, former brokers at JPMorgan Chase asserted that they were encouraged to promote proprietary funds even when competitors had better-performing or cheaper options.[54] FINRA prohibits sales contests that favor proprietary funds because these "types of sales contests . . . increase[] the potential for investors to be steered into investments that are less suitable than some alternatives."[55] Investment advisers may also succumb to the

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49. Consent Order at 1, LPL Financial, LLC – Non Traded REITS, E-2012-0036 (Mass. Sec. Div. Feb. 6, 2013), *available at* http://www.sec.state.ma.us/sct/current/sctlpl/LPL%202012-0036%20Consent%20Order.pdf. LPL Financial, the fourth-largest brokerage firm in the U.S., has come under increasing regulatory scrutiny about its sales practices as it has expanded its business. Nathaniel Popper, *Fast-Growing Brokerage Firm Often Tangles with Regulators*, N.Y. TIMES, Mar. 22, 2013, at A1.

50. Consent Order, *supra* note 49, at 4.

51. *Id.* at 6, 23–25.

52. Ken Hawkins, *Mutual Funds: Brand Names vs. House Brands*, INVESTOPEDIA (Oct. 24, 2010), http://www.investopedia.com/articles/mutualfund/08/proprietary-mutual-funds.asp; Daniel Solin, *Lessons from Proprietary Mutual Fund Returns*, U.S. NEWS & WORLD REP. (May 3, 2012), http://money.usnews.com/money/blogs/On-Retirement/2012/05/03/lessons-from-proprietary-mutual-fund-returns.

53. *See Mutual Funds: Who's Looking Out for Investors?: Hearing on H.R. 2420 Before the Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 76–114, 254–63, 271–80 (2003) (statement of Mary L. Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, NASD) (describing common abuses in mutual fund sales).

54. Susanne Craig & Jessica Silver-Greenberg, *Conflict Seen in Sales Tactic at JPMorgan: Bank Is Said to Favor Its Own Products*, N.Y. TIMES, July 3, 2012, at A1 (explaining that ex-brokers said JPMorgan favored Bank's funds over others); Susanne Craig & Jessica Silver-Greenberg, *Selling the Home Brand: A Look Inside an Elite JPMorgan Unit*, N.Y. TIMES, Mar. 3, 2013, at 1 [hereinafter *Selling the Home Brand*].

55. *NASD Fines Morgan Stanley $2 Million for Prohibited Mutual Fund Sales Contests*, FINRA (Sept. 16, 2003), http://www.finra.org/Newsroom/NewsReleases/2003/P002879; *see also NASD Fines Long Island Brokerage Firm David Lerner Assoc. $100,000 for Prohibited Mutual Fund and Variable Product*

temptation to favor proprietary mutual funds. In 2008, for example, the SEC brought a disciplinary proceeding against an investment adviser that disregarded its stated guidelines for selecting mutual funds for clients in a mutual fund wrap fee program and instead focused on subjective criteria that favored its proprietary funds.[56]

In addition to the problem of proprietary funds, calculation of the costs of investing in certain mutual funds can be difficult because of various share classes with different costs, breakpoints, and loads.[57] Many retail investors may not understand the importance of costs and their effect on returns or may be confused by the different options,[58] and their brokers may not adequately explain the differences or may not even select the suitable options for their customers. FINRA has brought a number of enforcement actions against brokerage firms for suitability violations regarding sales of mutual funds with different classes. For example, it found that over an eighteen-month period, Merrill Lynch, Wells Fargo, and Linsco "recommended and sold Class B and/or Class C share mutual funds to their customers without considering or adequately disclosing, on a consistent basis, that an equal investment in Class A shares would generally have been more advantageous to those customers in view of all relevant considerations."[59] The firms were fined a total of $19.4 million, an amount that approximated the

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*Sales Contests*, FINRA (Apr. 12, 2004), http://www.finra.org/Newsroom/NewsReleases/2004/P002837.

56. Banc of Am. Inv. Servs., Inc., Securities Act Release No. 8913, Exchange Act Release No. 57748, Investment Company Act Release No. 28261, 93 SEC Docket 230, at 1–3 (May 1, 2008), *available at* http://sec.gov/litigation/admin/2008/33-8913.pdf.

57. *See Mutual Fund Classes*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/mfclass.htm (last modified Jan. 15, 2013) (explaining differences between different classes of mutual fund shares). FINRA's website has several Investor Alerts on mutual fund classes of shares and breakpoints. *See Mutual Funds & ETFs*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/ (last visited June 9, 2013). The website also has a Fund Analyzer that estimates the value of funds and the impact of fees and expenses on investments. *See Fund Analyzer*, FINRA, http://apps.finra.org/fundanalyzer/1/fa.aspx (last visited June 9, 2013).

58. *See Calculating Mutual Fund Fees and Expenses*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm (last modified Aug. 10, 2010).

59. *NASD Fines Merrill Lynch, Wells Fargo and Linsco $19.4 Million For Improper Sales of Class B and C Mutual Fund Shares*, FINRA (Dec. 19, 2005), http://www.finra.org/Newsroom/NewsReleases/2005/p015753; *accord NASD Fines Citigroup Global Markets, American Express and Chase Investment Services More Than $21 Million for Improper Sales of Class B and C Shares of Mutual Funds*, FINRA (Mar. 23, 2005), http://www.finra.org/Newsroom/NewsReleases/2005/p013648.

additional commissions received by the firms for these unsuitable sales.[60]

*E. Variable Annuities*

Variable annuities are complex products that combine aspects of securities and insurance.[61] They resemble mutual funds but typically offer three features not associated with mutual funds: tax-deferred treatment of earnings, a death benefit, and annuity payout options that can provide guaranteed income for life.[62] Some broker-dealers aggressively market variable annuities to senior investors, frequently by playing on their fears that they will run out of income in their retirement.[63] Because of these products' complexity and the variety of available features, because of their limitations, and because of their high costs, a registered representative must exercise care to ascertain that a particular product is suitable for his customer.[64] Unfortunately, many representatives do not exercise sufficient due diligence and, in fact, may not themselves understand the product they are selling. In addition, exchanging variable annuities for the purpose of generating commissions is another common abusive sales practice.[65]

FINRA Rule 2330, adopted in 2007, imposes enhanced compliance and supervisory systems on firms with respect to sales and exchanges of deferred variable annuities in order to provide additional protections to investors.[66] The requirements include (1)

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60. *NASD Fines Merrill Lynch, Wells Fargo and Linsco $19.4 Million For Improper Sales of Class B and C Mutual Fund Shares*, *supra* note 59.

61. In general, a variable annuity is a contract between an investor and an insurance company in which the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). *07-53 SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions; Effective Date: May 5, 2008*, FINRA n.2, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3004 (last visited June 9, 2013).

62. *Variable Annuities: Beyond the Hard Sell*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p005976 (last updated Aug. 31, 2009).

63. *Id.*

64. *Id.* (recommending variable annuities that brokers must explain to customers including important facts such as liquidity issues, fees and market risk, and conducting suitability analysis).

65. *Should You Exchange Your Variable Annuity?*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/P006045 (last updated Mar. 2, 2006) (warning that a salesperson may recommend an exchange of variable annuities to generate additional business).

66. *Rule 2330. Members' Responsibilities Regarding Deferred Variable Annuities*, FINRA (2012), http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=14663&element_id=8824&highlight=2330#r14663 (last visited Sept. 28, 2013).

specific suitability obligations on purchases or exchanges of deferred variable annuities on the part of the registered representative; (2) review and approval by a principal of all transactions prior to transmitting the application to the insurance company; (3) heightened supervisory procedures, including surveillance procedures to determine if salespersons enter into inappropriate exchanges; and (4) specific training programs for registered representatives who sell, and principals who review, transactions in deferred variable annuities, including training on the material features of the products.[67]

Despite considerable regulatory attention to the problem, abuses continue. A 2009 FINRA settlement with Fifth Third Securities Inc. ("FTS") is typical.[68] FINRA found that FTS made 250 unsuitable sales and exchanges of variable annuities to 197 customers through 42 individual brokers in a three-year period.[69] Many of the brokers worked in bank branches and used the bank's lists of customers with maturing certificates of deposit.[70] Many of the customers were elderly or unsophisticated investors with conservative investment goals and a need for liquidity.[71] FINRA also found that FTS's supervisory systems and procedures were inadequate to prevent unsuitable transactions, despite the presence of numerous red flags.[72]

Certain similarities are present in these five examples. First, these are complicated products. Second, registered representatives sell these products on the basis of features that may not be fully explained to the customer, may not be fully understood by the registered representative, or may not in fact exist.[73] Third, the firms' compliance systems did not adequately deal with these prevalent abusive sales practices. Finally, the registered representatives and the firms make a lot of money selling these products. Consequently, it may come as no surprise that many retail customers have been harmed by unsuitable recommendations to purchase these products.

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67. *Id.* (establishing sales practice standards regarding recommended purchases and exchanges of deferred variable annuities).

68. *News Release, FINRA Fines Fifth Third Securities $1.75 Million for 250 Unsuitable Annuities Transactions*, FINRA (Apr. 14, 2009), http://www.finra.org/Newsroom/NewsReleases/2009/P118471.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. ARSs (liquidity and safety), REITs (periodic income distributions), promissory note (high yield), annuity ("guarantee" of retirement income, tax benefits), proprietary funds ("name brand").

## III. EXPLORING ANOTHER SOLUTION: PROFESSOR JENSEN'S INTEGRITY FRAMEWORK

Currently, the securities industry, regulators, and academics are engaged in a vigorous debate over the appropriate standard of conduct for regulating the sales practices of providers of investment advice to retail investors. The debate is usually framed as a choice between the fiduciary standard applicable to investment advisers registered under the Investment Advisers Act of 1940 and the suitability standard applicable to broker-dealers registered under the Securities Exchange Act of 1934, with investment advisers asserting that the fiduciary standard is more protective of investors.[74] Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to conduct a six-month study of the issue and authorized the agency to adopt, with certain critical limitations, a fiduciary standard for broker-dealers who provide advice to retail investors.[75] SEC staff released the required study in January 2011 and recommended establishing a uniform fiduciary standard "consistent with the standard that currently applies to investment advisers."[76] After the release of the study, it was expected that the SEC would release proposed rules for public comment. *Business Roundtable v. Securities and Exchange Commission*,[77] however, shook the SEC's confidence in its ability to adopt rules that would survive judicial scrutiny. The agency took no further action until March 2013, when it released a request for information on the duties of broker-dealers and investment advisers, "in particular quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers."[78]

Much of the contentious debate over the fiduciary duty standard has focused on whether the investment adviser's obligation to act in

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74. *See* Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 64–66 (2010) (describing the legal standards).

75. *Id.* at 70–72 (describing § 913 and the limits imposed on the SEC's authority).

76. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, at ii (2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf. Two SEC Commissioners objected to the release of the study as premature because of the lack of empirical evidence of harm to retail investors. *See* Kathleen L. Casey & Troy A. Paredes, *Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers and Broker-Dealers*, U.S. SEC. & EXCHANGE COMMISSION (Jan. 21, 2011), http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

77. 647 F.3d 1144, 1148–49 (D.C. Cir. 2011) (vacating proxy access rule because of insufficient consideration of economic factors).

78. Duties of Brokers, Dealers, and Investment Advisers, 78 Fed. Reg. 14,848, 14,848 (Mar. 7, 2013).

the best interests of the client is a higher standard than the broker-dealer's suitability standard. Despite the vociferous debate between the broker-dealer and investment adviser communities over this issue, there is, as I have previously demonstrated, scant legal support for the supposed distinction between the two standards.[79] Moreover, adoption of a so-called uniform fiduciary standard is unlikely to improve the quality of investment advice and advance retail investor protection, both because of significant limitations on any standard imposed by Congress[80] and because investors have no remedies under the federal securities laws against their investment advice providers (either investment advisers or broker-dealers) in the absence of fraud.[81] I have argued previously for adoption of a standard of conduct based on professionalism and creation of a federal negligence remedy, an approach that could provide more meaningful protection for retail customers.[82] In this Essay I explore whether Michael Jensen's integrity framework, which focuses on improving business performance, offers another approach for improving broker-dealers' sales practices.

Jensen describes integrity as the state of being whole, complete, unbroken, unimpaired, sound, in perfect condition.[83] His emphasis is on integrity as a necessary condition for maximum performance: "As the *integrity* (the state of being whole and complete, etc.) of an object, system, person, or other human entity or practice declines, *workability* declines, and as workability declines the opportunity for performance declines."[84] Jensen presents his integrity model as independent of any normative value judgments,[85] although for many of us it is difficult to dissociate "whole and complete" from a value judgment. Jensen asserts that his model is empirically testable: "'Long run value maximization requires integrity' is a positive proposition that is testable and refutable."[86]

The attractiveness of Jensen's model in the context of broker-dealers' sales practices is that it resonates with the industry's emphasis on trust and its importance as a business strategy.

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79. Black, *supra* note 74, at 85–87.

80. *Id.* at 71–72.

81. Black, *supra* note 26, at 104–06. Investors have limited remedies under state law. *Id.* at 107–17.

82. *See generally* Black, *supra* note 74; Black, *supra* note 26.

83. Erhard & Jensen, *supra* note 9, at 12 (explaining that this definition of integrity does not include a normative content, i.e., not "the normative concepts of 'being of sound moral principle; uprightness, honesty, and sincerity'").

84. *Id.* (emphasis added).

85. Werner H. Erhard et al., *Integrity: A Positive Model that Incorporates the Normative Phenomena of Morality, Ethics, and Legality* 7 (Harvard Bus. Sch. Negotiation, Orgs. & Mkts., Research Paper No. 06-11, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920625.

86. Erhard & Jensen, *supra* note 9, at 13 (describing integrity as a "necessary but not sufficient condition for long-run value maximization").

FINRA's core principle is that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[87] FINRA generally describes this as an ethical principle for the protection of investors,[88] but broker-dealers certainly understand the importance of trust in soliciting business and use it in their promotional materials. Television commercials portray broker-dealers as knowledgeable trusted family advisors working tirelessly to achieve their customers' investment goals. The website of one brokerage firm prominently displays a customer's testimonial: "I not only like you, but I trust you."[89] Another emphasizes that "[y]our Financial Advisor becomes your personal advocate—gaining an understanding of your needs, advising you and helping you select the right capabilities from our company to meet them."[90] Surely, then, these businesses would recognize Jensen's essential premise: that out-of-integrity businesses cannot, in the long term, fare well.

Ponzi schemes are egregious examples of fraud and, using Jensen's terminology, can be described as the most "out-of-integrity" system in the securities industry: while early participants receive "profits" from the contributions of later participants, the enterprise is doomed to failure because it is a broken business model.[91] I suggest that out-of-integrity practices can extend to the sales practices that I described in Part II where the conduct may not rise to the level of intentional wrong. Because securities professionals owe their customers a duty to understand the products they are selling, to have a reasonable basis for believing that their recommendations are suitable for their customers, and to explain them accurately to investors, their failures to do so constitute what Jensen describes as out-of-integrity conduct.

Jensen describes integrity as an "ontological law of human nature,"[92] a "necessary but not sufficient condition for long-run

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87. *2010. Standards of Commercial Honor and Principles of Trade*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=6905&element_id=5504&highlight=2010#r6905 (last visited Sept. 28, 2013). Conduct that violates another specific rule, such as FINRA Rule 2111, will also violate Rule 2010.

88. *Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc.*, FINRA, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589 (last visited June 11, 2013).

89. *Reviews and Awards*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/why_choose_schwab/awards_and_offers (last visited June 11, 2013) (recounting the experience of a Charles Schwab customer on meeting her Schwab Financial Consultant).

90. *Our Approach*, MORGAN STANLEY, http://www2.morganstanley.com/wealth/ourapproach/ (last visited June 11, 2013).

91. *What is a Ponzi Scheme?*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/spotlight/enf-actions-ponzi.shtml (last modified Apr. 2, 2013).

92. Erhard et al., *supra* note 85, at 19.

value maximization,"[93] and focuses on integrity as a factor of production:[94] as integrity declines, the opportunity for performance declines.[95] In contrast, whether described as FINRA's "just and equitable principles of trade,"[96] the investment adviser's fiduciary duty,[97] the broker-dealer's suitability requirement,[98] or my professionalism standard,[99] the conduct standards applicable to retail investment advice providers establish legal standards for judging conduct that, in addition, have an ethical component that Jensen disavows. Accordingly, because of their different purposes, one needs to be cautious in making comparisons. Nevertheless, because the brokerage industry is built upon trust and confidence and firms advertise on that basis,[100] Jensen's proposition that "long run value maximization requires integrity"[101] should resonate with the industry.

Jensen's bedrock principle for operating with integrity is "honoring your word," which he defines as either keeping your word, or, as soon as you know that you will not, owning up and cleaning up the mess you have caused.[102] Jensen repeatedly tells us that integrity requires doing cost-benefit analyses before giving your word[103] and not later, when deciding whether to keep your word.[104] In the five instances described above, it seems clear that, under Jensen's model, retail investment providers and their firms engage in conduct that is "out-of-integrity." Acting with integrity requires that when the registered representative recommends an investment or strategy to a customer, he is making a representation that the necessary due diligence has been performed to determine the suitability of the investment for the customer; he is not simply making a sales pitch. The firm, in turn, is responsible for the conduct of its sales force and must have measures in place to assure

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93. Erhard & Jensen, *supra* note 9, at 13.
94. Erhard et al., *supra* note 85, at 85–86.
95. *Id.* at 30.
96. *See supra* note 87 and accompanying text.
97. *See supra* notes 74–76 and accompanying text.
98. *See supra* notes 21–24 and accompanying text.
99. *See supra* note 82 and accompanying text.
100. *See supra* notes 89–90 and accompanying text.
101. Erhard & Jensen, *supra* note 9, at 13.
102. *Id.* at 15–16 (emphasis omitted).
103. *Id.* at 20; *see also* Videotape: Michael Jensen: Beyond Agency Theory (Wake Forest University School of Business 2013), *available at* http://capitalism.wfu.edu/videos/jensen-michael/ ("Sincerity is vastly overrated.").
104. Erhard & Jensen, *supra* note 9, at 20–21. As someone who taught contract law for many years, I find the contrast with the prevailing contractual theory (based on economic theory) of "the efficient breach" startling. *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS § 12.3, at 763 (3d ed. 1999) (explaining that economic theory encourages breaking promises when it is economically efficient).

that they are acting with integrity. Acting with integrity also requires a registered representative to explain to the customer the salient features of the investment, including the costs, when recommending a complicated product.[105] Acting with integrity also means that if the sales representative or the firm subsequently discovers that the recommendation is not in fact suitable, one of them will take steps to correct the situation without regulatory compulsion to do so. The previously described sales practices of the brokerage firms are examples of registered representatives and their firms acting out-of-integrity.

It should also be clear that a product or strategy that results in losses is not, for that reason, out-of-integrity. Investing entails risks and disappointments, and providers of investment advice are not guarantors of success so long as they adequately explain the investment product or strategy, particularly its risks, to their customers.

Since retail investment advice providers sell their products and services on the basis of competence and care and invite customers to trust them, the industry apparently understands the importance of integrity. Why then are there so many instances of broker-dealers acting out-of-integrity?

Jensen tells us that people and organizations, while committed to performance, systemically sacrifice integrity in the name of increasing performance, thereby reducing performance.[106] He addresses the contradiction through the "integrity-performance" paradox: if operating with integrity is so productive, why do people systemically sacrifice their integrity and suffer the consequences?[107] He answers his question by positing that a "veil of invisibility" obscures the effects of integrity on performance.[108] In other words, short-term profits and, in the brokerage industry, the need to close the sale to get the commission are paramount.

Can the culture of honoring your word be instilled in the brokerage industry, which, after all, is a business where salesmanship is rewarded? Jensen's principal example of a business performing with integrity (apart from his own experience at SSRN, about which he provides little detail) is the oft-told story of Johnson

105. He would not have to provide an explanation if the agreement between the customer and the firm was that the sales representative had discretion to make decisions on behalf of the customer, in which case the representative would be held to a standard of undivided loyalty.

106. Erhard & Jensen, *supra* note 9, at 14, 16.

107. *Id.* at 16–17.

108. *Id.* at 17–21. As specific examples of out-of-integrity conduct, Erhard and Jensen discuss sales by Goldman Sachs to its clients of Abacus securities without disclosing that the securities were selected by a trader who planned to short them, *id.* at 25–27, and the practice of some mutual funds in allowing favored clients to market-time transactions in violation of the fund rules, *id.* at 28.

& Johnson's decision to remove Tylenol from stores nationwide.[109] This was a crisis situation, where Johnson & Johnson admirably rose to the occasion. To my mind, Jensen provides less guidance on dealing with the more mundane decisions. Can an environment be created where a broker will devote the time to understanding and explaining the intricacies of comparable variable annuities to a customer, even though he is confident that the customer will rely on whatever he recommends, whether she understands it or not, and the broker will receive a sizable fee only if he sells the product? Can an ethos be created where a broker will not recommend a private placement to a customer because after doing the research he concludes that the product is too risky for the investor—even though he would receive a sizable commission for selling the product? Or take the case of a proprietary mutual fund, whose portfolio may be suitable for a customer, but the salesperson's research finds comparable funds with lower costs, and he cannot come up with an explanation to justify the proprietary fund's higher costs? Perhaps the day will come when the brokerage industry will stop offering certain products because the sales practices for selling them are out-of-integrity, but that day has not yet come.[110]

Jensen advocates creation of an environment where the sales representatives understand the importance of keeping their word, an where expectation is created that they will do so, and where they are called to account when they fail to do so through training sessions and reinforcement of the message.[111] He makes it clear that it is constant work: "integrity is a mountain with no top."[112]

The promise of the integrity model is that, even if only modestly successful, it could help to improve the quality of investment advice provided to retail investors in a way that regulatory compliance alone cannot achieve. The approach of the regulators is to require supervisory and compliance systems to look over the shoulders of the sales representatives in order to ascertain that they have performed the requisite due diligence; the regulators, in turn, examine the firms to assess the adequacy of the compliance controls. Disciplinary proceedings describe numerous instances where

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109. Erhard et al., *supra* note 85, at 98–99.

110. It is reported that some firms are no longer marketing proprietary mutual funds. *See Selling the Home Brand*, *supra* note 54 (noting that JPMorgan Chase pressured brokers to sell proprietary funds even when competitors had better-performing and cheaper products).

111. Erhard & Jensen, *supra* note 9, at 16, 21 (explaining that integrity is a process with no end, and when an organization or other human entity violates integrity, "integrity requires it to make this clear to all others and to willingly bear the costs of not playing by one or more of the rules of the game").

112. *Id.* at 18 (internal citations omitted).

compliance is shortchanged in the face of the business necessity of making the sales.[113]

Professor James Fanto has recently advocated the reorientation of compliance in financial firms. He describes the current approach to compliance as an external approach based on numerous compliance policies and procedures, where the compliance officer is regarded as a stand-in for the regulator, and salespersons view compliance as a necessary evil that is distinct from the business function.[114] He proposes, as an alternative, an internal perspective in which decisions would be shaped by the policies underlying the securities laws (presumably investor protection in the case of broker-dealers' sales practices) and "principles of the trade, " and compliance officers would serve to identify those policies in decision making.[115] In this way, professional and ethical standards become part of employee decision making.[116] Fanto's approach obviously differs from Jensen's with the former's emphasis on ethical principles, but it has similarities, particularly with its linkage of business decision making and integrity. Both are attempting to add content to the frequently used phrase "culture of compliance."[117]

It is unlikely, however, that implementing an integrity model will replace the necessity for enforcing regulatory standards. Jensen appears to recognize the importance of enforcement: "[L]eft to their own devices, individuals, groups and organizations behave as though they systematically underestimate the impact of integrity on performance."[118] Moreover, keeping promises is more important when people believe the promises have legal consequences.[119]

The formidable obstacle to curbing broker-dealers' abusive sales practices is greed. The securities industry is a hyper-competitive business, where generating profits for the firm is emphasized and richly rewarded, while doing research and understanding your customers' objectives may not be. The suitability obligation, in particular, may become nothing more than an obligation imposed by regulatory compliance and be viewed as nothing more meaningful than filling out the suitability checklist. Time is money, and the pressure is to close the sale and move to the next one, however

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113. *Id.* at 27; *see also id.* at 44–52 (describing various disciplinary proceedings brought against multiple companies).

114. Fanto, *supra* note 14, at 21–22.

115. *Id.* at 27–31.

116. Similarly, Professor Tamar Frankel has written about the importance of codes of ethics at investment advisory firms in deterring insider trading. Videotape: Symposium: The Growth and Importance of Compliance in Financial Firms (Brooklyn Law School 2013), *available at* http://www.brooklaw.edu /newsandevents/mediagallery/Videos/symposia/02-08-13/1.aspx?.

117. Fanto acknowledges that otherwise, the phrase seems devoid of content. Fanto, *supra* note 14, at 28.

118. Erhard et al., *supra* note 85, at 70.

119. *Id.* at 76.

haphazard the research. Because of the nature of the business, Professor Langevoort argues that "selection bias . . . favors those able to rationalize the careful pursuit of self-interest and other competitively adaptive traits, masking the bad odor that comes from unabashed selfishness."[120]

More fundamentally, the securities industry may be an industry that is out-of-integrity, what Jensen would call an out-of-integrity design.[121] Many express skepticism about whether the industry sells skill and expertise or simply snake oil. Professor Daniel Kahnemann, for example, asks: "[M]y questions about the stock market have hardened into a larger puzzle: a major industry appears to be built largely on an illusion of skill."[122]

## CONCLUSION

I would like to circle back to where I started. Large numbers of U.S. workers have reached, or are approaching, retirement and must provide for themselves in their retirement years. Many depend on their broker-dealers to assist them through these difficult times. Broker-dealers owe it to these workers to treat them with integrity. Perhaps it is time for managers of financial services firms to adopt training sessions on integrity for their sales force. It is worth a try.

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120. Donald C. Langevoort, *Psychological Perspectives on the Fiduciary Business*, 91 B.U. L. REV. 995, 1003 (2011) (discussing the mix of personality traits and incentives that produce successful salesmanship in the securities business).

121. Erhard & Jensen, *supra* note 9, at 14.

122. DANIEL KAHNEMAN, THINKING, FAST AND SLOW 212 (2011) (emphasis omitted).