Regulatory Convergence and Organizational Culture

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Regulatory Convergence and Organizational Culture

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I. INTRODUCTION

Organizational culture—a system of shared assumptions that define an organization—is deeply embedded in most firms. Culture affects everything, or nearly everything, that happens in an organization, including important decisions—such as who is promoted, hired, and fired—how people act around one another, and even what people wear. Not surprisingly, culture also can determine a firm’s flexibility and its ability to undergo change.

Financial services regulators are moving along a path toward regulatory convergence or regulatory harmonization, which will require certain financial services firms to transform. Yet regulators

often do not address whether culture might present a barrier to their harmonization goals. In this Article, I maintain that culture is an underappreciated challenge to regulatory harmonization and that regulators are more likely to succeed if they recognize culture as a barrier to change and consider how they can overcome cultural differences.

Regulatory convergence can be approached from a number of perspectives. The government, for example, may wish to standardize certain requirements, such as privacy or anti-money-laundering rules, across a variety of service providers. Or regulators may wish to standardize consumer credit laws across a variety of lenders. I shall discuss convergence in the area of investment advice within the larger context of the debate over whether to harmonize the duties and obligations imposed on broker-dealers and investment advisers. Brokers and advisers both provide advice to retail investors about securities, but they are regulated differently. The question for regulators is whether to harmonize the duties imposed on brokers and advisers when giving advice to retail investors.

Brokers and advisers have a different history and a different culture. These differences emerge in the divergent regulations governing brokers and advisers. Cultural differences help explain resistance to harmonization and help inform how one might craft more effective regulation. However, cultural differences cannot be erased by legislative or regulatory fiat in an attempt to harmonize standards. Thus, any attempt to harmonize the duties and obligations imposed on brokers and advisers is more likely to succeed if culture is taken into account. I shall focus on the attempt to harmonize the regulation of broker-dealers and investment advisers in particular, but the tensions that present themselves in this context likely exist in other areas where harmonization is desired.1

In addition, apart from the context of regulatory harmonization, firm culture is garnering attention among financial regulators. In February 2016, the Financial Industry Regulatory Authority (FINRA) identified firm culture as a new area of focus. According to FINRA, it will now review “how firms establish, communicate and implement

1. A primary obstacle to harmonizing accounting standards, for example, is the different social, legal, and economic environments that exist across borders. See José A. Lainez & Mar Gasca, Obstacles to the Harmonisation Process in the European Union: The Influence of Culture, 3 Int'l J. Acct. Auditing & Performance Evaluation 68, 68-69 (2006) (arguing that cultural factors are a significant obstacle to accounting harmonization in the European Union).
cultural values” and the effect of culture on business conduct. FINRA stated that it will formalize its assessment of culture to understand how culture affects compliance and risk management. FINRA will assess five aspects of a firm’s culture, focusing on control functions, toleration of breaches, identification of compliance events, whether supervisors serve as cultural role models, and development of subcultures that are inconsistent with overall culture. The topic of organizational culture, therefore, is more timely than ever.

I shall proceed in eight short Parts. Part II briefly reviews the debate over broker-dealer and investment adviser regulatory harmonization. Part III discusses the functions of brokers and advisers as a prelude to an examination of culture. Part IV addresses the importance of organizational culture. Part V discusses key differences in the culture of brokerage and advisory firms. Part VI addresses the effect these differences can have on harmonization—whether culture is a barrier to harmonization. Part VII discusses the effect that harmonization can have on culture—whether changes in the law can result in changes in culture. Part VIII provides a short conclusion.

II. REGULATORY HARMONIZATION FOR BROKER-DEALERS AND INVESTMENT ADVISERS

Since 1999, regulators have debated whether and how to harmonize the regulation of broker-dealers and investment advisers. This debate has historical roots dating to the 1930s and the birth of federal securities laws. Both brokers and advisers provide investment advice to customers and clients, but they are regulated under different statutory schemes. Moreover, brokers nowadays market themselves as advisers, using titles such as “financial adviser” and “financial
Although brokers and advisers both hold themselves out as providing advisory services and actually provide advice, their regulation differs in important respects. Brokers are regulated under the Securities Exchange Act of 1934 (Exchange Act) and are subject to a suitability standard. Advisers are regulated under the Investment Advisers Act of 1940 (Advisers Act) and are subject to a fiduciary standard. The fiduciary obligation, a "best interest" rule, calls for a higher standard of conduct than determining whether an investment is "suitable" for a given investor. Elsewhere I have chronicled how and why these two sets of professionals perform similar functions, but are regulated differently.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave the United States Securities and Exchange Commission (SEC or Commission) authority to adopt new rules that would place a fiduciary duty on brokers that give advice to retail customers. Dodd-Frank does not require the SEC to adopt new rules; it only requires that the SEC prepare a study of brokers and advisers. The SEC staff completed the study and recommended that the Commission adopt a uniform, fiduciary-duty standard that would govern both brokers and advisers who give advice to retail investors.

Although the Commission staff completed the study in 2011, the SEC continues to grapple with whether to harmonize the duties imposed on brokers and advisers. In 2013, the SEC issued a request for data and

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11. See Arthur B. Laby, Implementing Regulatory Harmonization at the SEC, 30 REV. BANKING & FIN. L. 189 (2010-2011); Laby, supra note 6; Laby, supra note 7.


14. See id.


other information relating to the costs and benefits of changing the standard of conduct for broker-dealers providing advice. More recently, the United States Department of Labor (DOL) adopted rules that place a fiduciary duty on brokers advising on retirement accounts, such as pension plans, IRAs, and 401(k) accounts. In response to these initiatives, certain members of the securities industry have opposed harmonization and waged a lobbying campaign to halt regulatory action. Do cultural differences between brokerage and advisory firms help explain the opposition?

III. THE FUNCTION OF BROKER-DEALERS AND INVESTMENT ADVISERS

Before exploring culture in brokerage and advisory firms, let us first understand brokers’ and advisers’ functions. Although certain functions are similar, such as providing investment advice to clients, important differences remain.

A. Broker-Dealers

Stockbrokers have existed for centuries in the United States, the United Kingdom, and elsewhere. In the late 1700s, the large quantity of securities in circulation in major commercial hubs gave rise to a group of people trying to make a living as brokers—or “jobbers,” as they were once known—who usually operated out of local coffee houses. Early brokers and jobbers were largely speculators: they...
bought and sold securities, as well as land, commodities, and currency, for profit. 21

By the time the federal securities laws were passed in the 1930s in the United States, regulators differentiated between brokers and dealers. 22 A broker was engaged by a customer to negotiate the purchase or sale of securities from or to a third party. 23 By contrast, a securities dealer bought securities for, or sold securities from, its own account, transacting as a principal with a customer. 24 The activity of a securities dealer was similar to the activity of a dealer, or jobber, in merchandise. 25

Today, broker-dealers engage in myriad functions. They execute trades (acting as agent or principal), sell securities as part of the securities underwriting process, make loans to securities customers who wish to trade on margin, maintain custody of securities and cash, arrange for delivery of securities certificates (when certificates still exist), and provide advice, but only when the advice is considered "solely incidental" to brokerage. 26 Note that when a broker executes a trade for a customer, the customer does not know, unless she looks carefully at the trade confirmation, whether the broker is matching the customer with another buyer or seller (acting as agent) or is transacting with the customer from the broker's own account (acting as dealer). 27

When acting as a broker, a broker-dealer is typically paid on commission. 28 When acting as a dealer, it receives a commission equivalent, which is a markup or markdown on securities traded out of the broker-dealer's own account. 29 A commission or commission equivalent is a one-time charge—a fee assessed on the particular transaction—a fee assessed on the particular transaction—akin to punching a ticket or paying a toll. 30 In recent years, many brokers have migrated toward charging an asset-based fee,

21. Id. at 28.
23. Id.
24. Id.
25. See id.
29. Id. ("Generally, the compensation in a broker-dealer relationship is transaction-based and is earned through commissions, mark-ups, mark-downs, sales loads or similar fees on specific transactions, where advice is provided that is solely incidental to the transaction.").
30. Laby, supra note 6, at 417; Staff of the SEC, supra note 15, at 10-11.
more typical of investment-adviser compensation. Although this trend is significant, commission-based compensation continues to dominate in the broker-dealer world.

B. Investment Advisers

Compared to broker-dealers, investment advisers are a relatively new group of securities professionals. Before World War II, investment advice was usually provided by lawyers, banks, trust companies, and, sometimes, by broker-dealers. After the Great Crash, the demand for advisory services that were supervisory in nature increased, and a dedicated profession of investment counsel developed. A large number of the advisers came from bank trust departments. These advisers generally agreed to discharge their duties on an ongoing basis. They agreed to advise clients “at stated intervals” and keep clients “constantly advised” of changes in their accounts. Often, advisory relationships were meant to be long-term relationships. The cultural differences between brokers and advisers are rooted in this early history. The number of advisers grew during the 1930s. In addition, many broker-dealers migrated to become investment advisers and attempted to differentiate themselves from brokers.

Today, the investment advisory industry is enormous, overseeing the allocation of approximately $53 trillion in assets. Advisers perform different functions than brokers. They provide advice, such as portfolio selection, asset allocation, portfolio management, and selection of other advisers, and they perform financial-planning services. Unlike brokers, advisers typically charge an annual asset-based fee, such as 1% of the assets held in a client’s account. What is more, payment of the fee over time at stated intervals, such as monthly

31. Laby, supra note 6, at 406-07.
32. Staff of the SEC, supra note 15, at 10-11.
33. Frederick W. Jones, Sources of Information and Advice, in THE SECURITY MARKETS: FINDINGS AND RECOMMENDATIONS OF A SPECIAL STAFF OF THE TWENTIETH CENTURY FUND 610, 647 (Alfred L. Bernheim & Margaret Grant Schneider eds., 1935).
34. Id. at 649.
37. See Staff of the SEC, supra note 15, at 7.
38. Id. (“Most investment advisers charge clients fees for investment advisory services based on the percentage of assets under management (over 95%).”).
or quarterly, establishes expectations that the adviser will perform a supervisory role over a client account. An adviser is expected to guard the assets over time and monitor performance.

By dividing the industry into commission-based brokers and fee-based advisers, I am oversimplifying a diversified industry. Today, many firms are dual registrants, registered as both broker-dealers and investment advisers. Moreover, many individuals employed by those firms are both broker-dealer registered representatives and investment-adviser representatives. In addition, another class of advisers is composed of financial planners, who charge commissions. Still other financial planners are compensated on a fee basis. Thus, in the world of advisers to retail customers, the form of compensation, and the associated cultural norms, are not black and white. I draw a distinction between asset managers and wire-house broker-dealers to identify cultural differences discussed in the following Part.

IV. ORGANIZATIONAL CULTURE

Parts II and III introduced broker-dealers and investment advisers as distinct organizations that perform largely different services, although both provide advice to retail investors about securities. Regulators now face a policy choice regarding whether to harmonize brokers’ and advisers’ duties and obligations, at least insofar as the advice-giving function is concerned. I shall now turn to organizational culture as an important consideration in deciding whether to harmonize brokers’ and advisers’ duties. As demonstrated below, culture is deeply embedded in most organizations, and any attempt at reform inconsistent with culture is prone to fail.

A. The Importance of Organizational Culture

A large body of research explores organizational behavior and organizational culture. "Organizational culture" has been described "as a system of shared values (that define what is important) and

39. Laby, supra note 6, at 417.
40. Id.
41. For a sampling of further reading on organizational culture, see Terrence E. Deal & Allan A. Kennedy, Corporate Cultures: The Rites and Rituals of Corporate Life (1982); Joanne Martin, Organizational Culture: Mapping the Terrain (2002); Edgar H. Schein, Organizational Culture and Leadership (4th ed. 2010); Handbook of Organizational Culture & Climate (Neal M. Ashkanasy, Celeste P.M. Wilderom & Mark F. Peterson eds., 2000); Organizational Climate and Culture (Benjamin Schneider ed., 1990); and The Sociology of Culture: Emerging Theoretical Perspectives (Diana Crane ed., 1994).
norms that define appropriate attitudes and behaviors for organizational members.42 “Organizational culture” refers broadly “to the shared meaning, interpretations, and understanding” of behavior by organizational members and of events that occur in an organization.43 It comprises “a pattern of shared basic assumptions learned by a group ... which has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in” the organization.44 FINRA defines “firm culture” as the “set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm’s business.”45 Broader references to “organizational culture” focus on a shared mentality—shared values, shared beliefs, and common attitudes that form a collective outlook.46

Culture has a powerful influence throughout an organization, affecting practically everything that goes on, including what decisions get made, who is promoted, and how people dress and act.47 Organizational culture is a “subtle, intangible phenomenon” that is difficult to manage or change.48 It is descriptive in that it provides an understanding of how and why organizational members behave as they do. And it is prescriptive in that it acts as a guide for members to behave in ways that are proven to be effective.49 Some experts view organizational culture as layered, including, first, norms that identify acceptable behavior; second, conscious values and beliefs of organizational members; and, on the deepest level, unconscious fundamental assumptions shared by members.50 Culture is often self-sustaining. From a diverse pool of applicants, organizations choose employees with traits that leadership believes will be useful to the

44. Schein, supra note 41, at 18.
45. 2016 Regulatory and Examination Priorities Letter, supra note 3.
47. See Deal & Kennedy, supra note 41, at 4.
50. Id.
organization.51 Employees with traits that better fit the organization’s culture will tend to perform better as well.52

Although I have been referring to “organizational culture”—culture nested within a firm—entire industries have cultures too. The technology sector is a good example. Silicon Valley has a culture that encourages experimentation and entrepreneurship.53 Informal communication and collaboration are common between and among firm divisions and with suppliers and customers.54 Risk-taking is highly valued and failure is a fact of life and accepted.55 Moreover, within industries, like within organizations, some cultural characteristics are pervasive and differ from those of other industries.56

Organizations often develop in the context of an industry’s assumptions about customers, competitors, and society, and those assumptions often form the basis of the organization’s culture.57 The assumptions then generate values, and from those values, management develops strategies, structures, and processes for running the organization.58 Understanding cultural differences is important because the potential for change within a given organization is limited to change that is neutral with respect to culture or consistent with what the industry demands.59

B. Employee Compensation and Firm Culture

Compensation is an important feature of any organization and has the ability to shape firm culture.60 Culture is concerned with controlling attitudes and behavior of the organization’s members, and a reward system is a key mechanism for achieving control. An organization’s compensation system structures the relationship between the organization and its members by defining the terms of

52. Id. at 6-7.
54. Id. at 5.
55. Id. at 38.
57. Id. at 399.
58. Id.
59. Id. at 396.
exchange. The compensation system specifies the contributions a member is expected to make to the organization and the response, monetary and nonmonetary, that the member can expect in return. In that sense, the reward system expresses the organization's values and its culture. Behavior elicited by reward systems can become the dominant pattern of behavior in firms. This behavior leads to opinions and beliefs about the values of the organization. As a result, some writers believe that pay is the key to understanding any firm's culture.

Because broker-dealers historically have worked on commission, examining broker-dealers' culture must entail a look at a commission structure of compensation. Over fifty years ago, social scientists recognized that commission-based compensation changes firm culture because of the effects on worker incentives. Payment on commission can lead to expedients to achieve sales goals, such as using high-pressure sales tactics, "grabbing" (taking a customer who appears to be heading toward another employee), and "tying up the trade" (preventing another customer from approaching another sales person while already working with one customer). Experimenters observed that a change to commission-based compensation led to quarreling during and after the consummation of a sale and to shirking (avoiding time-consuming work—such as sorting, arranging, and ordering merchandise—that was necessary to run the business, but took workers away from the core activity of selling).

Other research found additional effects on culture from incentive-based compensation, including an adversarial relationship between employees and the designers of the compensation system; noncooperative work relationships; and various forms of gaming, such as keeping production levels low to prevent management from setting expected production rates too high. Researchers concluded that instituting incentive-based compensation for certain employees can improve productivity, but it can also lead to a culture of low trust, lack

62. Id.
63. See Lawler & Jenkins, supra note 60, at 1016.
64. Id.
65. See, e.g., Kerr & Slocum, supra note 48, at 99.
67. Id.
68. Id.
69. Lawler & Jenkins, supra note 60, at 1028.
of information sharing, conflict, minimal support for problem solving, and inflexibility. By citing this research, I am not suggesting that all firms that employ incentive-based compensation are characterized by negative attributes, such as low trust and inflexibility. In fact, eliminating commission-based compensation in financial services can lead to a culture of underutilization, or “reverse churning,” as the practice is called. Reverse churning occurs when a broker or adviser has an incentive to trade infrequently when compensation for managing the account is fixed. This incentive creates at least two hazards. First, the customer might be missing out on opportunities because the broker or adviser is paying insufficient attention to the account, and, second, the account might be traded so infrequently that the customer would have incurred lower costs had the account been commission-based. In that regard, an account that trades infrequently, producing few commissions, might be changed to a fee-based account, which will be more costly for the customer, without any change in the services provided. By citing this research, I wish to demonstrate that compensation is an important determinant of culture.

In the next Part, I address in more detail whether brokers’ and advisers’ different compensation structures bear on their organizational culture. As described below, the brokerage industry is characterized by a series of assumptions, primarily about compensation, which have led to a culture that differs from the culture of advisory firms. For years, a widely shared assumption was that brokers are paid on commission and advisers are paid asset-based fees. Although there were exceptions, brokers and advisers who provided similar functions differentiated themselves through their method of compensation.

V. BROKER-DEALER AND INVESTMENT ADVISER CULTURE

Notwithstanding the vast literature on organizational culture, there appears to be little or no study of the cultural differences between and among financial services sectors, such as banking, finance, insurance, brokerage, and asset management. Literature on cultural aspects of the financial services industry tends to discuss banking or

70. Id.
71. See Staff of the SEC, supra note 15, at 152.
72. Id.
73. See id. at 152-53; see also Laby, supra note 10, at 740-41 (describing the risks of churning and reverse churning).
74. Laby, supra note 6, at 404; Laby, supra note 7, at 726.
finance as a monolithic profession, grouping together trading, private banking, and investment management.75

The lack of nuance is significant given that within a single organization, multiple reward systems can exist and, therefore, multiple cultures or subcultures can develop alongside one another.76 This is true in securities firms, where brokerage and investment-advisory services often coexist within a single enterprise. As mentioned, dual registrants register with regulators as both broker-dealers and investment advisers.77 Both activities, each with its own method of compensation, are conducted under one roof.

To begin to uncover cultural differences that permeate brokerage and advisory firms, I focus on their method of compensation because compensation is such an important determinant of culture. As discussed, brokers are paid a commission, or a commission equivalent, when customers buy or sell securities. A commission is a one-time, episodic charge. By contrast, compensation for advisers is not episodic. Advisers typically charge an annual asset-based fee, such as 1% of the value of a client’s account, typically paid monthly or quarterly.

From their compensation alone, one can surmise that brokerage firms are likely to develop a sales culture, whereas advisers are likely to advance a service culture, although the risk of underutilization discussed above is present. The contrast is between a transactional culture for brokers and a relational culture for advisers. Let us examine in more detail why this would be the case.

A. Broker-Dealers

A broker’s compensation is often transaction-based. A commission-based broker has an incentive to encourage a customer to purchase investments the customer does not own or to sell investments that the customer already owns in her portfolio. One advantage to this method of compensation is that it provides an incentive for a broker to closely monitor a customer’s account. If it becomes apparent that a particular security is not performing well or is otherwise not appropriate for the

customer, the broker will encourage the customer to optimize her portfolio—sell what she owns and purchase another security. Investors benefit from this vigilance. A downside to commission-based compensation is that some brokers might engage in “churning”—buying and selling securities for a customer’s account to generate commissions, without regard to a customer’s interests.\(^7\)\(^8\)

A broker’s commission-based compensation can also affect incentives to sell securities to customers in the securities-offering context. When a financial firm underwrites a company’s securities, the firm, by contract, must sell the securities to complete the offering.\(^9\) Nearly all underwriters are broker-dealers.\(^9\) A principal underwriter typically will turn to other broker-dealers to become part of a syndicate employed to sell the shares.\(^1\) The brokerage firms must sell the shares to complete the offering, and, in some cases, the pressure to complete the offering is enormous.\(^2\)

Former SEC Chairman Arthur Levitt summarized the sales culture that has come to dominate brokerage firms in his 2002 book:

Brokers may seem like clever financial experts, but they are first and foremost salespeople. Many brokers are paid a commission, or a service fee, on every transaction in accounts they manage. They want you to buy stocks you don’t own and sell the ones you do, because that’s how they make money for themselves and their firms. They earn commissions even when you lose money.\(^3\)

Levitt may be overgeneralizing, and his jaundiced view does not characterize all brokers. Still, some firms use devices such as sales contests to motivate the brokers.\(^4\) And in some cases, brokers are pressured to make cold calls from scripts, sometimes with little or no familiarity with the securities sold.\(^5\) Even firms such as Merrill Lynch, which experimented with eliminating commissions and paying brokers a salary, continued to adjust salaries to reflect each broker’s contribution to the profitability of the branch.\(^6\)

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78. Id. at 64-66 n.290.
80. See id.; Cox, Hillman & Langevoort, supra note 27, at 2.
81. Hazen, supra note 79, at 71.
82. Cox, Hillman & Langevoort, supra note 27, at 112.
84. Id. at 19.
85. Id. at 26.
86. Edwin J. Perkins, Wall Street to Main Street: Charles Merrill and Middle-Class Investors 154-56 (1999). Today, Merrill Lynch brokers are paid, at least in part, according to the business they generate. See Reuters, Merrill Raises Broker Bonuses.
Merrill Lynch serves as an interesting study because one can date the sales culture of brokerage firms to the path-breaking career of Charles Merrill, founder of the Merrill Lynch firm. It is worth a brief glance at Merrill’s career to better understand how brokers’ sales culture began. Before the 1900s, most securities firms eschewed promotional techniques. The leading firms did almost no advertising, content to list their names on “tombstone” announcements of securities offerings. Advertising and aggressive marketing were considered unethical. At the same time, the inability to market aggressively kept new entrants out of the business.

Merrill decided to break with tradition. Early in his career, Merrill took a job at George H. Burr & Co., a commercial paper house, which expanded into investment banking. Merrill decided to use advertising and other marketing techniques to sell bonds into what he believed was an untapped market: average investors looking for higher returns and willing to take on greater risk. In the early 1900s, Merrill began to use newspaper advertisements and circulars to convince upper-middle class investors to purchase securities. Merrill’s success in managing the bond department at George H. Burr & Co. set the stage for the marketing policies Merrill Lynch would employ decades later when Merrill returned to Wall Street after the Great Depression.

During the Depression years, Merrill left Wall Street and spent most of his time managing Safeway Stores, Inc. (Safeway), in which he had invested heavily. When Merrill returned to Wall Street in the 1940s, he drew from his experience at George H. Burr & Co. and from his experience at Safeway. Merrill recognized that, like the retail food business, brokerage generated small returns on individual transactions and, as a result, high volume was essential. Just as Safeway owned

Eliminates Pay on Small Accounts, FIN. ADVISOR (Dec. 11, 2014), http://www.fa-mag.com/news/merrill-raises-broker-bonuses--eliminates-pay-on-small-accounts-20161.html ("[Merrill brokers in 2015] will collect between about 20 percent to 48 percent of the fees and commissions clients pay Merrill, with higher producers getting the higher payouts.").

87. PERKINS, supra note 86, at 57.
88. Id.
89. Id.
90. Id.
91. Id at 54-55.
92. Id at 54-56.
93. Id at 57-58.
94. Id at 58.
95. Id at 125.
96. Id at 146.
97. Id.
and operated over 3,000 stores, Merrill sought to expand the delivery of retail brokerage services to what would today be called the “mass affluent”—people whose wealth and income were above average but below the top strata.98

Merrill wanted to do for brokerage what the chain stores did for retail—earning smaller profits per customer, but making up for it in the sheer numbers.99 Merrill sought to convince hundreds of thousands of individuals who had never invested to shed their negative view of the stock market and open an account with his firm.100 It worked. Starting in the 1950s, with Merrill Lynch leading the way, millions of middle-class Americans became investors in the stock market.101 The trend to increasing numbers of investors was a positive development, leading to broad equity ownership in the United States long before it occurred in some other countries. This development also established a growing base of customers to whom Wall Street could market investment products and from whom it could earn commissions. For a time, Merrill Lynch experimented with paying its brokers salaries, not commissions. But this experiment would not last, and eventually the firm reverted to a commission structure, like the rest of the industry.102

Today, a sales culture dominates brokerage firms. Commission-based compensation—a link between the product sold and the broker’s compensation—can provide an incentive to sell more expensive investments.103 The industry talks of its success in the language of sales, referring to “production levels” by its registered representatives.104 In addition, various sources such as Barron’s, On Wall Street, and the Financial Times perform annual rankings of broker-dealer firms, listing which firms had the most number of “producers” at various levels, such as $1 million, $600,000, $400,000, and so on.105

Broker-dealer firms carefully scrutinize the amount of commissions generated by their registered representatives. Within the firms, management typically uses a compensation grid to determine a
registered representative’s pay. Although grids vary across firms, typically two factors determine a registered representative’s compensation: the total amount of revenue generated and “the payout percentage the registered representative receives on that revenue.” The payout percentage received typically increases as a broker’s production increases.

A registered representative may receive only 28% of her gross commissions on revenues between $200,000 and $300,000. But she will receive 35% of gross commissions on revenues between $300,000 and $400,000, and so on, all the way up to 48% on revenues of $2.5 million or more. Moreover, some firms vary compensation based on the type of product sold, providing the lowest percentage payout for options and futures; the highest for equities, bonds, and exchange-traded funds; and a payout somewhere in the middle for mutual funds.

In the mutual fund context, brokers use a variety of compensation practices not commonly used for other financial products. Before the 1980s, brokers’ compensation for the sale of fund shares came primarily from front-end sales loads on mutual fund purchases. A “sales load” is a sales charge, much like a commission, that investors pay when they purchase other securities from a broker. The selling broker-dealer firm received a portion of the sales charge—a dealer concession—paid by the investor at the time of purchase.

By the late 1990s, compensation systems were more advanced. Brokers were compensated for selling mutual fund shares through a variety of means besides dealer concessions, such as revenue-sharing arrangements under which mutual fund service providers, including investment advisers, paid amounts to a selling broker-dealer firm from their own revenue. Many mutual funds also made ongoing payments to brokers pursuant to Rule 12b-1 fees. These fees, named after the

107. Id.
108. Id. at 28.
109. Id. at 27.
110. Id.
111. Id.
113. Id.
115. Krawczyk, supra note 112, at 27.
116. Id. at 27-28.
117. See Mutual Fund Fees and Expenses, supra note 114.
rule that authorizes them, are fees paid by a mutual fund out of fund assets to cover costs of compensating brokers who market and sell fund shares.\textsuperscript{118} Some broker-dealers received additional payments when they sold funds designated as "preferred funds" under a preferred-partner program maintained by the selling firm, sometimes called payments for "shelf space."\textsuperscript{119}

The sales practices described above reflect what management and organizational scholars call a "market culture" within a firm.\textsuperscript{120} In a market culture, the individual is responsible for a particular level of performance, and the organization promises a given level of compensation or other reward in return.\textsuperscript{121} Increased levels of performance can be exchanged for increased levels of rewards, specified in advance.\textsuperscript{122} The firm does not promise security, and the individual does not guarantee loyalty.\textsuperscript{123} Instead, there is a prevailing ethic of individuality and independence, and "everyone pursues his or her own interests."\textsuperscript{124} Individuals do not harbor strong allegiances other than personal initiative and entrepreneurship.\textsuperscript{125}

One should recognize that although a market culture tends to pervade brokerage firms, this culture is not tantamount to an environment of "caveat emptor."\textsuperscript{126} It is not the case that broker-dealer registered representatives have complete freedom to encourage investors to purchase any security that benefits the broker with no disclosure to the customer. As discussed below, broker-dealer regulation helps prevent the misconduct that can occur when brokers fail completely to consider their customers’ interests.

\textbf{B. Investment Advisers}

Brokers’ market culture contrasts with the culture of advisory firms. As described above, advisers manage assets. They do not execute transactions; underwrite securities on behalf of issuers; or, as a general matter, act as principals, transacting with clients for advisers’

\begin{footnotesize}
\begin{enumerate}
\item[118.] See id.
\item[119.] Krawczyk, \textit{supra} note 112, at 28.
\item[120.] Kerr & Slocum, \textit{supra} note 48, at 103.
\item[121.] Id.
\item[122.] Id.
\item[123.] Id.
\item[124.] Id.
\item[125.] Id. at 104.
\end{enumerate}
\end{footnotesize}
own accounts. In addition, most advisers charge for their services based on the amount an adviser has under management for a client. In addition, most advisers charge for their services based on the amount an adviser has under management for a client.\textsuperscript{127} Historically, investment advisers focused on developing a relationship between adviser and client. The advisory profession arose in the 1920s and 1930s out of a demand for services that were supervisory in nature, as discussed above.\textsuperscript{128} Ongoing service was essential. Witnesses testifying before the United States Congress leading up to passage of the Advisers Act emphasized the close, personal, and confidential nature of the advisory relationship.\textsuperscript{129} The culture is one of long-term alliance.

In the 1930s, advisers welcomed the passage of the Advisers Act because they sought to differentiate themselves from the culture of brokers. Adviser regulation resulted from the SEC's 1935 report (Report) on investment companies and investment advisers.\textsuperscript{130} The Report identified problems besetting the fledgling investment adviser community.\textsuperscript{131} For example, so-called "tipster" firms disguised themselves as legitimate advisers.\textsuperscript{132} In addition, some firms providing advice were affiliated with broker-dealers or investment banks and, therefore, had an interest in recommending certain securities.\textsuperscript{133} Advisers also took umbrage at brokers, who referred to themselves as "investment counsel"—an appellation advisers believed was reserved for qualified experts providing professional services, not those conducting trading activities.\textsuperscript{134} In the Advisers Act, Congress restricted use of the term, as the adviser community desired.\textsuperscript{135}

The advisory firms also lamented that brokers and investment banks were paid on a spread or on commission and consequently could not be objective.\textsuperscript{136} One adviser put it this way:
[A] merchant in securities to be sold at a profit is primarily concerned with moving the wares he has on the shelf that he will make money out of, and therefore is not in a position to give unbiased advice, which we have stated to be the function of the professional investment counsel.  

Passage of the Advisers Act would separate advisers from brokers, or at least from so-called tipsters, which is exactly what the adviser community desired.

Although differences in culture persist, the contrast today is not as clear as it once was. The promotional activity of mutual fund advisers demonstrates that many advisory firms are sales-oriented, much like brokerage firms. In past decades, through the 1950s and 1960s, mutual fund managers engaged solely in investment management, research, and portfolio supervision. The sales and distribution function was handled by separately owned and operated broker-dealers. Today, however, many mutual fund firms have established their own in-house broker-dealer for marketing and selling purposes, and thus mutual fund portfolio management and mutual fund sales and distribution are performed by affiliated firms. The mutual fund industry has evolved from a focus exclusively on investment management to a focus that includes sales and distribution as well. Although investment advisers continue to perform a management function, the line is not nearly as clear as it once was.

C. Law as a Reflection of Culture

The cultures that pervade brokerage and advisory firms are reflected in their governing law. Broker regulation, like broker compensation, is transaction-specific. As discussed, broker regulation in the Exchange Act focuses on securities transactions, and brokers have a duty of suitability with respect to particular recommendations. Suitability is only one aspect of a comprehensive regulatory scheme for brokers. Both the SEC and FINRA regulate broker-dealer firms. Regulation includes rules regarding fair dealing, just and equitable principles of trade, and supervision. Brokers must perform due

138. See Laby, supra note 7, at 721-22.
140. See id. at 19-20.
141. See id.
142. See Ketchum, supra note 126.
143. See id.
diligence on securities they recommend to ensure the securities are appropriate for any customer and for the specific customer, based on the customer's particular circumstances. The key point, however, is that broker-dealer regulation is transaction-specific. The broker must have a reasonable basis to believe that a particular securities recommendation or strategy is suitable. The duty is episodic—it is not an ongoing obligation—and it is generally considered weaker than the fiduciary duty. Typically, broker-dealers have no duty to monitor a brokerage account or to provide ongoing advice.

Adviser law reflects advisers' culture as well. Regulation focuses on the advisory relationship. Advisers are fiduciaries and have a duty to act in their clients' best interest. The duty is typically an ongoing obligation. Witnesses testifying before Congress in advance of the passage of the Advisers Act emphasized the close, personal, and confidential nature of the advisory relationship. In addition, legal rules articulated over years infiltrate cultural practice. Law reflects the culture, but as the law becomes embedded, the law tends to shape culture as well.

The leading investment adviser case, SEC v. Capital Gains Research Bureau, Inc., is a prime example of how adviser law can infiltrate industry culture. In Capital Gains, the United States Supreme Court reviewed an SEC enforcement action against an advisory firm that published investment newsletters for a practice known as "scalping." Scalping occurs when an adviser buys a security for its own account, recommends the same security to clients, and then sells the security at a profit without disclosing the firm's

144. See id.
145. Laby, supra note 1, at 725.
146. Id. at 724-25; Robert B. Thompson, Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown, 89 WASH. U. L. REV. 323, 361 (2011) ("[The Supreme Court's] description of an adviser's duty goes beyond the traditional legal duties of broker-dealers.").
147. De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002). Depending on the terms of the advisory contract, an adviser similarly may not have ongoing duties to monitor. And an adviser that provides quarterly asset allocation has no obligations between quarter ends. Historically and culturally, however, advisers provided ongoing supervisory services even if a particular contract eliminated those sorts of obligations.
148. Laby, supra note 7, at 724-25.
149. Id. at 722.
151. See id.
interest. The Court held that the adviser breached its fiduciary duty and violated the antifraud provision of the Advisers Act.

In language that has become well-recognized in the industry, the Court stated that advisers must adhere to a “duty of ‘utmost good faith,’” a duty of “full and fair disclosure of all material facts,” and a duty to use “reasonable care to avoid misleading” clients. The Court, however, went further in establishing the culture that now imbues advisory firms. The Court stated that the Advisers Act “reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship,” as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested. The Court’s use of the phrase “delicate fiduciary nature of an investment advisory relationship,” borrowed from the venerated Louis Loss, has encouraged the industry to live up to the Court’s portrayal and to develop a fiduciary culture.

The case’s cultural influence should not be underestimated. Norms set forth in Capital Gains are regularly repeated in industry guidelines, which often refer to an adviser’s fiduciary obligation. The Investment Adviser Association, the trade association for SEC-registered investment advisers, has published “Standards of Practice” (Standards) for the industry. The Standards state, “An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients.” The Standards also state that an “adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients.”

153. Capital Gains, 375 U.S. at 201 ("The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients.").
154. Id. at 194 (first quoting WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 535 (2d ed. 1955); then quoting 1 FOWLER V. HARPER & FLEMING JAMES, JR., THE LAW OF TORTS 541 (1956)).
155. Id. at 191-92 (quoting 2 LOUIS LOSS, SECURITIES REGULATION 1412 (2d ed. 1961)) (footnote omitted).
156. See id.
158. Id.
159. Id.
Fiduciary duty, like "fault" and "reasonableness," is one area scholars point to when highlighting the capacity of law to influence the way people understand the environment where they live and work.\footnote{160} Some writers refer specifically to a "fiduciary culture," whereby a service provider emphasizes fairness and a goal of achieving success alongside clients, as opposed to competing with them.\footnote{161} As for the \textit{Capital Gains} case, lawyers and investment professionals still look to the decision for the standard articulation of an investment adviser’s fiduciary obligation.\footnote{162}

VI. THE EFFECT OF CULTURE ON HARMONIZATION

The previous Part demonstrated that brokers and advisers have different histories and different cultures and that these differences are reflected in the law. As mentioned, regulators are considering whether to harmonize the duties imposed on brokers and advisers and whether to impose a fiduciary duty on brokers that give advice. Thus, this Part examines whether cultural differences will impede the harmonization effort. One should recognize at the outset that a given culture is not necessarily good or bad, effective or ineffective. Whether a culture is effective depends on an organization’s goals.\footnote{163} A market culture may be appropriate for a broker-dealer firm in the business of selling securities, but it might not fit well in the context of an advisory firm.

One might analogize the attempt to merge regulatory standards imposed on brokers and advisers to an attempt to merge two corporations with different cultures. Like managers at two corpora-
tions considering a merger, regulators, such as the SEC and the DOL, are focused primarily on logistical or operational issues attendant to merging regulatory standards. In the statutory provision authorizing the SEC to impose a fiduciary duty on brokers, Congress was careful to state that receipt of commissions would not, alone, be considered a breach of fiduciary duty and that imposing a fiduciary duty on a broker does not necessarily require the broker to have a “continuing” duty to the customer after providing advice. In other words, the SEC may adopt a rule imposing a fiduciary duty on brokers that give advice, but those brokers will still be able to work on commission and will not necessarily have an ongoing duty to customers.

Similarly, in the DOL rule requiring brokers servicing retirement accounts to operate under a fiduciary standard, the DOL provided that brokerage commissions are generally prohibited. However, a special exemption allows broker-dealers acting as fiduciaries to receive commissions that, in the absence of the exemption, would be prohibited. The DOL, like Congress, seems to be focusing on making convergence work from a logistical perspective. Like astute corporate managers, who focus on culture before a merger occurs, regulators may wish to focus attention on industry culture—the deeper, more complex identities of the individuals regulated.

Will cultural differences between brokers and advisers impede harmonization? Brokers’ sales culture is a nonfiduciary culture. In many respects, sales is the antithesis of fiduciary service. In a market relationship, the parties are at arm’s length with their own interests at heart. Market arrangements can be viewed as a zero-sum game: benefits to the buyer or seller come at the other’s expense. An arm’s length relationship is governed by what Justice Benjamin Cardozo called the “morals of the market place” in Meinhard v. Salmon. In a market culture, each person looks out for herself and attempts to maximize gain. The cultural difference between broker-dealers and investment advisers is most evident in the case of dealers—the second

166. See id. at 21,003.
168. ENCYCLOPEDIA OF AMERICAN BUSINESS 493 (W. Davis Folsom & Rick Boulware eds., 2004).
half of the broker-dealer designation. There is a fundamental contradiction between a dealer's role and a fiduciary relationship. A securities dealer places its own interest first—transacting directly with a customer and selling securities out of the dealer's inventory, just like any dealer selling merchandise from inventory to customers.

Advisers do not share this market culture to the same degree. Advisers typically do not try to sell a financial product, and they are generally not paid on commission. Although an adviser can augment its compensation as an account grows, the changes are incremental and there is a diminished incentive to recommend purchases and sales for the limited purpose of enhancing one's compensation. Moreover, a recommendation to purchase a nonperforming asset might increase account size in the short term, but poor performance ultimately will only compromise the account and reduce fees. Consequently, advisers are better able to operate under a fiduciary standard. They are focused on incremental growth in a client's account as opposed to product sales.

Advisers, of course, are not immune to market pressures. Like lawyers, trustees, and other fiduciaries, advisers must attract new business and retain existing business, or they will not survive. Thus, in this regard, I do not want to overstate the differences between brokers and advisers. In many cases, the differences can be subtle, based more on the way the industries have grown and developed than on today's practices. Yet, the brokers' sales culture, combined with commission-based compensation structures, suggests that one can contrast brokers' market culture with advisers' fiduciary culture.

The question of whether and how to impose a fiduciary duty on brokers is also a question of whether it is possible to reform brokers' market culture. How can regulators move the needle away from a focus on generating commissions and toward one of fiduciary responsibility? Culture cannot easily be pushed aside. Reforms that counteract an embedded culture, particularly those that require restraint, are likely to be unstable. As discussed above, regulators will continue to allow brokers to charge commissions, even under a fiduciary standard. If that is the case, and brokers' compensation methods remain unchanged, one can question whether brokers are acting as fiduciaries.

The same question can be asked about brokers who engage in principal transactions with customers. Brokers, unlike advisers, are

170. See Cohan, supra note 75.
permitted to transact with clients as principals, and they do this regularly in their market-making function. Restricting brokers from trading as principals contravenes their market culture and disregards an important function they serve. However, if principal trading continues to be permitted for brokers, and they continue to participate in underwritings and use sales contests, can it truly be said that brokers are fiduciaries to their clients and acting in their clients' best interest? The DOL rule discussed above addresses principal trading by acknowledging that it is prohibited and then providing an exemption for certain principal trading in debt securities. The same question asked about commissions can be asked about brokers who continue to engage in principal transactions: Is the activity consistent with fiduciary norms? Harmonization is a challenge because there are no easy solutions to these problems and because the solutions to date do not erase cultural differences; they step around them.

VII. THE EFFECT OF HARMONIZATION ON CULTURE

If culture is a barrier to legal reform, perhaps it is also the case that a change in law can change the prevailing culture. Brokers' sales culture and advisers' service culture has been borne out through history, practice, and developments in the law. The last Part suggested that cultural differences might be a barrier to reform. Culture, however, is not static, and one might consider whether a change in the law might have the salutary effect of changing the culture. Perhaps imposing duties on brokers akin to those imposed on advisers will change brokers' culture. At a minimum, the process of harmonization is likely to expose cultural differences, just as a corporate merger tends to expose corporations' cultural differences. Culture often lives out of plain sight. Harmonization, however, will adjust the lens and bring cultural differences into sharper focus.

In addition to bringing cultural differences into focus, perhaps a change in law can change the culture as well. It may be a mistake to view law and culture as opposite forces. Law might better be viewed as one cultural actor whose various agents such as legislators, regulators, and courts—take steps to reorder and redefine meanings,

171. Thompson, supra note 146, at 333-35.
173. See Schein, supra note 41, at 294-95.
174. Dickson & Mitchelson, supra note 43.
such as the meaning of adviser, broker, and fiduciary. Social practices, such as the compensation schemes discussed above—commissions for brokers and asset-based fees for advisers—are inseparable from the laws that shape them; indeed, the social practices cannot be fully understood without also understanding the laws that gave rise to them in the first place.

The prevailing culture in brokerage and advisory firms developed in part from legal rules unknown to most customers and clients and likely unknown to most financial services professionals. The law can operate out of the sight and out of the mind of both investors and industry participants. An old legal rule, rooted in the securities laws’ legislative history and promoted by the SEC, is a good example. Under this rule, receipt of compensation other than brokerage commissions would cause a broker to be treated, for regulatory purposes, as an adviser. Thus, financial services professionals providing advice splintered into two groups: those who charged commissions (broker-dealers) and those who were compensated in some other way, such as on a fee basis (investment advisers), each with its own customs and practices. Law shaped culture.

Moreover, the SEC’s underenforcement of another part of the law governing brokers formed part of the legal background that allowed brokers to market themselves as investment advisers, but continue to be regulated as broker-dealers, not advisers. Just like the speed limit enforced by local police sets the de facto “legal” speed limit, so too do the limits enforced by the SEC shape conduct by financial services providers. The laws and regulations were instrumental in driving the prevailing culture of brokers and advisers.

177. See Mezey, supra note 175, at 48.
178. Laby, supra note 7, at 723.
179. Section 202(a)(11)(C) also provides that brokers are excluded from the Advisers Act as long as the brokers provide advice that is considered “solely incidental” to brokerage. The SEC has been criticized for its underenforcement of this provision, allowing brokers to market themselves as advisers, but avoid regulation as advisers.
180. See Mezey, supra note 175, at 52.
Law and culture operate in a reciprocal fashion; each influences the other. Law and culture are interdependent, and a change in law can result in a change in culture over time. Although it is possible that a change in law might be rejected because of a lack of cultural fit, it might also be the case that the change in law will become integrated and ultimately effect broader cultural change. When the industry environment changes—as it would under harmonization—behavior based on old assumptions and values will no longer be effective, creating pressure for cultural change. Like a game of tug of war, however, culture tied to the past resists transformation. One can expect resistance to change to the broker-dealer industry.

One way to begin would be through clear communication of performance criteria and through application of rewards consistent with the culture sought. A change in the law will likely change performance criteria and the system of rewards. For example, although commissions will still be permitted, forcing a fiduciary duty on the firms makes it at least more likely that many will turn away from commissions to an asset-based model, a model more consistent with a fiduciary approach.

VIII. CONCLUSION

Brokers and advisers have different functions, but both provide advice to retail investors about securities. Although one would expect similar regulation for performing a similar function, brokers and advisers are regulated under two different regulatory schemes. Brokers owe a duty of suitability to customers; advisers owe a fiduciary duty to their clients. Regulators are considering reforming

182. Id.; see also Cotterrell, supra note 46, at 104 (describing ways in which culture and laws have reciprocal influence).
the duties imposed on brokers who give advice so that they too are subject to a fiduciary obligation.

An investigation of organizational culture suggests that implementing harmonization might be more difficult than anticipated. "Organizational culture," defined as shared values, beliefs, and attitudes in an organization, is a powerful influence in any firm. Brokers and advisers are no different. Brokers have developed a sales culture; advisers have developed a service culture. Both have advantages and disadvantages. The point is not to prefer one over the other, but rather to recognize that the differences might impede the ability to converge the duties and obligations of these two sets of professionals.

The different duties that exist today—suitability and fiduciary—are not arbitrary. They are tethered to the culture that prevails in the firms, and it will be difficult to change the duties and obligations without changing culture. But if culture is deeply rooted and cannot be mandated from above, then regulators face obstacles in attempts to institute reforms.

The break in the clouds is that just as culture can be a barrier to legal reform, so too can legal reform effect a cultural shift. Firm culture in some respects is dependent upon law. Brokers and advisers developed different cultures, in part, based on legal rules; they differentiated themselves from one another based on their method of compensation. It is no surprise, therefore, that these compensation methods became embedded and entrenched the culture within the firms as well. Although culture can influence the law, it is also the case that changes in law can cause a change in culture. Perhaps regulators must first force a change in the law before one can expect to transform culture.